98th Annual Report

2011

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

98th Annual Report

2011

Board of Governors of the Federal Reserve System

2011 Annual Report Errata

On p. 83, under "Performance of bank holding companies" the fourth sentence was printed incorrectly and has been revised. (5/24/12)

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Letter of Transmittal

Board of Governors of the Federal Reserve System
Washington, D.C.

May 2012

The Speaker of the House of Representatives:

Pursuant to the requirements of section 10 of the Federal Reserve Act, I am pleased to submit the ninety-eighth annual report of the Board of Governors of the Federal Reserve System.

This report covers operations of the Board during calendar year 2011.

Sincerely,

Ben Bernanke
Chairman

Contents

Overview

The Federal Reserve, the central bank of the United States, is a federal system composed of a central governmental agency—the Board of Governors—and 12 regional Federal Reserve Banks.

The Board of Governors, located in Washington, D.C., consists of seven members appointed by the President of the United States and supported by a 2,400-person staff. Besides conducting research, analysis, and policymaking related to domestic and international financial and economic matters, the Board plays a major role in the supervision and regulation of U.S. financial institutions and activities, has broad oversight responsibility for the nation's payments system and the operations and activities of the Federal Reserve Banks, and plays an important role in promoting consumer protection, fair lending, and community development.

About this Report

This report covers Board and System operations and activities during calendar-year 2011. The report includes 11 sections:

- **Monetary Policy and Economic Developments.** Section 1 provides adapted versions of the Board's semiannual monetary policy reports to Congress.
- **Federal Reserve Operations.** Section 2 provides a summary of Board and System activities in the areas of supervision and regulation; Section 3, in consumer and community affairs; and Section 4, in Reserve Bank operations.
- **Dodd-Frank Act Implementation and Other Requirements.** Section 5 summarizes the Board's efforts in 2011 to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act as well as the Board's compliance with the Government Performance and Results Act of 1993.
- **Policy Actions and Litigation.** Section 6 and Section 7 provide accounts of policy actions taken by the Board in 2011, including new or amended rules and regulations and other actions as well as the deliberations and decisions of the Federal Open Market Committee (FOMC); Section 8 summarizes litigation involving the Board.[1]
- **Statistical Tables.** Section 9 includes 14 statistical tables that provide updated historical data concerning Board and System operations and activities.
- **Federal Reserve System Audits.** Section 10 provides detailed information on the several levels of audit and review conducted in regards to System operations and activities, including those provided by outside auditors and the Board's Office of Inspector General.
- **Federal Reserve System Organization.** Section 11 provides listings of key officials at the Board and in the Federal Reserve System, including the Board of Governors, its officers, FOMC members, several System councils, and Federal Reserve Bank and Branch officers and directors.

For More Background on Board Operations

For more information about the Federal Reserve Board and the Federal Reserve System, visit the Board's website at www.federalreserve.gov/aboutthefed/default.htm. An online version of this *Annual Report* is available at www.federalreserve.gov/pubs/alpha.htm.

About the Federal Reserve System

The Federal Reserve System, which serves as the nation's central bank, was created by an act of Congress on December 23, 1913. The System consists of a seven-member Board of Governors with headquarters in Washington, D.C., and the 12 Reserve Banks located in major cities throughout the United States.

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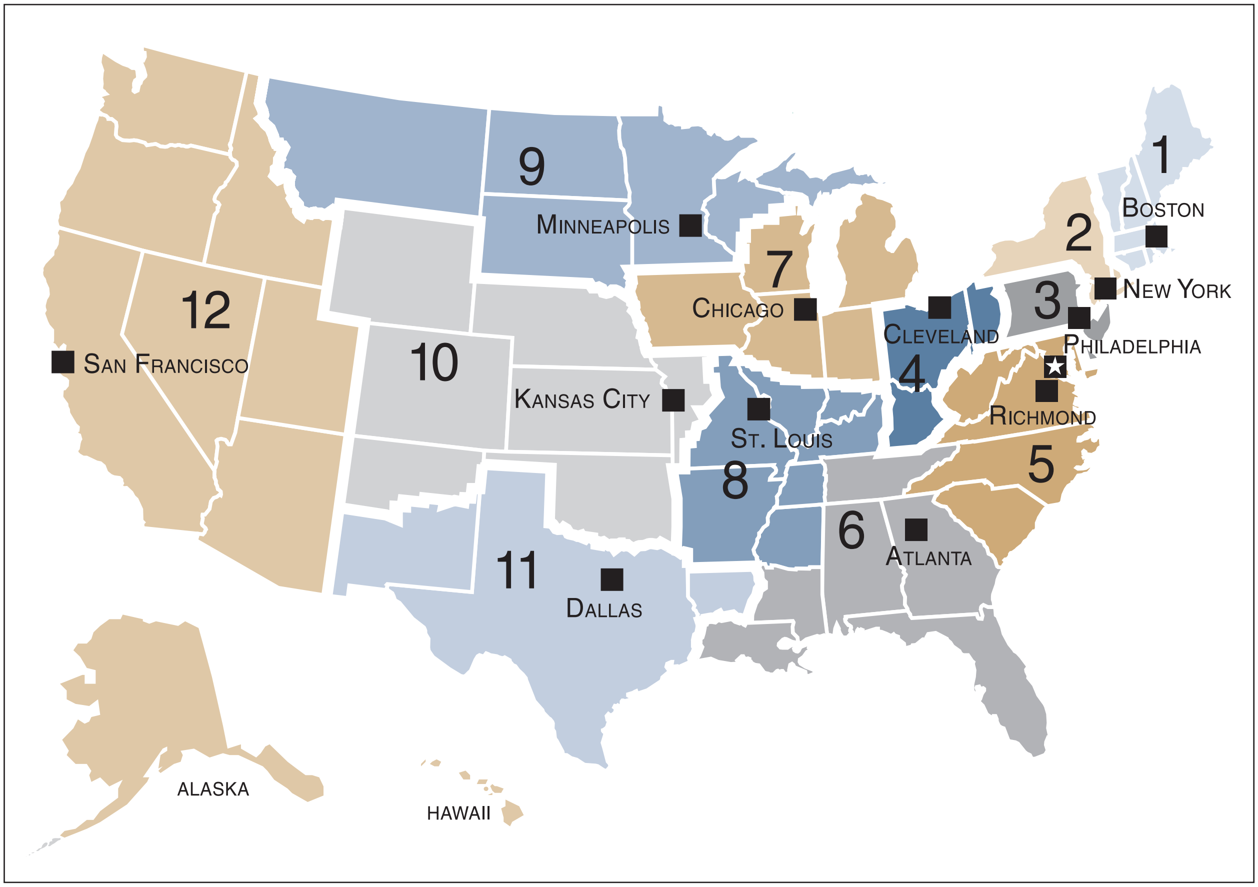
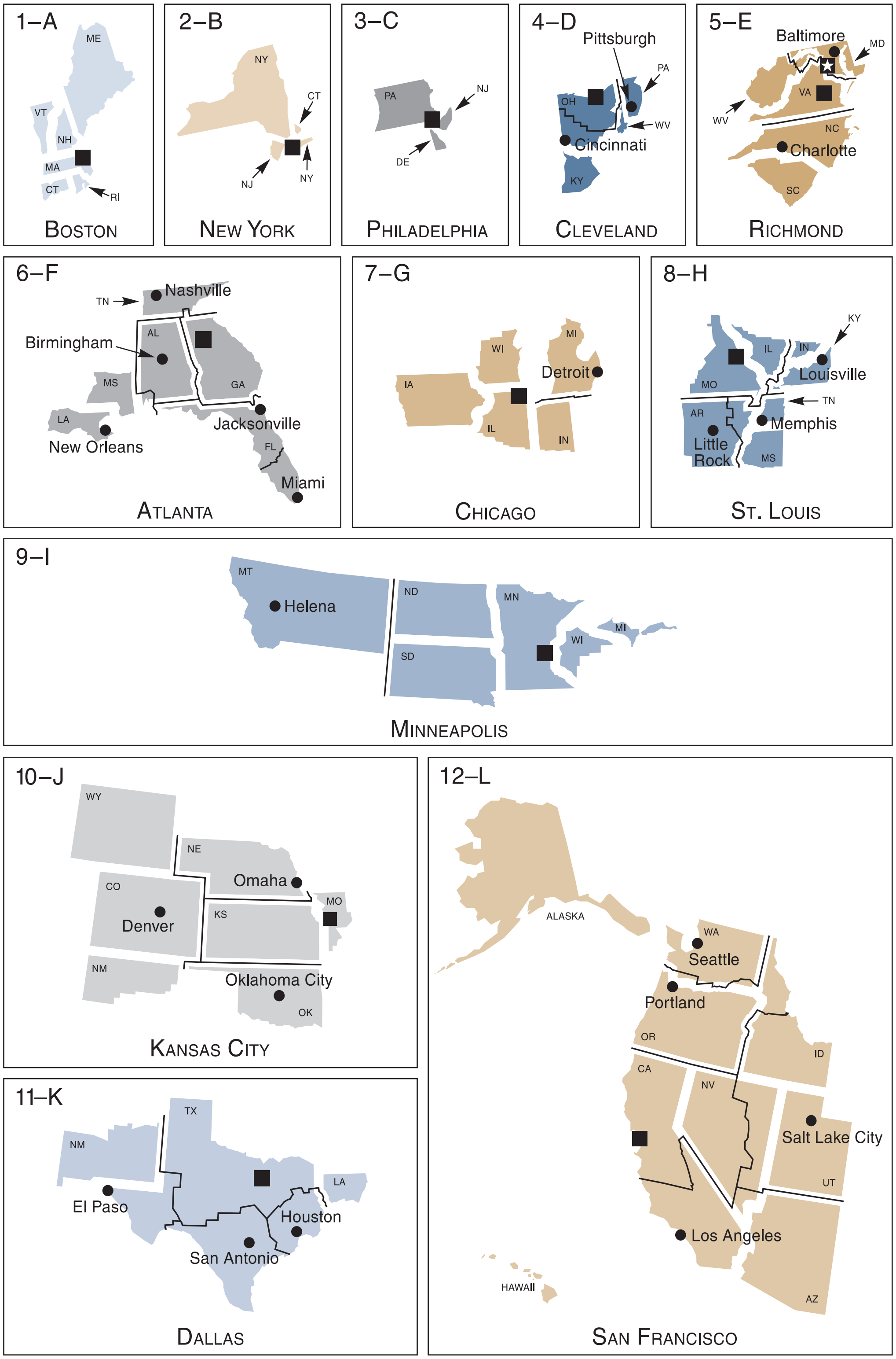
1 For more information on the FOMC, see the Board's website at www.federalreserve.gov/monetarypolicy/fomc.htm.

The Federal Reserve Banks are the operating arms of the central banking system, carrying out a variety of System functions, including operating a nationwide payment system; distributing the nation's currency and coin; under authority delegated by the Board of Governors, supervising and regulating a variety of financial institutions and activities; serving as fiscal agents of the U.S. Treasury; and providing a variety of financial services for the Treasury, other government agencies, and other fiscal principals.

The maps below and opposite identify Federal Reserve Districts by their official number, city, and letter designation.



■ Federal Reserve Bank city
✪ Board of Governors of the Federal Reserve System, Washington, D.C.



■ Federal Reserve Bank city

● Federal Reserve Branch city

✪ Board of Governors of the Federal Reserve System, Washington, D.C.

— Branch boundary

Monetary Policy and Economic Developments

As required by section 2B of the Federal Reserve Act, the Federal Reserve Board submits written reports to the Congress that contain discussions of "the conduct of monetary policy and economic developments and prospects for the future." The *Monetary Policy Report to the Congress,* submitted semiannually to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Banking and Financial Services, is delivered concurrently with testimony from the Federal Reserve Board Chairman.

The following discussion is an annual review of U.S. monetary policy and economic developments in 2011. It includes the text, tables, and selected figures from the February 29, 2012, report; the figures have been renumbered, and therefore the figure numbers differ from those in the report. Also included are the text and table from Parts 1–3 of the July 13, 2011, report; Part 4 of that report is identical to the addendum to the minutes of the June 21−22, 2011, meeting of the Federal Open Market Committee (FOMC) and is presented with those minutes in the "Minutes" section of this annual report.

The complete *Monetary Policy Report*s are available on the Board's website. Other materials in this annual report related to the conduct of monetary policy include the minutes of the 2011 meetings of the FOMC (see the "Minutes" section on page 173) and statistical tables 1–4 (see the "Statistical Tables" section on page 311).

Monetary Policy Report of February 2012

Part 1 Overview: Monetary Policy and the Economic Outlook

Economic activity in the United States expanded at a moderate rate in the second half of 2011 following an anemic gain in the first half, and the moderate pace of expansion appears to have continued into the opening months of 2012. Activity was held down in the first half of 2011 by temporary factors, particularly supply chain disruptions stemming from the earthquake in Japan and the damping effect of higher energy prices on consumer spending. As the effects of these factors waned over the second half of the year, economic activity picked up. Conditions in the labor market have improved since last summer, with an increase in the pace of job gains and a noticeable reduction in the unemployment rate. Meanwhile, consumer price inflation has stepped down from the temporarily high levels observed over the first half of 2011, as commodity and import prices retreated and as longer-term inflation expectations remained stable. Looking ahead, growth is likely to be modest during the coming year, as several factors appear likely to continue to restrain activity, including restricted access to credit for many households and small businesses, the still-depressed housing market, tight fiscal policy at all levels of government, and some slowing in global economic growth.

In light of these conditions, the Federal Open Market Committee (FOMC) took a number of steps during the second half of 2011 and early 2012 to provide additional monetary policy accommodation and thereby support a stronger economic recovery in the context of price stability. These steps included modifying the forward rate guidance included in postmeeting statements, increasing the average maturity of the Federal Reserve's securities holdings, and shifting the reinvestment of principal payments on agency securities from Treasury securities to agency-guaranteed mortgage-backed securities (MBS).

Throughout the second half of 2011 and early 2012, participants in financial markets focused on the fiscal and banking crisis in Europe. Concerns regarding the potential for spillovers to the U.S. economy and financial markets weighed on investor sentiment, contributing to significant volatility in a wide range of asset prices and at times prompting sharp pullbacks from risk-taking. Strains eased somewhat in a number of financial markets in late 2011 and early this year as investors seemed to become more confident that European policymakers would take the steps necessary to address the crisis. The more positive market sentiment was bolstered by recent U.S. data releases, which pointed to greater strength, on balance, than investors had expected. Nonetheless, market participants reportedly remain cautious about risks in the financial system, and credit default swap spreads for U.S. financial institutions have widened, on net, since early last summer.

After rising at an annual rate of just ¾ percent in the first half of 2011, real gross domestic product (GDP) is estimated to have increased at a 2¼ percent rate in the second half.[1] The growth rate of real consumer spending also firmed a bit in the second half of the year, although the fundamental determinants of household spending improved little: Real household income and wealth stagnated, and access to credit remained tight for many potential borrowers. Consumer sentiment has rebounded from the summer's depressed levels but remains low by historical standards. Meanwhile, real investment in equipment and software and exports posted solid gains over the second half of the year. In contrast, the housing market remains depressed, weighed down by the large inventory of vacant houses for sale, the substantial volume of distressed sales, and homebuyers' concerns about the strength of the recovery and the potential for further declines in house prices. In the government sector, real purchases of goods and services continued to decline over the second half of the year.

Labor market conditions have improved. The unemployment rate moved down from around 9 percent over the first eight months of 2011 to 8¼ percent in January 2012. However, even with this improvement, the jobless rate remains quite elevated. Furthermore, the share of the unemployed who have been jobless for more than six months, although down slightly from its peak, was still above 40 percent in January—roughly double the fraction that prevailed during the economic expansion of the previous decade. Meanwhile, private payroll employment gains averaged 165,000 jobs per month in the second half of 2011, a bit slower than the pace in the first half of the year, but gains in December and January were more robust, averaging almost 240,000 per month.

Consumer price inflation stepped down in the second half of 2011. After rising at an annual rate of 3½ percent in the first half of the year, prices for personal consumption expenditures (PCE) rose just 1½ percent in the second half. PCE prices excluding food and energy also decelerated, rising at an annual rate of roughly 1½ percent in the second half of 2011, compared with about 2 percent in the first half. The decline in inflation was largely in response to decreases in global commodity prices following their surge early in 2011, as well as a restoration of supply chains for motor vehicle production that had been disrupted after the earthquake in Japan and some deceleration in the prices of imported goods other than raw commodities.

The European fiscal and banking crisis intensified in the second half of the year. During the summer, the governments of Italy and Spain came under significant financial pressure and borrowing costs increased for many euro-area governments and banks. In early August, the European Central Bank (ECB) responded by resuming purchases of marketable debt securities. Although yields on the government debt of Italy and Spain temporarily moved lower, market conditions deteriorated in the fall and funding pressures for some governments and banks increased further. Over the second half of the year, European leaders worked toward bolstering the financial backstop for euro-area governments, reinforcing the fiscal discipline of those governments, and strengthening the capital and liquidity positions of banks. Additionally, the ECB made a significant injection of euro liquidity via its first three-year refinancing operation, and central banks agreed to reduce the price of U.S. dollar liquidity based on swap lines with the Federal Reserve. Since December, following these actions, yields on the debt of vulnerable European governments declined to some extent and funding pressures on European banks eased.

A number of sources of investor anxiety—including the European crisis, concerns about the sustainability of U.S. fiscal policy, and a slowdown in global growth—weighed on U.S. financial markets early in the second half of 2011. More recently, these concerns eased somewhat, reflecting actions taken by global central banks as well as U.S. data releases that pointed to greater strength, on balance, than market participants had anticipated. Broad equity prices fell notably in August but subsequently retraced, and they are now little changed, on net, since early July. Corporate bond spreads remain elevated. Partly as a result of the forward guidance and ongoing maturity

[1] The numbers in this report are based on the Bureau of Economic Analysis's (BEA) advance estimate of fourth-quarter GDP, which was released on January 27, 2012. The BEA will release a revised estimate on February 29, 2012.

extension program provided by the Federal Reserve, market participants expect the target federal funds rate to remain low for a longer period than they thought early last July, and Treasury yields have moved down significantly. Meanwhile, measures of inflation compensation over the next five years derived from yields on nominal and inflation-indexed Treasury securities are little changed, on balance, though the forward measure 5-to-10 years ahead remains below its level in the middle of last year.

Among nonfinancial corporations, larger and higher-credit-quality firms with access to capital markets took advantage of generally attractive financing conditions to raise funds in the second half of 2011. On the other hand, for smaller firms without access to credit markets and those with less-solid financial situations, borrowing conditions remained more challenging. Reflecting these developments, investment-grade nonfinancial corporations continued to issue debt at a robust pace while speculative-grade issuance declined, as investors' appetite for riskier assets diminished. Similar issuance patterns were evident in the market for syndicated loans, where investment-grade issuance continued to be strong while that of higher-yielding leveraged loans fell back. In addition, commercial and industrial (C&I) loans on banks' books expanded strongly, particularly for larger domestic banks that are most likely to lend to big firms. According to the January Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), domestic banks eased terms on C&I loans and experienced increased loan demand during the fourth quarter of the year, the latter development in part reflecting a shift in some borrowing away from European banks.[2] By contrast, although credit supply conditions for smaller firms appear to have eased somewhat in the last several months, they remained tighter relative to historical norms than for larger firms. Commercial mortgage debt continued to decline through the third quarter of 2011, albeit at a more moderate pace than in 2010.

Household debt appears to have declined at a slightly slower pace in the second half of 2011 than in the first half, with the continued contraction in mortgage debt partially offset by growth in consumer credit. Even though mortgage rates continued to be near historically low levels, the volume of new mortgage loans remained muted. The smaller quantity of new mortgage origination reflects potential buyers' lack of either the down payment or credit history required to qualify for these loans, and many appear reluctant to buy a house now because of concerns about their income prospects and employment status, as well as the risk of further declines in house prices. Delinquency rates on most categories of residential mortgages edged lower but stayed near recent highs, and the number of properties in the foreclosure process remained elevated. Issuance of consumer asset-backed securities in the second half of 2011 ran at about the same rate as it had over the previous 18 months. A modest net fraction of SLOOS respondents to both the October and January surveys indicated that they had eased their standards on all categories of consumer loans.

Measures of the profitability of the U.S. banking industry have edged up, on net, since mid-2011, as indicators of credit quality continued to show signs of improvement and banks trimmed noninterest expenses. Meanwhile, banks' regulatory capital ratios remained at historically high levels, as authorities continued to take steps to enhance their regulation of financial institutions. Nonetheless, conditions in unsecured interbank funding markets deteriorated. Strains were particularly evident for European financial institutions, with funding costs increasing and maturities shortening, on balance, as investors focused on counterparty credit risk amid growing anxiety about the ongoing crisis in Europe. Given solid deposit growth and modest expansion in bank credit across the industry, most domestic banks reportedly had limited need for unsecured funding.

Concerns about the condition of financial institutions gave rise to heightened investor anxiety regarding counterparty exposures during the second half of 2011. Responses to the December Senior Credit Officer Opinion Survey on Dealer Financing Terms, or SCOOS, indicated that dealers devoted increased time and attention to the management of concentrated credit exposures to other financial intermediaries over the previous three months, and 80 percent of dealers reported reducing credit limits for some specific counterparties.[3] Respondents also reported a broad but moderate tightening of credit terms applicable to important classes of counterparties over the previous three months, importantly reflecting a worsening in general market liquidity and functioning as well as a reduced willingness to take on risk.

[2] The SLOOS is available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

[3] The SCOOS is available on the Federal Reserve Board's website at www.federalreserve.gov/econresdata/releases/scoos.htm.

In order to support a stronger economic recovery and help ensure that inflation, over time, is at levels consistent with its dual mandate, the FOMC provided additional monetary policy accommodation during the second half of 2011 and early 2012. In August, the Committee modified its forward rate guidance, noting that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. The FOMC decided at its September meeting to extend the average maturity of its Treasury holdings, and to reinvest principal payments from its holdings of agency debt and agency MBS in agency MBS rather than in Treasury securities.[4] Finally, at the Committee's January 2012 meeting, the FOMC modified its forward guidance to indicate that it expected economic conditions to warrant exceptionally low levels for the federal funds rate at least through late 2014. The Committee noted that it would regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in the context of price stability.

In addition to these policy actions, the Federal Reserve took further steps to improve communications regarding its monetary policy decisions and deliberations. At the Committee's January 2012 meeting, the FOMC released a statement of its longer-run goals and policy strategy in an effort to enhance the transparency, accountability, and effectiveness of monetary policy and to facilitate well-informed decisionmaking by households and businesses. The statement emphasizes the Federal Reserve's firm commitment to pursue its congressional mandate to promote maximum employment, stable prices, and moderate long-term interest rates. To clarify how it seeks to achieve these objectives, the FOMC stated that inflation at the rate of 2 percent, as measured by the annual change in the PCE price index, is most consistent over the longer run with the Federal Reserve's statutory mandate. While noting that the Committee's assessments of the maximum level of employment are necessarily uncertain and subject to revision, the statement indicated that the central tendency of FOMC participants' current estimates of the longer-run normal rate of unemployment is between 5.2 and 6.0 percent. It stressed that the Federal Reserve's statutory objectives are generally complementary, but when they are not, the Committee will follow a balanced approach in its efforts to return both inflation and employment to levels consistent with its mandate.

In addition, the January Summary of Economic Projections (SEP) provided information for the first time about FOMC participants' individual assessments of the appropriate timing of the first increase in the target federal funds rate given their view of the economic situation and outlook, as well as participants' assessments of the appropriate level of the target federal funds rate in the fourth quarter of each year through 2014 and over the longer run. The SEP also included qualitative information regarding individual participants' expectations for the Federal Reserve's balance sheet under appropriate monetary policy.

The economic projections in the January SEP (presented in Part 4 of this report) indicated that FOMC participants (the members of the Board of Governors and the presidents of the 12 Federal Reserve Banks) generally anticipated aggregate output to increase at a somewhat faster pace in 2012 than in 2011. Although the participants marked down their GDP growth projections slightly compared with those prepared in November, they stated that the economic information received since that time showed continued gradual improvement in the pace of economic activity during the second half of 2011, as the influence of the temporary factors that damped activity in the first half of the year subsided. However, a number of additional factors, including ongoing weakness in the housing sector, modest growth in real disposable income, and the restraining effects of fiscal consolidation, suggested that the pace of the recovery would be modest in coming quarters. Participants also read the information on economic activity abroad, particularly in Europe, as pointing to weaker demand for U.S. exports. As these factors wane, FOMC participants anticipated that the pace of the economic expansion will gradually strengthen over the 2013–14 period, pushing the rate of increase in real GDP above their estimates of the longer-run rate of output growth. With real GDP expected to increase at a modest rate in 2012, the unemployment rate was projected to decline only a little this year. Participants expected further gradual improvement in labor market conditions over 2013 and 2014 as the pace of output growth picks up. They also noted that inflation expectations had remained stable over the past year despite fluctuations in headline inflation. Most participants anticipated that both headline and

[4] Between the August 2010 and September 2011 FOMC meetings, principal payments from securities held on the Federal Reserve balance sheet had been reinvested in longer-term Treasury securities.

core inflation would remain subdued over the 2012–14 period at rates at or below the FOMC's longer-run objective of 2 percent.

With the unemployment rate projected to remain elevated over the projection period and inflation expected to be subdued, most participants expected that the federal funds rate would remain extraordinarily low for some time. Six participants anticipated that, under appropriate monetary policy, the first increase in the target federal funds rate would occur after 2014, and five expected policy firming to commence during 2014. The remaining six participants judged that raising the federal funds rate sooner would be required to forestall inflationary pressures or avoid distortions in the financial system. All of the individual assessments of the appropriate target federal funds rate over the next few years were below the participants' estimates of the longer-run level of the federal funds rate. Eleven of the 17 participants placed the target federal funds rate at 1 percent or lower at the end of 2014, while 5 saw the appropriate rate as 2 percent or higher.

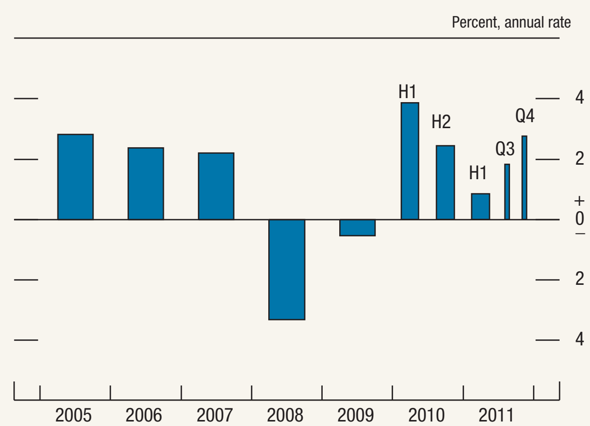
A sizable majority of participants continued to judge the level of uncertainty associated with their projections for real activity and the unemployment rate as exceeding the average of the past 20 years. Many also attached a greater-than-normal level of uncertainty to their forecasts for inflation. As in November, many participants saw downside risks attending their forecasts of real GDP growth and upside risks to their forecasts of the unemployment rate; most participants viewed the risks to their inflation projections as broadly balanced. Participants also reported their assessments of the values to which key macroeconomic variables would be expected to converge over the longer term under appropriate monetary policy and in the absence of further shocks to the economy. The central tendencies of these longer-run projections were 2.3 to 2.6 percent for real GDP growth and 5.2 to 6.0 percent for the unemployment rate. In light of the 2 percent inflation that is the objective included in the statement of longer-run goals and policy strategy adopted at the January meeting, the range and central tendency of participants' projections of longer-run inflation were all equal to 2 percent.

Part 2 Recent Economic and Financial Developments

Real gross domestic product (GDP) increased at an annual rate of 2¼ percent in the second half of 2011, according to the advance estimate prepared by the Bureau of Economic Analysis, following growth of less than 1 percent in the first half (**figure 1**). Activity was held down in the first half of the year by temporary factors, particularly supply chain disruptions stemming from the earthquake in Japan and the damping effect of higher energy prices on consumer spending. As the effects of these factors waned over the second half of the year, the pace of economic activity picked up. But growth remained quite modest compared with previous economic expansions, and a number of factors appear likely to continue to restrain the pace of activity into 2012; these factors include restricted access to credit for many households and small businesses, the depressed housing market, tight fiscal policy, and the spillover effects of the fiscal and financial difficulties in Europe.

Conditions in the labor market have improved since last summer. The pace of private job gains has increased, and the unemployment rate has moved lower. Nonetheless, at 8¼ percent, the jobless rate is still quite elevated. Meanwhile, consumer price infla-

Figure 1. Change in real gross domestic product, 2005–11



Note: Here and in subsequent figures, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.

Source: Department of Commerce, Bureau of Economic Analysis.

tion stepped down from the higher levels observed over the first half of last year, as commodity and import prices retreated while longer-term inflation expectations remained stable.

The fiscal and banking crisis in Europe was a primary focus of financial markets over the course of the second half of 2011 and early 2012. Growing concerns regarding the potential for spillovers to the U.S. economy and financial markets weighed on investor sentiment, contributing to significant volatility in a wide range of asset prices. Nonetheless, developments in financial markets have been mixed, on balance, since July. Unsecured dollar funding markets became significantly strained, particularly for European institutions, though U.S. institutions generally did not appear to face substantial funding difficulties. Risk spreads on corporate debt stayed elevated, on net, but yields on corporate bonds generally moved lower. Broad equity prices, which declined significantly in July and August, subsequently returned to levels near those seen in early July. Credit conditions for most large nonfinancial firms were accommodative and corporate profit growth remained strong.

In response to a pace of economic growth that was somewhat slower than expected, the Federal Reserve provided additional monetary policy accommodation during the second half of 2011 and early 2012. Partly as a result, Treasury yields moved down significantly, and market participants pushed out the date at which they expect the federal funds rate to move above its current target range of 0 to ¼ percent and built in expectations of a more gradual pace of increase in the federal funds rate after liftoff.

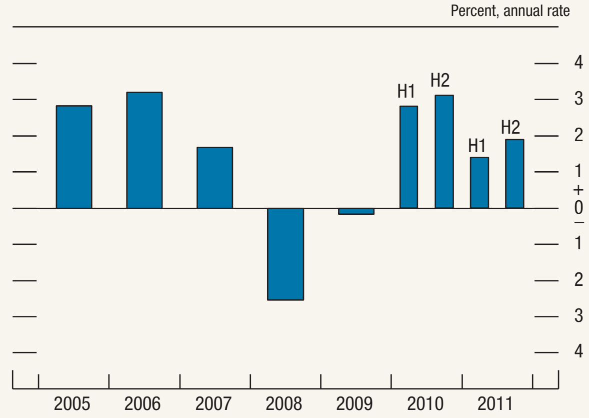
Domestic Developments

The Household Sector

Consumer Spending and Household Finance

Real personal consumption expenditures (PCE) rose at an annual rate of about 2 percent in the second half of 2011, following a rise of just 1½ percent in the first half of the year (figure 2). Part of the spending gain was attributable to a fourth-quarter surge in purchases of motor vehicles following very weak spending last spring and summer stemming from the damping effects of the earthquake in Japan on motor vehicle supply. Even with the step-up, however, PCE growth was modest compared with previous business cycle recoveries. This subpar performance reflects the continued weakness in the underlying determinants of consumption, including sluggish income growth,

Figure 2. Change in real personal consumption expenditures, 2005–11



Note: The data are quarterly and extend through 2011:Q4.

Source: Department of Commerce, Bureau of Economic Analysis.

sentiment that remains relatively low despite recent improvements, the lingering effects of the earlier declines in household wealth, and tight access to credit for many potential borrowers. With consumer spending subdued, the saving rate, although down from its recent high point, remained above levels that prevailed prior to the recession.

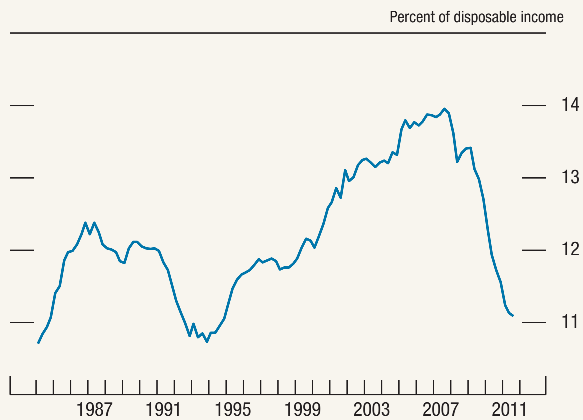
Real income growth is currently estimated to have been very weak in 2011. After rising 2 percent in 2010, aggregate real disposable personal income (DPI)—personal income less personal taxes, adjusted for price changes—was essentially flat in 2011. The wage and salary component of real DPI, which reflects both the number of hours worked and average hourly wages adjusted for inflation, rose at an annual rate of 1 percent in 2011. The increase in real wage and salary income reflected the continued, though tepid, recoveries in both employment and hours worked; in contrast, hourly pay was little changed in real terms.

The ratio of household net worth to DPI dropped back a little in the second half of 2011, reflecting further declines in house prices and equity values. The wealth-to-income ratio has hovered close to 5 in recent years, roughly the level that prevailed prior to the late 1990s, but well below the highs recorded during the boom in house prices in the mid-2000s. Consumer sentiment, which dropped sharply last summer, has rebounded since then; nevertheless, these gains only moved sentiment back to near the top of the range that has prevailed since late 2009.

Household debt—the sum of both mortgage and consumer debt—continued to move lower in the second half of 2011. Since peaking in 2008, household debt has fallen a total of 5 percent. The drop in debt in the second half of 2011 reflected a continued contraction in mortgage debt that was only partially offset by a modest expansion in consumer credit. Largely due to the reduction in overall household debt levels in 2011, the debt service ratio—the aggregate required principal and interest payment on existing mortgages and consumer debt relative to income—also decreased further and now is at a level last seen in 1994 and 1995 (**figure 3**).

The moderate expansion in consumer credit in the second half of 2011, at an annual rate of about 4½ percent, has been driven primarily by an increase in nonrevolving credit, which accounts for about two-thirds of total consumer credit and is composed mainly of auto and student loans. Revolving consumer credit (primarily credit card lending), while continuing to lag, appeared to pick up somewhat toward the end of the year. The increase in consumer credit is consistent with recent responses to the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS). Indeed, modest net fractions of banks in both the October and January surveys reported that they had eased standards on all major categories of consumer loans, and that demand had strengthened for auto and credit cards loans on balance. However, data on credit card solicitations suggest that lenders in that area are primarily interested in pursuing higher-quality borrowers.

Figure 3. Household debt service, 1984–2011



Note: The data are quarterly and extend through 2011:Q3. Debt service payments consist of estimated required payments on outstanding mortgage and consumer debt.

Source: Federal Reserve Board, "Household Debt Service and Financial Obligations Ratios," statistical release.

Indicators of consumer credit quality generally improved. Delinquency rates on credit card loans moved down in the second half of 2011 to the low end of the range observed in recent decades. Delinquencies and charge-offs on nonrevolving consumer loans also generally improved. Moreover, a majority of respondents to the January SLOOS reported that they expect further improvement in the quality of credit card and other consumer loans this year.

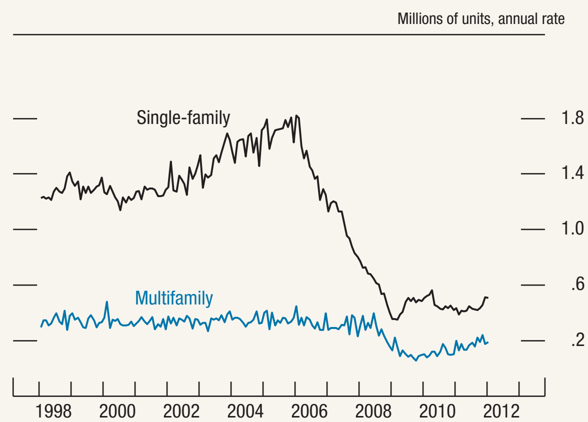
Interest rates on consumer loans held fairly steady, on net, in the second half of 2011 and into 2012. Interest rates on new-auto loans continued to be quite low, while rates on credit card loans remained stubbornly high. Indeed, spreads of credit card interest rates to the two-year Treasury yield are very elevated.

Consumer asset-backed securities (ABS) issuance in the second half of 2011 was in line with that of the previous 18 months. Securities backed by auto loans continued to dominate the market, while issuance of credit card ABS remained weak, as growth of credit card loans has remained subdued and most major banks have chosen to fund such loans on their balance sheets. Yields on ABS and their spreads over comparable-maturity swap rates were little changed, on net, over the second half of 2011 and early 2012 and remained in the low range that has prevailed since early 2010.

Housing Activity and Finance

Activity in the housing sector remains depressed by historical standards (**figure 4**). Although affordability has been boosted by declines in house prices and his-

Figure 4. Private housing starts, 1998–2012



Note: The data are monthly and extend through January 2012.

Source: Department of Commerce, Bureau of the Census.

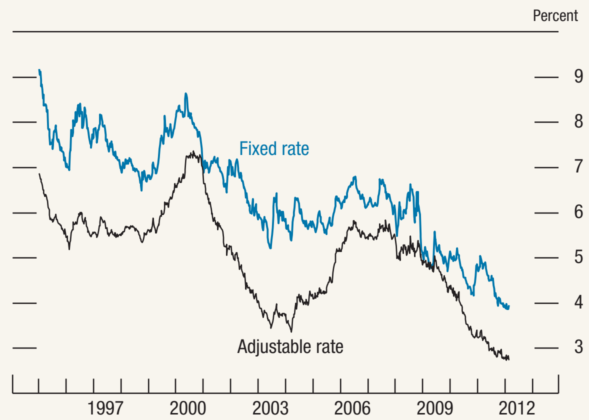
torically low interest rates for conventional mortgages, many potential buyers either lack the down payment and credit history to qualify for loans or are discouraged by ongoing concerns about future income, employment, and the potential for further declines in house prices. Yet other potential buyers—even those with sufficiently good credit records to qualify for a mortgage insured by one of the housing government-sponsored enterprises (GSEs)—continue to face difficulty in obtaining mortgage financing. Moreover, much of the demand that does exist has been channeled to the abundant stock of relatively inexpensive, vacant single-family houses, thereby limiting the need for new construction activity. Given the magnitude of the pipeline of delinquent and foreclosed homes, this factor seems likely to continue to weigh on activity for some time.

Nonetheless, recent indicators of housing construction activity have been slightly more encouraging. In particular, from July 2011 to January 2012, new single-family homes were started at an average annual rate of about 455,000 units, up a bit from the pace in the first half of 2011. In the multifamily market, demand for apartments appears to be increasing and vacancy rates have fallen, as families who are unable or unwilling to purchase homes are renting properties instead. As a result, starts in the multifamily sector averaged about 200,000 units at an annual rate in the second half of 2011, still below the 300,000-unit rate that had prevailed for much of the previous decade but well above the lows recorded in 2009 and early 2010.

House prices, as measured by several national indexes, fell further over the second half of 2011. One such measure with wide geographic coverage—the CoreLogic repeat-sales index—fell at an annual rate of about 6 percent in the second half of the year. House prices are being held down by the same factors that are restraining housing construction: the high number of distressed sales, the large inventory of unsold homes, tight mortgage credit conditions, and lackluster demand. The inventory of unsold homes likely will remain high for some time, given the large number of homes that are already in the foreclosure pipeline or could be entering the pipeline in the coming months. As a result of the cumulative decline in house prices over the past several years, roughly one in five mortgage holders owe more on their mortgages than their homes are worth.

Indicators of credit quality in the residential mortgage sector continued to reflect strains on homeowners confronting depressed home values and high unemployment. In December, serious delinquency rates on prime and near-prime loans stood at 5 percent and 13 percent for fixed- and variable-rate loans, respectively. While delinquencies on variable-rate mortgages for both prime and subprime borrowers have moved down over the past two years, delinquencies on fixed-rate mortgages have held steady at levels near their peaks in early 2010.[5] Meanwhile, delinquency and charge-off rates on second-lien mortgages held by banks also are at elevated levels, and they have declined only slightly from their peaks.

Figure 5. Mortgage interest rates, 1995–2012



Note: The data, which are weekly and extend through February 22, 2012, are contract rates on 30-year mortgages.

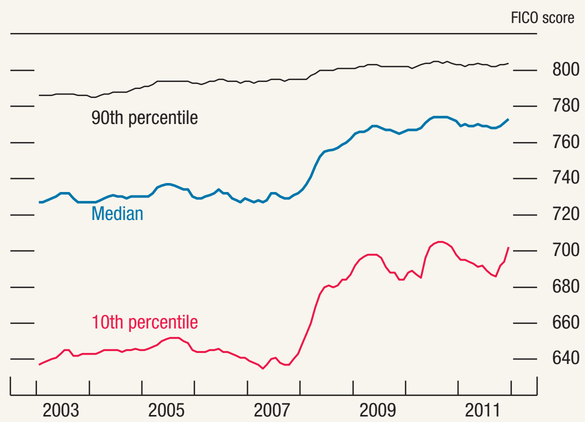
Source: Federal Home Loan Mortgage Corporation.

The number of properties at some stage of the foreclosure process remained elevated in 2011. This high level partly reflected the difficulties that mortgage servicers continued to have with resolving deficiencies in their foreclosure procedures. Resolution of these issues could eventually be associated with a sustained increase in the pace of completed foreclosures as servicers work through the backlog of severely delinquent loans.

Interest rates on fixed-rate mortgages fell steadily during the second half of 2011 and in early 2012 (**figure 5**), though not as much as Treasury yields, leaving spreads to Treasury securities of comparable maturities wider. The ability of potential borrowers to obtain mortgage credit for purchase transactions or refinancing continued to be limited. In part, the low level of mortgage borrowing reflected character-

5 A mortgage is defined as seriously delinquent if the borrower is 90 days or more behind in payments or the property is in foreclosure.

Figure 6. Credit scores on new prime mortgages, 2003–11



Note: The data, which include purchase mortgages only, are monthly and extend through December 2011.

Source: LPS Applied Analytics.

istics of the would-be borrowers, most prominently the widespread incidence of negative equity and unemployment. In addition, credit supply conditions remained tight. Indeed, it appeared that some lenders were reluctant to extend mortgages to borrowers with less-than-pristine credit even when the resulting loans would be eligible for purchase or guarantee by GSEs.[6] One manifestation of this constriction was the fact that the distribution of credit scores among borrowers who succeed in obtaining mortgages had shifted up significantly (figure 6). As a result of these influences, the pace of mortgage applications for home purchase declined, on net, over the second half of 2011 and remains very sluggish. The same factors also appear to have limited refinancing activity, which remains subdued compared with the large number of households that would potentially benefit from the low rates available to high-quality borrowers.

The outstanding stock of mortgage-backed securities (MBS) guaranteed by the GSEs was little changed, on net, over the second half of 2011. The securitization market for mortgage loans not guaranteed by a housing-related GSE or the Federal Housing Administration continued to be essentially closed.

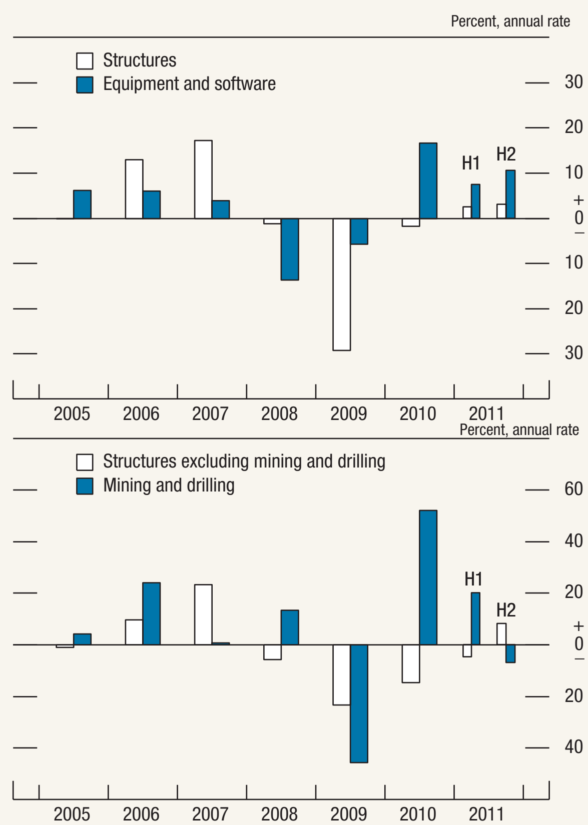
The Business Sector

Fixed Investment

Real spending by businesses for equipment and software (E&S) rose at an annual rate of about 11 percent over the second half of 2011, a pace that was a bit faster than in the first half (figure 7). Much of this strength was recorded in the third quarter. Spending growth dropped back in the fourth quarter, to 5 percent, likely reflecting—among other influences—heightened uncertainty of business owners about global economic and financial conditions. Although spending by businesses for high-tech equipment has held up reasonably well, outlays for a broad range of other E&S slowed appreciably. More recently, however, indicators of business sentiment and capital spending plans generally have improved, suggesting that firms may be in the process of becoming more willing to undertake new investments.

After tumbling throughout most of 2009 and 2010, real investment in nonresidential structures other than drilling and mining turned up last spring, rising

Figure 7. Change in real business fixed investment, 2005–11



Source: Department of Commerce, Bureau of Economic Analysis.

6 For example, only about half of lenders reported to LoanSifter data services that they would offer a conventional fully documented mortgage with a 90 percent loan-to-value ratio for borrowers with FICO scores of 620.

at a surprisingly brisk pace in the second and third quarters of 2011. However, investment dropped back in the fourth quarter. Conditions in the sector remain difficult: Vacancy rates are still high, prices of existing structures are low, and financing conditions for builders are still tight. Spending on drilling and mining structures also dropped back in the fourth quarter, but outlays in this category should continue to be supported by elevated oil prices and advances in technology for horizontal drilling and hydraulic fracturing.

Inventory Investment

Real inventory investment stepped down a bit in the second half of 2011. Stockbuilding outside of motor vehicles increased at a modest pace, and surveys suggest that firms are generally comfortable with their own, and their customers', current inventory positions. In the motor vehicle sector, inventories were drawn down in the second half, as the rise in sales outpaced the rebound in production following the supply disruptions associated with the earthquake in Japan last spring.

Corporate Profits and Business Finance

Operating earnings per share for S&P 500 firms continued to rise in the third quarter of 2011, increasing at a quarterly rate of nearly 10 percent. Fourth-quarter earnings reports by firms in the S&P 500 published through late February indicate that this measure has remained at or near its pre-crisis peaks throughout the second half of 2011.

In the corporate sector as a whole, economic profits, which had been rising rapidly since 2008, increased further in the second half of 2011. This relatively strong profit growth contributed to the continued robust credit quality of nonfinancial firms in the second half of 2011. Although the ratio of liquid assets to total assets on the balance sheets of nonfinancial corporations edged down in the third quarter, it remained at a very high level, and the aggregate ratio of debt to assets—a measure of corporate leverage—stayed low. With corporate balance sheets in generally healthy shape, credit rating upgrades once again outpaced downgrades, and the bond default rate for nonfinancial firms remained low. In addition, the delinquency rate on commercial and industrial (C&I) loans at commercial banks continued to decline and stood at around 1½ percent at year-end, a level near the low end of its historical range. Most banks responding to the January SLOOS reported that they expected further improvements in the credit quality of C&I loans in 2012.

Borrowing by nonfinancial corporations continued at a reasonably robust pace through the second half of 2011, particularly for larger, higher-credit-quality firms. Issuance of investment-grade bonds progressed at a strong pace, similar to that observed in the first half of the year, buoyed by good corporate credit quality, attractive financing conditions, and an improving economic outlook. In contrast to higher-grade bonds, issuance of speculative-grade bonds dropped in the second half of the year as investors' appetite for riskier assets waned. In the market for syndicated loans, investment-grade issuance moved up in the second half of 2011 from its already strong first-half pace, while issuance of higher-yielding syndicated leveraged loans weakened.

C&I loans on banks' books grew steadily over the second half of 2011. Banks reportedly competed aggressively for higher-rated credits in the syndicated leveraged loan market, and some nonfinancial firms reportedly substituted away from bond financing because of volatility in bond spreads. In addition, according to the SLOOS, some domestic banks gained business from customers that shifted away from European banks. Although domestic banks reported little change, on net, in lending standards for C&I loans, they reduced the spreads on these loans as well as the costs of credit lines. Banks that reported having eased their credit standards or terms for C&I loans over the second half of 2011 unanimously cited increased competition from other banks or nonbank sources of funds as a factor.

Borrowing conditions for smaller businesses continued to be tighter than those for larger firms, and their demand for credit remained relatively weak. However, some signs of easing began to emerge. Surveys conducted by the National Federation of Independent Business showed that the net fraction of small businesses reporting that credit had become more difficult to obtain relative to the previous three months declined, on balance, during the second half of 2011. Moreover, the January 2012 SLOOS found that terms for smaller borrowers had continued to ease, and about 15 percent of banks, on net, reported that demand for C&I loans from smaller firms had increased, the highest reading since 2005. Indeed, C&I loans held by regional and community banks—those not in the 25 largest banks and likely to lend mostly to middle-market and small firms—advanced at about a 6 percent annual rate in the second half of 2011, up from a 2½ percent pace in the first half.

Commercial mortgage debt has continued to decline, albeit at a more moderate pace than during 2010. Commercial real estate (CRE) loans held on banks' books contracted further in the second half of 2011 and early 2012, though the runoff appeared to ebb somewhat in 2011. That slowing is more or less consistent with recent SLOOS responses, in which moderate net fractions of domestic banks reported that demand for such loans had strengthened. In the January survey, banks also reported that, for the first time since 2007, they had raised the maximum loan size and trimmed spreads of rates on CRE loans over their cost of funds during the past 12 months. By contrast, life insurance companies reportedly increased their holdings of CRE loans, especially of loans issued to higher-quality borrowers. Although delinquency rates on CRE loans at commercial banks edged down further in the fourth quarter, they remained at high levels, especially on loans for construction and land development; delinquencies on loans held by life insurance companies remained extraordinarily low, as they have done for more than a decade. Vacancy rates for most types of commercial properties are still elevated, exerting downward pressure on property prices and impairing the performance of CRE loans.

Conditions in the market for commercial mortgage-backed securities (CMBS) worsened somewhat in the second half of the year. Risk spreads on highly rated tranches of CMBS moved up, on balance, and about half of the respondents to the December Senior Credit Officer Opinion Survey on Dealer Financing Terms (SCOOS) indicated that liquidity conditions in the markets for such securities had deteriorated somewhat. Issuance of CMBS slowed further, but did not halt completely. Delinquency rates on CRE loans in CMBS pools held steady just below 10 percent.

In the corporate equity market, gross issuance dropped significantly in the third quarter amid substantial equity market volatility, but it retraced a part of that decline in the fourth quarter as some previously withdrawn issues were brought back to the market. Net equity issuance continued to decline in the third quarter, reflecting the continued strength of cash-financed mergers and share repurchases.

The Government Sector

Federal Government

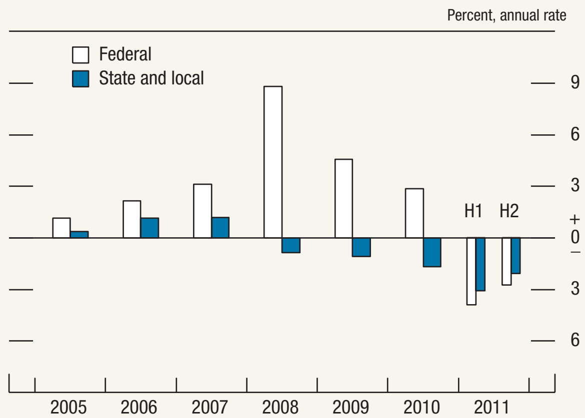
The deficit in the federal unified budget remains very wide. The budget deficit for fiscal year 2011 was \$1.3 trillion, or 8½ percent of nominal GDP—a level comparable with deficits recorded in 2009 and 2010 but sharply higher than the deficits recorded prior to the onset of the financial crisis and recession. The budget deficit continued to be boosted by spending that was committed by the American Recovery and Reinvestment Act of 2009 (ARRA) and other stimulus policy actions as well as by the weakness of the economy, which has reduced tax revenues and increased payments for income support.

Tax receipts rose 6½ percent in fiscal 2011. However, the level of receipts remained very low; indeed, at around 15½ percent of GDP, the ratio of receipts to national income is only slightly above the 60-year lows recorded in 2009 and 2010. The rise in revenues in fiscal 2011 was the result of a robust increase of more than 20 percent in individual income tax payments that reflected strong final payments on 2010 income. Social insurance tax receipts fell about 5 percent in fiscal 2011, held down by the temporary 2 percentage point reduction in payroll taxes enacted in 2010. Corporate taxes also fell around 5 percent in 2011, with the decline largely the result of legislation providing more-favorable tax treatment for some business investment. In the first four months of fiscal 2012, total tax receipts increased 4 percent relative to the comparable year-earlier period.

Total federal outlays rose 4 percent in fiscal 2011. Much of the increase relative to last year is attributable to the earlier unwinding of the effects of financial transactions, such as the repayments to the Treasury of obligations for the Troubled Asset Relief Program, which temporarily lowered measured outlays in fiscal 2010. Excluding these transactions, outlays were up about 2 percent in 2011. This small increase reflects reductions in both ARRA spending and unemployment insurance payments as well as a subdued pace of defense and Medicaid spending. By contrast, net interest payments rose sharply, reflecting the increase in federal debt. Spending has remained restrained in the current fiscal year, with outlays (adjusted to exclude financial transactions) down about 5 percent in the first four months of fiscal 2012 relative to the comparable year-earlier period.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of GDP—decreased at an annual rate of about 3 percent in the second half of 2011, a little less rapidly than in the first half of the year (**figure 8**). Defense spending fell

Figure 8. Change in real government expenditures on consumption and investment, 2005–11



Source: Department of Commerce, Bureau of Economic Analysis.

at an annual rate of about 4 percent in the second half of the year, a somewhat sharper pace of decline than in the first half, while nondefense purchases were unchanged over this period.

Federal debt surged in the second half of 2011, after the debt ceiling was raised in early August by the Budget Control Act of 2011.[7] Standard and Poor's (S&P), which had put the U.S. long-term sovereign credit rating on credit watch negative in June, downgraded that rating from AAA to AA+ following the passage of the act, citing the risks of a continued rise in federal government debt ratios over the medium term and declining confidence that timely fiscal measures necessary to place U.S. public finances on a sustainable path would be forthcoming. Other credit rating agencies subsequently posted a negative outlook on their rating of U.S. sovereign debt, on similar grounds, but did not change their credit ratings. These actions do not appear to have affected participation in Treasury auctions, which continued to be well subscribed. Demand for Treasury securities was supported by market participants' preference for the relative safety and liquidity of such securities. Bid-to-cover ratios were within historical ranges, and indicators of foreign participation remained near their recent levels. Federal debt held by the public, as a percentage of GDP, continued to rise in the third quarter, reaching about 68 percent.

State and Local Government

State and local governments remain under significant fiscal strain. Since July, employment in the sector has declined by an average of 15,000 jobs per month, just slightly under the pace of job losses recorded for the first half of 2011. Meanwhile, reductions in real construction expenditures abated after a precipitous drop in the first half of 2011. As measured in the NIPA, real state and local expenditures on consumption and gross investment decreased at an annual rate of about 2 percent in the second half of 2011, a somewhat slower pace of decline than in the first half of the year (figure 8).

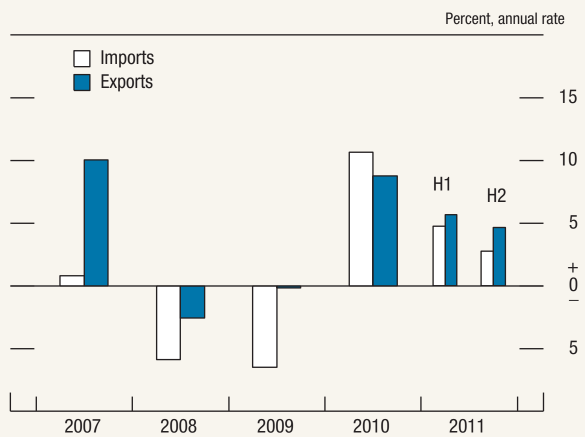
State and local government revenues appear to have increased modestly in 2011. Notably, at the state level, third-quarter tax revenues rose 5½ percent over the year-earlier period, with the majority of the states experiencing gains. However, this increase in tax revenues was partly offset by a reduction in federal stimulus grants. Tax collections have been less robust at the local level. Property tax receipts have been roughly flat, on net, since the start of 2010 (based on data through the third quarter of 2011), reflecting the downturn in home prices. Furthermore, many localities have experienced a decrease in grants-in-aid from their state government.

Issuance of long-term securities by state and local governments moved up in the second half of 2011 to a pace similar to that seen in 2009 and 2010. Issuance had been subdued during the first half of the year, in part because the expiration of the Build America Bonds program led to some shifting of financing from 2011 into late 2010.

Yields on state and local government securities declined in the second half of 2011 and into 2012, reaching levels near the lower end of their range over the past decade, but they fell to a lesser degree than yields on comparable-maturity Treasury securities. The increase in the ratio of municipal bond yields to Treasury yields likely reflected, in part, continued concern regarding the financial health of state and local governments. Indeed, credit default swap (CDS) indexes for municipal bonds rose, on balance, over the second half of 2011 but have narrowed somewhat in early 2012. Credit rating downgrades outpaced upgrades in the second half of 2011, particularly in

7 On May 16, the federal debt reached the $14.294 trillion limit, and the Secretary of the Treasury declared a "debt issuance suspension period" for the Civil Service Retirement and Disability Fund, permitting the Treasury to redeem a portion of existing Treasury securities held by that fund as investments and to suspend issuance of new Treasury securities to that fund as investments. The Treasury also began suspending some of its daily reinvestment of Treasury securities held as investments by the Government Securities Investment Fund of the Federal Employees' Retirement System Thrift Savings Plan.

Figure 9. Change in real imports and exports of goods and services, 2007–11



Source: Department of Commerce, Bureau of Economic Analysis.

December, following the downgrade of a municipal bond guarantor.[8]

The External Sector

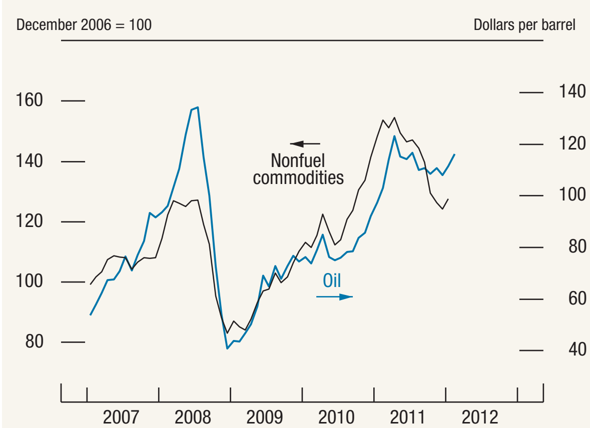
Real exports of goods and services rose at an annual rate of 4¾ percent in the second half of 2011, boosted by continued growth in overall foreign economic activity and the lagged effect of declines in the foreign exchange value of the dollar earlier in the year (**figure 9**). Exports of aircraft and consumer goods registered some of the largest gains. The increase in export demand was concentrated in the emerging market economies (EMEs), while exports to the euro area declined toward the end of the year.

With growth of economic activity in the United States moderate during the second half of 2011, real imports of goods and services rose at only about a 3 percent annual rate, down from about 5 percent in the first half. Import growth was weak across most trading partners in the second half of last year, with the notable exception of imports from Japan, which grew significantly after dropping sharply in the wake of the March earthquake.

Altogether, net exports contributed about ¼ percentage point to real GDP growth in the second half of 2011, as export growth outpaced import growth. At an annual rate, the current account deficit in the third quarter of 2011 (the latest available data) was $441 billion, or about 3 percent of nominal GDP, a touch narrower than the $470 billion deficit recorded in 2010.

Oil prices moved down, on net, over the second half of last year. The spot price of West Texas Intermediate (WTI) crude oil, which jumped to $110 per barrel last April after a near-complete shutdown of Libyan oil production, subsequently reversed course and declined sharply to an average of just under $86 per barrel in September. The prices of other major benchmark crude oils also fell over this period, although by less than the spot price of WTI (**figure 10**). The drop in oil prices through September likely was prompted by the winding down of the conflict in Libya as well as growing concern about the strength of global growth as the European sovereign debt crisis intensified, particularly toward the end of summer. From September to January of this year, the price of oil from the North Sea (the Brent benchmark) was essentially flat as the potential implications of increased geopolitical tensions—most notably with Iran—have offset ongoing concern over the strength of global demand and a faster-than-expected rebound in Libyan oil production. In February, the price of Brent moved higher, both with increasing optimism regarding the outlook for global growth as well as a further heightening of tensions with Iran. The spot price of WTI crude oil also increased in February, though by less than Brent, fol-

Figure 10. Prices of oil and nonfuel commodities, 2007–12



Note: The data are monthly. The oil price is the spot price of Brent crude oil, and the last observation is the average for February 1–24, 2012. The price of nonfuel commodities is an index of 45 primary-commodity prices and extends through January 2012.

Source: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

[8] Downgrades to bond guarantors can affect the ratings of all municipal securities guaranteed by those firms, as the rating of a security is the higher of either the published underlying security rating or the rating of the entity providing the guarantee.

lowing a relatively rapid rise over the final three months of last year.[9]

After peaking early in 2011, prices of many non-oil commodities also moved lower during the remainder of 2011. Despite moving up recently, copper prices remain well below their early 2011 level. In agricultural markets, corn and wheat prices ended 2011 down about 20 percent from their relatively high levels at the end of August as global production reached record levels. In early 2012, however, corn prices edged up on worries about dry growing conditions in South America.

After increasing at an annual rate of 6½ percent in the first half of 2011, prices of non-oil imported goods were flat in the second half. Fluctuations in prices of imported finished goods (such as consumer goods and capital goods) were moderate.

National Saving

Total U.S. net national saving—that is, the saving of U.S. households, businesses, and governments, net of depreciation charges—remains extremely low by historical standards. After having reached 4 percent of nominal GDP in 2006, net national saving dropped over the subsequent three years, reaching a low of negative 2½ percent in 2009. Since then, the national saving rate has increased on balance: In the third quarter of 2011 (the latest quarter for which data are available), net national saving was negative ½ percent of nominal GDP. The recent contour of the saving rate importantly reflects the pattern of federal budget deficits, which widened sharply in 2008 and 2009, but have edged down as a share of GDP since then. National saving will likely remain relatively low this year in light of the continuing large federal budget deficit. If low levels of national saving persist over the longer run, they will likely be associated with both low rates of capital formation and heavy borrowing from abroad, limiting the rise in the standard of living of U.S. residents over time.

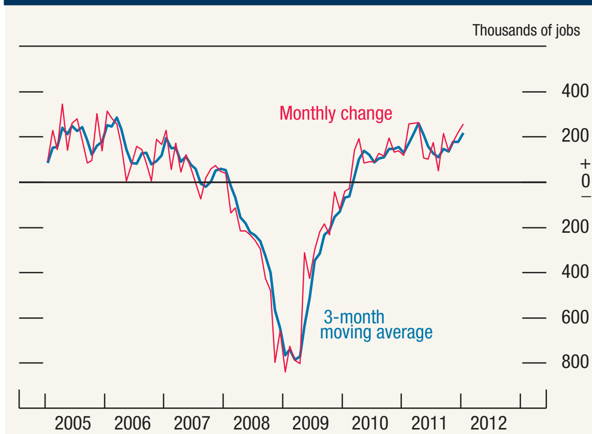
The Labor Market

Employment and Unemployment

Conditions in the labor market have improved some of late. Private payroll employment gains averaged 165,000 jobs per month in the second half of 2011, a bit slower than the pace in the first half of the year, but gains in December and January were more robust, averaging almost 240,000 per month (**figure 11**). The unemployment rate, which hovered around 9 percent for much of last year, is estimated to have moved down noticeably since September, reaching 8¼ percent in January, the lowest reading in almost three years (**figure 12**).

Although the recent decline in the jobless rate is encouraging, the level of unemployment remains very elevated. In addition, long-duration joblessness continues to account for an especially large share of the total. Indeed, in January, 5½ million persons among those counted as unemployed—about 43 percent of the total—had been out of work for more than six months, figures that were only a little below record levels (**figure 13**). Moreover, the number of individuals who are working part time for economic reasons—another indicator of the underutilization of labor—remained roughly twice its pre-recession value.

Figure 11. Net change in private payroll employment, 2005–12



Note: The data are monthly and extend through January 2012.

Source: Department of Labor, Bureau of Labor Statistics.

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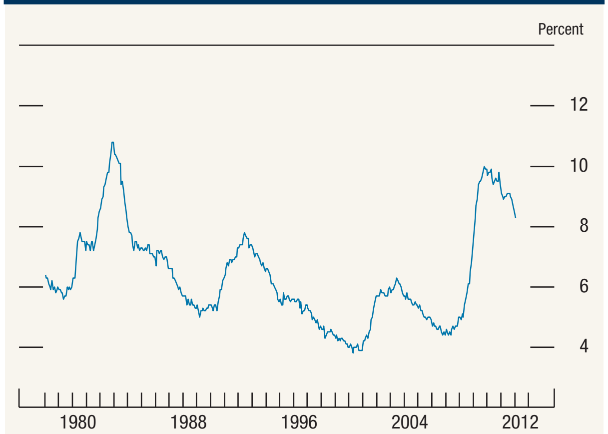
9 The more rapid rise of WTI than other grades of crude oil at the end of 2011 reflects the narrowing of a discount that had opened up between WTI and other grades earlier in the year. Throughout most of 2011, continued increases in the supply of oil, primarily from Canada and North Dakota, available to flow into Cushing, Oklahoma (the delivery point for the WTI crude oil), and the lack of transportation infrastructure to pass the supplies on to global markets, depressed the price of WTI relative to other grades of crude oil. In mid-November, however, plans were announced to reverse the flow of a key pipeline that currently transports crude oil from the Gulf Coast into Cushing. By raising the possibility of alleviating the supply glut of crude oil in the Midwest, the announcement of this flow reversal has led spot WTI prices to rise to a level that is more in line with the price of other grades of crude oil.

Figure 12. Civilian unemployment rate, 1978–2012



Note: The data are monthly and extend through January 2012.

Source: Department of Labor, Bureau of Labor Statistics.

Productivity and Labor Compensation

Labor productivity growth slowed last year. Productivity had risen rapidly in 2009 and 2010 as firms strove to cut costs in an environment of severe economic stress. In 2011, however, with operations leaner and workforces stretched thin, firms needed to add labor inputs to achieve the desired output gains, and output per hour in the nonfarm business sector rose only ½ percent.

Increases in hourly compensation remained subdued in 2011, restrained by the wide margin of labor market slack. The employment cost index, which measures both wages and the cost to employers of providing benefits, for private industry rose just 2¼ percent in nominal terms in 2011. Nominal compensation per hour in the nonfarm business sector—derived from the labor compensation data in the NIPA—is estimated to have increased only 1¾ percent in 2011, well below the average gain of about 4 percent in the years before the recession. Adjusted for the rise in consumer prices, hourly compensation was roughly unchanged in 2011. Unit labor costs rose 1¼ percent in 2011, as the rise in nominal hourly compensation outpaced that of labor productivity in the nonfarm business sector. In 2010, unit labor costs fell almost 1 percent.

Figure 13. Long-term unemployed, 1978–2012

Note: The data are monthly and extend through January 2012. The series shown is the percentage of total unemployed persons who have been unemployed for 27 weeks or more.

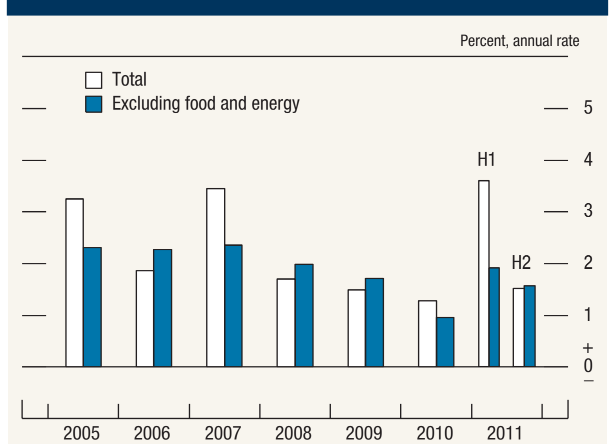
Source: Department of Labor, Bureau of Labor Statistics.

Prices

Consumer price inflation stepped down in the second half of 2011. After rising at an annual rate of 3½ percent in the first half of the year, the overall PCE chain-type price index increased just 1½ percent in the second half (**figure 14**). PCE prices excluding food and energy also decelerated in the second half of 2011, rising at an annual rate of about 1½ percent, compared with roughly 2 percent in the first half. The recent contour of consumer price inflation has reflected movements in global commodity prices, which rose sharply early in 2011 but have moved lower during the second half of the year. Information from the consumer price index and other sources suggests that inflation remained subdued through January 2012, although energy prices have turned up more recently.

The index of consumer energy prices, which surged in the first half of 2011, fell back in the second half of the year. The contour mainly reflected the rise and subsequent reversal in the price of crude oil; however,

Figure 14. Change in the chain-type price index for personal consumption expenditures, 2005–11



Source: Department of Commerce, Bureau of Economic Analysis.

gasoline prices started to rise again in February following a recent upturn in crude oil prices. Consumer natural gas prices also fell at the end of 2011, as unseasonably mild temperatures and increases in supply from new domestic wells helped boost inventories above typical levels. All told, the overall index of consumer energy prices edged lower during the second half of 2011, compared with an increase of almost 30 percent in the first half of the year.

Consumer prices for food and beverages exhibited a similar pattern as that of energy prices. Prices for farm commodities rose briskly early last year, reflecting the combination of poor harvests in several countries that are major producers along with the emerging recovery in the global economy. These commodity price increases fed through to higher consumer prices for meats and a wide range of other more-processed foods. With the downturn in farm commodity prices late in the summer, the index of consumer food prices rose at an annual rate of just 3¾ percent in the second half of 2011 after increasing 6½ percent in the first half.

Prices for consumer goods and services other than energy and food have also slowed, on net, in recent months. Core PCE prices had been boosted in the spring and summer of 2011 by a number of transitory factors, including the pass-through of the first-half surge in prices of raw commodities and other imported goods and a boost to motor vehicle prices that stemmed from supply shortages following the earthquake in Japan. As the impulse from these factors faded, core PCE price inflation stepped down so that, for 2011 as a whole, core PCE price inflation was just 1¾ percent.

Survey-based measures of near-term inflation expectations are down since the middle of 2011. Median year-ahead inflation expectations as reported in the Thomson Reuters/University of Michigan Surveys of Consumers (Michigan survey), which had risen sharply earlier in the year reflecting the run-up in energy and food prices, subsequently fell back as those prices decelerated. Longer-term expectations have remained generally stable. In the Michigan survey, the inflation rate expected over the next 5 to 10 years was 2.9 percent in February, within the range that has prevailed over the past 10 years; in the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations for the increase in the price index for PCE over the next 10 years remained at 2¼ percent, in the middle of its recent range.

Measures of inflation compensation derived from yields on nominal and inflation-indexed Treasury securities declined early in the second half of 2011 at both medium-term and longer-term horizons, likely reflecting a worsening in the economic outlook and the intensification of the European fiscal crisis. More recently, inflation compensation estimates over the next five years have edged back up, apparently reflecting investors' more optimistic economic outlook, and is about unchanged, on net, for the period. However, the forward measure of five-year inflation compensation five years ahead remains about 55 basis points below its level in the middle of last year.

Financial Developments

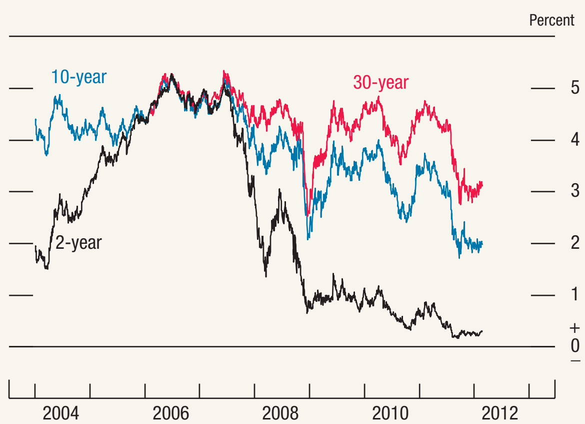
In light of the disappointing pace of progress toward meeting its statutory mandate to promote maximum employment and price stability, the Federal Open Market Committee (FOMC) took a number of steps to provide additional monetary policy accommodation during the second half of 2011 and early 2012. These steps included increasing the average maturity of the Federal Reserve's securities holdings, shifting the reinvestment of principal payments on agency securities from Treasury securities to agency-guaranteed MBS, and strengthening the forward rate guidance included in postmeeting statements.

Financial markets were buffeted over the second half of 2011 and in early 2012 by changes in investors' assessments of the ongoing European crisis as well as in their evaluation of the U.S. economic outlook. As a result, developments in financial market conditions have been mixed since July. Unsecured dollar funding markets, particularly for European institutions, became significantly strained, though domestic financial firms generally maintained ready access to short-term unsecured funding. Corporate bond spreads remained elevated, on net, while broad equity prices were little changed, although they exhibited unusually high volatility. Partially reflecting additional monetary policy accommodation, Treasury yields moved down significantly. Similarly, investors pushed out the date at which they expect the federal funds rate to rise above its current target range, and they are currently anticipating a more gradual pace of increase in the funds rate following liftoff than they did last July.

Monetary Policy Expectations and Treasury Rates

In response to the steps taken by the FOMC to strengthen its forward guidance and provide addi-

Figure 15. Interest rates on Treasury securities at selected maturities, 2004–12



Note: The data are daily and extend through February 24, 2012.

Source: Department of the Treasury.

tional support to the economic recovery, market participants pushed out further the date when they expect the federal funds rate to first rise above its current target range of 0 to ¼ percent and scaled back their expectations of the pace at which monetary policy accommodation will be removed. On balance, quotes on overnight index swap (OIS) contracts, as of late February, imply that investors anticipate the federal funds rate will rise above its current target range in the fourth quarter of 2013, about four quarters later than the date implied in July. Investors expect, on average, that the effective federal funds rate will be about 70 basis points by late 2014, roughly 165 basis points lower than anticipated in mid-2011.[10]

Yields on nominal Treasury securities declined significantly over the second half of 2011 (**figure 15**). The bulk of this decline occurred in late July and August, in part reflecting weaker-than-anticipated U.S. economic data and increased investor demand for the relative safety and liquidity of Treasury securities amid an intensification of concerns about the situation in Europe. Following the FOMC announcement of the maturity extension program (MEP) at its September meeting, yields on longer-dated Treasury securities declined further, while yields on shorter-dated securities held steady at very low levels.[11] On net, yields on 2-, 5-, and 10-year Treasury notes have declined roughly 10, 65, and 110 basis points from their levels in mid-2011, respectively. The yield on the 30-year bond has dropped about 120 basis points. Though liquidity and functioning in money markets deteriorated notably for several days at the height of the debt ceiling debate last summer, neither the downgrade of the U.S. long-term sovereign credit rating by S&P in August nor the failure of the Joint Select Committee on Deficit Reduction to reach an agreement in November appeared to leave a permanent imprint on the Treasury market. Uncertainty about longer-term interest rates, as measured by the implied volatility on 10-year Treasury securities, moved sideways through most of the second half of 2011 and then declined late in the year and into 2012, reflecting improved sentiment in financial markets following a number of policy actions by central banks and some signs of strengthening in the pace of economic recovery.

Measures of market functioning suggest that the Treasury market has continued to operate smoothly since mid-2011 despite the S&P downgrade in August. Bid–asked spreads for most Treasury securities were roughly unchanged, though they have widened a bit, on net, for the 30-year bond since August. Dealer transaction volumes have remained within historically normal ranges.

Short-Term Funding Markets

Conditions in unsecured short-term dollar funding markets deteriorated, on net, over the second half of 2011 and in early 2012 amid elevated anxiety about the crisis in Europe and its implications for European firms and their counterparties. Funding costs increased and tenors shortened dramatically for European institutions throughout the third and into the fourth quarter. Funding pressures eased somewhat late in the year following the European Central Bank's (ECB) first injection of euro liquidity via a three-year refinancing operation and the reduction of the price of U.S. dollar liquidity offered by the ECB and other central banks; they subsequently eased further following the passage of year-end. On balance, spreads of London interbank offered rates (LIBOR) over comparable-maturity OIS rates—a measure of stress in short-term bank funding markets—have

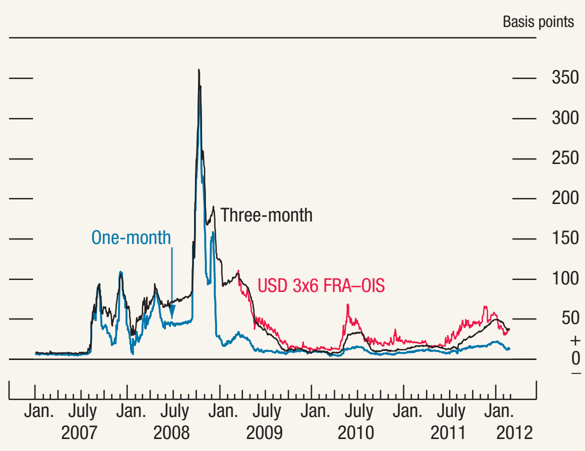
[10] When interest rates are close to zero, determining the point at which financial market quotes indicate that the federal funds rate will move above its current range can be complicated. The path described in the text is the mean of a distribution calculated from OIS rates. Alternatively, one can use similar derivatives to calculate the most likely, or "modal," path of the federal funds rate, a measure that tends to be more stable. This alternative measure has also moved down, on net, since the middle of 2011, but it suggests a flatter overall trajectory for the target federal funds rate, according to which the effective rate does not rise above its current target range through the end of 2015.

[11] As of February 24, the Open Market Desk had sold $223 billion in shorter-term Treasury securities and purchased $211 billion in longer-term Treasury securities.

widened considerably since July, particularly for tenors beyond one month, though they have moved down since late last year. Indeed, throughout much of the third and fourth quarters, many European institutions were reportedly unable to obtain unsecured dollar funding at tenors beyond one week. Additionally, more-forward-looking measures of interbank funding costs—such as the spread between a three-month forward rate agreement and the rate on an OIS contract three to six months ahead—moved up considerably in the second half of 2011 and have only partially retraced in 2012 (**figure 16**). Despite the pressures faced by European financial institutions, U.S. firms generally maintained ready access to short-term unsecured funding markets. Against a backdrop of solid deposit growth and modest expansion in bank credit across the industry, most domestic banks reportedly had limited need for unsecured funding.

Pressures were also evident in the commercial paper (CP) market. Issuance in the United States of unsecured financial CP and negotiable certificates of deposit by entities with European parents declined significantly in the second half of 2011. By contrast, the pace of issuance by U.S. firms edged down only slightly, on net, over the period. On balance, spreads of rates on unsecured A2/P2 commercial paper over equivalent maturity AA-rated nonfinancial CP rose a bit for both overnight and 30-day tenors. AA-rated asset-backed CP spreads increased more notably over the second half of 2011 but largely retraced following year-end.

Figure 16. LIBOR minus overnight index swap rate, 2007–12



Note: The data are daily and extend through February 24, 2012. An overnight index swap (OIS) is an interest rate swap with the floating rate tied to an index of daily overnight rates, in this case the effective federal funds rate. At maturity, the two parties to the swap agreement exchange, on the basis of the agreed notional amount, the difference between interest accrued at the fixed rate and interest accrued by averaging the floating, or index, rate. The U.S. dollar (USD) spread is calculated from a London interbank offered rate (LIBOR) forward rate agreement (FRA) three to six months in the future and the implied forward OIS rate for the same period.

Source: Bloomberg.

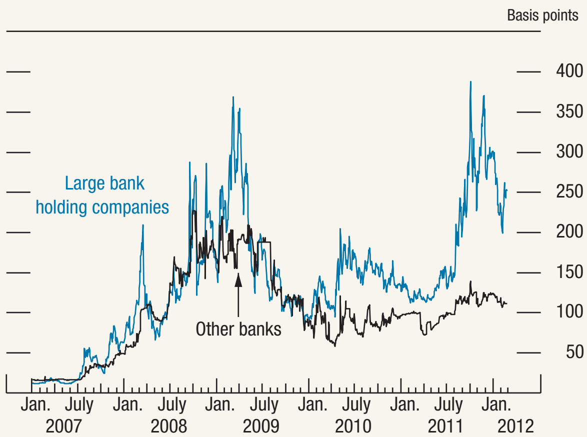
In contrast to unsecured dollar funding markets, signs of stress were largely absent in secured short-term dollar funding markets. For example, in the market for repurchase agreements (repos), bid–asked spreads for most collateral types were little changed. In addition, despite a seasonal dip around year-end, volumes in the triparty repo market were largely stable on balance. That said, the composition of collateral pledged in the repo market moved further away from equities and fixed-income collateral that is not eligible for open market operations, shifting even more heavily toward Treasury and agency securities as counterparty concerns became more evident. Respondents to the SCOOS in both September and December noted a continued increase in demand for funding across collateral types but reported a general tightening in credit terms under which several securities types are financed. In addition, market participants reportedly became somewhat less willing to fund riskier collateral types at longer tenors as year-end approached. However, year-end pressures remained muted overall, with few signs of dislocations in either secured or unsecured short-term markets, and conditions in term funding markets have improved in early 2012.

Money market funds, a major provider of funds to short-term funding markets such as those for CP and for repo, experienced significant outflows across fund categories in July, as investors' focus turned to the deteriorating situation in Europe and to the debt ceiling debate in the United States. Those outflows largely shifted to bank deposits, resulting in significant pressure on the regulatory leverage ratios of a few large banks. However, investments in money market funds rose, on net, over the remainder of 2011, with the composition of those increases reflecting the general tone of increased risk aversion, as government-only funds faced notable inflows while prime funds experienced steady outflows.

Financial Institutions

Market sentiment toward the banking industry declined rapidly early in the second half of 2011 as investors turned their focus on exposures to European sovereigns and financial institutions and on the possible spillover effects of the European crisis. Some large U.S. institutions also remained significantly exposed to legal risks stemming from their mortgage

Figure 17. Spreads on credit default swaps for selected U.S. banking organizations, 2007–12



Note: The data are daily and extend through February 24, 2012. Median spreads for six bank holding companies and nine other banks.

Source: Markit.

banking operations and foreclosure practices.[12] More recently, however, investor sentiment has improved somewhat following the actions of central banks and incoming data suggesting a somewhat better economic outlook in the United States. On balance, equity prices for banking organizations have completely retraced their declines from last summer, while CDS spreads (**figure 17**)—which reflect investors' assessments of and willingness to bear the risk that these institutions will default on their debt obligations—have declined from their peaks reached in the fall, but not all the way back to mid-2011 levels.

Measures of bank profitability edged up, on net, in recent quarters but remained well below the levels that prevailed before the financial crisis began. Although profits at the largest institutions were supported over that period by reductions in noninterest expenses, net interest margins remained very low, capital markets revenues were subdued, loan loss provisions are still somewhat elevated relative to pre-crisis norms, and a few banks booked large reserves for litigation risks associated with their mortgage portfolios.

[12] On February 9, it was announced that the federal government and 49 state attorneys general had reached a $25 billion agreement with the nation's five largest mortgage servicers to address mortgage loan servicing and foreclosure abuses. The agreement does not prevent state and federal authorities from pursuing criminal enforcement actions related to this or other conduct by the servicers or from punishing wrongful securitization conduct; it also does not prevent any action by individual borrowers who wish to bring their own lawsuits.

Indicators of credit quality at commercial banks continued to show signs of improvement. Aggregate delinquency and charge-off rates moved down, though they remained quite elevated on residential mortgages and both residential and commercial construction loans. Loss provisioning has leveled out in recent quarters near the upper end of its pre-crisis range. Nonetheless, in the January SLOOS, a large fraction of the respondents indicated that they expect credit quality to improve over the next 12 months for most major loan categories if economic activity progresses in line with consensus forecasts.

Credit provided by domestic banks—the sum of loans and securities—increased moderately in the second half of 2011, its first such rise since the first half of 2008. Bank credit grew as holdings of agency MBS expanded steadily and most major loan categories exhibited improvement in the second half of the year. The expansion was consistent with recent SLOOS responses indicating that lending standards and loan terms eased somewhat and that demand for loans from businesses and households increased, on net, in the second half of 2011. In particular, C&I loans showed persistent and considerable strength over the second half of 2011 and into early 2012. Loans to nonbank financial institutions, a category that tends to be volatile, also grew rapidly over that period as did holdings of agency MBS. Consumer loans held by banks edged up in the third and fourth quarters. Those increases offset ongoing declines in commercial real estate and home equity loans, both of which remained very weak.

Regulators continued to take steps to strengthen their oversight of the financial industry. In particular, a variety of measures mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are being, or are soon to be, implemented, including enhanced capital and liquidity requirements for large banking organizations, annual stress testing, additional risk-management requirements, and the development of early remediation plans (see **box 1**). As part of those efforts, the Federal Reserve began annual reviews of the capital plans for U.S. bank holding companies with total consolidated assets of $50 billion or more under its Comprehensive Capital Analysis and Review program. Going into those reviews, reported regulatory capital ratios of U.S. banking institutions generally remained at historically high levels over the second half of 2011.

Concerns about the condition of European financial institutions, coupled with periods of heightened

Box 1. Financial Stability at the Federal Reserve

The Federal Reserve's responsibility for promoting financial stability stems from its role in supervising and regulating banks, operating the nation's payments system, and serving as the lender of last resort. In the decades prior to the financial crisis, financial stability policy tended to be overshadowed by monetary policy, which had come to be viewed as the principal function of central banks. However, in the aftermath of the financial crisis, financial stability policy has taken on greater prominence and is now generally considered an equally critical responsibility of central banks. As such, the Federal Reserve has made significant organizational changes and taken other actions to improve its ability to understand and address systemic risk. In addition, its statutory role in maintaining financial stability has been expanded by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

One key feature of the Dodd-Frank Act is its macroprudential orientation, as reflected in many of the provisions to be implemented by the Federal Reserve and other financial regulators. The macroprudential approach to regulation and supervision still pays close attention to the safety and soundness of individual financial institutions, but it also takes into account the linkages among those entities and the condition of the financial system as a whole. To implement the macroprudential approach, the Dodd-Frank Act established the multiagency Financial Stability Oversight Council (FSOC), which is tasked with promoting a more comprehensive approach to monitoring and mitigating systemic risk. The Federal Reserve is one of 10 voting members of the FSOC.

A significant aspect of the macroprudential approach is the heightened focus on entities whose failure or financial distress could result in outsized destabilizing effects on the rest of the system. Under the Dodd-Frank Act, the Federal Reserve is responsible for the supervision of all systemically important financial institutions (SIFIs), which include both large bank holding companies and nonbank financial firms designated by the FSOC as systemically important. Even before the Dodd-Frank Act was enacted, the Federal Reserve was making organizational changes to facilitate the incorporation of systemic risk considerations into the supervisory process. Notably, it created the Large Institution Supervision Coordinating Committee (LISCC) to bring an interdisciplinary and cross-firm perspective to the supervision of large, complex financial institutions; the LISCC acts to ensure that the financial positions of these large institutions are strong enough to withstand adverse shocks. A similar body has been set up to help in the oversight of systemically important financial market utilities.

The Federal Reserve has also established the Office of Financial Stability Policy and Research (OFS) to help the Federal Reserve more effectively monitor the financial system and develop policies for mitigating systemic risks. The OFS's function is to coordinate and analyze information bearing on financial stability from a wide range of perspectives and to place the supervision of individual institutions within a broader macroeconomic and financial context. In

(continued on next page)

attention paid to U.S. securities dealers, raised investor anxiety regarding counterparty exposure to dealers during the second half of 2011. Indeed, responses to the December SCOOS suggested that dealers devoted increased time and attention to the management of concentrated credit exposures to dealers and other financial intermediaries over the previous three months (**figure 18**).[13] In addition, survey respondents reported that they had reduced aggregate credit limits for certain specific institutions. Investors appeared to be particularly concerned about the stability of funding in the event of financial market stress because most dealer firms are highly reliant on short-term secured funding.

Respondents to the December SCOOS reported a broad but moderate tightening of credit terms applicable to important classes of counterparties over the previous three months. This tightening was especially evident for hedge fund clients and trading real estate investment trusts.[14] The institutions that reported having tightened credit terms pointed to a worsening in general market liquidity and functioning and a reduced willingness to take on risk as the most important reasons for doing so. Indeed, for each type of collateral covered in the survey, notable net fractions of respondents reported that liquidity and functioning in the underlying asset market had deteriorated over the previous three months. Dealers reported that the demand for funding most types of securities continued to increase over the previous

[13] Following the failure of a primary dealer, the Federal Reserve Bank of New York implemented a risk-management program that required primary dealers to post margin on forward-settling agency MBS transactions.

[14] Trading real estate investment trusts invest in assets backed by real estate rather than directly in real estate.

Box 1. Financial Stability at the Federal Reserve—*continued*

addition, the Federal Reserve works with other U.S. agencies and international bodies on a range of issues to strengthen the financial system.

Systemic financial risks can take several forms. Some risks can be described as structural in nature because they are associated with structural features of financial markets and thus are largely independent of economic conditions; these include, for example, the risk posed by a SIFI whose failure can have outsized effects on the financial system or the degree to which money market mutual funds are susceptible to liquidity pressures. Other risks can be described as cyclical in nature and include, for example, elevated asset valuations and excessive credit growth that arise in buoyant economic times but can unwind in destabilizing ways should conditions change. Attentiveness to both types of risk is critical in the monitoring of systemic risk and the formulation of appropriate macroprudential policy responses.

The Federal Reserve has taken steps to identify structural vulnerabilities in the financial system and to devise policies to mitigate the associated risks. For example, in December 2011, the Board released a proposal to strengthen the regulation and supervision of large bank holding companies and systemically important nonbank financial firms. The proposal comprises a wide range of measures, including risk-based capital and leverage requirements, liquidity requirements, stress tests, single-counterparty credit limits, and early remediation requirements. In addition, in October 2011, the Board approved a final rule to implement the resolution plan (living will) requirement of the Dodd-Frank Act, which is intended to reduce the likelihood that the failure of a SIFI—should it occur—would cause serious damage to the financial system. In all of its rulemaking responsibilities, the Federal Reserve is attentive to the international dimension of financial regulation. It is also working with its regulatory counterparts to improve the quality and timeliness of financial data.

The Federal Reserve is likewise moving forward to address cyclical systemic risks. To identify such risks, it routinely monitors a number of items—including, for example, measures of leverage and maturity mismatch at financial intermediaries—and looks for signs of a credit-induced buildup of systemic risk. In addition, it conducts regular stress tests of the nation's largest banking firms; these tests are based on detailed confidential data about the balance sheets of the firms and provide a comprehensive, rigorous assessment of how the firms' financial conditions would likely evolve over a multiyear period under adverse economic and financial scenarios. Meanwhile, efforts are under way to evaluate and develop new macroprudential tools that could help limit future buildups of cyclical systemic risk.

In summary, the Federal Reserve has taken a series of actions to implement the relevant provisions of the Dodd-Frank Act and to meet its broader financial stability responsibilities in a timely way. The Federal Reserve has made important changes to its organizational structure to support a macroprudential approach to supervision and regulation, and it has instituted processes for identifying and responding to sources of systemic risk.

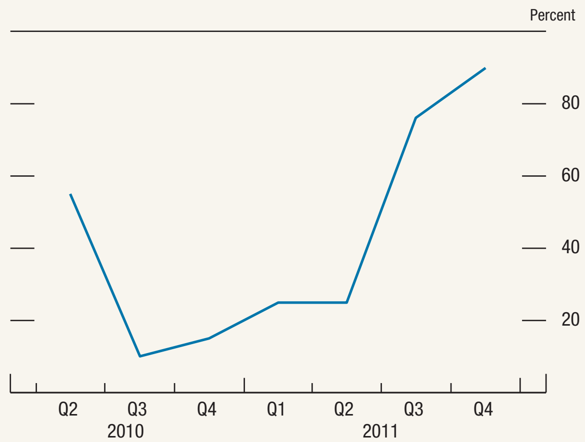
three months, particularly the demand for term funding with a maturity greater than 30 days, which increased for all security types.

Net investment flows to hedge funds in the third and fourth quarters were reportedly significantly smaller than in the first half of the year as hedge funds markedly underperformed the broader market in 2011. Information from a variety of sources suggests that the use of dealer-intermediated leverage has declined, on balance, since mid-2011. Indeed, while the use of dealer-intermediated leverage was roughly unchanged for most types of counterparties according to September and December SCOOS respondents, about half of those surveyed indicated that hedge funds' use of financial leverage, considering the entire range of transactions with such clients, had decreased somewhat.

Corporate Debt and Equity Markets

On net since July of last year, yields on investment-grade corporate bonds have declined notably, while those on speculative-grade corporate debt posted mixed changes. However, reflecting a decline in investor risk-taking amid concerns about the European situation and heightened volatility in financial markets, spreads of these yields to those on comparable-maturity Treasury securities widened notably in the third quarter and have only partly retraced since that time (**figure 19**). In the secondary market for leveraged loans, the average bid price dropped in line with the prices of other risk assets in August but has

Figure 18. Net percentage of dealers reporting increased attention to exposure to other dealers, 2010–11

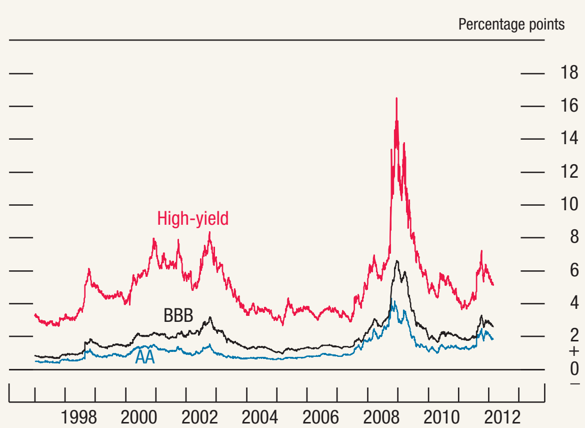


Note: The data are drawn from a survey conducted four times per year; the last observation is from the December 2011 survey, which covers 2011:Q4. Net percentage equals the percentage of institutions that reported increasing attention ("increased considerably" or "increased somewhat") minus the percentage of institutions that reported decreasing attention ("decreased considerably" or "decreased somewhat").

Source: Federal Reserve Board, Senior Credit Officer Opinion Survey on Dealer Financing Terms.

recovered since then, as institutional investors—which include collateralized loan obligations, pension funds, insurance companies and other funds investing in fixed-income instruments—have reportedly continued to exhibit strong appetites for higher-yielding leveraged loans against a backdrop of little new supply of such loans. Liquidity in that market has recovered recently after a sharp deterioration during the summer.

Figure 19. Spreads of corporate bond yields over comparable off-the-run Treasury yields, by securities rating, 1997–2012



Note: The data are daily and extend through February 24, 2012. The spreads shown are the yields on 10-year bonds less the 10-year Treasury yield.

Source: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

Broad equity prices are about unchanged, on balance, since mid-2011 but exhibited an unusually high level of volatility. Equity markets fell sharply in late July and early August in response to concerns about the European crisis, the U.S. debt ceiling debate, and a possible slowdown in global growth. Equity prices roughly retraced these losses during the fourth quarter of 2011 and early 2012, reflecting somewhat better-than-expected economic data in the United States as well as actions taken by major central banks to mitigate the financial strains in Europe. Nonetheless, equity prices have remained highly sensitive to news regarding developments in Europe. Implied volatility for the S&P 500 index, calculated from option prices, ramped up in the third quarter of 2011 but has since reversed much of that rise.

Amid heightened stock market volatility over the course of the second half of 2011, equity mutual funds experienced sizable outflows. Loan funds, which invest primarily in LIBOR-based syndicated leveraged loans, also experienced outflows as retail investors responded to loan price changes following indications that the Federal Reserve would keep interest rates lower for longer than previously anticipated. With declining yields on fixed-income securities boosting the performance of bond mutual funds, these funds, including speculative-grade and municipal bond funds, attracted net inflows.

Monetary Aggregates and the Federal Reserve's Balance Sheet

The M2 monetary aggregate expanded at an annual rate of about 12 percent over the second half of 2011.[15] The rapid growth in M2 appears to be the result of increased demand for safe and liquid assets due to concerns about the European situation, combined with a very low level of interest rates on alter-

[15] M2 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; (4) other checkable deposits (negotiable order of withdrawal, or NOW, accounts and automatic transfer service accounts at depository institutions; credit union share draft accounts; and demand deposits at thrift institutions); (5) savings deposits (including money market deposit accounts); (6) small-denomination time deposits (time deposits issued in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (7) balances in retail money market funds less IRA and Keogh balances at money market funds.

native short-term investments. In addition, a number of regulatory changes have likely boosted M2 of late. In particular, unlimited insurance by the Federal Deposit Insurance Corporation (FDIC) of onshore noninterest-bearing deposits has made these deposits increasingly attractive at times of heightened volatility and uncertainty in financial markets. In addition, the change in the FDIC assessment base in April 2011 added deposits in domestic banks' offshore offices, eliminating some of the benefits to banks of booking deposits abroad and apparently leading, in some cases, to a decision to rebook some of these deposits onshore. Indeed, liquid deposits, the single largest component of M2, grew at an annual rate of 20 percent in the second half of 2011.[16] The currency component of the money stock grew at an annual rate of 7 percent over the second half of 2011, a bit faster than the historical average but a slower pace than in the first half of the year. The monetary base—which is equal to the sum of currency in circulation and the reserve balances of depository institutions held at the Federal Reserve—expanded at an annual rate of 3¾ percent in the second half of the year, as the rise in currency more than offset a slight decrease in reserve balances.[17]

The size of the Federal Reserve's balance sheet remained at a historically high level throughout the second half of 2011 and into early 2012 and stood at about $2.9 trillion as of February 22. The small rise of about $61 billion since July largely reflected increases in temporary U.S. dollar liquidity swap balances with the ECB, which were partially offset by a decline in securities holdings (**table 1**). Holdings of U.S. Treasury securities grew $32 billion over the second half of 2011, as the proceeds from paydowns of agency debt and agency MBS were reinvested in longer-term Treasury securities until the FOMC decision in September to switch the reinvestment of those proceeds to agency MBS; total holdings of MBS declined into the fall. The subsequent small increase in MBS holdings reflects the reinvestment of maturing agency debt into MBS. Agency debt declined about $14 billion over the entire period. The composition of Treasury holdings also changed over this period as a result of the implementation of the MEP. As of February 24, 2012, the Open Market Desk at the Federal Reserve Bank of New York (FRBNY) had purchased $211 billion in Treasury securities with remaining maturities of 6 to 30 years and sold $223 billion in Treasury securities with maturities of 3 years or less.

In the second half of 2011 and early 2012, the Federal Reserve reduced some of its exposure to lending facilities established during the financial crisis to support specific institutions. The portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC—entities that were created during the crisis to acquire certain assets from the Bear Stearns Companies, Inc., and American International Group, Inc., or AIG, to avoid the disorderly failures of those institutions—declined, on net, primarily as a result of asset sales and principal payments. Of note, the FRBNY sold assets with a face amount of $13 billion from the Maiden Lane II portfolio in early 2012 through two competitive processes conducted by the FRBNY's investment manager.[18]

Use of regular discount window lending facilities, such as the primary credit facility, continued to be minimal. Loans outstanding under the Term Asset-Backed Securities Loan Facility declined and stood just below $8 billion in late February.

On November 30, 2011, in order to ease strains in global financial markets and thereby mitigate the effects of such strains on the supply of credit to U.S. households and businesses, the Federal Reserve announced coordinated actions with other central banks to enhance their capacity to provide liquidity support to the global financial system.[19] The FOMC authorized an extension of the existing temporary U.S. dollar liquidity swap arrangements through February 1, 2013, and the rate on these swap arrangements was reduced from the U.S. dollar OIS rate plus 100 basis points to the OIS rate plus 50 basis points.

[16] Regulation Q, which had prohibited the payment of interest on demand deposits, was repealed by the Board on July 14. This repeal may have also contributed, in a small way, to the growth in M2.

[17] The MEP that was announced at the September FOMC meeting was designed to increase the average maturity of the Federal Reserve's securities holdings while leaving the quantity of reserve balances roughly unchanged.

[18] On January 19, 2012, the FRBNY announced the sale of assets with a face amount of $7.0 billion from the Maiden Lane II LLC portfolio through a competitive process. On February 8, 2012, the FRBNY announced the sale of additional assets with a face amount of $6.2 billion from the Maiden Lane II LLC portfolio, also through a competitive process. Proceeds from these two transactions will enable the repayment of the entire remaining outstanding balance of the senior loan from the FRBNY to Maiden Lane II LLC.

[19] The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank coordinated this action. In addition, as a contingency measure, the FOMC agreed to establish similar temporary swap arrangements with these five central banks to provide liquidity in any of their currencies if necessary.

Table 1. Selected components of the Federal Reserve balance sheet, 2010–12
Millions of dollars

Balance sheet item	Dec. 29, 2010	July 6, 2011	Feb. 22, 2012
Total assets	**2,423,457**	**2,874,049**	**2,935,149**
Selected assets			
Credit extended to depository institutions and dealers			
Primary credit	58	5	3
Central bank liquidity swaps	75	0	107,959
Credit extended to other market participants			
Term Asset-Backed Securities Loan Facility (TALF)	24,704	12,488	7,629
Net portfolio holdings of TALF LLC	665	757	825
Support of critical institutions			
Net portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC[1]	66,312	59,637	30,822
Credit extended to American International Group, Inc.	20,282	...	...
Preferred interests in AIA Aurora LLC and ALICO Holdings LLC	26,057	...	...
Securities held outright			
U.S. Treasury securities	1,016,102	1,624,515	1,656,581
Agency debt securities	147,460	115,070	100,817
Agency mortgage-backed securities (MBS)[2]	992,141	908,853	853,045
Total liabilities	**2,366,855**	**2,822,382**	**2,880,556**
Selected liabilities			
Federal Reserve notes in circulation	943,749	990,861	1,048,004
Reverse repurchase agreements	59,246	67,527	89,824
Deposits held by depository institutions	1,025,839	1,663,022	1,622,800
Of which: Term deposits	5,113	0	0
U.S. Treasury, general account	88,905	67,270	36,033
U.S. Treasury, Supplementary Financing Account	199,963	5,000	0
Total capital	**56,602**	**51,667**	**54,594**

Note: LLC is a limited liability company.

1 The Federal Reserve has extended credit to several LLCs in conjunction with efforts to support critical institutions. Maiden Lane LLC was formed to acquire certain assets of the Bear Stearns Companies, Inc. Maiden Lane II LLC was formed to purchase residential mortgage-backed securities from the U.S. securities lending reinvestment portfolio of subsidiaries of American International Group, Inc. (AIG). Maiden Lane III LLC was formed to purchase multisector collateralized debt obligations on which the Financial Products group of AIG has written credit default swap contracts.

2 Includes only MBS purchases that have already settled.

. . . Not applicable.

Source: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks."

The lower cost spurred increased use of those swap lines; the outstanding amount of dollars provided through the swap lines rose from zero in July to roughly $108 billion in late February.

On the liability side of the Federal Reserve's balance sheet, reserve balances held by depository institutions declined roughly $40 billion in the second half of 2011 and early 2012 while Federal Reserve notes in circulation increased roughly $57 billion. The Federal Reserve conducted a series of small-scale reverse repurchase transactions involving all eligible collateral types and its expanded list of counterparties. The Federal Reserve also continued to offer small-value term deposits through the Term Deposit Facility. In July of last year, the Treasury reduced the balance of its Supplementary Financing Account at the Federal Reserve from $5 billion to zero.

International Developments

In the second half of the year, financial market developments abroad were heavily influenced by concerns about the heightened fiscal stresses in Europe and the resultant risks to the global economic outlook. Foreign real GDP growth stepped up in the third quarter, as Japan rebounded from the effects of its March earthquake and tsunami, leading to an easing of supply chain disruptions. In contrast, recent data indicate that foreign economic growth slowed in the fourth quarter, as activity in the euro area appears to have contracted and as flooding in Thailand weighed on growth in several economies in Asia.

International Financial Markets

The foreign exchange value of the dollar has risen since July about 3½ percent on a trade-weighted basis against a broad set of currencies (**figure 20**).

Figure 20. U.S. dollar nominal exchange rate, broad index, 2007–12

Note: The data, which are in foreign currency units per dollar, are daily. The last observation for the series is February 24, 2012. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of the most important U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

Source: Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

Most of the appreciation occurred in September as market participants became increasingly pessimistic about the situation in Europe. Safe-haven flows buoyed the yen and the Swiss franc, and in response, the Bank of Japan and the Swiss National Bank separately intervened to counter further appreciation of their currencies.

On net in the second half of the year, government bond yields for Canada, Germany, and the United Kingdom fell over 100 basis points to record lows, driven by safe-haven flows as well as a deteriorating global outlook. By contrast, sovereign bond spreads for Greece rose steeply, and Spanish and Italian sovereign spreads over German bunds also increased. Prices of other risky assets were very volatile over the period as market participants reacted to news about the crisis. (See **box 2**.)

As sovereign funding pressures spread to Italy and Spain in July and August and as concerns also mounted regarding U.S. fiscal policy and the durability of the global recovery, equity prices in the advanced foreign economies (AFEs) generally plunged. Those equity markets remained quite volatile but largely depressed through early December, when market sentiment seemed to take a more concerted turn for the better. Although most AFE equity indexes remain below their midsummer levels, they have risen markedly in the past two months. Emerging markets equity prices followed a path similar to those in the AFEs. Emerging markets bond and equity funds experienced large outflows during periods of heightened concerns about the European crisis, but inflows have resumed more recently.

Euro-area bank stock prices underperformed the broader market, as concerns about the health of European banks intensified over the second half of 2011. The CDS premiums on the debt of many large banks in Europe rose substantially, reflecting market views of increased risk of default. Quarterly earnings for many banks were reduced by write-downs on Greek debt. Although only eight banks failed the European Banking Authority (EBA) European Union–wide stress test in July, concerns about the capital adequacy of large European banks persisted. Partly in response to these concerns, the EBA announced in October that banks would be required to put in place a temporary extraordinary capital buffer by June 2012, boosting their core Tier 1 risk-based capital ratio to 9 percent. As market sentiment about European banks deteriorated over the period, their access to unsecured dollar funding diminished, particularly at tenors beyond one week. (See **box 3**.) European banks also faced pressure in euro funding markets. As banks' willingness to lend excess liquidity to one another decreased, the cost of obtaining funding in the market rose, and banks relied more heavily on the ECB for funding. The first three-year refinancing operation, held by the ECB on December 21, led to a significant injection of new liquidity, and funding conditions in Europe seemed to improve gradually in the weeks that followed. Short-term euro interbank rates declined, euro-area shorter-duration sovereign bond yields fell sharply, and both governments and banks were able to raise funds more easily.

The Financial Account

Financial flows in the second half of 2011 reflected heightened concerns about risk and the pressures in currency markets resulting from the European crisis. Based on data for the third quarter and monthly indicators for the fourth quarter (not shown), foreign private investors flocked to U.S. Treasury securities as a safe-haven investment while selling U.S. corporate securities, especially in months when appetite for risk was particularly weak. U.S. investors also pulled back from investments in Europe, significantly reduc-

Box 2. An Update on the European Fiscal Crisis

The European fiscal crisis intensified in the second half of 2011, as concerns over fiscal sustainability spread to additional euro-area economies amid weakening economic growth prospects and missed fiscal targets. European financial institutions also faced sharply reduced access to funds, given their large exposures to vulnerable sovereigns. In response, policymakers took steps to improve fiscal balances, bolster the region's financial backstop, and address liquidity shortages for banks. On balance, market conditions have improved somewhat since December, but concerns about a possible Greek default and the adequacy of the financial backstop for other vulnerable economies have kept yields on sovereign debt elevated and funding for European financial institutions limited.

The crisis began in smaller euro-area countries with high fiscal deficits or debt and vulnerable banking systems. In 2010 and the first half of 2011, governments in Greece, Ireland, and Portugal suffered reduced access to market funding and required financial assistance from the European Union (EU) and the International Monetary Fund (IMF). Last July, sovereign spreads over German bunds rose markedly for Italy and Spain, as economic growth disappointed, doubts increased over political commitment to fiscal consolidation, and calls for the restructuring of Greek sovereign debt rattled investor confidence. The deterioration of financial conditions led to heightened political tensions in vulnerable economies, contributing to leadership changes in Greece, Italy, and Spain later in the fall.

Financial stresses spread quickly to European banks with large exposures to Italy, Spain, and the other vulnerable economies, and access to funding became limited for all but the shortest maturities and strongest institutions. In turn, concerns over the potential fiscal burdens for governments, should they need to recapitalize financial institutions, caused sovereign yields to rise sharply in the fall for other euro-area countries, including Austria, Belgium, and France.

European leaders responded to these developments with a number of policy measures. In July, amid the growing realization that Greece would need further financial assistance, EU and IMF officials announced plans for a second rescue package, including a call for limited reduction in the value of the debt held by private creditors. In February 2012, in response to Greece's faltering fiscal performance and plunging output, the Greek government and its creditors agreed on an enhanced rescue package, including a larger reduction in private creditors' claims. The Greek government and its creditors are now working to put in place the private-sector debt exchange and the new official-sector support program before a large debt amortization payment comes due in mid-March.

In recent months, European authorities have also made progress on plans to improve fiscal governance within the region. EU members (excluding the United Kingdom and Czech Republic) have agreed on the text of a new fiscal compact treaty designed to strengthen fiscal rules, surveillance, and enforcement. Among other measures, this treaty will require countries to legislate national fiscal rules, which should generally limit structural fiscal deficits to ½ percent of gross domestic product. The treaty is expected to be signed in March, after which national parliaments must ratify it and implement the required legislation.

Leaders also took a number of steps to increase the size of the financial backstop for the euro area. The flexibility, scope, and effective lending capacity of the €440 billion European Financial Stability Facility (EFSF), designed to support vulnerable governments, were increased. Authorities also moved up the introduction of the European Stability Mechanism (ESM), a permanent €500 billion lending facil-

(continued on next page)

ing deposits with European banks and selling securities from euro-area countries. Overall, U.S. purchases of foreign securities edged down in the third quarter.

The large purchases of Treasury securities dominated total private financial flows in the third quarter, a pattern that likely continued in the fourth quarter. Net flows by banks located in the United States were small, but these flows masked large offsetting movements by foreign- and U.S.-owned banks. U.S. branches of European banks brought in substantial funds from affiliates abroad over the course of 2011, building reserve balances in the first half of the year and covering persistent declines in U.S. funding sources. In contrast, U.S. banks, subject to less-severe market stress, sent funds abroad to meet strong dollar demand.

Inflows from foreign official institutions slowed notably in the second half of 2011. A number of advanced countries acquired some U.S. assets, seeking to counteract upward pressure on their currencies by purchasing U.S. dollars in foreign exchange markets. However, inflows from official institutions in the

Box 2. An Update on the European Fiscal Crisis—*continued*

ity, to July 2012, about a year earlier than originally planned. This March, euro-area leaders will consider lifting the €500 billion ceiling on the combined lending of the EFSF and the ESM. In addition, European officials called for an expansion of the IMF's lending capacity and pledged a joint contribution of €150 billion toward that goal. Finally, to improve the functioning of sovereign debt markets, the European Central Bank (ECB) resumed purchases of euro-area marketable debt in August, reportedly including the debt of Italy and Spain.

Policymakers also took steps to support financial markets and institutions affected by the sovereign crisis. To improve transparency and bolster the ability of European banks to withstand losses on sovereign holdings, the European Banking Authority (EBA) conducted a second stress test of large EU financial institutions, the results of which were released in mid-July, along with detailed information about banks' exposures to borrowers in EU countries. Market concerns about bank capital persisted, however, and in October, the EBA announced that large banks would be required to build up "exceptional and temporary" capital buffers to meet a core Tier 1 capital ratio of 9 percent and cover the cost of marking sovereign exposures to market by the end of June 2012. In December, the EBA disclosed that the aggregate required capital buffer for large banks would be €115 billion if risk-weighted assets were to remain at the levels they had reached at the end of September 2011. The banks submitted their capital plans to their national supervisors for approval, and the EBA has now summarized these plans. Excluding the Greek banks and three other institutions that will be recapitalized separately by national authorities, the remaining 62 banks intend to create capital buffers equivalent to €98 billion, about 25 percent larger than their required buffers, and they plan to use direct capital measures (such as retaining earnings, issuing new shares, and converting hybrid instruments to common equity) to achieve €75 billion of their buffer. The remainder of the buffer will be generated by measures that reduce risk-weighted assets—primarily selling assets and switching from the standardized to the advanced approach to measure risk weights. These measures will be subject to supervisory agreement.

To address spillovers to U.S. dollar funding markets from stresses in Europe, in late November the Federal Reserve, the ECB, and four other major central banks agreed to reduce the fee on draws on their dollar liquidity swap lines and extend the duration of such facilities. In early December, the ECB announced a reduction in its policy interest rate and its reserve requirement, an easing of rules on collateral for ECB refinancing operations, and the provision of three-year refinancing to banks to improve their funding situation. Banks borrowed €489 billion at the new facility in December, raising the total amount of outstanding ECB refinancing operations by roughly €200 billion. A second three-year liquidity operation is scheduled for the end of February.

The improved availability of dollar and euro funds late in the year, against the background of the other policies being employed to address the crisis, appears to have partly allayed market concerns about banks as well as governments in vulnerable euro-area countries. Over the past two months, European banks have seen improvements in their access to funding, and in vulnerable economies, credit spreads on the banks and spreads on government bonds have generally declined. Nevertheless, significant risks remain as Europeans struggle to implement the new Greek program and debt exchange, meet targets for budgets and bank capital, and expand the financial backstop. Over the longer term, the region must meet the difficult challenges of achieving sustained fiscal consolidation, stimulating growth, and improving competitiveness.

EMEs trended down significantly in 2011, especially in the third and fourth quarters when the strength of the dollar led to reductions in their intervention activity.

Advanced Foreign Economies

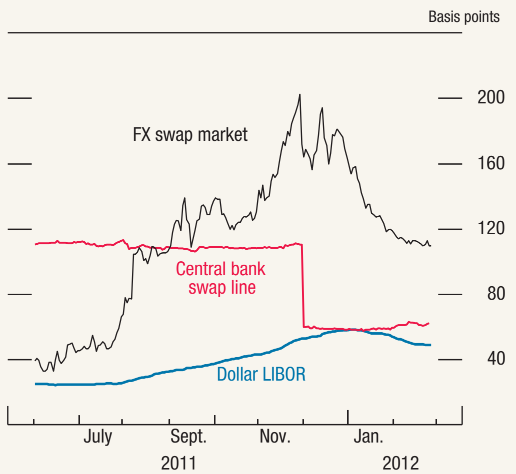
The intensification of the euro-area sovereign debt crisis was accompanied by a widespread slowing of economic activity in the AFEs. In the euro area, financial tensions increased despite the various measures announced by European leaders to combat the crisis. Real GDP contracted in the euro area at the end of last year according to preliminary estimates, and spillovers from the euro area likely contributed to the fourth-quarter GDP decline in the United Kingdom. In Japan, economic activity rebounded rapidly from the disruptions of the March earthquake and tsunami but dipped again in the last quarter of 2011 as exports slumped. In Canada, elevated commodity prices and a resilient labor market have supported economic activity, but the export sector is showing signs of weakening.

Survey indicators suggest that conditions improved somewhat around the turn of the year, with widespread upticks in different countries' purchasing managers indexes. However, uncertainty about the

Box 3. U.S. Dollar Funding Pressures and Dollar Liquidity Swap Arrangements

As the euro-area crisis intensified, European banks faced greater dollar funding pressures. Many European banks were especially vulnerable to changes in investor sentiment through their reliance on short-term dollar-denominated funding. As market sentiment deteriorated, European banks' access to medium- and long-term dollar funding markets diminished markedly, with many unable to obtain unsecured dollar funding at maturities exceeding one week. The pullback of U.S. money market funds (MMFs) from liabilities of euro-area banks beginning in mid-2011 was an important part of the runoff of short-term dollar funds, although MMFs were not the only investors to reduce their exposures to European banks. As a result, many European banks faced higher dollar funding costs. For example, the cost for euro-area banks to obtain three-month dollar funding through the foreign exchange (FX) swap market rose as financial pressures increased. The cost of dollar funding through this market (the black line in figure A), as banks borrow euros at the euro London interbank offered rate (LIBOR) and swap into dollars in the FX swap market, rose from 40 basis points early last summer to about 200 basis points in late November.

Figure A. Costs of three-month dollar funding through the foreign exchange swap market, the central bank swap line, and dollar LIBOR, 2011–12



Note: The data are daily. The last observation for each series is February 24, 2012. Three-month dollar funding through the foreign exchange (FX) swap market assumes that the banks first pay euro LIBOR (London interbank offered rate) to obtain euro funding.

Source: Bloomberg.

Although the effects of these dollar funding strains are difficult to gauge, they pose substantial risks for the U.S. economy. Large European banks borrow heavily in dollars partly because they are active in U.S. markets, purchasing government and corporate securities as well as making loans to U.S. households and businesses. A possible response to dollar funding strains, along with heightened capital requirements, might be for European banks to sell their dollar assets or refrain from further dollar lending, which could in turn result in a reduction of the credit they supply to U.S. firms and households while also reducing credit to European and other foreign firms involved in trade with the United States. Therefore, further stresses on European banks could spill over to the United States by weighing on business and consumer activity, restraining our exports, and adding to pressures on U.S. financial markets and institutions.

To address strains in dollar funding markets, the Federal Reserve, the European Central Bank (ECB), and the central banks of Canada, Japan, Switzerland, and the United Kingdom announced an agreement on November 30 to revise, extend, and expand the U.S. dollar swap lines. The revised agreement lowered the price of dollar funding provided through the swaps (the red line in figure A) to a rate of 50 basis points over the dollar overnight index swap rate, a reduction of 50 basis points in the rate at which the foreign central banks had been providing dollar loans since May 2010.

The reduction in dollar funding costs due to the revised pricing of the central bank swap lines helped strengthen the liquidity positions of European and other foreign banks, thereby benefiting the United States by supporting the continued supply of credit to U.S. households and businesses while mitigating other channels of risk. Draws on the swap lines, especially from the ECB, have been significant. On December 7, at the first three-month dollar tender under the new pricing scheme, the ECB allocated about $51 billion, a substantial increase over previous operations. As of February 24, the ECB, the Bank of Japan, and the Swiss National Bank had about $89 billion, $18 billion, and $0.5 billion outstanding, respectively, from their dollar swap line allotments, for a total of about $108 billion. In an indication that the swap lines have been effective at reducing overall dollar funding pressure, the cost of obtaining dollars in the FX swap market has dropped substantially since November 30. Dollar LIBOR, which measures dollar funding costs in the interbank market for U.S. and foreign institutions, has also declined over the past two months.

resolution of the euro-area crisis continues to affect investors' sentiment, while trade and financial spillovers weigh on activity for all of the AFEs.

Twelve-month headline inflation remained elevated in most of the AFEs through the end of 2011, largely reflecting the run-up in commodity prices earlier last year and, in some countries, currency depreciation and increases in taxes. However, underlying inflation pressures remained contained and, in recent months, inflation rates have begun to turn down, reflecting weaker economic activity and, as in the United States, declines in commodity prices since last spring. As with output, inflation performance differs significantly across countries. Twelve-month headline inflation currently ranges from 3.6 percent in the United Kingdom, partly due to hikes in utility prices, to slightly negative in Japan, where deflation resumed toward the end of 2011 as energy price inflation moderated.

Several foreign central banks in the AFEs eased monetary policy in the second half of last year. The ECB cut its policy rate 50 basis points in the fourth quarter, bringing the main refinancing rate back to 1 percent, where it was at the beginning of the year. At its December meeting, the ECB also expanded its provision of liquidity to the banking sector by introducing two three-year longer-term refinancing operations, reducing its reserve ratio requirement from 2 percent to 1 percent, and easing its collateral requirements. The Bank of England has held the Bank Rate at 0.5 percent but announced a £75 billion expansion of its asset purchase facility in October and a further £50 billion increase in February that will bring total asset holdings to £325 billion upon its completion in May 2012. The Bank of Japan also expanded its asset purchase program, raising it from ¥15 trillion to ¥20 trillion in October and then to ¥30 trillion in February.

Emerging Market Economies

Many EMEs experienced a slowdown in economic growth in the third quarter of last year relative to the pace seen in the first half. Both earlier policy tightening, undertaken amid concerns about overheating, and weakening external demand weighed on growth. However, third-quarter growth in China and Mexico remained strong, supported by robust domestic demand. Recent data indicate that the slowdown continued and broadened in the fourth quarter, as the financial crisis in Europe softened external demand and the floods in Thailand impeded supply chains. In the second half of last year, concerns about the global economy prompted EME authorities either to put monetary policy tightening on hold or, in several cases—such as Brazil, China, Indonesia, and Thailand—to loosen monetary policy.

In China, real GDP growth stepped down to an annual rate of about 8 percent in the fourth quarter. Retail sales and fixed-asset investment slowed a touch but continued to grow briskly, reflecting solid domestic demand. But net exports exerted a small drag on growth, as weak external demand damped exports. Twelve-month headline inflation moderated to about 4½ percent in January, as food prices retreated from earlier sharp rises. With growth slowing and inflation on the decline, Chinese authorities reversed the course of monetary policy toward easing by lowering the reserve requirement for large banks 100 basis points to 20.5 percent. In 2011, the Chinese renminbi appreciated 4½ percent against the dollar and about 6 percent on a real trade-weighted basis; the latter measure gauges the renminbi's value against the currencies of China's major trading partners and adjusts for differences in inflation rates.

In Mexico, economic activity accelerated in the second and third quarters as domestic demand expanded robustly. However, incoming indicators, such as tepid growth of exports to the United States, point to a slowdown in the fourth quarter. Mexican consumer price inflation rose sharply in the second half of the year, driven largely by rising food prices and the removal of electrical energy subsidies. In Brazil, in contrast to most EMEs, GDP contracted slightly in the third quarter, but incoming indicators point to a return to growth in the fourth quarter, partly as a result of several rounds of monetary policy easing that began in August. As the direction of capital flows turned to a net outflow, Brazilian authorities loosened capital controls that had been introduced earlier in the face of massive inflows and associated fears of overheating.

Part 3
Monetary Policy: Recent Developments and Outlook

Monetary Policy over the Second Half of 2011 and Early 2012

To promote the Federal Open Market Committee's (FOMC) objectives of maximum employment and price stability, the Committee maintained a target range for the federal funds rate of 0 to ¼ percent throughout the second half of 2011 and into 2012. With the incoming data suggesting a somewhat slower pace of economic recovery than the Committee had anticipated, and with inflation seen as settling at levels at or below those consistent with its statutory mandate, the Committee took steps during the second half of 2011 and in early 2012 to provide additional monetary accommodation in order to support a stronger economic recovery and to help ensure that inflation, over time, runs at levels consistent with its mandate. These steps included strengthening its forward rate guidance regarding the Committee's expectations for the period over which economic conditions will warrant exceptionally low levels for the federal funds rate, increasing the average maturity of the Federal Reserve's securities holdings through a program of purchases and sales, and reinvesting principal payments on agency securities in agency-guaranteed mortgage-backed securities (MBS) rather than Treasury securities.

On August 1, the Committee met by videoconference to discuss issues associated with contingencies in the event that the Treasury was temporarily unable to meet its obligations because the statutory federal debt limit was not raised or in the event of a downgrade of the U.S. sovereign credit rating. Participants generally anticipated that there would be no need to make changes to existing bank regulations, the operation of the discount window, or the conduct of open market operations.[20] With respect to potential policy actions, participants agreed that the appropriate response would depend importantly on the actual conditions in markets and should generally consist of standard operations.

The information reviewed at the regularly scheduled FOMC meeting on August 9 indicated that the pace of the economic recovery had remained slow in recent months and that labor market conditions continued to be weak. In addition, revised data for 2008 through 2010 from the Bureau of Economic Analysis indicated that the recent recession had been deeper than previously thought and that the level of real gross domestic product (GDP) had not yet regained its pre-recession peak by the second quarter of 2011. Moreover, downward revisions to first-quarter GDP growth and the slow growth reported for the second quarter indicated that the recovery had been quite sluggish in the first half of 2011. Private nonfarm payroll employment rose at a considerably slower pace in June and July than earlier in the year, and participants noted a deterioration in labor market conditions, slower household spending, a drop in consumer and business confidence, and continued weakness in the housing sector. Inflation, which had picked up earlier in the year as a result of higher prices for some commodities and imported goods as well as supply chain disruptions resulting from the natural disaster in Japan, moderated more recently as prices of energy and some commodities fell back from their earlier peaks. Longer-term inflation expectations remained stable. U.S. financial markets were strongly influenced by developments regarding the fiscal situations in the United States and in Europe and by generally weaker-than-expected readings on economic activity, as foreign economic growth appeared to have slowed significantly. Yields on nominal Treasury securities fell notably, on net, while yields on both investment- and speculative-grade corporate bonds fell a little less than those on comparable-maturity Treasury securities, leaving risk spreads wider. Broad U.S. stock price indexes declined significantly.

Most members agreed that the economic outlook had deteriorated by enough to warrant a Committee response at the August meeting. Those viewing a shift toward more accommodative policy as appropriate generally agreed that a strengthening of the Committee's forward guidance regarding the federal funds rate, by being more explicit about the period over which the Committee expected the federal funds rate to remain exceptionally low, would be a measured response to the deterioration in the outlook over the intermeeting period. The Committee agreed to keep the target range for the federal funds rate at 0 to ¼ percent and to state that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. That anticipated path for the federal funds rate was viewed as appropriate in light of most members' outlook for the economy.

The data in hand at the September 20–21 FOMC meeting indicated that economic activity continued to expand at a slow pace and that labor market conditions remained weak. Consumer price inflation appeared to have moderated since earlier in the year as prices of energy and some commodities declined from their peaks, but it had not yet come down as much as participants had expected at previous meetings. Industrial production expanded in July and August, real business spending on equipment and software appeared to expand further, and real con-

[20] *Members* of the FOMC consist of the members of the Board of Governors of the Federal Reserve System plus the president of the Federal Reserve Bank of New York and 4 of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. *Participants* at FOMC meetings consist of the members of the Board of Governors of the Federal Reserve System and all 12 Reserve Bank presidents.

sumer spending posted a solid gain in July. However, private nonfarm employment rose only slightly in August, and the unemployment rate remained high. Consumer sentiment deteriorated significantly further in August and stayed downbeat in early September. Activity in the housing sector continued to be depressed by weak demand, uncertainty about future home prices, tight credit conditions for mortgages and construction loans, and a substantial inventory of foreclosed and distressed properties. Financial markets were volatile over the intermeeting period as investors responded to somewhat disappointing news, on balance, regarding economic activity in the United States and abroad. Weak economic data contributed to rising expectations among market participants of additional monetary accommodation; those expectations and increasing concerns about the financial situation in Europe led to an appreciable decline in intermediate- and longer-term nominal Treasury yields. Fluctuations in investors' level of concern about European fiscal and financial prospects also contributed to market volatility, particularly in equity markets, and spreads of yields on investment- and speculative-grade corporate bonds over those on comparable-maturity Treasury securities rose significantly over the intermeeting period, reaching levels last registered in late 2009.

In the discussion of monetary policy, most members agreed that the outlook had deteriorated somewhat, and that there were significant downside risks to the economic outlook, including strains in global financial markets. As a result, the Committee decided that providing additional monetary accommodation would be appropriate to support a stronger recovery and to help ensure that inflation, over time, was at a level consistent with the Committee's dual mandate. Those viewing greater policy accommodation as appropriate at this meeting generally supported a maturity extension program that would combine asset purchases and sales to extend the average maturity of securities held in the System Open Market Account without generating a substantial expansion of the Federal Reserve's balance sheet or reserve balances. Specifically, those members supported a program under which the Committee would announce its intention to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. They expected this program to put downward pressure on longer-term interest rates and to help make broader financial conditions more accommodative. In addition, to help support conditions in mortgage markets, the Committee decided to reinvest principal received from its holdings of agency debt and agency MBS in agency MBS rather than continuing to reinvest those funds in longer-term Treasury securities as had been the Committee's practice since the August 2010 FOMC meeting. At the same time, the Committee decided to maintain its existing policy of rolling over maturing Treasury securities at auction. In its statement, the Committee noted that it would continue to regularly review the size and composition of its securities holdings and that it was prepared to adjust those holdings as appropriate. The Committee also decided to keep the target range for the federal funds rate at 0 to ¼ percent and to reaffirm its anticipation that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

The information reviewed at the November 1–2 meeting indicated that the pace of economic activity strengthened somewhat in the third quarter, reflecting in part a reversal of the temporary factors that weighed on economic growth in the first half of the year. Global supply chain disruptions associated with the natural disaster in Japan had diminished, and the prices of energy and some commodities had come down from their recent peaks, easing strains on household budgets and likely contributing to a somewhat stronger pace of consumer spending in recent months. Real equipment and software investment expanded appreciably, and real personal consumption expenditures (PCE) rose moderately in the third quarter. However, real disposable income declined in the third quarter and consumer sentiment continued to be downbeat in October. In addition, labor market conditions remained weak as the pace of private-sector job gains in the third quarter as a whole was less than it was in the first half of the year. Overall consumer price inflation was more moderate than earlier in the year, as prices of energy and some commodities declined from their recent peaks, and measures of longer-run inflation expectations remained stable. Financial markets were quite volatile and investor sentiment was strongly influenced by prospects for Europe, as market participants remained highly attuned to developments regarding possible steps to contain the fiscal and banking problems there. Longer-term Treasury yields declined appreciably, on net, over the period, and yields on investment- and speculative-grade corporate bonds moved lower, leaving their spreads to Treasury securities slightly narrower. Although equity markets were volatile, broad U.S. equity price indexes ended the intermeeting period little changed.

Most FOMC members anticipated that the pace of economic growth would remain moderate over coming quarters, with unemployment declining only gradually and inflation settling at or below levels consistent with the dual mandate. Moreover, the recovery was still seen as subject to significant downside risks, including strains in global financial markets. Accordingly, in the discussion of monetary policy, all Committee members agreed to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced in September. The Committee decided to maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency MBS in agency MBS and of rolling over maturing Treasury securities at auction. In addition, the Committee agreed to keep the target range for the federal funds rate at 0 to ¼ percent and to reiterate its expectation that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

Over subsequent weeks, financial markets appeared to become increasingly concerned that a timely resolution of the European sovereign debt situation might not occur despite the measures that authorities there announced in October; pressures on European sovereign debt markets increased, and conditions in European funding markets deteriorated appreciably. The greater financial stress appeared likely to damp economic activity in the euro area and potentially to pose a risk to the economic recovery in the United States.

On November 28, the Committee met by videoconference to discuss a proposal to amend and augment the Federal Reserve's temporary liquidity swap arrangements with foreign central banks in light of the increased strains in global financial markets. The proposal included a six-month extension of the sunset date and a 50 basis point reduction in the pricing on the existing dollar liquidity swap arrangements with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank (ECB), and the Swiss National Bank. In addition, the proposal included the establishment, as a contingency measure, of swap arrangements that would allow the Federal Reserve to provide liquidity to U.S. institutions in foreign currencies should the need arise. The proposal was aimed at helping to ease strains in financial markets and thereby to mitigate the effects of such strains on the supply of credit to U.S. households and businesses, thus supporting the economic recovery. Most participants agreed that the proposed changes to the swap arrangements would represent an important demonstration of the commitment of the Federal Reserve and the other central banks to work together to support the global financial system. At the conclusion of the discussion, almost all members agreed to support the changes to the existing swap line arrangements and the establishment of the new foreign currency swap agreements.

As of the December 13 FOMC meeting, the data indicated that U.S. economic activity had expanded moderately despite some apparent slowing in the growth of foreign economies and strains in global financial markets. Conditions in the labor market seemed to have improved somewhat, as the unemployment rate dropped in November and private nonfarm employment continued to increase moderately. In October, industrial production rose, and overall real PCE grew modestly following significant gains in the previous month. However, revised estimates indicated that households' real disposable income declined in the second and third quarters, the net wealth of households decreased, and consumer sentiment was still at a subdued level in early December. Activity in the housing market remained depressed by the substantial inventory of foreclosed and distressed properties and by weak demand that reflected tight credit conditions for mortgage loans and uncertainty about future home prices. Overall consumer price inflation continued to be more modest than earlier in the year, and measures of long-run inflation expectations had been stable. The risks associated with the fiscal and financial difficulties in Europe remained the focus of attention in financial markets over the intermeeting period and contributed to heightened volatility in a wide range of asset markets. However, stock prices and longer-term interest rates had changed little, on balance, since the November meeting.

Members viewed the information on U.S. economic activity received over the intermeeting period as suggesting that the economy would continue to expand moderately. Strains in global financial markets continued to pose significant downside risks to economic activity. Members also anticipated that inflation would settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate. In the discussion of monetary policy for the period immediately ahead, Committee members generally agreed that their overall assessments of the economic outlook had not changed greatly since their previous meeting. As a result, the Committee decided to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced in September, to retain the existing policies regarding the reinvestment of principal payments from Federal Reserve holdings of securities, and to keep the target range for the federal funds rate at 0 to ¼ percent. While several members noted that the reference to mid-2013 in the forward rate guidance might need to be adjusted before long, and a number of them looked forward to considering possible enhancements to the Committee's communications, the Committee agreed to reiterate its anticipation that economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

The information reviewed at the January 24–25 meeting indicated that U.S. economic activity continued to expand moderately, while global growth appeared to be slowing. Labor market indicators pointed to some further improvement in labor market conditions, but progress was gradual and the unemployment rate remained elevated. Household spending had continued to advance at a moderate pace despite diminished growth in real disposable income, but growth in business fixed investment had slowed. The housing sector remained depressed. Inflation had been subdued in recent months, there was little evidence of wage or cost pressures, and longer-term inflation expectations had remained stable. Meeting participants observed that financial conditions had improved and financial market stresses had eased somewhat during the intermeeting period: Equity prices were higher, volatility had declined, and bank lending conditions appeared to be improving. Participants noted that the ECB's three-year refinancing operation had apparently resulted in improved conditions in European sovereign debt markets. Nonetheless, participants expected that global financial markets would remain focused on the evolving situation in Europe and they anticipated that further policy efforts would be required to fully address the fiscal and financial problems there.

With the economy facing continuing headwinds and growth slowing in a number of U.S. export markets, members generally expected a modest pace of economic growth over coming quarters, with the unemployment rate declining only gradually. At the same time, members thought that inflation would run at levels at or below those consistent with the Committee's dual mandate. Against this backdrop, members agreed that it would be appropriate to maintain the existing highly accommodative stance of monetary policy. They agreed to keep the target range for the federal funds rate at 0 to ¼ percent, to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced in September, and to retain the existing policies regarding the reinvestment of principal payments from Federal Reserve holdings of securities. In light of the economic outlook, most members also agreed to indicate that the Committee expects to maintain a highly accommodative stance for monetary policy and anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014, longer than had been indicated in recent FOMC statements. The Committee also stated that it is prepared to adjust the size and composition of its securities holdings as appropriate to promote a stronger economic recovery in a context of price stability.

FOMC Communications

Transparency is an essential principle of modern central banking because it appropriately contributes to the accountability of central banks to the government and to the public and because it can enhance the effectiveness of central banks in achieving their macroeconomic objectives. To this end, the Federal Reserve provides to the public a considerable amount of information concerning the conduct of monetary policy. Immediately following each meeting of the FOMC, the Committee releases a statement that lays out the rationale for its policy decision, and detailed minutes of each FOMC meeting are made public three weeks following the meeting. Lightly edited transcripts of FOMC meetings are released to the public with a five-year lag.[21] Moreover, since last April, the Chairman has held press conferences after regularly scheduled two-day FOMC meetings. At the press conferences, the Chairman presents the current economic projections of FOMC participants and provides additional context for its policy decisions.

The Committee continued to consider additional improvements in its communications approach in the second half of 2011 and the first part of 2012. In a discussion on external communications at the September 20–21 FOMC meeting, most participants indicated that they favored taking steps to increase

[21] FOMC statements, minutes, and transcripts, as well as other related information, are available on the Federal Reserve Board's website at www.federalreserve.gov/monetarypolicy/fomc.htm.

further the transparency of monetary policy, including providing more information about the Committee's longer-run policy objectives and the factors that influence the Committee's policy decisions. Participants generally agreed that a clear statement of the Committee's longer-run policy objectives could be helpful; some noted that it would also be useful to clarify the linkage between these longer-run objectives and the Committee's approach to setting the stance of monetary policy in the short and medium runs. Participants generally saw the Committee's postmeeting statements as not well suited to communicate fully the Committee's thinking about its objectives and its policy framework, and they agreed that the Committee would need to use other means to communicate that information or to supplement information in the statement. A number of participants suggested that the Committee's periodic Summary of Economic Projections (SEP) could be used to provide more information about their views on the longer-run objectives and the likely evolution of monetary policy.

At the November 1–2 FOMC meeting, participants discussed alternative monetary policy strategies and potential approaches for enhancing the clarity of their public communications, though no decision was made at that meeting to change the Committee's policy strategy or communications. It was noted that many central banks around the world pursue an explicit inflation objective, maintain the flexibility to stabilize economic activity, and seek to communicate their forecasts and policy plans as clearly as possible. Many participants pointed to the merits of specifying an explicit longer-run inflation goal, but it was noted that such a step could be misperceived as placing greater weight on price stability than on maximum employment; consequently, some suggested that a numerical inflation goal would need to be set forth within a context that clearly underscored the Committee's commitment to fostering both parts of its dual mandate. Most of participants agreed that it could be beneficial to formulate and publish a statement that would elucidate the Committee's policy approach, and participants generally expressed interest in providing additional information to the public about the likely future path of the target federal funds rate. The Chairman asked the subcommittee on communications, headed by Governor Yellen, to give consideration to a possible statement of the Committee's longer-run goals and policy strategy, and he also encouraged the subcommittee to explore potential approaches for incorporating information about participants' assessments of appropriate monetary policy into the SEP.[22]

At the December 13 FOMC meeting, participants further considered ways in which the Committee might enhance the clarity and transparency of its public communications. The subcommittee on communications recommended an approach for incorporating information about participants' projections of appropriate future monetary policy into the SEP, which the FOMC releases four times each year. In the SEP, participants' projections for economic growth, unemployment, and inflation are conditioned on their individual assessments of the path of monetary policy that is most likely to be consistent with the Federal Reserve's statutory mandate to promote maximum employment and price stability, but information about those assessments has not been included in the SEP. Most participants agreed that adding their projections of the target federal funds rate to the economic projections already provided in the SEP would help the public better understand the Committee's monetary policy decisions and the ways in which those decisions depend on members' assessments of economic and financial conditions. At the conclusion of the discussion, participants decided to incorporate information about their projections of appropriate monetary policy into the SEP beginning in January.

Following up on the Committee's discussion of policy frameworks at its November meeting, the subcommittee on communications presented a draft statement of the Committee's longer-run goals and policy strategy. Participants generally agreed that issuing such a statement could be helpful in enhancing the transparency and accountability of monetary policy and in facilitating well-informed decisionmaking by households and businesses, and thus in enhancing the Committee's ability to promote the goals specified in its statutory mandate in the face of significant economic disturbances. However, a couple of participants expressed the concern that a statement that was sufficiently nuanced to capture the diversity of views on the Committee might not, in fact, enhance public understanding of the Committee's actions and intentions. Participants commented on the draft statement, and the Chairman encouraged the subcommittee to make adjustments to the

[22] The subcommittee on communications is chaired by Governor Yellen and includes Governor Raskin and Presidents Evans and Plosser.

Box 4. FOMC Statement Regarding Longer-Run Goals and Monetary Policy Strategy

Following careful deliberations at its recent meetings, the Federal Open Market Committee (FOMC) has reached broad agreement on the following principles regarding its longer-run goals and monetary policy strategy. The Committee intends to reaffirm these principles and to make adjustments as appropriate at its annual organizational meeting each January.

The FOMC is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society.

Inflation, employment, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Moreover, monetary policy actions tend to influence economic activity and prices with a lag. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. Communicating this inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances.

The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments. Information about Committee participants' estimates of the longer-run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, FOMC participants' estimates of the longer-run normal rate of unemployment had a central tendency of 5.2 percent to 6.0 percent, roughly unchanged from last January but substantially higher than the corresponding interval several years earlier.

In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

draft and to present a revised version for the Committee's further consideration in January.

At the January 24–25 meeting, the subcommittee on communications presented a revised draft of a statement of principles regarding the FOMC's longer-run goals and monetary policy strategy. Almost all participants supported adopting and releasing the revised statement (see **box 4**). It was noted that the proposed statement did not represent a change in the Committee's policy approach. Instead, the statement was intended to help enhance the transparency, accountability, and effectiveness of monetary policy.

In addition, in light of the decision made at the December meeting, the Committee provided in the January SEP information about each participant's assessments of appropriate monetary policy. Specifically, the SEP included information about participants' estimates of the appropriate level of the target federal funds rate in the fourth quarter of the current year and the next few calendar years, and over the longer run; the SEP also reported participants' current projections of the likely timing of the appropriate first increase in the target rate given their projections of future economic conditions. The accompanying narrative described the key factors underlying those assessments and provided some qualitative information regarding participants' expectations for the Federal Reserve's balance sheet. A number of participants suggested further possible enhancements to the SEP; the Chairman asked the subcommittee to explore such enhancements over coming months.

Part 4
Summary of Economic Projections

The following material appeared as an addendum to the minutes of the January 24–25, 2012, meeting of the Federal Open Market Committee.

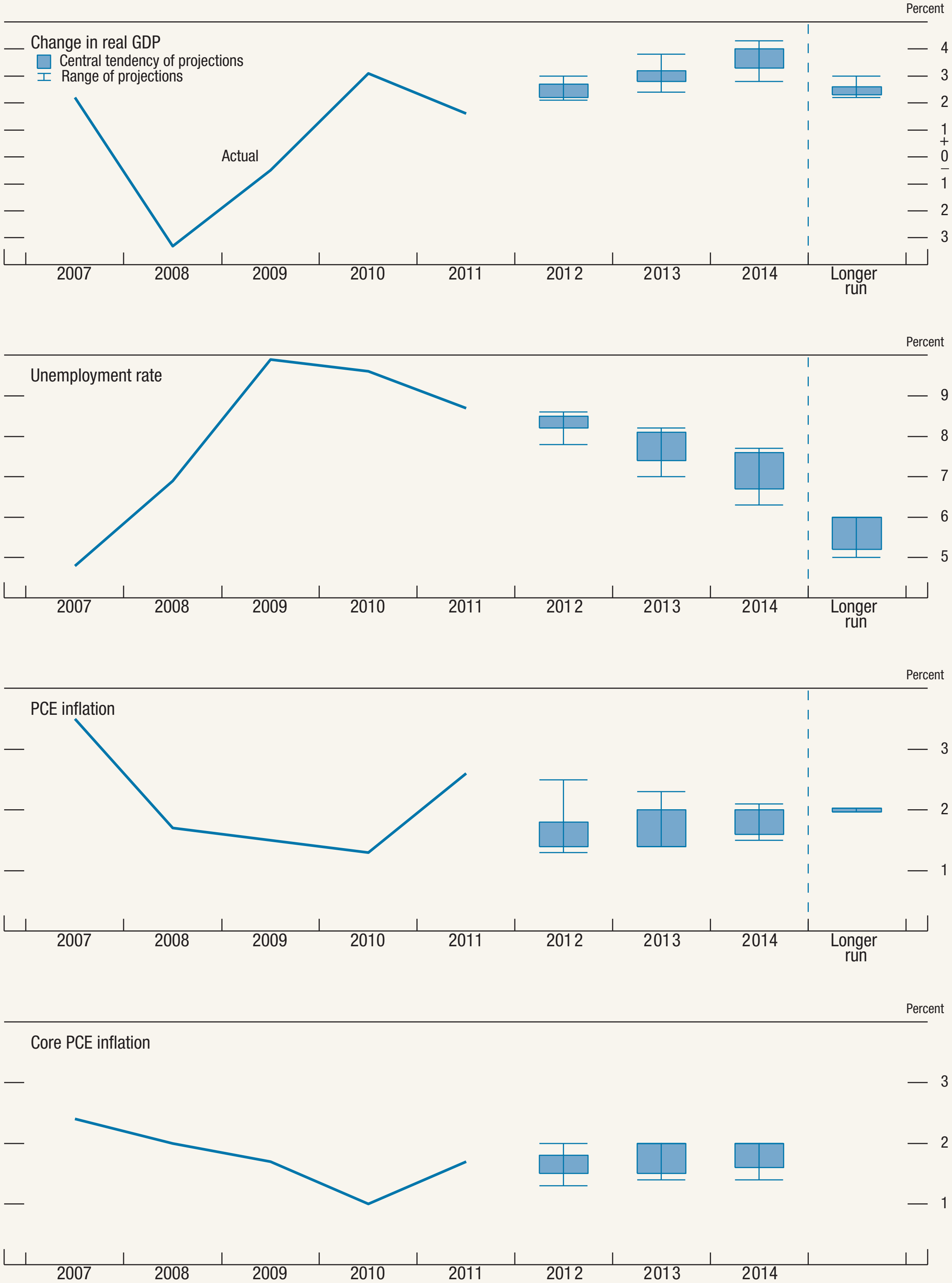
In conjunction with the January 24–25, 2012, Federal Open Market Committee (FOMC) meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC, submitted projections for growth of real output, the unemployment rate, and inflation for the years 2012 to 2014 and over the longer run. The economic projections were based on information available at the time of the meeting and participants' individual assumptions about factors likely to affect economic outcomes, including their assessments of appropriate monetary policy. Starting with the January meeting, participants also submitted their assessments of the path for the target federal funds rate that they viewed as appropriate and compatible with their individual economic projections. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks. "Appropriate monetary policy" is defined as the future path of policy that participants deem most likely to foster outcomes for economic activity and inflation that best satisfy their individual interpretation of the Federal Reserve's objectives of maximum employment and stable prices.

As depicted in **figure 1**, FOMC participants projected continued economic expansion over the 2012–14 period, with real gross domestic product (GDP) rising at a modest rate this year and then strengthening further through 2014. Participants generally anticipated only a small decline in the unemployment rate this year. In 2013 and 2014, the pace of the expansion was projected to exceed participants' estimates of the longer-run sustainable rate of increase in real GDP by enough to result in a gradual further decline in the unemployment rate. However, at the end of 2014, participants generally expected that the unemployment rate would still be well above their estimates of the longer-run normal unemployment rate that they currently view as consistent with the FOMC's statutory mandate for promoting maximum employment and price stability. Participants viewed the upward pressures on inflation in 2011 from factors such as supply chain disruptions and rising commodity prices as having waned, and they anticipated that inflation would fall back in 2012. Over the projection period, most participants expected inflation, as measured by the annual change in the price index for personal consumption expenditures (PCE), to be at or below the FOMC's objective of 2 percent that was expressed in the Committee's statement of longer-run goals and policy strategy. Core inflation was projected to run at about the same rate as overall inflation.

As indicated in **table 1**, relative to their previous projections in November 2011, participants made small downward revisions to their expectations for the rate of increase in real GDP in 2012 and 2013, but they did not materially alter their projections for a noticeably stronger pace of expansion by 2014. With the unemployment rate having declined in recent months by more than participants had anticipated in the previous Summary of Economic Projections (SEP), they generally lowered their forecasts for the level of the unemployment rate over the next two years. Participants' expectations for both the longer-run rate of increase in real GDP and the longer-run unemployment rate were little changed from November. They did not significantly alter their forecasts for the rate of inflation over the next three years. However, in light of the 2 percent inflation that is the objective included in the statement of longer-run goals and policy strategy adopted at the January meeting, the range and central tendency of their projections of longer-run inflation were all equal to 2 percent.

As shown in **figure 2**, most participants judged that highly accommodative monetary policy was likely to be warranted over coming years to promote a stronger economic expansion in the context of price stability. In particular, with the unemployment rate projected to remain elevated over the projection period and inflation expected to be subdued, six participants anticipated that, under appropriate monetary policy, the first increase in the target federal funds rate would occur after 2014, and five expected policy firming to commence during 2014 (the upper panel). The remaining six participants judged that raising the federal funds rate sooner would be required to forestall inflationary pressures or avoid distortions in the financial system. As indicated in the lower panel, all of the individual assessments of the appropriate target federal funds rate over the next several years were below the longer-run level of the

Figure 1. Central tendencies and ranges of economic projections, 2012–14 and over the longer run



Note: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual. The data for the change in real GDP, PCE inflation, and core PCE inflation shown for 2011 incorporate the advance estimate of GDP for the fourth quarter of 2011, which the Bureau of Economic Analysis released on January 27, 2012. This information was not available to FOMC meeting participants at the time of their meeting.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, January 2012
Percent

Variable	Central tendency[1]				Range[2]			
	2012	2013	2014	Longer run	2012	2013	2014	Longer run
Change in real GDP	2.2 to 2.7	2.8 to 3.2	3.3 to 4.0	2.3 to 2.6	2.1 to 3.0	2.4 to 3.8	2.8 to 4.3	2.2 to 3.0
November projection	2.5 to 2.9	3.0 to 3.5	3.0 to 3.9	2.4 to 2.7	2.3 to 3.5	2.7 to 4.0	2.7 to 4.5	2.2 to 3.0
Unemployment rate	8.2 to 8.5	7.4 to 8.1	6.7 to 7.6	5.2 to 6.0	7.8 to 8.6	7.0 to 8.2	6.3 to 7.7	5.0 to 6.0
November projection	8.5 to 8.7	7.8 to 8.2	6.8 to 7.7	5.2 to 6.0	8.1 to 8.9	7.5 to 8.4	6.5 to 8.0	5.0 to 6.0
PCE inflation	1.4 to 1.8	1.4 to 2.0	1.6 to 2.0	2.0	1.3 to 2.5	1.4 to 2.3	1.5 to 2.1	2.0
November projection	1.4 to 2.0	1.5 to 2.0	1.5 to 2.0	1.7 to 2.0	1.4 to 2.8	1.4 to 2.5	1.5 to 2.4	1.5 to 2.0
Core PCE inflation[3]	1.5 to 1.8	1.5 to 2.0	1.6 to 2.0		1.3 to 2.0	1.4 to 2.0	1.4 to 2.0	
November projection	1.5 to 2.0	1.4 to 1.9	1.5 to 2.0		1.3 to 2.1	1.4 to 2.1	1.4 to 2.2	

Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The November projections were made in conjunction with the meeting of the Federal Open Market Committee on November 1–2, 2011.

1 The central tendency excludes the three highest and three lowest projections for each variable in each year.

2 The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

3 Longer-run projections for core PCE inflation are not collected.

federal funds rate, and 11 participants placed the target federal funds rate at 1 percent or lower at the end of 2014. Most participants indicated that they expected that the normalization of the Federal Reserve's balance sheet should occur in a way consistent with the principles agreed on at the June 2011 meeting of the FOMC, with the timing of adjustments dependent on the expected date of the first policy tightening. A few participants judged that, given their current assessments of the economic outlook, appropriate policy would include additional asset purchases in 2012, and one assumed an early ending of the maturity extension program.

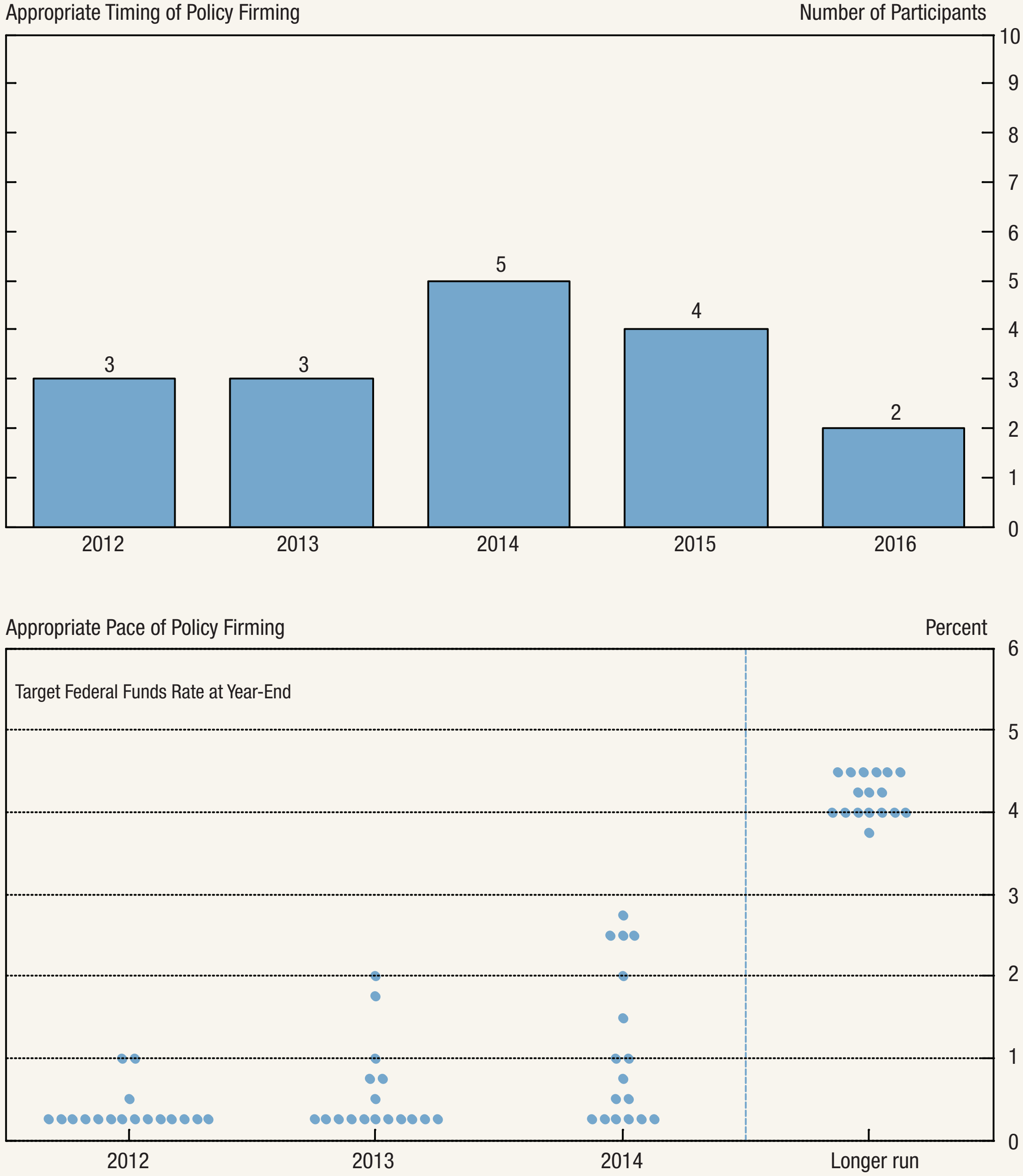
A sizable majority of participants continued to judge the level of uncertainty associated with their projections for real activity and the unemployment rate as unusually high relative to historical norms. Many also attached a greater-than-normal level of uncertainty to their forecasts for inflation, but, compared with the November SEP, two additional participants viewed uncertainty as broadly similar to longer-run norms. As in November, many participants saw downside risks attending their forecasts of real GDP growth and upside risks to their forecasts of the unemployment rate; most participants viewed the risks to their inflation projections as broadly balanced.

The Outlook for Economic Activity

The central tendency of participants' forecasts for the change in real GDP in 2012 was 2.2 to 2.7 percent. This forecast for 2012, while slightly lower than the projection prepared in November, would represent a pickup in output growth from 2011 to a rate close to its longer-run trend. Participants stated that the economic information received since November showed continued gradual improvement in the pace of economic activity during the second half of 2011, as the influence of the temporary factors that damped activity in the first half of the year subsided. Consumer spending increased at a moderate rate, exports expanded solidly, and business investment rose further. Recently, consumers and businesses appeared to become somewhat more optimistic about the outlook. Financial conditions for domestic nonfinancial businesses were generally favorable, and conditions in consumer credit markets showed signs of improvement.

However, a number of factors suggested that the pace of the expansion would continue to be restrained. Although some indicators of activity in the housing sector improved slightly at the end of 2011, new homebuilding and sales remained at depressed levels, house prices were still falling, and mortgage credit remained tight. Households' real disposable income rose only modestly through late 2011. In addition, federal spending contracted toward year-end, and the restraining effects of fiscal consolidation appeared likely to be greater this year than anticipated at the time of the November projections. Participants also read the information on economic activity abroad, particularly in Europe, as pointing to

Figure 2. Overview of FOMC participants' assessments of appropriate monetary policy



Note: In the upper panel, the height of each bar denotes the number of FOMC participants who judge that, under appropriate monetary policy and in the absence of further shocks to the economy, the first increase in the target federal funds rate from its current range of 0 to ¼ percent will occur in the specified calendar year. In the lower panel, each shaded circle indicates the value (rounded to the nearest ¼ percent) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run.

weaker demand for U.S. exports in coming quarters than had seemed likely when they prepared their forecasts in November.

Participants anticipated that the pace of the economic expansion would strengthen over the 2013–14 period, reaching rates of increase in real GDP above their estimates of the longer-run rates of output growth. The central tendencies of participants' forecasts for the change in real GDP were 2.8 to 3.2 percent in 2013 and 3.3 to 4.0 percent in 2014. Among the considerations supporting their forecasts, participants cited their expectation that the expansion would be supported by monetary policy accommodation, ongoing improvements in credit conditions, rising household and business confidence, and strengthening household balance sheets. Many participants judged that U.S. fiscal policy would still be a drag on economic activity in 2013, but many anticipated that progress would be made in resolving the fiscal situation in Europe and that the foreign economic outlook would be more positive. Over time and in the absence of shocks, participants expected that the rate of increase of real GDP would converge to their estimates of its longer-run rate, with a central tendency of 2.3 to 2.6 percent, little changed from their estimates in November.

The unemployment rate improved more in late 2011 than most participants had anticipated when they prepared their November projections, falling from 9.1 to 8.7 percent between the third and fourth quarters. As a result, most participants adjusted down their projections for the unemployment rate this year. Nonetheless, with real GDP expected to increase at a modest rate in 2012, the unemployment rate was projected to decline only a little this year, with the central tendency of participants' forecasts at 8.2 to 8.5 percent at year-end. Thereafter, participants expected that the pickup in the pace of the expansion in 2013 and 2014 would be accompanied by a further gradual improvement in labor market conditions. The central tendency of participants' forecasts for the unemployment rate at the end of 2013 was 7.4 to 8.1 percent, and it was 6.7 to 7.6 percent at the end of 2014. The central tendency of participants' estimates of the longer-run normal rate of unemployment that would prevail in the absence of further shocks was 5.2 to 6.0 percent. Most participants indicated that they anticipated that five or six years would be required to close the gap between the current unemployment rate and their estimates of the longer-run rate, although some noted that more time would likely be needed.

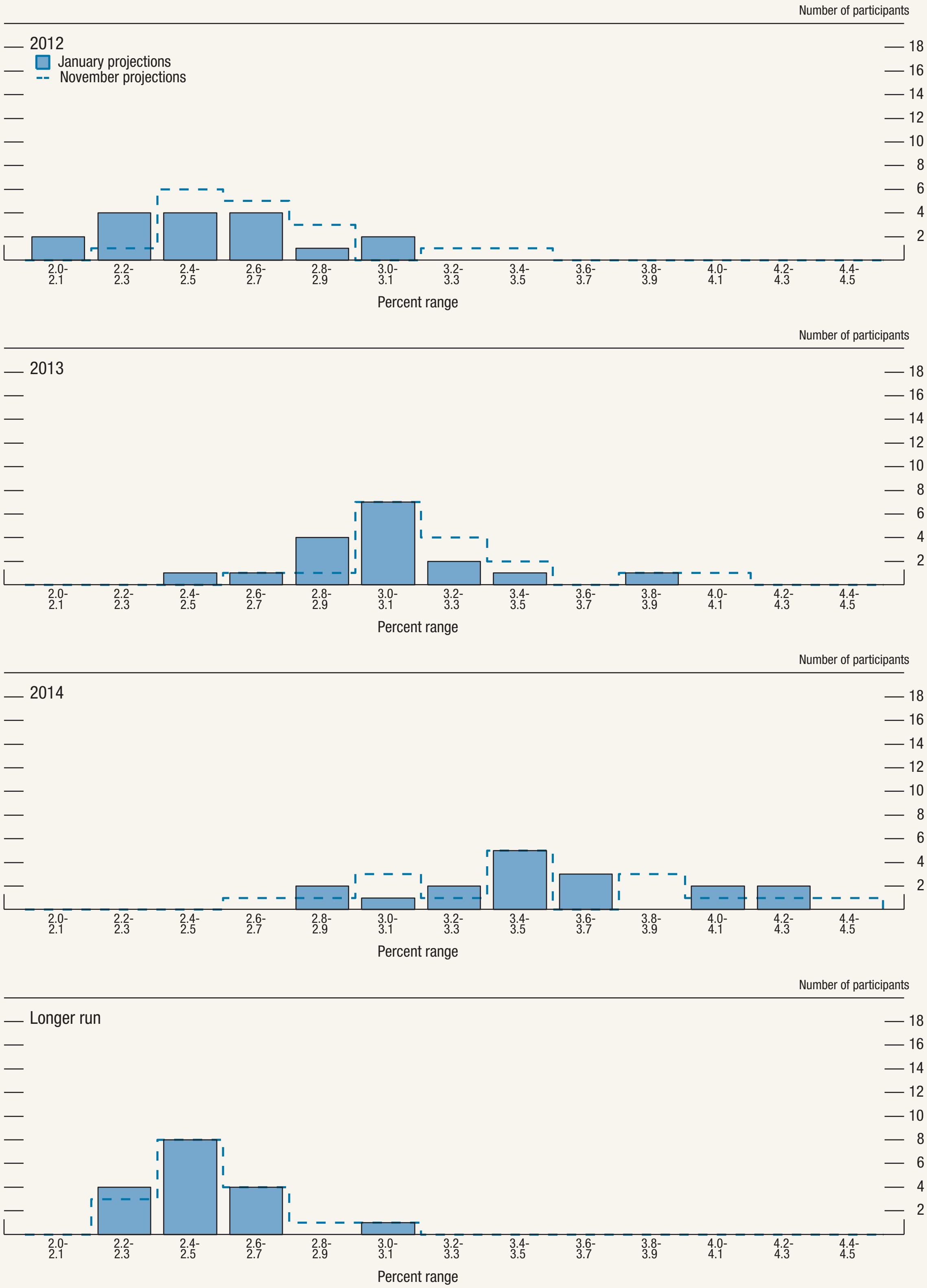
Figures 3.A and **3.B** provide details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate over the next three years and over the longer run. The dispersion in these projections reflected differences in participants' assessments of many factors, including appropriate monetary policy and its effects on economic activity, the underlying momentum in economic activity, the effects of the European situation, the prospective path for U.S. fiscal policy, the likely evolution of credit and financial market conditions, and the extent of structural dislocations in the labor market. Compared with their November projections, the range of participants' forecasts for the change in real GDP in 2012 narrowed somewhat and shifted slightly lower, as some participants reassessed the outlook for global economic growth and for U.S. fiscal policy. Many, however, made no material change to their forecasts for growth of real GDP this year. The dispersion of participants' forecasts for output growth in 2013 and 2014 remained relatively wide. Having incorporated the data showing a lower rate of unemployment at the end of 2011 than previously expected, the distribution of participants' projections for the end of 2012 shifted noticeably down relative to the November forecasts. The ranges for the unemployment rate in 2013 and 2014 showed less pronounced shifts toward lower rates and, as was the case with the ranges for output growth, remained wide. Participants made only modest adjustments to their projections of the rates of output growth and unemployment over the longer run, and, on net, the dispersions of their projections for both were little changed from those reported in November. The dispersion of estimates for the longer-run rate of output growth is narrow, with only one participant's estimate outside of a range of 2.2 to 2.7 percent. By comparison, participants' views about the level to which the unemployment rate would converge in the long run are more diverse, reflecting, among other things, different views on the outlook for labor supply and on the extent of structural impediments in the labor market.

The Outlook for Inflation

Participants generally viewed the outlook for inflation as very similar to that in November. Most indicated that, as they expected, the effects of the run-up in prices of energy and other commodities and the supply disruptions that occurred in the first half of 2011 had largely waned, and that inflation had been subdued in recent months. Participants also noted that inflation expectations had remained stable over the past year despite the fluctuations in headline inflation. Assuming no further supply shocks, most participants anticipated that both headline and core inflation would remain subdued over the 2012–14 period at rates at or below the FOMC's longer-run objective of 2 percent. Specifically, the central tendency of participants' projections for the increase in inflation, as measured by the PCE price index, in 2012 was 1.4 to 1.8 percent, and it edged up to a central tendency of 1.6 to 2.0 percent in 2014; the central tendencies of the forecasts for core PCE inflation were largely the same as those for the total measure.

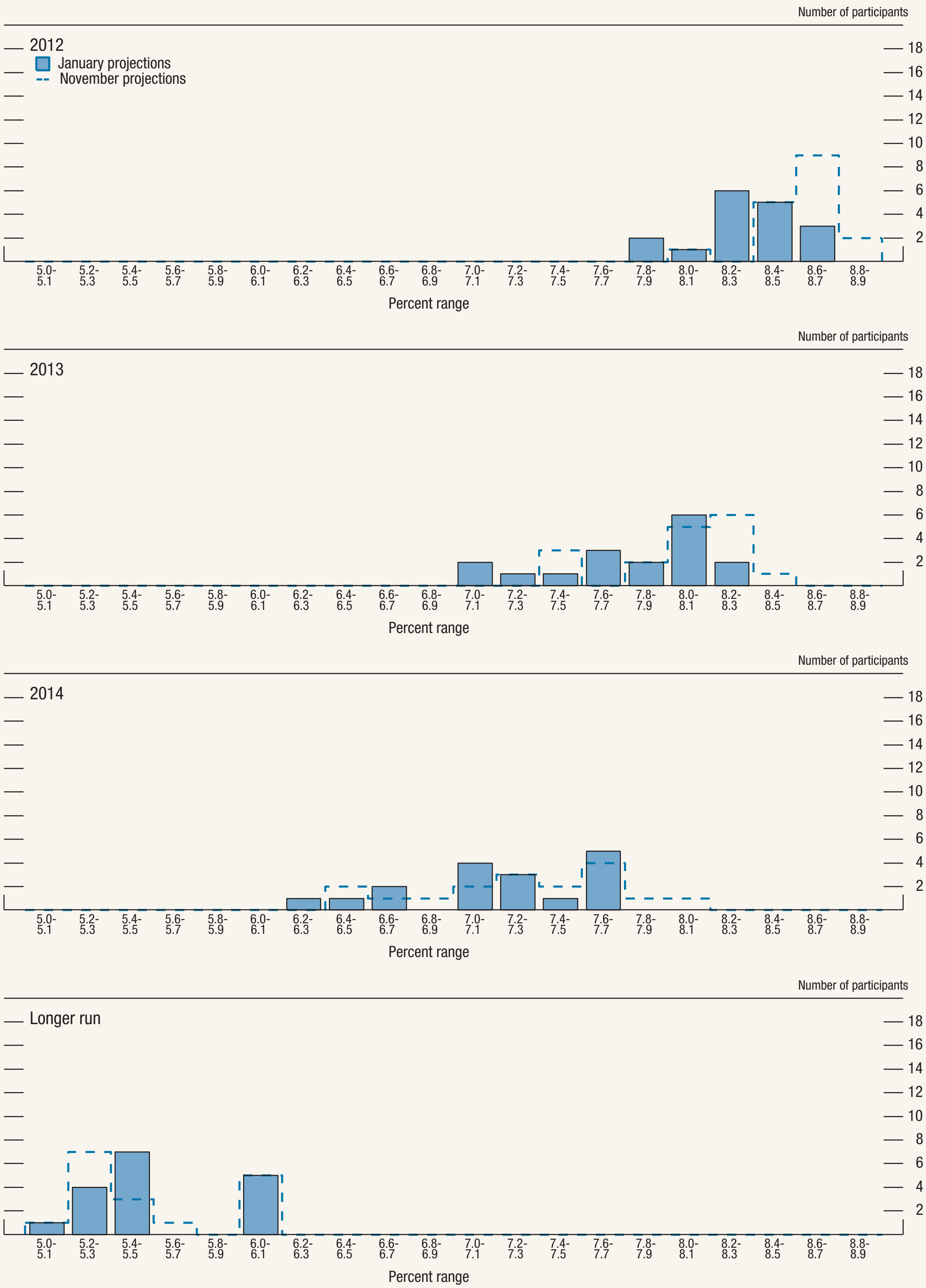
Figures 3.C and **3.D** provide information about the diversity of participants' views about the outlook for inflation. Compared with their November projections, expectations for inflation in 2012 shifted down a bit, with some participants noting that the slowing

Figure 3.A. Distribution of participants' projections for the change in real GDP, 2012–14 and over the longer run



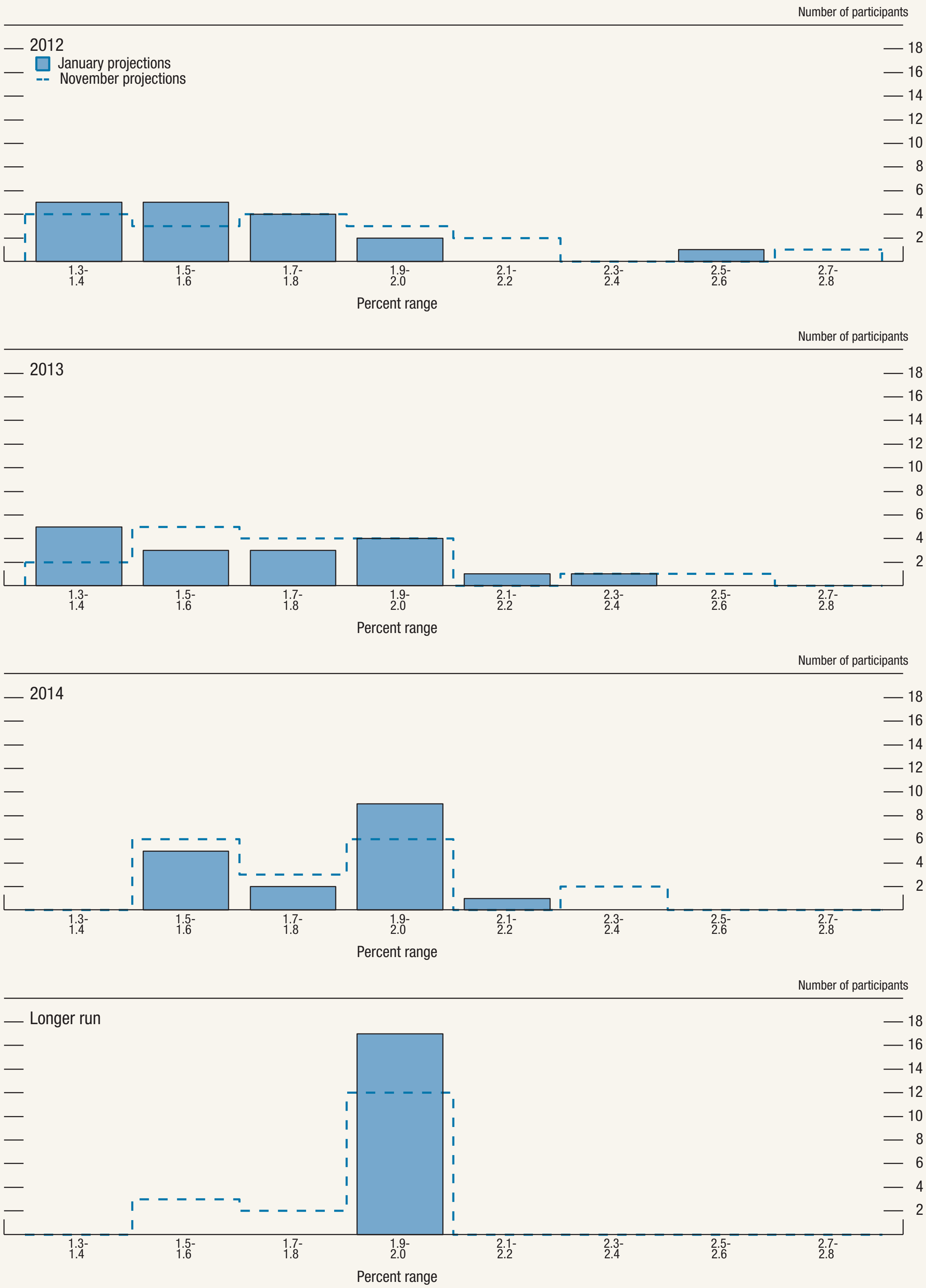
Note: Definitions of variables are in the general note to table 1.

Figure 3.B. Distribution of participants' projections for the unemployment rate, 2012–14 and over the longer run



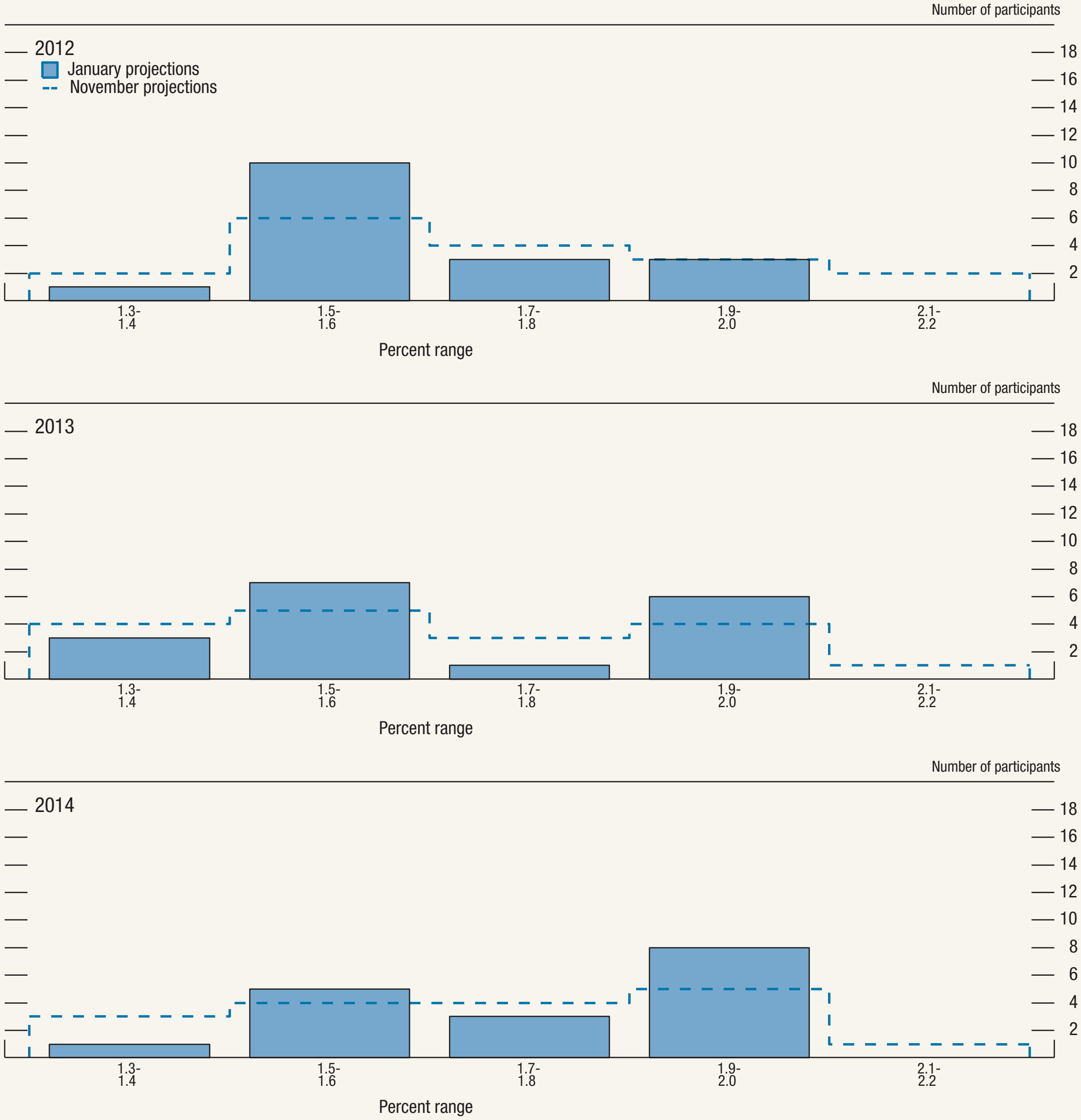
Note: Definitions of variables are in the general note to table 1.

Figure 3.C. Distribution of participants' projections for PCE inflation, 2012–14 and over the longer run



Note: Definitions of variables are in the general note to table 1.

Figure 3.D. Distribution of participants' projections for core PCE inflation, 2012–14



Note: Definitions of variables are in the general note to table 1.

in inflation at the end of 2011 had been greater than they anticipated. Nonetheless, the range of participants' forecasts for inflation in 2012 remained wide, and the dispersion was only slightly narrower in 2013. By 2014, the range of inflation forecasts narrowed more noticeably, as participants expected that, under appropriate monetary policy, inflation would begin to converge to the Committee's longer-run objective. In general, the dispersion of views on the outlook for inflation over the projection period represented differences in judgments regarding the degree of slack in resource utilization and the extent to which slack influences inflation and inflation expectations. In addition, participants differed in their estimates of how the stance of monetary policy would influence inflation expectations.

Appropriate Monetary Policy

Most participants judged that the current outlook—for a moderate pace of economic recovery with the unemployment rate declining only gradually and inflation subdued—warranted exceptionally low levels of the federal funds rate at least until late 2014. In particular, five participants viewed appropriate policy firming as commencing during 2014, while six others judged that the first increase in the federal funds rate would not be warranted until 2015 or 2016. As a result, those 11 participants anticipated that the appropriate federal funds rate at the end of 2014 would be 1 percent or lower. Those who saw the first increase occurring in 2015 reported that they anticipated that the federal funds rate would be ½ percent at the end of that year. For the two participants who put the first increase in 2016, the appropriate target federal funds rate at the end of that year was 1½ and 1¾ percent. In contrast, six participants expected that an increase in the target federal funds rate would be appropriate within the next two years, and those participants anticipated that the target rate would need to be increased to around 1½ to 2¾ percent at the end of 2014.

Participants' assessments of the appropriate path for the federal funds rate reflected their judgments of the policy that would best support progress in achieving the Federal Reserve's mandate for promoting maximum employment and stable prices. Among the key factors informing participants' expectations about the appropriate setting for monetary policy were their assessments of the maximum level of employment, the Committee's longer-run inflation goal, the extent to which current conditions deviate from these mandate-consistent levels, and their projections of the likely time horizons required to return employment and inflation to such levels. Several participants commented that their assessments took into account the risks to the outlook for economic activity and inflation, and a few pointed specifically to the relevance of financial stability in their policy judgments. Participants also noted that because the appropriate stance of monetary policy depends importantly on the evolution of real activity and inflation over time, their assessments of the appropriate future path of the federal funds rate could change if economic conditions were to evolve in an unexpected manner.

All participants reported levels for the appropriate target federal funds rate at the end of 2014 that were well below their estimates of the level expected to prevail in the longer run. The longer-run nominal levels were in a range from 3¾ to 4½ percent, reflecting participants' judgments about the longer-run equilibrium level of the real federal funds rate and the Committee's inflation objective of 2 percent.

Participants also provided qualitative information on their views regarding the appropriate path of the Federal Reserve's balance sheet. A few participants' assessments of appropriate monetary policy incorporated additional purchases of securities in 2012, and a number of participants indicated that they remained open to a consideration of additional asset purchases if the economic outlook deteriorated. All but one of the participants continued to expect that the Committee would carry out the normalization of the balance sheet according to the principles approved at the June 2011 FOMC meeting. That is, prior to the first increase in the federal funds rate, the Committee would likely cease reinvesting some or all payments on the securities holdings in the System Open Market Account (SOMA), and it would likely begin sales of agency securities from the SOMA sometime after the first rate increase, aiming to eliminate the SOMA's holdings of agency securities over a period of three to five years. Indeed, most participants saw sales of agency securities starting no earlier than 2015. However, those participants anticipating an earlier increase in the federal funds rate also called for earlier adjustments to the balance sheet, and one participant assumed an early end of the maturity extension program.

Figure 3.E details the distribution of participants' judgments regarding the appropriate level of the target federal funds rate at the end of each calendar year from 2012 to 2014 and over the longer run. Most participants anticipated that economic conditions would warrant maintaining the current low level of the federal funds rate over the next two years. However, views on the appropriate level of the federal funds rate at the end of 2014 were more widely dispersed, with two-thirds of participants seeing the appropriate level of the federal funds rate as 1 percent or below and five seeing the appropriate rate as 2 percent or higher. Those participants who judged that a longer period of exceptionally low levels of the federal funds rate would be appropriate generally also anticipated that the pace of the economic expansion would be moderate and that the unemployment rate would decline only gradually, remaining well above its longer-run rate at the end of 2014. Almost all of these participants expected that inflation would be relatively stable at or below the FOMC's longer-run objective of 2 percent until the time of the first increase in the federal funds rate. A number of them also mentioned their assessment that a longer period of low federal funds rates is appropriate when the federal funds rate is constrained by its effective lower bound. In contrast, the six participants who judged that policy firming should begin in 2012 or 2013 indicated that the Committee would need to act decisively to keep inflation at mandate-consistent levels

Figure 3.E. Distribution of participants' projections for the target federal funds rate, 2012–14 and over the longer run

Note: The target funds rate is measured as the level of the target rate at the end of the calendar year or in the longer run.

Table 2. Average historical projection error ranges
Percentage points

Variable	2012	2013	2014
Change in real GDP[1]	±1.3	±1.7	±1.8
Unemployment rate[1]	±0.7	±1.4	±1.8
Total consumer prices[2]	±0.9	±1.0	±1.0

Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1991 through 2010 that were released in the winter by various private and government forecasters. As described in box 5, under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

1 For definitions, refer to general note in table 1.

2 Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

and to limit the risk of undermining Federal Reserve credibility and causing a rise in inflation expectations. Several were projecting a faster pickup in economic activity, and a few stressed the risk of distortions in the financial system from an extended period of exceptionally low interest rates.

Uncertainty and Risks

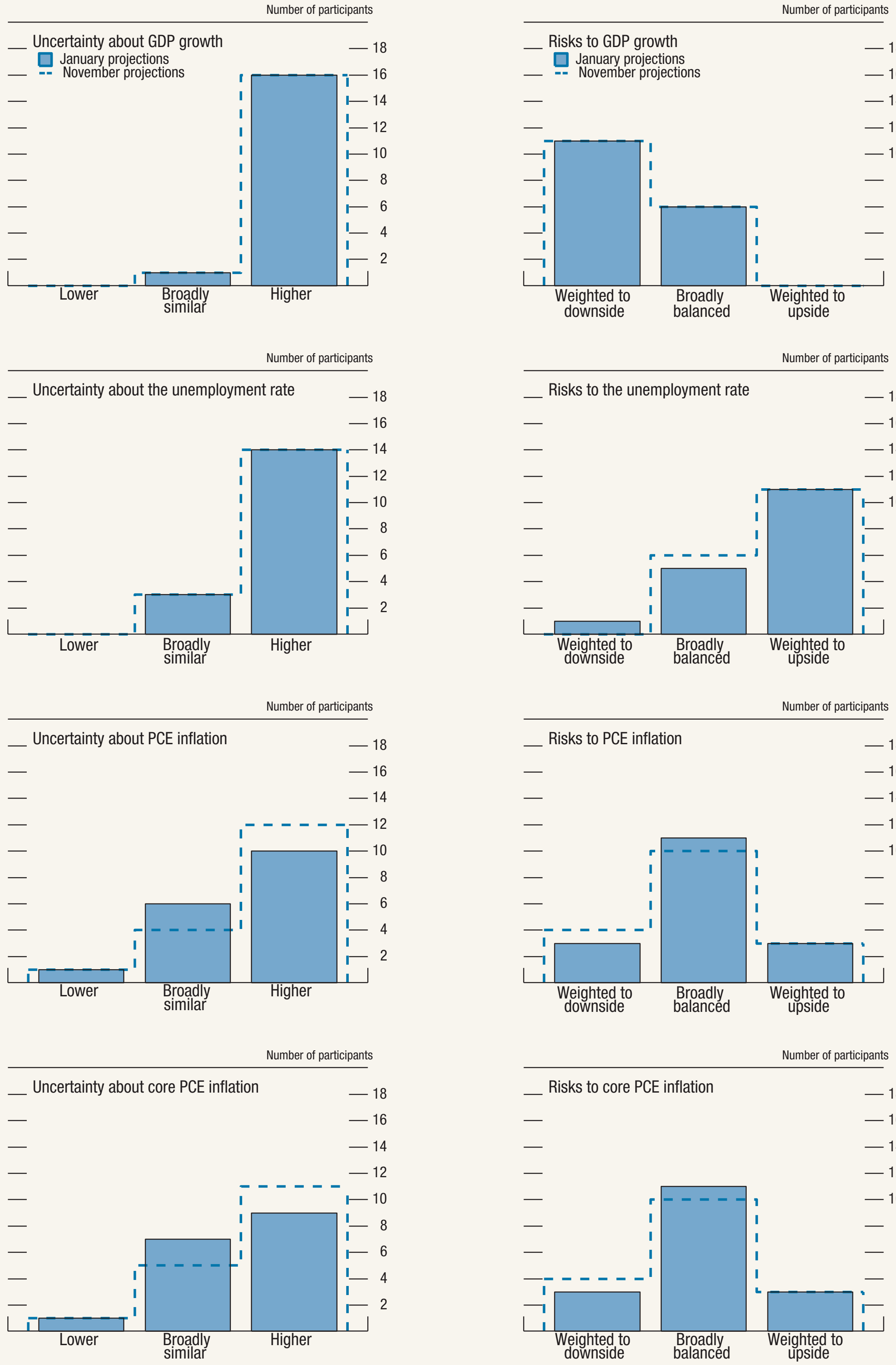
Figure 4 shows that most participants continued to share the view that their projections for real GDP growth and the unemployment rate were subject to a higher level of uncertainty than was the norm during the previous 20 years.[23] Many also judged the level of uncertainty associated with their inflation forecasts to be higher than the longer-run norm, but that assessment was somewhat less prevalent among participants than was the case for uncertainty about real activity. Participants identified a number of factors that contributed to the elevated level of uncertainty about the outlook. In particular, many participants continued to cite risks related to ongoing developments in Europe. More broadly, they again noted difficulties in forecasting the path of economic recovery from a deep recession that was the result of a severe financial crisis and thus differed importantly from the experience with recoveries over the past 60 years. In that regard, participants continued to be uncertain about the pace at which credit conditions would ease and about prospects for a recovery in the housing sector. In addition, participants generally saw the outlook for fiscal and regulatory policies as still highly uncertain. Regarding the unemployment rate, several expressed uncertainty about how labor demand and supply would evolve over the forecast period. Among the sources of uncertainty about the outlook for inflation were the difficulties in assessing the current and prospective margins of slack in resource markets and the effect of such slack on prices.

A majority of participants continued to report that they saw the risks to their forecasts of real GDP growth as weighted to the downside and, accordingly, the risks to their projections for the unemployment rate as skewed to the upside. All but one of the remaining participants viewed the risks to both projections as broadly balanced, while one noted a risk that the unemployment rate might continue to decline more rapidly than expected. The most frequently cited downside risks to the projected pace of the economic expansion were the possibility of financial market and economic spillovers from the fiscal and financial issues in the euro area and the chance that some of the factors that have restrained the recovery in recent years could persist and weigh on economic activity to a greater extent than assumed in participants' baseline forecasts. In particular, some participants mentioned the downside risks to consumer spending from still-weak household balance sheets and only modest gains in real income, along with the possible effects of still-high levels of uncertainty regarding fiscal and regulatory policies that might damp businesses' willingness to invest and hire. A number of participants noted the risk of another disruption in global oil markets that could not only boost inflation but also reduce real income and spending. The participants who judged the risks to be broadly balanced also recognized a number of these downside risks to the outlook but saw them as counterbalanced by the possibility that the resilience of economic activity in late 2011 and the recent drop in the unemployment rate might signal greater underlying momentum in economic activity.

In contrast to their outlook for economic activity, most participants judged the risks to their projections of inflation as broadly balanced. Participants generally viewed the recent decline in inflation as having been in line with their earlier forecasts, and they noted that inflation expectations remain stable. While many of these participants saw the persistence of substantial slack in resource utilization as likely to keep inflation subdued over the projection period, a few others noted the risk that elevated resource slack

23 **Table 2** provides estimates of the forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1991 to 2010. At the end of this summary, **box 5** discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

Figure 4. Uncertainty and risks in economic projections



Note: For definitions of uncertainty and risks in economic projections, see box 5. Definitions of variables are in the general note to table 1.

Box 5. Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world, and the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Report*s and those prepared by the Federal Reserve Board's staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 1.7 to 4.3 percent in the current year, 1.3 to 4.7 percent in the second year, and 1.2 to 4.8 in the third year. The corresponding 70 percent confidence intervals for overall inflation would be 1.1 to 2.9 percent in the current year and 1.0 to 3.0 percent in the second and third years.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past, as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

As with real activity and inflation, the outlook for the future path of the federal funds rate is subject to considerable uncertainty. This uncertainty arises primarily because each participant's assessment of the appropriate stance of monetary policy depends importantly on the evolution of real activity and inflation over time. If economic conditions evolve in an unexpected manner, then assessments of the appropriate setting of the federal funds rate would change from that point forward.

might put more downward pressure on inflation than expected. In contrast, some participants noted the upside risks to inflation from developments in global oil and commodity markets, and several indicated that the current highly accommodative stance of monetary policy and the substantial liquidity currently in the financial system risked a pickup in inflation to a level above the Committee's objective. A few also pointed to the risk that uncertainty about the Committee's ability to effectively remove policy accommodation when appropriate could lead to a rise in inflation expectations.

Abbreviations

ABS	asset-backed securities
AFE	advanced foreign economy
AIG	American International Group, Inc.
ARRA	American Recovery and Reinvestment Act
CDS	credit default swap
C&I	commercial and industrial
CMBS	commercial mortgage-backed securities
CP	commercial paper
CRE	commercial real estate
DPI	disposable personal income
EBA	European Banking Authority
ECB	European Central Bank
EME	emerging market economy
E&S	equipment and software
FDIC	Federal Deposit Insurance Corporation
FOMC	Federal Open Market Committee; also, the Committee
FRBNY	Federal Reserve Bank of New York
GDP	gross domestic product
GSE	government-sponsored enterprise
LIBOR	London interbank offered rate
MEP	maturity extension program
MBS	mortgage-backed securities
NIPA	national income and product accounts
OIS	overnight index swap
PCE	personal consumption expenditures
repo	repurchase agreement
SCOOS	Senior Credit Officer Opinion Survey on Dealer Financing Terms
SEP	Summary of Economic Projections
SLOOS	Senior Loan Officer Opinion Survey on Bank Lending Practices
S&P	Standard and Poor's
SOMA	System Open Market Account
WTI	West Texas Intermediate

Monetary Policy Report of July 2011

Part 1
Overview: Monetary Policy and the Economic Outlook

Economic activity continued to recover over the first half of 2011, but the pace of the expansion has been modest. The subdued rate of expansion reflects in part factors that are likely to be temporary, including the damping effect of higher food and energy prices on consumer spending as well as supply chain disruptions associated with the tragic earthquake in Japan. Nonetheless, even after setting aside temporary influences, the growth of economic activity appears to have slowed over the first half of this year. Conditions in the labor market remain weak. Although the average pace of job creation picked up during the early months of the year, employment growth softened in May and June and the unemployment rate edged up. Meanwhile, consumer price inflation increased noticeably in the first part of the year, reflecting in part higher prices for some commodities and imported goods as well as shortages of several popular models of automobiles. The recent rise in inflation is expected to subside as the effects of past increases in the prices of energy and other commodities dissipate in an environment of stable longer-term inflation expectations, and as supply chain disruptions in the automobile industry are remediated.

On net, financial market conditions became somewhat more supportive of economic growth in the first half of 2011, partly reflecting the continued monetary policy accommodation provided by the Federal Reserve. Yields on Treasury securities and corporate debt as well as rates on fixed-rate residential mortgages fell to very low levels, on balance, over the first half of the year, and equity prices rose. Borrowing conditions for households and businesses eased somewhat further, although credit conditions remained tight for some borrowers.

After rising at an annual rate of 2¾ percent in the second half of 2010, real gross domestic product (GDP) increased at about a 2 percent rate in the first quarter of 2011. Available information suggests that the pace of economic growth remained soft in the second quarter. Real consumer spending, which had brightened near the end of 2010, rose at a noticeably slower rate over the first five months of 2011, as household purchasing power was constrained by the weak pace of nominal income growth and by rising fuel and food prices, and as consumers remained downbeat. Meanwhile, the housing market continued to be weighed down by the large inventory of vacant houses for sale, the substantial volume of distressed sales, and by homebuyers' concerns about the strength of the recovery and fears of future declines in house prices. In the government sector, state and local government budgets continued to be very tight, as a reduction in federal assistance to those governments was only partially offset by an increase in tax collections; in addition, federal spending appears to have contracted. In contrast, exports—which have been a bright spot in the recovery—moved up briskly, and businesses continued to increase their outlays for equipment and software.

In the labor market, private payroll employment gains picked up in the first four months of the year, averaging about 200,000 jobs per month, an improvement from the average of 125,000 jobs per month recorded in the second half of 2010. However, private employment gains slowed sharply in May and June, averaging only 65,000 per month, with the step-down widespread across industries. Furthermore, the unemployment rate, which leveled off at around 9 percent in the early months of the year, has edged up since then, reaching 9.2 percent in June. The share of the unemployed who have been jobless for six months or longer remained close to 45 percent, a post–World War II high.

Consumer price inflation picked up noticeably in the first part of 2011. Prices for personal consumption expenditures rose at an annual rate of about 4 percent over the first five months of the year, compared with an annual rate of increase of a little less than 2 percent during the second half of 2010. A significant portion of the rise in inflation was associated with energy and food prices, reflecting the pass-through to retail prices of surges in the costs of crude oil and a wide range of agricultural commodities. Recently, however, these commodity prices have apparently stabilized, a development that should ease pressure on consumer energy and food prices in coming months. Another important source of upward pressure on inflation during the first half of the year was a sharp acceleration in the prices of other imported items. This factor contributed to a pickup in consumer inflation for items other than food and energy; over the first five months of this year, such inflation ran at an annual rate of more than 2 percent, up from an unusually low ½ percent annual rate of increase over the second half of 2010. Despite the increase in inflation, longer-term inflation expectations remained stable.

In U.S. financial markets, strong corporate profits and investors' perceptions that the economic recovery was firming supported a rise in equity prices and a narrowing of credit spreads in the early part of the year. By May, however, indications that the economic recovery in the United States was proceeding at a slower pace than previously anticipated—as well as a perceived moderation in global economic growth and heightened concerns about the persisting fiscal problems in Europe—weighed on market sentiment, prompting a pullback from riskier financial assets. On net over the first half of the year, yields on longer-term Treasury securities declined. Yields on corporate debt and other fixed-income products as well as rates on fixed-rate residential mortgages fell from already low levels, and credit spreads were little changed. Broad equity price indexes rose significantly, on balance, over the first half of the year; however, stock prices of banks declined.

By early July, investors had marked down their expectations for the path of the federal funds rate relative to the trajectory anticipated at the start of the year in response to economic and financial developments and the reiteration by the Federal Open Market Committee (FOMC) that it expected to maintain exceptionally low levels of the federal funds rate for an extended period. These same factors, as well as safe-haven demands stemming from investor concerns about global economic growth and about developments in Europe, contributed to the decline in nominal Treasury yields. Thus far, uncertainties surrounding the outcome of discussions to raise the U.S. government's statutory debt limit do not appear to have left an appreciable imprint on Treasury prices, but investors have noted statements by major ratings agencies regarding the actions the agencies may take if the fiscal situation is not adequately addressed. Measures of inflation compensation derived from yields on nominal and inflation-indexed Treasury securities fluctuated over the first half of the year in response to changes in commodity prices and the outlook for economic growth. On balance, medium-term inflation compensation edged higher over the first half of the year, but compensation further out was little changed.

Large nonfinancial corporations with access to capital markets took advantage of favorable financial market conditions to issue debt at a robust pace in the first half of the year, and issuance of corporate bonds and syndicated leveraged loans surged. The portfolios of commercial and industrial loans on banks' books expanded as standards and terms for such loans eased further and demand increased. In contrast, despite some improvement over the first half of the year, credit conditions for small businesses appeared to remain tight and demand for credit by such firms was subdued. Financing conditions for commercial real estate assets eased somewhat, but the fundamentals in commercial real estate markets stayed extremely weak.

Household debt continued to contract in the first half of 2011, driven primarily by the ongoing decline in mortgage debt. Even though mortgage rates remained near historically low levels, demand for new mortgage loans was weak, reflecting still-depressed conditions in housing markets and the uncertain outlook for the economic recovery and labor markets. Delinquency rates on most categories of mortgages edged lower but stayed near recent highs. The number of homes entering the foreclosure process declined in the first quarter of 2011, but the number of properties at some point in the foreclosure process remained elevated. Mortgage servicers continued to grapple with deficiencies in their foreclosure procedures; resolution of these issues could eventually be associated with an increase in the number of foreclosure starts as servicers work through the backlog of severely delinquent loans more quickly. Revolving consumer credit—mostly credit card borrowing—also continued to contract, on net, although at a slower pace than in 2010. In contrast, nonrevolving consumer credit, consisting predominantly of auto and student loans, rose appreciably in 2011, as rates on most types of these loans remained near the bottom of their historical ranges and as banks eased standards and terms for such loans. Issuance of consumer asset-backed securities, particularly securities backed by auto loans, was strong.

Conditions in short-term funding markets changed little over the first several months of 2011, although signs of stress for some European financial institutions started to emerge as market participants became more concerned about potential exposures to the debts of peripheral European countries. To continue to support liquidity conditions in global money markets and to help minimize the risk that strains abroad could spread to the United States, the FOMC in June approved an extension of the temporary U.S. dollar liquidity swap arrangements with a number of foreign central banks until August 1, 2012.

Responses to the Federal Reserve's Senior Credit Officer Opinion Survey on Dealer Financing Terms (SCOOS) indicated that dealers continued to gradually ease price and nonprice terms applicable to major classes of counterparties over the six months ending in May, and that demand for funding for a variety of security types increased over the same period. Investor appetite for risky assets likely supported issuance of some debt instruments (including speculative-grade corporate bonds and syndicated leveraged loans) and contributed to a narrowing of risk spreads evident in the first several months of the year. In addition, information from a variety of sources, including special questions in the SCOOS, suggested that the use of dealer-intermediated leverage increased modestly among both levered investors and traditionally unlevered investors, although the overall use of leverage appeared to be roughly midway between its pre-crisis peak and post-crisis trough. In recent weeks, however, anecdotal information has suggested that investors have pulled back somewhat from risk-taking and that their use of leverage has declined.

With the unemployment rate still elevated and inflation expected to subside to levels at or below those consistent, over the longer run, with the FOMC's dual mandate of maximum employment and price stability, the Committee maintained a target range for the federal funds rate of 0 to ¼ percent throughout the first half of 2011. The Committee reiterated that economic conditions were likely to warrant exceptionally low levels for the federal funds rate for an extended period. At the end of June, the Federal Reserve completed its program of purchasing $600 billion of longer-term Treasury securities that was announced in November. In addition, the Committee maintained its existing policy of reinvesting principal payments from its agency debt and agency mortgage-backed securities (MBS) holdings in longer-term Treasury securities. The Federal Reserve continued to develop and test tools to eventually drain or immobilize large volumes of banking system reserves in order to ensure that it will be able to smoothly and effectively exit from the current accommodative stance of policy at the appropriate time. The Committee will continue to monitor the economic outlook and financial developments, and it will act as needed to best foster maximum employment and price stability.

The size and composition of the Federal Reserve's balance sheet continued to evolve over the first half of the year. As a result of the FOMC's policies of reinvesting principal payments from its securities holdings and purchasing additional longer-term Treasury securities, holdings of Treasury securities rose more than $600 billion and holdings of agency debt and agency MBS declined about $115 billion. Emergency credit provided during the crisis continued to decline: The closing of a recapitalization plan for American International Group, Inc. (AIG), terminated the Federal Reserve's direct assistance to AIG; the Federal Reserve Bank of New York sold some of the securities held in the portfolio of Maiden Lane II LLC, a special purpose vehicle that was established to acquire residential mortgage-backed securities from AIG; and loans outstanding under the Term Asset-Backed Securities Loan Facility continued to decline as improved conditions in securitization markets allowed borrowers to refinance and prepay loans made under the facility. On the liability side of the Federal Reserve's balance sheet, reserve balances held by depository institutions rose to $1.7 trillion, largely as a result of the Federal Reserve's longer-term security purchase program. Federal Reserve notes in circulation also rose. The Treasury Department's Supplementary Financing Account balance at the Federal Reserve declined from $200 billion early in the year to $5 billion as part of the Treasury's efforts to maximize flexibility in its debt management as the statutory debt limit approached.

The economic projections prepared in conjunction with the June FOMC meeting are presented in Part 4 of this report.[1] In broad terms, FOMC participants (the members of the Board of Governors and the presidents of the 12 Federal Reserve Banks) marked down their forecasts for economic growth in 2011 relative to their forecasts in January and April, largely as a result of unexpected weakness in the first half of the year. Nonetheless, participants anticipated a modest acceleration in economic output in both 2012 and 2013 based on the effects of continued monetary policy accommodation, some further easing of credit conditions, a waning in the drag from elevated commodity prices, and some pickup in spending from pent-up demand. Participants expected the unemployment rate to trend down over the near term, though at a slower pace than they anticipated in January and April. They continued to

[1] These projections were prepared in late June and thus did not incorporate more recent economic news.

anticipate that the unemployment rate at the end of 2013 would remain well above their estimates of the longer-run rate that they see as consistent with the Committee's dual mandate. Participants' forecasts indicated a pickup in inflation for 2011 relative to 2010 and their expectations earlier this year. However, most participants expected that the influence on inflation of higher commodity prices and supply disruptions from Japan would be temporary, and that inflation pressures would remain subdued against a backdrop of stable commodity prices, well-anchored inflation expectations, and large margins of slack in labor markets. As a result, they anticipated that overall inflation would step down in 2012 and remain at that lower level in 2013, moving back in line with core inflation at levels at or slightly below participants' estimates of the longer-run, mandate-consistent rate of inflation.

Participants generally reported that the levels of uncertainty attached to their projections for economic growth and inflation had risen since April and were above historical norms. Most participants judged that the balance of risks to economic growth was weighted to the downside, whereas in April, a majority had seen the risks to growth as balanced. Most participants saw the risks surrounding their inflation expectations as broadly balanced, while in April, a majority had judged those risks as skewed to the upside. Participants also reported their assessments of the rates to which macroeconomic variables would be expected to converge over the longer run under appropriate monetary policy and in the absence of further shocks to the economy. The central tendencies of these longer-run projections, which have not changed since April, were 2.5 to 2.8 percent for real GDP growth, 5.2 to 5.6 percent for the unemployment rate, and 1.7 to 2.0 percent for the inflation rate. Because inflation in the long run is largely determined by monetary policy, the longer-run projections for inflation can be viewed as the levels of inflation that FOMC participants consider to be most consistent with the Committee's mandate to foster maximum employment and price stability.

Part 2 Recent Economic and Financial Developments

After increasing at a solid pace in the fourth quarter of 2010, economic activity expanded more slowly over the first half of 2011. In the first quarter of this year, real gross domestic product (GDP) increased at an annual rate of 1.9 percent; preliminary indicators suggest that the pace of the recovery remained soft in the second quarter. Activity in the second quarter was held down by factors that are likely to be temporary, including the damping effect of higher food and energy prices on consumer spending as well as the supply chain disruptions stemming from the earthquake in Japan. But even after setting aside those effects, the pace of economic expansion in the second quarter appears to have been subdued.

In the labor market, employment gains picked up noticeably at the beginning of 2011 but slowed markedly in May and June. The unemployment rate, which fell in late 2010, held close to 9 percent during the early months of the year but then edged up, reaching 9.2 percent in June. Furthermore, long-duration joblessness remained at near-record levels. Meanwhile, consumer price inflation moved up noticeably over the first half of the year, largely in response to rapid increases in the prices of some commodities and imported goods as well as the recent supply chain disruptions. However, longer-term inflation expectations remained stable.

On balance, financial market conditions became somewhat more supportive of economic growth over the first half of 2011, reflecting in part continued monetary policy accommodation provided by the Federal Reserve. In the early part of the year, strong corporate profits and investors' perceptions that the economic recovery was firming supported a rise in equity prices and a narrowing of credit spreads. Since May, however, indications that the U.S. economic recovery was proceeding at a slower pace than previously anticipated, a perceived moderation in global growth, and heightened concerns about the persisting fiscal pressures in Europe weighed on investor sentiment and prompted a pullback from riskier financial assets. On net over the first half of the year, yields on Treasury securities and corporate debt and rates on fixed-rate residential mortgages declined, and equity prices rose significantly. Borrowing conditions for households and businesses eased somewhat further, although credit conditions continued to be tight for some borrowers.

Domestic Developments

The Household Sector

Housing Activity and Finance

The housing market remained exceptionally weak in the first half of 2011. Housing demand continued to be restrained by households' concerns about the strength of the recovery for incomes and jobs as well as the potential for further declines in house prices; still-tight credit conditions for potential mortgage borrowers with less-than-pristine credit also appear to be damping demand. As a result, sales of single-family homes showed no signs of sustained recovery during the first half of the year. With demand weak, the overhang of vacant properties for sale substantial, distressed sales elevated, and construction financing tight, new units were started at an average annual rate of about 410,000 units between January and May—a bit below the level recorded in the fourth quarter of 2010 and just 50,000 units above the quarterly low reached in the first quarter of 2009.

Activity in the multifamily sector has been a bit more buoyant, as the ongoing reluctance of potential homebuyers to purchase a home, compounded by tight mortgage credit standards, appears to have led to an increase in demand for rental housing. Indeed, vacancy rates for multifamily rental units have dropped noticeably, and rents for apartments in multifamily buildings have moved up. However, construction financing remains difficult to obtain for many potential borrowers. Starts in the multifamily sector averaged 160,000 units at an annual rate in the first five months of 2011, noticeably above the 100,000 units started in the fourth quarter of 2010 but still well below the 300,000-unit rate that had prevailed for much of the previous decade.

House prices fell further over the first half of 2011. The latest readings from national indexes show price declines for existing homes over the past 12 months in the range of 5 to 8 percent. One such measure with wide geographic coverage—the CoreLogic repeat-sales index—fell 8 percent over the 12 months ending in May to a level that is about 4 percent below the previous trough in April of 2009. House prices are being held down by the same factors restraining housing construction—the large inventory of unsold homes, the high number of distressed sales, and lackluster household demand. The inventory of unsold homes will likely put downward pressure on house prices for some time, given the large number of seriously delinquent mortgages that could still enter the foreclosure inventory. As a result of the decline in house prices, the share of mortgages with negative equity has continued to rise: In March 2011, roughly one in four mortgage holders owed more on their mortgages than their homes were worth.

Indicators of credit quality in the residential mortgage sector continued to reflect strains on homeowners confronting depressed home values and high unemployment. Although delinquency rates on most categories of mortgages edged modestly lower in the first part of 2011, they stayed at historically high levels. As of May, serious delinquency rates on loans to prime and near-prime borrowers stood at about 5 percent for fixed-rate loans and 14 percent for variable-rate loans.[2] For subprime loans, as of April (the latest month for which data are available), serious delinquency rates remained near 20 percent for fixed-rate loans and 40 percent for variable-rate loans. The number of homes entering the foreclosure process declined in the first quarter of 2011, but the number of properties at some point in the foreclosure process remained elevated. Mortgage servicers continued to grapple with deficiencies in their foreclosure procedures; resolution of these issues could eventually be associated with an increase in the number of properties entering the foreclosure process as servicers work through the backlog of severely delinquent loans more quickly.[3]

Interest rates on fixed-rate mortgages fell, on net, during the first half of 2011, a move that largely paralleled the decline in Treasury yields over the period. Even with mortgage rates near historically low levels, access to mortgage credit continued to be restrained by negative equity and tight lending standards. For example, the April 2011 Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) indicated that standards on prime and nontraditional

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[2] A mortgage is defined as seriously delinquent if the borrower is 90 days or more behind in payments or the property is in foreclosure.

[3] The Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation conducted an in-depth interagency review of practices at the largest mortgage servicing operations to examine foreclosure practices generally, but with an emphasis on the breakdowns that led to inaccurate affidavits and other questionable legal documents being used in the foreclosure process. The review found, among other things, critical weaknesses in foreclosure-governance practices, foreclosure-documentation processes, and oversight and monitoring of third-party law firms and other vendors. Based on the findings from the review, the agencies issued enforcement actions by consent against 14 mortgage servicers in April 2011 to address the significant deficiencies in mortgage-servicing and foreclosure practices. See Board of Governors of the Federal Reserve System (2011), "Federal Reserve Issues Enforcement Actions Related to Deficient Practices in Residential Mortgage Loan Servicing and Foreclosure Processing," press release, April 13, www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm; and Board of Governors of the Federal Reserve System (2011), "Statement for the Record: On Mortgage Servicing," testimony submitted to the Subcommittees on Financial Institutions and Consumer Credit and on Oversight and Investigations, Committee on Financial Services, U.S. House of Representatives, Washington, July 7, www.federalreserve.gov/newsevents/testimony/statement20110707a.htm.

residential mortgages and home equity loans were about unchanged or moderately tighter during the first quarter, and that demand for these loans continued to decline.[4] The pace of mortgage applications for home purchases remained very sluggish in the first half of the year, probably reflecting the stringency of lending terms and the overall weakness of housing demand. Refinancing activity increased modestly in the second quarter in response to the downward drift in interest rates, but such activity remains subdued compared with that seen in 2010. Overall, mortgage debt outstanding continued to contract.

Net issuance of mortgage-backed securities (MBS) guaranteed by government-sponsored enterprises (GSEs) expanded slightly in the first half of the year but remained relatively low, consistent with the slow pace of mortgage originations to finance home purchases. Net issuance of Ginnie Mae securities remained considerably more robust than net issuance of securities by Fannie Mae and Freddie Mac, reflecting the substantial share of mortgages insured by the Federal Housing Administration (FHA). The securitization market for mortgage loans not guaranteed by a housing-related GSE or the FHA remained essentially closed. Yields on agency MBS fell roughly in line with those on Treasury securities. The Treasury Department announced on March 21 that it would begin to sell its $142 billion agency MBS portfolio at a pace of about $10 billion per month; the announcement appeared to have little lasting effect on spreads of yields on MBS over those on comparable-maturity Treasury securities. Through the end of June, the Treasury had sold MBS with a current face value of about $34 billion.

Consumer Spending and Household Finance

The rate of increase in consumer spending slowed appreciably during the first half of the year. After rising at an annual rate of more than 3 percent in the second half of 2010, real personal consumption expenditures (PCE) stepped down to about a 2 percent rate of increase in the first quarter, and available information suggests that the rise in spending in the second quarter was quite modest as well. Consumer outlays in the second quarter were held down in part by the reduced availability of motor vehicles, especially for those models affected by the supply chain disruptions that followed the earthquake in Japan; purchases of motor vehicles should rebound in coming months as dealer supplies are replenished. More fundamentally, however, continued consumer pessimism and a slower pace of increase in real household income, only partly due to temporarily high energy and food prices, also appear to have weighed on consumption. The saving rate, although continuing to edge down, remains well above levels that prevailed prior to the recession.

Despite a temporary reduction in payroll tax rates beginning in January, aggregate real disposable personal income—personal income less personal taxes, adjusted for price changes—was unchanged, on net, over the first five months of the year after rising 2 percent in 2010. Before taxes, real wage and salary income, which reflects both the number of hours worked and average hourly wages adjusted for inflation, was also flat from December to May after having risen 1¾ percent last year. Wage gains have been restrained by the weakness in the labor market. Moreover, the purchasing power of wages and salaries has been drained by this year's run-up in price inflation. One measure of real wages—average hourly earnings of all employees, adjusted for the rise in PCE prices—fell about 1½ percent at an annual rate over the first five months of 2011 after having increased ½ percent over the 12 months of 2010.

Two other important determinants of consumer outlays are also acting as a restraint on spending. Although the wealth-to-income ratio has trended up since the beginning of 2009, it remains near the low end of the range that has prevailed since the mid-1990s. In addition, consumer sentiment, which had moved up early in 2011, retreated again when gas prices spiked in the spring. More broadly, consumer sentiment seems to have improved little, if any, from the readings that were typical of 2009 and 2010.

Total household debt contracted at an annual rate of about 2 percent in the first quarter of the year, roughly the same pace seen in 2010, as the decline in mortgage debt noted earlier was only partially offset by a moderate increase in consumer credit. Tight credit conditions precluded some households from obtaining credit, and charge-offs remained elevated on many categories of loans. The ongoing reduction in overall household debt levels, combined with low interest rates and a slight increase in personal income, resulted in a further decline in the debt service ratio—the aggregate required principal and interest payment on existing mortgages and consumer debt relative to income. Indeed, as of the first quarter of 2011, the debt service ratio was 11.5 percent, the lowest level seen since 1995.

4 The SLOOS is available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/SnLoanSurvey.

The modest expansion of consumer credit, which began in late 2010, reflects a mixed picture. Nonrevolving consumer credit, which consists largely of auto and student loans and accounts for about two-thirds of total consumer credit, rose at an annual rate of almost 5 percent in the first five months of 2011. The increase is consistent with responses to the April 2011 SLOOS, which indicated a sharp rise in banks' willingness to make consumer installment loans and an ongoing easing of terms and standards on them. However, revolving consumer credit—mostly credit card borrowing—declined through April, albeit at a slower pace than in 2010; early estimates point to an increase in May. Although a net fraction of about 20 percent of banks responding to the April 2011 SLOOS reported an easing of standards for approval of credit card applications, access to credit card loans for borrowers with blemished credit histories remained limited. In addition, the contraction in home equity loans, historically a source of funding for consumer durables and other large household expenditures, appears to have intensified during the first half of 2011, in part owing to declines in home equity and still-stringent lending standards.

Indicators of consumer credit quality generally improved. The delinquency rates on credit card loans, both at commercial banks and in securitized pools, retreated to less than 4 percent in the first quarter and May, respectively—at the low ends of their ranges over recent decades. Delinquencies on nonrevolving consumer loans at commercial banks also edged lower, while delinquencies on auto loans at captive finance companies were flat, on net, over the first four months of the year; both of these measures remained around their historical averages.

Interest rates on consumer loans held fairly steady, on net, in the first half of 2011. Interest rates on new-auto loans continued to linger at historically low levels. Rates on credit card loans are around their historical averages, but the spread of these rates to the two-year Treasury yield is quite wide, in part because of pricing adjustments made in response to the Credit Card Accountability Responsibility and Disclosure Act, or Credit Card Act, of 2009.[5]

In the first half of 2011, issuance of consumer asset-backed securities (ABS) remained at about the same pace as in 2010 but still well below average issuance rates prior to the financial crisis. Securities backed by auto loans made up a large share of the new supply. Issuance of credit card ABS, however, remained weak, as the sharp contraction in credit card lending limited the need for new funding and as last year's accounting rule changes reportedly damped the attractiveness of securitizing these loans, particularly since banks remained awash in other sources of cheap funding.[6] Yields on ABS and the spreads of such yields over comparable-maturity interest rate swap rates were little changed, on net, over the first half of the year, stabilizing at levels only slightly higher than those seen prior to the financial crisis.

The Business Sector

Fixed Investment

Real business spending for equipment and software (E&S) rose at an annual rate of about 10 percent in the first quarter, roughly the same pace as in the second half of 2010. Business purchases of motor vehicles rose briskly, and outlays on information technology (IT) capital and on equipment other than transportation and IT continued to rise at solid rates. More-recent data on orders and shipments for a broad range of equipment categories suggest that E&S spending will likely post another sizable gain in the second quarter. Spending is being boosted by the need to replace older, less-efficient equipment and, in some cases, to expand capacity. One soft spot in the second quarter will likely be in business purchases of motor vehicles, which, like consumer purchases, were held down by the shortages of Japanese nameplate cars in the wake of the earthquake in Japan, but this effect should be reversed during the second half of the year.

By contrast, investment in nonresidential structures remains at a low level. After falling 17 percent in 2010, real business outlays on structures outside of the drilling and mining sector fell at an annual rate of 25 percent in the first quarter. Although the incoming data point to a small increase in outlays in the second quarter, high vacancy rates, continuing price declines in all but a few markets, and difficult financing conditions for builders suggest that spending will

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5 The Credit Card Act includes some provisions that place restrictions on issuers' ability to impose certain fees and to engage in risk-based pricing.

6 Issued by the Financial Accounting Standards Board (FASB), Statements of Financial Accounting Standards Nos. 166 (*Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140*) and 167 (*Amendments to FASB Interpretation No. 46(R)*) became effective at the start of a company's first fiscal year beginning after November 15, 2009, or, for companies reporting earnings on a calendar-year basis, after January 1, 2010. The amendments required many credit card issuers to bring securitizations onto their balance sheets and therefore to hold more capital against them.

be weak for some time to come. However, spending on drilling and mining structures has continued to rise at a robust pace in response to elevated oil prices and advances in technology for horizontal drilling and hydraulic fracturing.

Inventory Investment

Real inventory investment stepped up in the first quarter, as stockbuilding outside of motor vehicles increased somewhat and motor vehicle inventories were about unchanged following a substantial fourth-quarter runoff. Outside of the motor vehicle sector, the inventory-to-sales ratios for most industries covered by the Census Bureau's book-value data remain near the levels observed before the recession, and surveys suggest that inventory positions for most businesses generally are not perceived as being excessive. In the motor vehicle sector, the effects of the earthquake in Japan and supply constraints on the production of some of the most fuel-efficient domestic nameplate cars led to a sharp drop in inventories in the second quarter, but some significant rebuilding of inventories is likely to occur this quarter.

Corporate Profits and Business Finance

Operating earnings per share for S&P 500 firms continued to rise in the first quarter of 2011, increasing at a quarterly rate of about 6 percent. With the latest rise, aggregate earnings per share advanced to their pre-crisis peak. During much of the first half of the year, analysts marked up their forecasts of year-ahead earnings by a modest amount; however, their forecasts were flat from May to June.

The credit quality of nonfinancial corporations improved further in the first half of 2011 as firms continued to strengthen their balance sheets. Liquid assets remained at record-high levels in the first quarter, and the aggregate ratio of debt to assets—a measure of corporate leverage—edged lower. Credit rating upgrades of corporate debt outpaced downgrades through June, and the six-month trailing bond default rate for nonfinancial firms remained close to zero. The delinquency rate on commercial and industrial (C&I) loans at commercial banks decreased in the first quarter to 2½ percent, about the middle of its range over the past two decades.

Borrowing by nonfinancial corporations remained robust in the first half of the year, reflecting both strong corporate credit quality and favorable financing conditions in capital markets. Gross issuance of nonfinancial corporate bonds rose to a monthly record high in May amid heavy issuance of both investment- and speculative-grade debt. Firms sought to refinance existing debt, lock in new funding at current low yields, and, to a lesser extent, finance merger and acquisition activity. The amount of unsecured nonfinancial commercial paper outstanding also picked up a bit in the first half of the year. Issuance in the syndicated leveraged loan market reached pre-crisis levels, partly owing to heavy refinancing activity and in response to strong demand for floating-rate assets from institutional investors. Likely reflecting in part an increased appetite for higher-yielding debt instruments, the market for collateralized loan obligations (CLOs) showed signs of renewed activity, and issuance picked up.

After declining sharply in 2009 and 2010, C&I loans on banks' books rose at a vigorous pace in the first half of 2011. The SLOOSs of January 2011 and April 2011 showed that banks continued to ease standards and terms for C&I loans. In April, more than half of the survey's respondents reported having trimmed spreads over their cost of funds on loans to firms of all sizes. Respondents also indicated that nonprice loan terms have eased; these results were corroborated by the May 2011 Survey of Terms of Business Lending (STBL), which suggested that the average size of loan commitments at domestic banks and the average maturity of loans drawn on those commitments have trended up in recent quarters. Banks responding to the SLOOS also noted an ongoing firming of demand for C&I loans, particularly by large and medium-sized firms.

For small businesses, borrowing conditions remained tight. The May STBL revealed that the weighted-average spread on C&I loan commitments of less than $1 million stayed stubbornly high in recent quarters, in contrast to a modest decline in the spread on commitments of more than $1 million. However, some signs of improvement in credit availability for small businesses have emerged in recent months. In addition to the easing of terms and standards for C&I loans reported in the April SLOOS, surveys conducted by the National Federation of Independent Business showed that the net fraction of small businesses reporting that credit had become more difficult to obtain than three months ago has declined to its lowest level since the financial crisis, although it remains well above its pre-crisis average. Moreover, the net percentage of respondents expecting credit conditions to become tighter over the next three months remained, on average, lower than in 2010. Demand for credit by small businesses is still weak, with a historically small fraction of such businesses indicating that they have borrowing needs. In addition, the fraction of businesses that cited credit availability as the most important problem that they faced continued to be small; many firms pointed instead to weak demand from customers as their greatest concern.

The fundamentals in commercial real estate (CRE) markets remained extremely weak in the first half of 2011, although financing conditions for certain CRE assets did see some modest improvement. Banks' holdings of CRE loans continued to contract in the first half of the year, driven by reduced lending for construction and land development and sizable charge-offs on existing loans. Although delinquency rates for CRE loans at commercial banks receded slightly from recent peaks, they remained at historically high levels, while the delinquency rate for loans funded by commercial mortgage-backed securities (CMBS) also continued to be elevated. Responses to questions on CRE lending in the April 2011 SLOOS showed that most domestic banks reported no change in their lending standards for approving CRE loans, although a few large banks and foreign banks reported having eased such standards.

On net, financing conditions for investment-quality properties—roughly, those with stable rent streams in large cities—improved in the first half of the year, although conditions worsened a bit in June with the more general pullback from risky assets. Secondary-market spreads for AAA-rated CMBS declined to multiyear lows through May before retracing somewhat in June, and respondents to the Federal Reserve's June 2011 Senior Credit Officer Opinion Survey on Dealer Financing Terms (SCOOS) indicated that funding for less-liquid legacy CMBS had increased.[7] New issuance of CMBS continued to pick up, with issuance in the first half of 2011 exceeding that in all of 2010. Renewed investor interest in high-quality properties has also been evident in investment flows into, and the share prices for, equity real estate investment trusts, or REITs.

In the corporate equity market, combined gross issuance of seasoned and initial offerings continued in the first quarter of 2011 at the same solid pace seen throughout 2010. At the same time, however, volumes of equity retirements from share repurchases and cash-financed mergers and acquisitions remained high and continued to rise.

7 The SCOOS is available on the Federal Reserve Board's website at www.federalreserve.gov/econresdata/releases/scoos.htm.

The Government Sector

Federal Government

The deficit in the federal unified budget remains elevated. The Congressional Budget Office (CBO) projects that the deficit for fiscal year 2011 will be close to $1.4 trillion, or roughly 9 percent of GDP—a level comparable to deficits recorded in 2009 and 2010 but sharply higher than the deficits recorded prior to the onset of the recession and financial crisis. The budget deficit continues to be boosted by the effects of the stimulus policies enacted in recent years, including the provisions of the American Recovery and Reinvestment Act of 2009 (ARRA) and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. In addition, the weakness in the economy continues to damp revenues and boost payments for income support.

Federal receipts have risen rapidly lately—they are up about 10 percent in the first eight months of fiscal 2011 compared with the same period in fiscal 2010. Nonetheless, the level of receipts remains low; indeed, the ratio of receipts to national income is less than 16 percent, near the lowest reading for this ratio in 60 years. The robust rise in revenues thus far this fiscal year is largely a result of strong growth in individual income tax receipts, likely reflecting some step-up in the growth of nominal wage and salary income and an increase in capital gains realizations. Corporate taxes in the first eight months of the fiscal year were up only about 5 percent from last year, as the effect of strong profits growth on receipts was partially offset by recent legislation providing more-favorable tax treatment for some business investment.

Total federal outlays have risen nearly 6 percent in the first eight months of fiscal 2011 relative to the comparable year-earlier period. Much of the increase in outlays this year relative to last has been related to financial transactions. In particular, repayments to the Treasury of obligations for the Troubled Asset Relief Program lowered measured outlays last year and hence reduced the base figure for this year's comparison. Excluding these transactions, outlays were up less than 2 percent this year. This relatively small increase in outlays reflects reductions in both ARRA spending and unemployment insurance payments as well as a subdued pace of defense spending. By contrast, net interest payments have increased sharply, while most other spending has increased at rates comparable to fiscal 2010.

As measured in the national income and product accounts (NIPA), real federal expenditures on consumption and gross investment—the part of federal spending that enters directly into the calculation of real GDP—fell at an annual rate of close to 8 percent in the first quarter. Defense spending, which tends to be erratic from quarter to quarter, plunged almost 12 percent and nondefense purchases were unchanged.

Federal Borrowing

Federal debt expanded at a somewhat slower pace in the first half of this year than in 2010. On May 16, the federal debt reached the $14.294 trillion limit, and the Treasury began to implement extraordinary measures to extend its ability to fund government operations.[8] The Treasury estimates that if the Congress does not raise the debt limit, the capacity of these extraordinary measures will be exhausted on August 2. Thus far, financial market participants do not seem to be pricing in significant odds of a "technical default." However, the risk of such a default has been noted by the rating agencies. In June, Moody's Investors Service, Fitch Ratings, and Standard & Poor's each indicated that they may downgrade, to varying degrees, the credit rating of some or all U.S. debt securities if principal or interest payments are missed. Moody's noted that even if default is avoided, its rating outlook would depend on the achievement of a credible agreement on substantial deficit reduction. In mid-April, Standard & Poor's revised its outlook for the federal government's AAA long-term and A-1+ short-term sovereign credit ratings to negative, citing "material risks" that policymakers might fail to reach an agreement within the next two years on how to address medium- and long-term fiscal imbalances.

Federal debt held by the public reached about 65 percent of nominal GDP in the second quarter of 2011 and, according to CBO projections, will surpass 70 percent of GDP in 2012. Despite continued high levels of federal government financing needs and the concerns raised by the debt limit, Treasury auctions have been generally well received so far this year. For the most part, bid-to-cover ratios and indicators of foreign participation at auctions fell within historical ranges. Demand for Treasury securities likely continued to be supported by heightened investor demand for relatively safe and liquid assets in light of fiscal troubles in some European countries. However, foreign net purchases of Treasury securities and the pace of growth of foreign custody holdings of Treasury securities at the Federal Reserve Bank of New York moderated, on net, during the first half of the year.

State and Local Government

State and local governments remained under significant fiscal pressure in the first half of 2011. Over the first six months of the year, these governments cut an average of 28,000 jobs per month, similar to the pace of job loss observed in 2010. Real construction expenditures have also declined. After falling modestly in 2010, real structures investment by state and local governments plunged in the first quarter of 2011, and available information on nominal construction through May suggests that construction spending continued to decline in recent months. Although federal stimulus funds have boosted construction expenditures on highways and other transportation infrastructure, other types of construction spending—most notably construction of schools—have been declining. Capital expenditures are not typically subject to balanced budget requirements. Nevertheless, the payments of principal and interest on the bonds used to finance capital projects are generally made out of operating budgets, which are subject to balanced budget constraints. As a result, state and local governments have had to make difficult choices even about this form of spending.

State and local revenues appear to have risen moderately over the first half of this year. Many states reported strong revenue collections during the income tax filing season, but federal stimulus grants, while still sizable, have begun to phase out. At the local level, property tax collections appear to be softening as the sharp declines in house prices increasingly show through to assessments and hence to collections. Thus, despite the recent good news on state revenues, the state and local sector is likely to continue to face considerable budgetary strain for a while. Moreover, many state and local governments will need to set aside money in coming years to rebuild their employee pension funds after the financial losses sustained over the past couple of years and to fund health-care benefits for their retired employees.

[8] On May 16, the Secretary of the Treasury declared a "debt issuance suspension period" for the Civil Service Retirement and Disability Fund, permitting the Treasury to redeem a portion of existing Treasury securities held by that fund as investments and to suspend issuance of new Treasury securities to that fund as investments. The Treasury also began suspending some of its daily reinvestment of Treasury securities held as investments by the Government Securities Investment Fund of the Federal Employees' Retirement System Thrift Savings Plan.

State and Local Government Borrowing

While conditions in the municipal bond market improved somewhat in the first half of the year, those conditions continue to reflect ongoing concerns over the financial health of state and local governments. On balance this year, yields on long-term general obligation bonds fell somewhat more than those on comparable-maturity Treasury securities; however, the ratio of municipal bond yields to Treasury yields remained high by historical standards. Credit default swap (CDS) spreads for many states narrowed to their lowest levels in at least a year but remain well above their pre-crisis levels, while downgrades of the credit ratings of state and local governments continued to outpace upgrades by a notable margin during the first half of the year.

Issuance of long-term securities by state and local governments dropped to multiyear lows in the first half of 2011. In part, the decline is a consequence of the outsized issuance seen in the fourth quarter of 2010, when states and municipalities rushed to issue long-term bonds before the expiration of the Build America Bond program at the end of the year.[9] However, the recent weakness likely also reflected tepid investor demand. Mutual funds that invest in long-term municipal bonds experienced heavy net outflows late last year and in January 2011. Net redemptions slowed substantially in subsequent months, and flows have been roughly flat since May.

The External Sector

Both real exports and imports of goods and services expanded at a solid pace in the first quarter of 2011. Real exports increased at an annual rate of 7½ percent, supported by continued robust foreign demand and the lower value of the dollar. Most major categories of exports rose, with industrial supplies, capital goods, and automotive products posting the largest gains. Across trading partners, exports to Canada, Mexico, and other emerging market economies (EMEs) were particularly strong, while exports to the European Union (EU) and China were about flat. Data for April and May suggest that exports continued to grow at a robust pace in the second quarter.

After moving up only modestly in the second half of 2010, real imports of goods and services accelerated noticeably in the first quarter of this year, increasing at an annual rate of almost 5¼ percent, reflecting a return to a more normal pace of expansion. Imports of all major categories increased, with these gains fairly broad based across trading partners. Data for April and May indicate that, despite some drag from the disruptions to automotive imports from Japan following the earthquake, imports of goods and services have continued to rise at a moderate pace.

All told, net exports made a small positive contribution of almost ¼ percentage point to real GDP growth in the first quarter of 2011. The current account deficit widened slightly from an average annual rate of $465 billion in the second half of 2010 to $477 billion, or about 3¼ percent of GDP, in the first quarter of this year; the widening resulted primarily from the increase in the price of imported oil.

The spot price of West Texas Intermediate (WTI) crude oil continued its ascent into the early months of 2011, rising sharply from around $90 per barrel at the beginning of the year to peak at almost $115 by late April. The increase over the first four months of the year likely reflected continued robust growth in global oil demand, particularly in the EMEs, coupled with supply disruptions and the potential for further disruptions due to the political unrest in the Middle East and North Africa (MENA) region. In recent weeks, the spot price of WTI has fallen back to under $100 per barrel because of increasing concerns that global activity might be decelerating. On June 23, the International Energy Agency decided to release 60 million barrels of oil from strategic reserves over the following 30 days. The price of the far-dated futures contracts for crude oil (that is, the contracts expiring in December 2019) mostly fluctuated in the neighborhood of $100 during the first half of the year, implying that the markets viewed the run-up in oil prices seen earlier in the year as partly transitory.

Over the first quarter, prices for a broad variety of nonfuel commodities also moved up significantly. As with oil, these increases were supported primarily by continued strength in global demand, especially from the EMEs. In addition, tight supply conditions played a significant role in pushing up prices for many food commodities. At the onset of the second quarter, prices stabilized and generally began to retreat amid growing uncertainty about the outlook for the global economy, falling back to around the elevated levels registered at the start of this year (see **box 1**).

[9] The Build America Bond program, authorized under the ARRA, allowed state and local governments to issue taxable bonds for capital projects and receive a subsidy payment from the Treasury for 35 percent of interest costs.

Box 1. Commodity Price Developments

Despite recent declines, nominal prices for many commodities are near record highs. The increase in commodity prices since 2002 runs counter to the trend over the prior two decades of declining real prices. The earlier trend decline in part reflected the aftermath of a spike in commodity prices in the 1970s, which eventually boosted supply and curtailed demand for commodities. The relatively low real commodity prices of the 1980s and 1990s, in turn, set the stage for the pickup in prices over the past decade, as underinvestment in new supply capacity left commodity markets ill-prepared to meet a surge in demand linked to rapid growth in global real gross domestic product (GDP). The pickup in world GDP growth was led by the emerging market economies (EMEs). As EME growth is relatively commodity intensive, the concentration of world GDP growth in these economies added to upward pressures on demand for commodities and thus their prices.

EME demand has been important for growth in global consumption of various commodities over the past decade. For oil, metals, and soybeans, the entire increase in consumption over the period is attributable to the EMEs, particularly China. For corn, increased U.S. ethanol production also has been an important factor in boosting consumption.

While demand for commodities has been strong, growth of supply has been relatively limited. For example, oil production over the past decade increased by only about half as much as was projected by the U.S. Department of Energy at the start of the decade. Production in the Organisation for Economic Co-operation and Development countries was depressed by lower-than-expected production in Mexico and the North Sea. The substantial miss in the forecasted production by the Organization of the Petroleum Exporting Countries (OPEC) in part reflects a surprising unresponsiveness of OPEC's supply to higher prices, suggesting that an upward shift in OPEC's perceived price target also held back supply growth. Likewise, for metals, industry groups were repeatedly overly optimistic in regard to projected supply growth, most notably for copper. For agricultural products, although yields and acreage increased over the past 10 years, unusually unfavorable weather has restrained supplies in recent years.

The current high level of commodity prices is likely to prompt an expansion of supply and a moderation in demand that could relieve some of the pressures currently boosting prices. For energy, nonconventional oil production continues to expand, including the Canadian oil sands and the recent developments in North Dakota's Bakken Shale. Similarly, for natural gas, new drilling technology has unlocked previously inaccessible deposits of shale gas, resulting in much higher U.S. natural gas production and lower prices. For agriculture, although harvested acres overseas have expanded briskly since 2000, yields for corn and some other crops are currently much lower than in the United States, suggesting the potential for further gains abroad.

Although there are reasons for optimism, the relative timing and magnitude of these supply and demand adjustments are uncertain. Commodity prices will continue to be affected by the general evolution of the global economy and by even less predictable factors, such as weather and political strife.

Prices of non-oil imported goods accelerated in the first quarter of 2011, surging at an annual rate of 7¼ percent, the fastest pace since the first half of 2008. This pickup was driven by a few factors, including the rise in commodity prices, significant increases in foreign inflation, and the depreciation of the dollar. In the second quarter of this year, with commodity prices apparently stabilizing, import price inflation likely moderated.

National Saving

Total U.S. net national saving—that is, the saving of U.S. households, businesses, and governments, excluding depreciation charges—remains extremely low by historical standards. After having reached nearly 4 percent of nominal GDP in early 2006, net national saving dropped over the subsequent three years, reaching a low of negative 3 percent in the third quarter of 2009. Since then, the national saving rate has edged up, on balance, but remains negative: Net national saving was negative 1.4 percent of nominal GDP in the first quarter of 2011 (the latest data available). The increase in the federal deficit more than accounts for the decline in the net national saving rate since 2006, as private saving rose considerably, on balance, over this period. National saving will likely remain relatively low this year in light of the continuing large federal budget deficit. If low levels of national saving persist over the longer run, they will likely be associated with both low rates of capital formation and heavy borrowing from abroad, limiting the rise in the standard of living of U.S. residents over time.

The Labor Market

Employment and Unemployment

Conditions in the labor market have improved only gradually and unevenly. In the first four months of 2011, private payroll employment increased an average of about 200,000 jobs per month, up from the average pace of 125,000 jobs per month recorded in the second half of 2010. However, private employment gains slowed in May and June, averaging only 65,000, with the step-downs widespread across industries. In addition, cutbacks in jobs continued at state and local governments.

The unemployment rate, which had appeared to be on a downward trajectory at the turn of the year, leveled off at around 9 percent in the early months of the year. Since then, it has edged up, and it reached 9.2 percent in June. Long-term joblessness has also remained elevated. In June, 44 percent of those unemployed had been out of work for more than six months (see **box 2**). Meanwhile, the labor force participation rate, which had declined gradually over 2009 and 2010, has remained roughly flat at a low level since the beginning of 2011.

Other labor market indicators also corroborate the view that the labor market remains weak. Initial claims for unemployment insurance, which had trended steadily downward over the first part of this year, backed up some in the second quarter. Measures of job vacancies edged up, on balance, over the first half of the year, but hiring has remained quite tepid.

Productivity and Labor Compensation

Labor productivity has risen less rapidly recently. Following an outsized increase of 6 percent in 2009, output per hour in the nonfarm business sector increased 2 percent in 2010 and at an annual rate of 1¾ percent in the first quarter of 2011. Available information suggests that labor productivity likely decelerated further in the second quarter.

Increases in hourly compensation continue to be restrained by the weak condition of the labor market. The 12-month change in the employment cost index for private industry workers, which measures both wages and the cost to employers of providing benefits, has been 2 percent or less since the start of 2009 after several years of increases in the neighborhood of 3 percent. Nominal compensation per hour in the nonfarm business sector—a measure derived from the labor compensation data in the NIPA—has also decelerated noticeably over the past couple of years; this measure rose just 2 percent over the year ending in the first quarter of 2011, well below the average increase of about 4 percent in the years before the recession. Similarly, average hourly earnings for all employees—the timeliest measure of wage developments—rose 1.9 percent in nominal terms over the 12 months ending in June.

Box 2. Long-Term Unemployment

The deep recession and subsequent slow improvement in the labor market have resulted in a sharp increase in the incidence of long-term unemployment, defined here as being out of work 27 weeks or longer. In the first quarter of this year, about 6 million persons (4 percent of the labor force) were long-term unemployed. The long-term unemployment rate is almost twice as high as its previous peak of about 2½ percent of the labor force following the recession of the early 1980s. Indeed, the long-term unemployed currently make up 44 percent of all unemployed, up from a previous peak of 25 percent in the early 1980s.

Although all unemployed persons experience a loss of income, the long-term unemployed often face particularly serious economic hardships. They are at greater risk of exhausting unemployment insurance benefits and drawing down savings and other assets, and thus they likely suffer a greater deterioration of living standards.

Even in good times, the likelihood of finding a new job is generally lower for those who have remained unemployed longer. During the most recent recession, job finding rates fell for workers at all unemployment durations. More recently, job finding rates have inched up some from their lows at the end of the recession, but they remain quite low at all durations.

In part, low job finding rates among the long-term unemployed reflect the fact that, at any given time, some attributes—including certain skills, locations, or other characteristics—are associated with greater difficulty in finding employment. In addition, long-term unemployment may compound the difficulty that some individuals have in finding a job by degrading their skills, employment networks, and reputations. Moreover, some who have been unsuccessful in their job search for a long period may permanently drop out of the labor force, in some cases by retiring earlier than planned or applying for disability benefits, thereby reducing aggregate employment for years to come.

Unit labor costs in the nonfarm business sector edged up ¾ percent over the year ending in the first quarter of 2011, as the rate of increase of nominal hourly compensation was just slightly higher than that of labor productivity. Over the preceding year, unit labor costs fell nearly 3 percent.

Prices

Inflation stepped up considerably in the first half of 2011. After rising less than 1¼ percent over the 12 months of 2010, the overall PCE chain-type price index increased at an annual rate of more than 4 percent between December 2010 and May 2011 as energy prices soared and food prices accelerated. PCE prices excluding food and energy also accelerated over the first five months of the year, rising at an annual rate of 2¼ percent, compared with the extremely low rate of about ¾ percent over the 12 months of 2010. The recent increases in both overall inflation and inflation excluding food and energy appear to reflect influences that are likely to wane in coming months.

Consumer energy prices—particularly for motor fuel and home heating oil—rose sharply in the first few months of 2011 as the price of crude oil surged. Between December and April, the PCE price index for consumer energy items climbed almost 12 percent (not at an annual rate), and the national-average price of gasoline approached $4 per gallon. But consumer energy prices began to turn down in May in response to declines in the prices of crude oil and wholesale refined products; while the June reading on the PCE index is not yet available, survey-based information on retail gasoline prices suggests that consumer energy prices likely declined further last month.

After rising modestly last year, consumer prices for food and beverages accelerated this year, rising at an annual rate of more than 6 percent from December to May. Farm commodity prices increased sharply over the past year as the emerging recovery in the global economy coincided with poor harvests in several major producing countries, and this sharp increase has fed through to consumer prices for meats and a wide range of other more-processed foods. In addition, a freeze-related upswing in consumer prices for fruits and vegetables boosted PCE food prices earlier this year; these prices began to retreat in the spring.

Price inflation for consumer goods and services other than energy and food appears to have been boosted during the first five months of 2011 by higher prices of imported items as well as by cost pressures generated by increases in the prices of oil and other industrial commodities; given the apparent stabilization of commodity prices, these pressures should fade in coming months. In addition, prices of motor vehicles increased sharply when supplies of new models were curtailed by parts shortages associated with the earthquake in Japan. These shortages are expected to diminish in coming months as supply chain problems are alleviated and motor vehicle production increases.

Longer-term inflation expectations remained stable during the first half of the year. In the Thomson Reuters/University of Michigan Surveys of Consumers, median longer-term expectations were 3 percent in June, well within the range seen over the past several years. Moreover, the second-quarter reading of 10-year-ahead inflation expectations from the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, stood at 2¼ percent in the second quarter, only slightly higher than the 2 percent reading recorded in the fourth quarter of last year. Measures of inflation compensation derived from yields on nominal and inflation-indexed Treasury securities fluctuated over the first half of the year in response to changes in commodity prices and the outlook for economic growth. On balance, medium-term inflation compensation ended the first half of the year slightly higher, but compensation at longer-term horizons was little changed.

Survey-based measures of near-term inflation expectations moved up during the first half of the year, likely reflecting the run-up in energy and food prices. Median year-ahead inflation expectations in the Michigan survey, which had been relatively stable throughout much of 2010, stepped up markedly through April but then fell back a bit in May and June as prices for gasoline and food decreased.

Financial Developments

Financial market conditions became somewhat more supportive of economic growth, on balance, in the first half of 2011, reflecting in part continued monetary policy accommodation provided by the Federal Reserve. In the early part of the year, strong corporate profits and investors' perceptions that the economic recovery was firming supported a rise in equity prices and a narrowing of credit spreads. Since May, however, indications that the U.S. economic recovery was proceeding at a slower pace than previously anticipated, a perceived moderation in global growth, and mounting concerns about the persisting fiscal pressures in Europe weighed on investor sentiment, prompting some pullback from riskier financial assets.

Monetary Policy Expectations and Treasury Rates

On net over the first half of the year, amid indications of a slowing in the pace of economic recovery, market participants pushed out the date when they expect the target federal funds rate to first rise above its current range of 0 to ¼ percent and scaled back their expectations of the pace at which monetary policy accommodation will be removed. Quotes on money market futures contracts imply that, as of early July 2011, investors expect the federal funds rate to rise above its current target range in the fourth quarter of 2012, about three quarters later than the date implied at the start of the year.[10] Investors also expect, on average, that the effective federal funds rate will be about 75 basis points by the middle of 2013, about 90 basis points lower than anticipated at the beginning of 2011. Over the first half of the year, investors coalesced around the view that the Federal Reserve would complete the $600 billion program of purchases of longer-term Treasury securities announced at the November 2010 meeting of the Federal Open Market Committee (FOMC); the program was completed at the end of June.

Yields on nominal Treasury securities declined, on balance, over the first half of 2011. Treasury yields initially rose in the first quarter amid signs that the U.S. economic recovery was on a firmer footing and that higher prices for energy and other commodities were boosting inflation and investor uncertainty about future inflation. However, yields subsequently more than reversed their earlier increases, as weaker-than-expected economic data pointed to a slower pace of economic recovery in the United States, commodity prices eased somewhat, and investors sought the relative safety and liquidity of Treasury securities in the face of heightened concerns about the ongoing fiscal strains in Europe. As of early July, yields on 2-, 5-, and 10-year Treasury notes had dropped about 20, 40, and 30 basis points, respectively, since the start of the year, reaching very low levels. Uncertainty about longer-term interest rates, as measured by the implied volatility on 10-year Treasury securities, declined, on balance, reflecting in part the resolution of uncertainty about the ultimate size and duration of the Federal Reserve's asset purchase program and the lower odds perceived by investors of a rapid removal of monetary policy accommodation. However, volatility increased for a time in mid-June as concerns escalated about the effects of Europe's fiscal problems on European banks. Thus far, the issues surrounding the statutory debt limit seem not to have affected either Treasury yields or implied volatility noticeably, suggesting that investors generally believe that policymakers will reach an agreement to raise the limit before the Treasury exhausts its capacity to borrow in early August.

Corporate Debt and Equity Markets

Yields on corporate bonds across the credit spectrum generally declined, on net, during the first half of the year by amounts broadly similar to those on comparable-maturity Treasury securities, leaving risk spreads little changed. After narrowing in the first four months of the year, spreads subsequently retraced, reflecting disappointing news about the strength of the economic recovery at home as well as the ongoing fiscal stresses in Europe. Nonetheless, bond spreads remained at the lower ends of their historical ranges. The term structure of corporate yield spreads indicated that the recent widening was concentrated in near-term forward spreads rather than far-term forward spreads. This information suggests that while investors have become a bit more concerned about near-term risks, there has been little if any change in their willingness to bear risk at longer horizons; in fact, far-term forward spreads, particularly for high-yield bonds, are close to their historical lows. In the secondary market for syndicated leveraged loans, the average bid price edged up further, reflecting strong demand from institutional investors for the asset class and a further improvement in fundamentals.

Broad equity price indexes posted hefty gains in the first quarter of 2011 because of strong earnings reports and expectations that the economic recovery was firming. Equity prices fell back somewhat in May and June as investors downgraded their expectations for economic growth and reacted to the situation in Europe, but the market subsequently rebounded as concerns about the near-term risks in Europe appeared to ease. On net, stock prices ended the first half of the year significantly higher. Implied volatility of the S&P 500 stock price index, as calculated from options prices, was slightly lower, on net, but fluctuated in response to various risk events during the first half of the year.

With some investors seeking to boost nominal returns in an environment of very low interest rates,

[10] When interest rates are close to zero, determining the point at which financial market quotes indicate that the federal funds rate will move above its current range can be challenging. The path described in the text is the mean of a distribution calculated from derivatives contracts on federal funds and Eurodollars. The asymmetry induced in this distribution by the zero lower bound causes the mean to be influenced strongly by changes in uncertainty regarding the policy path, complicating the interpretation of the expected path. Alternatively, one can use similar derivatives to calculate the most likely, or "modal," path of the federal funds rate, which tends to be more stable. This alternative measure has also moved down, on net, since the beginning of the year, but it suggests a flatter overall trajectory for the target federal funds rate, according to which the effective rate does not rise above its current target range until the second half of 2013.

monies continued to flow, on net, into mutual funds that invest in higher-yielding debt instruments (including speculative-grade corporate bonds and leveraged loans) in the first half of 2011. These inflows likely supported strong issuance and contributed to the easing of conditions in corporate bond markets. However, consistent with the subsequent downturn in risk sentiment, equity mutual funds experienced large net outflows in May and June—the first monthly outflows from such funds since October 2010. Money market mutual funds continued to have moderate net outflows amid the very low yields that these funds pay. Within the universe of money market funds, institutional prime money market funds experienced a stepped-up pace of outflows in June, likely reflecting in part some concerns about such funds' exposures to European financial institutions.

Market Functioning and Dealer-Intermediated Credit

Conditions in short-term funding markets were generally stable in the first half of 2011. Spreads of London interbank offered rates, or Libor, over comparable-maturity overnight index swap rates—a measure of stress in short-term bank funding markets—remained relatively narrow. However, forward agreements for short-term U.S. dollar funding starting three months hence jumped in mid-June as concerns increased regarding the exposures of some European banks to peripheral European sovereign debt. In addition, some European financial institutions faced reduced access to U.S. dollar funding, as evidenced by their declining issuance of commercial paper in the United States and rates on their paper that remain noticeably elevated compared with rates paid by other issuers. In commercial paper markets more broadly, spreads of yields on lower-quality A2/P2-rated paper over those on higher-quality AA-rated nonfinancial paper edged slightly higher, both at overnight and 30-day tenors; spreads of yields on AA-rated asset-backed commercial paper over those on AA-rated nonfinancial paper remained narrow.

In repurchase agreement (repo) transactions, haircuts on securities used as collateral were, on balance, little changed over the first half of the year. The Federal Deposit Insurance Corporation's implementation on April 1 of a change in its deposit insurance assessment system—which, for the first time, effectively assessed premiums on the nondeposit liabilities of large banks—reduced banks' demand for short-term funding, putting downward pressure on short-term rates.[11] Money market rates softened further in late June, with rates in secured funding markets near zero; investors pointed to a shortage of collateral and higher demand for safe, liquid assets as factors contributing to the decline.

Information from the Federal Reserve's quarterly SCOOS suggested a continued gradual easing in credit terms for most types of counterparties in securities financing and over-the-counter (OTC) derivatives markets in the first half of the year. Dealers indicated that the easing came primarily in response to more-aggressive competition from other institutions and an improvement in general market liquidity and functioning. The easing of terms occurred primarily for securities financing transactions, while nonprice terms on OTC derivatives transactions were little changed on balance. Dealers also reported a continued increase in demand for funding for most types of securities, excluding equities.

The use of dealer-intermediated leverage appears to have increased from its very low level reached during the financial crisis. Responses to special questions included in the SCOOS in March 2011 and June 2011 also tended to corroborate the view that dealer-intermediated leverage had increased somewhat over the past six months among both hedge funds and traditionally unlevered investors. Nonetheless, respondents to the June survey reported that the overall use of leverage remained at levels roughly midway between the pre-crisis peak and the post-crisis trough. That the usage of dealer-intermediated leverage is still well below the peak appears consistent with other evidence, including current triparty and securities lending activity, a lack of any meaningful issuance of structured finance products other than CLOs, and no sign of a pickup in financing instruments that embed significant leverage, such as total return swaps. Responses to another special question on the June 2011 SCOOS indicated that there was some unused funding capacity under existing agreements for all types of institutional clients, and that unused capacity had generally increased since the

[11] On April 1, 2011, the Federal Deposit Insurance Corporation implemented changes to its deposit insurance assessment system that broadened the definition of the assessment base and altered assessment rates, especially for large banks. Under the new system, insurance premiums are based on an insured depository institution's total assets less tangible capital—essentially all liabilities—rather than domestic deposits. The new assessment rate schedule continued to assign higher assessment rates to banks that pose greater risks to the insurance system. In the aggregate, the changes in the assessment system were intended to be revenue neutral.

beginning of 2011. This finding suggests that leverage is constrained by counterparties' risk appetites rather than funding availability. With the pullback from risk-taking and turn in market sentiment in June (after responses to the June SCOOS were filed), leverage use appears to have declined. Hedge funds saw an erosion of the returns posted during the first few months of the year, leaving their returns roughly flat for the year to date.

Measures of liquidity and functioning in most financial markets suggest that conditions were generally stable during the first half of 2011. In the Treasury market, various indicators, such as differences in the prices between alternative securities with similar remaining maturities and spreads between yields on on-the-run and off-the-run issues, suggest that the market continued to operate normally and that the implementation and subsequent completion of the Federal Reserve's program of purchases of longer-term Treasury securities did not have an adverse effect on market functioning. Bid-asked spreads and dealer transaction volumes were within historically normal ranges. Estimates of the bid-asked spreads in corporate bond markets were steady at low levels, and the dispersion of dealer quotes in the CDS market reached the lowest level since the financial crisis. In the secondary market for leveraged loans, bid-asked spreads also moved modestly lower, on net, over the first half of the year.

Banking Institutions

After a relatively positive first quarter, market sentiment toward the banking industry dimmed in the second quarter against the backdrop of the more guarded economic outlook and heightened uncertainty over future regulatory requirements for financial institutions. As a result, equity prices of commercial banks fell markedly, significantly underperforming the broader stock market over the first half of the year. Measures of the profitability of the banking industry in the first quarter remained at levels noticeably below those that prevailed before the financial crisis. A decline in pre-provision net revenue was about offset by a further reduction in loan loss provisions, which presumably reflected the improvement in most measures of the quality of banks' assets.[12] However, net charge-offs exceeded provisions for the fifth consecutive quarter, and loan loss reserves remained low relative to delinquent loans and charge-offs. Net interest margins slid a bit, while a decline in banks' income from deposit fees was offset by gains in income from trading activities. About 50 of the roughly 6,500 banks in the United States failed in the first half of the year, fewer than the approximately 70 failures in the second half of 2010.

Indicators of credit quality at commercial banks improved in the first quarter of 2011; the overall delinquency rate on loans held by such banks fell somewhat and charge-off rates declined. Median spreads on CDS written on banking institutions, which reflect investors' assessments of and willingness to bear the risk that those institutions will default on their debt obligations, were about unchanged, on net, for a group of six of the largest banks and slightly narrower for a group of nine other banks. CDS spreads for foreign banking organizations with a presence in U.S. markets widened some, owing to concerns about developments in Europe and the organizations' exposures to sovereign European debt.

Credit provided by domestic banks and the U.S. branches and agencies of foreign banks decreased slightly further in the first half of this year, as banks' holdings of securities were about flat and an increase in C&I loans to businesses was more than offset by declines in real estate loans and consumer loans. C&I loan balances rose vigorously over the first half of the year; most of this increase was concentrated at large domestic banks and branches and agencies of foreign banks, consistent with the easing of credit conditions for large corporate borrowers seen in other credit markets. In contrast, available proxies for lending to small businesses continued to suggest considerable weakness, likely reflecting constraints on both the demand for, and the supply of, such credit. CRE loans contracted sharply, especially those funding construction and land development activities. On the household side, banks' holdings of closed-end residential mortgages declined as banks sold large quantities of such loans to the GSEs. Moreover, originations trailed off with the end of the refinancing wave that occurred last fall, when interest rates declined in anticipation of the Federal Reserve's second round of large-scale asset purchases. Bank lending through home equity lines also remained extraordinarily weak, reflecting in part tight lending standards amid declines in home prices that cut further into home equity. Both credit card and other consumer loans from banks contracted, on balance, over the first half of the year, albeit at a much slower pace in the second quarter than in the first. Banks' holdings of securities were little changed over the first

[12] Pre-provision net revenue is the sum of net interest income and noninterest income less noninterest expense.

half of the year, as an increase in holdings of agency MBS was about offset by declines in holdings of Treasury and other securities.

Regulatory capital ratios of bank holding companies rose further as large institutions prepared to meet future requirements that are expected to be more stringent than those currently in place. The Basel III framework agreed to by the governors and heads of supervision of countries represented on the Basel Committee on Banking Supervision will raise required capital ratios, tighten the definition of regulatory capital, and increase the risk weights assigned to some assets and off-balance-sheet exposures. The Basel III framework will also strengthen banks' liquidity requirements. In addition, the Basel Committee is expected to release later this summer a proposal to require that global systemically important banks hold additional capital to reduce the potential economic and financial effect of the failure of such banks. This proposal would be consistent with the requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act that bank holding companies with more than $50 billion in assets be subject to additional capital and liquidity requirements.

Monetary Aggregates and the Federal Reserve's Balance Sheet

The M2 monetary aggregate expanded at a moderate annual rate of 5 percent in the first half of 2011.[13] Liquid deposits, the largest component of M2, continued to rise at a solid pace, while investors extended their reallocation away from other lower-yielding M2 assets. Balances held in small time deposits and retail money market mutual funds contracted to their lowest levels since 2005 as their yields remained extremely low. The currency component of the money stock increased at an annual rate of 10 percent in the first half of the year, likely driven by both further strong demand from abroad and solid domestic demand. The monetary base—which is roughly equal to the sum of currency in circulation and the reserve balances of depository institutions held at the Federal Reserve—increased rapidly in the first half of the year, reflecting an expansion of reserve balances that resulted from the Federal Reserve's longer-term security purchase program and a reduction in the Treasury Department's Supplementary Financing Account as well as the strong increase in currency.

The size of the Federal Reserve's balance sheet rose to $2.9 trillion as of July 6, 2011, about $450 billion more than at the end of 2010 (**table 1**). Holdings of Treasury securities rose more than $600 billion for the year to date as a result of the FOMC's decisions to reinvest the proceeds from paydowns of agency debt and agency MBS in longer-term Treasury securities, announced at the August 2010 FOMC meeting, and to purchase an additional $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, announced at the November 2010 FOMC meeting. In contrast, holdings of agency debt and agency MBS declined about $115 billion as securities either matured or experienced principal prepayments related to mortgage refinancing activity.

Use of regular discount window lending facilities, such as the primary credit facility, continued to be minimal. Loans outstanding under the Term Asset-Backed Securities Loan Facility (TALF) declined from $25 billion at the end of 2010 to $12 billion in mid-2011 as improved conditions in securitization markets resulted in prepayments of loans made under the facility. The facility, which was established to assist financial markets in accommodating the credit needs of consumers and businesses by facilitating the issuance of ABS collateralized by a variety of consumer and business loans, was closed to new lending in June 2010. All remaining TALF loans are current on their payments and will mature no later than March 30, 2015.

In the first half of this year, the Federal Reserve reduced some of its exposures from lending facilities established during the financial crisis to support specific institutions. On January 14, 2011, in conjunction with the closing of a recapitalization plan that terminated the Federal Reserve's assistance to American International Group, Inc. (AIG), AIG repaid the credit extended by the Federal Reserve under the revolving credit line, and the Federal Reserve was paid in full for its preferred interests in the special purpose vehicles AIA Aurora LLC and ALICO

[13] M2 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) traveler's checks of nonbank issuers; (3) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; (4) other checkable deposits (negotiable order of withdrawal, or NOW, accounts and automatic transfer service accounts at depository institutions; credit union share draft accounts; and demand deposits at thrift institutions); (5) savings deposits (including money market deposit accounts); (6) small-denomination time deposits (time deposits issued in amounts of less than $100,000) less individual retirement account (IRA) and Keogh balances at depository institutions; and (7) balances in retail money market mutual funds less IRA and Keogh balances at money market mutual funds.

Table 1. Selected components of the Federal Reserve balance sheet, 2010–11
Millions of dollars

Balance sheet item	Dec. 29, 2010	July 6, 2011
Total assets	**2,423,457**	**2,874,049**
Selected assets		
Credit extended to depository institutions and dealers		
Primary credit	58	5
Central bank liquidity swaps	75	0
Credit extended to other market participants		
Term Asset-Backed Securities Loan Facility (TALF)	24,704	12,488
Net portfolio holdings of TALF LLC	665	757
Support of critical institutions		
Net portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC[1]	66,312	59,637
Credit extended to American International Group, Inc.	20,282	…
Preferred interests in AIA Aurora LLC and ALICO Holdings LLC	26,057	…
Securities held outright		
U.S. Treasury securities	1,016,102	1,624,515
Agency debt securities	147,460	115,070
Agency mortgage-backed securities (MBS)[2]	992,141	908,853
Total liabilities	**2,366,855**	**2,822,382**
Selected liabilities		
Federal Reserve notes in circulation	943,749	990,861
Reverse repurchase agreements	59,246	67,527
Deposits held by depository institutions	1,025,839	1,663,022
Of which: Term deposits	5,113	0
U.S. Treasury, general account	88,905	67,270
U.S. Treasury, Supplementary Financing Account	199,963	5,000
Total capital	**56,602**	**51,667**

Note: LLC is a limited liability company.

1 The Federal Reserve has extended credit to several LLCs in conjunction with efforts to support critical institutions. Maiden Lane LLC was formed to acquire certain assets of the Bear Stearns Companies, Inc. Maiden Lane II LLC was formed to purchase residential mortgage-backed securities from the U.S. securities lending reinvestment portfolio of subsidiaries of American International Group, Inc. (AIG). Maiden Lane III LLC was formed to purchase multisector collateralized debt obligations on which the Financial Products group of AIG has written credit default swap contracts.

2 Includes only MBS purchases that have already settled.

…Not applicable.

Source: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks."

Holdings LLC. Neither the revolving credit facility nor the preferred interests held in connection with the revolving credit facility generated any loss to the Federal Reserve or taxpayers. The portfolio holdings of Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC—entities that were created during the crisis to acquire certain assets from the Bear Stearns Companies, Inc., and AIG to avoid the disorderly failures of those institutions—declined, on net, primarily as a result of principal payments and asset sales. Of note, the Federal Reserve Bank of New York (FRBNY) sold a total of $10 billion in current face value of residential mortgage-backed securities out of the Maiden Lane II portfolio; competitive sales of these securities were conducted through the FRBNY's investment manager.[14] The estimated fair values of the portfolios of the three Maiden Lane LLCs continue to exceed the corresponding loan balances outstanding to each limited liability company from the FRBNY.

Only small draws on U.S. dollar liquidity swap arrangements between the Federal Reserve and foreign central banks have been made since their reestablishment in May 2010, and there have been no draws on them since early March of this year.

On the liability side of the Federal Reserve's balance sheet, reserve balances held by depository institutions rose about $640 billion over the first half of the year to $1.7 trillion as of July 6. Federal Reserve notes in circulation rose from $944 billion to $991 billion. The Treasury reduced the balance in its Supplementary Financing Account at the Federal Reserve to $5 billion early in the year as part of its efforts to maximize flexibility in its debt management as the statutory debt limit approached. Balances in the Treasury's general account at the Federal Reserve also declined. Reverse repurchase agreements executed with foreign official and international accounts were generally steady. As part of its ongoing program to expand the range of tools available to drain reserves, the Federal Reserve conducted three 28-day, $5 billion auctions of term deposits to depository institutions as well as a series of small-scale, real-value triparty reverse repurchase operations with eligible primary dealer and money market fund counterparties.

On March 22, the Federal Reserve System released audited financial statements for 2010 for the combined Federal Reserve Banks, the 12 individual Reserve Banks, the limited liability companies that were created to respond to strains in financial markets, and the Board of Governors. The Reserve Banks reported comprehensive income of close to $82 billion for the year ending December 31, 2010, an increase of $28 billion from 2009. The increase was attributable primarily to interest earnings on the Federal Reserve's holdings of agency debt and MBS, acquired largely in 2009. The Reserve Banks transferred $79 billion of the $82 billion in comprehensive income to the U.S. Treasury in 2010, a record high and $32 billion more than was transferred in 2009.

14 Current face value is the remaining principal balance of the mortgage assets underlying the securities, after prepayments and amortizations.

International Developments

In the first half of the year, developments abroad have largely been dominated by several shocks, including the political turmoil in the MENA region, a major earthquake and tsunami in Japan, heightened fiscal stresses in Europe, and swings in commodity prices. In the face of these shocks, global financial markets were fairly resilient and foreign economic activity held up. Foreign real GDP accelerated in the first quarter, most notably in the EMEs, where performance has continued to outpace that in the advanced foreign economies (AFEs). Recent data indicate that foreign economic growth slowed in the second quarter, but the recovery from the global recession continued.

International Financial Markets

Spurred in part by monetary policy tightening abroad and fears that the pace of economic recovery in the United States was slowing, the foreign exchange value of the dollar declined over much of the first half of the year. The lower level of the dollar is consistent with a weakening of the safe-haven demands that had boosted it during the global financial crisis; however, the dollar has moved slightly higher since May on heightened concerns over the fiscal problems in Europe and uncertainties about global economic growth. On net, the dollar is about 3¾ percent lower on a trade-weighted basis against a broad set of currencies over the first half of the year. Following Japan's earthquake, as traders anticipated that Japanese investors would need to repatriate funds, the yen appreciated sharply, reaching a record high versus the dollar. In response, the Group of Seven (G-7) countries conducted coordinated sales of yen in the foreign exchange markets on March 18. The yen more than reversed its steep appreciation immediately following the intervention.

Ten-year sovereign yields in the AFEs generally rose early in the year on expectations that continued economic recovery and greater inflationary pressures would prompt monetary policy tightening. However, since April, yields have begun to retreat. On net, yields for Germany, Canada, and the United Kingdom are down slightly from the end of last year.

Fiscal and financial stresses worsened in Greece, Portugal, and Ireland over the first half of the year, with the major credit rating agencies downgrading significantly these countries' sovereign credit ratings. The spreads of yields on Greek, Portuguese, and Irish bonds over those on German bonds soared as market confidence in the ability of these three countries to meet their fiscal obligations diminished. Following a €78 billion rescue package by the EU and the International Monetary Fund (IMF) in early May, spreads for Portuguese bonds stabilized but soon rose again amid the high-profile discussions by European officials on a possible restructuring of Greek debt. In late June, Greece approved a new austerity and privatization package, opening the door for approval of a €12 billion EU–IMF disbursement needed to meet upcoming payments. Although spreads for Greek, Portuguese, and Irish bonds declined some following these developments, they have since risen as Moody's Investors Service downgraded Portugal's sovereign debt rating to junk status and EU officials continued to seek commitments from private creditors to roll over maturing Greek debt. Movements in spreads for the sovereign debts of Italy and Spain have been more muted, but they have moved up in recent months.

Equity prices in the AFEs generally continued to rise through the first few months of this year, falling sharply after Japan's earthquake on March 11 but, outside of Japan, recouping their losses afterward. By early May, increased uncertainties about global economic growth and heightened concerns over the sovereign debt problems in Europe prompted a pullback in equity prices. However, the passage of Greece's austerity and privatization legislations in late June, which assuaged market concerns about an imminent Greek default, prompted some renewed demand for risky assets; equity prices in most of the AFEs were, on net, at about their levels at the start of the year. In the EMEs, equity prices had also risen early in the year, but, as in the AFEs, they began to pull back by early May. On net, over the first half of the year, equity prices are down in Latin America but are up in emerging Asia.

Bank stock prices in Europe have declined nearly 9 percent since the start of the year. CDS premiums for European banks remained significantly higher than those of nonfinancial firms with similar credit ratings. European banks experienced large losses during the global financial crisis, and their lending exposure to Greece, Ireland, and other vulnerable European economies remains a concern. In addition, some banks in the core European countries, such as France and Germany, still have considerable dollar funding needs. Most peripheral European banks have only limited access to market funding and have relied on ECB funding instead. In Japan, banks have not experienced crisis-related losses nearly as large as those incurred by European institutions, but Japanese bank profits have been persistently weaker, reflecting the fragile state of Japan's economy.

The newly created European Banking Authority is in the process of completing an EU-wide stress test of large European banks. The methodology used in this year's test is broadly similar to that of the stress tests conducted by the Committee of European Banking Supervisors last year. The results of the stress test are expected to be released on July 15 of this year. In anticipation of the test, some European banks took steps to raise additional capital in recent months.

The Financial Account

Net purchases of U.S. securities by foreign private investors slowed in the first quarter from the pace of 2010, in part because of reduced safe-haven demand for U.S. Treasury securities. Foreign investors, on net, sold both U.S. agency and corporate bonds in the first quarter, in contrast to purchases of these securities in the second half of last year, but they continued to make large purchases of U.S. equities. U.S. investors increased the pace of their purchases of foreign securities, especially foreign equities.

Banks located in the United States registered strong net inflows from abroad in the first quarter following small net inflows in the fourth quarter of last year. These recent net inflows primarily reflect increased net borrowing from affiliated banking offices abroad and are in marked contrast to sizable net lending abroad from U.S. banks in the first half of 2010, when dollar funding pressures in European interbank markets had contributed to increased reliance on funding from U.S. counterparties.

Inflows from foreign official investors eased somewhat in late 2010 and continued at a moderate pace in the first quarter this year. Such inflows continued to come primarily from countries seeking to counteract upward pressure on their currencies by purchasing U.S. dollars in foreign currency markets. These countries then used the proceeds to acquire U.S. assets, mainly Treasury and U.S. agency securities. Available data through May indicate that foreign official inflows slowed a bit further in the second quarter.

Advanced Foreign Economies

The pace of economic recovery in the AFEs picked up in early 2011 following a soft patch in the second half of 2010, but performance was uneven across countries. Real GDP rose at a solid pace in the first quarter in Canada, boosted by a surge in investment. In the euro area, economic activity was strong in Germany and France but remained generally weak in the peripheral countries, as concerns about sovereign debt sustainability continued to weigh on economic growth. In the United Kingdom, output rebounded in the first quarter of this year from a contraction in the fourth quarter of 2010, but the pace was restrained by declines in households' real incomes as inflation increased. Japan's economic activity was also bouncing back from its dip in the fourth quarter of last year until the earthquake and ensuing tsunami and nuclear disaster caused first-quarter real GDP to contract sharply.

The disaster in Japan damaged production facilities, disrupted supply chains, and reduced electricity generation capacity. In addition, spending on consumer durables and capital investment fell sharply, reflecting a substantial slump in consumer and business confidence. The Japanese authorities responded swiftly to support the economy. The Bank of Japan injected record amounts of liquidity into money markets, doubled the size of its asset purchase program to ¥10 trillion, set up a ¥1 trillion loan program for firms in disaster-hit areas, and expanded by ¥500 billion the funds for an existing program aimed at supporting economic growth. The Japanese Diet approved a ¥4 trillion supplementary budget to fund the construction of temporary housing, the restoration of damaged infrastructure, and the provision of low-interest loans to small businesses. Japan also requested a coordinated intervention of G-7 countries' central banks in foreign exchange markets to stem the appreciation of the yen. Supported by the various official actions, the financial system continued to operate smoothly and reconstruction activity has begun, setting the stage for an economic recovery in the second half of the year.

Supply disruptions due to the Japanese earthquake weighed on economic growth in other AFEs, and other incoming data corroborate that economic activity in the AFEs slowed in the second quarter. The composite purchasing managers indexes have moved lower in recent months across the AFEs. In addition, business confidence has turned down, and the underlying momentum in consumer spending has remained weak in the euro area.

A surge in energy and food prices and, in some cases, higher value-added taxes lifted headline inflation rates in the major foreign economies earlier in the year. Twelve-month headline inflation rose to 4½ percent in the United Kingdom and to about 3¾ percent and 2¾ percent in Canada and the euro area, respectively. In Japan, the rise in commodity prices pushed inflation above zero. Excluding the effects of commodity price movements and tax changes, inflation in the AFEs has remained relatively subdued amid considerable economic resource slack. With the recent pullback in commodity prices, overall inflation also appears to be stabilizing.

Monetary policy remained accommodative in all the major AFEs, and market participants appear to expect only gradual tightening. After having kept its benchmark policy rate at 1 percent since May 2009, the ECB raised it twice—by 25 basis points in April and by another 25 basis points in early July—citing upside risks to the inflation outlook. The Bank of Canada, which began to tighten last year, has paused so far this year, maintaining its target for the overnight rate at 1 percent. The Bank of England kept its policy rate at 0.5 percent and the size of its Asset Purchase Facility at £200 billion.

Emerging Market Economies

The EMEs continued to expand at a strong pace in the first quarter of 2011, boosted by both exports and domestic demand. Exports were lifted by sustained global demand. Domestic demand was supported by macroeconomic policies that remained generally accommodative despite recent tightening and by robust household income amid strong labor market conditions. Recent data indicate that growth moderated in the second quarter, but to a still-solid pace, reflecting governments' policies to cool the economies that were running unsustainably fast, a deceleration in activity in the advanced economies, and spillover effects of the Japanese earthquake.

The Chinese economy expanded at a strong pace in the first half of 2011, although economic growth slowed a bit compared with the second half of last year, largely due to measures by authorities to rein in the economy. Headline consumer prices were up 6.4 percent in June from a year earlier, led by a rise in food prices. This year, Chinese authorities have raised required reserve ratios for all banks 300 basis points—the requirement for large banks now stands at 21.5 percent. Authorities have also raised the benchmark one-year bank lending rate ¾ percentage point. Over the first half of the year, the Chinese renminbi has appreciated, on net, about 2½ percent against the dollar. However, on a real multilateral, trade-weighted basis, which gauges the renminbi's value against the currencies of China's major trading partners and adjusts for differences in inflation rates, the renminbi has depreciated. Nonetheless, strong domestic demand led import growth in the first half of this year to exceed export growth, and consequently, China's trade surplus narrowed.

Elsewhere in emerging Asia, the vigorous Chinese economy provided impetus to exports for several countries, and domestic demand was also robust. Accordingly, economic activity was upbeat in the first quarter, with several countries, including Hong Kong, Singapore, and Taiwan, all posting double-digit annualized growth rates. Economic activity was also upbeat in India. Available indicators for the second quarter suggest that the pace of expansion slowed but remained solid.

In Mexico, a country with stronger economic linkages to the United States than most EMEs, performance continued to lag that of other EMEs. Reported first-quarter real GDP rose at an annual rate of only 2 percent. By contrast, first-quarter real GDP rose robustly in Brazil and in other South American countries, supported by generally accommodative macroeconomic policies and the tailwind from gains in commodity prices.

Higher food prices pushed up consumer price inflation in the EMEs earlier in the year. As food price pressures subsequently eased, 12-month inflation stabilized and began to retreat in several countries. In the midst of elevated inflation and strong economic growth, the stance of macroeconomic policy in the EMEs has been tightened further to mitigate the risks of overheating. In the first half of the year, many EMEs tightened monetary policy by raising policy rates and reserve requirement ratios several times, and progress was also made on the removal of the fiscal support measures enacted at the height of the global financial crisis.

Part 3
Monetary Policy: Recent Developments and Outlook

Monetary Policy over the First Half of 2011

To promote the economic recovery and price stability, the Federal Open Market Committee (FOMC) maintained a target range for the federal funds rate of 0 to ¼ percent throughout the first half of 2011. In the statement accompanying each FOMC meeting over the period, the Committee noted that economic conditions were likely to warrant exceptionally low levels for the federal funds rate for an extended period. At the end of June, the Federal Reserve concluded its purchases of longer-term Treasury securities under the $600 billion purchase program announced in November 2010; that program was undertaken to support the economic recovery and to help ensure that inflation, over time, returns to levels consistent with the FOMC's mandate of maximum employment and price stability. In addition, throughout the first half of 2011, the Committee maintained its existing policy of reinvesting principal payments from its agency debt and agency mortgage-backed securities in longer-term Treasury securities. In its June statement, the Committee noted that it would regularly review the size and composition of its securities holdings and was prepared to adjust those holdings, as appropriate, to foster maximum employment and price stability.

The information reviewed at the January 25–26 FOMC meeting indicated that the economic recovery was gaining a firmer footing, though the expansion had not yet been sufficient to bring about a significant improvement in labor market conditions. Consumer spending had risen strongly in late 2010, and the ongoing expansion in business outlays for equipment and software appeared to have been sustained in recent months. Industrial production had increased solidly in November and December. However, construction activity in both the residential and nonresidential sectors remained weak. Modest gains in employment had continued, and the unemployment rate remained elevated. Conditions in financial markets were viewed by FOMC participants as having improved somewhat further over the intermeeting period, as equity prices had risen and credit spreads on the debt of nonfinancial corporations had continued to narrow, while yields on longer-term nominal Treasury securities were little changed.[15] Credit conditions were still tight for smaller, bank-dependent firms, although bank loan growth had picked up in some sectors. Despite further increases in commodity prices, measures of underlying inflation remained subdued and longer-run inflation expectations were stable.

The information received over the intermeeting period had increased Committee members' confidence that the economic recovery would be sustained, and the downside risks to both economic growth and inflation were viewed as having diminished. Nevertheless, members noted that the pace of the recovery was insufficient to bring about a significant improvement in labor market conditions and that measures of underlying inflation were trending down. Moreover, the economic projections submitted for this meeting indicated that unemployment was expected to remain above, and inflation to remain somewhat below, levels consistent with the Committee's objectives for some time. Accordingly, the Committee decided to maintain its existing policy of reinvesting principal payments from its securities holdings and reaffirmed its intention to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. Members emphasized that the Committee would continue to regularly review the pace of its securities purchases and the overall size of the asset purchase program in light of incoming information and would adjust the program as needed to best foster maximum employment and price stability. In addition, the Committee maintained the target range of 0 to ¼ percent for the federal funds rate and reiterated its expectation that economic conditions were likely to warrant exceptionally low levels of the federal funds rate for an extended period.

The data presented at the March 15 FOMC meeting indicated that the economic recovery continued to proceed at a moderate pace, with a gradual improvement in labor market conditions. Looking through weather-related distortions in various indicators, measures of consumer spending, business investment, and employment continued to show expansion. Housing, however, remained depressed, and credit conditions were still uneven. Large firms with access to financial markets continued to find credit, including bank loans, available on relatively attractive terms; however, credit conditions reportedly remained tight for smaller, bank-dependent firms. Sizable increases in prices of crude oil and other commodities pushed up headline inflation, but measures of underlying inflation were subdued, and longer-run inflation expectations remained stable. A number of participants expected that slack in resource utilization would continue to restrain increases in labor costs and prices. Nonetheless, participants observed that rapidly rising commodity prices posed upside risks to the stability of longer-term inflation expectations, and thus to the outlook for inflation, even as they posed downside risks to the outlook for growth in consumer spending and business investment. In addition, participants noted that

[15] *Members* of the FOMC in 2011 consist of the members of the Board of Governors of the Federal Reserve System plus the presidents of the Federal Reserve Banks of Chicago, Dallas, Minneapolis, New York, and Philadelphia. *Participants* at FOMC meetings consist of the members of the Board of Governors of the Federal Reserve System and all Reserve Bank presidents.

unfolding events in the Middle East and North Africa, along with the tragic developments in Japan, had further increased uncertainty about the economic outlook.

In the FOMC's discussion of monetary policy for the period ahead, the members agreed that no changes to the Committee's asset purchase program or to its target range for the federal funds rate were warranted. The economic recovery appeared to be on a firmer footing, and overall conditions in the labor market were gradually improving. Although the unemployment rate had declined in recent months, it remained elevated relative to levels that the Committee judged to be consistent, over the longer run, with its statutory mandate to foster maximum employment and price stability. Similarly, measures of underlying inflation continued to be somewhat low relative to levels seen as consistent with the dual mandate over the longer run. With longer-term inflation expectations remaining stable and measures of underlying inflation subdued, members anticipated that recent increases in the prices of energy and other commodities would result in only a transitory increase in headline inflation. Given this economic outlook, the Committee agreed to maintain the existing policy of reinvesting principal payments from its securities holdings and reaffirmed its intention to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011 to promote a stronger pace of economic recovery and to help ensure that inflation, over time, was at levels consistent with the Committee's mandate. Members emphasized that the Committee would continue to regularly review the pace of its securities purchases and the overall size of the asset purchase program in light of incoming information and would adjust the program as needed to best foster maximum employment and price stability. The Committee maintained the target range for the federal funds rate at 0 to ¼ percent and continued to anticipate that economic conditions were likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The information reviewed at the April 26–27 FOMC meeting indicated that, on balance, economic activity was expanding at a moderate pace and that labor market conditions were continuing to improve gradually. Headline consumer price inflation had been boosted by large increases in food and energy prices, but measures of underlying inflation were still subdued and longer-run inflation expectations remained stable. Participants observed that while construction activity was still anemic, measures of consumer spending and business investment continued to expand, and overall labor market conditions were improving, albeit gradually. Nevertheless, they agreed that the pace of economic growth in the first quarter had slowed unexpectedly. Participants viewed this weakness as likely to be largely transitory, influenced by unusually severe weather, increases in energy and other commodity prices, and lower-than-expected defense spending; as a result, they saw economic growth picking up later in the year. In addition, they noted that higher gasoline and food prices had weighed on consumer sentiment about near-term economic conditions but that underlying fundamentals pointed to continued moderate growth in spending. Activity in the industrial sector had expanded further and manufacturers remained upbeat, although automakers were reporting some difficulties in obtaining parts normally produced in Japan, which could damp motor vehicle production in the second quarter. Participants noted that financial conditions continued to improve. Equity prices had risen significantly since the beginning of the year, buoyed by an improved outlook for earnings. Although loan demand in general remained weak, banks reported an easing of their lending standards and terms on commercial and industrial loans. Consumer credit conditions also eased somewhat, although the demand for consumer credit other than auto loans reportedly changed little.

Meeting participants judged the information received over the intermeeting period as indicating that the economic recovery was proceeding at a moderate pace, although somewhat more slowly than had been anticipated earlier in the year. Overall conditions in the labor market were gradually improving, but the unemployment rate remained elevated relative to levels that the Committee judged to be consistent, over the longer run, with its statutory mandate of maximum employment and price stability. Significant increases in the prices of energy and other commodities had boosted overall inflation, but members expected this rise to be transitory. Indicators of medium-term inflation remained subdued and somewhat below the levels seen as consistent with the dual mandate as indicated by the Committee's longer-run inflation projections. Accordingly, the Committee agreed that no changes to its asset purchase program or to its target range for the federal funds rate were warranted at this meeting. Specifically, the Committee agreed to maintain its policy of reinvesting principal payments from its securities holdings and affirmed that it would complete purchases of

$600 billion of longer-term Treasury securities by the end of the second quarter. The Committee also agreed to maintain the target range of the federal funds rate at 0 to ¼ percent and anticipated that economic conditions would likely warrant exceptionally low levels for the federal funds rate for an extended period. Members agreed that the Committee would regularly review the size and composition of its securities holdings in light of incoming information and that they were prepared to adjust those holdings as needed to best foster maximum employment and price stability.

The information received ahead of the June 21–22 FOMC meeting indicated that the pace of the economic recovery had slowed in recent months and that conditions in the labor market had softened. Measures of inflation had picked up this year, reflecting in part higher prices for some commodities and imported goods. Longer-run inflation expectations, however, remained stable. In their discussion of the economic situation and outlook, meeting participants noted a number of transitory factors that were restraining growth, including the global supply chain disruptions in the wake of the earthquake in Japan, the unusually severe weather in some parts of the United States, a drop in defense spending, and the effect of increases in oil and other commodity prices on household purchasing power and spending. Participants expected that the expansion would gain strength as the effects of these temporary factors waned. Nonetheless, most participants judged that the pace of economic recovery was likely to be somewhat slower over coming quarters than they had projected in April, reflecting the persistent weakness in the housing market, the ongoing efforts by some households to reduce debt burdens, the recent sluggish growth of income and consumption, the fiscal contraction at all levels of government, and the effect of uncertainty regarding the economic outlook and future tax and regulatory policies on the willingness of firms to hire and invest. Changes in financial conditions since the April meeting suggested that investors had become more concerned about risk. Equity markets had seen a broad selloff, and risk spreads for many corporate borrowers had widened noticeably since April. Nonetheless, large businesses continued to enjoy ready access to credit.

In their discussion of monetary policy for the period ahead, members agreed that the Committee should complete its $600 billion asset purchase program at the end of the month and that no changes to the target range of the federal funds rate were warranted. The information received over the intermeeting period indicated that the economic recovery was continuing at a moderate pace, though somewhat more slowly than the Committee had expected, and that the labor market had been weaker than anticipated. Inflation had increased in recent months as a result of higher prices for some commodities, as well as supply chain disruptions related to the tragic events in Japan. Nonetheless, members saw the pace of the economic expansion as picking up over the coming quarters and the unemployment rate resuming its gradual decline toward levels consistent with the Committee's dual mandate. Moreover, with longer-term inflation expectations stable, members expected that inflation would subside to levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate. However, many members saw the outlook for both employment and inflation as unusually uncertain. Against this backdrop, members agreed that it was appropriate to maintain the Committee's current policy stance and accumulate further information regarding the outlook for growth and inflation before deciding on the next policy step. A few members noted that, depending on how economic conditions evolve, the Committee might have to consider providing additional monetary policy stimulus, especially if economic growth remained too slow to meaningfully reduce the unemployment rate in the medium run. A few other members, however, viewed the increase in inflation risks as suggesting that economic conditions might evolve in a way that would warrant the Committee taking steps to begin removing policy accommodation sooner than currently anticipated.

Also at its June meeting, in light of ongoing strains in some foreign financial markets, the Committee approved an extension through August 1, 2012, of its temporary U.S. dollar liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank. The authorization of the swap arrangements had been set to expire on August 1, 2011.

Tools and Strategies for the Withdrawal of Monetary Policy Accommodation

Although the FOMC continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period, the Federal Reserve will eventually need to remove policy accommodation to maintain a stance of policy that is consistent with its statutory mandate to foster maximum employment and stable prices. The FOMC has several tools for smoothly and effectively exiting at the appropriate time from the current accommodative policy stance. One tool is the ability to pay interest on reserve balances; the Federal Reserve will be able to put significant upward pressure on short-term market interest rates by increasing the rate paid on excess reserves. Two other tools—executing triparty reverse repurchase agreements (RRPs) with primary dealers and other counterparties and issuing term deposits to depository institutions through the Term Deposit Facility (TDF)—will be capable of temporarily reducing the quantity of reserves held by the banking system and thereby tightening the relationship between the interest rate paid on reserves and short-term market interest rates.[16] Finally, the Federal Reserve could pare the size of its balance sheet over time by ceasing to reinvest principal payments from its securities holdings or by selling its securities holdings.

During the first half of 2011, the Federal Reserve continued to refine and test its temporary reserve draining tools. The Federal Reserve Bank of New York (FRBNY) took further steps to expand the range of counterparties for RRPs to include entities other than primary dealers in order to enhance the capacity of such operations. The FRBNY completed its third wave of counterparty expansions aimed at domestic money market funds in May, bringing the total number of RRP counterparties, including the primary dealers, to 110. In May, the FRBNY also set forth criteria for the acceptance of government-sponsored enterprises as eligible counterparties for the next counterparty expansion wave. During the first half of the year, the FRBNY conducted a series of small-scale triparty RRP transactions with its primary dealer and money market fund RRP counterparties. The Federal Reserve also conducted three 28-day, $5 billion auctions of term deposits. As a matter of prudent planning, these operations are intended to ensure the operational readiness of the TDF and RRP programs and to increase the familiarity of the participants with the auction procedures.

At its April and June meetings, the Committee discussed strategies for normalizing both the stance and conduct of monetary policy. Participants noted that their discussions of this topic were undertaken as part of prudent planning and did not imply that a move toward such normalization would necessarily begin sometime soon. Almost all participants agreed with the following principles to guide the exit process:

- The Committee will determine the timing and pace of policy normalization to promote its statutory mandate of maximum employment and price stability.
- To begin the process of policy normalization, the Committee will likely first cease reinvesting some or all payments of principal on the securities holdings in the System Open Market Account (SOMA).
- At the same time or sometime thereafter, the Committee will modify its forward guidance on the path of the federal funds rate and will initiate temporary reserve-draining operations aimed at supporting the implementation of increases in the federal funds rate when appropriate.
- When economic conditions warrant, the Committee's next step in the process of policy normalization will be to begin raising its target for the federal funds rate, and from that point on, changing the level or range of the federal funds rate target will be the primary means of adjusting the stance of monetary policy. During the normalization process, adjustments to the interest rate on excess reserves and to the level of reserves in the banking system will be used to bring the funds rate toward its target.
- Sales of agency securities from the SOMA portfolio will likely commence sometime after the first increase in the target for the federal funds rate. The timing and pace of sales will be communicated to the public in advance; that pace is anticipated to be relatively gradual and steady, but it could be adjusted up or down in response to material changes in the economic outlook or financial conditions.
- Once sales begin, the pace of sales is expected to be aimed at eliminating the SOMA's holdings of agency securities over a period of three to five years, thereby minimizing the extent to which the SOMA portfolio might affect the allocation of credit across sectors of the economy. Sales at this pace would be expected to normalize the size of the SOMA securities portfolio over a period of two to three years. In particular, the size of the securities portfolio and the associated quantity of bank reserves are expected to be reduced to the smallest

[16] In a triparty repurchase agreement, both parties to the agreement must have cash and collateral accounts at the same triparty agent, which is by definition also a clearing bank. The triparty agent will ensure that collateral pledged is sufficient and meets eligibility requirements, and all parties agree to use collateral prices supplied by the triparty agent.

levels that would be consistent with the efficient implementation of monetary policy.

- The Committee is prepared to make adjustments to its exit strategy if necessary in light of economic and financial developments.

FOMC Communications

Transparency is an essential principle of modern central banking because it appropriately contributes to the accountability of central banks to the government and to the public and because it can enhance the effectiveness of central banks in achieving their macroeconomic objectives. To this end, the Federal Reserve provides a considerable amount of information concerning the conduct of monetary policy. Immediately following each meeting of the FOMC, the Committee releases a statement that lays out the rationale for its policy decision, and detailed minutes of each FOMC meeting are made public three weeks following the meeting. Lightly edited transcripts of FOMC meetings are released to the public with a five-year lag.[17]

In recent years, the Federal Reserve has taken additional steps to enhance its communications regarding monetary policy decisions and deliberations. In November 2010, the FOMC directed a subcommittee, headed by Governor Yellen, to conduct a review of the Committee's communications guidelines with the aim of ensuring that the public is well informed about monetary policy issues while preserving the necessary confidentiality of policy discussions until their scheduled release. In a discussion on external communications at the January 25–26 FOMC meeting, participants noted the importance of fair and equal access by the public to information about future policy decisions. Several participants indicated that increased clarity of communications was a key objective, and some referred to the central role of communications in the monetary policy transmission process. Discussion focused on how to encourage dialogue with the public in an appropriate and transparent manner, and the subcommittee on communications was to consider providing further guidance in this area.

At the March 15 FOMC meeting, the Committee endorsed the communications subcommittee's recommendation that the Chairman conduct regular press conferences after the four FOMC meetings each year for which participants provide numerical projections of several key economic variables. While those projections are already made public with the minutes of the relevant FOMC meetings, press conferences were viewed as being helpful in explaining how the Committee's monetary policy strategy is informed by participants' projections of the rates of output growth, unemployment, and inflation likely to prevail during each of the next few years, and by their assessments of the values of those variables that would prove most consistent, over the longer run, with the Committee's mandate to promote both maximum employment and stable prices. It was agreed that the Chairman would begin holding press conferences effective with the April 26–27, 2011, FOMC meeting; the second press briefing was held on June 22 in conjunction with the forecasts that policymakers submitted at that FOMC meeting.

At its June 21–22 meeting, the Committee followed up on the discussions from its January meeting about policies to support effective communication with the public regarding the outlook for the economy and monetary policy. The Committee unanimously approved a set of principles, proposed by the subcommittee on communications, for Committee participants and for the Federal Reserve System staff to follow in their communications with the public in order to reinforce the public's confidence in the transparency and integrity of the monetary policy process.[18]

[17] FOMC statements, minutes, and transcripts, as well as other related information, are available on the Federal Reserve Board's website at www.federalreserve.gov/monetarypolicy/fomc.htm.

[18] The FOMC policies on external communications of Committee participants and of the Federal Reserve System staff are available on the Federal Reserve Board's website at www.federalreserve.gov/monetarypolicy/files/FOMC_ExtCommunicationParticipants.pdf and www.federalreserve.gov/monetarypolicy/files/FOMC_ExtCommunicationStaff.pdf, respectively.

Supervision and Regulation

The Federal Reserve has supervisory and regulatory authority over a variety of financial institutions and activities with the goal of promoting a safe, sound, and stable banking and financial system that supports the growth and stability of the U.S. economy. As described in this report, the Federal Reserve carries out its supervisory and regulatory responsibilities and supporting functions primarily by

- promoting the safety and soundness of individual financial institutions supervised by the Federal Reserve;
- developing supervisory policy (rulemakings, supervision and regulation letters (SR letters), policy statements, and guidance);
- identifying requirements and setting priorities for supervisory information technology initiatives;
- ensuring ongoing staff development to meet evolving supervisory responsibilities;
- regulating the U.S. banking and financial structure by acting on a variety of proposals; and
- enforcing other laws and regulations.

2011 Developments

During 2011, the U.S. banking system and financial markets improved further, continuing their recovery from the financial crisis that started in mid-2007.

Performance of bank holding companies. While a turnaround in bank holding companies' (BHCs) performance was evident during 2011, performance remains weak by historical standards, and the industry recovery could face challenges due to ongoing and elevated nonperforming asset levels. U.S. BHCs, in aggregate, reported earnings of $108 billion for 2011, up from $80 billion for the year ending December 31, 2010. Much of this improvement was due to lower loan loss provisioning and consequent reserve releases. The proportion of unprofitable BHCs, although down from 28 percent in 2010, remains high at 18 percent; unprofitable BHCs encompass roughly 15 percent of banking industry assets. Nonperforming assets present a significant challenge to industry recovery, with the nonperforming asset ratio remaining high at 4.1 percent of loans and foreclosed assets, the same percent as in 2010. Weaknesses were broad based, encompassing residential mortgages (first-lien), commercial real estate—especially non-owner nonfarm nonresidential and construction other than single-family—and commercial and industrial (C&I) loans. In 2011, an additional 172 BHCs that received funds from the U.S. Department of the Treasury's (Treasury) Troubled Asset Relief Program (TARP) repaid all funds received—120 of these companies repaid with funds received from the Small Business Lending Fund (SBLF). At year-end 2011, a total of 332 BHCs and banks that received funds from the TARP had repaid all funds received, and Treasury reports that approximately 89 percent of all distributed TARP funds have been repaid. Including income from dividends, interest and other sources, Treasury has received $258.44 billion back from bank support programs, exceeding the $245.10 billion in funds disbursed.

Although Treasury's SBLF Program's authorizing legislation provided up to $30 billion for investing, interest in SBLF was lower than anticipated, with 935 financial institutions applying to the program for a combined funding request of $11.7 billion. About one-third (320) of the total number of applicants were seeking to refinance TARP Capital Purchase Program (CPP) and Community Development Capital Initiative (CDCI) funds. This group of institutions requested $6.7 billion in funds, which was 57 percent of the total dollar amount requested. Ultimately, 332 institutions received $4.03 billion in SBLF investments. Treasury approved 137 of the applicants seeking to refinance TARP CPP and CDCI funds, investing a total of $3.3 billion in these institutions. This represented about 82 percent of all SBLF investments.[1] (Also see "Bank Holding Companies" on page 89.)

Performance of state member banks. Similar to BHCs, the turnaround at state member banks in 2011 was muted. As a group, state member banks reported a profit of $11.5 billion for 2011, up from 6.1 billion for 2010. While earnings were up due largely to lower provisions ($7.7 billion versus 17.7 billion in 2010), almost 11 percent of all state member banks continued to report losses. Mirroring trends at BHCs, the nonperforming assets ratio remained relatively high at 3.2 percent of loans and foreclosed assets, reflecting both contracting loan balances and ongoing weaknesses in asset quality. Growth in problem loans continued to slow during 2011, but weakness encompassed nonfarm nonresidential lending, residential mortgages, and C&I loans. The number of foreclosed properties continued to increase, particularly those associated with construction and land development and one- to four-family residential lending. The risk-based capital ratios for state member banks improved during 2011 in the aggregate, and the percent of state member banks deemed well capitalized under prompt corrective action standards remained high at 98 percent. In 2011, 12 state member banks with $8.4 billion in assets failed, with losses of $1.7 billion according to Federal Deposit Insurance Corporation (FDIC) estimates. (Also see "State Member Banks" on page 88.)

Implementation of enhanced prudential standards of the Dodd-Frank Act. In December, the Board issued a notice of proposed rulemaking (NPR) to implement the enhanced prudential standards and early remediation requirements in sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The proposal generally applies to all U.S. BHCs with consolidated assets of $50 billion or more and any nonbank financial company that may be designated by the Financial Stability Oversight Council (FSOC) as systemically important. A proposal implementing enhanced prudential standards for foreign banking organizations that have $50 billion or more in consolidated assets and a U.S. banking presence will be issued separately. In general, savings and loan holding companies (SLHCs) would not be subject to the requirements of this proposal, except certain stress test requirements, although the Board plans to issue a separate proposal in the future to address the applicability of the enhanced standards to SLHCs. (See **box 1** for more details.)

Capital adequacy standards. In 2011, the Board issued several rulemakings and guidance documents related to capital adequacy standards, including joint proposed rulemakings with the other federal banking agencies that would implement certain revisions to the Basel capital framework and that address certain provisions of the Dodd-Frank Act. These rulemakings included two NPRs to revise the market-risk capital rules, a final rule that amends the advanced approaches capital adequacy framework to set minimum capital requirements consistent with section 171 of the Dodd-Frank Act, rules related to the treatment of subordinated debt for certain small banking organizations, and a final rule requiring U.S. BHCs with total consolidated assets of $50 billion or more to submit annual capital plans to the Federal Reserve for review. (See "Supervisory Policy" on page 96.)

Supervision of savings and loan holding companies. On July 21, 2011, responsibility for supervision and regulation of SLHCs transferred from the Office of Thrift Supervision (OTS) to the Federal Reserve, pursuant to the Dodd-Frank Act.[2] (See "Savings and Loan Holding Companies" on page 90 for details.)

Recovery and resolution planning. The Federal Reserve is working with other regulatory agencies to reduce the probability of failure of the largest, most complex financial firms and to minimize the losses to the financial system and the economy if such a firm should fail. (See **box 2** for details.)

Actions against mortgage servicers for faulty foreclosure proceedings. In April 2011, the Federal Reserve announced formal enforcement actions against certain large mortgage servicers to ensure that those servicers addressed deficient practices in residential mortgage loan servicing and foreclosure processing. (See **box 3** for details.)

Supervision

The Federal Reserve is the federal supervisor and regulator of all U.S. BHCs, including financial holding companies, and state-chartered commercial banks that are members of the Federal Reserve System. The

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[1] The TARP statistics only include those BHCs that did not participate in the Supervisory Capital Assessment Program in 2009.

[2] Pursuant to the Home Owners' Loan Act, 12 U.S.C. Section 1461 *et. seq.*, an SLHC is defined as any company that directly or indirectly controls either a savings association or any other company that is an SLHC.

Box 1. Enhanced Prudential Standards and Early Remediation Requirements

In December, the Board issued an NPR to implement the enhanced prudential standards and early remediation requirements in sections 165 and 166 of the Dodd-Frank Act for large BHCs and systemically important nonbank financial companies.

The NPR would implement

Risk-based capital and leverage requirements in two phases. In the first phase, the covered companies would be subject to the Board's capital plan rule, which was issued in November 2011. In the second phase, the Board would issue a proposal to implement a risk-based capital surcharge based on the framework and methodology developed by the Basel Committee on Banking Supervision.

Liquidity requirements in multiple phases. First, covered companies would be subject to qualitative liquidity risk-management standards generally based on the interagency liquidity risk-management guidance issued in March 2010. These standards would require covered companies to conduct internal liquidity stress tests and set internal quantitative limits to manage liquidity risk. In later phases, the Board would issue one or more subsequent proposals to implement quantitative liquidity requirements based on the Basel III liquidity rules.

Supervisory and company-run stress test requirements. Supervisory stress tests similar to those conducted in recent years would be conducted annually by the Board. A summary of the results, including company-specific information, would be made public. In addition, the proposal requires companies to conduct one or more company-run stress tests each year and to make a summary of their results public.

Single-counterparty credit limits. The proposal would limit credit exposure of a covered company to a single counterparty as a percentage of the covered company's regulatory capital. Credit exposure between the largest covered companies would be subject to a tighter limit.

Early remediation requirements. The proposal would implement a framework to address financial weaknesses promptly. The Board is proposing a number of triggers for remediation—such as capital levels, stress test results, and risk-management weaknesses—calibrated to identify problems at an early stage. Required actions would vary based on the severity of the situation, but could include restrictions on growth, capital distributions, and executive compensation, as well as capital raising or asset sales.

Other requirements. The proposal would also implement risk committee requirements and enhanced risk-management standards for covered companies and debt-to-equity requirements for companies that the FSOC determines pose a grave threat to financial stability and should be subject to a debt-to-equity limit.

A joint FDIC-Board final rule implementing the resolution plan requirements contained in section 165 of the Dodd-Frank Act was issued in October (www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf).

The comment period for the NPR ends on April 30, 2012. See press release and notice at www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm.

Federal Reserve also has responsibility for supervising the operations of all Edge Act and agreement corporations, the international operations of state member banks and U.S. BHCs, and the U.S. operations of foreign banking organizations. Furthermore, through the Dodd-Frank Act, the Federal Reserve has been assigned responsibilities for nonbank financial firms and financial market utilities (FMUs) designated by the FSOC as systemically important. In addition, the act transferred authority for consolidated supervision of more than 400 SLHCs and their non-depository subsidiaries from the OTS to the Federal Reserve, effective July 21, 2011. In overseeing the institutions under the Federal Reserve's authority, the Federal Reserve seeks primarily to promote safety and soundness, including compliance with laws and regulations.

Safety and Soundness

To promote the safety and soundness of financial institutions, the Federal Reserve conducts on-site examinations and inspections, conducts off-site surveillance and monitoring, and takes enforcement and other supervisory actions as necessary. The Federal Reserve also provides training and technical assistance to foreign supervisors and minority-owned and de novo depository institutions.

Examinations and Inspections

The Federal Reserve conducts examinations of state member banks, FMUs, the U.S. branches and agencies of foreign banks, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of holding companies

Box 2. Recovery and Resolution Planning

Recovery and resolution planning are two separate, but related, efforts to ensure that the failure of a large global financial institution does not have serious adverse effects on the U.S. and the global financial system. The Federal Reserve, in conjunction with other U.S. supervisors, has continued to work with financial institutions to ensure a broad range of options for de-risking and de-leveraging in crisis. Large, globally active financial institutions are now developing the requisite governance and infrastructure to create and maintain recovery and resolution planning processes and to execute relevant strategies.

Recovery Planning

The Federal Reserve has required that the largest and most globally active U.S. financial institutions develop recovery plans that describe a menu of options and actions, excluding any extraordinary official sector assistance, to be taken by management to maintain the financial institution as a going concern during situations of extreme stress. These plans were reviewed in several iterations during 2010 and 2011 by the Federal Reserve and other U.S. banking supervisors.

Consistent with principles developed by the Financial Stability Board, these same financial institutions participated in a series of crisis management meetings with the Federal Reserve, FDIC, Office of the Comptroller of the Currency, and international supervisors that were intended to consider the specific issues and impediments to coordinated international action that may arise in handling severe stress at specific financial institutions.

Resolution Planning

The Dodd-Frank Act requires large, complex financial institutions to submit plans for their rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure. On November 1, 2011, the Federal Reserve and FDIC jointly issued rules implementing the resolution plan requirement for financial institutions that are subject to higher prudential standards (www.gpo.gov/fdsys/pkg/FR-2011-11-01/html/2011-27377.htm).

In a phased approach based on nonbank asset size, the first group of financial institutions will submit their plans by July 1, 2012, with two additional groups submitting plans through December 31, 2013. The plans will identify/describe

- critical operations (those operations that are important to financial stability);
- core business lines—that is, business lines that support the firm's franchise value;
- material legal entities;
- interconnections and interdependencies;
- the company's corporate governance structure for resolution; and
- impediments to resolution and the actions the financial institution will take to improve its resolvability.

Plans must also provide explanations as to how and to what extent affiliated insured depository institutions are protected from risks associated with activities of any of the financial institutions' nonbank subsidiaries. The plans of foreign banking operations in the United States must focus on their U.S. operations along with explanations of how overall resolution planning for U.S. operations is integrated into their global contingency planning processes.

The Federal Reserve and the FDIC must review plans submitted by the financial institutions and may determine that a plan is not credible, or that it would not facilitate an orderly bankruptcy of the institution. Financial institutions submitting deficient plans will be required to resubmit plans with proposed changes in business operations and corporate structure to facilitate implementation of the plan. If a financial institution fails to adopt an acceptable plan, the FDIC and Federal Reserve may impose additional capital, leverage, or liquidity requirements on the financial institution. If suitable plans are not resubmitted within two years, the Federal Reserve and the FDIC may place restrictions on growth, activities, or operations and may require the financial institutions to divest assets. The Federal Reserve, in close cooperation with the FDIC, is working with the first group of financial institutions to develop their plans.

and their nonbank subsidiaries. Whether an examination or an inspection is being conducted, the review of operations entails

1. an evaluation of the adequacy of governance provided by the board and senior management, including an assessment of internal policies, procedures, controls, and operations;
2. an assessment of the quality of the risk-management and internal control processes in place to identify, measure, monitor, and control risks;
3. an assessment of the key financial factors of capital, asset quality, earnings, and liquidity; and

Box 3. Actions against Mortgage Servicers for Faulty Foreclosure Proceedings

In April 2011, the Federal Reserve issued consent cease-and-desist orders against certain large mortgage servicers requiring those servicers to implement significant improvements to their mortgage loan servicing and foreclosure processing practices. These actions were designed to correct practices that resulted in servicer errors and to prevent future abuses in the loan modification and foreclosure processes. Under the consent orders, each servicer must, among other things, submit specific plans acceptable to the Federal Reserve that

- ensure there is adequate staff to carry out residential mortgage loan servicing, loss mitigation, and foreclosure activities;
- strengthen coordination of communications with borrowers throughout the loss mitigation and foreclosure processes by providing borrowers a primary point of contact who has access to current information about loss mitigation and foreclosure activities;
- ensure that foreclosures are not pursued once a loan modification has been approved, unless repayments under the modified loan are not made;
- establish robust controls and oversight over the activities of third parties that provide various residential mortgage loan servicing, loss mitigation, or foreclosure-related support, including local counsel in foreclosure or bankruptcy proceedings; and
- strengthen programs to ensure compliance with state and federal laws regarding servicing generally, and foreclosures in particular.

The orders also require the servicers to hire independent consultants to conduct reviews to identify borrowers who suffered financial injury as a result of wrongful foreclosure or other identified deficiencies. The orders require the servicer to provide remediation to such borrowers.

The Federal Reserve also issued consent cease-and-desist orders against six parent BHCs of national bank servicers to address deficient practices in the parent companies' oversight of residential mortgage loan servicing, loan modification, and foreclosure processes. The orders require the parent companies to implement policies, procedures, and practices designed to prevent future abuses.

Each institution under an order is required to submit quarterly reports to the Federal Reserve detailing the measures it has taken to comply with the enforcement action and the results of those measures.

See press release and notice at www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm.

4. a review for compliance with applicable laws and regulations.

Table 1 provides information on examinations and inspections conducted by the Federal Reserve during the past five years.

The Federal Reserve uses a risk-focused approach to supervision, with activities directed toward identifying the areas of greatest risk to financial institutions and assessing the ability of institutions' management processes to identify, measure, monitor, and control those risks. Key aspects of the risk-focused approach to consolidated supervision of the largest institutions supervised by the Federal Reserve include

1. developing an understanding of each organization's legal and operating structure, and its primary strategies, business lines, and risk-management and internal control functions;
2. developing and executing a tailored supervisory plan that outlines the work required to maintain a comprehensive understanding and assessment of each institution, incorporating reliance to the fullest extent possible on assessments and information developed by other relevant domestic and foreign supervisors and functional regulators;
3. maintaining continual supervision of these organizations—including through meetings with the organization's management and analysis of internal and external information—so that the Federal Reserve's understanding and assessment of each organization's condition remains current;
4. assigning to each organization a supervisory team composed of Reserve Bank staff who have skills appropriate for the organization's risk profile; and
5. promoting Systemwide and interagency information-sharing through automated systems and other mechanisms.

To strengthen its supervision of the largest, most complex financial institutions, the Federal Reserve has created a centralized multidisciplinary body called the Large Institution Supervision Coordinating Committee (LISCC) to oversee the supervision of these companies. The committee uses horizontal evaluations to monitor interconnectedness and common practices among companies that could lead to greater systemic risk. The committee also uses additional and improved quantitative methods for evaluating the financial condition of companies and the

Table 1. State member banks and bank holding companies, 2007–2011

Entity/item	2011	2010	2009	2008	2007
State member banks					
Total number	828	829	845	862	878
Total assets (billions of dollars)	1,891	1,697	1,690	1,854	1,519
Number of examinations	809	912	850	717	694
By Federal Reserve System	507	722	655	486	479
By state banking agency	302	190	195	231	215
Top-tier bank holding companies					
Large (assets of more than $1 billion)					
Total number	491	482	488	485	459
Total assets (billions of dollars)	16,443	15,986	15,744	14,138	13,281
Number of inspections	672	677	658	519	492
By Federal Reserve System[1]	642	654	640	500	476
On site	461	491	501	445	438
Off site	181	163	139	55	38
By state banking agency	30	23	18	19	16
Small (assets of $1 billion or less)					
Total number	4,251	4,362	4,486	4,545	4,611
Total assets (billions of dollars)	982	991	1,018	1,008	974
Number of inspections	3,306	3,340	3,264	3,192	3,186
By Federal Reserve System	3,160	3,199	3,109	3,048	3,007
On site	163	167	169	107	120
Off site	2,997	3,032	2,940	2,941	2,887
By state banking agency	146	141	155	144	179
Financial holding companies					
Domestic	417	430	479	557	597
Foreign	40	43	46	45	43

[1] For large bank holding companies subject to continuous, risk-focused supervision, includes multiple targeted reviews.

risks they might pose to each other and to the broader financial system. The supervisory framework applicable to the LISCC portfolio, other BHCs with assets of $50 billion or more, and nonbank financial firms designated by the FSOC for supervision by the Board will continue to evolve in coming years to reflect the recently issued rules for capital planning and resolution plans (see boxes 2 and 4). In addition, rules and guidance on enhanced prudential standards to increase regulatory requirements and expectations for each of these companies in line with their systemic footprints will be issued.

For other sized financial institutions, the risk-focused consolidated supervision program provides that examination and inspection procedures should be tailored to each organization's size, complexity, risk profile, and condition. The supervisory program for an institution, regardless of its asset size, entails both off-site and on-site work, including development of supervisory plans, pre-examination visits, detailed documentation, and preparation of examination reports tailored to the scope and findings of the examination.

State Member Banks

At the end of 2011, 2,120 banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System, of which 828 were state chartered. Federal Reserve System member banks operated 58,211 branches, and accounted for 34 percent of all commercial banks in the United States and for 71 percent of all commercial banking offices. State-charted commercial banks that are members of the Federal Reserve, commonly referred to as state member banks, represented approximately 13 percent of all insured U.S. commercial banks and held approximately 15 percent of all insured commercial bank assets in the United States.

Under section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development

Box 4. Capital Planning and Stress Testing

Since the onset of the financial crisis, the Board has led a series of initiatives to strengthen the capital positions of large, complex banking organizations, including working with the firms to bolster their internal processes for assessing capital needs and enhancing the Board's supervisory practices for assessing capital adequacy. These efforts culminated in a supervisory review of capital plans of 19 banking organizations in the first quarter of 2011, including any plans they had for increasing dividends or buying back stock, a process officially known as the Comprehensive Capital Analysis and Review (CCAR). The CCAR process is a formal part of the Board's annual assessment of all banking organizations with assets of $50 billion or more, and the requirement to submit annual capital plans to the Board has been codified by the issuance of the capital plan rule, as discussed further below.

A key objective of the annual CCAR exercise is to ensure that firms' capital planning processes are sufficiently comprehensive and forward-looking. Part of this process is the use of internal stress testing to assess whether firms would have sufficient capital to withstand a significant decline in revenues and potentially large losses so that they would be able to continue functioning as sources of credit and providers of other financial services, even in the event of a worse-than-anticipated weakening of the economy. Supervisory evaluations of individual firms' capital plans and the analysis supporting them are conducted simultaneously across all participating firms, allowing the process to be informed by a comparative analysis across the firms and to capture a large share of domestic U.S. banking system assets and activities.

This supervisory review of capital planning processes was formalized in November 2011, as the Board issued a final rule requiring top-tier U.S. BHCs with total consolidated assets of $50 billion or more to submit annual capital plans for review (the capital plans rule). Under this rule, the Federal Reserve will annually evaluate institutions' capital adequacy, internal capital adequacy processes, and plans to make capital distributions, such as dividend payments or stock repurchases. In addition, the Board's assessment of these practices and of the firms' capital adequacy is supported by supervisory stress testing carried out by the Board in association with the CCAR.

The organizations covered by the capital plan rule are required to make their projections using scenarios provided by the Board and at least one stress scenario developed by the firm itself, appropriate to its business model and portfolios. The rule also requires a firm to support its analysis of sources and uses of capital over the planning period. In the annual CCAR review, the Board assesses a firm's ability to effectively identify, measure, and assess its risks; its methodologies for estimating firm-wide losses and revenues under stress scenarios; and its analysis for determining the impact of a stressed operating environment on capital adequacy. And, consistent with CCAR, the rule requires firms to develop comprehensive capital policies to govern their capital planning, capital issuance, usage, and distribution.

The capital plan rule relates to certain requirements for large organizations in the Dodd-Frank Act, particularly the stress testing standards. As the Board implements these stress testing requirements, it is expected that firms subject to the capital plan rule would use their Dodd-Frank Act–required stress test results to help meet the stress testing requirements of the capital plans rule. Thus, results of firms' stress testing requirements in the Dodd-Frank Act will be an integral component of firms' capital plans as they evaluate possible capital needs and resources under stress scenarios. Additionally, the Dodd-Frank Act requires supervisors to conduct independent supervisory stress tests. As part of CCAR, the Board has further developed its ability to make independent supervisory estimates of firms' potential future losses and revenues, which is a key tool in the evaluation of stress testing performed by firms as part of their capital plans and a key component of our supervisory assessments of capital adequacy. It is expected that the supervisory tests required under Dodd-Frank will be an integral part of supervisory stress testing for CCAR. (Also see "Capital Adequacy Standards" on page 96.)

and Regulatory Improvement Act of 1994, the Federal Reserve must conduct a full-scope, on-site examination of state member banks at least once a year,[3] although certain well-capitalized, well-managed organizations having total assets of less than $500 million may be examined once every 18 months.[4] The Federal Reserve conducted 507 exams of state member banks in 2011.

Bank Holding Companies

At year-end 2011, a total of 5,341 U.S. BHCs were in operation, of which 4,742 were top-tier BHCs. These organizations controlled 5,247 insured commercial

3 The Office of the Comptroller of the Currency examines nationally chartered banks, and the FDIC examines state-chartered banks that are not members of the Federal Reserve.

4 The Financial Services Regulatory Relief Act of 2006, which became effective in October 2006, authorized the federal banking agencies to raise the threshold from $250 million to $500 million, and final rules incorporating the change into existing regulations were issued on September 21, 2007.

banks and held approximately 99 percent of all insured commercial bank assets in the United States.

Federal Reserve guidelines call for annual inspections of large BHCs and complex smaller companies. In judging the financial condition of the subsidiary banks owned by holding companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the supervisory burden on banking organizations.

Inspections of BHCs, including financial holding companies, are built around a rating system introduced in 2005. The system reflects the shift in supervisory practices away from a historical analysis of financial condition toward a more dynamic, forward-looking assessment of risk-management practices and financial factors. Under the system, known as RFI but more fully termed RFI/C(D), holding companies are assigned a composite rating (C) that is based on assessments of three components: Risk Management (R), Financial Condition (F), and the potential Impact (I) of the parent company and its nondepository subsidiaries on the subsidiary depository institution. The fourth component, Depository Institution (D), is intended to mirror the primary supervisor's rating of the subsidiary depository institution.[5] Noncomplex BHCs with consolidated assets of $1 billion or less are subject to a special supervisory program that permits a more flexible approach.[6] In 2011, the Federal Reserve conducted 642 inspections of large BHCs and 3,160 inspections of small, noncomplex BHCs.

Financial Holding Companies

Under the Gramm-Leach-Bliley Act, BHCs that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in a wider range of financial activities, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales. As of year-end 2011, 417 domestic BHCs and 40 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 36 had consolidated assets of $15 billion or more; 108, between $1 billion and $15 billion; 59, between $500 million and $1 billion; and 214, less than $500 million.

Savings and Loan Holding Companies

On July 21, 2011, responsibility for supervision and regulation of SLHCs transferred from the OTS to the Federal Reserve, pursuant to the Dodd-Frank Act. As of the transfer date, 427 top tier SLHCs with estimated total consolidated assets of $4.4 trillion transferred to the Federal Reserve. These SLHCs included more than 50 companies engaged primarily in nonbanking activities, such as insurance underwriting (approximately 26 SLHCs), commercial activities (approximately 20 SLHCs), and securities brokerage (10 SLHCs). The 25 largest SLHCs accounted for more than $3.9 trillion of total consolidated assets; however, the savings association subsidiaries of these companies accounted for just $384 billion of total consolidated assets. Only three institutions in the top 25 and approximately 86 percent of the total SLHCs (370 firms) were engaged primarily in depository activities. These firms, however, held only 19 percent ($839 billion) of the total consolidated assets of all SLHCs. The Office of the Comptroller of the Currency (OCC) is the primary regulator for most of the subsidiary savings associations of the firms engaged primarily in depository activities.

The transfer of SLHC supervision to the Federal Reserve precipitated legislative, supervisory, and policy changes. The Dodd-Frank Act requires the Board to issue specific rulemakings—such as rules to establish consolidated capital standards, evaluate the potential for creating intermediate holding companies to facilitate supervision of SLHCs that are primarily engaged in commercial activities, and assess supervisory fees for the largest companies. Other rulemakings are prompted by operational and practical considerations, such as rules regarding regulatory reports and guidance regarding the supervisory approach for SLHCs. Guidance and rulemakings issued include the following:

- SR letter 11-11, "Supervision of Savings and Loan Holding Companies" (July 21, 2011), describes the supervisory approach to be used for the first cycle of supervision of SLHCs (www.federalreserve.gov/bankinforeg/srletters/sr1111.htm).

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5 Each of the first two components has four subcomponents: *Risk Management*— (1) Board and Senior Management Oversight; (2) Policies, Procedures, and Limits; (3) Risk Monitoring and Management Information Systems; and (4) Internal Controls. *Financial Condition*— (1) Capital, (2) Asset Quality, (3) Earnings, and (4) Liquidity.

6 The special supervisory program was implemented in 1997 and modified in 2002. See SR letter 02-01 for a discussion of the factors considered in determining whether a BHC is complex or noncomplex (www.federalreserve.gov/boarddocs/srletters/2002/sr0201.htm).

- Two interim final rules: (1) "Savings and Loan Holding Companies," Regulation LL, sets forth the regulations governing SLHCs; and (2) "Mutual Holding Companies," Regulation MM, sets forth the regulations governing SLHCs organized in mutual form. See press release (August 12, 2011) at www.federalreserve.gov/newsevents/press/bcreg/20110812a.htm.
- Final notice to require most SLHCs to file Federal Reserve regulatory reports with the Board, along with an exemption for some SLHCs from initially filing existing regulatory reports. See press release (December 23, 2011) at www.federalreserve.gov/newsevents/press/bcreg/20111223a.htm.

In addition to the regulatory and supervisory guidance issued on SLHCs,[7] Board staff continues to work on operational, technical, and practical transition issues while engaging the industry, Reserve Banks, and other financial regulatory agencies. Board staff has also issued internal policies and procedures, presented training sessions, conducted bi-weekly conference calls, and developed job aids to enhance the understanding of the SLHC population and to ensure consistent supervisory treatment of these institutions throughout the Federal Reserve System. A dedicated SLHC section has been staffed and is working to continue the supervisory and policy oversight of the SLHCs.

Although significant milestones have been achieved, several complex policy issues still need to be addressed by the Board, including those related to consolidated capital requirements, intermediate holding companies, and the determination of the applicability of enhanced prudential standards to the SLHC population.

Financial Market Utilities

FMUs manage or operate multilateral systems for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the FMU. Under the Federal Reserve Act, the Board supervises FMUs that are chartered as member banks or Edge Act corporations and cooperates with other federal banking supervisors to supervise FMUs organized as bank service providers under the Bank Service Company Act. In its supervision of these FMUs, the Board is also guided by the risk-management standards and expectations contained in its "Policy on Payments System Risk."[8]

Under title VIII of the Dodd-Frank Act, the Board has an expanded set of responsibilities related to FMUs designated by the FSOC as systemically important, including promoting uniform risk-management standards, playing an enhanced role in the supervision of FMUs, reducing systemic risk, and supporting the stability of the broader financial system.

The Board's risk-based supervision program for FMUs is administered by the FMU Supervision Committee (FMU-SC). The FMU-SC is a multidisciplinary committee of senior supervision, payment policy, and legal staff at the Board and Reserve Banks who are responsible for and knowledgeable about supervisory issues for FMUs. The FMU-SC's primary objective is to provide senior-level oversight, consistency, and direction to the Federal Reserve's supervisory process for FMUs. The FMU-SC coordinates with the LISCC on issues related to large financial institutions' roles in FMUs; FMUs' activities and implications for large financial institutions; and the payment, clearing, and settlement activities of large financial institutions more generally.

In an effort to promote greater financial market stability and mitigate systemic risk, the Board also is working with the U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission, which also have supervisory authority for certain FMUs. The Federal Reserve's work with these agencies, including the planned sharing of appropriate information, aims to improve consistency in FMU supervision, promote robust FMU risk management, and improve the regulators' ability to monitor and mitigate systemic risk.

International Activities

The Federal Reserve supervises the foreign branches and overseas investments of member banks, Edge Act and agreement corporations, and BHCs (including the investments by BHCs in export trading companies). In addition, it supervises the activities that foreign banking organizations conduct through enti-

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7 See also SR-11-13 (7-25-11) "Guidance Regarding Prior Notices with respect to Dividend Declarations by Savings Association Subsidiaries of Savings and Loan Holding Companies" (www.federalreserve.gov/bankinforeg/srletters/sr1113.htm) and SR 11-12 (7-21-11) "Deregistration Procedures for Certain Savings and Loan Holding Companies" (www.federalreserve.gov/bankinforeg/srletters/sr1112.htm).

8 www.federalreserve.gov/paymentsystems/psr_about.htm.

ties in the United States, including branches, agencies, representative offices, and subsidiaries.

Foreign operations of U.S. banking organizations. In supervising the international operations of state member banks, Edge Act and agreement corporations, and BHCs, the Federal Reserve generally conducts its examinations or inspections at the U.S. head offices of these organizations, where the ultimate responsibility for the foreign offices lies. Examiners also visit the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to test their adherence to safe and sound banking practices and compliance with rules and regulations or to evaluate an organization's efforts to implement corrective measures. Examinations abroad are conducted with the cooperation of the supervisory authorities of the countries in which they take place; for national banks, the examinations are coordinated with the OCC. At the end of 2011, 46 member banks were operating 533 branches in foreign countries and overseas areas of the United States; 25 national banks were operating 475 of these branches; and 21 state member banks were operating the remaining 58. In addition, 17 nonmember banks were operating 25 branches in foreign countries and overseas areas of the United States.

Edge Act and agreement corporations. Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international business, especially exports. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into agreements with the Board to refrain from exercising any power that is not permissible for an Edge Act corporation. Sections 25 and 25A of the Federal Reserve Act grant Edge Act and agreement corporations permission to engage in international banking and foreign financial transactions. These corporations, most of which are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions and (2) make foreign investments that are broader than those permissible for member banks. At year-end 2011, 48 banking organizations, operating eight branches, were chartered as Edge Act or agreement corporations. These corporations are examined annually.

U.S. activities of foreign banks. The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, commercial banks, BHCs, and certain nonbanking companies.

Foreign banks continue to be significant participants in the U.S. banking system. As of year-end 2011, 173 foreign banks from 51 countries operated 205 state-licensed branches and agencies, of which six were insured by the FDIC, and 47 OCC-licensed branches and agencies, of which four were insured by the FDIC. These foreign banks also owned nine Edge Act and agreement corporations and one commercial lending company. In addition, they held a controlling interest in 53 U.S. commercial banks. Altogether, the U.S. offices of these foreign banks at the end of 2011 controlled approximately 20 percent of U.S. commercial banking assets. These 173 foreign banks also operated 82 representative offices; an additional 44 foreign banks operated in the United States through a representative office only.

The Federal Reserve—in coordination with appropriate state regulatory authorities—examines state-licensed, non-FDIC insured branches and agencies of foreign banks on-site at least once every 18 months.[9] In most cases, on-site examinations are conducted at least once every 12 months, but the period may be extended to 18 months if the branch or agency meets certain criteria. As part of the supervisory process, a review of the financial and operational profile of each organization is conducted to assess the organization's ability to support its U.S. operations and to determine what risks, if any, the organization poses to the banking system through its U.S. operations. The Federal Reserve conducted or participated with state regulatory authorities in 379 examinations in 2011.

Compliance with Regulatory Requirements

The Federal Reserve examines institutions for compliance with a broad range of legal requirements, including anti-money-laundering (AML) and consumer protection laws and regulations, and other laws pertaining to certain banking and financial activities. Most compliance supervision is conducted under the oversight of the Board's Division of Banking Supervision and Regulation, but consumer compliance supervision is conducted under the oversight

9 The OCC examines federally licensed branches and agencies, and the FDIC examines state-licensed FDIC-insured branches in coordination with the appropriate state regulatory authority.

of the Division of Consumer and Community Affairs. The two divisions coordinate their efforts with each other and also with the Board's Legal Division to ensure consistent and comprehensive Federal Reserve supervision for compliance with legal requirements.

Anti-Money-Laundering Examinations

The Treasury regulations implementing the Bank Secrecy Act (BSA) generally require banks and other types of financial institutions to file certain reports and maintain certain records that are useful in criminal, tax, or regulatory proceedings. The BSA and separate Board regulations require banking organizations supervised by the Board to file reports on suspicious activity related to possible violations of federal law, including money laundering, terrorism financing, and other financial crimes. In addition, BSA and Board regulations require that banks develop written BSA compliance programs and that the programs be formally approved by bank boards of directors. The Federal Reserve is responsible for examining institutions for compliance with applicable AML laws and regulations and conducts such examinations in accordance with the Federal Financial Institutions Examination Council (FFIEC) *Bank Secrecy Act/Anti-Money Laundering Examination Manual*.[10]

Specialized Examinations

The Federal Reserve conducts specialized examinations of supervised financial institutions in the areas of information technology, fiduciary activities, transfer agent activities, and government and municipal securities dealing and brokering. The Federal Reserve also conducts specialized examinations of certain nonbank entities that extend credit subject to the Board's margin regulations.

Information Technology Activities

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised financial institutions, as well as certain independent data centers that provide information technology services to these organizations. All safety-and-soundness examinations include a risk-focused review of information technology risk-management activities. During 2011, the Federal Reserve continued as the lead supervisory agency for three of the 16 large, multiregional data processing servicers recognized on an interagency basis and assumed leadership of two more of the large servicers.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for state member banks and state member nondepository trust companies that reported \$53.9 trillion and \$39.5 trillion of assets, respectively, as of year-end 2011. These assets were held in various fiduciary and custodial capacities. On-site examinations of fiduciary and custodial activities are risk-focused and entail the review of an organization's compliance with laws, regulations, and general fiduciary principles, including effective management of conflicts of interest; management of legal, operational, and reputational risk exposures; and audit and control procedures. In 2011, Federal Reserve examiners conducted 140 on-site fiduciary examinations, excluding transfer agent examinations, of state member banks.

Transfer Agents

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and BHCs that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of an organization's operations and its compliance with relevant securities regulations. During 2011, the Federal Reserve conducted on-site transfer agent examinations at 11 of the 32 state member banks and BHCs that were registered as transfer agents.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with the Treasury regulations governing dealing and brokering in government securities. Thirteen state member banks and six state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from the Treasury's regulations. During 2011, the Federal Reserve conducted three examinations of broker–dealer activities in government securities at these organizations. These examinations are generally con-

[10] The FFIEC is an interagency body of financial regulatory agencies established to prescribe uniform principles, standards, and report forms and to promote uniformity in the supervision of financial institutions. The Council has six voting members: the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, the OCC, the Consumer Financial Protection Bureau, and the chair of the State Liaison Committee.

ducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring that state member banks and BHCs that act as municipal securities dealers comply with the Securities Act Amendments of 1975. Municipal securities dealers are examined, pursuant to the Municipal Securities Rulemaking Board's rule G-16, at least once every two calendar years. Three of the 11 entities supervised by the Federal Reserve that dealt in municipal securities were examined during 2011.

Securities Credit Lenders

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchasing or carrying of securities. As part of its general examination program, the Federal Reserve examines the banks under its jurisdiction for compliance with Board Regulation U (Credit by Banks and Persons other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock). In addition, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to Regulation U. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration or the National Credit Union Administration (NCUA).

At the end of 2011, 533 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 171 of these lenders, and the remaining 362 were subject to limited Federal Reserve supervision. The Federal Reserve exempted 151 lenders from its on-site inspection program on the basis of their regulatory status and annual reports. Twenty-one inspections were conducted during the year.

Enforcement Actions

The Federal Reserve has enforcement authority over the financial institutions it supervises and their affiliated parties. Enforcement actions may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include cease-and-desist orders, written agreements, prompt corrective action directives, removal and prohibition orders, and civil money penalties. In 2011, the Federal Reserve completed 143 formal enforcement actions. Civil money penalties totaling \$85,279,700 were assessed. As directed by statute, all civil money penalties are remitted to either the Treasury or the Federal Emergency Management Agency. Enforcement orders and prompt corrective action directives, which are issued by the Board, and written agreements, which are executed by the Reserve Banks, are made public and are posted on the Board's website (www.federalreserve.gov/apps/enforcementactions/).

In addition to taking these formal enforcement actions, the Reserve Banks completed 353 informal enforcement actions in 2011. Informal enforcement actions include memoranda of understanding (MOU) and board of directors resolutions. Information about these actions is not available to the public.

Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and BHCs in the period between on-site examinations. Such monitoring and analysis helps direct examination resources to institutions that have higher-risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

The primary off-site monitoring tool used by the Federal Reserve is the Supervision and Regulation Statistical Assessment of Bank Risk model (SR-SABR). Drawing mainly on the financial data that banks report on their Reports of Condition and Income (Call Reports), SR-SABR uses econometric techniques to identify banks that report financial characteristics weaker than those of other banks assigned similar supervisory ratings. To supplement the SR-SABR screening, the Federal Reserve also monitors various market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations. In addition, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised banking organizations. The BHCPRs, which are compiled from data provided by large BHCs in quarterly regulatory reports (FR Y-9C and FR Y-9LP), contain, for individual companies, financial statistics and comparisons with peer companies. BHCPRs are made available to the public on the National Information Center (NIC) website, which can be accessed at www.ffiec.gov.

Federal Reserve analysts use Performance Report Information and Surveillance Monitoring (PRISM), a querying tool, to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial information drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, BHCPRs, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of surveillance screening for banks and BHCs. During 2011, four major upgrades to the web-based PRISM application were completed.

The Federal Reserve works through the FFIEC Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.

Training and Technical Assistance

The Federal Reserve provides training and technical assistance to foreign supervisors and minority-owned and de novo depository institutions.

International Training and Technical Assistance

In 2011, the Federal Reserve continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by Federal Reserve staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. The Federal Reserve, along with the OCC, the FDIC, and the Treasury, was an active participant in the Middle East and North Africa Financial Regulators' Training Initiative, which is part of the U.S. government's Middle East Partnership Initiative. The Federal Reserve also contributes to the regional training provision under the Asia Pacific Economic Cooperation Financial Regulators' Training Initiative.

In 2011, the Federal Reserve offered a number of training courses exclusively for foreign supervisory authorities, both in the United States and in a number of foreign jurisdictions. Federal Reserve staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Asian Development Bank, the Basel Committee on Banking Supervision, and the Financial Stability Institute.

The Federal Reserve is also an associate member of the Association of Supervisors of Banks of the Americas (ASBA), an umbrella group of bank supervisors from countries in the Western Hemisphere. The group, headquartered in Mexico,

- promotes communication and cooperation among bank supervisors in the region;
- coordinates training programs throughout the region with the help of national banking supervisors and international agencies; and
- aims to help members develop banking laws, regulations, and supervisory practices that conform to international best practices.

The Federal Reserve contributes significantly to ASBA's organizational management and to its training and technical assistance activities.

Initiatives for Minority-Owned and De Novo Depository Institutions

The Partnership for Progress program is a Federal Reserve System program created to preserve and promote minority-owned, woman-owned, and de novo depository institutions (MDIs). Launched in 2008, the program seeks to help these institutions compete effectively in today's marketplace by offering MDIs a combination of one-on-one assistance and targeted workshops on topics of particular relevance in terms of starting and growing a bank in a safe and sound manner. In addition, training and information on resources are provided through an extensive public website (www.fedpartnership.gov).

Designated Partnership for Progress coordinators serve as local program contacts in each of the 12 Reserve Bank Districts and the Board of Governors to answer questions and coordinate assistance for institutions requesting guidance.

During 2011, the banking industry continued to face significant challenges. MDIs faced increasing marketplace challenges, as many operated in some of the hardest-hit regions and were adversely impacted by the recession and sluggish economic recovery. The economic crisis has significantly impacted a large number of MDIs primarily due to high unemployment, weak credit demand, capital deficiencies, and increasing regulatory costs.

In an effort to strengthen the Partnership for Progress program and address the provisions of section 367 of the Dodd-Frank Act, enhancements to the program were made, including

- initiation of an interagency task force to focus on challenges raised by minority bankers;
- a review of the effectiveness of the methods currently used to promote and preserve minority banks;
- informational sessions for district coordinators to discuss the conditions of minority banks, on topics such as capital investment, asset quality, troubled asset management, and the impact of bank failures;
- transition of the program management function to a senior supervision staff member; and
- development of website enhancements that will operate as an electronic resource center for MDIs. This site is expected to be launched in 2012.

Throughout the year, the Federal Reserve Banks hosted conference calls and meetings with key minority bankers, community leaders, academia leaders, the National Bankers Association (NBA), the National Urban League in Philadelphia, the Small Business Administration in Philadelphia, and other national partners in order to help coordinate methods and strategies for preserving and promoting MDIs and the communities they serve.

In 2011, the Federal Reserve Banks hosted/participated in a variety of workshops and seminars, including

- a conference on Small Business and Entrepreneurs and the Impact of the Economic Crisis;
- a presentation on MDI conditions at the NBA Convention in Dallas;
- an outreach effort with investment firms interested in providing capital to MDIs;
- a Supplier Diversity Forum and a reception for small businesses and entrepreneurs— in partnership with the National Urban League—focusing on Doing Business with Large Businesses; and
- the FDIC MDI Roundtable in Los Angeles, held in collaboration with the National Association of Chinese American Bankers, on the topic of "Risk Management."

The results of these efforts collectively are expected to further our initiative to comply with section 367 of the Dodd-Frank Act in a very challenging environment for the banking industry in general and MDIs in particular.

Business Continuity

In 2011, the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions, including focused supervisory efforts to evaluate the resiliency of the banking institutions under its jurisdiction. The Federal Reserve, together with other federal and state financial regulators, is a member of the Financial Banking Information Infrastructure Committee (FBIIC), which was formed to improve coordination and communication among financial regulators, enhance the resiliency of the financial sector, and promote the public/private partnership. The FBIIC has established emergency communication protocols to maintain effective communication among members in the event of an emergency. The members of the FBIIC will convene by conference call no later than 90 minutes following the first public report of an event to share situational and operational status reports. As a member of FBIIC, the Federal Reserve is then responsible for establishing and maintaining communication with the institutions for which it has primary supervisory authority and for ensuring coordination between public affairs and media relations staff.

Supervisory Policy

The Federal Reserve's supervisory policy function, carried out by the Board, is responsible for developing regulations and guidance for financial institutions under the Federal Reserve's supervision, as well as guidance for examiners. The Board, often working together with the other federal banking agencies, issues rulemakings, public SR letters, and other policy statements and guidance in order to carry out its supervisory policy function. Federal Reserve staff also take part in supervisory and regulatory forums, provide support for the work of the FFIEC, and participate in international policymaking forums, including the Basel Committee on Banking Supervision, the Financial Stability Board, and the Joint Forum.

Capital Adequacy Standards

In 2011, the Board issued several rulemakings and guidance documents related to capital adequacy standards, including joint proposed rulemakings with the other federal banking agencies that would implement certain revisions to the Basel capital framework and that address certain provisions of the Dodd-Frank Act.

- In January, the federal banking agencies issued for comment an NPR to revise their market-risk capital rules. These proposed revisions would implement a number of changes to the Basel Accord intended to (1) better capture positions for which the market-risk capital rules are appropriate, (2) reduce procyclicality in market-risk capital requirements, (3) enhance the rules' sensitivity to risks that are not adequately captured by the current regulatory measurement methodologies, and (4) increase market discipline through enhanced disclosures. The NPR is available at www.gpo.gov/fdsys/pkg/FR-2011-01-11/pdf/2010-32189.pdf.

- The federal banking agencies issued a subsequent NPR in December that amended the January market-risk NPR by proposing to replace methodologies for calculating specific risk-capital requirements that relied on credit ratings with alternative methods for evaluating creditworthiness, as required by section 939A of the Dodd-Frank Act. The NPR is available at www.gpo.gov/fdsys/pkg/FR-2011-12-21/pdf/2011-32073.pdf.
- The federal banking agencies published a final rule in June that amends the advanced approaches capital adequacy framework, consistent with section 171 of the Dodd-Frank Act. The rule requires a banking organization operating under the advanced approaches framework to meet, on an ongoing basis, the higher of the minimum risk-based requirements under the general risk-based capital rules and the minimum requirements under the advanced approaches risk-based capital rules. The rule is available at www.gpo.gov/fdsys/pkg/FR-2011-06-28/pdf/2011-15669.pdf.
- In June, the Board sought comment on and adopted an interim final rule that allows small BHCs that are S-Corps or that are organized in mutual form to exclude subordinated debt issued to Treasury under the SBLF from treatment as "debt" for purposes of the debt-to-equity standard under the Board's "Small Bank Holding Company Policy Statement." The interim final rule is available at www.gpo.gov/fdsys/pkg/FR-2011-06-21/pdf/2011-14983.pdf.
- The Board also adopted a final rule in June that allows BHCs that are S-Corps or that are organized in mutual form to include in tier 1 capital all subordinated debt issued to Treasury under the TARP, subject to certain limits. The rule also allows small BHCs that are S-Corps or that are organized in mutual form to exclude subordinated debt issued to Treasury under TARP from treatment as "debt" for purposes of the debt-to-equity standard under the Board's "Small Bank Holding Company Policy Statement." This rule makes final an interim final rule that the Board adopted in June 2009 and is available at www.gpo.gov/fdsys/pkg/FR-2011-06-21/pdf/2011-14983.pdf.
- In December, the Board issued a final rule requiring top-tier U.S. BHCs with total consolidated assets of $50 billion or more to submit annual capital plans for review. The aim of the annual capital plans is to ensure that institutions have robust, forward-looking capital planning processes that account for their unique risks, and to help ensure that institutions have sufficient capital to continue operations throughout times of economic and financial stress. Under the rule, the Federal Reserve annually will evaluate institutions' capital adequacy; internal capital adequacy assessment processes; and plans to make capital distributions, such as dividend payments or stock repurchases. The capital plan rule is available at www.gpo.gov/fdsys/pkg/FR-2011-12-01/pdf/2011-30665.pdf. (Also see **box 4**.)
- In addition, the Board, under a separate rulemaking, proposed to use the capital planning requirements to meet the Board's obligations to impose enhanced capital standards on large financial firms under section 165(b)(1)(A)(i) of the Dodd-Frank Act. The NPR on enhanced prudential standards and early remediation requirement for covered companies is available at www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm. (Also see **box 1**.)

In 2011, Board and Reserve Bank staff conducted in-depth supervisory analyses of a number of complex capital issuances, private capital investments, and other transactions to evaluate their qualification for inclusion in regulatory capital and consistency with safety and soundness. For certain transactions, banking organizations were required to make changes necessary for instruments to satisfy regulatory capital criteria while other transactions were disallowed from inclusion in a banking organization's regulatory capital. With respect to certain sales and structured finance transactions, banking organizations were required to maintain additional capital for their exposures that were more commensurate with the risk of the arrangements and the organization's support for the transactions.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision, the Federal Reserve actively participates in efforts to advance sound supervisory policies for internationally active banking organizations and enhance the strength and stability of the international banking system.

Basel Capital Framework

During 2011, the Federal Reserve participated in ongoing international initiatives to enhance the Basel capital framework through the publication of the revised version of *Basel III: A global regulatory framework for more resilient banks and banking systems* in June 2011 and a series of "Frequently Asked Questions" on various Basel III-related topics, including the definition of "regulatory capital" and "counterparty credit (CCR) risk."

The Federal Reserve contributed to supervisory policy recommendations, reports, and papers issued for consultative purposes or finalized by the Basel Committee that were designed to improve the supervision of banking organizations' practices and to address specific issues that emerged during the financial crisis. The listing below includes key final and consultative papers from 2011.

Final papers:

- *Revisions to the Basel II market risk framework - updated as of 31 December 2010* (issued in February and available at www.bis.org/publ/bcbs193.htm).
- *Range of methodologies for risk and performance alignment of remuneration* (issued in May and available at www.bis.org/publ/bcbs194.htm).
- *Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011* (issued in June and available at www.bis.org/publ/bcbs189.htm). The revised version includes capital treatment for bilateral CCR risk finalized by the Basel Committee in June 2011.
- *Principles for the Sound Management of Operational Risk* (issued in June and available at www.bis.org/publ/bcbs195.htm).
- *Operational Risk - Supervisory Guidelines for the Advanced Measurement Approaches* (issued in June and available at www.bis.org/publ/bcbs196.htm).
- *Treatment of trade finance under the Basel capital framework* (issued in October and available at www.bis.org/publ/bcbs205.htm).
- *High cost credit protection* (issued in December and available at www.bis.org/publ/bcbs_nl16.htm).

Consultative papers:

- *Capitalisation of bank exposures to central counterparties - second consultative document* (issued in November and available at www.bis.org/publ/bcbs206.htm).
- *Core principles for effective banking supervision* (published in December and available at www.bis.org/publ/bcbs213.htm).

Joint Forum

In 2011, the Federal Reserve continued its participation in the Joint Forum—an international group of supervisors of the banking, securities, and insurance industries established to address various cross-sector issues, including the regulation of financial conglomerates. The Joint Forum operates under the aegis of the Basel Committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors.

The Joint Forum, through its founding organizations, issued a *Report on asset securitisation incentives* in July 2011 that provides an update on the conditions in the global securitization market, as well as an assessment of regulatory reforms implemented following the financial crisis analyses. The report is available at www.bis.org/publ/joint26.htm.

In addition, the Joint Forum issued, in December 2011, a consultative document, *Principles for the supervision of financial conglomerates*. The document is available at www.bis.org/publ/joint27.htm.

Accounting Policy

The Federal Reserve strongly endorses sound corporate governance and effective accounting and auditing practices for all regulated financial institutions. Accordingly, the Federal Reserve's supervisory policy function is responsible for monitoring major domestic and international proposals, standards, and other developments affecting the banking industry in the areas of accounting, auditing, internal controls over financial reporting, financial disclosure, and supervisory financial reporting.

During 2011, Federal Reserve staff addressed numerous issues related to financial sector accounting and reporting, including fair value accounting, financial instrument accounting and reporting, balance sheet offsetting, loan accounting, business combinations, lease accounting, securitizations, securities financing transactions, consolidation of structured entities, external and internal audit processes, and international financial reporting standards.

To address these and other issues, Federal Reserve staff consulted with key constituents in the accounting and auditing professions, including standard-setters, accounting firms, accounting and financial sector trade groups, and other financial sector regulators. The Federal Reserve also participated in meetings of the Basel Committee's Accounting Task Force, which represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. These efforts helped inform our understanding of domestic and international practices—as well as proposed accounting, auditing, and regulatory standards—and helped in our formulation of policy positions using insight obtained through these forums.

During 2011, the Federal Reserve shared its views with accounting and auditing standard-setters through informal discussions and public comment letters. Comment letters on the following proposals were issued during the past year:

- Public Company Accounting Oversight Board's proposal related to changes in the auditor's reporting model.
- Financial Accounting Standards Board's proposals related to netting of balance sheet amounts, hedge accounting, impairment of financial assets, and effective dates and transition methods.

Working with international bank supervisors, Federal Reserve staff contributed to the development of numerous other comment letters related to accounting and auditing matters that were submitted to the International Accounting Standards Board and the International Auditing and Assurance Standards Board through the Basel Committee.

Federal Reserve staff also participated in other supervisory activities to assess interactions between accounting standards and regulatory reform efforts. These activities included supporting Dodd-Frank Act initiatives related to stress testing of banks and credit-risk retention requirements for securitizations, as well as various Basel III activities.

The Federal Reserve issued supervisory guidance to financial institutions and supervisory staff on accounting matters, as appropriate, and participated in a number of supervisory-related activities. For example, Federal Reserve staff

- issued guidance to address supervisory considerations related to the disposal of nonperforming assets and foreclosed real estate through exchanges brokered by marketing agents;
- developed and participated in a number of domestic and international training programs to educate supervisors about new and emerging accounting and reporting topics affecting financial institutions; and
- supported the efforts of the Reserve Banks in financial institution supervisory activities related to financial accounting, auditing, reporting, and disclosure.

Credit-Risk Management

The Federal Reserve works with the other federal banking agencies to develop guidance on the management of credit risk; to coordinate the assessment of regulated institutions' credit risk; and to ensure that institutions properly identify, measure, and manage credit risk.

Supervisory Expectations for Risk Management of Agricultural Credit Risk

In October, the Federal Reserve issued supervisory guidance to serve as a reminder to banking organizations and supervisory staff of the key risk factors in agricultural lending and supervisory expectations for a banking organization's risk-management practices. The guidance was issued largely in response to recent market developments. The potential for volatile market conditions and risk factors raises the importance of ensuring that agricultural banks have in place appropriate risk-management programs and prudent lending standards. A key component of a sound risk-management program is the linkage between an analysis of market conditions and an agricultural bank's risk-management and capital planning practices. The range and extent of market analysis may vary depending on the composition of the bank's portfolio and overall risk exposure.

Shared National Credit Program

In August, the Federal Reserve and the other banking agencies released summary results of the 2011 annual review of the Shared National Credit (SNC) Program. The agencies established the program in 1977 to promote an efficient and consistent review and classification of SNCs. A SNC is any loan or formal loan commitment—and any asset, such as other real estate, stocks, notes, bonds, and debentures taken as debts previously contracted—extended to borrowers by a supervised institution, its subsidiaries, and affiliates that aggregates to $20 million or more and either (1) is shared by three or more unaffiliated supervised institutions under a formal lending agreement or (2) a portion of which is sold to two or more unaffiliated supervised institutions, with the purchasing institutions assuming their pro rata share of the credit risk.

The 2011 SNC review was based on analyses of credit data as of December 31, 2010, provided by federally supervised institutions. The 2011 SNC portfolio totaled $2.5 trillion, with 8,030 credit facilities to approximately 5,400 borrowers. From the previous period, the dollar volume of the portfolio commitment amount rose by $6 billion or 0.2 percent, and the number of credits declined by 259, or 3.1 percent.

Although credit quality improved significantly over the past two years, the percentage of criticized and classified assets remains elevated at 12.7 and 8.5 percent, respectively.[11] Criticized assets declined by $126 billion to $321 billion, a 28.2 percent decrease from the 2010 results. Criticized assets represented 12.7 percent of the portfolio, compared with 17.8 percent in the 2010 review. Classified credits declined by $90 billion, a 29.5 percent decrease. Classified credits represented 8.5 percent of the portfolio, compared with 12.1 percent in the 2010 review. Credits rated special mention declined by $36 billion to $106 billion, a 25.4 percent decline. Special mention credits represented 4.2 percent of the portfolio, compared with 5.7 percent in 2010. As in 2010, the reduction in the level of criticized assets is attributed to improved borrower operating performance, debt restructurings, bankruptcy resolutions, and greater borrower access to bond and equity markets.

The number of credits originated in 2010 rose dramatically compared to 2009 and 2008, and equaled approximately 75 percent of the large volume of credits originated in 2007. While the overall quality of underwriting in 2010 was significantly better than in 2007, some easing of standards was noted, specifically in leveraged finance credits, compared to the relatively tighter standards present in 2009 and the latter half of 2008. Underwriting standards were generally satisfactory overall though the observed softening may be due to increasing competition and market liquidity.

[11] Criticized assets are composed of special mention and classified assets. Special mention assets are loans and securities that exhibit potential weakness but are not classified. Classified assets are loans and securities that exhibit well-defined weaknesses or a distinct possibility of loss.

The performance of the SNC portfolio remained heavily influenced by significant exposure to 2006- and 2007-vintage credits with weak underwriting standards. These loans comprised 40.1 percent of SNC commitments, but accounted for 58.4 percent of criticized commitments. Refinancing risk remains elevated as nearly $2 trillion, or 78 percent, of the SNC portfolio will mature by the end of 2014. Of this amount, $204 billion is criticized.

Compliance Risk Management

The Federal Reserve works with international and domestic supervisors to develop guidance that promotes compliance with BSA/AML and counter terrorism laws.

Bank Secrecy Act and Anti-Money-Laundering Compliance

In 2011, the Federal Reserve continued to actively promote the development and maintenance of effective BSA/AML compliance risk-management programs. For example, the Federal Reserve issued guidance in March 2011, SR letter 11-6, "Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions (foreign missions)."[12] The interagency advisory (attached to SR letter 11-6) supplements prior guidance and provides information to financial institutions regarding the provision of account services to foreign missions in a manner that fulfills the needs of those foreign governments while complying with the provisions of the BSA. Also, Federal Reserve supervisory staff participated in interagency projects designed to clarify regulatory expectations, including guidance for financial institutions on the reorganization of the Financial Crimes Enforcement Network's (FinCEN) BSA regulations.

The Federal Reserve is a member of the Treasury-led BSA Advisory Group, which includes representatives of regulatory agencies, law enforcement, and the financial services industry and covers all aspects of the BSA. The Federal Reserve also participates in the FFIEC BSA/AML working group, which is a monthly forum for the discussion of pending BSA policy and regulatory matters. In addition to the FFIEC agencies, the BSA/AML working group includes FinCEN and, on a quarterly basis, the SEC, the Commodity Futures Trading Commission, the Internal Revenue Service, and the Office of Foreign Assets Control (OFAC) in order to share and discuss information on policy issues and general trends more broadly.

[12] www.federalreserve.gov/bankinforeg/srletters/sr1106.htm.

The FFIEC BSA/AML working group also is responsible for updating the FFIEC *Bank Secrecy Act/Anti-Money Laundering Examination Manual* (Manual). The FFIEC developed the Manual as part of its ongoing commitment to provide current and consistent interagency guidance on risk-based policies, procedures, and processes for financial institutions to comply with the BSA and safeguard their operations from money laundering and terrorist financing.

In 2011, the Federal Reserve, together with the FDIC and the OCC, issued a Spanish-language translation of the Manual. This initiative was largely in response to requests from industry and trade groups and furthers the collective goal of making regulatory expectations regarding BSA/AML compliance programs as accessible and useful as possible.

The Federal Reserve and other federal banking agencies continued during 2011 to regularly share examination findings and enforcement proceedings with FinCEN under the interagency MOU that was finalized in 2004.

In 2011, the Federal Reserve coordinated extensively with OFAC on their efforts under the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010. This law builds upon the U.S. government's role in protecting its domestic financial system from exposure to Iran's illicit and deceptive financial practices by strengthening existing U.S. sanctions. The Federal Reserve continued during 2011 to regularly share examination findings and enforcement proceedings with OFAC under the 2006 interagency MOU.

International Coordination on Sanctions, Anti-Money-Laundering, and Counter-Terrorism Financing

The Federal Reserve participates in a number of international coordination initiatives related to sanctions, money laundering, and terrorism financing. For example, the Federal Reserve has a long-standing role in the U.S. delegation to the intergovernmental Financial Action Task Force (FATF) and its working groups, contributing a banking supervisory perspective to formulation of international standards on these matters. In 2011, the Federal Reserve actively contributed to the development of a FATF typologies report that addressed laundering the proceeds of corruption. In addition, the Federal Reserve has provided input and review of ongoing work to revise the FATF Recommendations in order to ensure that they continue to provide a comprehensive and current framework for combating money laundering and terrorist financing. Also, the Federal Reserve continues to participate in a subcommittee of the Basel Committee that focuses on AML/counter-terrorism financing issues.

Other Policymaking Initiatives

In 2011, the Board issued or proposed guidance in a number of areas including the following:

- In January, the Board issued guidance on the potential impact of high-cost credit protection transactions on the assessment of a banking organization's overall capital adequacy. The guidance states that while credit-risk mitigation techniques can significantly reduce a banking organization's level of risk, in some cases the high premiums or fees paid for certain credit protection, combined with other terms and conditions, call into question the degree of risk transfer of the transaction. The guidance provides a set of criteria for evaluating the degree of risk transfer of a transaction and describes actions that the Board may take in order to account for high-cost credit protection transactions when assessing a banking organization's overall capital adequacy. The guidance is available at www.federalreserve.gov/bankinforeg/srletters/sr1101.htm.
- The Board and the OCC jointly issued guidance in April that expands on previous guidance on the use of models and sets forth the agencies' expectations regarding a robust approach to the assessment and management of model risk. The guidance summarizes the principles of a model risk-management framework, including robust model development, implementation, and use; effective validation; and sound governance, policies, and controls. The guidance is available at www.federalreserve.gov/bankinforeg/srletters/sr1107.htm.
- In April, the federal banking agencies, Federal Housing and Finance Agency, Housing and Urban Development, and the SEC jointly sought comment on an NPR that would implement the requirements of section 941(b) of the Dodd-Frank Act. More specifically, the NPR would (1) require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party; and (2) prohibit a securitizer from directly or indirectly hedging or transferring the credit risk the securitizer is required to retain. The NPR would exempt from

risk retention any asset-backed security collateralized solely by qualified residential mortgages as defined in the proposed rule. The NPR is available at http://edocket.access.gpo.gov/2011/pdf/2011-8364.pdf.

- In June, the federal banking agencies jointly requested comment on proposed stress testing guidance that outlines high-level principles for stress testing practices, which are applicable to all banking organizations with more than $10 billion in total consolidated assets (see **box 4**). The proposed guidance highlights the importance of stress testing as an ongoing risk-management practice that supports a banking organization's forward-looking assessment of its risks. The proposed guidance is available at www.federalreserve.gov/newsevents/press/bcreg/20110609a.htm.
- The federal banking agencies issued guidance in July on their expectations for sound CCR risk-management practices. This guidance reinforces sound governance of CCR risk-management practices through prudent board and senior management oversight, management reporting, and risk-management functions. In addition, the guidance also summarizes the sound practices necessary for an effective CCR management framework and the characteristics of an appropriate systems infrastructure. The guidance is available at www.federalreserve.gov/newsevents/press/bcreg/20110705a.htm.
- The Federal Reserve, along with the other FFIEC agencies, issued the "Supplement to Authentication in an Internet Banking Environment" (supplement), which supplements the similarly titled guidance issued in 2005. The supplement is intended to enhance supervised organizations' Internet banking control environments. Accordingly, the supplement clarifies and increases supervisory expectations in the areas of risk assessments, customer authentication, layered security controls, and awareness and education programs. The guidance is available at www.federalreserve.gov/bankinforeg/srletters/sr1109.htm.
- In March, the federal banking agencies requested comment on a joint proposed rule to ensure that regulated financial institutions design their incentive compensation arrangements to take account of risk. The proposed rule, which is being issued pursuant to the Dodd-Frank Act, would apply to certain financial institutions with more than $1 billion in assets. It also contains heightened standards for the largest of these institutions. The proposed rule is available at www.federalreserve.gov/newsevents/press/bcreg/20110330a.htm. (Also see **box 5**.)

Regulatory Reports

The Federal Reserve's supervisory policy function is also responsible for developing, coordinating, and implementing regulatory reporting requirements for various financial reporting forms filed by domestic and foreign financial institutions subject to Federal Reserve supervision. Federal Reserve staff members interact with other federal agencies and relevant state supervisors, including foreign bank supervisors as needed, to recommend and implement appropriate and timely revisions to the reporting forms and the attendant instructions.

Bank Holding Company Regulatory Reports

The Federal Reserve requires that U.S. BHCs periodically submit reports that provide information about their financial condition and structure. This information is essential to formulating and conducting bank regulation and supervision. It is also used in responding to requests by Congress and the public for information about BHCs and their nonbank subsidiaries. Foreign banking organizations also are required to periodically submit reports to the Federal Reserve.

- FR Y-9 series reports—the FR Y-9C, FR Y-9LP, and FR Y-9SP—provide standardized financial statements for BHCs on both a consolidated and a parent-only basis. The reports are used to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for BHC mergers and acquisitions, and to analyze a holding company's overall financial condition.
- Nonbank subsidiary reports—the FR Y-11, FR 2314, FR Y-7N, and FR 2886b—help the Federal Reserve determine the condition of BHCs that are engaged in nonbank activities and also aid in monitoring the number, nature, and condition of the companies' nonbank subsidiaries.
- The FR Y-8 report provides information on transactions between an insured depository institution and its affiliates that are subject to section 23A of the Federal Reserve Act; it is used to monitor bank exposures to affiliates and to ensure banks' compliance with section 23A of the Federal Reserve Act.
- The FR Y-10 report provides data on changes in organization structure at domestic and foreign banking organizations.

Box 5. Incentive Compensation

Flawed incentive compensation practices in the financial industry—providing executives and other employees with incentives to take imprudent risks inconsistent with the long-term health of their financial organizations—were among the many factors contributing to the financial crisis. To help address these problems, the Federal Reserve issued draft supervisory guidance on incentive compensation practices for public comment in October 2009. After modest revisions, it was adopted by the federal banking agencies (Federal Reserve, OCC, FDIC, OTS) in June 2010 (www.federalreserve.gov/newsevents/press/bcreg/20100621a.htm).

In 2009, the Federal Reserve undertook a supervisory initiative—a "horizontal review" of incentive compensation practices at the 25 largest banking organizations. The horizontal review was designed to assess

- the potential for incentive compensation arrangements to encourage imprudent risk-taking;
- the actions that the large complex banking organizations have taken to correct deficiencies in incentive compensation design; and
- the adequacy of the organizations' compensation-related risk management, controls, and corporate governance.

These organizations have made significant changes to their practices and are approaching substantial conformance with the guidance. A recent Financial Stability Board report shows that U.S. banks are at or near the leading edge of practice internationally. More details about the horizontal review are presented in an October 2011 white paper (www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf).

The Dodd-Frank Act requires the reporting to regulators of incentive compensation arrangements and prohibits incentive compensation arrangements that provide excessive compensation or that could expose the firm to inappropriate risks. Banking organizations, broker–dealers, investment advisers, and certain other firms are covered under the act if they have $1 billion or more in total assets. To implement the act, seven financial regulatory agencies (Federal Reserve, OCC, FDIC, OTS, NCUA, SEC, and the Federal Housing and Finance Agency) issued a joint proposed rule in April 2011 (www.gpo.gov/fdsys/pkg/FR-2011-04-14/pdf/2011-7937.pdf). The banking agencies' existing reviews have been done using their safety-and-soundness authority; the proposed rule would add to that authority and provide regulatory authority to some other agencies, such as the SEC. The core principles of the proposed rule are similar to those in the banking agencies' guidance. A very large number of comments were received from the public, and these comments are being carefully considered in the drafting of the final rule. The final rule is forthcoming in 2012.

- The FR Y-6 and FR Y-7 reports gather additional information on organization structure and shareholders from domestic banking organizations and foreign banking organizations, respectively; the information is used to monitor structure so as to determine compliance with provisions of the Bank Holding Company Act (BHC Act) and Regulation Y and to assess the ability of a foreign banking organization to continue as a source of strength to its U.S. operations.

During 2011, the Federal Reserve implemented a number of changes to the FR Y-9C reporting requirements to better understand BHCs' risk exposures, primarily with respect to lending and securitizations; to better support macroeconomic analysis and monetary policy purposes; and to collect certain information prescribed by changes in accounting standards. These revisions included (1) break out by loan category of other loans and leases that are troubled debt restructurings for those that (a) are past due 30 days or more or in nonaccrual status or (b) are in compliance with their modified terms and clarify reporting of restructured troubled debt consumer loans; (2) break out of other consumer loans into automobile loans and all other consumer loans in several schedules; (3) break out of commercial mortgage-backed securities issued or guaranteed by U.S. government agencies and sponsored agencies; (4) creation of a new Schedule HC-V, Variable Interest Entities (VIEs), for reporting major categories of assets and liabilities of consolidated VIEs; (5) break out of loans and other real estate owned (OREO) information covered by FDIC loss-sharing agreements by loan and OREO category; (6) break out of life insurance assets into data items for general account and separate account life insurance assets; (7) addition of new data items for the total assets of captive insurance and reinsurance subsidiaries; (8) addition of new income statement items for credit valuation adjustments and debit valuation adjustments included in trading revenues (for BHCs with total assets of $100 billion or more); (9) revision of the reporting instructions in the areas of construction lending, one- to four-family residential mortgage banking activities, and maturity and repricing data; and (10) collection of expanded information on the quarterly-averages schedule.

In 2011, the Federal Reserve proposed the following revisions to the FR Y-9C for implementation in 2012 to better understand BHCs' risk exposures, to better support macroeconomic analysis and monetary policy purposes, and to collect certain information prescribed by changes in accounting standards: (1) add a section to Schedule HC-C, Loans and Lease Financing Receivables, to collect information on the allowance for loan and lease losses by loan category; (2) add two data items to Schedule HC-P, 1–4 Family Residential Mortgage Banking Activities, to collect the amount of representation and warranty reserves for one- to four-family residential mortgage loans sold; (3) add a data item to Schedule HC-N, Past Due and Nonaccrual Loans, Leases, and Other Assets, to collect the outstanding balance of purchased credit impaired loans by past due and nonaccrual status; (4) add a new Schedule HC-U, Loan Origination Activity in Domestic Offices, to collect information on loan originations; and (5) modify the reporting instructions to clarify the reporting and accounting treatment of specific valuation allowances.

Savings and Loan Holding Company Regulatory Reports

On July 21, 2011, the responsibility for supervision and regulation of SLHCs transferred from the OTS to the Board, pursuant to section 312 of the Dodd-Frank Act. In preparation of this event, the Federal Reserve, on February 8, 2011, published in the *Federal Register* a notice of intent (76 *Fed. Reg.* 7091) to require SLHCs to submit the same reports as BHCs (FR Y–6, FR Y–7, FR Y–9 reports, FR Y–11/11S, FR 2314/2314S, FR Y–8, FR Y–12/12A, FR Y–7Q, or FR Y–7N/NS) beginning with the March 31, 2012, reporting period.[13] The notice of intent stated that the Board would issue a formal proposed notice on information collection activities for SLHCs after the transfer date. On August 25, 2011, the Board issued a proposal to exempt a limited number of SLHCs from initially submitting Federal Reserve regulatory reports and allow a two-year phased-in reporting for most SLHCs beginning with the March 31, 2012, reporting period (76 *Fed. Reg.* 53129).[14]

After consideration of the comments received on the proposal, the Board issued a press release, on December 23, 2011, announcing that the proposed collections of information from SLHCs had been finalized with modifications. The final notice was published in the *Federal Register* on December 29, 2011, (76 *Fed. Reg.* 81933) in which the Board retained the two-year phase-in approach for most SLHCs and modified the exemption criteria for commercial SLHCs and certain insurance SLHCs.[15] The exemption for commercial SLHCs will be reviewed periodically and may be rescinded if the Board determines that FR Y–9 financial information and other regulatory reports are needed to effectively and consistently assess compliance with capital and other regulatory requirements. Insurance SLHCs will be exempt only until consolidated regulatory capital rules are finalized for SLHCs, at which time they may be required to file consolidated financial statements—to demonstrate their compliance with the capital rules—and other Federal Reserve reports.

Commercial Bank Regulatory Reports

As the federal supervisor of state member banks, the Federal Reserve, along with the other banking agencies (through the FFIEC), requires banks to submit quarterly Call Reports. Call Reports are the primary source of data for the supervision and regulation of banks and the ongoing assessment of the overall soundness of the nation's banking system. Call Report data provide the most current statistical data available for evaluating institutions' corporate applications, for identifying areas of focus for both on-site and off-site examinations, and for considering monetary and other public policy issues. Call Report data, which also serve as benchmarks for the financial information required by many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community.

During 2011, the FFIEC implemented revisions to the Call Report to better understand banks' risk exposures, primarily with respect to lending and securitizations, to better support macroeconomic analysis and monetary policy purposes, and to collect certain information prescribed by changes in accounting standards. The revisions included (1) break out by loan category of other loans and leases that are troubled debt restructurings for those that (a) are past due 30 days or more or in nonaccrual status or (b) are in compliance with their modified terms and clarify reporting of restructured troubled debt consumer loans; (2) break out other consumer loans into automobile loans and all other consumer loans in several schedules; (3) break out of commercial mortgage-backed securities issued or

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[13] See notice of intent at www.gpo.gov/fdsys/pkg/FR-2011-02-08/html/2011-2782.htm.

[14] See proposal at www.gpo.gov/fdsys/pkg/FR-2011-08-25/html/2011-21736.htm.

[15] See press release and notice at www.federalreserve.gov/newsevents/press/bcreg/20111223a.htm.

guaranteed by U.S. government agencies and sponsored agencies; (4) addition of a new memorandum item for the estimated amount of nonbrokered deposits obtained through the use of deposit-listing service companies; (5) break out of existing items for deposits of individuals, partnerships, and corporations into deposits of individuals and deposits of partnerships and corporations; (6) creation of a new Schedule RC-V, VIEs, for reporting major categories of assets and liabilities of consolidated VIEs; (7) break out of loans and OREO information covered by FDIC loss-sharing agreements by loan and OREO category; (8) break out of life insurance assets into data items for general account and separate account life insurance assets; (9) addition of new data items for the total assets of captive insurance and reinsurance subsidiaries; (10) addition of new income statement items for credit valuation adjustments and debit valuation adjustments included in trading revenues (for banks with total assets of $100 billion or more); (11) change of the reporting frequency from annually to quarterly for the data reported in Schedule RC-T, Fiduciary and Related Services, on collective investment funds and common trust funds; and (12) revision of the reporting instructions in the areas of construction lending, one- to four-family residential mortgage banking activities, and maturity and repricing data.

In addition, during 2011, the FFIEC implemented several revisions to the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) to (1) collect additional detail on trading assets, (2) revise the reporting instructions in Schedule E for reporting of time deposits of $100,000 or more, and (3) expand the data collected on Schedule Q, Financial Assets and Liabilities Measured at Fair Value.

In 2011, the FFIEC proposed the following revisions to the Call Report for implementation in 2012 to better understand banks' risk exposures, to better support macroeconomic analysis and monetary policy purposes, and to collect certain information prescribed by changes in accounting standards: (1) add a section to Schedule RC-C, Loans and Lease Financing Receivables, to collect information on the allowance for loan and lease losses by loan category; (2) add two data items to Schedule RC-P, 1–4 Family Residential Mortgage Banking Activities, to collect the amount of representation and warranty reserves for one- to four-family residential mortgage loans sold; (3) add a data item to Schedule RC-N, Past Due and Nonaccrual Loans, Leases, and Other Assets, to collect the outstanding balance of purchased credit impaired loans by past due and nonaccrual status; (4) add a new Schedule RC-U, Loan Origination Activity in Domestic Offices, to collect information on loan originations; (5) add new items in Schedule RC-M, Memoranda, in which savings associations and certain state savings and cooperative banks would report on the test they use to determine compliance with the Qualified Thrift Lender requirement and whether they have remained in compliance with this requirement; (6) revise two existing items in Schedule RC-R, Regulatory Capital, used to calculate the leverage ratio denominator to accommodate certain differences between the regulatory capital standards that apply to the leverage capital ratios of banks versus savings associations; and (7) modify the reporting instructions to clarify the reporting and accounting treatment of specific valuation allowances.

Supervisory Information Technology

The Federal Reserve's supervisory information technology function, carried out by the Board's Division of Banking Supervision and Regulation and the Reserve Banks under the guidance of the Subcommittee on Supervisory Administration and Technology, works to identify and set priorities for information technology initiatives within the supervision and regulation business line.

In 2011, the supervisory information technology function focused on

- **Large Bank Supervision**. Improved the supervision of large and regional financial institutions with new processes and linked workflows to enable continuous updates of information provided through examinations and ongoing monitoring activities.
- **Community Bank Supervision**. Worked with community bank examiners and other regulators to implement enhanced tools to support community bank examinations.
- **Data Management**. (1) Improved the data management infrastructure and inventorying of supervisory information and (2) enhanced data analytics to support core business needs. These improvements were the result of stress testing, capital assessments, and additional risk monitoring that created additional demands for investment in data collections.
- **Collaboration**. (1) Enhanced information sharing among staff at the Board and Reserve Banks

through tools to support communities of practice, (2) developed and piloted an electronic solution to support exam teams' ability to share documents, and (3) created an Interagency Steering Group to improve methods for sharing work among state and federal regulators.

- **Modernization.** Initiated significant projects to modernize software products and business capabilities in the areas of document management, resource prioritization, and scheduling.

National Information Center

The NIC is the Federal Reserve's comprehensive repository for supervisory, financial, and banking-structure data. It is also the main repository for many supervisory documents. NIC includes (1) data on banking structure throughout the United States as well as foreign banking concerns; (2) the National Examination Desktop, which enables supervisory personnel as well as federal and state banking authorities to access NIC data; (3) the Banking Organization National Desktop, an application that facilitates secure, real-time electronic information sharing and collaboration among federal and state banking regulators for the supervision of banking organizations; and (4) the Central Document and Text Repository, which contains documents supporting the supervisory processes.

Within the NIC, the supporting systems have been modified over time to extend their usefulness and improve business workflow efficiency. During 2011, work was completed on upgrading the entire NIC infrastructure to provide easier access to information, a consistent Federal Reserve-enterprise information data repository, a comprehensive metadata repository, and uniform security across the Federal Reserve System. The transition began in May 2010 and effectively was substantially complete by year-end 2011 with only a limited number of applications requiring transition in early 2012. Business changes were implemented to the systems of record for both examination and inspection mandates, and improvements were made to the collection and reporting of key examination and inspection findings to track consistently on a national level across the Federal Reserve System.

The structure and supervisory databases in the NIC were modified to support Dodd-Frank changes and to facilitate the supervision of SLHCs. A significant amount of progress occurred during 2011 to successfully capture and integrate the former OTS data and documents into the NIC database constructs. Data comparisons and validation analyses were performed to determine which SLHCs and non-depository institution subsidiaries of SLHCs were missing or incomplete on NIC. New data elements were added to the repositories. Integration of data related to SLHC organizations will continue in 2012 as regulatory reports are modified to collect structure, financial, and supervisory information directly from these entities.

The NIC also supports the Shared National Credit Modernization project (SNC Mod), a multiyear, interagency, information technology development effort to improve the efficiency and effectiveness of the systems that support the SNC Program. SNC Mod focuses on a complete rewrite of the current legacy systems to take advantage of modern technology to enhance and extend the system's capabilities. During 2011, the SNCnet application was implemented in three phases in support of the 2011 SNC examination process. The creation of this automated tool is an interagency initiative led by the Federal Reserve System. Timely delivery of the SNCnet tool enabled significant process efficiencies for the examination teams and ultimately resulted in the ability to publish the summary of findings approximately six to eight weeks ahead of the previous schedule. During 2012, additional enhancements are expected for both the collection repository and to the exam tool application that will provide further benefits to the examination teams.

During 2011, in support of the Comprehensive Capital Analysis and Review initiative and in planning for the Dodd-Frank Act stress testing program, NIC staff were engaged with the teams responsible for planning the new data collections (FR Y-14). The Supervision Risk program is also undergoing significant changes with substantial increases in the data requirements as well as modeling tools to use with those data. NIC staff are responsible for providing project management for those initiatives to best serve the business sponsors.

Finally, the Federal Reserve participated in a number of technology-related initiatives supporting the supervision function as part of FFIEC task forces and interagency committees. These efforts support standardized data collections and cross-agency information sharing. Work in this area will continue to be important as the agencies work through the implementation of the Dodd-Frank Act.

Staff Development

The Federal Reserve's staff development program is responsible for the ongoing development of nearly 3,109 professional supervisory staff to ensure that they have the skills necessary to meet their evolving supervisory responsibilities. The Federal Reserve also provides course offerings to staff at state banking agencies. Training activities in 2011 are summarized in **table 2**.

Examiner Commissioning Program

The Examiner Commissioning Program (ECP) involves approximately 22 weeks of instruction. Individuals move through a combination of classroom offerings, self-paced assignments, and on-the-job training over a period of two to five years. Achievement is measured by two professionally validated proficiency examinations: the first proficiency exam is required of all ECP participants, and the second proficiency exam is offered in two specialty areas—(1) safety and soundness and (2) consumer compliance. A third specialty, in information technology, requires that individuals earn the Certified Information Systems Auditor certification offered by the Information Systems Audit Control Association. In 2011, 252 examiners passed the first proficiency exam and 69 passed the second proficiency exam (55 in safety and soundness and 14 in consumer compliance).

Continuing Professional Development

Other formal and informal learning opportunities are available to examiners, including other schools and programs offered within the System and FFIEC-sponsored schools. System programs are also available to state and federal banking agency personnel. The Rapid Response® program, introduced in 2008, offers System and state personnel 60–90 minute teleconference presentations on emerging issues or urgent training needs associated with implementation or issuance of new laws, regulations, or guidance.

Regulation

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system, and the structure of the system, through its administration of several federal statutes. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out its responsibilities, the Federal Reserve coordinates supervisory activities with the other federal banking agencies, state agencies, functional regulators (that is, regulators for insurance, securities, and commodities firms), and foreign bank regulatory agencies.

Regulation of the U.S. Banking Structure

The Federal Reserve administers five federal statutes that apply to BHCs, financial holding companies, member banks, and foreign banking organizations—the BHC Act, the Bank Merger Act, the Change in Bank Control Act, the Federal Reserve Act, and the International Banking Act. On July 21, 2011, as a result of the Dodd-Frank Act, the Federal Reserve also became responsible for administering section 10 of the Home Owners' Loan Act that applies to SLHCs. The Federal Reserve is now also responsible for administering the Change in Bank Control Act with respect to SLHCs.

In administering these statutes, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of the U.S. banking system at the local, regional, and national levels; the international operations of domestic banking organizations; or the U.S. banking operations of foreign banks. The

Table 2. Training for banking supervision and regulation, 2011

Course sponsor or type	Number of enrollments		Instructional time (approximate training days)[1]	Number of course offerings
	Federal Reserve personnel	State and federal banking agency personnel		
Federal Reserve System	2,273	495	910	182
FFIEC	394	217	360	90
The Options Institute[2]	4	7	3	1
Rapid Response™	11,406	1,045	10	78

1 Training days are approximate. System courses were calculated using five days as an average, with FFIEC courses calculated using four days as an average.

2 The Options Institute, an educational arm of the Chicago Board Options Exchange, provides a three-day seminar on the use of options in risk management.

proposals concern BHC and SLHC formations and acquisitions, bank mergers, and other transactions involving banks and savings associations or nonbank firms. In 2011, the Federal Reserve acted on 414 proposals representing 1,035 individual applications filed under the six statutes. Many of these proposals involved banking organizations in less than satisfactory financial condition.

Bank Holding Company Act Proposals

Under the BHC Act, a corporation or similar legal entity must obtain the Federal Reserve's approval before forming a BHC through the acquisition of one or more banks in the United States. Once formed, a BHC must receive Federal Reserve approval before acquiring or establishing additional banks. Also, BHCs generally may engage in only those nonbanking activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the BHC Act. Depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.[16]

When reviewing a BHC application or notice that requires prior approval, the Federal Reserve may consider the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. In 2011, the Federal Reserve acted on 307 applications and notices filed by BHCs to acquire a bank or a nonbank firm, or to otherwise expand their activities, including proposals involving private equity firms.

A BHC may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2011, the Federal Reserve acted on seven stock repurchase proposals by a BHC.

The Federal Reserve also reviews elections submitted by BHCs seeking financial holding company status under the authority granted by the Gramm-Leach-Bliley Act. BHCs seeking financial holding company status must file a written declaration with the Federal Reserve. In 2011, 14 domestic financial holding company declarations were approved.

Bank Merger Act Proposals

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the relevant federal banking agency. The Federal Reserve has primary jurisdiction if the institution surviving the merger is a state member bank. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined organizations, the convenience and needs of the community(ies) to be served, and the competitive effects of the proposed merger. The Federal Reserve also must consider the views of the U.S. Department of Justice regarding the competitive aspects of any proposed bank merger involving unaffiliated insured depository institutions. In 2011, the Federal Reserve approved 67 merger applications under the act.

Change in Bank Control Act Proposals

The Change in Bank Control Act requires individuals and certain other parties that seek control of a U.S. bank, BHC, or SLHC to obtain approval from the relevant federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks, BHCs, and SLHCs. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank, BHC, or SLHC being acquired; the future prospects of the institution to be acquired; the effect of the proposed change on competition in any relevant market; the completeness of the information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the Deposit Insurance Fund. A proposed transaction should not jeopardize the stability of the institution or the interests of depositors. During its review of a proposed transaction, the Federal Reserve may con-

[16] Since 1996, the act has provided an expedited prior notice procedure for certain permissible nonbank activities and for acquisitions of small banks and nonbank entities. Since that time, the act has also permitted well-run BHCs that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

tact other regulatory or law enforcement agencies for information about relevant individuals. In 2011, the Federal Reserve approved 115 change in control notices related to state member banks, BHCs, and SLHCs, including proposals involving private equity firms.

Federal Reserve Act Proposals

Under the Federal Reserve Act, a bank must seek Federal Reserve approval to become a member bank. A member bank may be required to seek Federal Reserve approval before expanding its operations domestically or internationally. State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals for membership, the Federal Reserve considers, among other things, the bank's financial condition and its record of compliance with banking laws and regulations. When reviewing proposals to establish domestic branches, the Federal Reserve considers, among other things, the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2011, the Federal Reserve acted on membership proposals for 44 banks, and new and merger-related branch proposals for 427 domestic branches and eight foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities-related and insurance agency-related activities. In 2011, no financial subsidiary applications were submitted.

Overseas Investment Proposals by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Federal Reserve, large and other significant investments require prior approval. In 2011, the Federal Reserve approved 20 applications and notices for overseas investments by U.S. banking organizations, many of which represented investments through an Edge Act or agreement corporation.

International Banking Act Proposals

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires foreign banks to obtain Federal Reserve approval before establishing branches, agencies, commercial lending company subsidiaries, or representative offices in the United States.

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. It also considers whether the home-country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home-country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Federal Reserve, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law. In 2011, the Federal Reserve approved seven applications by foreign banks to establish branches, agencies, or representative offices in the United States.

Home Owners' Loan Act Proposals

Under the Home Owners' Loan Act, a corporation or similar legal entity must obtain the Federal Reserve's approval before forming an SLHC through the acquisition of one or more savings associations in the United States. Once formed, an SLHC must receive Federal Reserve approval before acquiring or establishing additional savings associations. Also, SLHCs generally may engage in only those nonbanking activities that are specifically enumerated in the Home Owners' Loan Act or which the Board has previously determined to be closely related to banking under section 4(c)(8) of the BHC Act. Depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement. In 2011, the Federal Reserve acted on five applications and notices filed by SLHCs to acquire a bank or a nonbank firm, or to otherwise expand their activities.

Under the Home Owners' Loan Act, a savings association reorganizing to a mutual holding company (MHC) structure must receive Federal Reserve approval prior to its reorganization. In addition, an MHC must receive Federal Reserve approval before converting to stock form, and MHCs must receive Federal Reserve approval before waiving dividends declared by the MHC's subsidiary. In 2011, the Federal Reserve received no applications for MHC reorganizations. In 2011, the Federal Reserve acted on no applications filed by MHCs to convert to stock form and 14 applications to waive dividends.

When reviewing an SLHC application or notice that requires prior approval, the Federal Reserve may consider the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law.

The Federal Reserve also reviews elections submitted by SLHCs seeking treatment as financial holding companies under the authority granted by the Dodd-Frank Act. SLHCs seeking financial holding company treatment must file a written declaration with the Federal Reserve. In 2011, no SLHC financial holding company declarations were approved.

Public Notice of Federal Reserve Decisions

Certain decisions by the Federal Reserve that involve an acquisition by a BHC, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank are made known to the public by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release. The H.2 release also contains announcements of applications and notices received by the Federal Reserve upon which action has not yet been taken. For each pending application and notice, the related H.2A release gives the deadline for comments. The Board's website (www.federalreserve.gov) provides information on orders and announcements as well as a guide for U.S. and foreign banking organizations that wish to submit applications.

Enforcement of Other Laws and Regulations

The Federal Reserve's enforcement responsibilities also extend to the disclosure of financial information by state member banks and the use of credit to purchase and carry securities.

Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the SEC. At the end of 2011, 12 state member banks were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchasing or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to purchase debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Several regulatory agencies enforce the Board's securities credit regulations. The SEC, the Financial Industry Regulatory Authority, and the Chicago Board Options Exchange examine brokers and dealers for compliance with Regulation T. With respect to compliance with Regulation U, the federal banking agencies examine banks under their respective jurisdictions; the Farm Credit Administration and the NCUA examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Consumer and Community Affairs

The Division of Consumer and Community Affairs (DCCA) has primary responsibility for carrying out the Board's consumer protection, supervision, and community development programs. DCCA augments its expertise in consumer protection law, regulation, and policy with resources from other functions of the Board and the Federal Reserve System to write and interpret regulations, educate and inform consumers, and enforce laws and regulations for consumer financial products and services.

Throughout 2011, the division engaged in significant activities to further consumer protection and community development, while also supporting the transfer of certain rules and supervisory responsibilities to the recently formed Consumer Financial Protection Bureau (CFPB). Key elements of the division's program, include

- drafting and proposing regulations to implement legislation, updating regulations, designing disclosures to provide consumers consistent and vital information on financial products, and prohibiting unfair and deceptive acts and practices
- supervising state member banks and bank holding companies and their nonbank affiliates to enforce consumer protection laws and regulations
- processing consumer complaints and inquiries to help consumers resolve grievances with their financial institutions and to answer their questions
- conducting research on consumer decisionmaking regarding financial services to better understand consumers' choices
- researching the implications of policy on consumer financial markets
- reaching out to national and local government agencies, consumer and community groups, academia, and industry to gain a broad range of perspectives, and to inform policy decisions and highlight effective practices
- supporting national and local agencies and organizations that work to protect and promote community development and economic empowerment for historically underserved communities

On July 21, 2011, much of the Board's rulewriting and some of its supervisory authority regarding consumer protection transferred to the CFPB, which was established under the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act (the Dodd-Frank Act) to conduct rulemaking, supervise large insured depository institutions and credit unions (and their affiliates) for compliance with federal consumer financial laws, and to enforce those laws.[1]

The Board retains supervisory authority for state member banks with assets of $10 billion or less, as well as responsibility for examinations of all state member banks, regardless of asset size, for compliance with the Community Reinvestment Act, Fair Housing Act, Servicemembers' Civil Relief Act, and other laws. In addition, DCCA continues to promote community development and neighborhood revitalization, advise the Board on the implications of economic and supervisory policies on consumer protection, and conduct research on consumer financial behaviors and policies.

Rulemaking and Regulations

Mortgage Transactions

In 2011, the Federal Reserve issued proposed and final rules to implement various aspects of the Dodd-

[1] For additional information, see the Consumer Financial Protection Bureau's website at www.consumerfinance.gov and "Supervisory Statement: Determination of Depository Institution and Credit Union Asset Size for Purposes of Section 1025 and 1026 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" at www.federalreserve.gov/newsevents/press/bcreg/bcreg20111117a1.pdf.

Frank Act as it relates to certain home mortgages. Many of the proposed rulemakings transferred to the CFPB to be finalized.

Escrow Accounts

In late February, the Federal Reserve issued a final rule under Regulation Z (Truth in Lending) pursuant to the Dodd-Frank Act that increases the annual percentage rate (APR) threshold used to determine whether a mortgage lender is required to establish an escrow account for property taxes and insurance for first-lien, "jumbo" mortgage loans. Loans subject to this rule are defined as loans exceeding the conforming loan-size limit for purchase by the Federal Home Loan Mortgage Corporation (Freddie Mac), as specified by the legislation. Under this rule, the escrow requirement applies to first-lien jumbo loans only if the loan's APR is higher than the average prime offer rate by 2.5 percentage points or more.

A second rule was proposed under the Dodd-Frank Act that would expand the minimum period for mandatory escrow accounts for first-lien, higher-priced mortgage loans from one year to five years. Under certain circumstances, such as when the loan is delinquent or in default, the minimum period for mandatory escrow could be even longer. The proposed rule would provide an exemption from the escrow requirement for certain creditors that operate in "rural or underserved" counties, as authorized by the legislation. The proposal would also implement the Dodd-Frank Act requirement that consumers receive disclosures at least three business days before consummation of a mortgage loan to explain, as applicable, how the escrow account works or the effects of not having an escrow account if one is not being established. Under the Dodd-Frank Act, consumers must also receive disclosures three days before an escrow account is closed.

One concern that emerged from the mortgage crisis was that some subprime loans did not require an escrow account for taxes and insurance and, as a result, borrowers experienced payment shock when they were required to pay these costs outside of their monthly mortgage payment.

The aim of the final and proposed rules is to ensure more mortgage borrowers are aware of how taxes and insurance associated with a mortgage loan affect the overall costs of the transaction.[2]

Ability to Repay

In April, the Federal Reserve Board issued a proposed rule that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards.[3]

The proposed rule applied to all consumer mortgages, except home equity lines of credit, timeshare plans, reverse mortgages, or temporary loans.

The proposal provided four options for a creditor in complying with the ability-to-repay requirement:

1. Consider and verify specified underwriting factors, such as the consumer's income or assets.
2. Make a "qualified mortgage," which provides the creditor with special protection from liability if the loan does not have certain features, such as negative amortization; the fees are within specified limits; and the creditor underwrites the mortgage payment using the maximum interest rate in the first five years.[4]
3. For lenders operating predominantly in rural or underserved areas, make a balloon-payment qualified mortgage. This option was meant to preserve access to credit for consumers located in rural or underserved areas where banks originate balloon loans to hedge against interest rate risk for loans held in portfolio.
4. Refinance a "non-standard mortgage" with risky features into a more stable "standard mortgage" with a lower monthly payment. This option was meant to preserve access to streamlined refinancings.

Provisions of the proposal were designed to also implement Dodd-Frank Act limits on prepayment penalties. The proposed revisions to the regulation, which implement the Truth in Lending Act (TILA), were made pursuant to the Dodd-Frank Act, which also transferred general rulemaking authority for

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2 For more information about the Federal Reserve's final and proposed regulations relating to escrow accounts, go to www.federalreserve.gov/newsevents/press/bcreg/20110223b.htm.

3 For more information about the Federal Reserve's ability-to-repay proposal, go to www.federalreserve.gov/newsevents/press/bcreg/20110419a.htm.

4 The Board is soliciting comment on two alternative approaches for defining a "qualified mortgage."

TILA to the CFPB. Thus, the proposed rules were transferred to the CFPB to be finalized.

Credit Cards and Open-End Credit Plans

In March, the Board amended Regulation Z to clarify aspects of rules previously issued by the Board implementing the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the Credit Card Act).[5] The amendments enhance protections for consumers who use credit cards and resolve areas of uncertainty so that card issuers fully understand their compliance obligations.

In order to protect consumers from incurring unaffordable levels of credit card debt, the Credit Card Act requires that, before opening a new credit card account or increasing the credit limit on an existing account, card issuers consider a consumer's ability to make the required payments on the account. As directed by the Credit Card Act, the Board's rule addresses practices that can result in extensions of credit to consumers who lack the ability to pay. Specifically, the rule states that credit card applications generally cannot request a consumer's "household income" because that term is too vague to allow issu-

[5] For more information about the Federal Reserve's rule to protect consumers from incurring unaffordable levels of credit card debt, go to www.federalreserve.gov/newsevents/press/bcreg/20110318b.htm.

Box 1. The Impact of the Dodd-Frank Act on DCCA

Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) had unique implications for the Board's Division of Consumer and Community Affairs (DCCA). The statute created the Consumer Financial Protection Bureau (CFPB), and transferred to the CFPB much of the Board's rulewriting authority regarding consumer financial services and fair lending laws as of July 21, 2011.

However, the Board retains rulewriting authority for the Community Reinvestment Act (CRA) and for certain entities under specific statutory provisions. For example, under the Equal Credit Opportunity Act, the Board must issue rules for data collection by motor vehicle dealers on their lending to women- and minority-owned businesses and small businesses. The Board will also issue interagency rules to implement provisions of the Truth in Lending Act concerning real estate appraisals.

The Board also retains supervisory and examination oversight authority for more than 800 state member banks with assets of $10 billion or less for their compliance with consumer protection laws and regulations. As a result, DCCA will continue to develop and implement examination policy and programs for these institutions. The Board also continues to oversee all state member banks, regardless of size, for their compliance with the CRA, the Fair Housing Act, the Federal Trade Commission Act, the Servicemembers' Civil Relief Act, and other laws. DCCA staff will continue to conduct consolidated supervisory activities for bank holding companies, assessing consumer compliance risk at the enterprise-wide level and incorporating these analyses into the institution's overall supervisory standing. With these ongoing supervisory responsibilities, DCCA oversees the system's consumer compliance supervision programs, implements examiner training and commissioning programs, and reviews and analyzes banking applications.

The Dodd-Frank Act mandates new coordination and cooperation among federal banking agencies with respect to the CFPB. The CFPB is required to coordinate supervisory activities and conduct simultaneous examinations with prudential regulators, as well as share draft reports, and to consult the federal banking agencies in exercising its rulemaking functions. DCCA staff serves as the CFPB's primary point of contact for these coordinating activities, and consults with other Board divisions to provide comments to the CFPB as necessary. Board and Reserve Bank staff monitor CFPB regulatory actions and assess potential implications for consumers, financial institutions, and the relevant markets to help support the Chairman in his position on the Financial Stability Oversight Council.

In addition to these supervisory responsibilities, DCCA has expanded its work in community development, policy analysis, and consumer research. Because understanding consumer financial services issues and meeting the financial needs of underserved markets remain top priorities for the Board, staff analyze issues and monitor new developments. This process includes outreach to a broad range of leaders from industry, government, academic, think tank, and community organizations. Such outreach and research informs DCCA's work on issues such as housing, small business, neighborhood stabilization, underserved markets, and community economic development. With these roles, DCCA will continue to bring forth consumer protection and community development perspectives within broader federal efforts to support the American economy.

ers to properly evaluate the consumer's ability to pay. Instead, issuers must consider the consumer's individual income or salary.

In addition, the Board's rule clarifies that promotional programs that waive interest charges for a specified period of time are subject to the same Credit Card Act protections as promotional programs that apply a reduced rate for a specified period. For example, a card issuer that offers to waive interest charges for six months is prohibited from revoking the waiver and charging interest during the six-month period, unless the account becomes more than 60 days delinquent. Under the Board's final rule, application and similar fees that a consumer is required to pay before a credit card account is opened would be covered by the same Credit Card Act limitations as fees charged during the first year after the account is opened.

A lawsuit challenging the provisions of the final rule was filed in July 2011 and was still pending at year-end.

College Credit Card Agreements

In July, the Board released a report containing payment and account information for more than 1,000 agreements between credit card issuers and institutions of higher education or affiliated organizations in 2010.[6] The Board also updated its online database to include the full text of each agreement that was in effect during 2010 and the payment and accounts information submitted by issuers.[7] Users may also search for agreements by card issuer, educational institution or organization, or the city or state in which the institution or organization is located.

The report was issued pursuant to the Credit Card Act, which required issuers to submit to the Board annually their agreements with educational institutions or affiliated organizations, such as alumni associations. For each agreement, issuers are also required to submit information regarding payments made to the institution or organization and the number of accounts opened under the agreement.

Credit Score Disclosure

In conjunction with the Federal Trade Commission (FTC), the Board issued final rules in July to implement requirements of the Dodd-Frank Act stipulating that if a credit score is used in setting material terms of credit or in taking adverse action, creditors must disclose credit scores and related information to consumers in notices under the Fair Credit Reporting Act (FCRA).[8]

The final rules amended Regulation V (Fair Credit Reporting) to revise the content requirements for risk-based pricing notices, and to add related model forms that reflect the new credit score disclosure requirements. The final rules also amended certain model notices in Regulation B (Equal Credit Opportunity), which combine the adverse action notice requirements for Regulation B and the FCRA, to reflect the new credit score disclosure requirements.

Consumer Protection for Credit and Leases

In March, the Board adopted two rules to expand the coverage of consumer protection regulations to credit transactions and leases of higher dollar amounts.[9] These rules amend Regulation Z (TILA) and Regulation M (Consumer Leasing) to implement a provision of the Dodd-Frank Act, which requires that the protections of TILA and the Consumer Leasing Act (CLA) apply to consumer credit transactions and consumer leases up to $50,000. Previously, the law required these protections for transactions and leases up to $25,000. (Private education loans and loans secured by real property (such as mortgages) are subject to TILA regardless of the amount of the loan.) The Dodd-Frank Act requires that this amount be adjusted annually to reflect any increase in the consumer price index; the Board published the first annual adjustment in June.

Remittances

In May, the Board proposed a rule to create new protections for consumers who send remittance transfers

6 The report, *Federal Reserve Board of Governors Report to the Congress on College Credit Card Agreements, July 2011*, is available at www.federalreserve.gov/boarddocs/rptcongress/creditcard/2011/downloads/ccap_2011.pdf.

7 The online database can be accessed at www.federalreserve.gov/CollegeCreditCardAgreements.

8 For more information on the credit score disclosure requirements, go to www.federalreserve.gov/newsevents/press/bcreg/20110706a.htm.

9 For more information about the new rules regarding high-dollar amount credit transactions and leases, go to www.federalreserve.gov/newsevents/press/bcreg/20110325a.htm.

to recipients located in a foreign country.[10] The proposal was made under Regulation E (Electronic Fund Transfers) pursuant to the Dodd-Frank Act.

The proposed rule required remittance transfer providers to make certain disclosures to senders of remittance transfers, including information about fees and the exchange rate, as applicable, and the amount of currency to be received by the recipient. In addition, the proposed rule provided error resolution and cancellation rights for senders of remittance transfers. The authority for issuing final rules was transferred to the CFPB in July 2011.

Data Collection by Motor Vehicle Dealers

In September, the Board issued a final rule amending Regulation B to provide that motor vehicle dealers are not required to comply with the new data collection requirements in the Dodd-Frank Act until the Board issues final regulations to implement the statutory requirements.[11]

The Dodd-Frank Act amended the Equal Credit Opportunity Act to require creditors to collect information about credit applications made by women- or minority-owned businesses and small businesses. The CFPB must implement this provision for all creditors except certain motor vehicle dealers who are subject to the Board's jurisdiction. The CFPB previously announced that creditors are not obligated to comply with the data collection requirements until the CFPB issues detailed rules to implement the law. The Board amended Regulation B to apply the same approach to motor vehicle dealers.

Oversight and Enforcement

The Board's Division of Consumer and Community Affairs develops and supports supervisory policy and examination procedures for consumer protection laws and regulations, as well as the Community Reinvestment Act (CRA), as part of its supervision of state-chartered, depository institutions, and foreign banking organizations that are members of the Federal Reserve System. The division also administers the Federal Reserve System's risk-focused program for assessing consumer compliance risk at the largest bank and financial holding companies in the system. Division staff ensure consumer compliance risk is effectively integrated into the consolidated supervision of the holding company. The division also oversees the efforts of the 12 Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Division staff provide guidance and expertise to the Reserve Banks on consumer protection regulations, bank and bank holding company application analysis and processing, examination and enforcement techniques and policy matters, examiner training, and emerging issues. Staff also review Reserve Bank supervisory reports, examination work products, and consumer complaint analyses and responses. Finally, staff members participate in interagency activities that promote uniformity in examination principles, standards, and processes.

In addition, throughout 2011, the system continued its policy for conducting risk-focused consumer compliance supervision of, and the investigation of consumer complaints against, nonbank subsidiaries of bank holding companies (BHCs) and foreign banking organizations (FBOs) with activities covered by the consumer protection laws and regulations the Federal Reserve has the authority to enforce. This policy is designed to enhance understanding of the consumer compliance risk profile of nonbank subsidiaries and to guide supervisory activities for these entities. Initial supervisory activities first targeted those nonbank subsidiaries considered to be of highest risk to the Federal Reserve System.[12]

Examinations are the Federal Reserve's primary method of enforcing compliance with consumer protection laws and assessing the adequacy of consumer compliance risk-management systems within regulated entities. During the 2011 reporting period (July 1, 2010, through June 30, 2011), the Reserve Banks conducted 279 consumer compliance examinations of the system's 835 state member banks and two examinations of foreign banking organizations.[13]

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[10] For more information about the Federal Reserve's proposal regarding protections for consumers who send remittance transfers to recipients in foreign countries, go to www.federalreserve.gov/newsevents/press/bcreg/20110512a.htm.

[11] For more information about the Federal Reserve's rule regarding data collection by motor vehicle dealers, go to www.federalreserve.gov/newsevents/press/bcreg/20110920a.htm.

[12] Federal Reserve Board of Governors, 2009 Consumer Affairs Letters, Consumer Compliance Supervision Policy for Nonbank Subsidiaries of Bank Holding Companies and Foreign Banking Organizations, CA-09-8, September 14, 2009, www.federalreserve.gov/boarddocs/caletters/2009/0908/caltr0908.htm.

[13] The foreign banking organizations examined by the Federal Reserve are organizations that operate under section 25 or 25A of the Federal Reserve Act (Edge Act and agreement corporations) and state-chartered commercial lending companies owned or controlled by foreign banks. These institutions are not subject to the Community Reinvestment Act and typically engage in

Bank Holding Company Consolidated Supervision Program

During 2011, staff in the BHC Consolidated Supervision Program had responsibility for reviewing more than 90 bank and financial holding companies to ensure consumer compliance risk was appropriately incorporated into the consolidated risk assessment for the organization. Through a combination of risk-focused, on-/off-site examination and monitoring activities, supervisory staff were able to assess the impact enterprise-wide consumer issues had on the overall risk profiles of the consolidated entity. In addition, per changes brought about by the Dodd-Frank Act, supervisory functions related to savings and loan holding companies (SLHCs) were transferred to the Board, and SLHCs were added to the portfolio of entities covered by the Consolidated Supervision Program.

BHC Consolidated Supervision Program staff also participated jointly with staff of the Board's Division of Banking Supervision and Regulation on numerous Dodd-Frank Act related implementation projects regarding supervisory assessment fees, consolidated supervision, and thrift holding company integration. Also, as part of the consolidated supervision of BHCs, staff participated in the reviews of mortgage servicing and foreclosure processing at four of the 14 federally regulated mortgage servicers that took place between November 2010 and January 2011, and that resulted in enforcement actions in April 2011. Program staff monitor compliance with the provisions in the consent orders for the servicers and BHCs to ensure that noted deficiencies are corrected, future abuses in the loan modification and foreclosure process are prevented, and borrowers are compensated for financial injury they suffered as a result of errors, misrepresentations, or other deficiencies in the foreclosure process (see **box 2**).

relatively few activities covered by consumer protection laws. There are 197 such institutions throughout the Federal Reserve System.

Throughout 2011, the Federal Reserve System continued to conduct risk-focused consumer compliance supervision of nonbank subsidiaries of BHCs and FBOs with regard to activities covered by consumer protection laws and regulations the Federal Reserve has the authority to enforce, and to investigate certain consumer complaints against nonbank subsidiaries of BHCs and FBOs. This policy was designed to enhance the system's understanding of the consumer compliance risk profile of nonbank subsidiaries and to guide supervisory activities for these entities. Initial supervisory activities first targeted those nonbank subsidiaries considered to be of highest risk to the Federal Reserve System.

Supervisory Matters

In July 2011, the Board issued a consent cease and desist order against Wells Fargo & Company and its subsidiary, Wells Fargo Financial, Inc., for lack of sufficient controls in the refinancing of existing home mortgages.[14] The order assessed a $85 million civil money penalty, the largest penalty in a consumer-protection action, and is the first enforcement action taken by a federal banking regulator addressing alleged steering of borrowers to higher-cost loans. The order alleges that Wells Fargo Financial steered borrowers who potentially were eligible for prime rate loans to subprime loans. Additionally, the order addresses allegations that Wells Fargo Financial employees falsified borrowers' income in an effort to qualify the borrowers for loans they otherwise would have not qualified for based on their actual income.

The deficiencies noted in the order allege unsafe and unsound banking practices and unfair or deceptive acts and practices. The order requires Wells Fargo Financial to compensate borrowers affected by the practices between January 2006 and June 2008, and to develop specific plans to identify and compensate the affected borrowers. The Board is required to approve the compensation plans and will monitor ongoing compliance with the approved plans.

[14] See Press Release (July 20, 2011), available at www.federalreserve.gov/newsevents/press/enforcement/20110720a.htm.

Community Reinvestment Act Compliance

The CRA requires that the Federal Reserve and other federal banking and thrift agencies encourage financial institutions to help meet the credit needs of the local communities in which they do business, consistent with safe and sound operations. To carry out this mandate, the Federal Reserve

- examines state member banks to assess their compliance with the CRA
- analyzes applications for mergers and acquisitions by state member banks and bank holding companies in part within the context of CRA performance
- disseminates information about community development techniques to bankers and the public through Community Development offices at the Reserve Banks

The Federal Reserve assesses and rates the CRA performance of state member banks in the course of examinations conducted by staff at the 12 Reserve Banks. During the 2011 reporting period, the Reserve Banks conducted 250 CRA examinations of state member banks. Of those banks examined, 28 were rated "Outstanding," 215 were rated "Satisfactory," seven were rated "Needs to Improve," and none were rated "Substantial Non-Compliance."

During the summer of 2010, the Federal Reserve and the other federal banking and thrift regulatory agencies held public hearings in four cities (Arlington, Virginia; Atlanta, Georgia; Chicago, Illinois; and Los Angeles, California), and invited public comment on ways that the regulations implementing the CRA could be revised to better reflect current banking practices. In addition to public hearings, the agencies invited written comments, and the Federal Reserve received nearly 1,200 comment letters.[15] Input from the hearings and the comment letters continue to be considered as part of the process for updating CRA regulations that has been underway throughout 2011. The agencies are also considering updates to the regulations and examination policies to reflect changes in the financial services industry, including how banking services are delivered to consumers, to ensure that the CRA continues to be effective in encouraging institutions to meet community credit needs.[16]

Mergers and Acquisitions in Relation to the CRA

During 2011, the Board considered and approved 10 banking merger applications that were protested on CRA or fair lending grounds or that raised issues involving consumer compliance or the CRA.[17]

- An application by The Goldman Sachs Group, Inc., New York, New York, to retain 9.8 percent of the outstanding common stock of Avenue Financial Holdings, Inc., of Nashville, Tennessee, was approved in March.[18]
- An application by First Niagara Financial Group, Inc. and FNFG Merger Sub, Inc., both of Buffalo, New York, to acquire NewAlliance Bancshares, Inc., New Haven, Connecticut, was approved in March.
- An application by M&T Bank Corporation, Buffalo, New York, to acquire Wilmington Trust Corporation, Wilmington, Delaware, was approved in April.
- An application by Hancock Holding Company, Gulfport, Mississippi, to acquire Whitney Holding Corporation, New Orleans, Louisiana, was approved in May.
- An application by Bank of Montreal, Toronto, Canada, to acquire Marshall & Ilsley Corporation, Milwaukee, Wisconsin, was approved in June.
- An application by Comerica, Incorporated, Dallas, Texas, to acquire Sterling Bancshares, Houston, Texas, was approved in July.
- An application by Centennial Bank, Conway, Arkansas, to establish a mobile branch to serve Bay, Calhoun, Franklin, Gulf, Lake, Leon, Liberty, Orange, and Seminole Counties in Florida was approved under delegated authority in July.

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[15] For additional information on CRA rules, see www.federalreserve.gov/newsevents/press/bcreg/20101215a.htm.

[16] For additional information on the role of the Community Reinvestment Act, see www.federalreserve.gov/newsevents/speech/yellen20110609a.htm.

[17] Another protested application was withdrawn by the applicant. For more information on Orders on Banking Applications in 2011, go to www.federalreserve.gov/newsevents/press/orders/2011orders.htm.

[18] Two other applications by The Goldman Sachs Group, Inc., were approved under delegated authority. These were applications to retain 9.0 percent of the outstanding common stock of Atlantic Capital Bancshares, Inc., Atlanta, Georgia, and to retain its interest in The First Marblehead Corporation, Boston, Massachusetts.

Box 2. The Foreclosure Crisis: Federal Reserve Enforcement Action

The financial crisis and meltdown of the mortgage market that began in 2008 marked the beginning of a sharp rise in foreclosures that has not been seen since the Great Depression. By the fourth quarter of 2010, 2.4 million mortgage loans were at some point in the foreclosure process and another two million loans were 90 or more days past due and at risk of foreclosure.

In the midst of this wave of foreclosures, concerns surfaced about improper foreclosure processing practices by some mortgage servicers; alleged improper practices ranged from faulty paperwork processes to wrongful foreclosure. To gain insight into these matters, the Federal Reserve System, along with the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation, conducted on-site reviews of 14 federally regulated mortgage servicers that collectively represent more than two-thirds of the servicing industry, or nearly 36.7 million mortgages.[1] This process began in November 2010 and was concluded in January 2011.

The review found critical weaknesses in the firms' foreclosure governance processes, foreclosure documentation processes, staffing and training, and oversight and monitoring of third-party law firms and other vendors, as well as undue emphasis on quantitative production and timeliness. These weaknesses involved unsafe and unsound practices, violations of federal and state laws, and a pattern of misconduct and negligence by the mortgage servicers.

In April 2011, the Board issued formal enforcement actions against ten banking organizations under its jurisdiction, requiring them to promptly initiate steps to establish servicing and foreclosure processes that treat customers fairly, are fully compliant with all applicable law, and are safe and sound.[2] The banking organizations that have servicing entities regulated by the Board were also assessed monetary sanctions totaling about $767 million.[3] Consent orders required these mortgage servicers to hire independent consultants to develop action plans for remedying borrowers who had been harmed by the firms' deficient practices.[4] Mortgage servicers were also required to conduct broad outreach to alert consumers of the opportunity to apply for consideration for remedy. To assist in this effort, the Board launched a consumer education campaign on its website and conducted webinar trainings to educate housing counselors on the process.[5]

These enforcement actions are just one element of the Federal Reserve's ongoing efforts to assist consumers and communities dealing with the aftermath of the mortgage and foreclosure crisis. The mortgage servicing remediation process continues through 2012, and the Board will continue to work to ensure that a fair and impartial process for redress is available to borrowers who were harmed by servicer errors, misrepresentations, or other foreclosure deficiencies.

1 See *Interagency Review of Foreclosure Policies and Practices* at www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

2 See Press Release (April 13, 2011), available at www.federalreserve.gov/newsevents/press/enforcement/20110413a.htm.

3 See Press Release (February 9, 2012), available at www.federalreserve.gov/newsevents/press/enforcement/20120209a.htm.

4 See Press Release (February 27, 2012), available at www.federalreserve.gov/newsevents/press/enforcement/20120227a.htm.

5 See *What You Need to Know: Independent Foreclosure Review* (www.federalreserve.gov/consumerinfo/independent-foreclosure-review.htm) and "Independent Foreclosure Review process webinar training for housing counselors" (www.federalreserve.gov/consumerinfo/housing-counselors-webinar.htm).

- An application by Green Dot Corporation, Monrovia, California, to acquire Bonneville Bancorp, Provo, Utah, was approved in November.
- An application by Brookline Bancorp, Inc., Brookline, Massachusetts, to acquire Bancorp Rhode Island, Inc., Providence, Rhode Island, was approved in December.
- An application by Banco de Brasil, S.A., Brasilia and Caixa de Previdencia dos Funcionarios do Banco do Brasil, Rio de Janeiro, Brazil, to acquire EuroBank, Coral Gables, Florida, was approved in December.

Members of the public had the opportunity to submit comments on these applications; their comments raised various issues. Several commenters cited failure to make credit available to certain minority groups and to low- and moderate-income individuals and in low- and moderate-income geographies. Commenters also cited predatory and discriminatory lending practices with respect to residential mortgages and small business loans as well as failure to provide reverse mortgage candidates with counseling in violation of state law. Other commenters alleged predatory servicing and unethical business practices. Several comments warned of inadequate plans to meet communities' credit needs and a reduction in access to credit for affected communities. Additionally, commenters expressed general concerns about CRA, including concerns that branches in predominantly minority census tracts were not proportionate to the percentage of the population residing in those tracts.

In approving the application by Green Dot Corporation to become a bank holding company, by converting Bonneville Bank from a retail bank to a "monoline" prepaid debit card bank, the Board considered the inherent risks of a bank with one primary product, the safeguards established to reduce those risks, and ways in which the bank would meet its CRA obligations.

In addition, an application by Capital One Financial Corporation, McLean, Virginia, to acquire ING, FSB, Wilmington, Delaware (ING), was filed in July, and more than 900 comments were submitted by individuals and community groups, almost two-thirds of which opposed the merger. The proposal was one of the first of its kind to be subject to the financial stability factor mandated by the Dodd-Frank Act. The Board held three public meetings regarding this proposal: in Washington, D.C., on September 20, 2011; in Chicago, Illinois, on September 27, 2011; and in San Francisco, California, on October 5, 2011. The Board also extended the comment period from August 22, 2011, to October 12, 2011, to allow members of the public additional time to submit comments on the proposal. Commenters expressed concerns about Capital One's undue concentration in credit cards and inadequate affordable mortgage and small business lending given its nationwide credit card lending and deposit-taking activities. Commenters urged the Board to delay or deny the proposal until the CRA regulation has been reformed to accommodate such nationwide lenders as well as internet banks, such as ING. Commenters contended that any public benefits would be inadequate to offset the increase in risk posed to the financial system given projected increases in Capital One's size and complexity. The proposal ultimately was approved in February 2012.[19]

The Board also considered 89 applications with outstanding issues involving compliance with consumer protection statutes and regulations, including fair lending laws and the CRA. Some of those issues involved unfair and deceptive practices as well as concerns about stored value cards. Eighty-one of those applications were approved and eight were withdrawn.

Fair Lending Enforcement

The Federal Reserve is committed to ensuring that the institutions it supervises comply fully with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. The ECOA prohibits creditors from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in good faith, any right under the Consumer Credit Protection Act. The Fair Housing Act prohibits discrimination in residential real estate-related transactions, including the making and purchasing of mortgage loans, on the basis of race, color, religion, sex, handicap, familial status, or national origin.

Supervisory Matters

The Federal Reserve supervises approximately 825 state member banks. Pursuant to provisions of the Dodd-Frank Act, effective on July 21, 2011, the CFPB supervises state member banks with assets of more than $10 billion for compliance with the ECOA, while the Board retains supervisory authority for compliance with the Fair Housing Act. For the approximately 800 state member banks with assets of $10 billion or less, the Board retains the authority to enforce both the ECOA and the Fair Housing Act.

Fair lending reviews are conducted regularly within the supervisory cycle. Additionally, examiners may conduct fair lending reviews outside of the usual supervisory cycle, if warranted by fair lending risk. When examiners find evidence of potential discrimination, they work closely with the division's Fair Lending Enforcement Section, which brings additional legal and statistical expertise to the examination and ensures that fair lending laws are enforced consistently and rigorously throughout the Federal Reserve System.

Pursuant to the ECOA, if the Board has reason to believe that a creditor has engaged in a pattern or practice of discrimination in violation of the ECOA, the matter will be referred to the U.S. Department of Justice (DOJ). The DOJ reviews the referral and

[19] See Press Release (February 14, 2012), available at www.federalreserve.gov/newsevents/press/orders/20120214a.htm.

determines whether further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. Alternatively, the DOJ may decide to return the matter to the Board for administrative enforcement. When a matter is returned to the Board, staff ensures that the institution takes all appropriate corrective action.

During 2011, the Board referred the following five matters to the DOJ:

- One referral involved discrimination on the basis of national origin, in violation of the ECOA and the Fair Housing Act. The lender charged borrowers fees that were identified as discount points, but that did not actually result in a proportional decrease in the interest rate (unearned discount points). The practice violated Section 5 of the Federal Trade Commission Act, and had a disparate impact on Hispanic borrowers.
- One referral involved discrimination on the basis of sex, in violation of the ECOA and the Fair Housing Act, and on the basis of familial status, in violation of the Fair Housing Act. The lender failed to consider a woman's employment status and reasonably expected income while she was on unpaid maternity leave under the Family and Medical Leave Act.
- One referral involved discrimination on the basis of marital status and age, in violation of the ECOA. The lender treated unmarried joint applicants differently than married joint applicants and applicants 21 years old or younger differently than older applicants in underwriting for consumer credit.
- One referral involved discrimination on the basis of sex and marital status in credit reporting, in violation of the ECOA. The lender failed to provide information to consumer reporting agencies about the payment history of spouses (almost all of whom were women) that were contractually obligated on the note.
- One referral involved discrimination on the basis of marital status, in violation of the ECOA. The bank improperly required spousal guarantees and signatures on commercial or agricultural loans, in violation of Regulation B.

If a fair lending violation does not constitute a pattern or practice, the Federal Reserve acts on its own to ensure that the violation is remedied by the bank. Most lenders readily agree to correct fair lending violations. In fact, lenders often take corrective action as soon as they become aware of a problem. Thus, the Federal Reserve generally uses informal supervisory tools (such as memoranda of understanding between the bank's board of directors and the Reserve Bank, or board resolutions) to ensure that violations are corrected. If necessary to protect consumers, however, the Board can bring public enforcement actions.

Financial Fraud Enforcement Task Force and Other Outreach

As an active member of the Financial Fraud Enforcement Task Force (FFETF), the Board coordinates with other agencies to facilitate consistent and effective enforcement of the fair lending laws. The Director of the Board's Division of Consumer and Community Affairs co-chairs the FFETF's Non-Discrimination Working Group with the Assistant Attorney General for DOJ's Civil Rights Division, the Deputy General Counsel of the U.S. Department of Housing and Urban Development, the Assistant Director of the CFPB's Office of Fair Lending and Equal Opportunity, and the National Association of Attorneys General, represented by the Attorney General for the State of Illinois. The working group monitors new practices and trends to proactively address fair lending issues. The Board has taken a lead role in the working group's effort to analyze data on Treasury's Home Affordable Modification Program for any evidence of potential discrimination by participating servicers. The Board and the Non-Discrimination Working Group have also sponsored outreach events for local housing organizations, community groups, and financial institutions. These events have included listening sessions as well as a free interagency webinar that had over 6,000 registrants, most of which were community banks.

In addition, the Federal Reserve participates in numerous meetings, conferences, and trainings sponsored by consumer advocates, industry representatives, and interagency groups. Fair Lending Enforcement staff meets regularly with consumer advocates, supervised institutions, and industry representatives to discuss fair lending matters and receive feedback. Through this outreach, the Board is able to address emerging fair lending issues and promote sound fair lending compliance.

Flood Insurance

The National Flood Insurance Act imposes certain requirements on loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood hazards. Under the Federal Reserve's Regulation H, which implements the act, state member banks are generally prohibited from making, extending, increasing, or renewing any such loan unless the building or mobile home, as well as any personal property securing the loan, are covered by flood insurance for the term of the loan. The law requires the Board and other federal financial institution regulatory agencies to impose civil money penalties when they find a pattern or practice of violations of the regulation. The civil money penalties are payable to the Federal Emergency Management Agency (FEMA) for deposit into the National Flood Mitigation Fund.

During 2011, the Board imposed civil money penalties against 10 state member banks related to violations of Regulation H. The dollar amount of the penalties, which were assessed via consent orders, totaled $199,700.

Coordination with Other Federal Banking Agencies

The member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.[20] In 2011, the FFIEC member organizations issued the examination procedures and guidance regarding a number of regulations.

- **Interagency Examination Procedures for Regulation Z: Mortgage Disclosure.** Procedures were revised to incorporate two separate Regulation Z rulemaking changes that had January 2011 effective dates. The first rulemaking implemented the Helping Families Save Their Homes Act of 2009, which amended the Truth in Lending Act and requires that consumers receive notice when their mortgage loans are sold, assigned, or otherwise transferred. The second rulemaking implemented provisions of the Mortgage Disclosure Improvement Act (MDIA), which requires lenders to disclose how borrowers' regular mortgage payments can change over time. Specifically, the MDIA, which amended the Truth in Lending Act, seeks to ensure that mortgage borrowers are alerted to the risks of payment increases before they take out mortgage loans with variable rates or payments. Lenders were required to comply with these MDIA provisions for applications they receive on or after January 30, 2011.
- **Revised Interagency Examination Procedures for Regulation Z: Loan Originator Compensation.** Procedures were revised to incorporate final Regulation Z rules with an April 1, 2011, effective date. Specifically, the rules prohibit loan originators from receiving compensation that is based on the interest rate or other loan terms, except the amount of credit extended. They also prohibit a loan originator who receives compensation directly from the consumer from also receiving compensation from the lender or another party. Additionally, loan originators are prohibited from directing or "steering" a consumer to accept a mortgage loan that is not in the consumer's interest in order to increase the originator's compensation.

  The examination procedures also incorporated amendments to Regulation Z that implemented the appraisal independence provision of the Dodd-Frank Act. These amendments require that fee appraisers receive customary and reasonable compensation for their services. Finally, the revised procedures also implemented regulatory amendments that increase the APR threshold used to determine whether a mortgage lender is required to establish an escrow account for first lien, "jumbo" mortgage loans.
- **Revised Interagency Examination Procedures for Regulation Z: Exempt Transaction Thresholds.** Procedures were revised to incorporate Dodd-Frank Act revisions to Regulation Z that increase the thresholds for exempt consumer credit transactions from $25,000 to $50,000, effective July 21, 2011. In addition, the Dodd-Frank Act provides that, on or after December 31, 2011, the threshold must be adjusted annually by any annual percentage increase in the consumer price index. Accordingly, the exemption threshold increased from $50,000 to $51,800 effective January 1, 2012.
- **Interagency Examination Procedures for Regulation Z: Credit Card Protections.** The Federal Reserve approved a rule amending Regulation Z to clarify previous rules implementing the Credit Card Act. This rule is intended to enhance protections for consumers who use credit cards and to resolve areas of uncertainty so that card issuers fully understand their compliance obligations.[21]

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[20] FFIEC member agencies include the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the CFPB, which replaced the former Office of Thrift Supervision on the FFIEC.

[21] Federal Reserve Board, Banking Information and Regulation, Supervision, Consumer Affairs Letters, www.federalreserve.gov/bankinforeg/caletters/caltr1108.htm.

- **Revised Interagency Examination Procedures for Regulation P: Voluntary Model Privacy Notice.** Procedures were revised to incorporate Regulation P rulemaking through which several federal regulatory agencies adopted a voluntary model privacy notice form designed to make it easier for consumers to understand how financial institutions collect and share nonpublic personal information. A financial institution can use the model form to obtain a "safe harbor" for compliance with the requirements to notify consumers of its information-sharing practices and their right to opt out of certain sharing practices.[22]

Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervision process. As the number and complexity of consumer financial transactions grow, training for examiners of the organizations under the Federal Reserve's supervisory responsibility becomes even more important. The staff development function is responsible for the ongoing development of the professional consumer compliance supervisory staff, and ensuring that these staff members have the skills necessary to meet their supervisory responsibilities now and in the future.

Consumer Compliance Examiner Training Curriculum

The consumer compliance examiner training curriculum consists of six courses focused on various consumer protection laws, regulations, and examining concepts. In 2011, these courses were offered in 10 sessions, and training was delivered to a total of 197 system consumer compliance examiners and staff members, and 12 state banking agency examiners.

When appropriate, courses are delivered via alternative methods, such as the Internet or other distance-learning technologies. For instance, several courses use a combination of instructional methods: (1) classroom instruction focused on case studies and (2) specially developed computer-based instruction that includes interactive self-check exercises.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2011, staff initiated one curriculum review. The "Introduction to Consumer Compliance Examinations" course was reviewed in order to incorporate technical changes in policy and laws, along with changes in instructional delivery techniques. This course is designed to equip assistant-level examiners with the skills and knowledge of consumer laws and regulations that govern deposit operations and non-real estate lending. The course emphasizes the knowledge and practical application of consumer compliance laws, examination techniques, and examination procedures. In addition, a curriculum review of the "Fair Lending Examination Techniques" course was completed and the revised course was successfully piloted in June. This course is designed to equip assistant-level examiners with the skills and knowledge to plan and conduct a risk-focused fair lending examination, and incorporates the FFIEC fair lending examination procedures.

Lifelong Learning

In addition to providing core examiner training, the examiner staff development function emphasizes the importance of continuing lifelong learning. Opportunities for continuing learning include special projects and assignments, self-study programs, rotational assignments, the opportunity to instruct at system schools, mentoring programs, and an annual consumer compliance examiner forum, where senior consumer compliance examiners receive information on emerging compliance issues and are able to share best practices from across the system.

In 2011, the system continued to offer "Rapid Response" sessions, which are a powerful training delivery method for just-in-time training. Debuted in 2008, Rapid Response sessions offer examiners teleconference presentations on emerging issues or urgent training needs that result from the implementation of new laws, regulations, or supervisory guidance. A total of five consumer compliance Rapid Response sessions were designed, developed, and presented to system staff during 2011.

Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This section summarizes data collected from the 12 Federal Reserve Banks, the FFIEC mem-

[22] Federal Reserve Board, Banking Information and Regulation, Supervision, Consumer Affairs Letters, www.federalreserve.gov/boarddocs/caletters/2011/1104/caltr1104.htm.

ber agencies, and other federal enforcement agencies.[23]

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that approximately 89 percent of the institutions examined during the 2011 reporting period were in compliance with Regulation B, compared with 82 percent for the 2010 reporting period. The most frequently cited violations involved failure to

- provide a timely and/or accurate notice of approval, counteroffer, or adverse action within 30 days after receiving a completed credit application
- include the required information in the credit action notification letter, including ECOA-prohibited bases, the name of the federal agency responsible for overseeing compliance with the regulation, and the specific reasons for any adverse action
- collect information about applicants seeking credit primarily for the purchase or refinancing of a principal residence, including applicant race, ethnicity, sex, marital status, and age, for government monitoring purposes

The Office of the Comptroller of the Currency (OCC) initiated one formal Regulation B-related public enforcement action during the reporting period, while the Office of Thrift Supervision (OTS) initiated six and the Federal Deposit Insurance Corporation (FDIC) initiated 20.[24] There were no other enforcement actions by FFIEC agencies.

The other agencies that enforce the ECOA—the Federal Trade Commission (FTC), the Farm Credit Administration (FCA), the Department of Transportation (DOT), the Securities and Exchange Commission (SEC), the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise.

[23] Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2011 reporting period was July 1, 2010, through June 30, 2011.

[24] Consumer compliance public enforcement actions are categorized by regulation throughout the report. Because some enforcement actions include violations of more than one regulation, the overall sum of actions derived from each regulation will be greater than the actual total number of enforcement actions initiated, which was 107.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 94 percent of the institutions examined during the 2011 reporting period were in compliance with Regulation E, compared with 93 percent for the 2010 reporting period. The most frequently cited violations involved failure to

- investigate account errors within 10 business days of receiving a notice that an error has occurred, reporting the results of the investigation to the consumer within three business days, and correcting any error within one business day
- follow procedures when the financial institution determines that no account error or a different error occurred, such as providing a written explanation to the consumer
- provide initial disclosures to consumers that contain required information, including the consumer's liability for unauthorized transfers, contact information for reporting unauthorized transfers, fees for electronic fund transfers, etc.

The FDIC initiated nine formal Regulation E-related enforcement actions during the reporting period, while the OCC initiated four, and the OTS initiated two. There were no other enforcement actions by FFIEC agencies. However, the FTC initiated actions against two institutions, continued litigation against two institutions, and settled one case involving Regulation E violations.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that nearly 100 percent of the institutions examined during the 2011 reporting period were in compliance with Regulation M, down slightly from full 100 percent compliance during the 2010 reporting period. The FDIC reported one violation of Regulation M regarding the failure to provide required lease disclosures.

The FFIEC agencies did not issue any public enforcement actions specific to Regulation M during the period.

Regulation P (Privacy of Consumer Financial Information)

The FFIEC agencies reported that approximately 98 percent of the institutions examined during the 2011 reporting period were in compliance with Regulation P, which is the same rate of compliance as the 2010 reporting period. The most frequently cited violations involved failure to provide consumers with

- clear and conspicuous initial privacy notices
- a clear and conspicuous annual notice reflecting the institution's privacy policies and practices
- the required information in initial, annual, and revised privacy notices

The FDIC initiated seven formal Regulation P-related enforcement actions during the reporting period.[25] There were no other enforcement actions by FFIEC agencies.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that approximately 82 percent of the institutions examined during the 2011 reporting period were in compliance with Regulation Z, compared with 85 percent for the 2010 reporting period. The most frequently cited violations involved failure to

- provide a good faith estimate of the required disclosures before consummation, or not later than three business days after receipt of a written loan application, for certain residential mortgage transactions
- accurately disclose the finance charges in closed-end credit transactions
- accurately disclose the annual percentage rate (APR)

In addition, 111 banks supervised by the Federal Reserve, FDIC, OCC, and OTS were required, under the Interagency Enforcement Policy in Regulation Z, to reimburse a total of approximately $350,000 to consumers for understating APRs and/or finance charges in their consumer loan disclosures.

The FDIC initiated 17 formal Regulation Z-related enforcement actions during the reporting period, the OTS initiated five, and the OCC initiated one. The DOT continued to prosecute one air carrier for its alleged improper handling of credit card refund requests and other Federal Aviation Act violations. The FTC continued its law enforcement activities against institutions alleged to have violated Regulation Z, which included settling two cases and continuing litigation against another institution.

[25] The FDIC's reported information in this area relates to part 332—Privacy of Consumer Financial Information—of the agency's regulations and not Regulation P.

Regulation AA (Unfair or Deceptive Acts or Practices)

The FFIEC agencies reported that approximately 99 percent of the institutions examined during the 2011 reporting period were in compliance with Regulation AA, which is the same rate of compliance as for the 2010 reporting period. The most frequently cited violations involved

- providing inaccurate advertising or misrepresenting services, contracts, investments, or financial conditions
- failure to provide clear and conspicuous written notice of credit obligation to each co-signer prior to their becoming obligated on a loan
- participating in unfair or deceptive acts or practices

The OCC initiated five formal Regulation AA-related enforcement actions during the reporting period. There were no other enforcement actions by FFIEC agencies.

Regulation CC (Availability of Funds and Collection of Checks)

The FFIEC agencies reported that approximately 94 percent of institutions examined during the 2011 reporting period were in compliance with Regulation CC, compared with 90 percent for the 2010 reporting period. The most frequently cited violations involved failure to

- make funds deposited from local and certain other checks available for withdrawal within the times prescribed by the regulation
- ensure that account deposit slips contain required disclosures
- provide written notice to a consumer when placing an exception hold on an account

The FDIC initiated five formal Regulation CC-related enforcement actions during the reporting period, while the OTS and OCC each initiated three actions. There were no other enforcement actions by FFIEC agencies.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that approximately 89 percent of institutions examined during the 2011 reporting period were in compliance with Regulation DD, compared with 86 percent for the 2010 reporting period. The most frequently cited violations involved

- incorrect use of the phrase "annual percentage yield" in an advertisement without providing required additional terms and conditions
- providing misleading or inaccurate advertisements
- failure to provide accurate and complete account disclosures

The FDIC initiated 16 formal Regulation DD-related enforcement actions during the reporting period, while the OTS initiated two and the OCC initiated one. There were no other enforcement actions by FFIEC agencies.

Responding to Consumer Complaints and Inquiries

The Federal Reserve investigates complaints against state member banks and selected nonbank subsidiaries of bank holding companies (Federal Reserve-regulated entities), and forwards complaints against other creditors and businesses to the appropriate enforcement agency. Each Reserve Bank investigates complaints against state member banks and selected nonbank subsidiaries in its district. The Federal Reserve also responds to consumer inquiries on a broad range of banking topics, including consumer protection questions.

In 2011, System complaint analysts processed 41,631 cases through Federal Reserve Consumer Help (FRCH), which was created in 2007 to centralize the processing of consumer complaints and inquiries. Of these cases, more than half (26,097) were inquiries and the remainder (15,534) were complaints, with most cases received directly from consumers. Approximately 4 percent of cases were referred to the Federal Reserve from other agencies.

While consumers can contact FRCH by telephone, fax, mail, e-mail, or online (at www.federalreserveconsumerhelp.gov), most FRCH consumer contacts occurred by telephone (58 percent). Nevertheless, 38 percent (15,675) of complaint and inquiry submissions were made electronically (including e-mail, online submissions, and fax) and the online form page received more than 350,380 visits during the year.

Consumer Complaints

Complaints against Federal Reserve-regulated entities totaled 4,840 in 2011. Approximately 38 percent of these complaints were closed without investigation pending the receipt of additional information from consumers. Approximately 2 percent of the total complaints are still under investigation. Of the remaining complaints (2,912), 68 percent (1,966) involved unregulated practices and 32 percent (946) involved regulated practices.

Table 1. Complaints against state member banks and selected nonbank subsidiaries of bank holding companies about regulated practices, by Regulation/Act, 2011

Regulation/Act	Number
Regulation AA (Unfair or Deceptive Acts or Practices)	12
Regulation B (Equal Credit Opportunity)	57
Regulation BB (Community Reinvestment)	2
Regulation C (Home Mortgage Disclosure)	0
Regulation CC (Expedited Funds Availability)	82
Regulation D (Reserve Requirements)	5
Regulation DD (Truth in Savings)	206
Regulation E (Electronic Funds Transfers)	116
Regulation G (Disclosure/Reporting of CRA-Related Agreements)	0
Regulation H (National Flood Insurance Act/Insurance Sales)	26
Regulation M (Consumer Lending)	8
Regulation P (Privacy of Consumer Financial Information)	25
Regulation Q (Payment of Interest)	1
Regulation V (Fair and Accurate Credit Transactions)	5
Regulation Z (Truth in Lending)	198
Fair Credit Reporting Act	67
Fair Debt Collection Practices Act	63
Fair Housing Act	15
Home Ownership Counseling	0
HOPA (Homeowners Protection Act)	8
Real Estate Settlement Procedures Act	44
Right to Financial Privacy Act	3
Protecting Tenants at Foreclosure Act	1
Servicemembers Civil Relief Act	2
Total	**946**

Complaints about Regulated Practices

The majority of regulated practice complaints concerned checking accounts (34 percent), real estate loans (23 percent), and credit cards (15 percent).[26] The most common checking account complaints related to insufficient funds or overdraft charges and procedures (38 percent); disputed withdrawal of funds (13 percent); disputed rates, terms, or fees (10 percent); and funds availability not as expected (9 percent). The most common real estate loan complaints by problem code related to credit denied (11 percent); disputed rates, terms, and fees (10 percent); payment errors or delays (9 percent); flood

[26] Real estate loans include adjustable-rate mortgages, residential construction loans, open-end home equity lines of credit, home improvement loans, home purchase loans, home refinance/closed-end loans, and reverse mortgages.

Table 2. Complaints against state member banks and selected nonbank subsidiaries of bank holding companies about regulated practices, by product type, 2011

Subject of complaint/product type	All complaints		Complaints involving violations	
	Number	Percent	Number	Percent
Total	**946**	**100**	**38**	**4.0**
Discrimination alleged				
Real estate loans	17	1.8	2	0.2
Credit cards	1	0.1	0	0
Other loans	11	1.1	1	0.1
Nondiscrimination complaints				
Checking accounts	317	34.0	14	1.4
Real estate loans	221	23.0	11	1.2
Credit cards	146	15.0	1	0.1
Other	233	25.0	9	1.0

insurance (9 percent); and escrow account problems (9 percent). The most common credit card complaints related to interest rates, terms, and fees (20 percent); inaccurate credit reporting (15 percent); bank debt collection tactics (15 percent); billing error resolutions (10 percent); and payment errors and delays (8 percent).

FRCH received 17 complaints alleging discrimination under regulated practices; discrimination was alleged on the basis of prohibited borrower traits or rights.[27] Thirty-four percent of these discrimination complaints were related to the race, color, national origin, or ethnicity of the applicant or borrower. Fourteen percent of discrimination complaints were related to either the age or handicap of the applicant or borrower. One violation, involving a real estate loan, was identified based on these complaints.

In 85 percent of investigated complaints against Federal Reserve-regulated entities, evidence revealed that institutions correctly handled the situation. Of the remaining 15 percent of investigated complaints, 2 percent were deemed violations of law, 2 percent were identified errors which were corrected by the bank, 1 percent was referred to other agencies, and the remainder were matters involving litigation or factual disputes, withdrawn complaints, internally referred complaints, or information was provided to the consumer. The most common violations involved real estate loans and checking accounts.

[27] Prohibited bases include race, color, religion, national origin, sex, marital status, age, applicant income derived from public assistance programs, or applicant reliance on provisions of the Consumer Credit Protection Act.

Complaints about Unregulated Practices

The Board continued to monitor complaints about banking practices not subject to existing regulations, with a focus on instances of potential unfair or deceptive practices. In 2011, the Board received 1,966 complaints against Federal Reserve-regulated entities that involved these unregulated practices. Most complaints were related to real estate concerns (41 percent), checking account activity (26 percent), and credit cards (4 percent). More specifically, consumers most frequently complained about issues involving debt collection/foreclosures; insufficient funds or overdraft charges; interest rates, terms, and fees; policy and procedure concerns; payment errors/delays; and opening and closing deposit accounts.

Complaints about Loan Modifications and Foreclosures

In 2011, the Federal Reserve received 669 complaints related to loan modifications and foreclosures. Of these, consumers complained primarily about home purchase loans (78 percent), home refinance/closed end loans (9 percent), and adjustable rate mortgage loans (7 percent). The top consumer protection issues documented with specific codes were: debt collection/foreclosure (50 percent) and interest rates, terms, and fees (22 percent).

Complaint Referrals

In 2011, the Federal Reserve forwarded 10,918 complaints against other banks and creditors to the appropriate regulatory agencies and government offices for investigation, including the CFPB after July 21, 2011. To minimize the time required to re-route complaints to these agencies, referrals were transmitted electronically.

The Federal Reserve forwarded 14 complaints to the Department of Housing and Urban Development (HUD) that alleged violations of the Fair Housing Act.[28] The Federal Reserve's investigation of these complaints revealed one instance of illegal credit discrimination.

Consumer Inquiries

The Federal Reserve received 26,097 consumer inquiries in 2011, covering a wide range of topics. Consumers were typically directed to other resources, including other federal agencies or written materials, to address their inquiries.

Consumer Policy and Emerging Issues Analysis

The Policy Analysis function of DCCA provides key insights, information, and analysis on emerging financial services issues that affect the well-being of consumers and communities. Throughout 2011, as financial markets continued to experience dynamic change in response to the economic downturn, monitoring the financial services landscape for new and unintended risks to households remained a top priority. To this end, Policy Analysis staff follow trends and conduct inquiries that help define the issues, identify emerging risks, and inform policy recommendations. The section also manages a cross-functional team charged with coordinating the division's activities and responses on key consumer and community development matters.

Throughout 2011, Policy Analysis staff facilitated the division's activities in response to the foreclosure crisis and recovery of the housing market. These activities included contributing to the efforts of the Board's internal working group for analyzing housing issues, and organizing a policy forum entitled, "The Housing Market Going Forward: Lessons Learned from the Recent Crisis."[29] The forum explored consumer and industry perspectives on factors contributing to the crisis and steps for re-starting the housing market.

Policy Analysis staff also contributed to the division's activities in support of the Board's mortgage servicing reviews and the publication of *Interagency Review of Foreclosure Policies and Practices*.[30] This public report documented the findings of the foreclosure reviews and was followed by enforcement actions against mortgage servicers for deficient practices in residential mortgage loan servicing and foreclosure processing, and by further public communication to increase awareness and transparency about the foreclosure review process.

Supporting Community Economic Development

The Federal Reserve System's Community Development function promotes economic growth and financial stability to underserved populations by informing and improving the research, policy, and practice of community development. As a decentralized function, the Community Affairs Officers (CAOs) at each of the 12 Reserve Banks design activities to respond to the specific needs of the communities they serve, with oversight from Board staff. They provide information and promote awareness of investment opportunities to financial institutions, government agencies, and organizations that serve low- and moderate-income communities and populations. Similarly, the Board's community development staff promote and coordinate System-wide priorities; in particular, community development staff focus on five key areas:

- research and community-level data compilation
- economic and small business development and entrepreneurship
- housing markets and neighborhood revitalization
- community development finance
- workforce and human capital development

Community Development Research

Having learned from the subprime crisis that microeconomic issues can have a magnified impact on the

[28] A memorandum of understanding between HUD and the federal bank regulatory agencies requires that complaints alleging a violation of the Fair Housing Act be forwarded to HUD.

[29] Materials from the policy forum are available online at www.federalreserve.gov/newsevents/conferences/housingconf2011.htm.

[30] See The Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (2011), *Interagency Review of Foreclosure Policies and Practices* (Washington: Board of Governors of the Federal Reserve System, April), www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

macroeconomy, the Community Development function across the Federal Reserve System is engaged in a variety of research initiatives that augment the Board's systemic risk responsibilities. These efforts to gather, analyze, and disseminate data on underserved communities are also useful to policymakers and community development practitioners.

In 2011, Reserve Banks continued to expand the use of applied research and analysis to inform community development policy and practice. This expanded capacity was highlighted at the biennial "Community Affairs Research Conference: The Changing Landscape of Community Development," which drew more than 350 participants and included a number of recognized experts across a range of disciplines.[31] Community Development staff members from across the system played key roles in this conference as presenters, moderators, and organizers. In addition, the conference was preceded by an internal system researchers' symposium where Federal Reserve staff discussed research efforts, shared results, and exchanged ideas on emerging research and policy issues.

Community Data Initiative

By leveraging information-sharing and partnership roles with a rigorous analytical capacity, Community Development provides reliable market intelligence that has helped to identify and close data gaps for low- and moderate-income communities. In 2011, the Board coordinated the Community Data Initiative (CDI), a CAO collaborative research project. The goal of the CDI project is to provide Board and Reserve Bank leadership with systematic and relevant community conditions and trend information on a consistent basis. The quarterly or biannual e-polling of selected district community stakeholders captures current and emerging community development issues. In 2011, 11 Reserve Banks were administering web-based polls and surveys. To provide a national context for the regional results of Reserve Bank polls, the Board continued to survey NeighborWorks® America affiliates and grantees.

While still in an early stage of development, the CDI has the potential to serve as a valuable complement to the information that Community Development staff continue to gather through regional convenings and applied research efforts.

Supporting Small Business Development, Entrepreneurship, and Indian Country

Over the past few years, small businesses have faced weak sales, diminished asset values, elevated uncertainty, and tight credit market conditions. Like owners of large firms, many small business owners have had to lay off employees or defer hiring. Even as credit conditions ease, perceptions of tight credit can discourage some entrepreneurs from even trying to obtain financing. These disruptions on the supply and demand sides of the small business credit market have resulted in notable credit gaps in lines of credit, patient capital, small-dollar loans, and commercial real estate.

In response to these persistent conditions, the Community Development function convened several regional forums to better understand the characteristics of and challenges facing small businesses. The discussions informed the framework of a national convening hosted at the Board in partnership with the Federal Reserve Bank of Atlanta and the Ewing Marion Kauffman Foundation entitled, "Small Business and Entrepreneurship during an Economic Recovery."[32] Research papers presented at the convening noted the importance of new and small firms to the vitality of the economy, the unique challenges experienced by female and minority entrepreneurs, and the need for more timely and relevant small business data.

Given the acute challenges that confront underserved communities, particularly in rural America, the Federal Reserve partnered with nine federal agencies to identify barriers to and opportunities for economic growth in Indian Country.[33] More than 750 tribal stakeholders participated in six regional workshops

[31] "Community Affairs Research Conference: The Changing Landscape of Community Development" was held April 28-29, 2011, in Arlington, Virginia. Materials from the conference are available at www.frbsf.org/community/conferences/2011ResearchConference.

[32] "Small Business and Entrepreneurship during an Economic Recovery" was held November 9-10, 2011, in Washington, D.C. Materials from the conference are available at www.federalreserve.gov/newsevents/conferences/small-business-entrepreneurship-conference.htm.

[33] Indian Country is defined as all land within the limits of an Indian reservation under the jurisdiction of the United States government; all dependent Indian communities, such as the New Mexico Pueblos; and all Indian allotments still in trust, whether they are located within reservations or not. The term includes land owned by non-Indians, as well as towns incorporated by non-Indians if they are within the boundaries of an Indian reservation. It is generally within these areas that tribal sovereignty applies and state power is limited.

that addressed specific gaps in capital and technical assistance. A national summit that will serve as a springboard for integrated research, policy, and economic development strategies is being planned for 2012.

Housing Markets and Neighborhood Revitalization

Fallout from the economic crisis has included large inventories of foreclosed properties that stand vacant and abandoned and can have significant destabilizing effects on communities, including increased crime and decreased property values. The longer these homes remain unoccupied, the worse the effect on the community and the harder it is to reverse their condition and put them back on the market. The challenge of disposing of these real estate owned (REO) properties often outstrips resources, particularly in low-income communities. Throughout 2011, the Federal Reserve's Community Development function focused on supporting regional efforts to stabilize and stimulate these neighborhoods, providing housing market data and/or convening local stakeholders to discuss ways to use existing data to make strategic investment decisions, such as the disposition of REO properties.

Community Development provided a wealth of resources to communities in crisis, including a video series, publication, and national forum. Videos documenting successful neighborhood stabilization strategies in Cleveland, Ohio; Detroit, Michigan; and Phoenix, Arizona, debuted at the 2011 Community Affairs Research Conference during Governor Elizabeth A. Duke's keynote remarks.[34] The publication, *Putting Data to Work: Data-Driven Approaches to Strengthening Neighborhoods*, comprises case studies that demonstrate how communities can use data to make strategic investment decisions.[35] Case-study authors were drawn from national nonprofits, community development organizations, local units of government, and academia. The report was distributed at the "Strategic Data-Use to Stabilize Neighborhoods" conference co-hosted by the Board and the Federal Reserve Bank of Richmond.[36]

Participants at the conference explored creative uses of data and technology to promote public and private investment in transitional communities.

Other Community Development Initiatives

As households and communities grapple with limited resources and persistent challenges, it is imperative that the Federal Reserve continue to connect with and respond to Main Street. To that end, the Community Development function works to engage communities in new ways and through new technologies. Many Reserve Banks produce webinars and podcasts. Several utilize visual analytics and blogs to share quantitative and qualitative information with their stakeholders.

In the fall of 2011, the Board partnered with the Federal Reserve Bank of St. Louis to launch "Connecting Communities," a communications platform designed to share best practices relating to community development.[37] In 2011, the platform offered a webinar that focused on the challenges of helping people facing foreclosure and the impact it will have on their credit score; another webinar shared strategies on how microfinance can serve as a catalyst to increasing economic opportunity in low- to moderate-income communities. The webinar series will continue to be a means for sharing system community development information in 2012.

Consumer Advisory Council

On July 21, 2011, the Board's Consumer Advisory Council (CAC) was dissolved pursuant to the Dodd-Frank Act. Nevertheless, the Council—which was established in 1976 to bring together representatives of consumer and community organizations, the financial services industry, academic institutions, and state agencies—advised the Board of Governors on several matters of Board-administered laws and regulations as well as other consumer-related financial

[34] The video reports and other community stabilization resources are available online at www.federalreserve.gov/communitydev/stablecommunities.htm.

[35] See Board of Governors of the Federal Reserve System (2011), *Putting Data to Work: Data-Driven Approaches to Strengthening Neighborhoods* (Washington: Board of Governors of the Federal Reserve System, December), www.federalreserve.gov/communitydev/files/data-driven-publication-20111212.pdf.

[36] "Strategic Data-Use to Stabilize Neighborhoods" was held December 6-7, 2011, in Baltimore, Maryland. Materials from the conference are available at www.richmondfed.org/conferences_and_events/community_development/2011/strategic_data_use_20111206.cfm.

[37] More information about "Connecting Communities" is available at www.stlouisfed.org/bsr/connectingcommunities/index.cfm.

services issues through the first half of 2011.[38] Council meetings, open to the public, were held in March and June.

Among the significant topics of discussion for the Council in 2011 were

- issues related to foreclosures and neighborhood stabilization
- proposed rules regarding debit card interchange fees and routing
- national mortgage servicing standards
- proposed rules regarding ability to pay for mortgage loans
- the proposed rule regarding risk retention and "qualified residential mortgages"

Foreclosure Assistance

In 2011, the Council discussed loss-mitigation efforts, including the Administration's Home Affordable Modification Program (HAMP), and other issues related to foreclosures. Consumer representatives urged that more funding be provided for housing counseling and legal services programs that assist borrowers facing foreclosure. Some consumer representatives endorsed a focus on principal reductions and the implementation of third-party mediation or settlement programs. One consumer representative also urged continued funding for programs that assist temporarily unemployed borrowers in making their mortgage payments.

Consumer representatives generally expressed the view that servicing problems remain numerous and systemic, noting continuing issues with servicers' capacity and the need for improvements in training. They pointed to issues such as lost or misplaced documentation, delays in making a decision about whether to grant a loan modification, steering of borrowers from HAMP to in-house modification programs with less favorable terms, the lack of a single point of contact, and the lack of response to borrower communications. They also stated that foreclosures continue to be filed while loan modifications are being considered. Some consumer representatives expressed concern that servicers are contributing to borrowers becoming delinquent, such as by inaccurately representing what constitutes eligibility for HAMP or by making errors regarding payments or fees.

[38] For a list of members of the Council, see the "Federal Reserve System Organization" section in this report. Transcripts of Council meetings are available at www.federalreserve.gov/aboutthefed/cac.htm.

Some consumer representatives also called attention to fair housing issues related to loss mitigation, expressing the view that loan-modification outcomes are generally worse for borrowers of color. They urged the Board and other regulators to ensure that fair housing concerns are included in their review of servicers, and emphasized the need for HMDA-like data reporting in the loan-modification context.

In discussing HAMP specifically, several consumer representatives urged more enforcement to ensure servicers' compliance with the program's guidelines. They also expressed concern about the lack of information provided to borrowers who are denied a HAMP modification and emphasized the need for more transparency and more data collection and reporting about HAMP activities.

Members commended the Board and other regulators for conducting the interagency review of servicing issues, but several consumer representatives expressed concern about what constitutes a "wrongful foreclosure" in the context of the review.[39] The consumer representatives stated that the concept of "wrongful foreclosures" should be defined more broadly, so that it covers foreclosures that are based on servicer errors or those that are filed by a party without an ownership interest in the mortgage.

Neighborhood Stabilization

In 2011, the Council also discussed the effects of foreclosures that extend beyond households to the surrounding community and efforts such as the federal Neighborhood Stabilization Program (NSP) to address the challenges of stabilizing communities. Several members praised the positive effects of NSP efforts but stated that significantly more funding would be required to effectively address the scope of the problem. They also commended recent regulatory changes that allow financial institutions to receive CRA consideration for certain neighborhood stabilization activities.

Consumer representatives described the negative effects of REO and vacant properties on neighbor-

[39] See The Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (2011), *Interagency Review of Foreclosure Policies and Practices* (Washington: Board of Governors of the Federal Reserve System, April), www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

hoods, such as increased blight, vandalism, and crime; the burdens they impose on municipalities; and the impact on the decisionmaking process of other homeowners who are struggling to stay current on their mortgage. They expressed concern about banks and servicers not maintaining REO properties and not complying with protections for tenants. They also expressed concern about lenders and servicers walking away from and not completing foreclosure sales, leading to "toxic titles" and additional vacant properties, and urged federal regulators to increase the oversight of regulated institutions regarding these issues. Several consumer representatives stated that the practices of servicer walkaways and lack of property upkeep are disproportionately concentrated in neighborhoods of color. One consumer representative described the phenomenon whereby new owners of REO properties delay recording their ownership in what may be an attempt to avoid responsibility and liability for the maintenance of the properties.

Both industry and consumer representatives expressed concern about increasing investor purchases of REOs and urged consideration of ways to give potential owner-occupants a better chance to acquire properties. A consumer representative also encouraged lenders and servicers to continue renting to tenants living in REO properties whenever possible, to help prevent additional vacant properties.

An industry representative commented that the Board and the Federal Reserve Banks could help to facilitate conversations about the future of neighborhoods in cities that have been hit hard by the foreclosure crisis.

Finally, members discussed the future of housing finance and recent proposals relating to this issue. An industry representative expressed concern that some proposed policies would block many people, particularly lower-income and minority individuals, from the opportunity of home ownership. Some consumer representatives emphasized the importance of ensuring that home ownership is achieved in a safe, sustainable way and providing counseling so that borrowers recognize the true costs of home ownership; they also noted that renting is appropriate for many people. Several members stated that further attention should be given to explaining and addressing the persistence of lower home ownership rates among minorities.

Debit Card Interchange Fees and Routing

At the March meeting, the Council discussed the Board's proposed rule that would (1) establish debit card interchange fee standards and (2) prohibit network exclusivity arrangements and routing restrictions. Some industry representatives expressed concerns about the proposal, urging the Board to consider certain additional costs involved in interchange transactions and to study the potential impact on consumers, the payment system, and smaller financial institutions. They pointed to the benefits of debit cards in terms of connecting consumers with mainstream financial services and expressed the view that those benefits could be jeopardized if, due to the loss of interchange revenue, banks were to add fees to bank accounts to cover their costs. One industry representative commented that the proposed exemption for small issuers would be difficult to implement effectively and that the loss of interchange revenue would have a severe impact on smaller banks and credit unions.

One industry representative expressed support for the proposal, stating that it represents a return to fairer pricing and a more competitive marketplace after distortions due to consolidation and concentration. Another member commented that some large retailers have engaged in innovative and effective efforts to reach unbanked individuals.

Regarding the prohibition on network exclusivity arrangements, an industry representative endorsed the proposal's first alternative, stating that the second alternative would impede innovations in payments.

Several consumer representatives expressed concern about the proposal's potential impact on consumers, particularly if new fees are imposed on bank accounts. They stated that bank account fees should be reasonably related to the services provided and that there should be some accommodation for low- to moderate-income customers through lower fees. They encouraged regulators to hold financial institutions accountable under CRA for how they respond to these changes and ensure that harmful effects on low-income consumers are minimized.

National Mortgage Servicing Standards

At the June meeting, the Council discussed the creation of national standards for residential mortgage loan servicing, providing views about what principles, policies, and procedures such standards should include. Several consumer representatives generally commended the work of the Board and other regulators in reviewing and reporting on servicing and foreclosure practices and the imposition of formal enforcement actions in connection with the interagency review. Members disagreed about how national servicing standards should interact with standards promulgated by states. Consumer representatives stated that national standards should operate as a floor and states should be able to provide additional protections that address unique circumstances in their particular jurisdiction. Industry representatives stated that national standards should set a high bar that operates as both a floor and a ceiling, providing consistent protections across states.

Consumer representatives recommended a variety of requirements for national servicing standards, including

- a general obligation of good faith and fair dealing
- robust data collection and reporting, especially regarding fair housing issues
- recordkeeping about communications with borrowers
- a single point of contact
- greater transparency about calculations of borrower income and net present value
- streamlined systems for document submission
- monitoring of law firms and other external vendors.

Consumer representatives also expressed the view that the standards should prohibit the dual-track system of proceeding simultaneously with a foreclosure and a loan modification and should address post-foreclosure issues, such as property maintenance obligations and compliance with tenant protections. Other recommendations included mandating an affirmative duty of loss mitigation that could be enforced by a private right of action and allowing borrowers to raise violations of the servicing standards as a defense to foreclosure.

Consumer representatives also stated that national standards should address issues related to servicer compensation. One member expressed the view that the compensation should provide greater incentives for servicers to do affordable, sustainable loan modifications. Another member noted that the compensation should be structured to ensure that servicers have sufficient funding to be able to operate effectively during times of increased delinquencies and foreclosures.

Members also pointed to securitization-related issues that should be addressed in national servicing standards. A consumer representative supported the creation of standardized pooling and servicing agreements that include greater flexibility for servicers to offer loan modifications without having to seek investor approval. An industry representative recommended the adoption, for all securitizations, of the set of standard representations and warranties created by the American Securitization Forum. A consumer representative suggested that trustees should be required to collect and keep up-to-date detailed information about servicers, and that servicing transfers should be registered with trustees. An industry representative recommended the implementation of consistent data fields on a loan-level basis for all securitizations to assist in tracking the performance of the underlying collateral.

Ability-to-Pay Requirement for Mortgage Loans

At the June meeting, the Council discussed a proposed rule under Regulation Z that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards. There was strong support for ability-to-pay standards among Council members and general agreement that many of the criteria in the proposal represented sound, common-sense underwriting principles.

In considering the definition of "qualified mortgage," both consumer and industry representatives expressed support for including the additional underwriting requirements contained in the proposal's Alternative 2. They encouraged the Board to adopt a rule that sets high, robust standards applying to all mortgage lenders. An industry representative commented that the rule's approach to the definition of "qualified mortgage" should operate as a legal safe harbor rather than as a rebuttable presumption of compliance. Industry representatives also urged the

Board to provide additional clarity about the standards that lenders would have to meet to fall within the safe harbor; a consumer representative recommended that the standards not specify particular numbers, such as for debt-to-income ratios or credit scores. Several members expressed concern that 5/1 adjustable-rate mortgages (ARMs) would be considered as qualified mortgages under the proposal; they stated that such ARMs should be subjected to greater regulation. A consumer representative praised the inclusion of a duty for lenders to make a reasonable and good faith determination that the consumer will have a reasonable ability to repay the loan.

A consumer representative and an industry representative expressed support for the proposal's approach to balloon-payment qualified mortgages offered by small creditors operating predominantly in rural or underserved areas. Another consumer representative emphasized the need to ensure that rural borrowers have adequate protection and urged regulators to use CRA exams to increase their scrutiny of financial institutions' performance in rural communities.

Risk Retention and "Qualified Residential Mortgages"

At the June meeting, the Council discussed the interagency proposed rule that would require risk retention for asset-backed securities and would exempt qualified residential mortgages (QRMs) from those requirements. Both industry and consumer representatives expressed concerns about the proposed definition of a QRM, particularly the requirement of a 20 percent down payment for QRM eligibility. Some members questioned the effectiveness of the 20 percent requirement: they commented that programs, such as Ginnie Mae, demonstrate that no- and low-down payment loans can be sound and sustainable and that many loans that are currently performing well would not qualify as a QRM.

Members generally expressed concern about the consequences across the mortgage market if QRM were to be seen as the "gold standard" and to become the primary mortgage product, rather than the narrow exception as intended. Possible consequences that were mentioned included restricted access to credit for consumers who do not qualify for QRMs, higher costs and/or less favorable terms for non-QRM loans, regulatory scrutiny of and limits on non-QRM loans, reputational risk for offering non-QRM loans, and lower ratings for non-QRM securities. Several consumer representatives expressed concern that lower-income individuals and people of color would be locked out of home ownership opportunities or forced to obtain credit at a much higher cost.

Members emphasized the need for a healthy, liquid non-QRM market and for further consideration of how to achieve safe, productive lending to emerging markets. They urged the Board and other regulators to investigate how the markets and investors would likely to react to the proposed QRM standard and what the price difference likely would be between QRM and non-QRM loans.

Other Discussion Topics

At the March meeting, the Council discussed the Board's proposed rule to expand and revise Regulation Z's existing escrow account requirements for certain mortgage loans. Members generally commended the effort to improve disclosures concerning escrow accounts and praised the clear, "plain English" nature of the proposed model forms. Concerns were expressed about the proposed exemption for loans made in "rural or underserved areas" if certain conditions are satisfied. A consumer representative commented that the 100-loan annual originations test could unduly limit lenders' ability to work with higher-risk borrowers and communities. Another consumer representative expressed concern that some money lenders engaging in risky, higher-cost lending would fall under the exemption.

At the June meeting, the Council discussed the Board's proposed rule that would create new protections for consumers who send remittance transfers to recipients located in a foreign country. Members generally supported the proposal, particularly the requirements relating to fee disclosures. Industry representatives noted, however, there can be challenges in determining fees when dealing with an unaffiliated international remittance provider. An industry representative expressed the view that the statutorily mandated 90-day timeframe for remittance transfer providers to provide error resolution is too long.

Federal Reserve Banks

The Federal Reserve Banks provide payment services to depository and certain other institutions, distribute the nation's currency and coin to depository institutions, and serve as fiscal agents and depositories for the U.S. government and other entities. The Reserve Banks also contribute to setting national monetary policy and supervision of banks and other financial entities operating in the United States (discussed in the preceding sections of this report).

Federal Reserve Priced Services

Federal Reserve Banks provide a range of payment and related services to depository institutions, including collecting checks, operating an automated clearinghouse (ACH) service, transferring funds and securities, and providing a multilateral settlement service. The Reserve Banks charge fees for providing these "priced services."

The Monetary Control Act of 1980 requires that the Federal Reserve establish fees for priced services provided to depository institutions so as to recover, over the long run, all direct and indirect costs actually incurred as well as the imputed costs that would have been incurred—including financing costs, taxes, and certain other expenses—and the return on equity (profit) that would have been earned if a private business firm had provided the services.[1] The imputed costs and imputed profit are collectively referred to as the *private-sector adjustment factor* (PSAF).[2] Over

1 Financial data reported throughout this chapter—including revenue, other income, costs, income before taxes, and net income—will reference to the "Pro Forma Financial Statements for Federal Reserve Priced Services" at the end of this chapter.

2 In addition to income taxes and the return on equity, the PSAF includes three other imputed costs: interest on debt, sales taxes, and an assessment for deposit insurance by the Federal Deposit Insurance Corporation (FDIC). Board of Governors assets and costs that are related to priced services are also allocated to priced services; in the pro forma financial statements at the end

Table 1. Priced Services Cost Recovery
Millions of dollars, except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity[3]	Total costs	Cost recovery (percent)[4, 5]
2002	918.3	891.7	92.5	984.3	93.3
2003	881.7	931.3	104.7	1,036.0	85.1
2004	914.6	842.6	112.4	955.0	95.8
2005	993.8	834.4	103.0	937.4	106.0
2006	1,029.7	874.8	72.0	946.8	108.8
2007	1,012.3	912.9	80.4	993.3	101.9
2008	873.8	820.4	66.5	886.9	98.5
2009	675.4	707.5	19.9	727.5	92.8
2010	574.7	532.8	13.1	545.9	105.3
2011	478.6	444.4	16.8	461.2	103.8
2002–2011	8,352.8	7,792.9	681.3	8,474.2	98.6

Note: Here and elsewhere in this chapter, components may not sum to totals or yield percentages shown because of rounding.

1 For the 10-year period, includes revenue from services of $7,837.0 million and other income and expense (net) of $515.7 million.

2 For the 10-year period, includes operating expenses of $7,506.9 million, imputed costs of $42.1 million, and imputed income taxes of $243.8 million.

3 Beginning in 2009, the PSAF has been adjusted to reflect the actual clearing balance levels maintained; previously, the PSAF was calculated based on a projection of clearing balance levels.

4 Revenue from services divided by total costs.

5 For the 10-year period, cost recovery is 95.3 percent, including the reduction in equity related to ASC 715 reported by the priced services.

the past 10 years, Reserve Banks have recovered 98.6 percent of their priced services costs, including the PSAF (see **table 1**).[3]

In 2011, Reserve Banks recovered 103.8 percent of total priced services costs, including the PSAF.[4] The Banks' operating costs and imputed expenses totaled $444.4 million. Revenue from operations totaled $477.4 million and other income was $1.2 million, resulting in net income from priced services of $34.1 million.[5]

The Reserve Banks are engaged in a number of technology initiatives that will modernize their priced services processing platforms over the next several years. The Banks are in the process of implementing a new end-to-end electronic check-processing system to improve the efficiency and reliability of their current check-processing operations. They also continued efforts to migrate the FedACH, Fedwire Funds, and Fedwire Securities services off a mainframe system and to a distributed computing environment.

Commercial Check-Collection Service

In 2011, Reserve Banks recovered 105.4 percent of the total costs of their commercial check-collection service, including the related PSAF. The Banks' operating expenses and imputed costs totaled $237.8 million. Revenue from operations totaled $259.2 million and other income totaled $0.7 million, resulting in net income of $22.2 million. In 2011, check-service revenue from operations decreased $94.4 million from 2010.[6] Reserve Banks handled 6.8 billion checks in 2011, a decrease of 12.1 percent from 2010 (see **table 2**). The decline in Reserve Bank check volume continues to be influenced by nationwide trends away from the use of checks.[7]

By year-end 2011, 99.9 percent of check deposits processed by the Reserve Banks and 99.7 percent of checks presented by the Reserve Banks to paying banks were processed electronically. By year-end 2011, 98 percent of unpaid checks were returned to a Reserve Bank electronically and 90 percent were delivered by the Reserve Bank to the bank of first deposit electronically. The increased acceptance of electronic returns in the past couple of years is partly due to expanded product options offered by the Reserve Banks, such as a PDF delivery option that smaller depository institutions use to receive returns.

Commercial Automated Clearinghouse Services

In 2011, the Reserve Banks recovered 100.8 percent of the total costs of their commercial ACH services, including the related PSAF. Reserve Bank operating expenses and imputed costs totaled $106.9 million.

Revenue from ACH operations totaled $111.7 million and other income totaled $0.3 million, resulting in net income of $5.1 million. The Reserve Banks processed 10.4 billion commercial ACH transactions, an increase of 1.1 percent from 2010.

In 2010, the Reserve Banks introduced an opt-in, same-day ACH product that clears and settles selected consumer debit payments on the same day rather than overnight. The service has had limited adoption over the past two years, but its availability has spurred broader industry discussions about whether to establish a same-day service involving both U.S. ACH operators and all ACH participants.

Fedwire Funds and National Settlement Services

In 2011, Reserve Banks recovered 103.0 percent of the costs of their Fedwire Funds and National Settle-

of this chapter, Board assets are part of long-term assets, and Board expenses are included in operating expenses.

3 Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* [Accounting Standards Codification (ASC) Topic 715 (ASC 715), *Compensation–Retirement Benefits*], which has resulted in the recognition of a $288.9 million reduction in equity related to the priced services' benefit plans through 2011. Including this reduction in equity, which represents a decline in economic value, results in cost recovery of 95.3 percent for the 10-year period. For details on how implementing ASC 715 affected the pro forma financial statements, refer to notes 3 and 5 to the "Pro Forma Financial Statements for Federal Reserve Priced Services" at the end of this chapter.

4 *Total cost* is the sum of operating expenses, imputed costs (income taxes, interest on debt, interest on float, sales taxes, and the FDIC assessment), and the targeted return on equity.

5 *Other income* is investment income earned on clearing balances net of the cost of earnings credits, an amount termed net income on clearing balances.

6 In 2008, the Reserve Banks discontinued the transportation of commercial checks between their check-processing offices. As a result, in 2011, there were no costs or imputed revenues associated with the transportation of commercial checks between Reserve Bank check-processing offices.

7 Federal Reserve System retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. For details, see "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States, 2006–2009" (December 2010), www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.

Table 2. Activity in Federal Reserve Priced Services, 2009–2011
Thousands of items

Service	2011	2010	2009	Percent change	
				2010 to 2011	2009 to 2010
Commercial check	6,779,607	7,711,833	8,584,929	-12.1	-10.2
Commercial ACH	10,348,802	10,232,757	9,966,260	1.1	2.7
Fedwire funds transfer	129,734	127,762	127,357	1.5	0.3
National settlement	571	522	464	9.4	12.5
Fedwire securities transfer	7,271	7,913	10,519	-8.3	-24.6

Note: Activity in commercial check is the total number of commercial checks collected, including processed and fine-sort items; in commercial ACH, the total number of commercial items processed; in Fedwire funds transfer and securities transfer, the number of transactions originated online and offline; and in national settlement, the number of settlement entries processed.

ment Services, including the related PSAF. Reserve Bank operating expenses and imputed costs for these operations totaled $78.8 million in 2011. Revenue from these services totaled $84.0 million, and other income amounted to $0.2 million, resulting in a net income of $5.4 million.

Fedwire Funds Service

The Fedwire Funds Service allows its participants to use their balances at Reserve Banks to transfer funds to other participants in the service. In 2011, the number of Fedwire funds transfers originated by depository institutions increased 1.5 percent from 2010, to approximately 129.7 million. The average daily value of Fedwire funds transfers in 2011 was $2.6 trillion, an increase of 9.6 percent from the previous year.

In November 2011, the Federal Reserve Banks introduced a new message format for the Fedwire Funds Service, the culmination of years of planning and engagement with depository institutions and their corporate customers. The new format was implemented to support extended character business remittance information, an improved cover payments solution, a new field to support payment notification and tracking, and better alignment with SWIFT message formats.

National Settlement Service

The National Settlement Service is a multilateral settlement system that allows participants in private-sector clearing arrangements to settle transactions using Federal Reserve balances. In 2011, the service processed settlement files for 16 local and national private-sector arrangements, a decrease from the 19 arrangements active in 2010. The Reserve Banks processed slightly more than 6,900 files that contained around 571,000 settlement entries for these arrangements in 2011. Activity in 2011 represents an increase from the 522,000 settlement entries processed in 2010.

Fedwire Securities Service

In 2011, the Reserve Banks recovered 103.1 percent of the total costs of the priced-service component of their Fedwire Securities Service, including the related PSAF. The Banks' operating expenses and imputed costs for providing this service totaled $21.0 million in 2011. Revenue from the service totaled $22.5 million and there was no other income, resulting in a net income of $1.5 million.

The Fedwire Securities Service allows its participants to transfer electronically to other service participants certain securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations.[8] In 2011, the number of non-Treasury securities transfers processed via the service decreased 8.3 percent from 2010, to approximately 7.3 million.

Float

In 2011, the Federal Reserve had daily average credit float of $1,151.8 million, compared with daily average credit float of $1,795.7 million in 2010.[9]

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8 The expenses, revenues, volumes, and fees reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and certain international organizations. Reserve Banks provide Treasury securities services in their role as the U.S. Treasury's fiscal agent. These services are not considered priced services. For details, see "Treasury Securities Services" on page 139.

9 Credit float occurs when the Reserve Banks present checks and other items to the paying bank prior to providing credit to the depositing bank (debit float occurs when the Reserve Banks credit the depositing bank before presenting checks and other items to the paying bank).

Provision of Federal Reserve Accounts and Services to Financial Market Utilities

Financial market utilities (FMUs) manage and operate multilateral systems for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions, or between financial institutions and an FMU. The Reserve Banks currently provide accounts and services only to FMUs with banking charters in a similar manner to other depository institutions. Title VIII of the Dodd-Frank Act allows the Board to authorize a Federal Reserve Bank to provide accounts and services to FMUs, irrespective of charter type, that are designated as systemically important by the Financial Stability Oversight Council, subject to any applicable rules, orders, standards, or guidelines as prescribed by the Board.

Currency and Coin

The Federal Reserve Board is the issuing authority for the nation's currency (in the form of Federal Reserve notes). In 2011, the Board paid the U.S. Treasury Department's Bureau of Engraving and Printing (BEP) approximately $623.3 million to produce 6.2 billion Federal Reserve notes. The Federal Reserve Banks distribute and receive currency and coin through depository institutions in response to public demand. In 2011, the Reserve Banks distributed 36.9 billion Federal Reserve notes into circulation (payments), a 1.6 percent increase from 2010, and received 35.1 billion Federal Reserve notes from circulation, a 0.7 percent decrease from 2010. The value of Federal Reserve notes in circulation increased approximately 9.6 percent in 2011, to $1,034.5 billion at year-end, largely because of international demand for $100 notes. In 2011, the Reserve Banks also distributed 68.1 billion coins into circulation, a 1.5 percent decrease from 2010, and received 59.8 billion coins from circulation, a 4.2 percent decrease from 2010.

During 2011, the Reserve Banks achieved a nearly 10 percent increase in currency-processing efficiency, which was associated with a program completed in 2010 to improve the hardware and upgrade the Reserve Banks' high-speed currency-processing machines' software. Reserve Banks continue to develop a new cash automation platform that will replace legacy software applications, automate business concepts and processes, and employ technologies to meet current and future needs for the cash business cost effectively. The applications will also facilitate business continuity and contingency planning and enhance the support provided to Reserve Bank customers.

During 2011, the Federal Reserve eliminated the currency paying, receiving, and processing operations at the San Antonio and Nashville Branches and replaced them with outsourced depot operations. Armored carriers operate the depots, which serve as collection points for depository institutions' currency deposits and distribution points for their orders. The armored carrier transports the deposits to the nearest Reserve Bank cash operation for processing, and the Reserve Bank prepares currency orders for the depot operator to distribute to depository institutions. The Pittsburgh Branch functioned as a Federal Reserve operated depot from 1997 to 2011. During 2011, the Federal Reserve outsourced the Pittsburgh depot operation to an armored carrier. The Federal Reserve now has 10 cash depots, all of which are outsourced to armored carriers.

New functionality of high-speed sorting sensors allowed the Banks to implement a policy in April that reduced the premature destruction of notes used extensively for transactional purposes ($1, $5, $10, and $20 notes) by allowing Reserve Banks to accept from and return to depository institutions bank notes either portrait-side-up or portrait-side-down. This misfaced notes policy decreased the destruction rate of $1 notes 5 percentage points, from 21 percent to 16 percent, and decreased the average destruction rate of $5 through $20 notes 4 percentage points, from 22 percent to 18 percent, between April and December. As a result of this policy, average note life for these denominations will increase by an estimated 10 months. Also as a result of the policy, the 2012 budget for new currency decreased by $14 million.

The Board continues to work with the BEP and the U.S. Secret Service to produce a more-secure, new-design $100 note. During 2011, the Board collaborated with the BEP and its paper supplier to resolve the creasing problem identified by the BEP in 2010. The BEP resumed production of the new-design $100 note in late 2011 and the results of production testing indicate that these mitigation steps have reduced the incidence of creasing.

The Board and its consulting firm continue to partner with the BEP in developing a new quality-assurance program for currency at the BEP. This new program will enable the BEP to meet the Board's increasing print order production quantity requirements and the production of more-complex bank notes into the future.

Fiscal Agency and Government Depository Services

As fiscal agents and depositories for the federal government, the Federal Reserve Banks auction Treasury securities, process electronic and check payments for Treasury, collect funds owed to the federal government, maintain Treasury's bank account, and develop, operate, and maintain a number of automated systems to support Treasury's mission. The Reserve Banks also provide certain fiscal agency and depository services to other entities; these services are primarily related to book-entry securities. Treasury and other entities fully reimbursed the Reserve Banks for the costs of providing fiscal agency and depository services.

In 2011, fiscal agency expenses amounted to $484.2 million, a 6.1 percent increase over 2010 (see table 3). These costs increased as a result of requests from Treasury's Bureau of the Public Debt and Financial Management Service. Support for Treasury programs accounted for 94.2 percent of the cost, and support for other entities accounted for 5.8 percent.

Treasury Securities Services

The Reserve Banks work closely with Treasury's Bureau of the Public Debt in support of the borrowing needs of the federal government. The Banks auction, issue, maintain, and redeem securities; provide customer service; and operate the automated systems supporting U.S. savings bonds and marketable Treasury securities (bills, notes, and bonds). Treasury securities services consist of retail securities programs (which primarily serve individual investors) and wholesale securities programs (which serve institutional customers).

Retail Securities Programs

Reserve Bank operating expenses for the retail securities programs were $79.3 million in 2011, reflecting an 8.5 percent increase compared with $73.1 million in 2010. This cost increase is largely explained by the transition and implementation costs associated with the Bureau of the Public Debt's mandate to consolidate the Reserve Banks' savings bond operations, implement image processing for savings bond redemptions, and continue implementing the Treasury Retail E-Services initiative.

In 2011, Treasury decided to consolidate the savings bond operations into a single location. The Reserve

Table 3. Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2009–2011
Thousands of dollars

Agency and service	2011	2010	2009
Department of the Treasury			
Bureau of the Public Debt			
Treasury retail securities	79,346	73,104	73,679
Treasury securities safekeeping and transfer	11,187	10,136	8,815
Treasury auction	29,258	30,750	30,216
Computer infrastructure development and support	1,969	1,980	2,333
Other services	4,036	1,646	1,375
Total	125,796	117,615	116,417
Financial Management Service			
Payment services	125,196	112,224	104,355
Collection services	38,707	37,611	37,967
Cash-management services	53,832	48,226	49,046
Computer infrastructure development and support	67,014	66,461	66,958
Other services	9,536	8,815	7,393
Total	294,285	273,337	265,719
Other Treasury			
Total	36,233	37,793	40,390
Total, Treasury	456,314	428,744	422,527
Other Federal Agencies			
Total, other agencies	27,893	27,700	27,758
Total reimbursable expenses	484,207	456,445	450,285

Banks completed the consolidation within budget, ahead of schedule, and with no degradation of customer service. In addition, the Reserve Banks began a project to take advantage of developments in image processing to handle savings bond redemptions, which will allow the Reserve Banks to retire software that was built solely to support Treasury savings-bond processing. Finally, the Reserve Banks continued working with the Bureau of the Public Debt on the Treasury Retail E-Services initiative, which will create a virtual customer service and support environment across the Bureau and Reserve Banks sites. Each of these initiatives involves up-front costs but is expected to yield significant savings in the future.

Wholesale Securities Programs

The Reserve Banks support wholesale securities programs through the sale, issuance, safekeeping, and transfer of marketable Treasury securities for institutional investors. Reserve Bank operating expenses in 2011 in support of Treasury securities auctions were $29.2 million, compared with $30.7 million in 2010. In 2011, the Banks conducted 269 Treasury securities auctions, compared with 301 in 2010. The decrease in the number of auctions was attributable primarily to the discontinuation of special cash-management bill auctions that funded the Supplementary Financing Program (SFP). The SFP was introduced by Treasury in 2008 to assist the Federal Reserve System with operations related to the financial crisis.

Operating expenses associated with Treasury securities safekeeping and transfer activities were $11.2 million in 2011, compared with $10.1 million in 2010. The cost increase reflected lower agency volume in 2011, which shifted more cost to Treasury.

Payments Services

The Reserve Banks work closely with Treasury's Financial Management Service and other government agencies to process payments to individuals and companies. For example, the Banks process federal payroll payments, Social Security and veterans' benefits, income tax refunds, vendor payments, and other types of payments.

Reserve Bank operating expenses for payments-related activity totaled $125.2 million in 2011, compared with $112.2 million in 2010. The significant increase in expenses is largely due to expanded requirements for several Treasury programs, notably Go Direct and GOVerify.

Go Direct is an ongoing effort focused on converting check benefit payments to direct deposit or debit cards. In 2011, expenses for Go Direct increased 69.0 percent, to more than $25 million, largely as a result of the construction of a new Go Direct call center. GOVerify is an initiative begun in 2011 and currently provides a single point of entry, or portal, where federal agencies will comply with an OMB mandate to query five data sources before making federal payments. These data sources are collectively known as the "Do Not Pay List." In 2011, expenses for GOVerify were $2.2 million.

The Reserve Banks also manage the Stored Value Card (SVC) program and the Internet Payment Platform (IPP). The SVC program provides stored value cards for use by military personnel on military bases. In 2011, the SVC program's expenses increased 6.6 percent, to $18.1 million, primarily because of a request from the military to purchase additional EagleCash (SVC) cards and new laptops. These expenses were slightly offset by the cancellation of a major SVC deployment.

The Internet Payment Platform (IPP) is part of Treasury's all-electronic initiative and is an electronic invoicing and payment information system that allows vendors to enter invoice data electronically, either through a web-based portal or electronic submission. The IPP accepts, processes, and presents data from agencies and supplier systems related to all stages of the transactions. During 2011, the Federal Reserve Banks' IPP expenses increased 25.8 percent, to $9.1 million. This increase is primarily driven by IPP's increased efforts to expand agency outreach and support in response to Treasury's initiative.

Collection Services

The Reserve Banks also work closely with Treasury's Financial Management Service to collect funds owed the federal government, including various taxes, fees for goods and services, and delinquent debts. In 2011, Reserve Bank operating expenses related to collection services increased by 2.9 percent largely as a result of ongoing support for Treasury's Collections and Cash Management Modernization initiative.

The Reserve Banks also continued to operate Pay.gov, an application supporting Treasury's program that allows the public to use the Internet to authorize and initiate payments to federal agencies. During the year, the Pay.gov program was expanded to include 103 new agency programs, which almost doubled the number of online payments processed by Pay.gov. This expansion resulted in expenses increasing 25.0 percent, to $10.5 million.

The Reserve Banks continued to support the government's centralized delinquent debt-collection program. Specifically, the Banks developed and maintained software that facilitates the collection of delinquent debts owed to federal agencies and states by matching federal payments against delinquent debts, including past-due child support payments owed to custodial parents.

Treasury Cash-Management Services

The Reserve Banks maintain Treasury's operating cash account and provide collateral-management and collateral-monitoring services for those Treasury programs that have collateral requirements. The Reserve Banks also support Treasury's efforts to modernize its financial management processes by developing software, operating help desks, and managing projects on behalf of the Financial Management Service. In 2011, Reserve Bank operating expenses related to Treasury cash-management services totaled $53.8 million, compared with $48.2 million in 2010.

During 2011, the Reserve Banks continued to support Treasury's effort to improve centralized government accounting and reporting functions. In particular, the Reserve Banks collaborated with the Financial Management Service on several ongoing software development efforts, such as the Governmentwide Accounting and Reporting Modernization initiative, which is intended to provide Treasury with a modernized system for the collection and dissemination of financial management and accounting information transmitted from and to federal program agencies.

Services Provided to Other Entities

When permitted by federal statute or when required by the Secretary of the Treasury, the Reserve Banks provide fiscal agency and depository services to other domestic and international entities. Reserve Bank operating expenses for services provided to other entities were $27.9 million in 2011, compared with $27.7 million in 2010, a change of less than 1 percent. Book-entry securities issuance and maintenance activities account for a significant amount of the work performed for other entities, with the majority performed for the Federal Home Loan Mortgage Association, the Federal National Mortgage Association, and the Government National Mortgage Association.

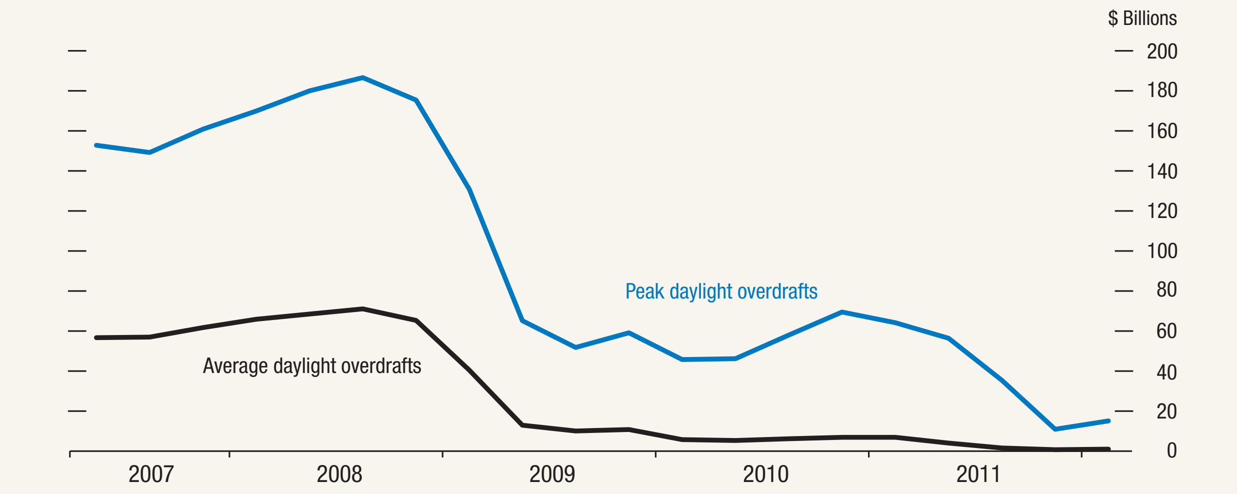
Postal money orders also account for a significant portion of the amount of work performed for other entities; they are processed primarily in image form, resulting in operational improvements, lower staffing levels, and lower costs to the U.S. Postal Service. Postal money orders accounted for 14.9 percent, or $4.1 million, of Reserve Bank operating expenses for services provided to other entities.

Use of Federal Reserve Intraday Credit

The Board's Payment System Risk (PSR) policy governs the use of Federal Reserve Bank intraday credit, also known as daylight overdrafts. A daylight overdraft occurs when an institution's account activity creates a negative balance in the institution's Federal Reserve account at any time in the operating day. Daylight overdrafts enable an institution to send payments more freely throughout the day than if it were limited strictly by its available funds balance. In 2011, the Board implemented significant revisions to the PSR policy to recognize explicitly the role of the central bank in providing intraday balances and credit to healthy depository institutions and to provide collateralized intraday credit at a zero fee. These changes better aligned the Federal Reserve's intraday credit policy with that of other central banks.

Institutions held historically high levels of overnight balances (on average about $1.5 trillion) at the Reserve Banks in 2011, while demand for daylight overdrafts on average remained historically low. In 2011, average daylight overdrafts across the System decreased to just under $2 billion from more than $6 billion in 2010, a decrease of about 70 percent (see figure 1). Similarly, the average level of peak daylight overdrafts decreased to almost $30 billion in 2011 from $60 billion in 2010, a decrease of about 50 percent. Before the financial crisis, overnight balances were much lower and daylight overdrafts significantly higher. In 2007, institutions held on average less than $20 billion in overnight balances and total average daylight overdrafts were $60 billion. In 2011, institutions paid less than $1 million in daylight overdraft fees, down from $6 million in 2010. The decrease in fees is largely attributable to the 2011 policy revision that eliminated fees for collateralized daylight overdrafts.

Figure 1. Aggregate Daylight Overdrafts, 2007–2011



Electronic Access to Reserve Bank Services

The Reserve Banks provide depository institutions with a variety of alternatives for electronically accessing the Banks' financial services payment and information services. These electronic-access solutions are designed to meet the individual connectivity and contingency requirements of depository institution customers.

For the past few years, as a result of the declining number of depository institutions, Reserve Bank electronic-access connections have decreased. At the same time, the number of employees within depository institutions who have credentials that establish them as trusted users increased, reflecting in part the expansion of electronic value-added services provided. Between 2007 and 2011, the total number of depository institutions in the U.S. declined 12.8 percent. The number of depository institutions with electronic-access connections declined 1.3 percent, while the number of trusted users increased 13.0 percent over the same period.

In 2011, the Reserve Banks expanded their service package options, adding a simplified, bundled payment services package, Fed Complete, and implementing a new product, Fed Transaction Analyzer, which is a risk-management tool to facilitate the analysis of payment transactions and to help automate risk and compliance-reporting requirements.

Information Technology

In 2011, the Federal Reserve Banks continued to improve the efficiency, effectiveness, and security of information technology (IT) services and operations.

To improve the efficiency and overall quality of operations, major multiyear initiatives are under way to consolidate the management and function of the Federal Reserve's help desk, server, and network operations. The consolidation of the help desk function was successfully completed, and progress continues toward the centralization of the remaining enterprise IT functions.

In addition, Federal Reserve Information Technology (FRIT) continued to lead the Reserve Banks' transition to a more robust information security posture by appointing a chief information security officer (CISO), who is responsible for maintaining System awareness of information security (IS) risk and coordinating IS activities among the Federal Reserve

Banks.[10] The CISO will be responsible, additionally, for overseeing the ongoing transition to the Federal Reserve System's IS framework, which is based on guidance from the National Institute of Science and Technology and adapted to the Federal Reserve's environment.[11]

Examinations of the Federal Reserve Banks

The Reserve Banks and the consolidated limited liability company (LLC) entities are subject to several levels of audit and review.[12] The combined financial statements of the Reserve Banks (see "Federal Reserve Banks Combined Financial Statements" in the "Federal Reserve System Audits" section of this report) as well as the financial statements of each of the 12 Banks and those of the consolidated LLC entities are audited annually by an independent public accountant retained by the Board of Governors.[13] In addition, the Reserve Banks, including the consolidated LLC entities, are subject to oversight by the Board of Governors, which performs its own reviews.

The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to assess their internal controls over financial reporting, including the safeguarding of assets. Within this framework, the management of each Reserve Bank annually provides an assertion letter to its board of directors that confirms adherence to COSO standards. Similarly, each consolidated LLC entity annually provides an assertion letter to the board of directors of the Federal Reserve Bank of New York (the New York Reserve Bank).

The Board engaged Deloitte & Touche LLP (D&T) to audit the 2011 combined and individual financial statements of the Reserve Banks and those of the consolidated LLC entities.[14]

In 2011, D&T also conducted audits of internal controls over financial reporting for each of the Reserve Banks and the consolidated LLC entities. Fees for D&T's services totaled $8 million, of which $2 million was for the audits of the consolidated LLC entities. To ensure auditor independence, the Board requires that D&T be independent in all matters relating to the audits. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence.

The Board's reviews of the Reserve Banks include a wide range of off-site and on-site oversight activities, conducted primarily by its Division of Reserve Bank Operations and Payment Systems. Division personnel monitor on an ongoing basis the activities of each Reserve Bank and consolidated LLC entity, FRIT, and the Office of Employee Benefits of the Federal Reserve System (OEB), and they conduct a comprehensive on-site review of each Reserve Bank, FRIT, and OEB at least once every three years.

The comprehensive on-site reviews typically include an assessment of the internal audit function's effectiveness and its conformance to the Institute of Internal Auditors' (IIA) *International Standards for the Professional Practice of Internal Auditing*, applicable policies and guidance, and the IIA's code of ethics.

The division also reviews the System Open Market Account (SOMA) and foreign currency holdings to determine whether the New York Reserve Bank, while conducting the related transactions, complies with the policies established by the Federal Open Market Committee (FOMC) and to assess SOMA-related IT project management and application development, vendor management, and system resiliency and contingency plans. In addition, D&T audits the year-end schedule of participated asset and liability accounts and the related schedule of participated income accounts. The FOMC is provided with the

10 FRIT supplies national infrastructure and business line technology services to the Federal Reserve Banks and provides thought leadership regarding the System's information technology architecture and business use of technology.

11 The National Institute of Science and Technology is a nonregulatory federal agency within the U.S. Department of Commerce.

12 The consolidated LLC entities were funded by the Federal Reserve Bank of New York (the New York Reserve Bank), and acquired financial assets and financial liabilities pursuant to the policy objectives. The consolidated LLC entities were determined to be variable interest entities, and the New York Reserve Bank is considered to be the controlling financial interest holder of each.

13 Each consolidated LLC entity reimburses the Board of Governors—from the entity's available net assets—for the fees related to the audit of its financial statements.

14 In addition, D&T audited the Office of Employee Benefits of the Federal Reserve System (OEB), the Retirement Plan for Employees of the Federal Reserve System (System Plan), and the Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The System Plan and the Thrift Plan provide retirement benefits to employees of the Board, the Federal Reserve Banks, and the OEB.

external audit reports and a report on the division's review.

Income and Expenses

Table 4 summarizes the income, expenses, and distributions of net earnings of the Reserve Banks for 2011 and 2010. Income in 2011 was $85,241 million, compared with $79,301 million in 2010.

Expenses totaled $8,719 million: $3,499 million in operating expenses, $3,773 million in interest paid to depository institutions on reserve balances and term deposits, and earnings credits granted to depository institutions, $44 million in interest expense on securities sold under agreements to repurchase, $472 million in assessments for Board of Governors expenditures, $649 million for new currency costs, $242 million for Consumer Financial Protection Bureau costs, and $40 million for Office of Financial Research costs. Net additions to and deductions from current net income totaled $2,016 million, which includes $2,268 million in realized gains on Treasury securities and federal agency and government-sponsored enterprise mortgage-backed securities (GSE MBS), $356 million in net loss associated with consolidated LLCs, $48 million in other deductions, and $152 million in unrealized gains on investments denominated in foreign currencies revalued to reflect current market exchange rates. Dividends paid to member banks, set at 6 percent of paid-in capital by section 7(1) of the Federal Reserve Act, totaled $1,577 million.

Distributions to the U.S. Treasury in the form of interest on Federal Reserve notes totaled $75,424 million in 2011. The distributions equal comprehensive income after the deduction of dividends paid and the amount necessary to equate the Reserve Banks' surplus to paid-in capital.

Table 4. Income, Expenses, and Distribution of Net Earnings of the Federal Reserve Banks, 2011 and 2010
Millions of dollars

Item	2011	2010
Current income	85,241	79,301
SOMA interest income	83,874	74,957
Loan interest income	674	3,528
Other current income[1]	693	816
Current expenses	7,316	6,270
Operating expenses[2]	3,499	3,489
Interest paid to depository institutions and earnings credits granted	3,773	2,687
Interest expense on securities sold under agreements to repurchase	44	94
Current net income	77,925	73,031
Net additions to (deductions from) current net income	2,016	9,746
Profit on sales of Treasury securities	2,258	0
Profit on sales of federal agency and government-sponsored enterprise mortgage-backed securities	10	782
Profit on foreign exchange transactions	152	554
Net income (loss) from consolidated LLCs	-356	7,560
Other additions[3]	-48	850
Assessments by the Board of Governors	1,403	1,088
For Board expenditures	472	422
For currency costs	649	623
For Consumer Financial Protection Bureau costs[4]	242	33
For Office of Financial Research costs[4]	40	10
Change in funded status of benefit plans	-1,162	46
Comprehensive income before distributions to Treasury	77,376	81,735
Dividends paid	1,577	1,583
Transferred to surplus and change in accumulated other comprehensive income	375	884
Distributions to U.S. Treasury[5]	75,424	79,268

1 Includes income from priced services, compensation received for services provided, and securities lending fees.

2 Includes a net periodic pension expense of $525 million in 2011 and $529 million in 2010.

3 Includes dividends on preferred interests and unrealized loss on Term Asset-Backed Securities Loan Facility loans.

4 The Board of Governors assesses the Reserve Banks to fund the operations of the Consumer Financial Protection Bureau and, for a two-year period beginning July 21, 2010, the Office of Financial Research.

5 Interest on Federal Reserve notes.

The "Statistical Tables" section of this report provides more detailed information on the Reserve Banks and the LLCs. Table 9 is a statement of condition for each Reserve Bank; table 10 details the income and expenses of each Reserve Bank for 2011; table 11 shows a condensed statement for each Reserve Bank for the years 1914 through 2011; and table 13 gives the number and annual salaries of officers and employees for each Reserve Bank. A detailed account of the assessments and expenditures of the Board of Governors appears in the Board of Governors Financial Statements (see "Federal Reserve System Audits").

SOMA Holdings and Loans

The Reserve Banks' average net daily holdings of securities and loans during 2011 amounted to $2,576,882 million, an increase of $453,109 million from 2010 (see **table 5**).

SOMA Securities Holdings

The average daily holdings of Treasury securities increased by $720,800 million, to an average daily amount of $1,557,878 million. The average daily holdings of GSE debt securities decreased by

Table 5. System Open Market Account (SOMA) Holdings and Loans of the Federal Reserve Banks, 2011 and 2010
Millions of dollars, except as noted

Item	Average daily assets (+)/liabilities (–)		Current income (+)/expense (–)		Average interest rate (percent)	
	2011	2010	2011	2010	2011	2010
U.S. Treasury securities[1]	1,557,878	837,078	42,257	26,373	2.71	3.15
Government-sponsored enterprise debt securities[1]	125,698	166,810	3,053	3,510	2.43	2.10
Federal agency and government-sponsored enterprise mortgage-backed securities[2]	918,007	1,079,230	38,281	44,839	4.17	4.15
Foreign currency denominated assets[3]	26,566	24,936	249	223	0.94	0.89
Securities purchased under agreements to resell	0	0	0	0	0.00	0.00
Central bank liquidity swaps[4]	5,368	989	34	12	0.63	1.21
Other SOMA assets[5]	8	288	*	*	…	…
Total SOMA assets	2,633,525	2,109,331	83,874	74,957	3.18	3.55
Securities sold under agreements to repurchase	-72,159	-58,476	-44	-94	0.06	0.16
Other SOMA liabilities[6]	-56	-799	*	…	0.00	0.00
Total SOMA liabilities	-72,215	-59,275	-44	-94	0.06	0.16
Total SOMA holdings	**2,561,310**	**2,050,056**	**83,830**	**74,863**	**3.27**	**3.65**
Primary, secondary. and seasonal credit	62	4,709	*	32	0.43	0.68
Term auction credit	0	7,105	0	18	…	0.25
Total loans to depository institutions	62	11,814	*	50	0.43	0.42
Credit extended to American International Group, Inc. (AIG), net[7, 8]	711	22,874	409	2,728	3.94	11.93
Term Asset-Backed Securities Loan Facility (TALF)[9]	14,799	39,029	265	750	1.79	1.92
Total loans to others	15,510	61,903	674	3,478	4.35	5.62
Total loans	**15,572**	**73,717**	**674**	**3,528**	**4.33**	**1.35**
Total SOMA holding and loans	**2,576,882**	**2,123,773**	**84,504**	**78,391**	**3.28**	**3.69**

1 Face value, net of unamortized premiums and discounts.
2 Face value of the securities, which is the remaining principal balance of the underlying mortgages, net of unamortized premiums and discounts. Does not include unsettled transactions.
3 Includes accrued interest. Foreign currency denominated assets are revalued daily at market exchange rates.
4 Dollar value of foreign currency held under these agreements valued at the exchange rate to be used when the foreign currency is returned to the foreign central bank. This exchange rate equals the market exchange rate used when the foreign currency was acquired from the foreign central bank.
5 Cash and short-term investments related to the federal agency and government-sponsored enterprise mortgage-backed securities portfolio.
6 Represents the obligation to return cash margin posted by counterparties as collateral under commitments to purchase and sell federal agency and GSE MBS, as well as obligations that arise from the failure of a seller to deliver securities on the settlement date.
7 Average daily balance includes outstanding principal and capitalized interest net of unamortized deferred commitment fees and allowance for loan restructuring, and excludes undrawn amounts and credit extended to consolidated limited liability companies.
8 As a result of the closing of the AIG recapitalization plan, $381 million of deferred commitment fees and allowances were recognized as interest income. The average interest rate calculation for 2011 excludes these items.
9 Represents the remaining principal balance. Excludes amount necessary to adjust TALF loans to fair value at December 31, which is reported in "Other assets" in the Statement of Condition of the Federal Reserve Banks in Table 9A in the "Statistical Tables" section of this report.
* Less than $500 thousand.
…Not applicable.

$41,112 million, to an average daily amount of $125,698 million. The average daily holdings of federal agency and GSE MBS decreased by $161,223 million, to an average daily amount of $918,007 million.

The increase in average daily holdings of Treasury securities is due to the purchases through a large-scale asset purchase program and reinvestment of principal payments from other SOMA holdings in Treasury securities. The average daily holdings of GSE debt securities and federal agency and GSE MBS decreased as a result of principal payments received.

Beginning in August 2010, principal payments received from Treasury securities, GSE debt securities, and federal agency and GSE MBS were reinvested in Treasury securities. Beginning in September 2011, principal payments from GSE debt securities and federal agency and GSE MBS were reinvested in federal agency and GSE MBS. There were no holdings of securities purchased under agreements to resell in 2011 or 2010. Average daily holdings of foreign currency denominated assets in 2011 were $26,566 million, compared with $24,936 million in 2010. The average daily balance of central bank liquidity swap drawings was $5,368 million in 2011 and $989 million in 2010. The average daily balance of securities sold under agreements to repurchase was $72,159 million, an increase of $13,683 million from 2010.

The average rates of interest earned on the Reserve Banks' holdings of Treasury securities decreased to 2.71 percent and the average rates on GSE debt securities increased to 2.43 percent in 2011. The average rate of interest earned on federal agency and GSE MBS increased to 4.17 percent in 2011. The average interest rates for securities sold under agreements to repurchase decreased to 0.06 percent in 2011. The average rate of interest earned on foreign currency denominated assets increased to 0.94 percent while the average rate of interest earned on central bank liquidity swaps decreased to 0.63 percent in 2011.

Lending

In 2011, the average daily primary, secondary, and seasonal credit extended by the Reserve Banks to depository institutions decreased by $4,647 million to $62 million. The average rate of interest earned on primary, secondary, and seasonal credit decreased to 0.43 percent in 2011, from 0.68 percent in 2010.

There were no extensions of credit outstanding under the Term Auction Facility in 2011; the last auction under the program was conducted in March 2010, and the related loans matured in April 2010.

On January 14, 2011, all outstanding draws under the American International Group, Inc. (AIG) revolving line of credit and the related accrued interest, capitalized interest, and capitalized commitment fees were paid in full as a result of the closing of the AIG recapitalization plan. AIG's outstanding draws under the revolving line of credit had an average daily balance of $711 million in 2011, which earned interest at an average rate of 3.94 percent.

The average daily balance of Term Asset-Backed Securities Loan Facility (TALF) loans in 2011 was $14,799 million, which earned interest at an average rate of 1.79 percent. The Board of Governors' authorization for the extension of new TALF loans expired in 2010. The authorization for TALF loans collateralized by newly issued asset-backed securities and legacy commercial mortgage-backed securities (CMBS) expired March 31, 2010, and TALF loans collateralized by newly issued CMBS expired June 30, 2010.

Investments of the Consolidated LLCs

Additional lending facilities established during 2008 and 2009, under authority of section 13(3) of the Federal Reserve Act, involved creating and lending to the consolidated LLC entities (see **table 6**). Consistent with generally accepted accounting principles, the assets and liabilities of these LLCs have been consolidated with the assets and liabilities of the New York Reserve Bank in the preparation of the statements of condition included in this report. The proceeds at the maturity or the liquidation of the consolidated LLCs' assets are used to repay the loans extended by the New York Reserve Bank.

Federal Reserve Bank Premises

Several Reserve Banks took action in 2011 to maintain and renovate their facilities. The multiyear renovation programs at the New York, St. Louis, and San Francisco Reserve Banks' headquarters buildings continued. Security-enhancement programs continued at several facilities, including the construction of a remote vehicle-screening facility and main entrance lobby security improvements for the Dallas Reserve Bank's headquarters buildings.

Table 6. Key Financial Data for Consolidated Limited Liability Companies, 2011 and 2010

Millions of dollars

Item	Commercial Paper Funding Facility LLC (CPFF)		TALF LLC		Maiden Lane LLC		Maiden Lane II LLC		Maiden Lane III LLC		Total LLCs	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
Net portfolio assets of the consolidated LLCs and the net position of the New York Reserve Bank (FRBNY) and subordinated interest holders												
Net portfolio assets[1]	...	...	811	665	7,805	27,961	9,257	16,457	17,820	23,583	35,693	68,666
Liabilities of consolidated LLCs	...	...	0	0	-684	-915	-3	-2	-3	-4	-690	-921
Net portfolio assets available[2]	...	...	811	665	7,121	27,046	9,254	16,455	17,817	23,579	35,003	67,745
Loans extended to the consolidated LLCs by the FRBNY[3]	...	...	0	0	4,859	25,845	6,792	13,485	9,826	14,071	21,477	53,401
Other beneficial interests[3, 4]	...	...	109	106	1,385	1,315	1,106	1,071	5,542	5,366	8,142	7,858
Total loans and other beneficial interests	...	...	109	106	6,244	27,160	7,898	14,556	15,368	19,437	29,619	61,259
Cumulative change in net assets since the inception of the program[5]												
Allocated to FRBNY	...	...	32	-65	877	0	1,130	1,582	1,641	2,775	3,680	4,292
Allocated to other beneficial interests	...	...	669	624	0	-114	226	317	808	1,367	1,703	2,194
Cumulative change in net assets	...	...	701	559	877	-114	1,356	1,899	2,449	4,142	5,383	6,486
Summary of consolidated LLC net income, including a reconciliation of total consolidated LLC net income to the consolidated LLC net income recorded by FRBNY												
Portfolio interest income[6]	...	213	0	1	808	1,133	609	794	2,012	2,299	3,429	4,440
Interest expense on loans extended by FRBNY[7]	...	-4	0	0	-138	-205	-117	-186	-146	-204	-401	-599
Interest expense–other	...	0	-4	-4	-70	-66	-36	-34	-175	-173	-285	-277
Portfolio holdings gains (losses)	...	1	0	0	434	2,571	-991	2,467	-3,363	3,141	-3,920	8,180
Professional fees	...	-2	0	-1	-43	-69	-8	-10	-20	-22	-71	-104
Net income (loss) of consolidated LLCs	...	208	-4	-4	991	3,364	-543	3,031	-1,692	5,041	-1,248	11,640
Less: Net income (loss) allocated to other beneficial interests	...	...	44	-75	114	1,135	-91	1,353	-558	2,266	-491	4,679
Net income (loss) allocated to FRBNY	...	208	-48	71	877	2,229	-452	1,678	-1,134	2,775	-757	6,961
Add: Interest expense on loans extended by FRBNY, eliminated in consolidation[7]	...	4	0	0	138	205	117	186	146	204	401	599
Net income (loss) recorded by FRBNY	...	212	-48[8]	71[8]	1,015	2,434	-335	1,864	-988	2,979	-356	7,560
Balances of loans extended to the consolidated LLCs by the FRBNY												
Balance at beginning of the year	...	9,378	0	0	25,845	29,233	13,485	16,004	14,071	18,500	53,401	73,115
Accrued and capitalized interest	...	4	0	0	138	204	117	186	146	204	401	598
Repayments	...	-9,382	0	0	-21,124	-3,592	-6,810	-2,705	-4,391	-4,633	-32,325	-20,312
Balance at end of the year	...	0	0	0	4,859	25,845	6,792	13,485	9,826	14,071	21,477	53,401

Note: CPFF LLC was formed to provide liquidity to the commercial paper market. The last commercial paper purchases by the CPFF matured on April 26, 2010, and the CPFF was dissolved on August 30, 2010. TALF LLC was formed in 2009 to purchase assets of the Term Asset-Backed Securities Loan Facility, which was formed to improve market conditions for asset-backed securities. Maiden Lane LLC was formed to acquire certain assets of Bear Stearns; Maiden Lane II LLC and Maiden Lane III LLC were formed to acquire certain assets of AIG and its subsidiaries.

1 TALF, Maiden Lane, Maiden Lane II, and Maiden Lane III holdings are recorded at fair value. Fair value reflects an estimate of the price that would be received upon selling an asset if the transaction were to be conducted in an orderly market on the measurement date.

2 Represents the net assets available for repayment of loans extended by FRBNY and “other beneficiaries” of the consolidated LLCs.

3 Book value. Includes accrued interest.

4 The other beneficial interest holders are the U.S. Treasury for TALF LLC, JPMorgan Chase for Maiden Lane LLC, and AIG for Maiden Lane II LLC and Maiden Lane III LLC.

5 Represents the allocation of the change in net assets and liabilities of the consolidated LLCs that are available for repayment of the loans extended by FRBNY and the other beneficiaries of the consolidated LLCs. The differences between the fair value of the net assets available and the book value of the loans (including accrued interest) are indicative of gains or losses that would be incurred by the beneficiaries if the assets had been fully liquidated at prices equal to the fair value.

6 Interest income is recorded when earned and includes amortization of premiums, accretion of discounts, and paydown gains and losses.

7 Interest expense recorded by each consolidated LLC on the loans extended by FRBNY is eliminated when the LLCs are consolidated in FRBNY's financial statements and, as a result, the consolidated LLCs’ net income (loss) recorded by FRBNY is increased by this amount.

8 In addition to the net income attributable to TALF LLC, FRBNY earned $181 million on TALF loans during the year ended December 31, 2011 (interest income of $265 million and a loss on the valuation of loans of $84 million). FRBNY earned $327 million on TALF loans during the year ended December 31, 2010 (interest income of $750 million, loss on the valuation of loans of $436 million, and administrative fees of $13 million).

...Not applicable.

The New York Reserve Bank evaluated the purchase of the 33 Maiden Lane property; the purchase was completed in February 2012. The San Francisco Reserve Bank continued its efforts to sell the building formerly used to house its Seattle Branch operations, and the Atlanta Reserve Bank initiated efforts to sell its Nashville Branch building. Additionally, the Cleveland and Dallas Reserve Banks consolidated certain operations performed at their Pittsburgh and San Antonio Branches, respectively, into other Reserve Bank offices. As a result, these Reserve Banks will maintain smaller Branch staffs. The Cleveland Reserve Bank is preparing to sell the Pittsburgh Branch building, and the Dallas Reserve Bank is evaluating options for the San Antonio Branch building.

For more information on the acquisition costs and net book value of the Federal Reserve Banks and Branches, see table 14 in the "Statistical Tables" sectionof this report.

Pro Forma Financial Statements for Federal Reserve Priced Services

Table 7: Pro Forma Balance Sheet for Federal Reserve Priced Services, December 31, 2011 and 2010
Millions of dollars

Item	2011		2010	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	262.3		248.8	
Imputed investments	2,805.3		3,463.4	
Receivables	38.7		45.6	
Materials and supplies	1.4		1.2	
Prepaid expenses	7.7		17.2	
Items in process of collection	275.4		374.5	
Total short-term assets		3,390.9		4,150.6
Long-term assets (Note 2)				
Premises	180.8		245.3	
Furniture and equipment	38.2		57.3	
Leases, leasehold improvements, and long-term prepayments	74.6		65.6	
Prepaid pension costs	321.9		354.7	
Prepaid FDIC asset	21.7		25.0	
Deferred tax asset	138.5		132.4	
Total long-term assets		775.7		880.2
Total assets		4,166.6		5,030.8
Short-term liabilities				
Clearing balances	2,622.5		2,487.6	
Deferred-availability items	910.3		1,814.7	
Short-term debt	0.0		0.0	
Short-term payables	44.1		43.6	
Total short-term liabilities		3,576.9		4,345.9
Long-term liabilities				
Long-term debt	0.0		0.0	
Accrued benefit costs	381.3		392.3	
Total long-term liabilities		381.3		392.3
Total liabilities		3,958.2		4,738.2
Equity (including accumulated other comprehensive loss of $288.9 million and $267.6 million at December 31, 2011 and 2010, respectively)		208.3		292.6
Total liabilities and equity (Note 3)		4,166.6		5,030.8

Note: Components may not sum to totals because of rounding. The accompanying notes are an integral part of these pro forma priced services financial statements.

Table 8: Pro Forma Income Statement for Federal Reserve Priced Services, 2011 and 2010
Millions of dollars

Item	2011		2010	
Revenue from services provided to depository institutions (Note 4)		477.4		566.7
Operating expenses (Note 5)		421.3		503.9
Income from operations		56.1		62.9
Imputed costs (Note 6)				
Interest on float	-1.3		-3.2	
Interest on debt	0.0		0.0	
Sales taxes	4.8		5.1	
FDIC Insurance	3.2	6.8	6.3	8.2
Income from operations after imputed costs		49.3		54.6
Other income and expenses (Note 7)				
Investment income	2.5		10.7	
Earnings credits	-1.4	1.2	-2.7	7.9
Income before income taxes		50.5		62.5
Imputed income taxes (Note 6)		16.3		20.7
Net income		34.1		41.8
Memo: Targeted return on equity (Note 6)		16.8		13.1

Note: Components may not sum to totals because of rounding. The accompanying notes are an integral part of these pro forma priced services financial statements.

Table 9: Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2011
Millions of dollars

Item	Total	Commercial check collection	Commercial ACH	Fedwire funds	Fedwire securities
Revenue from services (Note 4)	477.4	259.2	111.7	84.0	22.5
Operating expenses (Note 5)	421.3	224.0	102.7	74.7	20.0
Income from operations	56.1	35.3	9.0	9.3	2.5
Imputed costs (Note 6)	6.8	3.2	1.8	1.4	0.4
Income from operations after imputed costs	49.3	32.1	7.2	7.8	2.1
Other income and expenses, net (Note 7)	1.2	0.7	0.3	0.2	0.0
Income before income taxes	50.5	32.8	7.5	8.0	2.2
Imputed income taxes (Note 6)	16.3	10.6	2.4	2.6	0.7
Net income	34.1	22.2	5.1	5.4	1.5
Memo: Targeted return on equity (Note 6)	16.8	8.8	4.1	3.0	0.8
Cost recovery (percent) (Note 8)	103.8	105.4	100.8	103.0	103.1

Note: Components may not sum to totals because of rounding. The accompanying notes are an integral part of these pro forma priced services financial statements.

Notes to Pro Forma Financial Statements for Priced Services

(1) Short-Term Assets

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as balances maintained; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances and deposit balances arising from float are assumed to be invested in a portfolio of investments, shown as imputed investments.

Receivables are composed of fees due the Reserve Banks for providing priced services and the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection are gross Federal Reserve cash items in process of collection (CIPC), stated on a basis comparable to that of a commercial bank. They reflect adjustments for intra-System items that would otherwise be double-counted on a combined Federal Reserve balance sheet; adjustments for items associated with nonpriced items (such as those collected for government agencies); and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) Long-Term Assets

Long-term assets consist of long-term assets used solely in priced services, the priced-service portion of long-term assets shared with nonpriced services, an estimate of the assets of the Board of Governors used in the development of priced services, an imputed prepaid Federal Deposit Insurance Corporation (FDIC) asset (see note 6), and a deferred tax asset related to the priced services pension and postretirement benefits obligation (see note 3).

(3) Liabilities and Equity

Under the matched-book capital structure for assets, short-term assets are financed with short-term payables and clearing balances. Long-term assets are financed with long-term liabilities and core clearing balances. As a result, no short- or long-term debt is imputed. Other short-term liabilities include clearing balances maintained at Reserve Banks. Other long-term liabilities consist of accrued postemployment, postretirement, and qualified and nonqualified pension benefits costs and obligations on capital leases.

Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (codified in FASB Accounting Standards Codification (ASC) Topic 715 (ASC 715), Compensation–Retirement Benefits), which requires an employer to record the funded status of its benefit plans on its balance sheet. In order to reflect the funded status of its benefit plans, the Reserve Banks recognized the deferred items related to these plans, which include prior service costs and actuarial gains or losses, on the balance sheet. This resulted in an adjustment to the pension and benefit plans related to priced services and the recognition of an associated deferred tax asset with an offsetting adjustment, net of tax, to accumulated other comprehensive income (AOCI), which is included in equity. The Reserve Bank priced services recognized a net pension asset in 2011 and 2010. The change in the funded status resulted in a corresponding increase in accumulated other comprehensive loss of $21.3 million in 2011.

To satisfy the FDIC requirements for a well-capitalized institution, equity is imputed at 5 percent of total assets.

(4) Revenue

Revenue represents fees charged to depository institutions for priced services, and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits (see note 7).

(5) Operating Expenses

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses of the Board of Governors related to the development of priced services. Board expenses were $5.2 million in 2011 and $7.2 million in 2010.

Effective January 1, 1987, the Reserve Banks implemented SFAS No. 87, Employers' Accounting for Pensions (codified in ASC 715). Accordingly, the Reserve Bank priced services recognized qualified pension-plan operating expenses of $45.2 million in 2011 and $53.8 million in 2010. Operating expenses also include the nonqualified pension expense of $3.1 million in 2011 and $4.4 million in 2010. The implementation of SFAS No. 158 (ASC 715) does not change the systematic approach required by generally accepted accounting principles to recognize the expenses associated with the Reserve Banks' benefit plans in the income statement. As a result, these expenses do not include amounts related to changes in the funded status of the Reserve Banks' benefit plans, which are reflected in AOCI (see note 3).

The income statement by service reflects revenue, operating expenses, imputed costs, other income and expenses, and cost recovery.

(6) Imputed Costs

Imputed costs consist of income taxes, return on equity, interest on debt, sales taxes, an FDIC assessment, and interest on float. Many imputed costs are derived from the private-sector adjustment factor (PSAF) model. The cost of debt and the effective tax rate are derived from bank holding company data, which serve as the proxy for the financial data of a representative private-sector firm, and are used to impute debt and income taxes in the PSAF model. The after-tax rate of return on equity is based on the returns of the equity market as a whole and is applied to the equity on the balance sheet to impute the profit that would have been earned had the services been provided by a private-sector firm. In October 2008, the Federal

Reserve began paying interest on required reserve and excess balances held by depository institutions at Reserve Banks, as authorized by the Emergency Economic Stabilization Act of 2008. Beginning in 2009, given the uncertain long-term effect that payment of interest on reserve balances would have on the level of clearing balances, the equity used to determine the imputed profit has been adjusted to reflect the actual clearing balance levels maintained; previously, projections of clearing balance levels were used.

Interest is imputed on the debt assumed necessary to finance priced-service assets; there was no need to impute debt in 2011 or 2010. The imputed FDIC assessment reflects rate and assessment methodology changes in 2011.

Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for the check, Fedwire Funds, ACH, and Fedwire Securities services.

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses, less shipping expenses, for each service to the total expenses, less the total shipping expenses, for all services.

The following shows the daily average recovery of actual float by the Reserve Banks for 2011, in millions of dollars:

Total float	-1,151.8
Unrecovered float	4.1
Float subject to recovery	-1,156.0
Sources of recovery of float	
Direct charges	1.6
Per-item fees	-1,157.5

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float that is created by account adjustments due to transaction errors and the observance of nonstandard holidays by some depository institutions was recovered from the depository institutions through charging institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2011 and 2010.

(7) Other Income and Expenses

Other income and expenses consist of investment and interest income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2011 and 2010 represents the average coupon-equivalent yield on three-month Treasury bills. The investment return is applied to the required portion of the clearing balance. Other income also includes imputed interest on the portion of clearing balances set aside as required reserves. Expenses for earnings credits granted to depository institutions on their clearing balances are based on a discounted average coupon-equivalent yield on three-month Treasury bills.

(8) Cost Recovery

Annual cost recovery is the ratio of revenue, including other income, to the sum of operating expenses, imputed costs, imputed income taxes, and targeted return on equity.

Other Federal Reserve Operations

Regulatory Developments: Dodd-Frank Act Implementation

The Federal Reserve continued to work diligently throughout 2011 to implement the many regulatory changes required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the act) (Pub. L. No. 111–203).

Enacted on July 21, 2010, the Dodd-Frank Act seeks to address critical gaps and weaknesses in the U.S. regulatory framework that were revealed by the financial crisis. The act gives the Federal Reserve important responsibilities to issue rules to enhance financial stability and preserve the safety and soundness of the banking system.

In addition to membership on the Financial Stability Oversight Council (FSOC), the Federal Reserve's new responsibilities include the supervision of savings and loan holding companies (SLHCs) as well as oversight of nonbank financial firms and certain payment, clearing, and settlement utilities that the FSOC designates as systemically important. In consultation with other agencies, the Federal Reserve also is responsible for developing more stringent prudential standards for all large banking organizations and for nonbank firms designated by the FSOC as systemically important.

As of December 31, 2011, the Board had issued seventeen final rules, four public notices, and nine reports required by the act. The Board had also proposed an additional 15 rules for public comment.[1] (See **box 1** for additional information.)

The Rulemaking Process

With each regulation, the Board seeks to identify—and, to the extent possible consistent with statutory requirements, minimize—the regulatory burden imposed by the rule. The Board does this in a variety of ways, and at several different stages in the regulatory process. For example, before developing a regulatory proposal, the Board often collects information through surveys and meetings directly from the parties that might be affected by the rulemaking. These efforts help the Board become more informed about the benefits and costs of the proposed rule and enable it to craft a proposal that is both effective and that minimizes regulatory burden.

During the rulemaking process, the Board also specifically seeks comment from the public on the benefits and costs of the proposed approach as well as on a variety of alternative approaches to the proposal.

Box 1. Dodd-Frank Implementation Progresses in 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gives the Federal Reserve important responsibilities to enhance financial stability and preserve the safety and soundness of the banking system. In 2011, staff throughout the Federal Reserve System participated in a wide range of rulemakings and other projects designed to implement these new responsibilities. While a sizable number of projects have already been completed, additional work is needed to ensure the Board's obligations under the Dodd-Frank Act are met quickly, carefully, and responsibly.

As of December 31, 2011, the Board had issued seventeen final rules, four public notices, and nine reports required by the act. The Board also has provided assistance to the Financial Stability Oversight Council, facilitated the transition of certain authority from the Office of Thrift Supervision to the Board, helped with the establishment of the Consumer Financial Protection Bureau and the Office of Financial Research, and participated in several joint rulemakings and consultations with other agencies.

For a full list of initiatives completed in 2011 (and to preview 2012 initiatives), visit the Board's Regulatory Reform website at www.federalreserve.gov/newsevents/reform_milestones.htm.

[1] These figures include Board actions since the enactment of the act on July 21, 2010.

In adopting the final rule, the Board aims for a regulatory approach that faithfully reflects the statutory provisions and the intent of Congress while minimizing regulatory burden. The Board also provides an analysis of the costs to small organizations of the rulemaking, consistent with the Regulatory Flexibility Act, and computes the anticipated costs of paperwork, consistent with the Paperwork Reduction Act.

Changes to Banking Supervision and Regulation

The Board has issued a variety of final rules to implement the provisions of the Dodd-Frank Act that are designed to promote the safety and soundness of the banking system. Following is a summary of the key regulatory initiatives that were completed during 2011 under the act.

Regulatory Capital

The Dodd-Frank Act establishes floors for regulatory capital requirements applied to domestic bank holding companies (BHCs) and designated nonbank financial companies supervised by the Board. Specifically, section 171 of the act requires the Board to establish minimum risk-based capital and leverage requirements for BHCs that are not less than the "generally applicable" capital requirements for insured depository institutions.

Consistent with this provision, on June 14, 2011, the Board adopted a final rule amending its capital framework to require a banking organization operating under the advanced approaches risk-based capital rules to meet the higher of the minimum requirements under the generally applicable capital requirements and the minimum requirements under the advanced approaches risk-based capital rules.

This rule was promulgated jointly with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC). In the coming months, the federal banking agencies expect to jointly propose revisions to their regulatory capital rules consistent with changes to international capital standards issued by the Basel Committee on Banking Supervision. The proposed rules would be consistent with the capital requirements established under section 171 of the act.

Resolution Planning

The Dodd-Frank Act requires BHCs with total consolidated assets of $50 billion or more and any nonbank financial company supervised by the Board (collectively, covered companies) to periodically submit to the Board, the FDIC, and the FSOC a plan for such company's rapid and orderly resolution, under the bankruptcy code, in the event of material financial distress or failure. These resolution plans, or "living wills," will assist covered companies and regulators in conducting advance resolution planning for a covered company.

On October 17, 2011, the Board and the FDIC issued a final rule requiring covered companies to annually submit resolution plans. Large, complex covered companies are required to submit a resolution plan that covers the entire organization. Smaller, less complex companies can file a streamlined resolution plan.

The Board's resolution plan rule is codified as Regulation QQ (12 CFR part 243). A company's resolution plan must describe the company's strategy for rapid and orderly resolution in bankruptcy during a time of financial distress or failure of the company, and the plan must include information concerning the company's operations and funding.

Under Regulation QQ, a company's resolution plan must also include information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of nonbank subsidiaries of the company; detailed descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company; identification of the cross-guarantees tied to different securities; and a description of the governance and oversight process related to resolution planning.

The act also instructed the Board to conduct two studies in consultation with the Administrative Office of the U.S. Courts regarding the resolution of financial companies: one regarding the resolution of domestic financial companies under the Bankruptcy Code, and one regarding international coordination relating to the resolution of systemic financial companies under the Bankruptcy Code and applicable foreign laws. The Board issued both studies in July 2011.[2]

Supervision of SLHCs

The act transferred all supervisory and regulatory authority over SLHCs from the Office of Thrift

[2] The studies are available on the Board's website at www.federalreserve.gov/publications/other-reports/default.htm.

Supervision (OTS) to the Board, effective July 21, 2011 (the transfer date). It also grants the Board the authority to examine, obtain reports from, and establish consolidated capital standards for SLHCs.

The Board undertook several initiatives to provide SLHCs with advance notice of how the Board would supervise and regulate SLHCs after the transfer date.

- The Board, OTS, OCC, and FDIC issued a joint report on January 25, 2011, regarding the agencies' plans to implement the transfer of OTS authorities on January 25, 2011.
- The Board issued a public notice on February 3, 2011, of its intention to require SLHCs to submit the same regulatory reports as BHCs.[3]
- The Board issued a public notice on April 15, 2011, that described how the Board would apply certain parts of its consolidated supervisory program for BHCs to SLHCs after the transfer date. On the transfer date, the Board issued a public notice of all the OTS regulations that the Board would continue to enforce.
- The Board issued an interim final rule on August 12, 2011, establishing regulations for SLHCs. New Regulation LL, governing SLHCs generally, and new Regulation MM, governing SLHCs in mutual form, transfer from the OTS to the Board the regulations necessary for the Board to administer the statutes governing SLHCs.

Debit Interchange

Section 1075 of the act restricts the interchange fees that debit card issuers may receive for electronic debit card transactions. Specifically, under the act, the interchange fee an issuer receives for a particular transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. The act requires the Board to set standards for determining whether an interchange fee is reasonable and proportional to the issuer's cost and permits the Board to adjust the interchange fee to account for an issuer's fraud-prevention costs. In addition, it requires the Board to prescribe rules prohibiting network exclusivity arrangements and routing restrictions in connection with electronic debit card transactions.

[3] On December 23, 2011, the Board issued a final notice permitting a two-year phase-in period for most SLHCs to file Federal Reserve regulatory reports and an exemption for some SLHCs from initially filing such reports.

On June 29, 2011, the Board issued a final rule to establish standards for debit card interchange fees. Under the final rule, the maximum permissible interchange fee that an issuer may receive for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. This provision regarding debit card interchange fees became effective on October 1, 2011. Also on June 29, the Board issued an interim final rule that allows for an upward adjustment of no more than one cent to an issuer's debit card interchange fee, provided the issuer satisfies the fraud-prevention standards set forth in the interim final rule. The interim final rule became effective on October 1, 2011.

In accordance with the statute, the final rule exempts issuers that, together with their affiliates, have assets of less than $10 billion from the debit card interchange fee standards. To facilitate implementation of the small issuer exemption, the Board has published lists of institutions with consolidated assets above and below the $10 billion exemption threshold and plans to survey networks and publish annually the average interchange fees each network provides to its exempt and nonexempt issuers.

In addition, the rule prohibits all issuers and networks from restricting the number of networks over which electronic debit transactions may be processed to less than two unaffiliated networks. The rule also prohibits issuers and networks from inhibiting a merchant's ability to direct the routing of the electronic debit transaction over any network that the issuer has enabled to process them.

The Board also has issued several reports regarding interchange fees, as required by the act. On June 29, 2011, the Board issued a report disclosing certain aggregate and summary information concerning transaction processing costs and interchange transaction fees charged or received in connection with electronic debit transactions.[4] On July 21, 2011, the Board issued a report on the use of prepaid cards by government-administered payment programs as well as the interchange and cardholder fees charged with respect to such prepaid cards.[5]

[4] See *2009 Interchange Revenue, Covered Issuer Cost, and Covered Issuer and Merchant Fraud Loss Related to Debit Card Transactions,* www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf.

[5] See *Report to the Congress on Government-Administered, General-Use Prepaid Cards*, www.federalreserve.gov/

Interest on Demand Deposits

Section 627 of the act repealed the provision of the Federal Reserve Act that prohibited member banks from paying interest on demand deposits. This prohibition had been implemented through the Board's Regulation Q. On July 14, 2011, the Board issued a final rule repealing Regulation Q and thereby allowing member banks to pay interest on demand deposits.

Key Regulatory Initiatives Still in Development

A number of important regulatory developments remain in the proposal stage. Following is a summary of additional regulatory initiatives that the Board proposed in 2011.

Enhanced Prudential Standards for Financial Firms

The act requires the Board to establish heightened prudential standards for covered companies.[6] The heightened standards must be more stringent than the standards that apply to other nonbank financial companies and BHCs that do not pose similar risks to the financial system.

On December 20, 2011, the Board proposed enhanced prudential standards related to capital, limits on credit exposure to single counterparties, liquidity, stress testing, and risk management. The enhanced prudential standards are intended to strengthen the financial resilience of covered companies and limit the exposure of such companies to individual counterparties. The proposed standards generally apply to covered companies other than covered companies that are foreign banking organizations (U.S. covered companies). The Board expects to issue a separate proposal that would apply the enhanced prudential standards to foreign banking organizations (FBOs).

The proposed standards would subject U.S. covered companies to the Board's capital plan rule, which the Board approved on November 22, 2011. Under the capital plan rule, the Federal Reserve annually would evaluate institutions' capital adequacy; their internal capital adequacy assessment processes; and their plans to make capital distributions, such as dividend payments or stock repurchases. The Federal Reserve would not object to proposed dividend increases or other capital distributions only if companies are able to demonstrate sufficient financial strength to operate as successful financial intermediaries under stressed macroeconomic and financial market scenarios, even after making the desired capital distributions.

The enhanced prudential standards would also apply a net limit for credit exposure of a U.S. covered company to any single counterparty as a percentage of the company's regulatory capital. In addition, the standards would set a two-tier single-counterparty credit limit, with a more stringent credit limit applied to credit exposures between the largest U.S. covered companies and large counterparties.

Further, the proposed standards would establish a general limit that prohibits a U.S. covered company from having aggregate net credit exposures to any single unaffiliated counterparty in excess of 25 percent of the enhanced standard company's capital stock and surplus. The proposal also would set a more stringent 10 percent aggregate net credit exposure limit between nonbank covered companies and BHCs with total consolidated assets of $500 billion or more (collectively, "major covered companies") on the one hand, and counterparties that are major covered companies or FBOs with total consolidated assets of $500 billion or more on the other hand.

Also under the proposed standards, U.S. covered companies would be required to comply with qualitative liquidity risk-management standards generally based on interagency liquidity risk-management guidance. Specifically, the proposal would require U.S. covered companies to conduct internal liquidity stress tests and set internal quantitative limits to manage liquidity risk.

In addition, the Board would conduct annual stress tests of U.S. covered companies using three economic and financial market scenarios and publish a summary of the results, including company-specific information. The proposed standards also would require U.S. covered companies and state member banks, BHCs, and—subject to a delayed effective date—SLHCs with assets above $10 billion to conduct one or more company-run stress tests each year and make a summary of the results public.

Moreover, the standards would require U.S. covered companies and publicly traded BHCs with total consolidated assets of $10 billion or more to establish

publications/other-reports/files/government-prepaid-report-201107.pdf.

[6] See "Resolution Planning" on page 156 for more information on covered companies.

risk committees of their boards of directors and to institute enterprise-wide risk-management programs that would be overseen by the risk committees. The proposal also would require that each U.S. covered company retain a chief risk officer, and maintain its risk committee as a separately chartered committee of the board of directors.

Finally, the proposed standards would establish early remediation triggers—such as capital levels, stress test results, and risk-management weaknesses—so that financial weaknesses are addressed by U.S. covered companies at an early stage.

Prohibitions against Proprietary Trading and Other Activities

Section 619 of the Dodd-Frank Act generally prohibits banking entities from engaging in short-term proprietary trading for a banking entity's own account, subject to certain exemptions. That section also prohibits a banking entity from owning, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. These prohibitions are commonly known as the "Volcker rule." The prohibitions and restrictions contained in the Volcker rule apply to all insured depository institutions; BHCs; SLHCs; companies that control an industrial loan company; foreign banks with a branch, agency, or subsidiary bank in the United States; and affiliates and subsidiaries of these entities.

The Board, OCC, FDIC, Commodity Futures Trading Commission (CFTC), and Securities and Exchange Commission (SEC) are responsible for developing and adopting regulations to implement the prohibitions and restrictions of the Volcker rule. On October 11, 2011, the Board requested comment on a proposed rule, developed jointly with the other agencies, to implement the Volcker rule. The proposal would implement the Volcker rule's prohibitions and, consistent with statutory authority, would provide certain key statutory exemptions, including market making, underwriting, and risk-mitigating hedging. On December 23, 2011, the Board, FDIC, OCC, and SEC extended the comment period on the proposal to implement the Volcker rule through February 13, 2012.

The Board alone is responsible for adopting rules to implement the conformance period provisions of the Volcker rule. On February 9, 2011, the Board issued a final rule to give banking entities a period of time to conform their activities and investments to the prohibitions and restrictions of the Volcker rule. The final rule includes a general two-year conformance period, and it allows the Board to extend, by rule or order, this two-year period by up to three one-year periods. In addition, the final rule implements a special five-year extended transition period available for certain qualifying investments in hedge funds and certain private equity funds. The conformance period is intended to give markets and firms an opportunity to adjust to the Volcker rule.

Regulation of Derivative Markets

The act makes a number of significant changes to the regulation of derivatives, which it refers to as "swaps" and "security-based swaps," as well as to the regulation of participants in the derivatives markets.

In general, the act requires (1) all standardized derivatives to be centrally cleared and traded on an exchange or registered execution facility; (2) all derivatives to be reported to registered data repositories; (3) all derivatives dealers ("swap dealers") and major market participants ("major swap participants") to register with the SEC and/or the CFTC; and (4) the establishment of new, regulated organizations to support the derivatives market, including exchanges, clearing organizations, and data repositories. In addition, the act amends sections 23A and 23B of the Federal Reserve Act by, among other things, expanding the definition of "covered transaction" to include credit exposure of a bank or its subsidiaries to an affiliate resulting from a derivative transaction.

On April 12, 2011, the Board issued a joint proposed rule with the Farm Credit Administration, FDIC, Federal Housing Finance Agency, and OCC to establish margin and capital requirements for swap dealers, major swap participants, security-based swap dealers, and security-based swap participants (collectively, "swap entities"). The proposed rule would require certain swap entities regulated by the five agencies to collect minimum amounts of initial margin and variation margin from counterparties to non-cleared swaps and non-cleared, security-based swaps.

The amount of margin that would be required under the proposed rule would vary based on the relative risk of the counterparty and of the swap or security-based swap. A swap entity would not be required to collect margin from a commercial end user as long as its margin exposure is below an appropriate credit exposure limit established by the swap entity.

On July 28, 2011, the Board issued a proposed rule that would set standards for banking organizations regulated by the Federal Reserve that engage in certain types of foreign exchange transactions with retail customers. The proposal outlines requirements for disclosure, recordkeeping, business conduct, and documentation for retail foreign exchange transactions. Institutions engaging in such transactions would be required to identify themselves to their regulator and to be well capitalized. They would also be required to collect margin for retail foreign exchange transactions.

Removal of References to Credit Ratings from Capital Guidelines

Section 939A of the act requires all federal agencies to review their regulations within one year after passage of the act to identify any reference to or requirements regarding credit ratings, and issue a report to Congress upon conclusion of the review. The Board completed the required review of its regulations and issued a report to Congress on July 25, 2011.[7]

Section 939A also requires the agencies to remove any reference to, or requirements of reliance on, credit ratings in regulations that require the use of an assessment of creditworthiness of a security or money-market instrument. On August 10, 2010, the Board, FDIC, and OCC issued an advanced notice of proposed rulemaking regarding alternatives to the use of credit ratings in their risk-based capital rules. The Board, with the FDIC and OCC, also held a roundtable discussion with industry, academic, and other participants in November 2010 to hear views on how to develop alternatives to credit ratings. The staffs of the agencies considered comments received on the advanced notice of proposed rulemaking as well as at the roundtable discussion as they worked to develop alternatives.

On December 7, 2011, the Board, FDIC, and OCC issued a second notice of proposed rulemaking that would modify the agencies' market risk capital rules for banking organizations with significant trading activities. The modified notice of proposed rulemaking included alternative standards of creditworthiness that would be used in place of credit ratings to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rules. The Board anticipates that it will propose additional amendments to remove references to credit ratings from its regulations in the near future.

Credit-Risk Retention

Section 941(b) of the act imposes certain credit-risk retention obligations on securitizers or originators of assets securitized through the issuance of asset-backed securities (ABS). On March 29, 2011, the Board issued a joint proposed rule with five other federal agencies that would require securitizers to retain risk through one of several options, which were designed to take into account market practices and securitization structures across different asset classes. Under the proposed rule, sponsors of ABS would be required to retain at least 5 percent of the credit risk of the assets underlying the securities.

As required by the act, the proposed rule includes a variety of exemptions from the requirement that sponsors of ABS retain credit risk of the assets underlying the securities, including an exemption for U.S. government-guaranteed ABS and for mortgage-backed securities that are collateralized exclusively by residential mortgages that qualify as qualified residential mortgages (QRMs). In addition, the proposal would establish a definition for QRMs—incorporating such criteria as borrower credit history, payment terms, down payment for purchased mortgages, and loan-to-value ratio—designed to ensure they are of very high credit quality.

Ultimately, the proposed rule aims to ensure that the amount of credit risk retained by sponsors is meaningful, while taking into account market practices and reducing the potential for the rule to affect negatively the availability and cost of credit to consumers and businesses.

The agencies received more than 13,000 comments (including more than 300 non-form substantive comments) on the proposed rule. The staffs of the rulemaking agencies have been meeting regularly to discuss the comments and options for moving forward on the rulemaking.

Payment, Settlement, and Clearing Activities and Utilities

The act gives the FSOC the authority to identify and designate as systemically important a financial market utility (FMU) if the FSOC determines that failure of or a disruption to the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or

[7] See *Report to the Congress on Credit Ratings*, www.federalreserve.gov/publications/other-reports/files/credit-ratings-report-201107.pdf.

markets and thereby threaten the stability of the U.S. financial system.

On July 18, 2011, the FSOC issued a final rule describing the criteria that will inform its processes and procedures for designating an FMU as systemically important. Under the rule, which incorporates the act's criteria, the FSOC will consider the aggregate monetary value of transactions processed by an FMU; the aggregate exposure of an FMU to its counterparties; the relationship, interdependencies, or other interactions of an FMU with other FMUs; and the effect that the failure of or disruption to an FMU would have on critical markets, financial institutions, or the broader financial system. The FSOC also will perform a more in-depth review and analysis of specific FMUs from both a quantitative and qualitative perspective before making a designation.

In addition, the act authorizes the Board to prescribe risk-management standards governing the operations of designated FMUs (except for designated FMUs that are registered with the CFTC as derivative clearing organizations or registered with the SEC as clearing agencies). On March 30, 2011, the Board proposed a rule establishing risk-management standards governing the operations related to payment, clearing, and settlement activities of designated FMUs that are not registered with the CFTC or SEC. The proposed risk-management standards are based on the existing international standards that the Board has incorporated previously into its Policy on Payment System Risk. The proposed rule would also establish requirements and procedures for advance notice of material changes to the rules, procedures, or operations of a designated FMU for which the Board is the primary supervisor.

In addition, as required by the act, in July 2011 the Board, CFTC, and SEC issued a joint report to Congress containing recommendations for promoting robust risk-management standards and consistency in the supervisory programs of the CFTC and SEC for designated clearing entities.[8]

Executive Compensation

Section 956 of the act requires applicable federal regulators to develop jointly regulations or guidelines implementing disclosures and prohibitions concerning incentive-based compensation at depository institutions, depository institution holding companies, registered securities broker-dealers, credit unions, investment advisors, and certain government-sponsored enterprises (collectively, "covered financial institutions") with at least $1 billion in assets.

On April 14, 2011, the Board and other federal regulators requested comment on a proposal to implement the act's prohibition on incentive-based compensation arrangements. The proposal is significantly similar to the interagency guidance published in June 2010 on which the Federal Reserve led development. In particular, the proposal requires that incentive compensation practices at covered financial institutions be consistent with three key principles: (1) they should appropriately balance risk and financial rewards, (2) they should be compatible with effective controls and risk management, and (3) they should be supported by strong corporate governance.

Further, the agencies proposed that covered financial institutions with at least $1 billion in assets be required to have policies and procedures to ensure compliance with the requirements of the rule, and submit an annual report to their federal regulator describing the structure of their incentive compensation arrangements. The agencies also proposed that larger covered financial institutions—generally those with $50 billion or more in assets—defer at least 50 percent of the incentive compensation of certain executive officers for at least three years, and that the amounts ultimately paid reflect losses or other aspects of performance over time. The Board and other agencies are in the process of addressing public comments on the proposal.

Registration of Securities Holding Companies (SHCs)

The Dodd-Frank Act eliminated the SHC supervision framework pursuant to which the SEC supervised SHCs. In its place, the act permits an SHC to elect to register with and be supervised by the Board in order to satisfy the requirements of a foreign regulator or a provision of foreign law that the company be subject to comprehensive, consolidated supervision. On September 2, 2011, the Board invited public comment on a proposed rule outlining the registration requirements and procedures for SHCs.

Consumer Financial Protection

The Dodd-Frank Act made many enhancements to consumer financial protection, and the Board began implementing several of these enhancements prior to the transfer of rulemaking authority for most federal consumer protection statutes to the Consumer

[8] See *Risk-Management Supervision of Designated Clearing Entities*, www.federalreserve.gov/publications/other-reports/files/risk-management-supervision-report-201107.pdf.

Financial Protection Bureau (CFPB) on July 21, 2011. For instance, the act amends the Truth in Lending Act (TILA) and Consumer Leasing Act (CLA) to extend the protections of those laws to consumer credit transactions and consumer leases of higher dollar amounts. Before the Dodd-Frank Act, TILA and CLA applied to consumer credit transactions and consumer leases, respectively, of $25,000 or less. The Dodd-Frank Act increased this limit to $50,000 for each statute. On March 25, 2011, the Board issued a final rule amending Regulation Z (Truth in Lending) and Regulation M (Consumer Leasing) to reflect these higher thresholds.

The Dodd-Frank Act further amends TILA with respect to home mortgage lending. On February 23, 2011, the Board issued a final rule to increase the annual percentage rate threshold used to determine whether a mortgage lender is required to establish an escrow account for property taxes and insurance for first-lien jumbo mortgages. Also on February 23, the Board proposed a rule that would expand the minimum period for mandatory escrow accounts for first-lien, higher-priced mortgage loans from one to five years, and longer under certain circumstances. The proposed rule would provide an exemption from the escrow requirement for certain creditors that operate in rural or underserved communities. It also contains new disclosure requirements mandated by the Dodd-Frank Act. The proposed rule was transferred to the CFPB on the transfer date.

In addition, the Dodd-Frank Act generally prohibits lenders from making residential mortgage loans unless the consumer has a reasonable ability to repay the loan. On April 19, 2011, the Board proposed a rule to implement this provision. Under the Board's proposal, a lender could comply with the ability-to-repay requirement by considering and verifying specified underwriting factors, making certain types of qualified mortgages, or refinancing a non-standard mortgage into a more stable standard mortgage. The proposed rule also would implement the Dodd-Frank Act's limits on prepayment penalties. This proposed rule also was transferred to the CFPB on the transfer date.

Further, the Dodd-Frank Act amends the Fair Credit Reporting Act to require a creditor to disclose credit scores and related information to a consumer when the creditor uses the consumer's credit score in setting material terms of credit or in taking adverse action. On July 6, 2011, the Board and the Federal Trade Commission issued final rules to implement this provision. The final rules revise the content requirements for risk-based pricing notices and add related model forms that reflect the new credit score disclosure requirements. The final rules were transferred to the CFPB on the transfer date.

On May 12, 2011, the Board issued a proposed rule to create protections for consumers who send remittance transfers to recipients located in a foreign country. Consistent with section 1073 of the Dodd-Frank Act, the Board proposed to amend Regulation E to require disclosure of information about fees, exchange rates, and amount of currency to be received by the recipient of a remittance transfer. The proposed rule, which was transferred to the CFPB on the transfer date, would also provide error resolution and cancellation rights for senders of remittance transfers. In addition, on July 19, 2011, the Board issued a report to Congress on the status of automated clearinghouse expansion for remittance transfers to foreign countries.[9]

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9 See *Report to the Congress on the Use of the Automated Clearinghouse System for Remittance Transfers to Foreign Countries*, www.federalreserve.gov/boarddocs/rptcongress/ACH_report_201107.pdf.

The Board of Governors and the Government Performance and Results Act

Overview

The Government Performance and Results Act (GPRA) of 1993 requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multiyear period and an annual performance plan. The GPRA Modernization Act of 2010 refines those requirements to include quarterly performance reporting. Although the Federal Reserve is not covered by the GPRA, the Board of Governors voluntarily complies with the spirit of the act.

Strategic Plan, Performance Plan, and Performance Report

The Board's strategic plan articulates the Board's mission, sets forth major goals, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses the evaluation of performance. The Board is currently revising its 2012–15 Strategic Plan, with Board approval anticipated in 2012.

The performance plan includes specific targets for some of the performance measures identified in the strategic plan and describes the operational processes and resources needed to meet those targets. It also discusses validation of data and verification of results. The performance report discusses the Board's performance in relation to its goals.

The strategic plan, performance plan, and performance report are available on the Board's website at www.federalreserve.gov/publications/gpra/default.htm.

Record of Policy Actions of the Board of Governors

Policy actions of the Board of Governors are presented pursuant to section 10 of the Federal Reserve Act. That section provides that the Board shall keep a record of all questions of policy determined by the Board and shall include in its annual report to Congress a full account of such actions. This chapter provides a summary of policy actions in 2011, as implemented through (1) rules and regulations, (2) policy statements and other actions, and (3) discount rates for depository institutions. Policy actions were approved by all Board members in office, unless indicated otherwise.[1] More information on the actions is available from the "Reading Rooms" on the Board's Freedom of Information (FOI) Act web page or on request from the Board's FOI Office.

For information on Federal Open Market Committee policy actions relating to open market operations, see "Minutes of Federal Open Market Committee Meetings" on page 173.

Rules and Regulations

Regulation B (Equal Credit Opportunity)

On September 14, 2011, the Board approved a final rule (Docket No. R-1426) to specify that motor vehicle dealers temporarily are not required to comply with new requirements for data collection in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[2] Under the act, creditors are required to collect information about credit applications made by women- or minority-owned businesses and by small businesses. The Consumer Financial Protection Bureau (CFPB) will implement this provision for all creditors except certain motor vehicle dealers subject to the Board's jurisdiction. The CFPB had previously announced that creditors were not obligated to comply with the data collection requirements until implementing rules were issued. Therefore, the Board amended Regulation B to apply the same approach to motor vehicle dealers. The final rule is effective September 26, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation B (Equal Credit Opportunity) and Regulation V (Fair Credit Reporting)

On July 1, 2011, the Board, acting with the Federal Trade Commission, approved final rules (Docket Nos. R-1408 and R-1407) to implement the credit score disclosure requirements of the Dodd-Frank Act.[3] Under the act, creditors are required to disclose credit scores and related information to consumers if their credit scores are used in setting credit terms or taking an adverse action. Regulation V is amended to revise the content requirements for risk-based pricing notices, and Regulations V and B are amended to add or revise related model forms or notices that reflect the new disclosure requirements. The final rules are effective August 15, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation H (Membership of State Banking Institutions in the Federal Reserve System) and Regulation Y (Bank Holding Companies and Change in Bank Control)

On June 9, 2011, the Board, acting with the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC), approved a final rule (Docket No. R-1402) amending their (1) advanced approaches risk-based capital rules to

1 Governor Warsh resigned from the Board on April 2, 2011.

2 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-09-26/html/2011-24300.htm

3 See *Federal Register* notices at www.gpo.gov/fdsys/pkg/FR-2011-07-15/html/2011-17585.htm and www.gpo.gov/fdsys/pkg/FR-2011-07-15/html/2011-17649.htm.

establish a floor for the capital requirements applicable to the largest and internationally active banking organizations and (2) general risk-based capital rules to provide limited flexibility to establish capital requirements for certain low-risk assets generally not held by insured depository institutions.[4] The final rule is consistent with provisions of the Dodd-Frank Act and is effective July 28, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation M (Consumer Leasing) and Regulation Z (Truth in Lending)

On March 22, 2011, the Board approved final rules (Docket Nos. R-1400 and R-1399) that increase the coverage of consumer protection regulations to credit transactions and leases of higher dollar amounts.[5] Specifically, the rules increase the thresholds for exempt consumer credit transactions and consumer leases (including automobile leases) from $25,000 to $50,000, in accordance with the Dodd-Frank Act. This amount will be adjusted annually to reflect increases in the consumer price index. Private education loans and loans secured by real property (such as mortgages) remain subject to certain disclosure requirements and prohibitions regardless of the loan amount. The final rules are effective July 21, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin. **Absent and not voting:** Governor Warsh.

On June 11, 2011, the Board approved final rules (Docket Nos. R-1423 and R-1424) to increase the dollar threshold for exempt consumer credit and lease transactions from $50,000 to $51,800.[6] The new threshold reflects the annual percentage increase in the consumer price index, in accordance with the Dodd-Frank Act. The final rules are effective January 1, 2012.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation Q (Prohibition Against the Payment of Interest on Demand Deposits)

On July 12, 2011, the Board approved a final rule (Docket No. R-1413) to repeal Regulation Q.[7] Regulation Q implemented section 19(i) of the Federal Reserve Act, which prohibited the payment of interest on demand deposits by institutions that are members of the Federal Reserve System. The Dodd-Frank Act repealed section 19(i) of the Federal Reserve Act, effective July 21, 2011. Accordingly, the Board's final rule implements the repeal of section 19(i). The final rule also rescinds the Board's published interpretations of Regulation Q and removes references to Regulation Q in other regulations, such as in Regulation D (Reserve Requirements of Depository Institutions) and Regulation DD (Truth in Savings). The final rule is effective July 21, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation Y (Bank Holding Companies and Change in Bank Control)

On February 7, 2011, the Board approved a final rule (Docket No. R-1397) to implement the provisions of section 619 of the Dodd-Frank Act that grant banking entities a period of time to conform their activities and investments with the prohibitions and restrictions on proprietary trading or hedge fund or private equity fund activities imposed by the section (the so-called Volcker Rule).[8] The act generally provides these institutions with a two-year conformance period, which the Board may extend under certain conditions. The rule is effective April 1, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Warsh, Duke, Tarullo, and Raskin.

On June 11, 2011, the Board approved the following amendments (Docket No. R-1356) to its capital adequacy guidelines for bank holding companies: (1) a final rule to permit bank holding companies

4 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-06-28/html/2011-15669.htm.

5 See *Federal Register* notices at www.gpo.gov/fdsys/pkg/FR-2011-04-04/html/2011-7377.htm and www.gpo.gov/fdsys/pkg/FR-2011-04-04/html/2011-7376.htm.

6 See *Federal Register* notices at www.gpo.gov/fdsys/pkg/FR-2011-06-20/html/2011-15180.htm and www.gpo.gov/fdsys/pkg/FR-2011-06-20/html/2011-15178.htm.

7 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-07-18/html/2011-17886.htm.

8 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-02-14/html/2011-3199.htm.

that are organized as S-corporations or in mutual form to include in tier 1 capital subordinated debt issued to the Department of the Treasury (Treasury) under the Troubled Asset Relief Program and to allow those companies to exclude such debt for purposes of certain provisions of the Board's Small Bank Holding Company Policy Statement and (2) an interim final rule with request for comment to allow small bank holding companies that are organized as S-corporations or in mutual form to exclude subordinated debt issued to Treasury under the Small Business Lending Fund from treatment as "debt" for purposes of certain provisions of the policy statement.[9] The final rule and interim final rule are effective June 21, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

On November 17, 2011, the Board approved a final rule (Docket No. R-1425) to require large bank holding companies (those with $50 billion or more of total consolidated assets) to submit capital plans to the Federal Reserve annually and to require these companies to obtain approval under certain circumstances before making a capital distribution.[10] Under the final rule, the Federal Reserve evaluates institutions' capital adequacy, internal capital adequacy processes, and plans to make capital distributions, including dividend payments or stock repurchases. The Federal Reserve approves capital distributions only when a company's capital plan is satisfactory and the company can demonstrate sufficient financial strength to operate successfully as a financial intermediary under stress scenarios, even after making the desired distribution. The final rule is effective December 30, 2011, and institutions are required to submit their initial capital plans by January 9, 2012.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation Z (Truth in Lending)

On January 28, 2011, the Board approved an announcement that it does not expect to finalize three pending mortgage rulemakings (Docket Nos. R-1366, R-1367, and R-1390) before the transfer of rulemaking authority to the CFPB in July 2011.[11] The proposals had been issued in 2009 and 2010 as part of the Board's comprehensive review of its mortgage regulations under the Truth in Lending Act.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Warsh, Duke, Tarullo, and Raskin.

On February 22, 2011, the Board approved a final rule (Docket No. R-1392) to increase from 1.5 percent to 2.5 percent the annual percentage rate threshold used to determine whether a mortgage lender is required to establish an escrow account for property taxes and insurance for first-lien, "jumbo" mortgage loans, in accordance with the Dodd-Frank Act.[12] Jumbo loans are loans exceeding the conforming-loan size limit for purchase by Freddie Mac. The rule is effective for covered loans for which the creditor receives an application on or after April 1, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Warsh, Duke, Tarullo, and Raskin.

On March 16, 2011, the Board approved a final rule (Docket No. R-1393) to clarify aspects of Board rules for open-end (not home-secured) credit plans that were issued in 2010 to implement the Credit Card Accountability Responsibility and Disclosure Act.[13] Among other provisions, the rule states that credit card applications cannot request a consumer's "household income" because that term is too vague to allow credit card issuers to properly evaluate a consumer's ability to make payments on the account, which issuers are required to do under the act. Instead, issuers must consider a consumer's individual income or salary. The final rule is effective October 1, 2011.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke and Raskin.
Absent and not voting: Governors Warsh and Tarullo.

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9 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-06-21/html/2011-14983.htm.

10 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-12-01/html/2011-30665.htm.

11 See press release at www.federalreserve.gov/newsevents/press/bcreg/20110201a.htm.

12 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-03-02/html/2011-4384.htm.

13 See *Federal Register* notices at www.gpo.gov/fdsys/pkg/FR-2011-04-25/html/2011-8843.htm and www.gpo.gov/fdsys/pkg/FR-2011-05-31/html/2011-12795.htm (correction).

Regulation II (Debit Card Interchange Fees and Routing)

On June 29, 2011, the Board approved a final rule (Docket No. R-1404) to implement provisions of the Dodd-Frank Act that require the Board to establish standards for assessing whether a debit card interchange fee is reasonable and proportional to an issuer's costs and to prohibit network-exclusivity arrangements and routing restrictions. Under the final rule, the maximum permissible interchange fee that an issuer may receive for an electronic debit transaction is the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction. The Board also approved an interim final rule (Docket No. R-1404) with request for comment that permits an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the issuer meets the rule's fraud-prevention standards.[14] The Board will reevaluate this adjustment in light of comments received.

In accordance with the act, the interchange fee standards in the final rule do not apply to issuers that have total consolidated assets of less than $10 billion, debit cards issued pursuant to government-administered payment programs, and general-use reloadable prepaid cards. In addition, the final rule prohibits issuers and networks from (1) directly or indirectly restricting the number of payment card networks over which an electronic debit transaction may be processed to fewer than two unaffiliated networks and (2) inhibiting a merchant's ability to route transactions over any network that an issuer has enabled to process them. The final rule and interim final rule are effective October 1, 2011. For most debit cards, issuers must comply with the network-exclusivity provisions by April 1, 2012. However, issuers of certain health-related and other benefit cards and general-use prepaid cards have a delayed effective date of April 1, 2013, or later in certain circumstances.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Tarullo and Raskin. **Voting against this action:** Governor Duke.

On September 12, 2011, the Board approved the issuance of a small-entity compliance guide for Regulation II.[15]

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation LL (Savings and Loan Holding Companies) and Regulation MM (Mutual Holding Companies)

On August 8, 2011, the Board approved an interim final rule with request for comment (Docket No. R-1429) establishing regulations for savings and loan holding companies (SLHCs).[16] On July 21, 2011, the responsibility for supervision and regulation of SLHCs transferred from the Office of Thrift Supervision (OTS) to the Board, in accordance with the Dodd-Frank Act. The interim final rule provides for the corresponding transfer of the OTS regulations necessary for the Board to administer the statutes governing SLHCs. The interim final rule, which also made technical amendments to other Board regulations to reflect the new authority over SLHCs, is effective September 13, 2011. The Board approved additional technical amendments to its regulations delegating certain actions regarding SLHCs by order dated August 12, 2011.[17]

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulation QQ (Resolution Plans)

On October 13, 2011, the Board approved a final rule (Docket No. R-1414) to implement the resolution-plan requirement of the Dodd-Frank Act. The rule, which was promulgated jointly with the FDIC, requires bank holding companies with total consolidated assets of $50 billion or more and nonbank financial firms designated by the Financial Stability Oversight Council for supervision by the Federal Reserve to annually submit resolution plans ("living wills") to the Board and FDIC.[18] The plans must

[14] See *Federal Register* notices at www.gpo.gov/fdsys/pkg/FR-2011-07-20/html/2011-16861.htm (final rule) and www.gpo.gov/fdsys/pkg/FR-2011-07-20/html/2011-16860.htm (interim final rule).

[15] See the compliance guide at www.federalreserve.gov/bankinforeg/regiicg.htm.

[16] See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-09-13/html/2011-22854.htm.

[17] See the Board's order at www.federalreserve.gov/newsevents/press/bcreg/bcreg20110812a1.pdf.

[18] See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-11-01/html/2011-27377.htm.

describe a company's strategy for rapid and orderly resolution in bankruptcy during times of financial distress. Among other components, the plans must include a description of the range of specific actions a company proposes to take in resolution and a description of the company's organizational structure, material entities, interconnections and interdependencies, and management information systems. The final rule is effective November 30, 2011. Companies must submit their initial resolution plans on a staggered basis from July 1, 2012, through December 31, 2013, starting with companies that generally have $250 billion or more in total nonbank assets.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Policy Statements and Other Actions

S.A.F.E. Act Initial Registration Period

On January 28, 2011, the Board, acting with the FDIC, OCC, OTS, National Credit Union Administration (NCUA), and Farm Credit Administration (FCA), approved a notice (Docket No. R-1357) announcing the initial registration period under the Secure and Fair Enforcement for Mortgage Licensing Act (S.A.F.E. Act).[19] During this initial registration period (from January 31 through July 29, 2011), residential mortgage loan originators employed by agency-regulated institutions were required to register with the Nationwide Mortgage Licensing System and Registry, in accordance with the S.A.F.E. Act. The Board, along with the other agencies, had issued final rules implementing the act on July 28, 2010. Pursuant to those rules, agency-regulated mortgage loan originators must register with the registry, obtain a unique identifier from the registry, and maintain their registrations.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Warsh, Duke, Tarullo, and Raskin.

American International Group, Inc.

On March 29, 2011, the Board approved a process for the disposition of assets held by Maiden Lane II, LLC, a special-purpose vehicle established to alleviate funding and liquidity pressures on American International Group, Inc. (AIG) during the financial crisis.[20] Maiden Lane II had used the proceeds of a loan from the Federal Reserve Bank of New York and the acquisition of a subordinated interest by AIG to purchase residential mortgage-backed securities from several of AIG's regulated U.S. insurance subsidiaries. Under the approved disposition process, the Reserve Bank subsequently disposed of all the securities in the Maiden Lane II portfolio individually and in segments over time as warranted by market conditions through a competitive sales process. (Note: The disposition of the assets in 2011 and 2012 resulted in full repayment of the Reserve Bank's loan to Maiden Lane II and generated a net gain for the benefit of the public of approximately $2.8 billion.)

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin. **Absent and not voting:** Governor Warsh.

Guidance on Authentication in an Internet Banking Environment

On June 11, 2011, the Board approved interagency guidance, issued through the Federal Financial Institutions Examination Council (FFIEC), addressing customer authentication and security in Internet banking.[21] The guidance supplements FFIEC guidance issued in 2005, in light of the heightened and evolving threats facing online banking and other activities. The guidance reinforces the original risk-management framework for Internet and electronic banking and updates the agencies' expectations for supervised financial organizations regarding customer authentication, layered security, and other controls.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Interagency Questions and Answers Regarding Flood Insurance

On September 29, 2011, the Board, acting with the FDIC, OCC, NCUA, and FCA, approved revisions (Docket No. OP-1431) to the Interagency Questions and Answers Regarding Flood Insurance that were

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[19] See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-02-03/html/2011-2378.htm.

[20] See Federal Reserve Bank of New York press release at www.newyorkfed.org/newsevents/news/markets/2011/an110330.html.

[21] See FFIEC press release at www.ffiec.gov/press/pr062811.htm.

most recently issued in July 2009.[22] The revised guidance, which was published on October 14, 2011, finalized two questions and answers that related to insurable value and the force placement of flood insurance. An additional proposed question on insurable value was withdrawn. (Note: The guidance also requested comment on three additional proposed updates to questions and answers relating to flood insurance.)

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Policies for Directors of Federal Reserve Banks and Branches

On December 1, 2011, the Board approved revisions to its Eligibility, Qualifications, and Rotation Policy for Reserve Bank and Branch directors.[23] The revisions extend director stockholding and affiliation restrictions to institutions that were brought under the Federal Reserve System's supervisory authority by the Dodd-Frank Act. Other revisions address eligibility requirements for Board-appointed Branch directors and prescribe a standard annual certification for Class B and Class C directors.

The Board also revised its Guide to Conduct for Reserve Bank and Branch directors to formalize standards for director conduct regarding access to Board and Reserve Bank officials and staff and to prescribe a standard certification form to implement an existing requirement that directors certify their lack of financial interest in Reserve Bank procurements. In addition, the Guide to Conduct was revised to implement recommendations from the October 2011 Government Accountability Office Report on Federal Reserve Bank Governance, including recommendations to direct each Reserve Bank to clearly document, in its bylaws, the roles and responsibilities of directors and to adopt a process for requesting waivers to the Guide to Conduct.

The Board also adopted a new policy to implement the Dodd-Frank Act provision that excludes Class A directors from the appointment process for Reserve Bank presidents and first vice presidents. The new policy extends this exclusion to Class B directors affiliated with firms supervised by the Federal Reserve. The Board also formalized the existing prohibition on directors' access to confidential supervisory information and limited the involvement of Class A and some Class B directors in selecting and compensating Reserve Bank officers whose primary responsibilities involve supervisory matters.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Regulatory Reports for Savings and Loan Holding Companies

On December 22, 2011, the Board approved a two-year phase-in period for most SLHCs to file Federal Reserve regulatory reports and an exemption for some SLHCs from initially filing reports.[24] Under the Dodd-Frank Act, supervisory and regulatory authority for SLHCs and their nondepository subsidiaries transferred from the OTS to the Board on July 21, 2011. The phase-in approach is intended to allow SLHCs to develop reporting systems over a period of time and will begin with the March 31, 2012, reporting period.

Voting for this action: Chairman Bernanke, Vice Chair Yellen, and Governors Duke, Tarullo, and Raskin.

Discount Rates for Depository Institutions in 2011

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on discount window loans to depository institutions at least every 14 days, subject to review and determination by the Board of Governors.

Primary, Secondary, and Seasonal Credit

Primary credit, the Federal Reserve's main lending program for depository institutions, is extended at a rate above the federal funds rate target set by the Federal Open Market Committee. It is made available, with minimal administration and for very short terms, as a backup source of liquidity to depository institutions that, in the judgment of the lending Federal Reserve Bank, are in generally sound financial

22 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-10-17/html/2011-26749.htm.

23 See Reserve Bank director policies at www.federalreserve.gov/generalinfo/listdirectors/policies-directors.htm.

24 See *Federal Register* notice at www.gpo.gov/fdsys/pkg/FR-2011-12-29/html/2011-33432.htm.

condition. Throughout 2011, the primary credit rate was ¾ percent.

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set at a spread above the primary credit rate. Throughout 2011, the spread was set at 50 basis points; therefore, the secondary credit rate was 1¼ percent.

Seasonal credit is available to smaller depository institutions to meet liquidity needs that arise from regular swings in their loans and deposits. The rate on seasonal credit is calculated every two weeks as an average of selected money-market yields, typically resulting in a rate close to the federal funds rate target. At year-end, the seasonal credit rate was 0.30 percent.[25]

Votes on Changes to Discount Rates for Depository Institutions

About every two weeks during 2011, the Board approved proposals by the 12 Reserve Banks to maintain the formulas for computing the secondary and seasonal credit rates. In 2011, the Board did not approve any changes in the primary credit rate.

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25 For current and historical discount rates, see www.frbdiscountwindow.org/.

Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the Annual Report of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a summary of the information and discussions that led to the decisions. In addition, four times a year, starting with the October 2007 Committee meeting, a Summary of Economic Projections is published as an addendum to the minutes. The descriptions of economic and financial conditions in the minutes and the Summary of Economic Projections are based solely on the information that was available to the Committee at the time of the meetings.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under instructions from the Federal Open Market Committee that take the form of an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Federal Reserve Bank of New York operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. Changes in the instruments during the year are reported in the minutes for the individual meetings.[1]

[1] As of January 1, 2011, the Federal Reserve Bank of New York was operating under the Domestic Policy Directive approved at the December 14, 2010, Committee meeting and the Authorization for Domestic Open Market Operations as amended January 26, 2010. The other policy instruments (the Authorization for Foreign Currency Operations, the Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations) in effect as of January 1, 2011, were approved at the January 26–27, 2010, meeting.

Meeting Held on January 25–26, 2011

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, January 25, 2011, at 1:00 p.m. and continued on Wednesday, January 26, 2011, at 9:00 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Kevin Warsh

Janet L. Yellen

Jeffrey M. Lacker, Dennis P. Lockhart, John F. Moore, and Sandra Pianalto
Alternate Members of the Federal Open Market Committee

James Bullard, Thomas M. Hoenig, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Thomas C. Baxter
Deputy General Counsel

Nathan Sheets
Economist

David J. Stockton
Economist

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Loretta J. Mester, Simon Potter, David Reifschneider, Harvey Rosenblum, Daniel G. Sullivan, David W. Wilcox, and Kei-Mu Yi
Associate Economists

Brian Sack
Manager, System Open Market Account

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation, Board of Governors

Nellie Liang
Director, Office of Financial Stability Policy and Research, Board of Governors

William Nelson
Deputy Director, Division of Monetary Affairs, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Charles S. Struckmeyer[1]
Deputy Staff Director, Office of the Staff Director, Board of Governors

Lawrence Slifman and William Wascher
Senior Associate Directors, Division of Research and Statistics, Board of Governors

Andrew T. Levin
Senior Adviser, Office of Board Members, Board of Governors

Joyce K. Zickler
Visiting Senior Adviser, Division of Monetary Affairs, Board of Governors

Daniel M. Covitz
Associate Director, Division of Research and Statistics, Board of Governors

Gretchen C. Weinbach
Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Beth Anne Wilson[2]
Assistant Director, Division of International Finance, Board of Governors

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1 Attended Wednesday's session only.

2 Attended Tuesday's session only.

Bruce Fallick[2]
Group Manager, Division of Research and Statistics, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

David M. Arseneau
Senior Economist, Division of International Finance, Board of Governors

Stefania D'Amico and Edward M. Nelson
Senior Economists, Division of Monetary Affairs, Board of Governors

Norman J. Morin
Senior Economist, Division of Research and Statistics, Board of Governors

Mark A. Carlson
Economist, Division of Monetary Affairs, Board of Governors

Randall A. Williams
Records Management Analyst, Division of Monetary Affairs, Board of Governors

Patrick K. Barron
First Vice President, Federal Reserve Bank of Atlanta

Mark S. Sniderman
Executive Vice President, Federal Reserve Bank of Cleveland

David Altig, Alan D. Barkema, Glenn D. Rudebusch, Geoffrey Tootell, and Christopher J. Waller
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Kansas City, San Francisco, Boston, and St. Louis, respectively

Julie Ann Remache
Assistant Vice President, Federal Reserve Bank of New York

Ayşegül Şahin[2]
Officer, Federal Reserve Bank of New York

R. Jason Faberman[2] **and Robert L. Hetzel**
Senior Economists, Federal Reserve Banks of Philadelphia and Richmond, respectively

Annual Organizational Matters

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for a term beginning January 25, 2011, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William C. Dudley
President of the Federal Reserve Bank of New York, with

Christine Cumming
First Vice President of the Federal Reserve Bank of New York, as alternate.

Charles I. Plosser
President of the Federal Reserve Bank of Philadelphia, with

Jeffrey M. Lacker
President of the Federal Reserve Bank of Richmond, as alternate.

Charles L. Evans
President of the Federal Reserve Bank of Chicago, with

Sandra Pianalto
President of the Federal Reserve Bank of Cleveland, as alternate.

Richard W. Fisher
President of the Federal Reserve Bank of Dallas, with

Dennis P. Lockhart
President of the Federal Reserve Bank of Atlanta, as alternate.

Narayana Kocherlakota
President of the Federal Reserve Bank of Minneapolis, with

John F. Moore
First Vice President of the Federal Reserve Bank of San Francisco, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were selected to serve until the selection of their successors at the first regularly scheduled meeting of the Committee in 2012:

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

[2] Attended Tuesday's session only.

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Thomas Baxter
Deputy General Counsel

Richard M. Ashton
Assistant General Counsel

Nathan Sheets
Economist

David J. Stockton
Economist

James A. Clouse

Thomas A. Connors

Steven B. Kamin

Loretta J. Mester

Simon Potter

David Reifschneider

Harvey Rosenblum

Daniel G. Sullivan

David W. Wilcox

Kei-Mu Yi
Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account.

By unanimous vote, Brian Sack was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

> Secretary's note: Advice subsequently was received that the selection of Mr. Sack as Manager was satisfactory to the Board of Directors of the Federal Reserve Bank of New York.

By unanimous vote, the Committee adopted its Program for Security of FOMC Information with amendments to the section on ongoing responsibility for maintaining confidentiality and with a number of technical updates.

By unanimous vote, the Authorization for Domestic Open Market Operations was reaffirmed in the form shown below. The Guidelines for the Conduct of System Open Market Operations in Federal-Agency Issues remained suspended.

Authorization for Domestic Open Market Operations (Reaffirmed January 25, 2011)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

   A. To buy or sell U.S. government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. government and federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; and

   B. To buy or sell in the open market U.S. government securities, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, for the System Open Market Account under agreements to resell or repurchase such securities or obligations (including such transactions as are commonly referred to as repo and reverse repo transactions) in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual counterparties.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to use agents in agency MBS-related transactions.

3. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. government securities and securities that are direct obligations of any agency of the United States, held in the System Open Market Account, to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids that could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

4. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York:

    A. For the System Open Market Account, to sell U.S. government securities, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, to such accounts on the bases set forth in paragraph 1.A under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and

    B. For the New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph l.B, repurchase agreements in U.S. government securities, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank.

    Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

5. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate and to take actions that result in material changes in the composition and size of the assets in the System Open Market Account other than those anticipated by the Committee at its most recent meeting. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

By unanimous vote, the Authorization for Foreign Currency Operations, the Foreign Currency Directive, and the Procedural Instructions with Respect to Foreign Currency Operations were reaffirmed in the form shown below. The vote to reaffirm these documents included approval of the System's warehousing agreement with the U.S. Treasury.

Authorization for Foreign Currency Operations (Reaffirmed January 25, 2011)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for the System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

   Australian dollars
   Brazilian reais
   Canadian dollars
   Danish kroner
   euro
   Japanese yen
   Korean won
   Mexican pesos
   New Zealand dollars
   Norwegian kroner
   Pounds sterling
   Singapore dollars
   Swedish kronor
   Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies, excluding changes in dollar value due to foreign exchange rate movements and interest accruals. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada	2,000
Bank of Mexico	3,000

   Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at nonmarket exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). Such investments may include buying or selling outright obligations of, or fully guaranteed as to principal and interest by, a foreign government or agency thereof; buying such securities under agreements for repurchase of such securities; selling such securities under agreements for the resale of such securities; and holding various time and other deposit accounts at foreign institutions. In addition, when appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, the Vice Chairman's alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to the Manager's responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

    A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

    B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

    C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive (Reaffirmed January 25, 2011)

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with IMF Article IV, Section 1.

2. To achieve this end the System shall:

    A. Undertake spot and forward purchases and sales of foreign exchange.

    B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

    C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

    A. To adjust System balances in light of probable future needs for currencies.

    B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

   A. In close and continuous consultation and cooperation with the United States Treasury;

   B. In cooperation, as appropriate, with foreign monetary authorities; and

   C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under IMF Article IV.

Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 25, 2011)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee, unless otherwise directed by the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

   A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

   B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

   C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

   D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

   A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

   B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on December 14, 2010. He also reported on System open market operations, including the continuing reinvestment into longer-term Treasury securities of principal payments received on the SOMA's holdings of agency debt and agency-guaranteed mortgage-backed securities (MBS) as well as the ongoing purchases of additional Treasury securities authorized at the November 2–3, 2010, FOMC meeting. Since the first purchase schedule was released after the November FOMC meeting, the Open Market Desk at the Federal Reserve Bank of New York purchased a total of $236 billion of Treasury securities. These purchases included $69 billion associated with the reinvestment of principal payments on agency debt and MBS and $167 billion associated with the expansion of the Federal Reserve's securities holdings. The maturity distribution of the Desk's purchases resulted in an average duration of about 5½ years for the securities obtained. The Manager reported that given the purchases completed thus far, achieving a $600 billion expansion of the SOMA portfolio by the end of June 2011 would require purchasing the additional securities at a pace of about $80 billion per month. In addition, the Manager provided projections of the Federal Reserve's balance sheet and income under alternative assumptions. There were no open market operations in foreign currencies for the System's account over the intermeeting period. By unanimous vote, the Committee ratified the Desk's transactions over the intermeeting period.

Structural Unemployment

A staff presentation on structural unemployment summarized a broad range of economic research on the topic conducted across the Federal Reserve System. Among the factors cited that could affect the level of structural unemployment were demographics, changes in the intensity of job search and worker screening, differences in the geographic locations of potential workers and vacant jobs, and mismatches in characteristics between potential workers and available jobs. Most of the research reviewed suggested that structural unemployment had likely risen in recent years, but by less than actual unemployment had increased.

In discussing the staff presentation, meeting participants mentioned various factors that were seen as influencing the path of the unemployment rate. Several participants noted that estimates of the contributions of the individual factors depended importantly on the approach taken by researchers, including the models used and the assumptions made. Participants noted that many of the factors that contributed to the recent apparent rise in structural unemployment were likely to recede over time. Some participants stressed that certain determinants of the unemployment rate, such as mismatches in the labor market and firms' hiring practices, were both difficult to measure in real time and not directly affected by monetary policy. Others emphasized that in the current situation, monetary policy could still play an important role in reducing unemployment.

Staff Review of the Economic Situation

The information reviewed at the January 25–26 meeting indicated that the economic recovery was firming, though the expansion had not yet been sufficient to bring about a significant improvement in labor market conditions. Consumer spending rose strongly late last year, and the ongoing expansion in business outlays for equipment and software appeared to have been sustained in recent months. However, construction activity in both the residential and nonresidential sectors remained weak. Industrial production increased solidly in November and December. Modest gains in employment continued, and the unemployment rate remained elevated. Despite further increases in commodity prices, measures of underlying inflation remained subdued and longer-run inflation expectations were stable.

The labor market situation continued to improve gradually. Private nonfarm payroll employment increased in December at a pace roughly the same as its average for 2010 as a whole, and the average workweek for all employees was unchanged. Services industries continued to add most of the new jobs in the private sector. Initial claims for unemployment insurance trended lower in December and early January, and some indicators of job openings and firms' hiring plans improved. The unemployment rate decreased to 9.4 percent in December, but this decline in part reflected a further drop in the labor force participation rate. Long-duration unemployment remained elevated, and the employment-to-population ratio was still at a very low level at the end of the year.

Total industrial production posted solid increases in November and December, in part because colder weather boosted the output of utilities. Although motor vehicle assemblies dropped back in those months, production in the manufacturing sector outside of motor vehicles posted solid gains that were fairly widespread across industries; as a result, capacity utilization in manufacturing increased further, although it remained below its long-run average. Most indicators of near-term industrial activity, such as the new orders diffusion indexes in the national and regional manufacturing surveys, were at levels consistent with further increases in industrial production in the near term; in addition, motor vehicle production was scheduled to move up again in early 2011.

Growth in consumer spending appeared to have picked up in the fourth quarter from the more modest pace seen earlier in the year. Nominal retail sales, excluding purchases of motor vehicles and parts, rose again in December, following substantial increases in the previous four months. In addition, sales of new light motor vehicles climbed further in December after stepping up to a higher level during the preceding two months. The available data suggested that consumer spending was supported by gains in personal income in the fourth quarter of 2010. Moreover, household net worth appeared to have risen in the fourth quarter, as the large increase in equity prices more than offset further declines in house values. Consumer credit started to increase again in October and November after having generally declined since the fall of 2008. However, consumer sentiment only edged up, on net, in December and early January, and it was still at a relatively subdued level.

Activity in the housing market remained weak in an environment characterized by soft demand, a large inventory of foreclosed or distressed properties on the market, and tight credit conditions for construction loans and mortgages. Starts and permits for new single-family homes in November and December were still near the very low levels recorded since midyear. Sales of new homes rose in December but remained historically low. Sales of existing homes increased in November and December from the more depressed levels seen during the summer and early autumn, but these sales stayed relatively weak as well. Moreover, measures of house prices declined further in recent months, and survey responses indicated that households remained concerned that home values might continue to fall.

Real business investment in equipment and software appeared to have increased further in the fourth quarter, although likely at a more moderate rate than in the first three quarters of 2010. After declining in October, nominal orders and shipments of nondefense capital goods excluding aircraft rose in November, and the level of new orders remained above the level of shipments, indicating that the backlog of unfilled orders was still rising. Available indicators suggested that business purchases of software stayed on a solid uptrend, and outlays for computing and communications equipment appeared to have risen briskly. However, business spending for transportation equipment, including aircraft and motor vehicles, likely declined in the fourth quarter of 2010 after expanding rapidly earlier in the year. Surveys of purchasing managers reported that firms planned to increase their capital spending this year. Reports on planned capital expenditures by small businesses showed some signs of improvement in recent months, although they remained relatively subdued. Business outlays for nonresidential structures stayed weak, reflecting high vacancy rates and low property values for office and commercial properties, as well as tight credit conditions for commercial real estate. In contrast, investment in drilling and mining structures increased, buoyed by rising energy prices.

Real nonfarm inventory investment appeared to have slowed substantially in the fourth quarter after a sizable increase in the previous quarter. Much of the fourth-quarter downswing was likely associated with a drawdown of motor vehicle stocks after an accumulation in the third quarter. Book-value data for October and November suggested that the pace of inventory accumulation also was slowing outside of the motor vehicle sector. Inventory-to-sales ratios toward the end of 2010 were close to their prerecession norms, and most purchasing managers surveyed in December reported that their customers' inventories were not too high.

Measures of underlying consumer price inflation remained low. In December, the core consumer price index (CPI) edged up, as goods prices were unchanged and prices of non-energy services rose slightly. The 12-month change in the core CPI remained near the very low readings of the previous two months. Other measures of underlying inflation, such as the trimmed-mean and median CPIs, also remained subdued. Despite the steep run-up in agricultural commodity prices over the second half of last year, increases in retail food prices remained modest. However, consumer energy prices moved up sharply in December, and prices of most types of crude oil increased during December and into January. The prices of nonfuel industrial commodities also continued to rise over the intermeeting period. In December and early January, survey measures of households' long-term inflation expectations stayed in the range that has prevailed for some time.

Available measures of labor compensation showed that labor cost pressures were still restrained, as wage increases slowed along with inflation and productivity gains appeared to remain substantial. The 12-month change in average hourly earnings for all employees continued to be low in December.

The U.S. international trade deficit narrowed slightly in November, as both nominal exports and imports moved up by almost the same amount. The increase in exports was driven by agricultural goods, in part reflecting higher prices, as well as by consumer goods. In contrast, exports of machinery and automotive products fell, reversing their October gains. The rise in imports reflected an increase in the value of imported petroleum products, mostly explained by higher prices, and of capital goods, which was supported importantly by a jump in computers. At the same time, noticeable decreases were registered for imports of automotive products, services, and consumer goods, which were primarily due to pharmaceuticals. These developments, combined with the substantial narrowing in the trade deficit in October, implied that the trade deficit likely shrank considerably in the fourth quarter of 2010.

Recent indicators of foreign economic activity suggested that the global recovery was strengthening. Much of this strength was centered in the emerging market economies (EMEs), where widespread increases in exports and in manufacturing purchasing managers indexes (PMIs) pointed to a resurgence in economic growth following a slowdown in the third quarter of 2010. For China and Singapore, real gross domestic product (GDP) data for the fourth quarter confirmed a rebound in economic growth. In contrast, the rise in economic activity in the advanced foreign economies (AFEs) remained at a subdued pace. In the euro area, the incoming economic data were mixed: Industrial production, manufacturing PMIs, and industrial confidence firmed, but retail sales and consumer confidence softened. The data also pointed to an uneven expansion across the euro area, suggesting that economic growth in Germany continued to outpace that in the euro-area periphery. In Japan, exports and household spending were soft, although industrial production firmed. Foreign inflation picked up noticeably in the fourth quarter of 2010, mostly because of an acceleration of energy and food prices. Measures of core inflation remained much more subdued, although they also moved up in some countries. In the EMEs, concerns about inflation prompted a number of central banks to tighten policy. Some EMEs reportedly took steps to limit the appreciation of their currencies by intervening in foreign exchange markets, and some acted to discourage capital inflows.

Staff Review of the Financial Situation

The decision by the FOMC at its December meeting to maintain the 0 to ¼ percent target range for the federal funds rate was widely anticipated. Both the accompanying statement and the minutes of the meeting were broadly in line with market expectations and elicited limited price action in financial markets. Yields on medium- and longer-term nominal Treasury securities increased slightly, on net, over the intermeeting period. Yields rose in response to data releases that generally pointed to some firming of the economic recovery, but the upward pressure on yields apparently was tempered by expectations of only a gradual pace of improvement in the labor market, the belief that the Federal Reserve was likely to maintain an accommodative policy stance, and ongoing concerns about fiscal and banking pressures in the euro area. Futures quotes indicated that the expected path for the federal funds rate did not change appreciably over the intermeeting period. Market-based measures of uncertainty about longer-term Treasury yields, which had risen ahead of year-end, declined on balance, likely in part reflecting solidifying market expectations regarding the ultimate size of the FOMC's asset purchase program. The purchases of longer-term Treasury securities by the Desk during the intermeeting period reportedly had no significant effects on measures of day-to-day Treasury market functioning.

Inflation compensation over the next 5 years based on Treasury inflation-protected securities (TIPS) moved up, likely pushed higher by rising prices for oil and other commodities and by the firming of the economic outlook. Further out, TIPS-based inflation compensation 5 to 10 years ahead edged down slightly on net. Yields on investment-grade corporate bonds were little changed over the intermeeting period, while those on speculative-grade corporate bonds declined a little, leaving both investment- and speculative-grade spreads over yields on comparable-maturity Treasury securities somewhat narrower. In the secondary market for leveraged loans, the average bid price moved up further over the intermeeting period. The municipal bond market appeared to continue to price in an atypically high level of default risk. The ratios of yields on long-term general obligation bonds to those on comparable-maturity Treasury securities moved up to a very high level. Despite these strains, gross issuance of long-term municipal bonds remained strong in December.

Conditions in short-term funding markets remained stable over the intermeeting period. Spreads of dollar London interbank offered rates, or Libor, over overnight index swap rates held fairly steady across the term structure, as the year-end passed without incident. Some modest year-end pressures were observed in repurchase agreement markets, but they dissipated by early January. On net, spreads on unsecured nonfinancial commercial paper remained low, and spreads on asset-backed commercial paper appeared to have stabilized after having been somewhat volatile across year-end. Anecdotal reports suggested that the modestly rising trend in the use of dealer-intermediated leverage evident in 2010 had continued into 2011, but information from a variety of sources indicated that leverage remained well below the levels reached before the crisis.

Broad U.S. stock price indexes rose, on net, over the intermeeting period, extending their recent strong performance; bank stock prices modestly outperformed the broader market. The increase in equity prices reflected the apparent firming of the economic recovery and favorable early reports on fourth-quarter corporate earnings. Option-implied volatility on the S&P 500 index remained at a relatively low level. The spread between the staff's estimate of the expected real equity return for S&P 500 firms and the real 10-year Treasury yield—a rough measure of the equity risk premium—narrowed further over the period but remained elevated relative to longer-run norms.

Overall, net debt financing by U.S. nonfinancial corporations was robust in the fourth quarter of 2010. Net issuance of bonds was particularly strong, supported by heavy issuance in both the speculative- and investment-grade sectors. Meanwhile, nonfinancial commercial paper outstanding decreased slightly over the quarter. Issuance of syndicated leveraged loans, especially those funded by institutional investors, stayed strong. Measures of the credit quality of nonfinancial corporations continued to improve. Gross public equity issuance by nonfinancial firms dropped back in December to its average pace in 2010.

Financing conditions for most types of commercial real estate remained tight over the intermeeting period, and delinquency rates for broad categories of commercial real estate loans stayed elevated. However, for larger nonresidential properties in strong markets, credit appeared to have become somewhat less restricted, and prices moved up, on net, from their lows at the beginning of 2010; at the same time, prices of other nonresidential properties continued to trend down. Issuance of commercial mortgage-backed securities increased in the fourth quarter of 2010 but was still only a fraction of its pre-crisis level.

Rates on conforming fixed-rate residential mortgages edged down a bit during the intermeeting period after having risen appreciably in November and early December, leaving their spreads over the 10-year Treasury yield down slightly. Refinancing activity, which had fallen in response to the increase in mortgage rates in November, remained at a low level during the period. Outstanding residential mortgage debt declined further in the third quarter of 2010, reflecting weak housing activity and tight lending standards. Serious delinquency rates on prime and subprime mortgages flattened out in October and November after having moved down earlier in the year. Signs of improvement were evident in the consumer credit market, where issuance of consumer asset-backed securities was strong early in the fourth quarter. In addition, delinquency rates on consumer loans continued to trend down toward their longer-run norms.

Banks made a sizable reduction in their holdings of securities in December. Core loans on banks' books—the sum of commercial and industrial (C&I), real estate, and consumer loans—edged down again, but the rate of contraction appeared to be abating. C&I loans expanded at a robust pace in December. Despite continued weakness in many residential real estate indicators, closed-end residential mortgage loans held by large banks rose noticeably for the fifth consecutive month in December. By contrast, commercial real estate loans, home equity loans, and consumer loans decreased during that month. The behavior of the components of core loans in recent months was broadly consistent with the results of the Senior Loan Officer Opinion Survey on Bank Lending Practices conducted in January. The survey responses indicated that, during the fourth quarter of 2010, modest net fractions of banks continued to ease standards for C&I loans and that larger net fractions eased some terms on such loans. Changes in banks' lending policies for other categories of loans were reportedly mixed and generally small. Meanwhile, moderate net fractions of respondents indicated that demand for C&I loans had strengthened over the preceding three months, and that inquiries from business borrowers for new or increased credit lines had picked up. In contrast, demand reportedly weakened somewhat, on balance, for residential real estate loans and was little changed for consumer loans. Respondents indicated that the recent increase in their holdings of closed-end residential mortgage loans reflected the relative attractiveness of such loans compared with other assets and, for some, a desire to expand their balance sheets by adding to this loan category.

In December, M2 expanded at a rate a bit below its pace in November. Liquid deposits, the largest component of M2, continued to increase rapidly, while the contraction in small time deposits and retail money market mutual funds persisted. The ongoing compositional shift within M2 toward liquid deposits likely reflected the relatively high yields on liquid deposits compared with yields on many other components of M2. Currency growth slowed in December, due in part to weather-related transportation difficulties that delayed flows of U.S. bank notes to international destinations.

The broad nominal index of the U.S. dollar declined more than 1 percent over the intermeeting period, depreciating by roughly similar amounts, on average, against the currencies of the AFEs and the EMEs. The dollar's decline appeared to reflect a variety of factors: signs of stronger economic activity abroad, particularly in the EMEs; actual and prospective monetary policy tightening in foreign economies; and increases in the prices of oil and other commodities, which lent support to the currencies of commodity-exporting countries. Benchmark 10-year sovereign yields moved higher in the core euro-area economies and the United Kingdom but were little changed in Japan and Canada. Equity prices increased in the AFEs and in many EMEs as market participants appeared to revise upward their outlook for the global economy.

Financial market strains in the euro area continued during the intermeeting period. Greek, Irish, and Portuguese sovereign debt spreads over German bunds rose in December and early January as credit rating agencies downgraded the sovereign debt of Ireland and Portugal. Subsequently, though, spreads narrowed following some relatively successful sovereign debt auctions by countries in the euro-area periphery, evidence of stepped-up purchases of peripheral sovereign bonds by the European Central Bank (ECB), and reports that the European Union was considering expanding the backstop capacity of the European Financial Stability Facility. Some modest dollar funding pressures developed as year-end approached, but they did not persist into January. To continue to support liquidity conditions in global money markets, on December 21, the Federal Reserve announced an extension through August 1, 2011, of its swap line arrangements with the ECB and the central banks of Japan, Canada, Switzerland, and the United Kingdom. In addition, the Bank of England established a temporary liquidity swap facility with the ECB designed to provide Ireland's central bank with sterling to help meet the potential needs of the Irish banking system.

Staff Economic Outlook

Because the incoming data on production and spending were stronger, on balance, than the staff's expectations at the time of the December FOMC meeting, the near-term forecast for the increase in real GDP was revised up. However, the staff's outlook for the pace of economic growth over the medium term was adjusted only slightly relative to the projection prepared for the December meeting. Compared with the December forecast, the conditioning assumptions underlying the forecast were little changed and roughly offsetting: Although higher equity prices and a lower foreign exchange value of the dollar were expected to be slightly more supportive of economic growth, the staff anticipated that these influences would be about offset by lower house prices and higher oil prices. In addition, the staff's assumptions about fiscal policy changed little—the fiscal package enacted in December was close to what the staff had already incorporated in their previous projection. In the medium term, the recovery in economic activity was expected to receive support from accommodative monetary policy, further improvements in financial conditions, and greater household and business confidence. Over the projection period, the rise in real GDP was expected to be sufficient to slowly reduce the rate of unemployment, but the jobless rate was anticipated to remain elevated at the end of 2012.

The underlying rate of consumer price inflation in recent months was in line with what the staff anticipated at the time of the December meeting, and the staff continued to project that increases in core PCE prices would remain subdued in 2011 and 2012. As in previous projections, the persistent wide margin of economic slack in the forecast was expected to maintain downward pressure on inflation, but this influence was anticipated to be counterbalanced by the continued stability of inflation expectations and by increases in the prices of imported goods. The staff anticipated that brisk increases in energy prices would raise total consumer price inflation above core inflation this year, but that upward pressure from energy prices would wane by next year.

Participants' Views on Current Conditions and the Economic Outlook

In conjunction with this FOMC meeting, all meeting participants—the six members of the Board of Governors and the presidents of the 12 Federal Reserve Banks—provided projections of output growth, the unemployment rate, and inflation for each year from 2011 through 2013 and over the longer run. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks. Participants' forecasts are described in the Summary of Economic Projections, which is attached as an addendum to these minutes.

In the discussion of intermeeting developments and their implications for the outlook, the participants generally expressed greater confidence that the economic recovery would be sustained and would gradually strengthen over coming quarters. Their more positive assessment reflected both the tenor of the incoming economic data and information received from business contacts since the previous meeting. Spending by households picked up noticeably in the fourth quarter, business outlays continued to grow at a moderate pace, and conditions in labor and financial markets improved somewhat over the intermeeting period. Although business contacts remained somewhat cautious about the economic outlook, they generally indicated greater optimism regarding their own prospects for sales and hiring than at the time of the previous meeting. While participants viewed the downside risks to their forecasts of economic activity over the projection period as having diminished, their assessment of the most likely outcomes for economic activity and inflation over the projection period was not greatly changed. Most participants raised their forecast of real GDP growth in 2011 somewhat and continued to anticipate stronger growth this year than in 2010, with a further gradual acceleration during 2012 and 2013. The unemployment rate was still projected to decline gradually over the forecast period but to remain elevated. Total inflation was still expected to remain subdued, and core inflation was projected to trend up slowly over the next few years as economic activity picks up but inflation expectations remain well anchored.

Participants' judgment that the economic recovery was on a firmer footing was supported by the strength in household spending in the fourth quarter. The incoming data indicated that households stepped up sharply their purchases of durable goods, particularly automobiles, last quarter. Spending on luxury goods also increased, and the pace of holiday sales was better than in recent years. However, some participants noted that it was not clear whether the recent pace of consumer spending would be sustained. On the one hand, the additional spending could reflect pent-up demand following the downturn or greater confidence on the part of households about the future, in which case it might be expected to continue. On the other hand, the additional spending could prove short lived given that a good portion of it appeared to have occurred in relatively volatile categories such as autos.

Activity in the business sector also indicated that the economic recovery remained on track. For instance, indicators of business investment in equipment and software continued to rise. Industrial production posted solid gains, supported in part by U.S. exports that appeared to have been noticeably stronger in the fourth quarter. A wide range of business contacts expressed cautious optimism about the durability and strength of the recovery, and some were planning for an expansion in production in order to meet an anticipated rise in sales. In addition, although residential construction spending remained weak, spending on commercial construction projects showed some tentative signs of bottoming out.

Participants noted that conditions in labor markets continued to improve gradually. Payroll employment increased at a modest pace, and, although the data had been somewhat erratic, a slight downward trend was apparent in the recent pattern of weekly initial claims for unemployment insurance. In addition, some surveys of employers suggested a somewhat more upbeat outlook for employment. Business contacts provided a range of information regarding hiring intentions, with some indicating that workers at all skill levels were readily obtainable, while others reported that they had upgraded skill requirements and that some of the currently unemployed did not meet those new requirements. Some businesses remained reluctant to add permanent positions and were planning to meet their labor requirements with temporary workers. Overall, meeting participants continued to express disappointment in both the pace and the unevenness of the improvements in labor markets and noted that they would monitor labor market developments closely.

Conditions in financial markets improved somewhat further over the intermeeting period. Broad equity prices rose, adding to their substantial gains since the middle of 2010. Yields on longer-term nominal Treasury securities were little changed, on balance, over the period, but they had increased quite a bit in recent months, leaving the Treasury yield curve noticeably steeper. Some participants noted that a steep yield curve is a typical feature of an economy in recovery, and that much of the steepening appeared to have occurred in response to stronger-than-expected economic data. Market-based measures of inflation compensation over the next few years increased further over the intermeeting period, extending the rise that occurred over recent months. Some participants suggested that the increase likely reflected, in part, a decline in investors' perceptions of the near-term risk of further disinflation. At the same time, longer-term inflation expectations had remained stable. Credit spreads on the debt of nonfinancial corporations continued to narrow over the period, reaching levels noticeably lower than those posted several months ago, with the largest declines coming on speculative-grade bonds. However, credit conditions remained tight for smaller, bank-dependent firms, although bank loan growth had clearly picked up in some sectors. Some participants noted that, taken together, these financial developments were consistent with a more accommodative stance of monetary policy since last summer or a reduction in risk aversion on the part of market participants.

Meeting participants noted that headline inflation had been boosted by higher prices for energy and other commodities, as well as by increases in the prices of imported goods. Some participants indicated that while unit labor costs generally had declined and profit margins were wide, the higher commodity prices were boosting costs of production for many firms. Some business contacts indicated that they were going to try to pass a portion of these higher costs through to their customers but were uncertain about whether that would be possible given current market conditions. Many participants expected that, with significant slack in resource markets and longer-term inflation expectations stable, measures of core inflation would remain close to current levels in coming quarters. However, the importance of resource slack as a factor influencing inflation was debated, and some participants suggested that other variables, such as current and expected rates of economic growth, could be useful indicators of inflation pressures.

Overall, most participants indicated that the somewhat better-than-expected economic data and anecdotal information from business contacts had importantly increased their confidence in the continuation of a moderate recovery in activity this year. Accordingly, participants generally agreed that the downside risks to their forecasts of both economic growth and inflation—as well as the odds of a period of deflation—had diminished. Participants also generally agreed that the recent data had not led them to significantly change their outlooks for the most likely rates of economic growth and inflation in coming quarters. Participants noted that some of the strength in the recent data reflected factors that could prove temporary, such as the large contribution from net exports, a volatile category, and the sharp step-up in auto sales. Most participants continued to anticipate that the recovery in economic activity was likely to be restrained by a variety of economic factors, including still-high unemployment, modest income growth, lower housing wealth, high rates of mortgage foreclosure, elevated inventories of unsold homes, and tight credit conditions in a number of sectors. In addition, although many business contacts expressed more optimism about the economic recovery, a number had aimed their recent investments primarily at enhancing productivity rather than expanding employment, and hiring for some businesses reportedly was focused on temporary workers. Some participants noted that incoming data on production, spending, and employment would need to be solid for a while longer to justify a significant upward revision to their outlook for the likely pace of the recovery.

Participants generally saw the risks to their outlook for economic growth and employment as having become broadly balanced, but they continued to see significant risks to both sides of the outlook. On the downside, participants remained worried about the possible effects of spillovers from the banking and fiscal strains in peripheral Europe, the ongoing fiscal adjustments by U.S. state and local governments, and the continued weakness in the housing market. On the upside, the recent strength in household spending raised the possibility that domestic final demand could snap back more rapidly than anticipated. If so, a considerably stronger recovery could take hold, more in line with the sorts of recoveries seen following deep economic recessions in the past.

Regarding risks to the inflation outlook, some participants noted that increases in energy and other commodity prices as well as in the prices of imported goods from EMEs posed upside risks. Others, however, noted that the pass-through from increases in commodity prices to broad measures of consumer price inflation in the United States had generally been fairly small. Some participants expressed concern that in a situation in which businesses had been unable to raise prices in response to higher costs for some time, firms might increase them substantially once they found themselves with sufficient pricing power. In any case, the factors affecting the ability of businesses to pass through higher prices to consumers were viewed as complex and hard to monitor in real time. Most participants saw the large degree of resource slack in the economy as likely to remain a force restraining inflation, and while the risk of further disinflation had declined, a number of participants cited concerns that inflation was below its mandate-consistent level and was expected to remain so for some time. Finally, some participants noted that if the very large size of the Federal Reserve's balance sheet led the public to doubt the Committee's ability to withdraw monetary accommodation when doing so becomes appropriate, the result could be upward pressure on inflation expectations and so on actual inflation. To mitigate such risks, it was noted that the Committee should continue its planning for the eventual exit from the current exceptionally accommodative stance of policy.

Committee Policy Action

In their discussion of monetary policy for the period ahead, members agreed that no changes to the Committee's asset purchase program or to its target range for the federal funds rate were warranted at this meeting. While the information received over the intermeeting period increased members' confidence in the sustainability of the economic recovery, the pace of the recovery was insufficient to bring about a significant improvement in labor market conditions, and measures of underlying inflation had trended downward. Moreover, the economic projections submitted for this meeting indicated that unemployment was expected to remain above, and inflation to remain somewhat below, levels consistent with the Committee's objectives for some time. Accordingly, the Committee agreed to continue to expand its holdings of longer-term Treasury securities as announced in November in order to promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with the Committee's mandate. The Committee decided to maintain its existing policy of reinvesting principal payments from its securities holdings and reaffirmed its intention to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. A few members remained unsure of the likely effects of the asset purchase program on the economy, but felt that making changes to the program at this time was not appropriate. Members emphasized that the Committee would continue to regularly review the pace of its securities purchases and the overall size of the asset purchase program in light of incoming information—including information on the outlook for economic activity, developments in financial markets, and the efficacy of the purchase program and any unintended consequences that might arise—and would adjust the program as needed to best foster maximum employment and price stability. A few members noted that additional data pointing to a sufficiently strong recovery could make it appropriate to consider reducing the pace or overall size of the purchase program. However, others pointed out that it was unlikely that the outlook would change by enough to substantiate any adjustments to the program before its completion. In addition, the Committee reiterated its expectation that economic conditions were likely to warrant exceptionally low levels for the federal funds rate for an extended period. With respect to the statement to be released following the meeting, members agreed that only small changes were necessary to reflect the improvement in the near-term economic outlook and to make clear that the policy decision reflected a continuation of the asset purchase program announced in November.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to execute purchases of longer-term Treasury securities in order to increase the total face value of domestic securities held in the System Open Market Account to approximately $2.6 trillion by the end of June 2011. The Committee also directs the Desk to reinvest principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 2:15 p.m.:

"Information received since the Federal Open Market Committee met in December confirms that the economic recovery is continuing, though at a rate that has been insufficient to bring about a significant improvement in labor market conditions. Growth in household spending picked up late last year, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, while investment in nonresidential structures is still weak. Employers remain reluctant to add to payrolls. The housing sector continues to be depressed. Although commodity prices have risen, longer-term inflation expectations have remained stable, and measures of underlying inflation have been trending downward.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate is elevated, and measures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. Although the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, progress toward its objectives has been disappointingly slow.

To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to continue expanding its holdings of securities as announced in November. In particular, the Committee is maintaining its existing policy of reinvesting principal payments from its securities holdings and intends to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability.

The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Richard W. Fisher, Narayana Kocherlakota, Charles I. Plosser, Sarah Bloom Raskin, Daniel K. Tarullo, Kevin Warsh, and Janet L. Yellen.

Voting against this action: None.

Next, the Committee turned to a discussion of its external communications, specifically the importance of communicating both broadly and effectively. FOMC participants noted the importance of fair and equal access by the public to information that could be informative about future policy decisions, and they considered approaches to address this issue. Several participants noted that increased clarity of communications was a key objective, and some referred to the central role of communications in the monetary policy transmission process. A focus of the discussion was on how to encourage dialogue with the public in an appropriate and transparent manner. The subcommittee on communications agreed to consider whether further guidance in this area would be useful.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 15, 2011. The meeting adjourned at 2:40 p.m. on January 26, 2011.

Notation Vote

By notation vote completed on January 3, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on December 14, 2010.

William B. English
Secretary

Addendum: Summary of Economic Projections

In conjunction with the January 25–26, 2011, Federal Open Market Committee (FOMC) meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC, submitted projections for growth of real output, the unemployment rate, and inflation for the years 2011 to 2013 and over the longer run. The projections were based on information available through the end of the meeting and on each participant's assumptions about factors likely to affect economic outcomes, including his or her assessment of appropriate monetary policy. "Appropriate monetary policy" is defined as the future path of policy that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her interpretation of the Federal Reserve's dual objectives of maximum employment and stable prices. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks.

As depicted in **figure 1**, FOMC participants' projections for the next three years indicated that they expect a sustained recovery in real economic activity, marked by a step-up in the rate of increase in real gross domestic product (GDP) in 2011 followed by further modest acceleration in 2012 and 2013. They anticipated that, over this period, the pace of the recovery would exceed their estimates of the longer-run sustainable rate of increase in real GDP by enough to gradually lower the unemployment rate. However, by the end of 2013, participants projected that the unemployment rate would still exceed their estimates of the longer-run unemployment rate. Most participants expected that inflation would likely move up somewhat over the forecast period but would remain at rates below those they see as consistent, over the longer run, with the Committee's dual mandate of maximum employment and price stability.

As indicated in **table 1**, relative to their previous projections in November 2010, participants anticipated somewhat more rapid growth in real GDP this year, but they did not significantly alter their expectations for the pace of the expansion in 2012 and 2013 or for the longer run. Participants made only minor changes to their forecasts for the path of the unemployment rate and for the rate of inflation over the next three years. Although most participants anticipated that the economy would likely converge to sustainable rates of increase in real GDP and prices over five or six years, a number of participants indicated that they expected that the convergence of the unemployment rate to its longer-run level would require additional time.

As they did in November, participants judged the level of uncertainty associated with their projections for real economic activity and inflation as unusually high relative to historical norms. Most continued to see the risks surrounding their forecasts of GDP growth, the unemployment rate, and inflation over the next three years to be generally balanced. However, fewer noted downside risks to the likely pace of

Table 1. Economic projections of Federal Reserve Governors and Reserve Bank presidents, January 2011
Percent

Variable	Central tendency[1]				Range[2]			
	2011	2012	2013	Longer run	2011	2012	2013	Longer run
Change in real GDP	3.4 to 3.9	3.5 to 4.4	3.7 to 4.6	2.5 to 2.8	3.2 to 4.2	3.4 to 4.5	3.0 to 5.0	2.4 to 3.0
November projection	3.0 to 3.6	3.6 to 4.5	3.5 to 4.6	2.5 to 2.8	2.5 to 4.0	2.6 to 4.7	3.0 to 5.0	2.4 to 3.0
Unemployment rate	8.8 to 9.0	7.6 to 8.1	6.8 to 7.2	5.0 to 6.0	8.4 to 9.0	7.2 to 8.4	6.0 to 7.9	5.0 to 6.2
November projection	8.9 to 9.1	7.7 to 8.2	6.9 to 7.4	5.0 to 6.0	8.2 to 9.3	7.0 to 8.7	5.9 to 7.9	5.0 to 6.3
PCE inflation	1.3 to 1.7	1.0 to 1.9	1.2 to 2.0	1.6 to 2.0	1.0 to 2.0	0.7 to 2.2	0.6 to 2.0	1.5 to 2.0
November projection	1.1 to 1.7	1.1 to 1.8	1.2 to 2.0	1.6 to 2.0	0.9 to 2.2	0.6 to 2.2	0.4 to 2.0	1.5 to 2.0
Core PCE inflation[3]	1.0 to 1.3	1.0 to 1.5	1.2 to 2.0		0.7 to 1.8	0.6 to 2.0	0.6 to 2.0	
November projection	0.9 to 1.6	1.0 to 1.6	1.1 to 2.0		0.7 to 2.0	0.6 to 2.0	0.5 to 2.0	

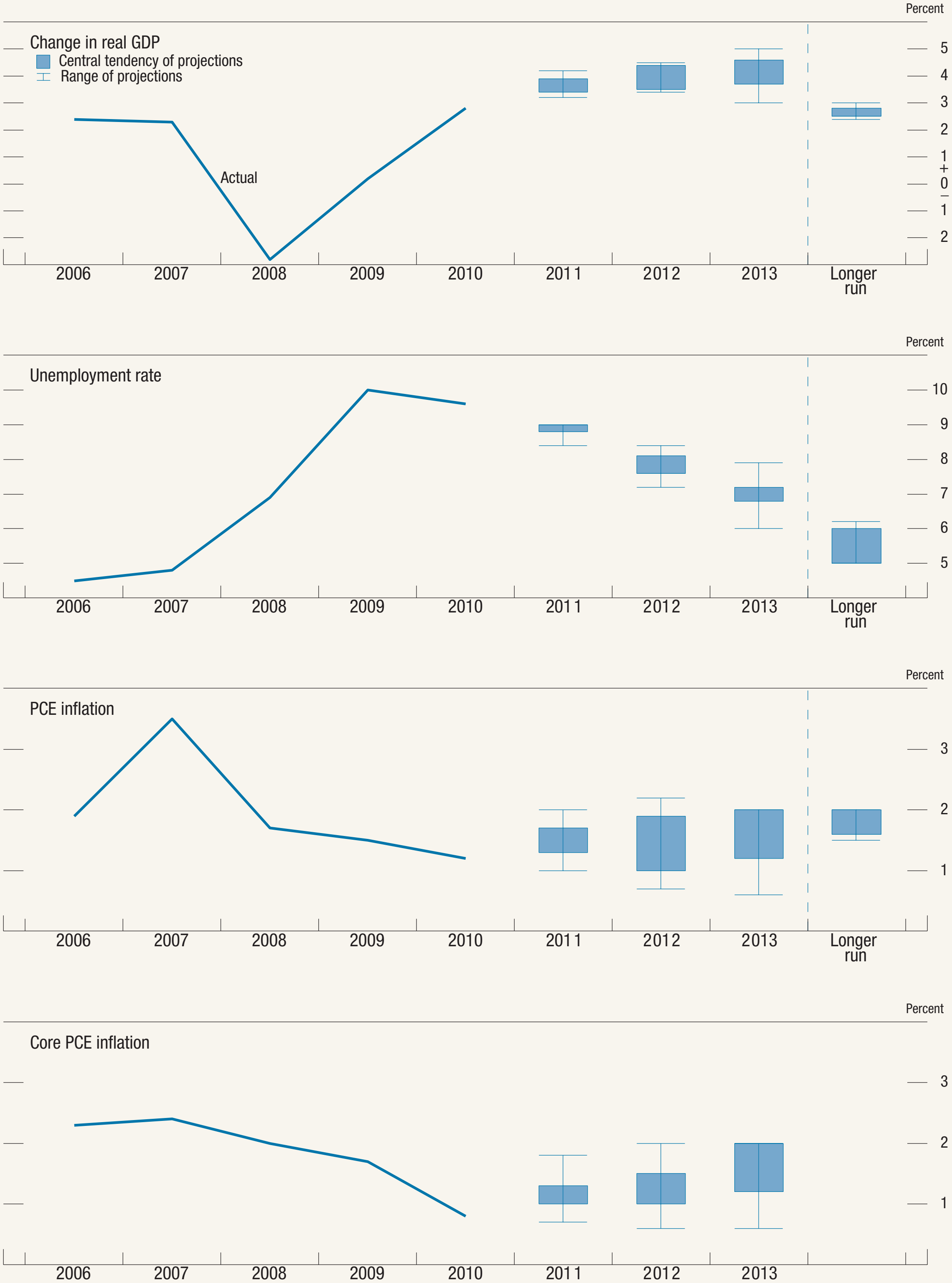
Note: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The November projections were made in conjunction with the meeting of the Federal Open Market Committee on November 2–3, 2010.

1 The central tendency excludes the three highest and three lowest projections for each variable in each year.

2 The range for a variable in a given year consists of all participants' projections, from lowest to highest, for that variable in that year.

3 Longer-run projections for core PCE inflation are not collected.

Figure 1. Central tendencies and ranges of economic projections, 2011–13 and over the longer run



Note: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual. The data for the change in real GDP, PCE inflation, and core PCE inflation shown for 2010 incorporate the advance estimate of GDP for the fourth quarter of 2010, which the Bureau of Economic Analysis released on January 28, 2011. This information was not available to FOMC meeting participants at the time of their meeting.

the expansion and, accordingly, upside risks to the unemployment rate than in November; fewer also saw downside risks to inflation.

The Outlook

The central tendency of participants' forecasts for the change in real GDP in 2011 was 3.4 to 3.9 percent, somewhat higher than in the November projections. Participants stated that the economic information received since November indicated that consumer spending, business investment, and net exports increased more strongly at the end of 2010 than expected earlier; industrial production also expanded more rapidly than they previously anticipated. In addition, after the November projections were prepared, the Congress approved fiscal stimulus measures that were expected to provide further impetus to household and business spending in 2011. Moreover, participants noted that financial conditions had improved since November, including a rise in equity prices, a pickup in activity in capital markets, reports of easing of credit conditions in some markets, and an upturn in bank lending in some sectors. Many participants viewed the stronger tenor of the recent information, along with the additional fiscal stimulus, as suggesting that the recovery had gained some strength—a development seen as likely to carry into 2011—and that the expansion was on firmer footing. Participants expected that the expansion in real economic activity this year would continue to be supported by accommodative monetary policy and by ongoing improvement in credit and financial market conditions. The strengthening in private demand was anticipated to be led by increases in consumer and business spending; over time, improvements in household and business confidence and in labor market conditions would likely reinforce the rise in domestic demand. Nonetheless, participants recognized that the information available since November also indicated that the expansion remained uneven across sectors of the economy, and they expected that the pace of economic activity would continue to be moderated by the weakness in residential and nonresidential construction, the still relatively tight credit conditions in some sectors, an ongoing desire by households to repair their balance sheets, business caution about hiring, and the budget difficulties faced by state and local governments.

Participants expected that the economic expansion would strengthen further in 2012 and 2013, with the central tendencies of their projections for the growth in real GDP moving up to 3.5 to 4.4 percent in 2012 and then to 3.7 to 4.6 percent in 2013. Participants cited, as among the likely contributors to a sustained pickup in the pace of the expansion, a continued improvement in financial market conditions, further expansion of credit availability to households and businesses, increasing household and business confidence, and a favorable outlook for U.S. exports. Several participants noted that, in such an environment, and with labor market conditions anticipated to improve gradually, the restraints on household spending from past declines in wealth and the desire to rebuild savings should abate. A number of participants saw such conditions fostering a broader and stronger recovery in business investment, with a few noting that the market for commercial real estate had recently shown signs of stabilizing. Nonetheless, participants saw a number of factors that would likely continue to moderate the pace of the expansion. Most participants expected that the recovery in the housing market would remain slow, restrained by the overhang of vacant properties, prospects for weak house prices, and the difficulties in resolving foreclosures. In addition, some participants expected that the fiscal strains on the budgets of state and local governments would damp their spending for a time and that the federal government sector would likely be a drag on economic activity after 2011.

Participants anticipated that a gradual but steady reduction in the unemployment rate would accompany the pickup in the pace of the economic expansion over the next three years. The central tendency of their forecasts for the unemployment rate at the end of 2011 was 8.8 to 9.0 percent—a decline of less than 1 percentage point from the actual rate in the fourth quarter of 2010. Although participants generally expected further declines in the unemployment rate over the subsequent two years—to a central tendency of 6.8 to 7.2 percent at the end of 2013—they anticipated that, at the end of that period, unemployment would remain noticeably higher than their estimates of the longer-run rate. Many participants thought that, with appropriate monetary policy and in the absence of further shocks, the unemployment rate would continue to converge gradually toward its longer-run rate within five to six years, but a number of participants indicated that the convergence process would likely be more extended.

While participants viewed the projected pace of the expansion in economic activity as the principal factor underlying their forecasts for the path of the unemployment rate, they also indicated that their projections were influenced by a number of other factors that were likely to contribute to a relatively gradual recovery in the labor market. In that regard, several participants noted that dislocations associated with the uneven recovery across sectors of the economy might retard the matching of workers and jobs. In addition, a number of participants viewed the modest pace of hiring in 2010 as, in part, the result of business caution about the durability of the recovery and of employers' efforts to achieve additional increases in productivity; several participants also cited the particularly slow recovery in demand experienced by small businesses as a factor restraining new job creation. With demand expected to strengthen across a range of businesses and with business confidence expected to improve, participants anticipated that hiring would pick up over the forecast period.

Participants continued to expect that inflation would be relatively subdued over the next three years and kept their longer-run projections of inflation unchanged. Many participants indicated that the persistence of large margins of slack in resource utilization should contribute to relatively low rates of inflation over the forecast horizon. In addition, participants noted that appropriate monetary policy, combined with stable longer-run inflation expectations, should help keep inflation in check. The central tendency of their projections for overall personal consumption expenditures (PCE) inflation in 2011 was 1.3 to 1.7 percent, while the central tendency of their forecasts for core PCE inflation was lower—1.0 to 1.3 percent. Increases in the prices of energy and other commodities, which were very rapid in 2010, were anticipated to continue to push headline PCE inflation above the core rate this year. The central tendency of participants' forecasts for inflation in 2012 and 2013 widened somewhat relative to 2011 and showed that inflation was expected to drift up modestly. In 2013, the central tendency of forecasts for both the total and core inflation rates was 1.2 to 2.0 percent. For most participants, inflation in 2013 was not expected to have converged to the longer-run rate of inflation that they individually considered most consistent with the Federal Reserve's dual mandate for maximum employment and stable prices. However, a number of participants anticipated that inflation would reach its longer-run rate within the next three years.

Uncertainty and Risks

Most participants continued to share the view that their projections for economic activity and inflation were subject to a higher level of uncertainty than was the norm during the previous 20 years.[3] They identified a number of uncertainties that compounded the inherent difficulties in forecasting output growth, unemployment, and inflation. Among them were uncertainties about the nature of economic recoveries from recessions associated with financial crises, the effects of unconventional monetary policies, the persistence of structural dislocations in the labor market, the future course of federal fiscal policy, and the global economic outlook.

Almost all participants viewed the risks to their forecasts for the strength of the recovery in real GDP as broadly balanced. By contrast, in November, the distribution of views had been somewhat skewed to the downside. In weighing the risks to the projected growth rate of real economic activity, some participants noted the upside risk that the recent strengthening of aggregate spending might mark the beginning of a more normal cyclical rebound in economic activity in which consumer spending might be spurred by pent-up demand for household durables and in which business investment might be accelerated by the desire to rebuild stocks of fixed capital. A more-rapid-than-expected easing of credit availabil-

Table 2. Average historical projection error ranges
Percentage points

Variable	2011	2012	2013
Change in real GDP[1]	±1.3	±1.7	±1.8
Unemployment rate[1]	±0.7	±1.3	±1.5
Total consumer prices[2]	±1.0	±1.0	±1.1

Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1990 through 2009 that were released in the winter by various private and government forecasters. As described in the box "**Forecast Uncertainty**," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

1 For definitions, refer to general note in **table 1**.

2 Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

3 **Table 2** provides estimates of forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1990 to 2009. At the end of this summary, the box "**Forecast Uncertainty**" discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

ity was also seen as a factor that might boost the pickup in private demand. As to the downside risks, many participants pointed to the recent declines in house prices and the potential for a slower resolution of existing problems in mortgage and real estate markets as factors that could have more-adverse-than-expected consequences for household spending and bank balance sheets. In addition, several participants expressed concerns that, in an environment of only gradual improvement in labor market and credit conditions, households might be unusually focused on reducing debt and boosting saving. A number of participants also saw a downside risk in the possibility that the fiscal problems of some state and local governments might lead to a greater retrenchment in their spending than currently anticipated. Finally, several participants expressed concerns that the financial and fiscal strains in the euro area might spill over to U.S. financial markets.

The risks surrounding participants' forecasts of the unemployment rate were also broadly balanced and generally reflected the risks attending participants' views of the likely strength of the expansion in real activity. However, a number of participants noted that the unemployment rate might decline less than they projected if businesses were to remain hesitant to expand their workforces because of uncertainty about the durability of the expansion or about employment costs or if mismatches of workers and jobs were more persistent than anticipated.

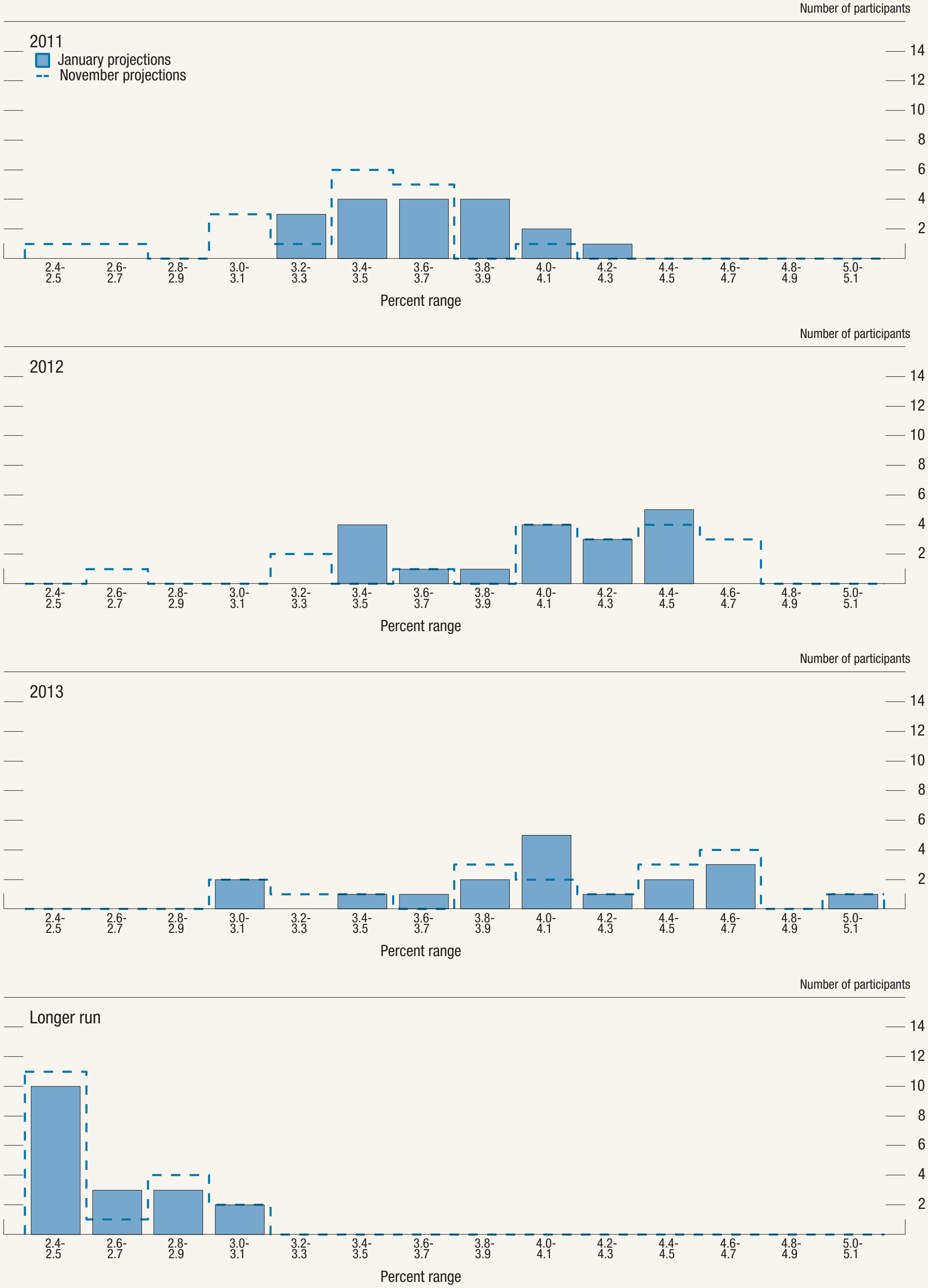
Most participants judged the risks to their inflation outlook over the period from 2011 to 2013 to be broadly balanced as well. Compared with their views in November, several participants no longer saw the risks as tilted to the downside, and an additional participant viewed the risks as weighted to the upside. In assessing the risks, a number of participants indicated that they saw the risks of deflation or further unwanted disinflation to have diminished. Many participants identified the persistent gap between their projected unemployment rate and its longer-run rate as a risk that inflation could be lower than they projected. A few of those who indicated that inflation risks were skewed to the upside expressed concerns that the expansion of the Federal Reserve's balance sheet, if left in place for too long, might erode the stability of longer-run inflation expectations. Alternatively, several participants noted that upside risks to inflation could arise from persistently rapid increases in the costs of energy and other commodities.

Diversity of Views

Figures 2.A and 2.B detail the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate in 2011, 2012, 2013, and over the longer run. The dispersion in these projections reflected differences in participants' assessments of many factors, including the likely evolution of conditions in credit and financial markets, the timing and the degree to which various sectors of the economy and the labor market will recover from the dislocations associated with the deep recession, the outlook for economic and financial developments abroad, and appropriate future monetary policy and its effects on economic activity. For 2011 and 2012, the dispersions of participants' forecasts for the strength in the expansion of real GDP and for the unemployment rate were somewhat narrower than they were last November, while the ranges of views for 2013 and for the longer run were little changed.

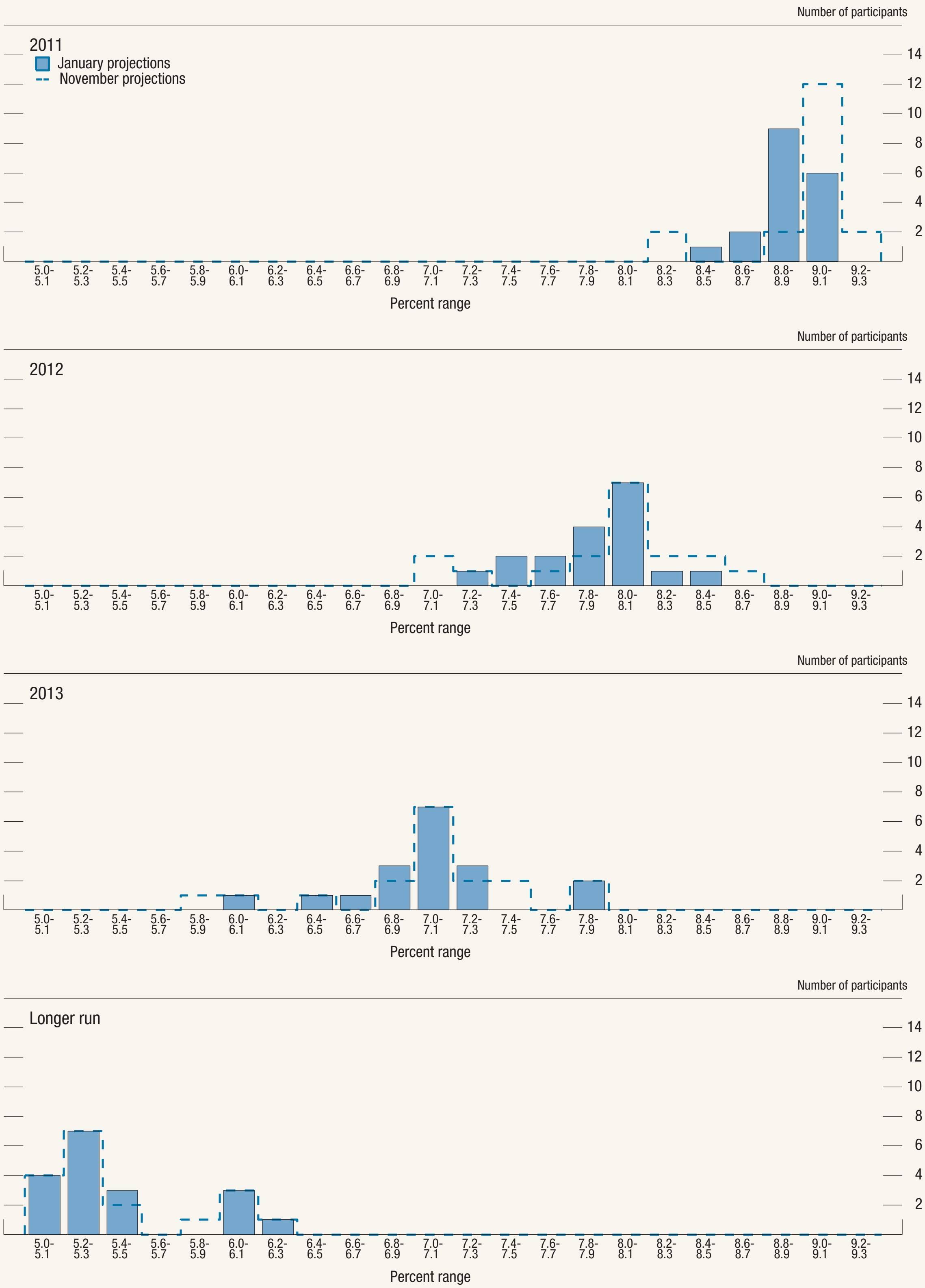
Figures 2.C and 2.D provide the corresponding information about the diversity of participants' views regarding the outlook for total and core PCE inflation. These distributions were somewhat more tightly concentrated for 2011, but for 2012 and 2013, they were much the same as they were in November. In general, the dispersion in the participants' inflation forecasts for the next three years represented differences in judgments regarding the fundamental determinants of inflation, including estimates of the degree of resource slack and the extent to which such slack influences inflation outcomes and expectations as well as estimates of how the stance of monetary policy may influence inflation expectations. Although the distributions of participants' inflation forecasts for 2011 through 2013 continued to be relatively wide, the distribution of projections of the longer-run rate of overall inflation remained tightly concentrated. The narrow range illustrates the broad similarity in participants' assessments of the approximate level of inflation that is consistent with the Federal Reserve's dual objectives of maximum employment and price stability.

Figure 2.A. Distribution of participants' projections for the change in real GDP, 2011–13 and over the longer run



Note: Definitions of variables are in the general note to table 1.

Figure 2.B. Distribution of participants' projections for the unemployment rate, 2011–13 and over the longer run

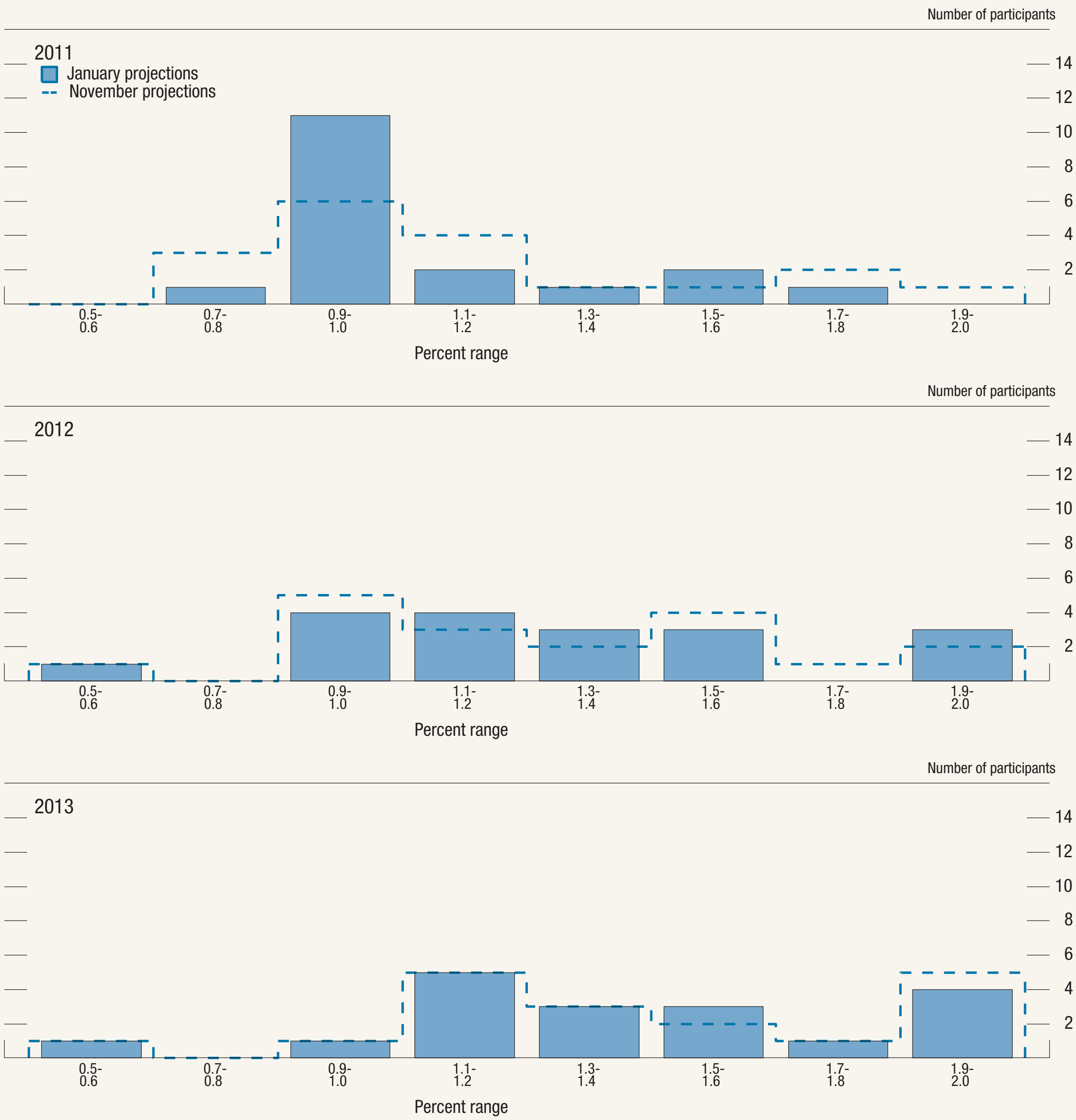


Note: Definitions of variables are in the general note to **table 1**.

Figure 2.C. Distribution of participants' projections for PCE inflation, 2011–13 and over the longer run

Note: Definitions of variables are in the general note to table 1.

Figure 2.D. Distribution of participants' projections for core PCE inflation, 2011–13



Note: Definitions of variables are in the general note to table 1.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world. And the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Report*s and those prepared by Federal Reserve Board staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 1.7 to 4.3 percent in the current year, 1.3 to 4.7 percent in the second year, and 1.2 to 4.8 percent in the third year. The corresponding 70 percent confidence intervals for overall inflation would be 1.0 to 3.0 percent in the current and second years, and 0.9 to 3.1 percent in the third year.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

Meeting Held on March 15, 2011

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, March 15, 2011, at 8:30 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard, Thomas M. Hoenig, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Nathan Sheets
Economist

David J. Stockton
Economist

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Loretta J. Mester, David Reifschneider, Harvey Rosenblum, Daniel G. Sullivan, and David W. Wilcox
Associate Economists

Brian Sack
Manager, System Open Market Account

Nellie Liang
Director, Office of Financial Stability Policy and Research, Board of Governors

Maryann F. Hunter
Deputy Director, Division of Banking Supervision and Regulation, Board of Governors

William Nelson
Deputy Director, Division of Monetary Affairs, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Charles S. Struckmeyer
Deputy Staff Director, Office of the Staff Director, Board of Governors

Lawrence Slifman and William Wascher
Senior Associate Directors, Division of Research and Statistics, Board of Governors

Andrew T. Levin
Senior Adviser, Office of Board Members, Board of Governors

Stephen A. Meyer
Senior Adviser, Division of Monetary Affairs, Board of Governors

Joyce K. Zickler
Visiting Senior Adviser, Division of Monetary Affairs, Board of Governors

Michael G. Palumbo
Associate Director, Division of Research and Statistics, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

Andrea L. Kusko
Senior Economist, Division of Research and Statistics, Board of Governors

Randall A. Williams
Records Management Analyst, Division of Monetary Affairs, Board of Governors

Blake Prichard
First Vice President, Federal Reserve Bank of Philadelphia

Jeff Fuhrer and Robert H. Rasche
Executive Vice Presidents, Federal Reserve Banks of Boston and St. Louis, respectively

David Altig, Richard P. Dzina, Ron Feldman, Craig S. Hakkio, Richard Peach, Glenn D. Rudebusch, Mark E. Schweitzer, and John A. Weinberg
Senior Vice Presidents, Federal Reserve Banks of Atlanta, New York, Minneapolis, Kansas City, New York, San Francisco, Cleveland, and Richmond, respectively

In the agenda for this meeting, it was reported that advices of the election of John C. Williams as an alternate member of the Federal Open Market Committee had been received by the Secretariat, and that he had executed his oath of office.

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on January 25–26, 2011. He also reported on System open market operations, including the ongoing reinvestment into longer-term Treasury securities of principal payments received on the SOMA's holdings of agency debt and agency-guaranteed mortgage-backed securities (MBS) that the Committee authorized in August 2010, as well as the purchase of additional longer-term Treasury securities to increase the face value of such securities held in the SOMA that the FOMC first authorized in November 2010. Since November, purchases by the Open Market Desk of the Federal Reserve Bank of New York had increased the SOMA's holdings by $310 billion. The Manager reported that achieving an increase of $600 billion in SOMA holdings by the end of June 2011 would require continuing to purchase additional securities at an unchanged pace of about $80 billion per month. There were no open market operations in foreign currencies for the System's account over the intermeeting period. By unanimous vote, the Committee ratified the Desk's transactions over the intermeeting period.

The Manager also discussed the possible benefits of gradually reducing the pace of the Federal Reserve's purchases of Treasury securities when the current asset purchase program nears completion. As its earlier program of agency MBS purchases drew to a close, the Federal Reserve tapered its purchases during the first quarter of 2010 in order to avoid disruptions in the market for those securities. However, the Manager indicated that the greater depth and liquidity of the Treasury securities market suggested that it would not be necessary to taper purchases in this market. The Manager noted that market participants appeared to have reached the same conclusion, as they generally did not seem to expect the Federal Reserve to taper its purchases of Treasury securities. In light of the Manager's report, almost all meeting participants indicated that they saw no need to taper the pace of the Committee's purchases of Treasury securities when its current program of asset purchases approaches its end.

Staff Review of the Economic Situation

The information reviewed at the March 15 meeting indicated that the economic recovery continued to proceed at a moderate pace, with a further gradual improvement in labor market conditions. Sizable increases in prices of crude oil and other commodities pushed up headline inflation, but measures of underlying inflation were subdued and longer-run inflation expectations remained stable.

The labor market continued to show signs of firming. Private nonfarm payroll employment rose noticeably in February after a small increase in January, with the swing in hiring likely magnified by widespread snowstorms, which may have held down the employment figure for January. Initial claims for unemployment insurance trended lower through early March, and surveys of hiring plans had improved this year. The unemployment rate dropped markedly in January after a similar decrease in the preceding month, then ticked down to 8.9 percent in February; the labor force participation rate was roughly flat in January and February. The share of workers employed part time for economic reasons declined further over the past two months, but long-duration unemployment was still elevated.

Total industrial production was little changed in January after a strong rise in December. Manufacturing output posted a relatively subdued gain in January, likely held down somewhat by the extensive snowfalls during that month; in addition, a scheduled step-up in assemblies of motor vehicles reportedly was restrained in part by some temporary bottlenecks in the supply chain. As a result, the rate of capacity utilization in manufacturing was essentially unchanged in January, and it remained well below its

1972–2010 average. In February, indicators of near-term industrial production, such as the new orders diffusion indexes in the national and regional manufacturing surveys, were at levels consistent with solid increases in factory output in the coming months. Moreover, motor vehicle assemblies picked up in February and were scheduled to rise further through the second quarter of this year.

Consumer spending appeared to have increased at a modest pace in early 2011 after rising briskly in the fourth quarter of 2010. In January, total real personal consumption expenditures (real PCE) were essentially flat. In February, nominal retail sales, excluding purchases of motor vehicles and parts, rose moderately; sales of light motor vehicles posted a robust gain. Consumer spending was supported by a solid increase in real disposable income in January, reflecting in part the temporary cut in payroll taxes. Household net worth rose in the fourth quarter, as the increase in equity values during that period more than offset the further fall in house prices. However, consumer sentiment dropped back in early March, retracing its increase over the preceding four months.

Activity in the housing market continued to be depressed, held down by the large inventory of foreclosed or distressed properties on the market and by weak demand. In January, starts and permits for new single-family homes remained near the low levels that had prevailed since the middle of 2010. New home sales moved down in January; existing home sales stepped up somewhat but still were quite low by historical standards. Measures of house prices softened again in December and January.

Real business investment in equipment and software (E&S) appeared to rise further in recent months. Nominal shipments of nondefense capital goods excluding aircraft increased, on net, in December and January, and the expanding backlog of unfilled orders pointed to further gains in shipments in subsequent months. In addition, readings on business conditions and sentiment remained consistent with solid near-term advances in outlays for E&S. Credit conditions continued to improve for many firms, though they reportedly were still tight for small businesses. In contrast to the apparent increase in E&S outlays, nonresidential construction expenditures dropped further in December and January, constrained by high vacancy rates, low prices for commercial real estate, and persistently tight borrowing conditions for construction loans for commercial properties.

Real nonfarm inventory investment appeared to have picked up in early 2011 after slowing markedly in the fourth quarter. In the motor vehicles sector, inventories rose slightly, on net, in January and February after having been drawn down in the fourth quarter. Outside of motor vehicles, the rise in the book value of business inventories was somewhat larger in January than the average monthly increase in the fourth quarter, while inventory-to-sales ratios for most industries covered by these data were similar to their pre-recession norms. Survey data also suggested that inventory positions were generally in a comfortable range.

In the government sector, the available information suggested that real defense spending in January and February was below its average level in the fourth quarter. At the state and local level, ongoing fiscal pressures were reflected in further job cuts in January and February. Construction outlays by these governments fell again in January.

The U.S. international trade deficit widened in December and again in January, with rapid gains in both exports and imports. The largest increases in exports were in capital goods, industrial supplies, and automotive products. Nominal imports of petroleum products rose sharply, reflecting both higher prices and greater volumes; imports in other major categories rose solidly on net.

Overall consumer prices in the United States rose somewhat faster in December and January than in earlier months, as consumer energy prices posted further sizable increases and consumer food prices responded to the recent upturn in farm commodity prices. The price index for PCE excluding food and energy (the core PCE price index) rose slightly in January, boosted by an uptick in prices of core goods after four months of declines; the 12-month change in this core price index stayed near the very low levels seen in late 2010. Recent surveys showed further hefty increases in retail gasoline prices in February and early March, and prices of nonfuel industrial commodities also rose sharply on net. According to the Thomson Reuters/University of Michigan Surveys of Consumers, households' near-term inflation expectations increased substantially in early March, likely because of the run-up in gasoline prices; longer-term inflation expectations moved up somewhat in the early March survey but were still within the range that prevailed over the preceding few years.

Labor cost pressures remained muted in the fourth quarter, as hourly compensation continued to be restrained by the wide margin of slack in the labor market and as productivity rose further. Average hourly earnings posted a modest increase, on net, in January and February.

Growth in real activity in the advanced foreign economies appeared to pick up after a lackluster performance in the fourth quarter. In the euro area, monthly indicators of activity, such as retail sales and purchasing managers indexes, were generally positive in January and February. But the divergence in economic performance across euro-area countries remained large, as economic activity appeared to have expanded strongly in Germany but to have contracted in Greece and Portugal. Prior to the earthquake and tsunami in mid-March, economic activity in Japan had shown signs of firming. The upbeat tenor of the incoming data for the emerging market economies suggested that the economic expansion in these countries continued to outpace that in the advanced economies. Foreign consumer price inflation, which stepped up noticeably in the fourth quarter, remained elevated in early 2011, largely because of higher food and energy prices.

Staff Review of the Financial Situation

The decisions by the FOMC at its January meeting to continue its asset purchase program and to maintain the 0 to ¼ percent target range for the federal funds rate were largely in line with market expectations, as was the accompanying statement; they elicited only a modest market reaction. Over the weeks following the FOMC meeting, nominal Treasury yields and the expected path of the federal funds rate in coming quarters moved higher, as market participants apparently read the incoming economic data as, on balance, somewhat better than expected. After mid-February, however, Treasury yields and policy expectations retraced their earlier rise amid concerns about the possible economic fallout from events in the Middle East and North Africa (MENA) region. In the days leading up to the March FOMC meeting, the tragic developments in Japan spurred a further decline in Treasury yields. On net, expectations for the federal funds rate, along with yields on nominal Treasury securities, were little changed over the intermeeting period.

Measures of inflation compensation over the next 5 years rose, on net, over the intermeeting period, with most of the increase concentrated at the front end of the curve, likely reflecting the jump in oil prices. In contrast, measures of forward inflation compensation 5 to 10 years ahead were little changed, suggesting that longer-term inflation expectations remained stable.

Over the intermeeting period, yields on investment- and speculative-grade corporate bonds edged down relative to those on comparable-maturity Treasury securities. The secondary-market prices of syndicated loans continued to move up. Strains in the municipal bond market eased as concerns about the budgetary problems of state and local governments seemed to diminish somewhat. Conditions in short-term funding markets were little changed.

Broad U.S. stock price indexes were about unchanged, on net, over the intermeeting period. Option-implied volatility on the S&P 500 index rose sharply in mid-February in response to events in the MENA region and remained somewhat elevated thereafter. The staff's estimate of the spread between the expected real equity return for S&P 500 firms and the real 10-year Treasury yield—a measure of the equity risk premium—narrowed a bit more over the intermeeting period but continued to be quite elevated relative to longer-term norms.

In the March 2011 Senior Credit Officer Opinion Survey on Dealer Financing Terms, dealers reported a further easing, over the previous three months, in the price and nonprice terms they offered to different types of counterparties for all of the categories of transactions covered in the survey. Dealers noted that the demand for funding had increased for a broad range of securities over the same period. In response to special questions, dealers reported some increase in the use of leverage over the prior six months by traditionally unlevered investors—in particular, asset managers, insurance companies, and pension funds. In addition, dealers reported an increase in leverage over the past six months by hedge funds that pursue a variety of investment strategies. More broadly, while the availability and use of dealer-intermediated leverage had increased since its post-crisis nadir in mid-2009, a review of information from a variety of sources suggested that leverage generally remained well below the levels reached prior to the recent financial crisis.

Net debt financing by nonfinancial corporations was solid in January and February, although it did not match the sizable amount seen in the fourth quarter. Net issuance of investment- and speculative-grade bonds was robust in the first two months of this year. Commercial and industrial (C&I) loans outstanding also increased, on balance, while the amount of nonfinancial commercial paper outstanding was little changed. Gross public equity issuance by nonfinancial firms was relatively subdued in January and February. Measures of the credit quality of nonfinancial firms continued to improve.

Financing conditions for commercial real estate generally remained tight. So far this year, issuance of commercial mortgage-backed securities (CMBS) appeared to have maintained its modest fourth-quarter pace. Data on delinquency rates for commercial real estate loans were mixed.

Rates on conforming fixed-rate residential mortgages, and their spreads relative to the 10-year Treasury yield, were about unchanged over the intermeeting period. With mortgage rates remaining above the low levels seen last fall, refinancing activity was tepid. Outstanding residential mortgage debt was estimated to have contracted again in the fourth quarter. Rates of serious delinquency for subprime and prime mortgages were little changed in December and January.

Consumer credit markets showed further signs of improvement. Total consumer credit expanded moderately in January. As was the case in the fourth quarter, nonrevolving credit expanded while revolving credit ran off. Delinquency rates on credit card loans in securitized pools and on auto loans at finance companies continued to decline through January, nearly returning to their longer-run averages. The issuance of consumer asset-backed securities, which had weakened around the turn of the year, posted a moderate gain in February.

Bank credit declined, on average, in January and February as a result of a contraction in core loans—the sum of C&I, real estate, and consumer loans; holdings of securities were about flat on net. The Survey of Terms of Business Lending conducted in the first week of February showed that spreads of interest rates on C&I loans over comparable-maturity Eurodollar and swap rates decreased somewhat but remained elevated.

M2 increased at a moderate rate, on average, over January and February. Liquid deposits, the largest component of M2, expanded somewhat less rapidly than in the fourth quarter of 2010. Nonetheless, as has been the case for some time, the composition of M2 shifted toward liquid deposits, likely reflecting their higher yields relative to other M2 components. Currency continued to advance at a relatively fast rate in January and February, likely boosted by a strong expansion in foreign holdings of U.S. bank notes.

In financial markets abroad, equity prices in the advanced economies rose early in the intermeeting period, but they turned down in mid-February as oil prices increased and then fell sharply in mid-March in the aftermath of the earthquake and tsunami in Japan. On net over the intermeeting period, stock prices were down in most of the advanced economies, with Japan's index having fallen most significantly. Emerging market equity price indexes, which had been underperforming in previous months, generally ended the period lower as well, and emerging market equity funds experienced outflows. Movements in 10-year sovereign bond yields in Europe and Canada mirrored those in equity prices, climbing early in the intermeeting period but falling later.

In part because of downgrades by credit rating agencies, yields on the 10-year sovereign bonds of Greece, Ireland, and Portugal rose sharply, relative to those on German bonds, through early March. These spreads subsequently declined somewhat in response to a general agreement among euro-area leaders to expand the capacity of the area's backstop funding facility, to extend the maturity of the facility's loans to Greece, and to lower the interest rates on those loans.

The European Central Bank (ECB) left its benchmark policy rate unchanged at its March meeting, but the emphasis on upside risks to inflation at the postmeeting press conference led market participants to infer that the ECB might well tighten policy at its meeting in April. In the United Kingdom, market-based readings on expected policy rates indicated that investors anticipated some tightening of policy before the end of this year. In addition, authorities in several emerging market economies took steps to tighten policy. The broad nominal index of the U.S. dollar declined about 1 percent, on balance, over the intermeeting period.

Staff Economic Outlook

The pace of economic activity appeared to have been a little slower around the turn of the year than the staff had anticipated at the time of the January FOMC meeting, and the near-term forecast for growth of real gross domestic product (GDP) was revised down modestly. However, the outlook for economic activity over the medium term was broadly similar to the projection prepared for the January FOMC meeting. Changes to the conditioning assumptions underlying the staff projection were mostly small and offsetting: Crude oil prices had risen sharply and federal fiscal policy seemed likely to be marginally more restrictive than the staff had judged in January, but these negative factors were counterbalanced by higher household net worth and a slightly lower foreign exchange value of the dollar. As a result, as in the January forecast, real GDP was expected to rise at a moderate pace over 2011 and 2012, supported by accommodative monetary policy, increasing credit availability, and greater household and business confidence. Reflecting the recent labor market data, the projection for the unemployment rate was lower throughout the forecast period than in the staff's January forecast, but the jobless rate was still expected to decline slowly and to remain elevated at the end of 2012.

The staff revised up its projection for consumer price inflation in the near term, largely because of the recent increases in the prices of energy and food. However, in light of the projected persistence of slack in labor and product markets and the anticipated stability in long-term inflation expectations, the increase in inflation was expected to be mostly transitory if oil and other commodity prices did not rise significantly further. As a result, the forecast for consumer price inflation over the medium run was little changed relative to that prepared for the January meeting.

Participants' Views on Current Conditions and the Economic Outlook

In discussing intermeeting developments and their implications for the economic outlook, participants agreed that the information received since their previous meeting was broadly consistent with their expectations and suggested that the economic recovery was on a firmer footing. Looking through weather-related distortions in various indicators, measures of consumer spending, business investment, and employment showed continued expansion. Housing, however, remained depressed. Meeting participants took note of the significant decline in the unemployment rate over the past few months but observed that other indicators pointed to a more gradual improvement in overall labor market conditions. They continued to expect that economic growth would strengthen over coming quarters while remaining moderate. Participants noted that recent increases in the prices of oil and other commodities were putting upward pressure on headline inflation, but that measures of underlying inflation remained subdued. They anticipated that the effects on inflation of the recent run-up in commodity prices would prove transitory, in part because they saw longer-term inflation expectations remaining stable. Moreover, a number of participants expected that slack in resource utilization would continue to restrain increases in labor costs and prices. Nonetheless, participants observed that rapidly rising commodity prices posed upside risks to the stability of longer-term inflation expectations, and thus to the outlook for inflation, even as they posed downside risks to the outlook for growth in consumer spending and business investment. In addition, participants noted that unfolding events in the Middle East and North Africa, along with the recent earthquake, tsunami, and subsequent developments in Japan, had further increased uncertainty about the economic outlook.

Participants' judgment that the recovery was gaining traction reflected both the incoming economic indicators and information received from business contacts. Spending by households, which had picked up noticeably in the fourth quarter, rose further during the early part of 2011, with auto sales showing particular strength. Although some participants noted that growth in consumer spending so far this year had not been as vigorous as they had anticipated, they attributed the shortfall in part to unusually bad weather. While participants expected that household spending would continue to expand, the pace of expansion was uncertain. On the one hand, labor market conditions were improving, though gradually, and the temporary cut in payroll taxes was contributing to rising after-tax incomes. Some easing of credit conditions for households, particularly for auto loans, also appeared to be supporting growth in consumer spending. On the other hand, declining house prices remained a drag on household wealth and thus on consumer spending. In addition, sizable recent increases in oil and gasoline prices had reduced real incomes and weighed on consumer confidence. Business contacts in a variety of industries had expressed concern that consumers might pull back if gasoline prices rose significantly further and persisted at those elevated levels.

A further increase in business activity also indicated that the economic recovery remained on track. Industrial production posted solid gains, supported in part by continuing growth in U.S. exports. Business contacts in a number of regions reported they were more confident about the recovery; a growing number of contacts indicated they were planning for an expansion in hiring and production to meet an anticipated rise in sales. Manufacturing firms were particularly upbeat. Some contacts reported they were increasing capital budgets to undertake investment that had been postponed during the recession and early stages of the recovery; in some cases, firms were planning to expand capacity. Consistent with the anecdotal evidence, indicators of current and planned business investment in equipment and software continued to rise and surveys showed a further improvement in business sentiment. In addition, although residential construction remained weak, investment in energy extraction was growing and spending on commercial construction projects appeared to be bottoming out.

Meeting participants judged that overall conditions in labor markets had continued to improve gradually. The unemployment rate had decreased significantly in recent months; other labor market indicators, including measures of job growth and hours worked, showed more-modest improvements. Several participants noted that the drop in unemployment was attributable more to people withdrawing from the labor force and to fewer layoffs than to increased hiring. Even so, participants agreed that gains in employment seemed to be on a gradually rising trajectory, although the recent data had been somewhat erratic and distorted by worse-than-usual weather in many parts of the country. In addition, surveys of employers showed that an increasing number of firms were planning to hire. Participants noted regional differences in the speed of improvement in labor markets; scattered reports indicated that firms in some regions were having difficulty hiring some types of highly skilled workers. Participants generally judged that there was still substantial slack in the labor market, though estimates of the degree of slack were admittedly imprecise and depended in part on judgments about a number of factors, including the extent to which labor force participation would increase as the recovery progresses and employment expands.

Credit conditions remained uneven. Bankers again reported improving credit quality and generally weak loan demand. Large firms that have access to financial markets continued to find credit, including bank loans, available on relatively attractive terms; however, credit conditions reportedly remained tight for smaller, bank-dependent firms. Participants noted evidence that the availability of student loans and of consumer loans—particularly auto loans—was increasing. Indeed, bank and nonbank lenders reported that terms and conditions for auto loans had returned to historical norms. In contrast, terms for commercial and residential real estate loans remained tight and the volume of outstanding loans continued to decline, though there was some issuance of CMBS backed by loans on high-quality properties in selected large metropolitan areas. A few participants expressed concern that the easing of credit conditions in some sectors was becoming or might become excessive as investors took on more risk in order to obtain higher yields.

Participants observed that headline inflation was being boosted by higher prices for energy and other commodities, and that prices of other imported goods also had risen by a substantial, though smaller, amount. A number of business contacts indicated that they were passing on at least a portion of these higher costs to their customers or that they planned to try to do so later this year; however, contacts were uncertain about the extent to which they could raise prices, given current market conditions and the cautious attitudes toward spending still held by households and businesses. Other participants noted that commodity and energy costs accounted for a relatively small share of production costs for most firms and that labor costs accounted for the bulk of such costs; moreover, they observed that unit labor costs generally had declined in recent years as productivity growth outpaced wage gains. Several participants noted that even large commodity price increases have had only limited effects on underlying inflation in recent decades.

In contrast to headline inflation, core inflation and other measures of underlying inflation remained subdued, though they appeared to have bottomed out. A number of participants noted that, with significant slack in resource utilization and with longer-term inflation expectations stable, underlying inflation likely would remain subdued for some time. However, the importance of resource slack as a factor influencing inflation was debated. Some participants pointed to research indicating that measures of slack were useful in predicting inflation. Others argued that, historically, such measures were only modestly helpful in explaining large movements in inflation; one noted the 2003–04 episode in which core inflation rose rapidly over a few quarters even though there appeared to be substantial resource slack.

Participants expected that the boost to headline inflation from recent increases in energy and other commodity prices would be transitory and that underlying inflation trends would be little affected as long as commodity prices did not continue to rise rapidly and longer-term inflation expectations remained stable. However, a significant increase in longer-term inflation expectations could contribute to excessive wage and price inflation, which would be costly to eradicate. Accordingly, participants considered it important to pay close attention to the evolution not only of headline and core inflation but also of inflation expectations. In this regard, participants observed that measures of longer-term inflation compensation derived from financial instruments had remained stable of late, suggesting that longer-term inflation expectations had not changed appreciably, although measures of one-year inflation compensation had risen notably. Survey-based measures of inflation expectations also indicated that longer-term expected inflation had risen much less than near-term inflation expectations. A few participants noted that the adoption by the Committee of an explicit numerical inflation objective could help keep longer-term inflation expectations well anchored.

Participants generally judged the risks to their forecasts of growth in economic activity to be roughly balanced. They continued to see some downside risks from the banking and fiscal strains in the European periphery, the continuing fiscal adjustments by U.S. state and local governments, and the ongoing weakness in the housing market. Several also noted the possibility of larger-than-anticipated near-term cuts in federal government spending. Moreover, the economic implications of the tragedy in Japan—for example, with respect to global supply chains—were not yet clear. On the upside, the improvement in labor market conditions in recent months raised the possibility that household spending—and subsequently business investment—might expand more rapidly than anticipated; if so, the recovery could be stronger than currently projected. Participants judged that the potential for more-widespread disruptions in oil production, and thus for a larger jump in energy prices, posed both downside risks to growth and upside risks to inflation. Several of them indicated, in light of recent developments, that the risks to their forecasts of inflation had shifted somewhat to the upside. Finally, a few participants noted that if the large size of the Federal Reserve's balance sheet were to lead the public to doubt the Committee's ability to withdraw monetary accommodation when appropriate, the result could be upward pressure on inflation expectations and so on actual inflation. To mitigate such risks, participants agreed that the Committee would continue its planning for the eventual exit from the current, exceptionally accommodative stance of monetary policy. In light of uncertainty about the economic outlook, it was seen as prudent to consider possible exit strategies for a range of potential economic outcomes. A few participants indicated that economic conditions might warrant a move toward less-accommodative monetary policy this year; a few others noted that exceptional policy accommodation could be appropriate beyond 2011.

Committee Policy Action

In their discussion of monetary policy for the period ahead, Committee members agreed that no changes to the Committee's asset purchase program or to its target range for the federal funds rate were warranted at this meeting. The information received over the intermeeting period indicated that the economic recovery was on a firmer footing and that overall conditions in the labor market were gradually improving. Although the unemployment rate had declined in recent months, it remained elevated relative to levels that the Committee judged to be consistent, over the longer run, with its statutory mandate to foster maximum employment and price stability. Similarly, measures of underlying inflation continued to be somewhat low relative to levels seen as consistent with the dual mandate over the longer run. With longer-term inflation expectations remaining stable and measures of underlying inflation subdued, members anticipated that recent increases in the prices of energy and other commodities would result in only a transitory increase in headline inflation. Given this economic outlook, the Committee agreed to continue to expand its holdings of longer-term Treasury securities as announced in November in order to promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with the Committee's mandate. Specifically, the Committee maintained its existing policy of reinvesting principal payments from its securities holdings and reaffirmed its intention to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. A few members remained uncertain about the benefits of the asset purchase program but judged that making changes to the program at this time was not appropriate. The Committee continued to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, were likely to warrant exceptionally low levels for the federal funds rate for an extended period.

Members emphasized that the Committee would continue to regularly review the pace of its securities purchases and the overall size of the asset purchase program in light of incoming information—including information on the outlook for economic activity, developments in financial markets, and the efficacy of the purchase program and any unintended consequences that might arise—and would adjust the program as needed to best foster maximum employment and price stability. A few members noted that evidence of a stronger recovery, or of higher inflation or rising inflation expectations, could make it appropriate to reduce the pace or overall size of the purchase program. Several others indicated that they did not anticipate making adjustments to the program before its intended completion.

With respect to the statement to be released following the meeting, members decided to note the further improvement in economic activity and in labor markets. The Committee also decided to summarize its current thinking about inflation pressures and to emphasize that it will closely monitor the evolution of overall inflation and inflation expectations.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Open Market Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to execute purchases of longer-term Treasury securities in order to increase the total face value of domestic securities held in the System Open Market Account to approximately $2.6 trillion by the end of June 2011. The Committee also directs the Desk to reinvest principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 2:15 p.m.:

> "Information received since the Federal Open Market Committee met in January suggests that the economic recovery is on a firmer footing, and overall conditions in the labor market appear to be improving gradually. Household spending and business investment in equipment and software continue to expand. However, investment in nonresidential structures is still weak, and the housing sector continues to be depressed. Commodity prices have risen significantly since the summer, and concerns about global supplies of crude oil have contributed to a sharp run-up in oil prices in recent weeks. Nonetheless, longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued.
>
> Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate remains elevated, and measures of underlying inflation continue to be somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. The recent increases in the prices of energy and other commodities are currently putting upward pressure on inflation. The Committee expects these effects to be transitory, but it will pay close attention to the evolution of inflation and inflation expectations. The Committee continues to anticipate a gradual return to higher levels of resource utilization in a context of price stability.
>
> To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to continue expanding its holdings of securities as announced in November. In particular, the Committee is maintaining its existing policy of reinvesting principal payments from its securities holdings and intends to purchase $600 billion of longer-term Treasury securities by the end of the second quarter of

2011. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability.

The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Richard W. Fisher, Narayana Kocherlakota, Charles I. Plosser, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: None.

The Committee then discussed a recommendation, from its subcommittee on communications, that the Chairman conduct regular press conferences. Participants generally saw such press conferences as a potentially useful way to enhance transparency and strengthen the Committee's policy communications. They discussed various implications of, and alternative arrangements for, such press conferences. They generally endorsed holding press conferences after the four FOMC meetings each year for which participants provide numerical projections of several key economic variables, conditional on appropriate monetary policy. While those projections already are made public in the minutes of the relevant FOMC meetings, press conferences could be helpful in explaining how the Committee's monetary policy strategy is informed by participants' projections of the rates of output growth, unemployment, and inflation likely to prevail during each of the next few years, and by their assessments of the values of those variables that will prove most consistent, over the longer run, with the Committee's mandate to promote both maximum employment and stable prices. The outcome of the discussion was a decision that the Chairman would begin holding press conferences effective with the April 26–27, 2011, meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, April 26–27, 2011. The meeting adjourned at 2:35 p.m. on March 15, 2011.

Notation Vote

By notation vote completed on February 15, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on January 25–26, 2011.

William B. English
Secretary

Meeting Held on April 26–27, 2011

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, April 26, 2011, at 10:30 a.m. and continued on Wednesday, April 27, 2011, at 8:30 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Christine Cumming, Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard, Thomas M. Hoenig, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Thomas C. Baxter
Deputy General Counsel

Nathan Sheets
Economist

David J. Stockton
Economist

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Loretta J. Mester, David Reifschneider, Harvey Rosenblum, David W. Wilcox, and Kei-Mu Yi
Associate Economists

Brian Sack
Manager, System Open Market Account

Jennifer J. Johnson
Secretary of the Board, Office of the Secretary, Board of Governors

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation, Board of Governors

Nellie Liang
Director, Office of Financial Stability Policy and Research, Board of Governors

Robert deV. Frierson
Deputy Secretary, Office of the Secretary, Board of Governors

William Nelson
Deputy Director, Division of Monetary Affairs, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Charles S. Struckmeyer
Deputy Staff Director, Office of the Staff Director, Board of Governors

Lawrence Slifman and William Wascher
Senior Associate Directors, Division of Research and Statistics, Board of Governors

Andrew T. Levin
Senior Adviser, Office of Board Members, Board of Governors

Joyce K. Zickler
Visiting Senior Adviser, Division of Monetary Affairs, Board of Governors

Michael G. Palumbo
Associate Director, Division of Research and Statistics, Board of Governors

Trevor A. Reeve[1]
Associate Director, Division of International Finance, Board of Governors

Fabio M. Natalucci
Assistant Director, Division of Monetary Affairs, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

Jeremy B. Rudd
Senior Economist, Division of Research and Statistics, Board of Governors

James M. Lyon
First Vice President, Federal Reserve Bank of Minneapolis

Jamie J. McAndrews and Mark S. Sniderman
Executive Vice Presidents, Federal Reserve Banks of New York and Cleveland, respectively

David Altig, Alan D. Barkema, Richard P. Dzina, David Marshall, Christopher J. Waller, and John A. Weinberg
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Kansas City, New York, Chicago, St. Louis, and Richmond, respectively

John Fernald and Giovanni Olivei
Vice Presidents, Federal Reserve Banks of San Francisco and Boston, respectively

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on March 15, 2011. He also reported on System open market operations, including the continuing reinvestment into longer-term Treasury securities of principal payments received on the SOMA's holdings of agency debt and agency-guaranteed mortgage-backed securities (MBS) as well as the ongoing purchases of additional Treasury securities first authorized in November 2010. Since November, purchases by the Open Market Desk of the Federal Reserve Bank of New York had increased the SOMA's holdings by $422 billion. The Manager reported on the U.S. authorities' participation in the coordinated foreign exchange intervention announced by the Group of Seven (G-7) finance ministers and central bank governors on March 17, 2011. By unanimous votes, the Committee ratified the Desk's domestic and foreign exchange market transactions over the intermeeting period.

By unanimous vote, the Committee agreed to extend the reciprocal currency (swap) arrangements with the Bank of Canada and the Banco de México for an additional year beginning in mid-December 2011; these arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement of 1994. The arrangement with the Bank of Canada is in the amount of $2 billion equivalent, and the arrangement with the Banco de México is in the amount of $3 billion equivalent. The vote to renew the System's participation in these swap arrangements was taken at this meeting because of a provision in the arrangements that requires each party to provide six months' prior notice of an intention to terminate its participation.

The staff next gave a presentation on strategies for normalizing the stance and conduct of monetary policy over time as the economy strengthens. Normalizing the *stance* of policy would entail the withdrawal of the current extraordinary degree of accommodation at the appropriate time, while normalizing the *conduct* of policy would involve draining the large volume of reserve balances in the banking system and shrinking the overall size of the balance sheet, as well as returning the SOMA to its historical composition of essentially only Treasury securities. The presentation noted a few key issues that the Committee would need to address in deciding on its approach to normalization. The first key issue was the extent to which the Committee would want to tighten policy, at the appropriate time, by increasing short-term interest rates, by decreasing its holdings of longer-term securities, or both. Because the two policies would restrain economic activity by tightening financial conditions, they could be combined in various ways to achieve similar outcomes. For example, in principle, the Committee could accomplish essentially the same degree of monetary tightening by selling assets sooner and faster but raising the target for the federal funds rate later and more slowly, or by selling assets later and more slowly but increasing the

[1] Attended Tuesday's session only.

federal funds rate target sooner and faster. The SOMA portfolio could be reduced by selling securities outright, by ceasing the reinvestment of principal payments on its securities holdings, or both. A second key issue was the extent to which the Committee might choose to vary the pace of any asset sales it undertakes in response to economic and financial conditions. If it chose to make the pace of sales quite responsive to conditions, the FOMC would be able to actively use two policy instruments—asset sales and the federal funds rate target—to pursue its economic objectives, which could increase the scope and flexibility for adjusting financial conditions. In contrast, sales at a pace that varied less with changes in economic and financial conditions and was preannounced and largely predetermined would leave the federal funds rate target as the Committee's primary active policy instrument, which could result in policy that is more straightforward for the Committee to calibrate and to communicate. Finally, the staff presentation noted that the Committee would need to decide if and when to use the tools that it has developed to temporarily reduce reserve balances—reverse repurchase agreements and term deposits—in order to tighten the correspondence between any changes in the interest rate the Federal Reserve pays on excess reserves and the changes in the federal funds rate.

Meeting participants agreed on several principles that would guide the Committee's strategy for normalizing monetary policy. First, with regard to the normalization of the stance of monetary policy, the pace and sequencing of the policy steps would be driven by the Committee's monetary policy objectives for maximum employment and price stability. Participants noted that the Committee's decision to discuss the appropriate strategy for normalizing the stance of policy at the current meeting did not mean that the move toward such normalization would necessarily begin soon. Second, to normalize the conduct of monetary policy, it was agreed that the size of the SOMA's securities portfolio would be reduced over the intermediate term to a level consistent with the implementation of monetary policy through the management of the federal funds rate rather than through variation in the size or composition of the Federal Reserve's balance sheet. Third, over the intermediate term, the exit strategy would involve returning the SOMA to holding essentially only Treasury securities in order to minimize the extent to which the Federal Reserve portfolio might affect the allocation of credit across sectors of the economy. Such a shift was seen as requiring sales of agency securities at some point. And fourth, asset sales would be implemented within a framework that had been communicated to the public in advance, and at a pace that potentially could be adjusted in response to changes in economic or financial conditions.

In addition, nearly all participants indicated that the first step toward normalization should be ceasing to reinvest payments of principal on agency securities and, simultaneously or soon after, ceasing to reinvest principal payments on Treasury securities. Most participants viewed halting reinvestments as a way to begin to gradually reduce the size of the balance sheet. It was noted, however, that ending reinvestments would constitute a modest step toward policy tightening, implying that that decision should be made in the context of the economic outlook and the Committee's policy objectives. In addition, changes in the statement language regarding forward policy guidance would need to accompany the normalization process.

Participants expressed a range of views on some aspects of a normalization strategy. Most participants indicated that once asset sales became appropriate, such sales should be put on a largely predetermined and preannounced path; however, many of those participants noted that the pace of sales could nonetheless be adjusted in response to material changes in the economic outlook. Several other participants preferred instead that the pace of sales be a key policy tool and be varied actively in response to changes in the outlook. A majority of participants preferred that sales of agency securities come after the first increase in the FOMC's target for short-term interest rates, and many of those participants also expressed a preference that the sales proceed relatively gradually, returning the SOMA's composition to all Treasury securities over perhaps five years. Participants noted that, for any given degree of policy tightening, more-gradual sales that commenced later in the normalization process would allow for an earlier increase of the federal funds rate target from its effective lower bound than would be the case if asset sales commenced earlier and at a more rapid pace. As a result, the Committee would later have the option of easing policy with an interest rate cut if economic conditions then warranted. An earlier increase in the federal funds rate was also mentioned as helpful to limit the potential for the very low level of that rate to encourage financial imbalances. A few participants expressed a preference that sales begin before any increase in the federal funds rate target, and a few other participants indicated that sales and increases in the federal funds rate target should commence at the same time. The participants who favored earlier sales also generally indicated a preference for relatively rapid sales, with some suggesting that agency securities in the SOMA be reduced to zero over as little as one or two years. Such an approach was viewed as allowing for a faster return to a normal policy environment, potentially reducing any upside risks to inflation stemming from outsized reserve balances, and more quickly eliminating any effects of SOMA holdings of agency securities on the allocation of credit.

Most participants saw changes in the target for the federal funds rate as the preferred active tool for tightening monetary policy when appropriate. A number of participants noted that it would be advisable to begin using the temporary reserves-draining tools in advance of an increase in the Committee's federal funds rate target, in part because doing so would put the Federal Reserve in a better position to assess the effectiveness of the draining tools and judge the size of draining operations that might be required to support changes in the interest on excess reserves (IOER) rate in implementing a desired increase in short-term rates. A number of participants also noted that they would be prepared to sell securities sooner if the temporary reserves-draining operations and the end of the reinvestment of principal payments were not sufficient to support a fairly tight link between increases in the IOER rate and increases in short-term market interest rates.

In the discussion of normalization, some participants also noted their preferences about the longer-run framework for monetary policy implementation. Most of these participants indicated that they preferred that monetary policy eventually operate through a corridor-type system in which the federal funds rate trades in the middle of a range, with the IOER rate as the floor and the discount rate as the ceiling of the range, as opposed to a floor-type system in which a relatively high level of reserve balances keeps the federal funds rate near the IOER rate. A couple of participants noted that any normalization strategy would likely involve an elevated balance sheet with the federal funds rate target near the IOER rate—as in floor-type systems—for some time, and therefore the Committee would accumulate experience during the process of normalizing policy that would allow it to make a more informed choice regarding the longer-term framework at a later date.

The Committee agreed that more discussion of these issues was needed, and no decisions regarding the Committee's strategy for normalizing policy were made at this meeting.

Staff Review of the Economic Situation

The information reviewed at the April 26–27 meeting indicated, on balance, that economic activity expanded at a moderate pace in recent months, and labor market conditions continued to improve gradually. Headline consumer price inflation was boosted by large increases in food and energy prices, but measures of underlying inflation were still subdued and longer-run inflation expectations remained stable.

Private nonfarm payroll employment increased again in March, and the gains in hiring for the first quarter as a whole were somewhat above the pace seen in the fourth quarter. A number of indicators of job openings and hiring plans improved in February and March. Although initial claims for unemployment insurance were flat, on net, from early March through the middle of April, they remained lower than earlier in the year. The unemployment rate edged down further to 8.8 percent in March, while the labor force participation rate was unchanged. However, both long-duration unemployment and the share of workers employed part time for economic reasons were still very high.

Industrial production in the manufacturing sector expanded at a robust pace in February and March. The manufacturing capacity utilization rate moved up further, though it continued to be a good bit lower than its longer-run average. Most forward-looking indicators of industrial activity, such as the new orders indexes in the national and regional manufacturing surveys, remained at levels consistent with solid gains in production in the near term. However, motor vehicle assemblies were expected to step down in the second quarter from their level in March, reflecting emerging shortages of specialized components imported from Japan.

The rise in consumer spending appeared to have slowed to a moderate rate in the first quarter from the stronger pace posted in the fourth quarter of last year. Total real personal consumption expenditures picked up in February after being about unchanged in January. Nominal retail sales, excluding purchases at motor vehicles and parts outlets, posted a sizable gain in March, but sales of new light motor vehicles declined somewhat. Real disposable income edged down in February following an increase in January that reflected the temporary reduction in payroll taxes. In addition, consumer sentiment declined noticeably in March and remained relatively downbeat in early April.

Activity in the housing market remained very weak, as the large overhang of foreclosed and distressed properties continued to restrain new construction. Starts and permits of new single-family homes inched down, on net, in February and March, and they have been essentially flat since around the middle of last year. Demand for housing also continued to be depressed. Sales of new and existing homes moved lower, on net, in February and March, while measures of home prices slid further in February.

Real business investment in equipment and software (E&S) appeared to have increased more robustly in the first quarter than in the fourth quarter of last year. Nominal shipments of nondefense capital goods rose in February and March, and businesses' purchases of new vehicles trended higher. New orders of nondefense capital goods continued to run ahead of shipments in February and March, and this expanding backlog of unfilled orders pointed to further increases in shipments in subsequent months. In addition, survey measures of business conditions and sentiment in recent months were consistent with continued robust gains in E&S spending. In contrast, business outlays for nonresidential construction remained extremely weak in February, restrained by high vacancy rates, low prices for office and commercial properties, and tight credit conditions for commercial real estate lending.

Real nonfarm inventory investment appeared to have moved up to a moderate pace in the first quarter after slowing sharply in the preceding quarter. Motor vehicle inventories were drawn down more slowly in the first quarter than in the fourth quarter, while data through February suggested that the pace of stockbuilding outside of motor vehicles had picked up a bit. Book-value inventory-to-sales ratios in February were in line with their pre-recession norms, and survey data in March provided little evidence that businesses perceived that their inventories were too high.

The available data on government spending indicated that real federal purchases fell in the first quarter, led by a reduction in defense outlays. Real expenditures by state and local governments also appeared to have declined, as outlays for construction projects decreased further in February to a level well below that in the fourth quarter, and state and local employment continued to contract in March.

The U.S. international trade deficit narrowed slightly in February after widening sharply in January. Following a solid increase in January, exports fell back some in February, with declines widespread across categories. Imports also declined in February after posting large gains in January. On average, the trade deficit in January and February was wider than in the fourth quarter.

Overall U.S. consumer price inflation moved up further in February and March, as increases in the prices of energy and food commodities continued to be passed through to the retail level. More recently, survey data through the middle of April pointed to additional increases in retail gasoline prices, while increases in the prices of food commodities appeared to have moderated somewhat. Excluding food and energy, core consumer price inflation remained relatively subdued. Although core consumer price inflation over the first three months of the year stepped up somewhat, the 12-month change in the core consumer price index through March was essentially the same as it was a year earlier. Near-term inflation expectations from the Thomson Reuters/University of Michigan Surveys of Consumers remained elevated in early April. But longer-term inflation expectations moved down in early April—reversing their uptick in March—and stayed within the range that has prevailed over the past several years.

Available measures of labor compensation suggested that wage increases continued to be restrained by the presence of a large margin of slack in the labor market. Average hourly earnings for all employees were flat in March, and their average rate of increase over the preceding 12 months remained low.

The pace of recovery abroad appeared to have strengthened earlier this year, but the disaster in Japan raised uncertainties about foreign activity in the near term. In the euro area, production expanded at a solid pace, though indicators of consumer spending weakened. While measures of economic activity in Germany posted strong gains, economic conditions in Greece and Portugal deteriorated further. The damage caused by the earthquake and tsunami in Japan appeared to be sharply curtailing Japanese economic activity and posed concerns about disruptions to supply chains and production in other economies. Emerging market economies (EMEs) continued to expand rapidly. Rising prices of oil and other commodities boosted inflation in foreign economies. However, core inflation remained subdued in most of the advanced foreign economies, and inflation in the EMEs seemed to have declined as food price inflation slowed.

Staff Review of the Financial Situation

The decisions by the FOMC at its March meeting to continue its asset purchase program and to maintain the 0 to ¼ percent target range for the federal funds rate were in line with market expectations; nonetheless, the accompanying statement prompted a modest rise in nominal yields, as market participants reportedly perceived a somewhat more optimistic tone in the Committee's economic outlook, as well as heightened concern about inflation risks. Over the intermeeting period, yields on nominal Treasury securities changed little, on net, amid swings in investors' assessments of global risks. Short-term funding rates, including the effective federal funds rate, shifted down several basis points in early April following a change in the Federal Deposit Insurance Corporation's deposit insurance assessment system. On net, the expected path of the federal funds rate over the next two years was little changed over the intermeeting period.

Measures of inflation compensation over the next 5 years based on nominal and inflation-protected Treasury securities increased slightly, on net, over the intermeeting period, partly reflecting the ongoing rise in commodity prices. Staff models suggested that the modest increase in inflation compensation 5 to 10 years ahead was mostly attributable to increases in liquidity and inflation-risk premiums rather than higher expected inflation.

Over the intermeeting period, yields on corporate bonds were generally little changed, on net, and spreads of investment- and speculative-grade corporate bonds relative to comparable-maturity Treasury securities narrowed slightly. Average secondary-market prices for syndicated leveraged loans moved up further. However, conditions in the municipal bond market remained somewhat strained.

Broad U.S. stock price indexes rose, on net, over the intermeeting period, as initial reports of better-than-expected first-quarter earnings lifted stock prices in late April. Option-implied volatility on the S&P 500 index was moderately lower, on net, ending the intermeeting period at the low end of its recent range.

Net debt financing by nonfinancial corporations remained robust in March. Net issuance of investment- and speculative-grade bonds by nonfinancial corporations continued to be strong, and outstanding amounts of commercial and industrial (C&I) loans and nonfinancial commercial paper increased noticeably. Gross public equity issuance by nonfinancial firms was robust in March, and indicators of the credit quality of nonfinancial firms improved further.

Commercial mortgage markets showed some signs of stabilization. Delinquency rates for commercial real estate loans appeared to have leveled off in recent months. Issuance of commercial mortgage-backed securities picked up in the first quarter, although commercial real estate loans at banks continued to run off. In commercial real estate markets, property sales remained tepid, and prices stayed at depressed levels.

Rates on conforming fixed-rate residential mortgages rose modestly during the intermeeting period, and their spreads relative to 10-year Treasury yields narrowed slightly. Mortgage refinancing activity remained near its lowest level in more than two years. The Treasury Department's announcement in late March that it would begin selling its holdings of agency MBS at a gradual pace had little lasting effect on MBS spreads. The Federal Reserve began competitive sales of the non-agency residential MBS held by Maiden Lane II LLC; initial sales met with strong demand, but market prices of non-agency residential MBS were reportedly little changed overall. The rates of serious delinquencies for subprime and prime mortgages were nearly unchanged but remained at elevated levels. However, the rate of new delinquencies on prime mortgages declined further.

Conditions in consumer credit markets continued to improve gradually. Total consumer credit growth picked up in February, as a gain in nonrevolving credit more than offset a further contraction in revolving credit. Delinquency and charge-off rates for credit card debt moved down in recent months and approached pre-crisis levels. Issuance of consumer asset-backed securities remained steady in the first quarter of the year.

Bank credit was about unchanged in March after declining, on average, in January and February. Core loans—the sum of C&I, real estate, and consumer loans—continued to contract, while holdings of securities increased moderately. The Senior Loan

Officer Opinion Survey on Bank Lending Practices conducted in April indicated that, on net, bank lending standards and terms had eased somewhat further during the first quarter of the year and demand for C&I loans, commercial mortgages, and auto loans had increased, while demand for residential mortgages continued to decline.

M2 expanded at a moderate pace in March. Liquid deposits, the largest component of M2, advanced at a solid pace likely reflecting very low opportunity costs of holding such deposits. Currency advanced significantly, supported by robust foreign demand for U.S. bank notes.

Foreign sovereign bond yields generally were little changed and equity prices rose, on net, over the intermeeting period, although equity prices in Japan remained below their pre-earthquake levels despite the record amounts of liquidity injected by the Bank of Japan and the expansion of its asset purchase program. The European Central Bank raised its main policy rate 25 basis points to 1¼ percent during the intermeeting period, and markets appeared to have priced in additional rate increases over the rest of the year. The Bank of England and the Bank of Canada left their policy rates unchanged, but quotes from futures markets continued to suggest that both central banks would raise rates later this year. China's monetary authority further increased banks' lending rates and deposit rates and continued to tighten reserve requirements; monetary policy in a number of other EMEs was also tightened over the intermeeting period.

The broad nominal index of the U.S. dollar declined more than 2 percent over the intermeeting period, though the dollar appreciated, on net, against the Japanese yen. The yen strengthened to an all-time high against the dollar after the earthquake in Japan, but this move was more than reversed when the G-7 countries intervened to sell yen.

In early April, the Portuguese government requested financial support from the European Union and the International Monetary Fund, but market participants reportedly remained concerned about whether the Portuguese government would reach agreement on an associated fiscal consolidation plan. Later in the intermeeting period, yields on Greece's and other peripheral European countries' sovereign debt jumped, reflecting heightened market focus on a possible restructuring of Greek sovereign debt.

Staff Economic Outlook

With the recent data on spending somewhat weaker, on balance, than the staff had expected at the time of the March FOMC meeting, the staff revised down its projection for the rate of increase in real gross domestic product (GDP) over the first half of 2011. The effects from the disaster in Japan were also anticipated to temporarily hold down real GDP growth in the near term. Over the medium term, the staff's outlook for the pace of economic growth was broadly similar to its previous forecast: As in the March projection, the staff expected real GDP to increase at a moderate rate through 2012, with the ongoing recovery in activity receiving continued support from accommodative monetary policy, increasing credit availability, and further improvements in household and business confidence. The average pace of GDP growth was expected to be sufficient to gradually reduce the unemployment rate over the projection period, though the jobless rate was anticipated to remain elevated at the end of 2012.

Recent increases in consumer food and energy prices, together with the small uptick in core consumer price inflation, led the staff to raise its near-term projection for consumer price inflation. However, inflation was expected to recede over the medium term, as food and energy prices were anticipated to decelerate. As in previous forecasts, the staff expected core consumer price inflation to remain subdued over the projection period, reflecting stable longer-term inflation expectations and persistent slack in labor and product markets.

Participants' Views on Current Conditions and the Economic Outlook

In conjunction with this FOMC meeting, all meeting participants—the five members of the Board of Governors and the presidents of the 12 Federal Reserve Banks—provided projections of output growth, the unemployment rate, and inflation for each year from 2011 through 2013 and over the longer run. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks. Participants' forecasts are described in the Summary of Economic Projections, which is attached as an addendum to these minutes.

In discussing intermeeting developments and their implications for the economic outlook, participants agreed that the information received since their previous meeting was broadly consistent with continuation of a moderate economic recovery, despite an unexpected slowing in the pace of economic growth in the first quarter. While construction activity remained anemic, measures of consumer spending and business investment continued to expand and labor market conditions continued to improve gradually. Participants viewed the weakness in first-quarter economic growth as likely to be largely transitory, influenced by unusually severe weather, increases in energy and other commodity prices, and lower-than-expected defense spending. As a result, they saw economic growth picking up later this year.

Participants' forecasts for economic growth for 2012 and 2013 were largely unchanged from their January projections and continued to indicate expectations that the recovery will strengthen somewhat over time. Nonetheless, the pickup in the pace of the economic expansion was expected to be limited, reflecting the effects of high energy prices, modest changes in housing wealth, subdued real income gains, and fiscal contraction at the federal, state, and local levels. Participants continued to project the unemployment rate to decline gradually over the forecast period but to remain elevated compared with their assessments of its longer-run level. Participants revised up their projections for total inflation in 2011, reflecting recent increases in energy and other commodity prices, but they generally anticipated that the recent increase in inflation would be transitory as commodity prices stabilize and inflation expectations remain anchored. However, they all agreed on the importance of closely monitoring developments regarding inflation and inflation expectations.

Participants' judgment that the recovery was continuing at a moderate pace reflected both the incoming economic indicators and information received from business contacts. Growth in consumer spending remained moderate despite the effects of higher gasoline and food prices, which appeared to have largely offset the increase in disposable income from the payroll tax cut. Participants noted that these higher prices had weighed on consumer sentiment about near-term economic conditions but that underlying fundamentals for continued moderate growth in spending remained in place. These underlying factors included continued improvement in household balance sheets, easing credit conditions, and strengthening labor markets.

Activity in the industrial sector also expanded further. Industrial production posted solid gains, and, while the most recent readings from some of the regional manufacturing surveys showed small declines, in some cases these were from near-record highs. Manufacturers remained upbeat, although automakers were reporting some difficulties in obtaining parts normally produced in Japan, which might weigh on motor vehicle production in the current quarter. Investment in equipment and software was fairly robust. In contrast, the housing sector remained distressed, with house prices flat to down and a large overhang of vacant properties restraining new construction, although reports indicated that sales volumes and traffic were higher in a few areas. Activity in the commercial real estate sector continued to be weak.

Several participants indicated that, in contrast to the somewhat weaker recent economic data, their business contacts were more positive about the economy's prospects, which supported the participants' view that the recent weakness was likely to prove temporary. They acknowledged, however, that sentiment can change quickly; indeed, one participant noted that his contacts had recently turned more pessimistic, and several participants indicated that their business contacts expressed concern about the effects of higher commodity prices on their own costs and on the purchasing power of households.

Participants judged that overall conditions in labor markets had continued to improve, albeit gradually. The unemployment rate had decreased further and payroll employment had risen again in March. Some participants reported that more of their business contacts have plans to increase their payrolls later this year. A few participants noted that firms may be poised to accelerate their pace of hiring because they have exhausted potential productivity gains, but others indicated that some firms may be putting hiring plans on hold until they are more certain of the future trend in materials and other input costs. Signs of rising wage pressures were reportedly limited to a few skilled job categories for which workers are in short supply, while, in general, increases in wages have been subdued. Participants discussed whether the significant drop in the unemployment rate might be overstating the degree of improvement in labor markets because many of the unemployed have dropped out of the labor force or have accepted jobs that are less desirable than their former jobs.

Financial market conditions continued to improve over the intermeeting period. Equity prices had risen, on balance, since the previous meeting, reflecting an improved outlook for earnings, and were up more substantially since the start of the year. Bankers again reported improvements in credit quality, with the volume of nonperforming assets declining at larger banks and leveling off at smaller banks. In general, loan demand remained weak. However, bank lending to medium-sized and larger companies increased, and lending to small businesses picked up slightly. Banks reported an easing of lending terms on C&I loans, usually prompted by increased competition in the face of still-weak loan demand. Consumer credit conditions also eased somewhat from the tight conditions seen during the recession. However, demand for consumer credit other than auto loans reportedly changed little. A few participants expressed concern that the easing of credit conditions was creating incentives for increased leverage and risk-taking in some areas, such as leveraged syndicated loans and loans to finance land acquisition, and that this trend, if it became widespread and excessive, could pose a risk to financial stability.

Participants discussed the recent rise in inflation, which had been driven largely by significant increases in energy and, to a somewhat lesser extent, other commodity prices. These commodity price increases, in turn, reflected robust global demand and geopolitical developments that had reduced supply. One participant suggested that excess liquidity might be leading to speculation in commodity markets, possibly putting upward pressure on prices. Many participants reported that an increasing number of business contacts expressed concerns about rising cost pressures and were intending, or already attempting, to pass on at least a portion of these higher costs to their customers in order to protect profit margins. This development was also reflected in the rising indexes of prices paid and received in several regional manufacturing surveys. Some participants noted that higher commodity prices were negatively affecting both business and consumer sentiment. Core inflation and other indicators of underlying inflation over the medium term had increased modestly in recent months, but their levels remained subdued.

Participants generally anticipated that the higher level of overall inflation would be transitory. This outlook was based partly on a projected leveling-off of commodity prices and the belief that longer-run inflation expectations would remain stable. Some participants noted that pressures on labor costs continued to be muted; if such circumstances continued, a large, persistent rise in inflation would be unusual. Measures of near-term inflation expectations had risen along with the recent rise in overall inflation. While some indicators of longer-term expectations had increased, others were little changed or down, on net, since March. Many participants had become more concerned about the upside risks to the inflation outlook, including the possibilities that oil prices might continue to rise, that there might be greater pass-through of higher commodity costs into broader price measures, and that elevated overall inflation caused by higher energy and other commodity prices could lead to a rise in longer-term inflation expectations. Participants agreed that monitoring inflation trends and inflation expectations closely was important in determining whether action would be needed to prevent a more lasting pickup in the rate of general price inflation, which would be costly to reverse. Maintaining well-anchored inflation expectations would depend on the credibility of the Committee's commitment to deliver on the price stability part of its mandate. A few participants suggested that clearer communication about the Committee's inflation outlook, such as explaining the measures it uses to gauge medium-term trends in general price inflation and announcing an explicit numerical inflation objective, would be helpful in this regard.

While rising energy prices posed an upside risk to the inflation forecast, they also posed a downside risk to economic growth. Although most participants continued to see the risks to their outlooks for economic growth as being broadly balanced, a number now judged those risks to be tilted to the downside. These downside risks included a larger-than-expected drag on household and business spending from higher energy prices, continued fiscal strains in Europe, larger-than-anticipated effects from supply disruptions in the aftermath of the disaster in Japan, continuing fiscal adjustments at all levels of government in the United States, financial disruptions that would be associated with a failure to increase the federal debt limit, and the possibility that the economic weakness in the first quarter was signaling less underlying momentum going forward. However, participants also noted that the rapid decline in the unemployment rate over the past several months suggested the possibility of stronger-than-anticipated economic growth over coming quarters.

In their discussion of monetary policy, some participants expressed the view that in the context of increased inflation risks and roughly balanced risks to economic growth, the Committee would need to be prepared to begin taking steps toward less-accommodative policy. A few of these participants thought that economic conditions might warrant action to raise the federal funds rate target or to sell assets in the SOMA portfolio later this year, but noted that even with such steps, monetary policy would remain accommodative for some time to come. However, some participants indicated that underlying inflation remained subdued; that longer-term inflation expectations were likely to remain anchored, partly because modest changes in labor costs would constrain inflation trends; and that given the downside risks to economic growth, an early exit could unnecessarily damp the ongoing economic recovery.

Committee Policy Action

Committee members agreed that no changes to the Committee's asset purchase program or to its target range for the federal funds rate were warranted at this meeting. The information received over the intermeeting period indicated that the economic recovery was proceeding at a moderate pace, albeit somewhat slower than had been anticipated earlier in the year. Overall conditions in the labor market were gradually improving, and the unemployment rate continued to decline, although it remained elevated relative to levels that the Committee judged to be consistent, over the longer run, with its statutory mandate of maximum employment and price stability. Significant increases in energy and other commodity prices had boosted overall inflation, but members expected this increase to be transitory and to unwind when commodity price increases abated. Notwithstanding recent modest increases, indicators of medium-term inflation remained subdued and somewhat below the levels seen as consistent with the dual mandate as indicated by the Committee's longer-run inflation projections. Near-term inflation expectations had increased with energy prices and overall inflation. Recent movements in measures of longer-term inflation expectations were discussed. While some measures of longer-term inflation expectations had risen, others were little changed or down, on net, since March, and members agreed that longer-term inflation expectations had remained stable. Given this economic outlook, the Committee agreed to continue to expand its holdings of longer-term Treasury securities as announced in November in order to promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with the Committee's mandate. Specifically, the Committee maintained its existing policy of reinvesting principal payments from its securities holdings and affirmed that it will complete purchases of $600 billion of longer-term Treasury securities by the end of the current quarter. A few members remained uncertain about the benefits of the asset purchase program but, with the program nearly completed, judged that making changes to the program at this time was not appropriate. The Committee continued to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, were likely to warrant exceptionally low levels for the federal funds rate for an extended period. That said, a few members viewed the increase in inflation risks as suggesting that economic conditions might well evolve in a way that would warrant the Committee taking steps toward less-accommodative policy sooner than currently anticipated.

Members agreed that the Committee will regularly review the size and composition of its securities holdings in light of incoming information and that they are prepared to adjust those holdings as needed to best foster maximum employment and price stability. Some members pointed out that there would need to be a significant change in the economic outlook, or the risks to that outlook, before another program of asset purchases would be warranted; in their view, absent such changes, the benefits of additional purchases would be unlikely to outweigh the costs.

In the statement to be released following the meeting, members decided to indicate that the economic recovery was proceeding at a moderate pace and that overall conditions in the labor market were gradually improving. The Committee also decided to summarize its current thinking about inflation pressures and to emphasize that it will closely monitor the evolution of inflation and inflation expectations. Members anticipated that the Chairman, who would deliver his first post-meeting press briefing later that afternoon, would provide additional context for the Committee's policy decisions.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will fos-

ter price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to execute purchases of longer-term Treasury securities in order to increase the total face value of domestic securities held in the System Open Market Account to approximately $2.6 trillion by the end of June 2011. The Committee also directs the Desk to reinvest principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 12:30 p.m.:

"Information received since the Federal Open Market Committee met in March indicates that the economic recovery is proceeding at a moderate pace and overall conditions in the labor market are improving gradually. Household spending and business investment in equipment and software continue to expand. However, investment in nonresidential structures is still weak, and the housing sector continues to be depressed. Commodity prices have risen significantly since last summer, and concerns about global supplies of crude oil have contributed to a further increase in oil prices since the Committee met in March. Inflation has picked up in recent months, but longer-term inflation expectations have remained stable and measures of underlying inflation are still subdued.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The unemployment rate remains elevated, and measures of underlying inflation continue to be somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. Increases in the prices of energy and other commodities have pushed up inflation in recent months. The Committee expects these effects to be transitory, but it will pay close attention to the evolution of inflation and inflation expectations. The Committee continues to anticipate a gradual return to higher levels of resource utilization in a context of price stability.

To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to continue expanding its holdings of securities as announced in November. In particular, the Committee is maintaining its existing policy of reinvesting principal payments from its securities holdings and will complete purchases of $600 billion of longer-term Treasury securities by the end of the current quarter. The Committee will regularly review the size and composition of its securities holdings in light of incoming information and is prepared to adjust those holdings as needed to best foster maximum employment and price stability.

The Committee will maintain the target range for the federal funds rate at 0 to ¼ percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Richard W. Fisher, Narayana Kocherlakota, Charles I. Plosser, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 21–22, 2011. The meeting adjourned at 10:15 a.m. on April 27, 2011.

Notation Vote

By notation vote completed on April 4, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on March 15, 2011.

William B. English
Secretary

Addendum: Summary of Economic Projections

In conjunction with the April 26–27, 2011, Federal Open Market Committee (FOMC) meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC, submitted projections for growth of real output, the unemployment rate, and inflation for the years 2011 to 2013 and over the longer run. The projections were based on information available through the end of the meeting and on each participant's assumptions about factors likely to affect economic outcomes, including his or her assessment of appropriate monetary policy. "Appropriate monetary policy" is defined as the future path of policy that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her interpretation of the Federal Reserve's dual objectives of maximum employment and stable prices. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks.

As depicted in **figure 1**, FOMC participants expected the economic recovery to continue at a moderate pace, with growth of real gross domestic product (GDP) picking up modestly this year (relative to 2010) and strengthening further in 2012 and a bit more in 2013. With the pace of economic growth exceeding their estimates of the longer-run sustainable rate of increases in real GDP, the unemployment rate is projected to gradually trend lower over this projection period. However, participants anticipated that, at the end of 2013, the unemployment rate would still be well above their estimates of the longer-run unemployment rate. Most participants expected that overall inflation would move up this year, but they projected this increase to be temporary, with overall inflation moving back in line with core inflation in 2012 and 2013 and remaining at or below rates they see as consistent, over the longer run, with the Committee's dual mandate of maximum employment and price stability. Participants generally saw core inflation gradually edging higher over the next two years from its current relatively low level.

On balance, as indicated in **table 1**, participants anticipated somewhat lower GDP growth and slightly higher inflation over the forecast period than they projected in January. Participants marked down their forecasts for real GDP growth this year, revised them down by less for 2012 and 2013, and did not

Table 1. Economic projections of Federal Reserve Governors and Reserve Bank presidents, April 2011
Percent

Variable	Central tendency[1]				Range[2]			
	2011	2012	2013	Longer run	2011	2012	2013	Longer run
Change in real GDP	3.1 to 3.3	3.5 to 4.2	3.5 to 4.3	2.5 to 2.8	2.9 to 3.7	2.9 to 4.4	3.0 to 5.0	2.4 to 3.0
January projection	3.4 to 3.9	3.5 to 4.4	3.7 to 4.6	2.5 to 2.8	3.2 to 4.2	3.4 to 4.5	3.0 to 5.0	2.4 to 3.0
Unemployment rate	8.4 to 8.7	7.6 to 7.9	6.8 to 7.2	5.2 to 5.6	8.1 to 8.9	7.1 to 8.4	6.0 to 8.4	5.0 to 6.0
January projection	8.8 to 9.0	7.6 to 8.1	6.8 to 7.2	5.0 to 6.0	8.4 to 9.0	7.2 to 8.4	6.0 to 7.9	5.0 to 6.2
PCE inflation	2.1 to 2.8	1.2 to 2.0	1.4 to 2.0	1.7 to 2.0	2.0 to 3.6	1.0 to 2.8	1.2 to 2.5	1.5 to 2.0
January projection	1.3 to 1.7	1.0 to 1.9	1.2 to 2.0	1.6 to 2.0	1.0 to 2.0	0.7 to 2.2	0.6 to 2.0	1.5 to 2.0
Core PCE inflation[3]	1.3 to 1.6	1.3 to 1.8	1.4 to 2.0		1.1 to 2.0	1.1 to 2.0	1.2 to 2.0	
January projection	1.0 to 1.3	1.0 to 1.5	1.2 to 2.0		0.7 to 1.8	0.6 to 2.0	0.6 to 2.0	

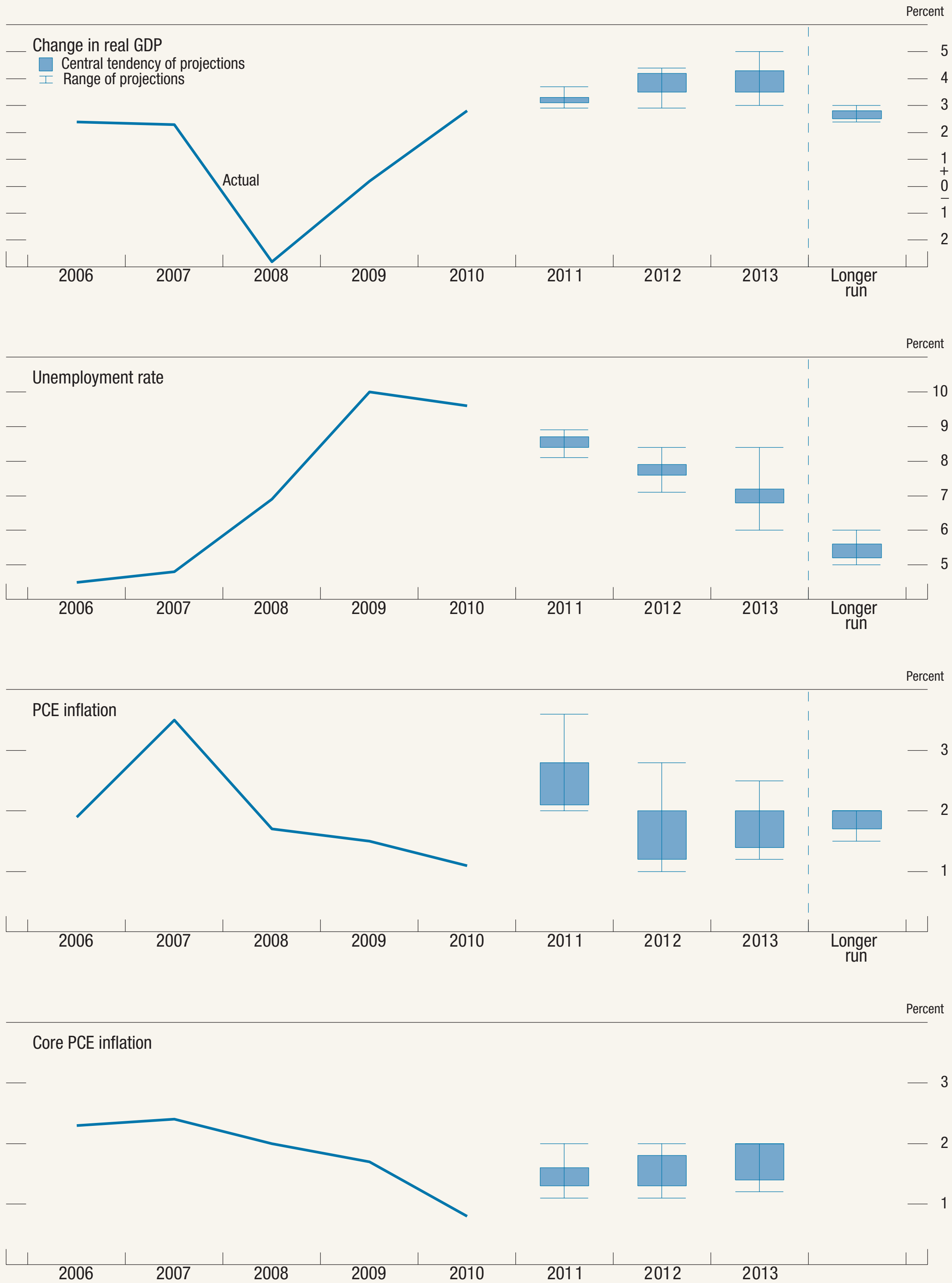
Note: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The January projections were made in conjunction with the meeting of the Federal Open Market Committee on January 25–26, 2011.

1 The central tendency excludes the three highest and three lowest projections for each variable in each year.

2 The range for a variable in a given year consists of all participants' projections, from lowest to highest, for that variable in that year.

3 Longer-run projections for core PCE inflation are not collected.

Figure 1. Central tendencies and ranges of economic projections, 2011–13 and over the longer run



Note: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual.

alter their expectations for economic growth in the longer run. Most participants also lowered their forecasts for the average unemployment rate at the end of this year, but they continued to see the unemployment rate moving down slowly in 2012 and 2013 to levels that were little changed from the previous projections. Participants raised their forecasts for overall inflation this year; however, most expected that the increase would be transitory and made only minor changes to their forecasts for the rate of inflation in 2012 and 2013 or for the longer run. Most participants anticipated that five or six years would likely be required for the economy to converge fully to its longer-run path characterized by rates of output growth, unemployment, and inflation consistent with their interpretation of the Federal Reserve's dual objectives.

A sizable majority of participants continued to judge the level of uncertainty associated with their projections for real economic activity and inflation as unusually high relative to historical norms. About one-half of the participants viewed the risks to output growth as balanced, but a number now judged those risks to be tilted to the downside. Meanwhile, a majority of participants viewed the risks to overall inflation as weighted to the upside.

The Outlook

Participants marked down their forecasts for real GDP growth in 2011, with the central tendency of their projections moving down to 3.1 to 3.3 percent from 3.4 to 3.9 percent in January. Participants stated that the change reflected importantly the somewhat slower-than-expected pace of expansion in the first quarter. Participants generally thought that much of the unexpected weakness in the first quarter would prove temporary, but they viewed a number of recent developments as potential restraints on the pace of economic recovery in the near term. Those developments included the effects of the rise in energy prices on real income and consumer sentiment, indications that the recovery in the housing market was further off, and constraints on state and local government budgets.

Looking further ahead, participants' revisions to their forecasts for economic growth were modest, and they continued to see the economic recovery strengthening over the forecast period, with the central tendency of their projections for growth in real GDP stepping up to 3.5 to 4.2 percent in 2012 and remaining near those rates in 2013. Participants cited the effects of continued monetary policy accommodation, further improvements in banking and financial market conditions, rising consumer confidence as labor market conditions strengthen gradually, improved household balance sheets, stabilizing commodity prices, continued expansion in business investment in equipment and software, and gains in U.S. exports as being among the likely contributors to a sustained pickup in the pace of expansion. However, participants also saw a number of factors that would likely continue to hinder the pace of expansion over the next two years. Most participants anticipated that the recovery in the housing market would remain slow, restrained by the overhang of vacant properties and depressed home values; most also expected increasing fiscal drag at the federal, state, and local levels. In addition, some participants noted the negative impact on household purchasing power of the elevated levels of energy and food prices. In the absence of further shocks, participants generally expected that, over time, real GDP growth would eventually settle down at an annual rate of 2.5 to 2.8 percent, a pace that appeared to be sustainable in view of expected long-run trends in labor supply and labor productivity.

Reflecting the decline in the unemployment rate in recent months, participants lowered their forecasts for the average unemployment rate in the fourth quarter of this year, with the central tendency of their projections at 8.4 to 8.7 percent, down from 8.8 to 9.0 percent in January. Participants' projections for the jobless rate at the end of 2012 and 2013 were little changed from their previous forecasts. Consistent with their expectations of a moderate economic recovery, most participants projected that the unemployment rate would be 6.8 to 7.2 percent even in late 2013—still well above the 5.2 to 5.6 percent central tendency of their estimates of the unemployment rate that would prevail over the longer run in the absence of further shocks. The central tendency for the participants' projections of the unemployment rate in the longer run was somewhat narrower than the 5 to 6 percent interval reported in January.

Participants noted that the prices of oil and other commodities had risen significantly since the time of their January projections, largely reflecting geopolitical developments and robust global demand. Those increases had led to a sharp rise in consumer energy prices and, to a lesser extent, food prices, which had boosted overall inflation. As a result, participants raised their forecasts for total personal consumption expenditures (PCE) inflation in 2011, with the central tendency of their estimates significantly higher. With the outlook for oil and other commodity prices uncertain, the dispersion of the projections was noticeably wider than in January. Most participants expected that overall inflation would run 2.1 to 2.8 percent this year, compared with 1.3 to 1.7 percent in their January projections. However, many participants anticipated that the pass-through of higher commodity prices into core inflation would be contained by downward pressures on inflation from large margins of slack in resource utilization and consequent subdued labor costs. Participants indicated that well-anchored inflation expectations, combined with the appropriate stance of monetary policy, should help keep inflation in check. As a result, participants anticipated that the increase in total PCE inflation would be temporary, with the central tendency of their estimates moving down to 1.2 to 2.0 percent in 2012 and 1.4 to 2.0 percent in 2013—at or below the 1.7 to 2.0 percent central tendency for their estimates of the longer-run, mandate-consistent rate of inflation. Nonetheless, the central tendencies of participants' projections for core PCE inflation for this year and next year shifted up a bit to 1.3 to 1.6 percent in 2011 and 1.3 to 1.8 percent in 2012. The central tendency of the core PCE inflation projections in 2013 was 1.4 to 2.0 percent, little changed from the January SEP.

Uncertainty and Risks

A sizable majority of participants continued to judge that the levels of uncertainty associated with their projections for economic activity and inflation were greater than the average levels that had prevailed over the past 20 years.[2] They pointed to a number of factors contributing to their assessments of the uncertainty that they attached to their projections, including structural dislocations in the labor market, the outlook for fiscal policy, the future path of energy and other commodity prices, the global economic outlook, and the effects of unconventional monetary policy.

About one-half of the participants continued to view the risks to their outlooks for economic growth as balanced, but a number of participants now judged that those risks had become tilted to the downside. The most frequently mentioned downside risks to GDP growth included the possibility of further increases in energy and other commodity prices, a tighter-than-anticipated stance of fiscal policy in the United States, an even weaker-than-expected housing sector adversely affecting consumer spending and the health of financial institutions, and possible spillovers from the fiscal strains in Europe. A few participants saw the risks to growth as tilted to the upside; it was noted that the cyclical rebound in economic activity might prove stronger than anticipated. The risks surrounding participants' forecasts of the unemployment rate remained broadly balanced and continued to reflect in large part the risks attending participants' views of the likely strength of the expansion in real activity.

Whereas most participants' assessments of the risks associated with their overall inflation projections over the period from 2011 to 2013 were broadly balanced in January, a majority of participants now judged the risks as weighted to the upside. Although participants generally indicated that the amount of pass-through of higher oil and other commodity prices into core inflation had so far remained limited and that inflation expectations continued to be stable, some participants noted the risk that the extent of pass-through might increase and that the resulting rise in inflation could unmoor longer-term inflation expectations. A few participants noted the possibility that the current highly accommodative stance of monetary policy could be maintained for too long, leading to higher inflation expectations and actual inflation.

Table 2. Average historical projection error ranges
Percentage points

Variable	2011	2012	2013
Change in real GDP[1]	±1.0	±1.6	±1.8
Unemployment rate[1]	±0.5	±1.2	±1.8
Total consumer prices[2]	±0.8	±1.0	±1.0

Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1991 through 2010 that were released in the spring by various private and government forecasters. As described in the box "Forecast Uncertainty," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

1 For definitions, refer to general note in table 1.

2 Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

2 Table 2 provides estimates of forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1991 to 2010. At the end of this summary, the box "Forecast Uncertainty" discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

Diversity of Views

Figures 2.A and 2.B provide further details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate in 2011, 2012, 2013, and over the longer run. The dispersion in these projections generally continued to reflect differences in participants' assessments of many factors, including the likely evolution of conditions in credit and financial markets, the current degree of underlying momentum in economic activity, the timing and the degree to which the labor market will recover from the dislocations associated with the deep recession, the outlook for economic and financial developments abroad, and appropriate future monetary policy and its effects on economic activity. Regarding participants' projections for real GDP growth, the distribution for this year shifted noticeably lower and was significantly more tightly concentrated than the distribution in January, with more than one-half of participants expecting the change in real GDP in 2011 to be in the 3.2 to 3.3 percent interval. By contrast, the distributions for real GDP growth in 2012 and 2013 were little changed. Regarding participants' projections for the unemployment rate, the distribution for this year shifted down relative to the distribution in January, with about one-half of participants anticipating the unemployment rate in the final quarter of 2011 to be 8.4 to 8.5 percent; this shift likely reflects the recent improvements in labor market conditions. The distributions of the unemployment rate for 2012 and 2013 were little changed. The distribution of participants' estimates of the longer-run unemployment rate was somewhat more tightly concentrated than in January, while that for their estimates of longer-run GDP growth was about unchanged.

Corresponding information about the diversity of participants' views regarding the inflation outlook is provided in figures 2.C and 2.D. In general, the dispersion in the participants' inflation forecasts for the next few years represented differences in judgments regarding the fundamental determinants of inflation, including estimates of the degree of resource slack and the extent to which such slack influences inflation outcomes and expectations, as well as estimates of how the stance of monetary policy may influence inflation expectations. Regarding overall PCE inflation, the distribution of participants' projections for 2011 shifted noticeably higher relative to the distribution in January, reflecting the recent increases in energy and other commodity prices, but the dispersion in forecasts was little changed. The distributions for 2012 and 2013 were generally little changed and remained fairly wide. Regarding core PCE inflation, the distribution of participants' projections for 2011 shifted noticeably to the right, but it remained about as wide as in January. The distributions of core inflation for 2012 and 2013 also shifted somewhat higher but were otherwise little changed. Although the distributions of participants' inflation forecasts for 2011 through 2013 continued to be relatively wide, the distribution of projections of the longer-run rate of overall PCE inflation remained tightly concentrated. The narrow range illustrates the broad similarity in participants' assessments of the approximate level of inflation that is consistent with the Federal Reserve's dual objectives of maximum employment and price stability.

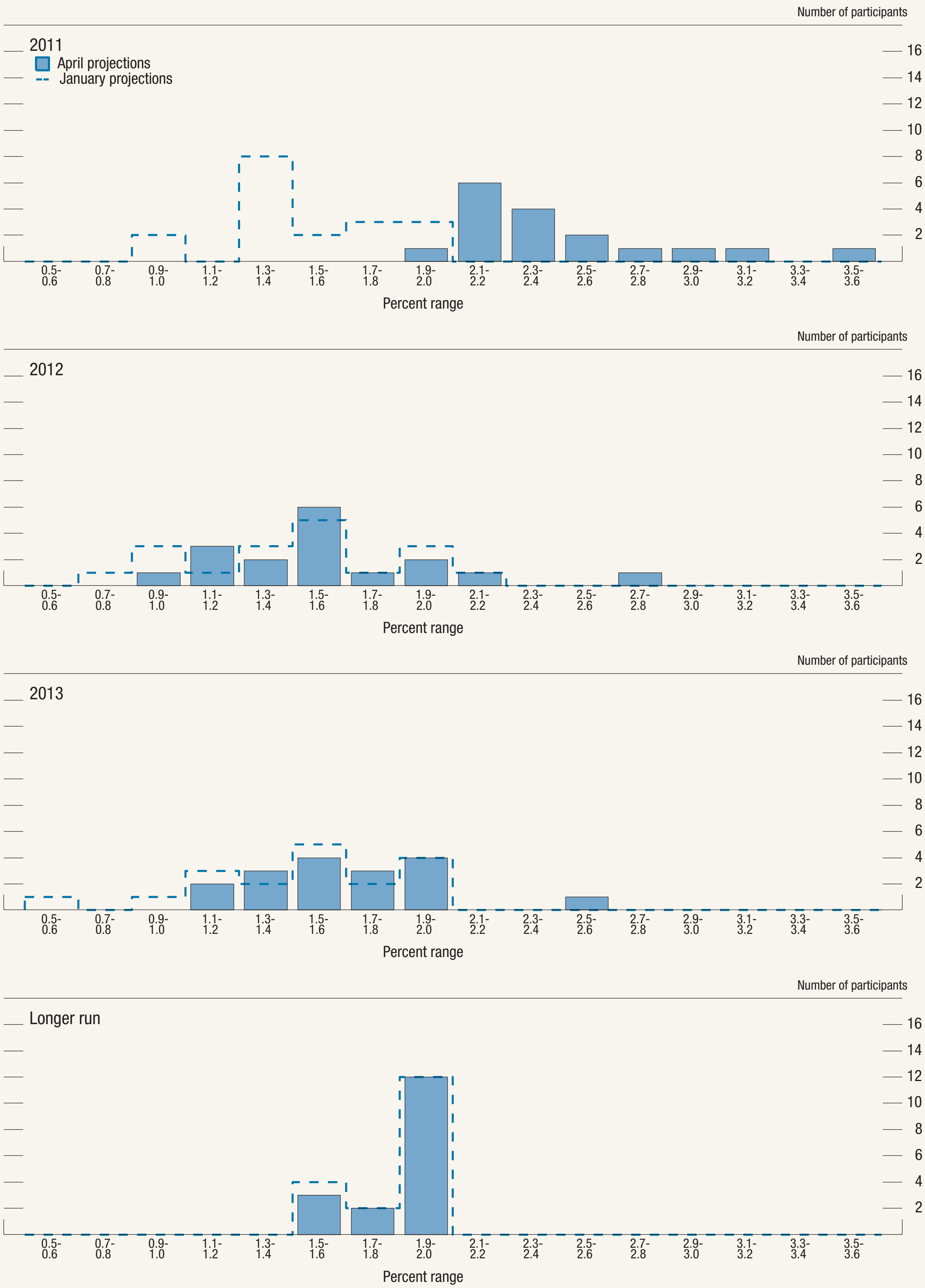
Figure 2.A. Distribution of participants' projections for the change in real GDP, 2011–13 and over the longer run

Note: Definitions of variables are in the general note to **table 1**.

Figure 2.B. Distribution of participants' projections for the unemployment rate, 2011–13 and over the longer run

Note: Definitions of variables are in the general note to table 1.

Figure 2.C. Distribution of participants' projections for PCE inflation, 2011–13 and over the longer run



Note: Definitions of variables are in the general note to **table 1**.

Figure 2.D. Distribution of participants' projections for core PCE inflation, 2011–13

Note: Definitions of variables are in the general note to table 1.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world. And the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Report*s and those prepared by the Federal Reserve Board's staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 2.0 to 4.0 percent in the current year, 1.4 to 4.6 percent in the second year, and 1.2 to 4.8 percent in the third year. The corresponding 70 percent confidence intervals for overall inflation would be 1.2 to 2.8 percent in the current year, and 1.0 to 3.0 percent in the second and third years.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

Meeting Held on June 21–22, 2011

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, June 21, 2011, at 10:30 a.m. and continued on Wednesday, June 22, 2011, at 9:00 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard, Thomas M. Hoenig, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

David J. Stockton
Economist

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Loretta J. Mester, David Reifschneider, Harvey Rosenblum, Daniel G. Sullivan, David W. Wilcox, and Kei-Mu Yi
Associate Economists

Brian Sack
Manager, System Open Market Account

Jennifer J. Johnson
Secretary of the Board, Office of the Secretary, Board of Governors

Nellie Liang
Director, Office of Financial Stability Policy and Research, Board of Governors

Robert deV. Frierson
Deputy Secretary, Office of the Secretary, Board of Governors

William Nelson
Deputy Director, Division of Monetary Affairs, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Charles S. Struckmeyer
Deputy Staff Director, Office of the Staff Director, Board of Governors

Seth B. Carpenter
Senior Associate Director, Division of Monetary Affairs, Board of Governors

Michael Foley
Senior Associate Director, Division of Banking Supervision and Regulation, Board of Governors

Lawrence Slifman and William Wascher
Senior Associate Directors, Division of Research and Statistics, Board of Governors

Andrew T. Levin
Senior Adviser, Office of Board Members, Board of Governors

Joyce K. Zickler
Visiting Senior Adviser, Division of Monetary Affairs, Board of Governors

Daniel M. Covitz and Eric M. Engen
Associate Directors, Division of Research and Statistics, Board of Governors

Trevor A. Reeve
Associate Director, Division of International Finance, Board of Governors

Egon Zakrajšek
Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Beth Anne Wilson
Assistant Director, Division of International Finance, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

Brahima Coulibaly
Senior Economist, Division of International Finance, Board of Governors

Louise Sheiner
Senior Economist, Division of Research and Statistics, Board of Governors

Jean-Philippe Laforte[1]
Economist, Division of Research and Statistics, Board of Governors

Penelope A. Beattie
Assistant to the Secretary, Office of the Secretary, Board of Governors

Randall A. Williams
Records Management Analyst, Division of Monetary Affairs, Board of Governors

Jeff Fuhrer
Executive Vice President, Federal Reserve Bank of Boston

David Altig, Glenn D. Rudebusch, and Mark E. Schweitzer
Senior Vice Presidents, Federal Reserve Banks of Atlanta, San Francisco, and Cleveland, respectively

Michael Dotsey,[1] **William Gavin, Andreas L. Hornstein, and Edward S. Knotek II**
Vice Presidents, Federal Reserve Banks of Philadelphia, St. Louis, Richmond, and Kansas City, respectively

Marco Del Negro,[1] **Joshua L. Frost, Deborah L. Leonard, and Jonathan P. McCarthy**
Assistant Vice Presidents, Federal Reserve Bank of New York

Jeff Campbell[1]
Senior Economist, Federal Reserve Bank of Chicago

[1] Attended the portion of the meeting relating to dynamic stochastic general equilibrium models.

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on April 26–27, 2011. He also reported on System open market operations, including the continuing reinvestment into longer-term Treasury securities of principal payments received on the SOMA's holdings of agency debt and agency-guaranteed mortgage-backed securities, as well as the ongoing purchases of additional Treasury securities authorized at the November 2–3, 2010, FOMC meeting. Since November, purchases by the Open Market Desk of the Federal Reserve Bank of New York had increased the SOMA's holdings by nearly the full $600 billion authorized.

In light of ongoing strains in some foreign financial markets, the Committee considered a proposal to extend its dollar liquidity swap arrangements with foreign central banks past August 1, 2011. Following their discussion, members unanimously approved the following resolution:

> The Federal Open Market Committee directs the Federal Reserve Bank of New York to extend the existing temporary reciprocal currency arrangements ("swap arrangements") for the System Open Market Account with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank. The swap arrangements shall now terminate on August 1, 2012, unless further extended by the Committee.

Dynamic Stochastic General Equilibrium Models

A staff presentation provided an overview of ongoing Federal Reserve research on dynamic stochastic general equilibrium (DSGE) models. DSGE models attempt to capture the dynamics of the overall economy in a way that is consistent both with the historical data and with optimizing behavior by forward-looking households and firms. The presentation began by discussing the general features of DSGE models and considering their advantages and limitations relative to other approaches of analyzing macroeconomic dynamics; with regard to the latter, the presentation noted that while the current generation of DSGE models is still somewhat limited in the range of policy issues these models can address, further advances in modeling should increase the usefulness of DSGE models for forecasting and policy analysis. The presentation then reviewed some specific features of DSGE models that are currently being studied at the Federal Reserve Board and the Federal Reserve Banks of New York, Philadelphia, and Chicago. This review included the four models' characterizations of the forces affecting the economy in recent years and the models' current forecasts for real economic activity, inflation, and short-term interest rates. In discussing the staff presentation, meeting participants expressed the view that DSGE models are a useful addition to the wide range of analytical approaches traditionally used at the Federal Reserve, in part because they provide an internally consistent way of exploring how the behavior of economic agents might change in response to systematic adjustments to policy. Some participants also expressed interest in seeing on a regular basis projections of key macroeconomic variables and other products from the DSGE models developed in the System. Finally, participants encouraged further staff work to improve these models by, for example, expanding the range of questions they can be used to address.

Exit Strategy Principles

The Committee discussed strategies for normalizing the stance and conduct of monetary policy, following up on its discussion of this topic at the April meeting. Participants stressed that the Committee's discussions of this topic were undertaken as part of prudent planning and did not imply that a move toward such normalization would necessarily begin sometime soon. For concreteness, the Committee considered a set of specific principles that would guide its strategy of normalizing the stance and conduct of monetary policy. Participants discussed several specific elements of the principles, including how they should characterize the monetary policy framework that the Committee would adopt after the conduct of policy returned to normal and whether the principles should encompass the possible timing between the normalization steps. At the conclusion of the discussion, all but one of the participants agreed on the following key elements of the strategy that they expect to follow when it becomes appropriate to begin normalizing the stance and conduct of monetary policy:

- The Committee will determine the timing and pace of policy normalization to promote its statutory mandate of maximum employment and price stability.
- To begin the process of policy normalization, the Committee will likely first cease reinvesting some or all payments of principal on the securities holdings in the SOMA.
- At the same time or sometime thereafter, the Committee will modify its forward guidance on the path of the federal funds rate and will initiate temporary reserve-draining operations aimed at supporting the implementation of increases in the federal funds rate when appropriate.
- When economic conditions warrant, the Committee's next step in the process of policy normalization will be to begin raising its target for the federal funds rate, and from that point on, changing the level or range of the federal funds rate target will be the primary means of adjusting the stance of monetary policy. During the normalization process, adjustments to the interest rate on excess reserves and to the level of reserves in the banking system will be used to bring the funds rate toward its target.
- Sales of agency securities from the SOMA will likely commence sometime after the first increase in the target for the federal funds rate. The timing and pace of sales will be communicated to the public in advance; that pace is anticipated to be relatively gradual and steady, but it could be adjusted up or down in response to material changes in the economic outlook or financial conditions.
- Once sales begin, the pace of sales is expected to be aimed at eliminating the SOMA's holdings of agency securities over a period of three to five years, thereby minimizing the extent to which the SOMA portfolio might affect the allocation of credit across sectors of the economy. Sales at this pace would be expected to normalize the size of the SOMA securities portfolio over a period of two to three years. In particular, the size of the securities portfolio and the associated quantity of bank reserves are expected to be reduced to the smallest

levels that would be consistent with the efficient implementation of monetary policy.

- The Committee is prepared to make adjustments to its exit strategy if necessary in light of economic and financial developments.

Staff Review of the Economic Situation

The information reviewed at the June 21–22 meeting indicated that the pace of the economic recovery slowed in recent months and that conditions in the labor market had softened. Measures of inflation picked up this year, reflecting in part higher prices for some commodities and imported goods. Longer-run inflation expectations, however, remained stable.

The expansion of private nonfarm payroll employment in May was markedly below the average pace of job gains in the previous months of this year. Initial claims for unemployment insurance rose, on net, between the first half of April and the first half of June. The unemployment rate moved up in April and then rose further to 9.1 percent in May, while the labor force participation rate remained unchanged. Both long-duration unemployment and the share of workers employed part time for economic reasons continued to be elevated.

Total industrial production expanded only a bit during April and May after rising at a solid pace in the first quarter. Shortages of specialized components imported from Japan contributed to a decline in the output of motor vehicles and parts. Manufacturing production outside of the motor vehicles sector increased moderately, on balance, during the past two months. The manufacturing capacity utilization rate remained close to its first-quarter level, but it was still well below its longer-run average. Forward-looking indicators of industrial activity, such as the new orders diffusion indexes in the national and regional manufacturing surveys, weakened noticeably during the intermeeting period to levels consistent with only tepid gains in factory output in coming months. However, motor vehicle assemblies were scheduled to rise notably in the third quarter from their levels in recent months, as bottlenecks in parts supplies were anticipated to ease.

Growth in consumer spending declined in recent months from the already modest pace in the first quarter. Total real personal consumption expenditures only edged up in April. Nominal retail sales, excluding purchases at motor vehicles and parts outlets, increased somewhat in May, but sales of new light motor vehicles declined markedly. Labor income rose moderately, as aggregate hours worked trended up, but total real disposable income remained flat in March and April, as increases in consumer prices offset gains in nominal income. In addition, consumer sentiment stayed relatively low through early June.

Activity in the housing market remained depressed, as both weak demand and the sizable inventory of foreclosed or distressed properties continued to hold back new construction. Starts and permits of new single-family homes were essentially unchanged in April and May, and they stayed near the very low levels seen since the middle of last year. Sales of new and existing homes remained at subdued levels in recent months, while measures of home prices fell further.

The available indicators suggested that real business investment in equipment and software was rising a bit more slowly in the second quarter than the solid pace seen in the first quarter. Nominal orders and shipments of nondefense capital goods declined in April. Business purchases of light motor vehicles edged up in April but dropped in May, while spending for medium and heavy trucks continued to increase in recent months. Survey measures of business conditions and sentiment weakened during the intermeeting period. Business expenditures for office and commercial buildings remained depressed by elevated vacancy rates, low prices for commercial real estate, and tight credit conditions for construction loans. In contrast, outlays for drilling and mining structures continued to be lifted by high energy prices.

Real nonfarm inventory investment rose moderately in the first quarter, but data for April suggested that the pace of inventory accumulation had slowed. Book-value inventory-to-sales ratios in April were similar to their pre-recession norms, and survey data also suggested that inventory positions generally remained in a comfortable range.

The available data on government spending indicated that real federal purchases increased in recent months, led by a rebound in outlays for defense in April and May from unusually low levels in the first quarter. In contrast, real expenditures by state and local governments appeared to have declined further, as outlays for construction projects fell in March and April, and state and local employment continued to contract in April and May.

The U.S. international trade deficit widened slightly in March and then narrowed in April to a level below its average in the first quarter. Exports rose strongly in both months, with increases widespread across major categories in March, while the gains in April were concentrated in industrial supplies and capital goods. Imports grew robustly in March, but they fell slightly in April, as the drop in automotive imports from Japan together with the decline in imports of petroleum products more than offset increases in other imported products.

Headline consumer price inflation, which had risen in the first quarter, edged down a bit in April and May, as the prices of consumer food and energy decelerated from the pace seen in previous months. More recently, survey data through the middle of June pointed to declines in retail gasoline prices, and prices of food commodities appeared to have decreased somewhat. Excluding food and energy, core consumer price inflation picked up in April and May, pushing the 12-month change in the core consumer price index through May above its level of a year earlier. Upward pressures on core consumer prices appeared to reflect the elevated prices of commodities and other imports, along with notable increases in motor vehicle prices likely arising from the effects of recent supply chain disruptions and the resulting extremely low level of automobile inventories. However, near-term inflation expectations from the Thomson Reuters/University of Michigan Surveys of Consumers moved down a little in May and early June from the high level seen in April, and longer-term inflation expectations remained within the range that has generally prevailed over the preceding few years.

Available measures of labor compensation showed that labor cost pressures were still subdued, as wage increases continued to be restrained by the large amount of slack in the labor market. In the first quarter, unit labor costs only edged up, as the modest rise in hourly compensation in the nonfarm business sector was mostly offset by further gains in productivity. More recently, average hourly earnings for all employees rose in April and May, but the average rate of increase over the preceding 12 months remained quite low.

Global economic activity appeared to have increased more slowly in the second quarter than in the first quarter. The rate of growth in the emerging market economies stepped down from its rapid pace in the first quarter, although it remained generally solid. The Japanese economy contracted sharply following the earthquake in March, and the associated supply chain disruptions weighed on the economies of many of Japan's trading partners. The pace of economic growth in the euro area remained uneven, with Germany and France posting moderate gains in economic activity, while the peripheral European economies continued to struggle. Recent declines in the prices of oil and other commodities contributed to some easing of inflationary pressures abroad.

Staff Review of the Financial Situation

Investors appeared to adopt a more cautious attitude toward risk, particularly later in the intermeeting period. The shift in investors' sentiment likely reflected the weak tone of incoming economic data in the United States along with concerns about the outlook for global economic growth and about potential spillovers from a possible further deterioration of the situation in peripheral Europe.

The decisions by the FOMC at its April meeting to continue its asset purchase program and to maintain the 0 to ¼ percent target range for the federal funds rate were generally in line with market expectations. The accompanying statement and subsequent press briefing by the Chairman prompted a modest decline in nominal yields, as market participants reportedly perceived a somewhat less optimistic tone in the Committee's economic outlook. Over the remainder of the intermeeting period, the expected path for the federal funds rate, along with yields on nominal Treasury securities, moved down appreciably further, as the bulk of the incoming economic data was more downbeat than market participants had apparently anticipated. Consistent with the weaker-than-expected economic data and the recent decline in the prices of oil and other commodities, measures of inflation compensation over the next 5 years and 5 to 10 years ahead based on nominal and inflation-protected Treasury securities decreased considerably over the intermeeting period.

Market quotes did not suggest expectations of significant movements in nominal Treasury yields following the anticipated completion of the asset purchase program by the Federal Reserve at the end of June. Although discussions about the federal debt ceiling attracted attention in financial markets, judging from Treasury yields and other asset prices, investors seemed to anticipate that the debt ceiling would be increased in time to avoid any significant market disruptions.

Yields on corporate bonds stepped down modestly, on net, over the intermeeting period, but by less than the decline in yields on comparable-maturity Treasury securities, leaving credit risk spreads a little wider. In the secondary market for syndicated loans, conditions were little changed, with average bid prices for leveraged loans holding steady.

Broad U.S. stock price indexes declined, on net, over the intermeeting period, apparently in response to the downbeat economic data. Stock prices of financial firms underperformed the broader market, reflecting the weaker economic outlook, potential credit rating downgrades, and heightened concerns about the anticipated capital surcharge for systemically important financial institutions. Option-adjusted volatility on the S&P 500 index rose somewhat on net.

In the June 2011 Senior Credit Officer Opinion Survey on Dealer Financing Terms, dealers pointed to a continued gradual easing over the previous three months in credit terms applicable to major classes of counterparties across all types of transactions covered in the survey. Dealers also reported that the demand for funding had increased over the same period for a broad range of securities, with the exception of equities. More recently, however, against a backdrop of disappointing economic data, heightened uncertainty about the situation in Europe, and, possibly, concerns about the U.S. federal debt ceiling, market participants reported a general pullback from risk-taking and a decline in liquidity in a range of financial markets.

Net debt financing by nonfinancial corporations was strong in April and May. Gross issuance of both investment- and speculative-grade bonds by nonfinancial corporations hit a record high in May before slowing somewhat in June, and outstanding amounts of commercial and industrial (C&I) loans and nonfinancial commercial paper increased. Gross public equity issuance by nonfinancial firms maintained a solid pace over the intermeeting period, and most indicators of business credit quality improved further.

Commercial mortgage markets continued to show tentative signs of stabilization. In recent months, delinquency rates for commercial real estate loans edged down from their previous peaks. However, commercial real estate markets remained weak. Property sales were tepid, and prices remained at depressed levels. Issuance of commercial mortgage-backed securities slowed somewhat in the second quarter.

Conditions in residential mortgage markets were little changed overall but remained strained. Rates on conforming fixed-rate residential mortgages declined about in line with 10-year Treasury yields over the intermeeting period. Mortgage refinancing activity picked up, on net, over the intermeeting period but was still relatively subdued. Outstanding residential mortgage debt contracted further in the first quarter. Rates of serious delinquency for subprime and prime mortgages were little changed at elevated levels. The rate of new delinquencies on prime mortgages ticked up in April but remained well below the level of a few months ago. In March and April, delinquencies on mortgages backed by the Federal Housing Administration declined noticeably.

The Federal Reserve continued its competitive sales of non-agency residential mortgage-backed securities held by Maiden Lane II LLC over the intermeeting period. Although the initial offerings of these securities were well received, investor demand at the most recent sales was not as strong, a development consistent with the declines in the prices of non-agency residential mortgage-backed securities over the intermeeting period.

Conditions in consumer credit markets continued to improve. Growth in total consumer credit picked up in April, as the gain in nonrevolving credit more than offset a further contraction in revolving credit. Delinquency rates for consumer debt edged down further in recent months, with delinquency rates on some categories moving back to pre-crisis levels. Issuance of consumer asset-backed securities remained robust over the intermeeting period.

Bank credit was flat, on balance, in April and May. Core loans—the sum of C&I, real estate, and consumer loans—continued to contract modestly, pulled down by the ongoing decline in commercial and residential real estate loans. In contrast, C&I loans increased at a brisk pace in April and May. The most recent Survey of Terms of Business Lending conducted in May indicated that banks had eased some lending terms on C&I loans. The survey responses also suggested that the average size of loan commitments and their average maturity had trended up in recent quarters.

M2 expanded at a robust pace in April and May. Liquid deposits, the largest component of M2, maintained a solid rate of expansion, likely reflecting the very low opportunity costs of holding such deposits. Currency continued to advance, supported by strong demand for U.S. bank notes from abroad.

The broad nominal index of the U.S. dollar fluctuated over the intermeeting period in response to changes in investors' assessment of the outlook for the U.S. economy and the situation in the peripheral European economies. Since the April FOMC meeting, the dollar rose modestly, on net, after depreciating over the preceding several months. Headline equity indexes abroad and foreign benchmark sovereign yields declined over the intermeeting period in apparent response to signs of a slowdown in the pace of global economic activity and reduced demand for risky assets. Concerns about the possibility of a restructuring of Greek government debt drove spreads of yields on the sovereign debts of Greece, Ireland, and Portugal to record highs relative to yields on German bunds.

In the advanced foreign economies, most central banks left their policy rates unchanged, and the anticipated pace of monetary policy tightening indicated by money market futures quotes was pared back. However, central banks in several emerging market economies continued to tighten policy, and the monetary authorities in China increased required reserve ratios further.

Staff Economic Outlook

With the recent data on spending, income, production, and labor market conditions mostly weaker than the staff had anticipated at the time of the April FOMC meeting, the near-term projection for the rate of increase in real gross domestic product (GDP) was revised down. The effects of the disaster in Japan and of higher commodity prices on the rate of increase in real consumer spending were expected to hold down U.S. real GDP growth in the near term, but those effects were anticipated to be transitory. However, the staff also read the incoming economic data as suggesting that the underlying pace of the recovery was softer than they had previously anticipated, and they marked down their outlook for economic growth over the medium term. Nevertheless, the staff still projected real GDP to increase at a moderate rate in the second half of 2011 and in 2012, with the ongoing recovery in activity receiving continued support from accommodative monetary policy, further increases in credit availability, and anticipated improvements in household and business confidence. The average pace of real GDP growth was expected to be sufficient to bring the unemployment rate down very slowly over the projection period, and the jobless rate was anticipated to remain elevated at the end of 2012.

Although increases in consumer food and energy prices slowed a bit in recent months, the continued step-up in core consumer price inflation led the staff to raise slightly its projection for core inflation over the coming quarters. However, headline inflation was still expected to recede over the medium term, as increases in food and energy prices and in non-oil import prices were anticipated to ease further. As in previous forecasts, the staff continued to project that core consumer price inflation would remain relatively subdued over the projection period, reflecting both stable long-term inflation expectations and persistent slack in labor and product markets.

Participants' Views on Current Conditions and the Economic Outlook

In conjunction with this FOMC meeting, all meeting participants—the five members of the Board of Governors and the presidents of the 12 Federal Reserve Banks—provided projections of output growth, the unemployment rate, and inflation for each year from 2011 through 2013 and over the longer run. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks to the economy. Participants' forecasts are described in the Summary of Economic Projections, which is attached as an addendum to these minutes.

In their discussion of the economic situation and outlook, meeting participants agreed that the economic information received during the intermeeting period indicated that the economic recovery was continuing at a moderate pace, though somewhat more slowly than they had anticipated at the time of the April meeting. Participants noted several transitory factors that were restraining growth, including the global supply chain disruptions in the wake of the

Japanese earthquake, the unusually severe weather in some parts of the United States, a drop in defense spending, and the effects of increases in oil and other commodity prices this year on household purchasing power and spending. Participants expected that the expansion would gain strength as the influence of these temporary factors waned.

Nonetheless, most participants judged that the pace of the economic recovery was likely to be somewhat slower over coming quarters than they had projected in April. This judgment reflected the persistent weakness in the housing market, the ongoing efforts by some households to reduce debt burdens, the recent sluggish growth of income and consumption, the fiscal contraction at all levels of government, and the effects of uncertainty regarding the economic outlook and future tax and regulatory policies on the willingness of firms to hire and invest. Moreover, the recovery remained subject to some downside risks, such as the possibility of a more extended period of weak activity and declining prices in the housing sector, the chance of a larger-than-expected near-term fiscal tightening, and potential financial and economic spillovers if the situation in peripheral Europe were to deteriorate further. Participants still projected that the unemployment rate would decline gradually toward levels they saw as consistent with the Committee's dual mandate, but at a more gradual pace than they had forecast in April. While higher prices for energy and other commodities had boosted inflation this year, with commodity prices expected to change little going forward and longer-term inflation expectations stable, most participants anticipated that inflation would subside to levels at or below those consistent with the Committee's dual mandate.

Activity in the business sector appeared to have slowed somewhat over the intermeeting period. Although the effects of the Japanese disaster on U.S. motor vehicle production accounted for much of the deceleration in industrial production since March, the most recent readings from various regional manufacturing surveys suggested a slowing in the pace of manufacturing activity more broadly. However, business contacts in some sectors—most notably energy and high tech—reported that activity and business sentiment had strengthened further in recent months. Business investment in equipment and software generally remained robust, but growth in new orders for nondefense capital goods—though volatile from month to month—appeared to have slowed. While FOMC participants expected a rebound in investment in motor vehicles to boost capital outlays in coming months, some also noted that indicators of current and planned business investment in equipment and software had weakened somewhat, and surveys showed some deterioration in business sentiment. Business contacts in some regions reported that they were reducing capital budgets in response to the less certain economic outlook, but in other parts of the country, contacts noted that business sentiment remained on a firm footing, supported in part by strong export demand. Compared with the relatively robust outlook for the business sector, meeting participants noted that the housing sector, including residential construction and home sales, remained depressed. Despite efforts aimed at mitigation, foreclosures continued to add to the already very large inventory of vacant homes, putting downward pressure on home prices and housing construction.

Meeting participants generally noted that the most recent data on employment had been disappointing, and new claims for unemployment insurance remained elevated. The recent deterioration in labor market conditions was a particular concern for FOMC participants because the prospects for job growth were seen as an important source of uncertainty in the economic outlook, particularly in the outlook for consumer spending. Several participants reported feedback from business contacts who were delaying hiring until the economic and regulatory outlook became more certain and who indicated that they expected to meet any near-term increase in the demand for their products without boosting employment; these participants noted the risk that such cautious attitudes toward hiring could slow the pace at which the unemployment rate normalized. Wage gains were generally reported to be subdued, although wages for a few skilled job categories in which workers were in short supply were said to be increasing relatively more rapidly.

Changes in financial market conditions since the April meeting suggested that investors had become more concerned about risk. Equity markets had seen a broad selloff, and risk spreads for many corporate borrowers had widened noticeably. Large businesses that have access to capital markets continued to enjoy ready access to credit—including syndicated loans—on relatively attractive terms; however, credit conditions remained tight for smaller, bank-dependent firms. Bankers again reported gradual improvements in credit quality and generally weak loan demand. In identifying possible risks to financial stability, a few participants expressed concern that credit conditions in some sectors—most notably the agriculture sector—might have eased too much amid signs that investors in these markets were aggressively taking on more leverage and risk in order to obtain higher returns. Meeting participants also noted that an escalation of the fiscal difficulties in Greece and spreading concerns about other peripheral European countries could cause significant financial strains in the United States. It was pointed out that some U.S. money market mutual funds have significant exposures to financial institutions from core European countries, which, in turn, have substantial exposures to Greek sovereign debt. Participants were also concerned about the possible effect on financial markets of a failure to raise the statutory federal debt ceiling in a timely manner. While admitting that it was difficult to know what the precise effects of such a development would be, participants emphasized that even a short delay in the payment of principal or interest on the Treasury Department's debt obligations would likely cause severe market disruptions and could also have a lasting effect on U.S. borrowing costs.

Participants noted several factors that had contributed to the increase in inflation this year. The run-up in energy prices, as well as an increase in prices of other commodities and imported goods, had boosted both headline and core inflation. At same time, extremely low motor vehicle inventories resulting from global supply disruptions in the wake of the Japanese earthquake—by contributing to higher motor vehicle prices—had significantly raised inflation, although participants anticipated that these temporary pressures would lessen as motor vehicle inventories were rebuilt. Participants also observed that crude oil prices fell over the intermeeting period and other commodity prices also moderated, developments that were likely to damp headline inflation at the consumer level going forward. However, a number of participants pointed out that the recent faster pace of price increases was widespread across many categories of spending and was evident in inflation measures such as trimmed means or medians, which exclude the most extreme price movements in each period. The discussion of core inflation and similar indicators reflected the view expressed by some participants that such measures are useful for forecasting the path of inflation over the medium run. In addition, reports from business contacts indicated that some already had passed on, or were intending to try to pass on, at least a portion of their higher costs to customers in order to maintain profit margins. Most participants expected that much of the rise in headline inflation this year would prove transitory and that inflation over the medium term would be subdued as long as commodity prices did not continue to rise rapidly and longer-term inflation expectations remained stable. Nevertheless, a number of participants judged the risks to the outlook for inflation as tilted to the upside. Moreover, a few participants saw a continuation of the current stance of monetary policy as posing some upside risk to inflation expectations and actual inflation over time. However, other participants observed that measures of longer-term inflation compensation derived from financial instruments had remained stable of late, and that survey-based measures of longer-term inflation expectations also had not changed appreciably, on net, in recent months. These participants noted that labor costs were rising only slowly, and that persistent slack in labor and product markets would likely limit upward pressures on prices in coming quarters. Participants agreed that it would be important to pay close attention to the evolution of both inflation and inflation expectations. A few participants noted that the adoption by the Committee of an explicit numerical inflation objective could help keep longer-term inflation expectations well anchored. Another participant, however, expressed concern that the adoption of such an objective could, in effect, alter the relative importance of the two components of the Committee's dual mandate.

Participants also discussed the medium-term outlook for monetary policy. Some participants noted that if economic growth remained too slow to make satisfactory progress toward reducing the unemployment rate and if inflation returned to relatively low levels after the effects of recent transitory shocks dissipated, it would be appropriate to provide additional monetary policy accommodation. Others, however, saw the recent configuration of slower growth and higher inflation as suggesting that there might be less slack in labor and product markets than had been thought. Several participants observed that the necessity of reallocating labor across sectors as the recovery proceeds, as well as the loss of skills caused by high levels of long-term unemployment and permanent separations, may have temporarily reduced the economy's level of potential output. In that case, the withdrawal of monetary accommodation may need to begin sooner than currently anticipated in financial markets. A few participants expressed uncertainty about the efficacy of monetary policy in current circumstances but disagreed on the implications for future policy.

Committee Policy Action

In the discussion of monetary policy for the period ahead, members agreed that the Committee should complete its $600 billion asset purchase program at the end of the month and that no changes to the target range for the federal funds rate were warranted at this meeting. The information received over the intermeeting period indicated that the economic recovery was continuing at a moderate pace, though somewhat more slowly than the Committee had expected, and that the labor market was weaker than anticipated. Inflation had increased in recent months as a result of higher prices for some commodities, as well as supply chain disruptions related to the tragic events in Japan. Nonetheless, members saw the pace of the economic expansion as picking up over the coming quarters and the unemployment rate resuming its gradual decline toward levels consistent with the Committee's dual mandate. Moreover, with longer-term inflation expectations stable, members expected that inflation would subside to levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate. However, many members saw the outlook for both employment and inflation as unusually uncertain. Against this backdrop, members agreed that it was appropriate to maintain the Committee's current policy stance and accumulate further information regarding the outlook for growth and inflation before deciding on the next policy step. On the one hand, a few members noted that, depending on how economic conditions evolve, the Committee might have to consider providing additional monetary policy stimulus, especially if economic growth remained too slow to meaningfully reduce the unemployment rate in the medium run. On the other hand, a few members viewed the increase in inflation risks as suggesting that economic conditions might well evolve in a way that would warrant the Committee taking steps to begin removing policy accommodation sooner than currently anticipated.

In the statement to be released following the meeting, all members agreed that it was appropriate to acknowledge that the recovery had been slower than the Committee had expected at the time of the April meeting and to note the factors that were currently weighing on economic growth and boosting inflation. The Committee agreed that the statement should briefly describe its current projections for unemployment and inflation relative to the levels of those variables that members see as consistent with the Committee's dual mandate. In the discussion of inflation in the statement, members decided to reference *inflation*—meaning overall inflation—rather than *underlying inflation* or *inflation trends,* in order to be clear that the Committee's objective is the level of overall inflation in the medium term. The Committee also decided to reiterate that economic conditions were likely to warrant exceptionally low levels for the federal funds rate for an extended period; in addition, the Committee noted that it would review regularly the size and composition of its securities holdings, and that it is prepared to adjust those holdings as appropriate.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to complete purchases of $600 billion of longer-term Treasury securities by the end of this month. The Committee also directs the Desk to maintain its existing policy of reinvesting principal payments on all domestic securities in the System Open Market Account in Treasury securities in order to maintain the total face value of domestic securities at approximately $2.6 trillion. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 12:30 p.m.:

> "Information received since the Federal Open Market Committee met in April indicates that the economic recovery is continuing at a moderate pace, though somewhat more slowly than the Committee had expected. Also, recent labor

market indicators have been weaker than anticipated. The slower pace of the recovery reflects in part factors that are likely to be temporary, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the tragic events in Japan. Household spending and business investment in equipment and software continue to expand. However, investment in nonresidential structures is still weak, and the housing sector continues to be depressed. Inflation has picked up in recent months, mainly reflecting higher prices for some commodities and imported goods, as well as the recent supply chain disruptions. However, longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The unemployment rate remains elevated; however, the Committee expects the pace of recovery to pick up over coming quarters and the unemployment rate to resume its gradual decline toward levels that the Committee judges to be consistent with its dual mandate. Inflation has moved up recently, but the Committee anticipates that inflation will subside to levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To promote the ongoing economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to keep the target range for the federal funds rate at 0 to ¼ percent. The Committee continues to anticipate that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate for an extended period. The Committee will complete its purchases of $600 billion of longer-term Treasury securities by the end of this month and will maintain its existing policy of reinvesting principal payments from its securities holdings. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

The Committee will monitor the economic outlook and financial developments and will act as needed to best foster maximum employment and price stability."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Richard W. Fisher, Narayana Kocherlakota, Charles I. Plosser, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: None.

External Communications

In follow-up to discussions at the January meeting, the Committee turned to consideration of policies aimed at supporting effective communication with the public regarding the outlook for the economy and monetary policy. The subcommittee on communication, chaired by Governor Yellen and composed of Governor Duke and Presidents Fisher and Rosengren, proposed policies for Committee participants and for Federal Reserve System staff to follow in their communications with the public in order to reinforce the public's confidence in the transparency and integrity of the monetary policy process. By unanimous vote, the Committee approved the policies.[2] Participants all supported the policies, but several of them emphasized that the policy for staff, in particular, should be applied with judgment and common sense so as to avoid interfering with legitimate research.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 9, 2011. The meeting adjourned at 12:10 p.m. on June 22, 2011.

Notation Vote

By notation vote completed on May 17, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on April 26–27, 2011.

William B. English
Secretary

2 The policies are available at http://www.federalreserve.gov/monetarypolicy/files/FOMC_ExtCommunicationParticipants.pdf and http://www.federalreserve.gov/monetarypolicy/files/FOMC_ExtCommunicationStaff.pdf.

Addendum: Summary of Economic Projections

In conjunction with the June 21–22, 2011, Federal Open Market Committee (FOMC) meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC, submitted projections for growth of real output, the unemployment rate, and inflation for the years 2011 to 2013 and over the longer run. The projections were based on information available at the time of the meeting and on each participant's assumptions about factors likely to affect economic outcomes, including his or her assessment of appropriate monetary policy. "Appropriate monetary policy" is defined as the future path of policy that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her interpretation of the Federal Reserve's dual objectives of maximum employment and stable prices. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks.

As depicted in **figure 1**, FOMC participants expected the economic recovery to continue at a moderate pace, with growth of real gross domestic product (GDP) about the same this year as in 2010 and then strengthening over 2012 and 2013. With the pace of economic growth modestly exceeding their estimates of the longer-run sustainable rate of increase in real GDP, the unemployment rate is projected to trend gradually lower over this projection period. However, participants anticipated that, at the end of 2013, the unemployment rate would still be well above their estimates of the unemployment rate that they see as consistent, over the longer run, with the Committee's dual mandate of maximum employment and price stability. Most participants marked up their projections of inflation for 2011 in light of the increase in inflation in the first half of the year, but they projected this increase to be transitory, with overall inflation moving back in line with core inflation in 2012 and 2013 and remaining at or a bit below rates that they see as consistent, over the longer run, with the Committee's dual mandate. Participants generally saw the rate of core inflation as likely to stay roughly the same over the next two years as this year.

On balance, as indicated in **table 1**, participants anticipated somewhat lower real GDP growth over the near term relative to their projections in April but left their projections for inflation mostly unchanged since the April meeting. Participants made noticeable downward revisions to their projections for GDP growth this year and next, but they made little change to their projection for 2013 and no change to their longer-run projections. Meeting participants revised up their projections for the unemployment rate over the forecast period, although they continue to expect a gradual decline in the unemployment rate over time. Participants' projections for overall infla-

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, June 2011
Percent

Variable	Central tendency[1]				Range[2]			
	2011	2012	2013	Longer run	2011	2012	2013	Longer run
Change in real GDP	2.7 to 2.9	3.3 to 3.7	3.5 to 4.2	2.5 to 2.8	2.5 to 3.0	2.2 to 4.0	3.0 to 4.5	2.4 to 3.0
April projection	3.1 to 3.3	3.5 to 4.2	3.5 to 4.3	2.5 to 2.8	2.9 to 3.7	2.9 to 4.4	3.0 to 5.0	2.4 to 3.0
Unemployment rate	8.6 to 8.9	7.8 to 8.2	7.0 to 7.5	5.2 to 5.6	8.4 to 9.1	7.5 to 8.7	6.5 to 8.3	5.0 to 6.0
April projection	8.4 to 8.7	7.6 to 7.9	6.8 to 7.2	5.2 to 5.6	8.1 to 8.9	7.1 to 8.4	6.0 to 8.4	5.0 to 6.0
PCE inflation	2.3 to 2.5	1.5 to 2.0	1.5 to 2.0	1.7 to 2.0	2.1 to 3.5	1.2 to 2.8	1.3 to 2.5	1.5 to 2.0
April projection	2.1 to 2.8	1.2 to 2.0	1.4 to 2.0	1.7 to 2.0	2.0 to 3.6	1.0 to 2.8	1.2 to 2.5	1.5 to 2.0
Core PCE inflation[3]	1.5 to 1.8	1.4 to 2.0	1.4 to 2.0		1.5 to 2.3	1.2 to 2.5	1.3 to 2.5	
April projection	1.3 to 1.6	1.3 to 1.8	1.4 to 2.0		1.1 to 2.0	1.1 to 2.0	1.2 to 2.0	

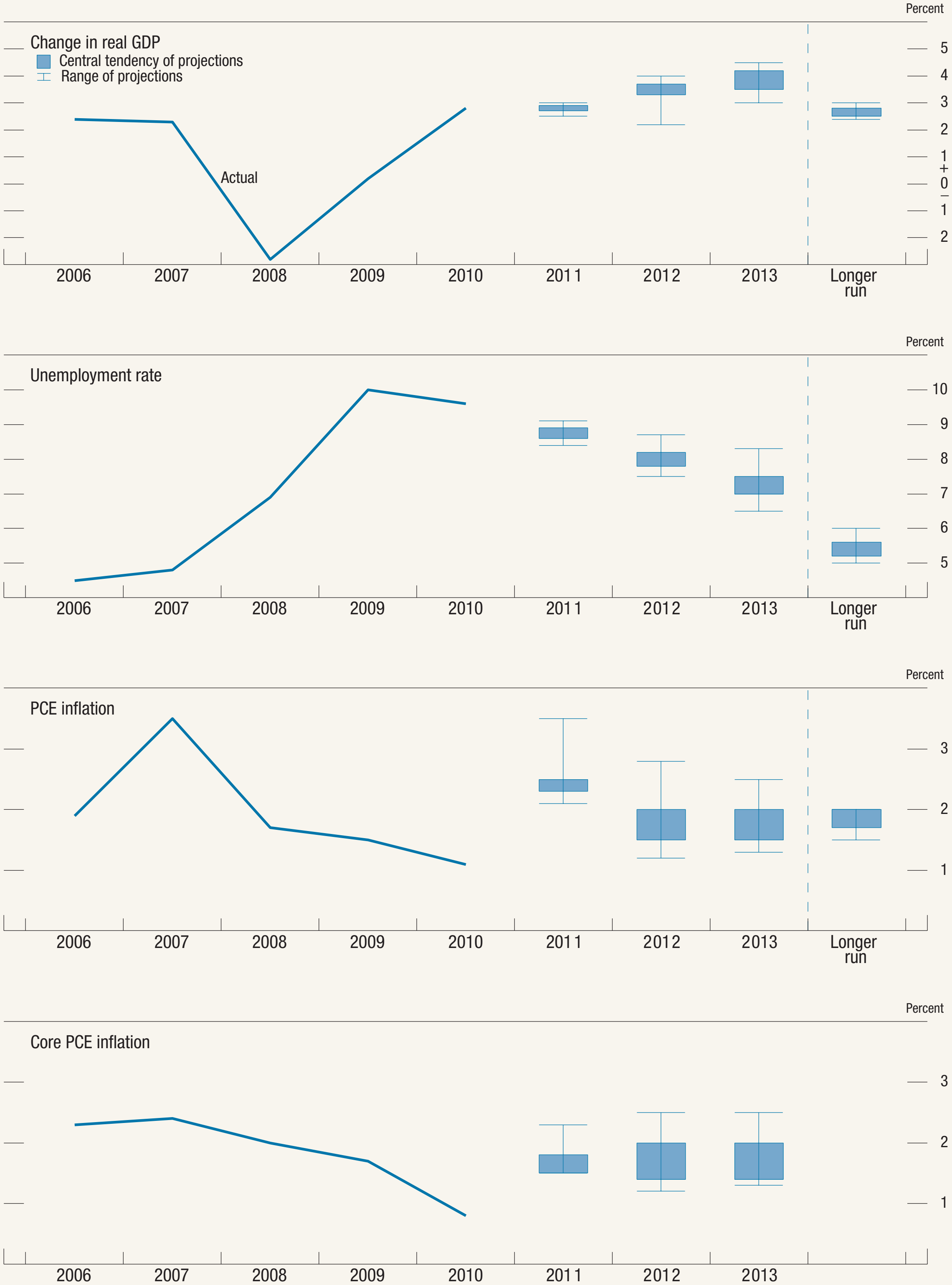
Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The April projections were made in conjunction with the meeting of the Federal Open Market Committee on April 26–27, 2011.

1 The central tendency excludes the three highest and three lowest projections for each variable in each year.

2 The range for a variable in a given year consists of all participants' projections, from lowest to highest, for that variable in that year.

3 Longer-run projections for core PCE inflation are not collected.

Figure 1. Central tendencies and ranges of economic projections, 2011–13 and over the longer run



Note: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual.

tion this year were somewhat more narrowly distributed than in April, and their projections for 2012 and 2013 were similar to the projections made in April.

A sizable majority of participants continued to judge the level of uncertainty associated with their projections for economic growth and inflation as unusually high relative to historical norms. Most participants viewed the risks to output growth as being weighted to the downside, and none saw those risks as weighted to the upside. Meanwhile, a majority of participants saw the risks to overall inflation as balanced.

The Outlook

Participants marked down their forecasts for real GDP growth in 2011 to reflect the unexpected weakness witnessed in the first half of the year, with the central tendency of their projections moving down to 2.7 to 2.9 percent from 3.1 to 3.3 percent in April. Participants attributed the downward revision in their growth outlook to the likely effects of elevated commodity prices on real income and consumer sentiment, as well as indications of renewed weakness in the labor market, surprisingly sluggish consumer spending, a continued lack of recovery in the housing market, supply disruptions from the events in Japan, and constraints on government spending at all levels.

Looking further ahead, participants' forecasts for economic growth were also marked down in 2012, as participants saw some of the weakness in economic activity this year as likely to persist. Nevertheless, participants still anticipated a modest acceleration in economic output next year, and they expected a further modest acceleration in 2013 to growth rates that were largely unchanged from their previous projection. The central tendency of their current projections for real GDP growth in 2012 was 3.3 to 3.7 percent, compared with 3.5 to 4.2 percent in April, and in 2013 the central tendency of the projections for real GDP growth was 3.5 to 4.2 percent. Participants cited the effects of continued monetary policy accommodation, some further easing in credit market conditions, a waning in the drag from elevated commodities prices, and an increase in spending from pent-up demand as factors likely to contribute to a pickup in the pace of the expansion. Participants did, however, see a number of factors that would likely continue to weigh on GDP growth over the next two years. Most participants pointed to strains in the household sector, noting impaired balance sheets, continued declines in house prices, and persistently high unemployment as restraining the growth of consumer spending. In addition, some participants noted that although energy and commodity prices were expected to stabilize, they would do so at elevated levels and would likely continue to damp spending growth for a time. Finally, several participants pointed to a likely drag from tighter fiscal policy at all levels of government. In the absence of further shocks, participants generally expected that, over time, real GDP growth would eventually settle down at an annual rate of 2.5 to 2.8 percent in the longer run.

Partly in response to the recent weak indicators of labor demand and participants' downwardly revised views of the economic outlook, participants marked up their forecasts for the unemployment rate over the entire forecast period. For the fourth quarter of this year, the central tendency of their projections rose to 8.6 to 8.9 percent from 8.4 to 8.7 percent in April. Similar upward revisions were made for 2012 and 2013, with the central tendencies of the projections for those years at 7.8 to 8.2 percent and 7.0 to 7.5 percent, respectively. Consistent with their expectations of a moderate recovery, with growth only modestly above trend, the central tendency of the projections of the unemployment rate at the end of 2013 was well above the 5.2 to 5.6 percent central tendency of their estimates of the unemployment rate that would prevail over the longer run in the absence of further shocks. The central tendency for the participants' projections of the unemployment rate in the longer run was unchanged from the interval reported in April.

Participants noted that measures of consumer price inflation had increased this year, reflecting in part higher prices of oil and other commodities. However, participants' forecasts for total personal consumption expenditures (PCE) inflation in 2011 were little changed from April, with the central tendency of their estimates narrowing to a range of 2.3 to 2.5 percent, compared with 2.1 to 2.8 percent in April. Most participants anticipated that the influence of higher commodity prices and supply disruptions from Japan on inflation would be temporary, and that inflation pressures in the future would be subdued as commodity prices stabilized, inflation expectations remained well anchored, and large margins of slack in labor markets kept labor costs in check. As a result, participants anticipated that total PCE inflation would step down in 2012 and 2013, with the central tendency of their projections in those years at 1.5 to 2.0 percent. The lower end of these central tendencies was revised up somewhat from April, suggesting that fewer participants saw a likelihood of very low inflation in those years. The projections for these two years were at or slightly below the 1.7 to 2.0 percent central tendency of participants' estimates of the longer-run, mandate-consistent rate of inflation. The central tendencies of participants' projections of core PCE inflation this year shifted up a bit to 1.5 to 1.8 percent, as participants saw some of the run-up in commodity prices passing through to core prices. For 2012 and 2013, participants saw commodity prices as likely to stabilize near current levels, and the central tendencies for their forecasts of core inflation were 1.4 to 2.0 percent, essentially unchanged from their April projections.

Uncertainty and Risks

A substantial majority of participants continued to judge that the levels of uncertainty associated with their projections for economic growth and inflation were greater than the average levels that had prevailed over the past 20 years.[3] They pointed to a number of factors that contributed to their assessments of the uncertainty that they attached to their projections, including the severity of the recent recession, the uncertain effects of the current stance of monetary policy, uncertainty about the direction of fiscal policy, and structural dislocations in the labor market.

Most participants now judged that the balance of risks to economic growth was weighted to the downside, and the rest viewed these risks as balanced. The most frequently cited downside risks included a potential for a large negative effect on consumer spending from higher food and energy prices, a weaker labor market, falling house prices, uncertainty from the debate over the statutory debt limit and its potential implications for near-term fiscal policy, and possible negative financial market spillovers from European sovereign debt problems. The risks surrounding participants' forecasts of the unemployment rate shifted higher, with a slight majority of participants now viewing the risks to the projection as weighted to the upside, and the rest of the participants seeing the risks as broadly balanced.

Table 2. Average historical projection error ranges
Percentage points

Variable	2011	2012	2013
Change in real GDP[1]	±0.9	±1.6	±1.8
Unemployment rate[1]	±0.4	±1.2	±1.7
Total consumer prices[2]	±0.8	±1.0	±1.0

Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1991 through 2010 that were released in the summer by various private and government forecasters. As described in the box "Forecast Uncertainty," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

[1] For definitions, refer to general note in table 1.

[2] Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

Although a majority of participants judged the risks to their inflation projections over the period from 2011 to 2013 to be weighted to the upside in April, most participants now viewed these risks as broadly balanced. On the one hand, participants noted that the effect on headline inflation of the rise in commodity prices earlier this year was likely to subside as those prices stabilized, but they could not rule out the possibility of those effects being more persistent than anticipated. On the other hand, with the outlook for the economy somewhat weaker than previously expected, some participants saw a risk that greater resource slack could produce more downward pressure on inflation than projected. A few participants noted the possibility that the current highly accommodative stance of monetary policy, if it were to be maintained longer than is appropriate, could lead to higher inflation expectations and actual inflation.

Diversity of Views

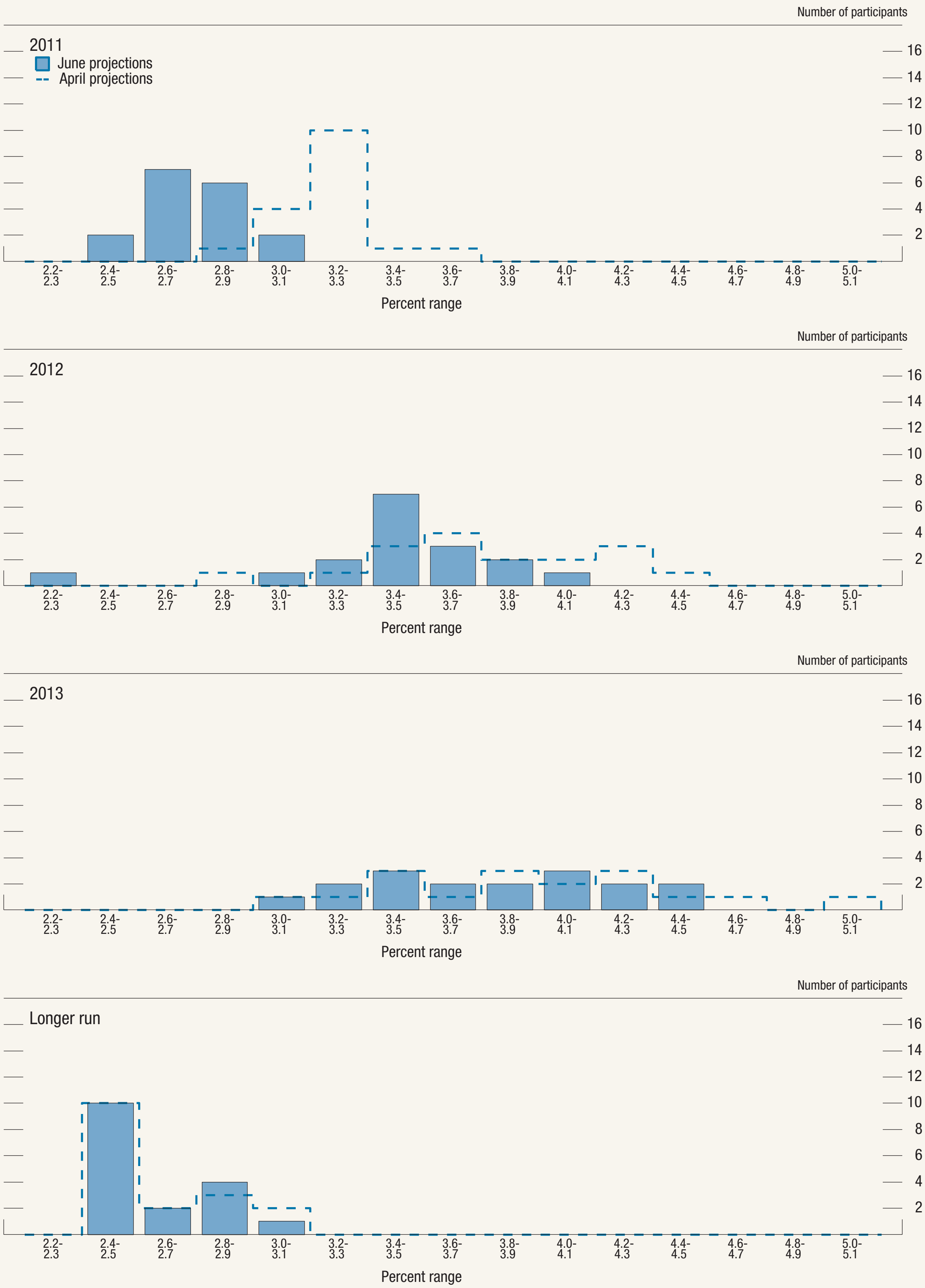
Figures 2.A and 2.B provide further details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate in 2011, 2012, 2013, and over the longer run. The dispersion in these projections continued to reflect differences in participants' assessments of many factors, including the current degree of underlying momentum in economic activity, the outlook for fiscal policy, the timing and degree of the recovery of labor markets following the very deep recession, and appropriate future monetary policy and its effects on economic activity. Regarding participants'

[3] Table 2 provides estimates of forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1991 to 2010. At the end of this summary, the box "Forecast Uncertainty" discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

projections for real GDP growth, the distribution for this year shifted noticeably lower but remained about as concentrated as the distribution in April. The distribution for 2012 also shifted down somewhat and became a bit more concentrated, while the distribution for 2013 did not change appreciably. Regarding participants' projections for the unemployment rate, the distribution for this year and for 2012 shifted up relative to the corresponding distributions in April, and more than one-half of participants expected the unemployment rate in 2012 to be in the 8.0 to 8.1 percent interval. These shifts reflect the recent softening in labor market conditions along with the marking down of expected economic growth this year and next. The distribution of the unemployment rate in 2013 also shifted upward somewhat but was narrower than the distribution in April. The distributions of participants' estimates of the longer-run growth rate of real GDP and of the unemployment rate were both little changed from the April projections.

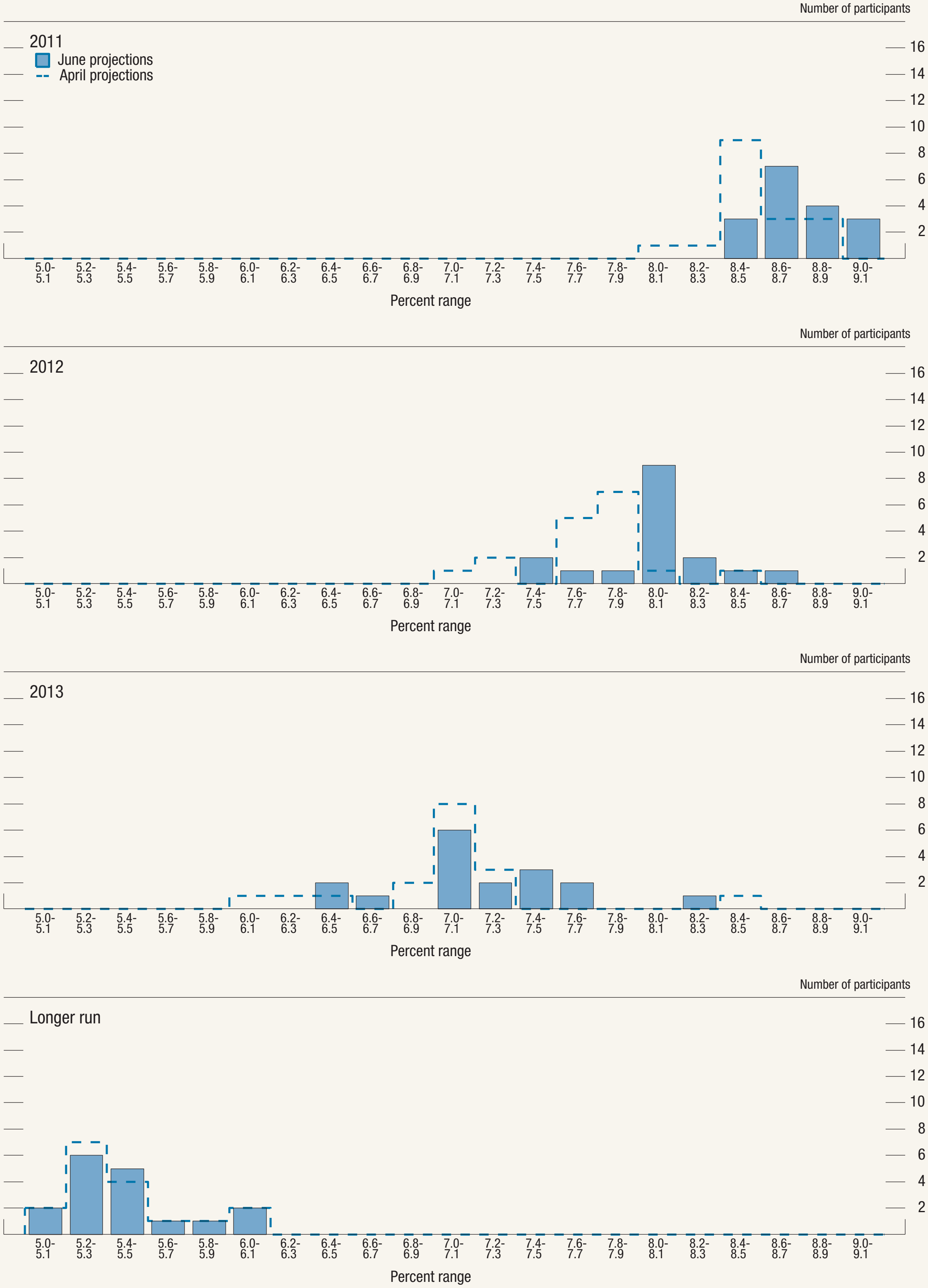
Corresponding information about the diversity of participants' views regarding the inflation outlook is provided in **figures 2.C** and **2.D**. In general, the dispersion of participants' inflation forecasts for the next few years represented differences in judgments regarding the fundamental determinants of inflation, including the degree of resource slack and the extent to which such slack influences inflation outcomes and expectations, as well as estimates of how the stance of monetary policy may influence inflation expectations. Regarding overall PCE inflation, the distributions for 2011, 2012, and 2013 all narrowed somewhat, with the top of the distributions remaining unchanged but the lower end of the distributions moving up somewhat. Although participants continued to expect that the somewhat elevated rate of inflation this year would subside in subsequent years, fewer participants anticipated very low levels of inflation. The distribution of participants' projections for core inflation for this year shifted noticeably higher, reflecting incoming data and a view that the pass-through of commodity prices to core prices may be greater than previously thought; however, the distributions for 2012 and 2013 were little changed. The distribution of participants' projections for overall inflation over the longer run was essentially unchanged from its fairly narrow distribution in April, reflecting the broad similarity in participants' assessments of the approximate level of inflation that is consistent with the Federal Reserve's dual objectives of maximum employment and price stability.

Figure 2.A. Distribution of participants' projections for the change in real GDP, 2011–13 and over the longer run



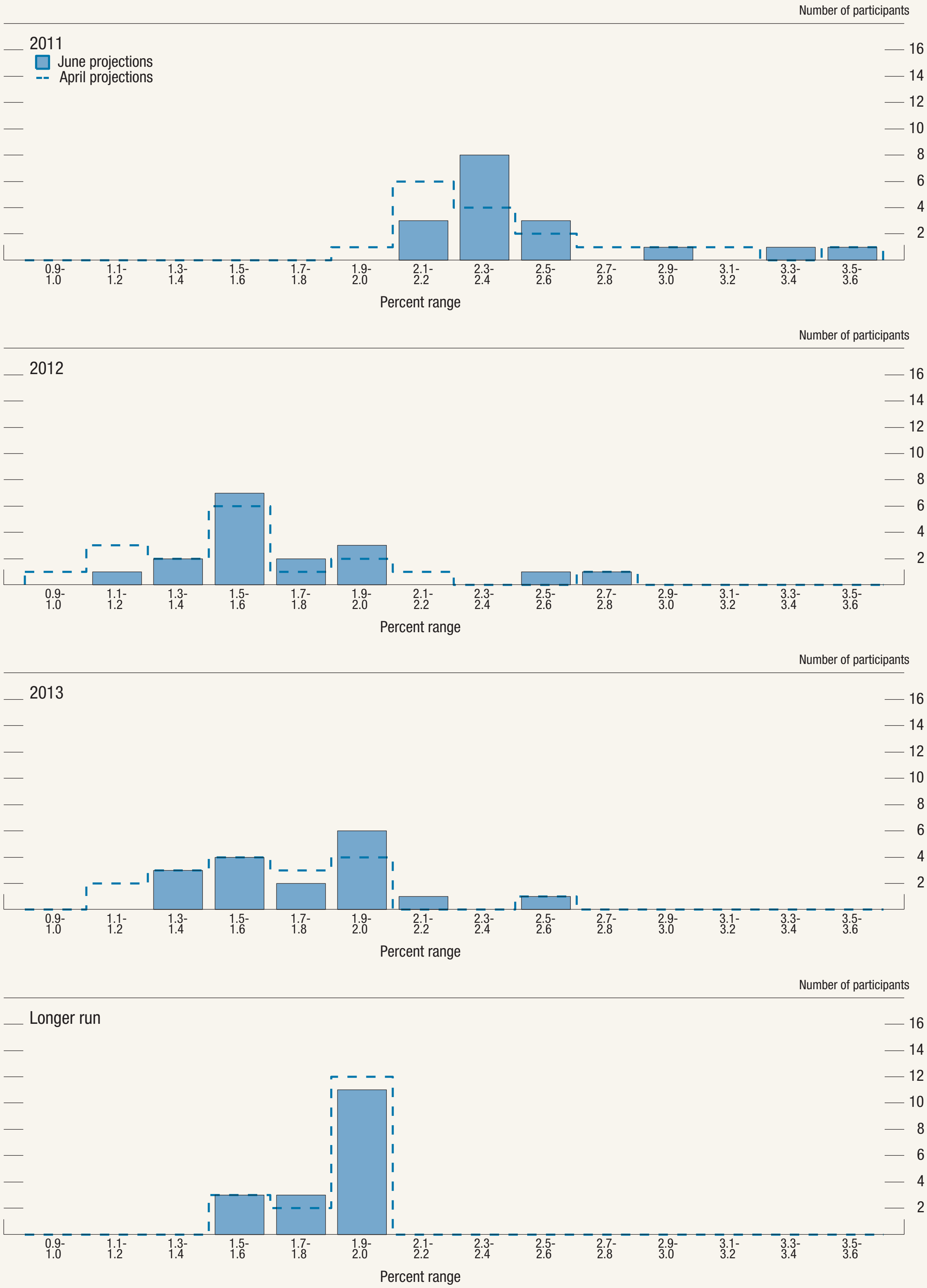
Note: Definitions of variables are in the general note to table 1.

Figure 2.B. Distribution of participants' projections for the unemployment rate, 2011–13 and over the longer run



Note: Definitions of variables are in the general note to **table 1**.

Figure 2.C. Distribution of participants' projections for PCE inflation, 2011–13 and over the longer run



Note: Definitions of variables are in the general note to **table 1**.

Figure 2.D. Distribution of participants' projections for core PCE inflation, 2011–13

Note: Definitions of variables are in the general note to table 1.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world, and the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Report*s and those prepared by the Federal Reserve Board's staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 2.1 to 3.9 percent in the current year, 1.4 to 4.6 percent in the second year, and 1.2 to 4.8 percent in the third year. The corresponding 70 percent confidence intervals for overall inflation would be 1.2 to 2.8 percent in the current year, and 1.0 to 3.0 percent in the second and third years.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past, as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

Meeting Held on August 9, 2011

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, August 9, 2011, at 8:00 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Christine Cumming, Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard, Thomas M. Hoenig, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Thomas C. Baxter
Deputy General Counsel

Richard M. Ashton
Assistant General Counsel

Thomas A. Connors, David Reifschneider, Daniel G. Sullivan, David W. Wilcox, and Kei-Mu Yi
Associate Economists

Brian Sack
Manager, System Open Market Account

Jennifer J. Johnson
Secretary of the Board, Office of the Secretary, Board of Governors

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation, Board of Governors

Robert deV. Frierson
Deputy Secretary, Office of the Secretary, Board of Governors

Andreas Lehnert
Deputy Director, Office of Financial Stability Policy and Research, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Seth B. Carpenter
Senior Associate Director, Division of Monetary Affairs, Board of Governors

Michael Leahy
Senior Associate Director, Division of International Finance, Board of Governors

Lawrence Slifman and William Wascher
Senior Associate Directors, Division of Research and Statistics, Board of Governors

Andrew T. Levin
Senior Adviser, Office of Board Members, Board of Governors

Stephen A. Meyer
Senior Adviser, Division of Monetary Affairs, Board of Governors

Joyce K. Zickler
Visiting Senior Adviser, Division of Monetary Affairs, Board of Governors

David E. Lebow
Associate Director, Division of Research and Statistics, Board of Governors

Joshua Gallin
Deputy Associate Director, Division of Research and Statistics, Board of Governors

Fabio M. Natalucci
Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Beth Anne Wilson
Assistant Director, Division of International Finance, Board of Governors

Penelope A. Beattie
Assistant to the Secretary, Office of the Secretary, Board of Governors

John C. Driscoll
Senior Economist, Division of Monetary Affairs, Board of Governors

Carol Low
Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Randall A. Williams
Records Management Analyst, Division of Monetary Affairs, Board of Governors

David Sapenaro
First Vice President, Federal Reserve Bank of St. Louis

Mark S. Sniderman
Executive Vice President, Federal Reserve Bank of Cleveland

David Altig, Alan D. Barkema, and Geoffrey Tootell
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Kansas City, and Boston, respectively

Chris Burke, Fred Furlong, Tom Klitgaard, Evan F. Koenig, and Daniel L. Thornton
Vice Presidents, Federal Reserve Banks of New York, San Francisco, New York, Dallas, and St. Louis, respectively

Keith Sill
Assistant Vice President, Federal Reserve Bank of Philadelphia

Robert L. Hetzel
Senior Economist, Federal Reserve Bank of Richmond

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on June 21–22, 2011. He also reported on System open market operations, including the continuing reinvestment into longer-term Treasury securities of principal payments received on the SOMA's holdings of agency debt and agency-guaranteed mortgage-backed securities. By unanimous vote, the Committee ratified the transactions by the Open Market Desk of the Federal Reserve Bank of New York over the intermeeting period.

Staff Review of the Economic Situation

The information reviewed at the August 9 meeting indicated that the pace of the economic recovery remained slow in recent months and that labor market conditions continued to be weak. In addition, revised data for 2008 through 2010 from the Bureau of Economic Analysis indicated that the recent recession was deeper than previously thought and that the level of real gross domestic product (GDP) had not yet attained its pre-recession peak by the second quarter of 2011. Moreover, the downward revision to first-quarter GDP growth and the slow growth reported for the second quarter indicated that the recovery was quite sluggish in the first half of this year. Overall consumer price inflation moderated in recent months, and survey measures of long-run inflation expectations remained stable.

Private nonfarm employment rose at a considerably slower pace in June and July than earlier in the year, and employment in state and local governments continued to trend lower. The unemployment rate edged up, on net, since the beginning of the year, and long-duration unemployment remained very high. Meanwhile, the labor force participation rate moved down further through July. Initial claims for unemployment insurance stepped down some in recent weeks but remained elevated, and indicators of hiring showed no improvement.

Manufacturing production was unchanged in June. Supply chain disruptions associated with the earthquake in Japan continued to hinder production at motor vehicle manufacturers and the firms that supply them. Excluding motor vehicles and parts, factory output posted only a modest increase. The manufacturing capacity utilization rate held about flat in recent months. With auto manufacturers expecting supply chain disruptions to ease, motor vehicle assembly schedules called for a substantial step-up in production in the third quarter, and initial estimates of production in June were consistent with such a step-up. But broader indicators of near-term manufacturing activity, such as the diffusion indexes of new orders from the national and regional manufacturing surveys, softened to levels consistent with only small gains in production in the coming months.

Real consumer spending was nearly unchanged in the second quarter. Motor vehicle purchases declined during the spring when the availability of some models was limited, but rebounded somewhat in July as supplies improved. Consumer spending on goods and services other than motor vehicles also appeared soft through June. Labor earnings rose in the second quarter, but increases in consumer prices offset much of the gain in nominal income. Consumer sentiment weakened markedly in July, and the Thomson Reuters/University of Michigan sentiment index fell to levels last seen in early 2009.

The housing market remained depressed. Although single-family housing starts moved up some in June, permit issuance stayed low. Similarly, sales of new and existing single-family homes were subdued in recent months, and home prices continued to trend lower. New construction remained constrained by the overhang of foreclosed or distressed properties as well as by weak demand in an environment of uncertainty about future home prices and tight underwriting standards for mortgage loans.

Real business spending on equipment and software rose at a modest pace in the second quarter, reflecting strong increases in outlays for high-tech equipment that more than offset declines in spending in many other equipment categories. Nominal new orders for nondefense capital goods excluding aircraft continued to rise through June, and orders remained well above shipments, suggesting further gains in outlays for equipment and software in the near term. However, indicators of business conditions and sentiment weakened in June and July. Business investment in nonresidential structures appeared to have stabilized at a low level in recent months, with vacancy rates elevated and construction financing conditions still tight. Outlays for drilling and mining equipment continued to increase. In the second quarter, businesses appeared to add to inventories at a moderate rate, as a drawdown in motor vehicle inventories associated with production disruptions was offset by higher accumulation elsewhere. In most industries outside of the motor vehicle sector, inventories seemed to be reasonably well aligned with sales.

Real federal purchases turned up in the second quarter, as defense expenditures rebounded after declining noticeably in the preceding quarter. At the state and local level, real purchases continued to decline in response to budgetary pressures; these governments continued to reduce payrolls, and their real construction outlays fell sharply.

The U.S. international trade deficit widened significantly in May in nominal terms, as exports edged down and imports moved up strongly. Declines in exports were concentrated in commodity-intensive categories such as industrial supplies and agricultural goods; sales of capital goods and automotive products increased. The rise in imports importantly reflected increases in spending on petroleum products (mainly the result of higher prices rather than increased volumes) and on capital goods, especially computers. For the second quarter as a whole, the advance release of the National Income and Product Accounts (NIPA) indicated that real exports of goods and services increased more than real imports, with the result that net exports added significantly to real GDP growth.

After decelerating in the preceding two months, indexes of U.S. consumer prices declined in June, reflecting a substantial drop in consumer energy prices. However, survey data indicated some backup in gasoline prices in July. The price index for personal consumption expenditures (PCE) excluding food and energy posted a small increase in June, and the PCE price index for non-energy services was essentially unchanged. In contrast, prices of nonfood, nonenergy goods were apparently boosted by upward pressure from earlier increases in commodity and import prices, and motor vehicle prices rose further, reflecting the extremely low levels of vehicle inventories. Near-term expected inflation from the Thomson Reuters/University of Michigan Surveys of Consumers moved down again in July from its elevated level in the spring, and longer-term inflation expectations remained stable.

Nominal hourly labor compensation, as measured both by compensation per hour in the nonfarm business sector and by the employment cost index, increased at a moderate rate over the year ending in the second quarter. Similarly, the 12-month change in average hourly earnings of all employees remained moderate in July. Productivity in the nonfarm business sector rose only slightly over the past four-quarter period, so unit labor costs posted a modest increase.

Foreign economic growth appeared to have slowed significantly in recent months. Real GDP growth declined sharply in the United Kingdom in the second quarter, and industrial production data and purchasing managers surveys pointed to a similar slowdown in Canada. Retail sales and business sentiment for the euro area also weakened in recent months amid intensified concerns over the fiscal situation of the peripheral euro-area countries. Economic performance in the emerging market economies was somewhat better, but indicators for those economies also suggested some cooling from the very rapid growth earlier this year. By contrast, the Japanese economy has begun to recover from the March disaster, with exports and production both retracing much of their substantial losses. Foreign inflation dipped in the second quarter as the effects of previous increases in food and energy prices began to dissipate.

Staff Review of the Financial Situation

Over the intermeeting period, U.S. financial markets were strongly influenced by developments regarding the fiscal situations in the United States and in Europe and by generally weaker-than-expected readings on economic activity. Throughout the period, waxing and waning concerns about the sovereign debt of peripheral euro-area countries appeared to have an effect on investor appetite for risk, leading to volatility in many asset markets. Late in the period, investor focus appeared to turn to the U.S. debt ceiling and the potential for delayed debt service payments by the Treasury Department, the possibility of a downgrade of U.S. sovereign debt, and the prospects for significant long-term fiscal consolidation. Liquidity and funding in money markets deteriorated in the last week of July, and interest rates on a number of short-term funding instruments increased markedly. The strains in these markets eased after legislation to raise the debt ceiling and to cut the federal budget deficit was signed into law on August 2. U.S. equity prices fell considerably in the last week of July and the first week of August, reportedly reflecting recent weaker-than-expected economic data releases, and they declined further after the August 5 announcement by Standard & Poor's of its downgrade of long-term U.S. sovereign debt.

The decisions by the FOMC at its June meeting to complete its asset purchase program and to maintain the 0 to ¼ percent target range for the federal funds rate were about in line with market expectations and elicited little market reaction; the same was true of the accompanying statement and the subsequent press briefing by the Chairman. Over the intermeeting period, investors marked down the expected path for the federal funds rate substantially, reflecting incoming economic data that were weaker than expected and concomitant concerns about the prospects for global growth. Yields on nominal Treasury securities also fell notably, on net, over the intermeeting period. The Federal Reserve's Treasury purchase program was completed on schedule on June 30.

Broad U.S. stock price indexes fell sharply, on net, over the intermeeting period, as increased concerns about economic growth appeared to overshadow generally strong second-quarter corporate earnings reports. Option-implied volatility on the S&P 500 index jumped late in the period. Yields on both investment- and speculative-grade corporate bonds fell a little less than those on comparable-maturity Treasury securities, leaving risk spreads wider. Financial market indicators of inflation expectations were mixed over the intermeeting period.

Net debt financing by nonfinancial corporations was solid in July, although below the elevated pace posted in the second quarter. Gross bond issuance fell, and the outstanding amount of commercial and industrial (C&I) loans on banks' books was about flat. Nonfinancial commercial paper (CP) posted a sizable gain. The market for CP issued by financial firms experienced some strains late in the period as institutional money market mutual funds reportedly increased their cash positions and sought to decrease exposure to CP issued by some entities perceived to be less creditworthy. Issuance of syndicated leveraged loans remained strong in the second quarter. The pace of gross public equity issuance by nonfinancial firms fell somewhat in July from its solid pace in the second quarter. Most indicators of business credit quality continued to improve.

Commercial real estate markets remained weak. Available data for the second quarter indicated that commercial mortgage debt contracted, prices of commercial properties were generally depressed, and issuance of commercial mortgage-backed securities (CMBS) slowed. However, the delinquency rate in June for loans that back existing CMBS stayed below its recent peak, and vacancy rates for commercial properties, while still high, generally continued to edge lower.

Rates on conforming fixed-rate residential mortgages declined, on net, over the intermeeting period. Mortgage refinancing activity picked up but remained relatively subdued. Outstanding residential mortgage debt is estimated to have contracted further in the second quarter. Rates of serious mortgage delinquency continued to moderate but remained high, while the rate of new delinquencies on prime mortgages flattened out in recent months at an elevated level.

Conditions in consumer credit markets generally continued to improve. Total consumer credit expanded at a moderate rate in May as both nonrevolving and revolving credit posted gains. Issuance of consumer asset-backed securities remained solid in July, although some deals later in the month were reportedly postponed a few days while issuers awaited the outcome of the debt ceiling deliberations. Delinquency rates for most types of consumer loans moved down in recent months.

Core commercial bank loans—the sum of C&I, real estate, and consumer loans—were about flat over the months of June and July, as a slowdown in lending to businesses was offset by a pickup in loans to households. The July Senior Loan Officer Opinion Survey on Bank Lending Practices showed that respondents again eased lending standards to some degree on all major loan types other than residential real estate loans. Nonetheless, banks also indicated that the current levels of their lending standards for all loan types were between moderate and relatively tight when compared with the range of standards that had prevailed since 2005. Nearly all second-quarter earnings reports from large banking companies exceeded expectations.

M2 expanded rapidly in June and July. Liquid deposits, the largest component of M2, increased robustly, likely reflecting safe-haven flows from riskier assets along with temporary increases in the amount of deposits that money market mutual funds held at their custodian banks. The rise in currency moderated over those two months but remained robust.

Headline equity indexes abroad and foreign benchmark sovereign yields declined over the intermeeting period in apparent response to signs of a slowdown in the pace of global economic activity and reduced demand for risky assets. At the same time, concerns about fiscal deficits and debt sustainability drove yields on the sovereign debt of Greece, Ireland, Portugal, Spain, and Italy to record highs relative to yields on German bunds, although later in the period, spreads fell back somewhat. Stock prices of European banks, which are significant investors in sovereign bonds issued by the peripheral euro-area countries, declined appreciably, and some of these banks reportedly faced tighter funding conditions toward the end of the intermeeting period. The broad nominal index of the U.S. dollar fluctuated over the period in response to changes in investors' assessment of the outlook for the U.S. economy, prospects for the lifting of the U.S. debt ceiling, and the situation in the European economies. On net over the intermeeting period, the dollar rose modestly after having depreciated earlier this year.

The European Central Bank (ECB) boosted its policy rate in July, a move that was widely anticipated. As indicated by money market futures quotes, however, the expected pace of monetary policy tightening declined substantially for the ECB as well as for other central banks in advanced foreign economies. Following its August meeting, the ECB expanded and extended its offerings of term liquidity and resumed purchases of sovereign debt in the secondary market. Central banks in several emerging market economies, including China, continued to tighten policy in response to inflationary pressures. Authorities in some emerging market economies also took measures to limit capital inflows and credit growth.

Staff Economic Outlook

The information on economic activity received since the June FOMC meeting was weaker than the staff had anticipated, and the projection for real GDP growth in the second half of 2011 and in 2012 was marked down notably. Moreover, the lower estimates of real GDP in recent years that were contained in the annual revisions to the NIPA led the staff to lower its estimate of potential GDP growth, both during recent years and over the forecast period, and to mark down further the staff forecast. The staff continued to expect some rebound in economic activity in the near term as the Japan-related supply chain disruptions in the motor vehicle sector eased. More generally, the staff still projected real GDP to accelerate gradually over the next year and a half, supported by accommodative monetary policy, improved credit availability, and a pickup in consumer and business sentiment. However, the increase in real GDP was projected to be sufficient to reduce slack in the labor market only slowly, and the unemployment rate was expected to remain elevated at the end of 2012.

The staff raised slightly its projection for inflation during the second half of this year, as the upward pressure on consumer prices from earlier increases in import and commodity prices was expected to persist a little longer than previously anticipated. But these influences were still expected to dissipate in coming quarters, as was the temporary upward pressure on motor vehicle prices from low inventories. Moreover, the large increases in consumer energy and food prices seen earlier this year were not expected to be repeated. With long-run inflation expectations stable and substantial slack expected to persist in labor and product markets, the staff continued to expect prices to rise at a subdued pace in 2012.

Participants' Views on Current Conditions and the Economic Outlook

In their discussion of the economic situation and outlook, meeting participants regarded the information received during the intermeeting period as indicating that economic growth so far this year was considerably slower than they had expected. Participants noted a deterioration in labor market conditions, slower household spending, a drop in consumer and business confidence, and continued weakness in the housing sector. Manufacturing activity was reported to be mixed. Participants judged that temporary factors affecting demand and production, including the damping effect of higher energy and other commodity prices and the supply disruptions from the Japanese earthquake, could account for only some of the weakness in economic growth over the first half of the year. While these effects appeared to be waning, the underlying strength of the economic recovery remained uncertain. In addition, many participants pointed to the recent downward revision to estimates of economic activity over the past three years, and some to the financial market strains seen during the intermeeting period, as contributing to a downgrade of the outlook for the economy. Moreover, many participants saw increased downside risks to the outlook for economic growth.

Meeting participants generally noted that overall labor market conditions had deteriorated in recent months. While the employment report for July showed that hiring was somewhat better than in previous months, the release was still seen as indicating relatively weak conditions. A couple of participants commented that the exceptionally high level of long-term unemployment could lead to permanent negative effects on the skills and employment prospects of those affected. Another participant, however, noted that it could instead reflect a mismatch between the characteristics of the unemployed and the jobs currently available. Participants also discussed the labor force participation rate, and it was noted that extended unemployment benefits could be increasing the measured unemployment rate by encouraging some workers to remain in the labor force longer than they otherwise would have. Other participants remarked that the declines in the unemployment rate that have occurred over the past year appeared to reflect primarily declines in labor force participation rather than significant gains in employment. Reports from business contacts suggested that depressed business confidence as well as uncertainty regarding the economic outlook, regulatory policy, and fiscal policy continued to restrain hiring and also capital investment.

Inflation had moderated in recent months after having been somewhat elevated earlier this year. Transitory factors, including supply chain disruptions from the earthquake in Japan and a surge in energy and other commodity prices, had pushed up both headline and core measures of inflation for a time. More recently, however, as prices of energy and some commodities have declined from their earlier peaks, headline inflation has moderated. Participants generally noted that, with apparently significant slack in labor and product markets, slow wage growth, and little evidence of pricing power among firms, inflation was likely to decline somewhat over time. Measures of inflation expectations had remained stable. Nevertheless, a number of participants noted that core inflation had moved up, on balance, since last fall. Some indicated that the rise in inflation from very low levels reflected the Committee's accommodative stance of monetary policy, which had helped address the deflation risks of a year ago. A couple of others, however, suggested that the juxtaposition of higher core inflation and somewhat lower unemployment could imply that the level of potential output was lower than had been thought.

Most meeting participants indicated that the weakness in consumer spending in recent months was unexpected. The flattening out of consumer spending was seen as reflecting, in part, the modest pace of gains in employment and labor income. In addition, household spending on autos had been held back by low inventories, and participants generally expected a pickup in sales of motor vehicles in coming months as production rebounded. Nonetheless, low consumer confidence, efforts to rebuild balance sheets, and heightened caution on the part of households facing an uncertain economic environment were seen as factors likely to continue to weigh on household spending going forward. Several participants also pointed to financial constraints, particularly depressed home prices and still-tight credit conditions, as further restraining consumer spending for a time.

Business outlays on equipment and software continued to advance, although at a slower pace than earlier in the year. Business contacts in many parts of the country reported that uncertainty about the pace of growth in coming quarters and a general slump in business confidence had made some firms reluctant to expand capacity. With home prices depressed, housing construction was quite subdued and seen as likely to remain so, while investment in nonresidential structures remained low.

The weakness in household and business spending was accompanied by fiscal consolidation at the state and local level. The shedding of state and local government jobs contributed to the deterioration in overall labor market conditions. Some policymakers noted that their outlooks for economic activity were shaped in part by an expectation of fiscal restraint at all levels of government.

Participants generally saw the degree of uncertainty surrounding the outlook for economic growth as having risen appreciably. A couple noted that the cyclical impetus to economic expansion appeared to be weaker than it had been in past recoveries, but that the reasons for the weakness were unclear, contributing to greater uncertainty about the economic outlook. Many participants also saw an increase in the downside risks to economic growth. While participants did not anticipate a downturn in economic activity, several noted that, with the recovery still somewhat tentative, the economy was vulnerable to adverse shocks. Potential shocks included the possibility of a more protracted period of weakness in household financial conditions, the chance of a larger-than-expected near-term fiscal tightening, and potential financial and economic spillovers if the situation in Europe were to deteriorate.

Participants noted that financial markets were volatile over the intermeeting period, as investors responded to news on the European fiscal situation and the negotiations regarding the debt ceiling in the United States. However, the broad declines in stock prices and interest rates over the intermeeting period were seen as mostly reflecting the incoming data pointing to a weaker outlook for growth both in the United States and globally as well as a reduced willingness of investors to bear risk in light of the greater uncertainty about the outlook. While conditions in funding markets had tightened, it was noted that the condition of U.S. banks had strengthened in recent quarters and that the credit quality of both businesses and households had continued to improve.

Participants discussed the range of policy tools available to promote a stronger economic recovery should the Committee judge that providing additional monetary accommodation was warranted. Reinforcing the Committee's forward guidance about the likely path of monetary policy was seen as a possible way to reduce interest rates and provide greater support to the economic expansion; a few participants emphasized that guidance focusing solely on the state of the economy would be preferable to guidance that named specific spans of time or calendar dates. Some participants noted that additional asset purchases could be used to provide more accommodation by lowering longer-term interest rates. Others suggested that increasing the average maturity of the System's portfolio—perhaps by selling securities with relatively short remaining maturities and purchasing securities with relatively long remaining maturities—could have a similar effect on longer-term interest rates. Such an approach would not boost the size of the Federal Reserve's balance sheet and the quantity of reserve balances. A few participants noted that a reduction in the interest rate paid on excess reserve balances could also be helpful in easing financial conditions. In contrast, some participants judged that none of the tools available to the Committee would likely do much to promote a faster economic recovery, either because the headwinds that the economy faced would unwind only gradually and that process could not be accelerated with monetary policy or because recent events had significantly lowered the path of potential output. Consequently, these participants thought that providing additional stimulus at this time would risk boosting inflation without providing a significant gain in output or employment. Participants noted that devoting additional time to discussion of the possible costs and benefits of various potential tools would be useful, and they agreed that the September meeting should be extended to two days in order to provide more time.

Committee Policy Action

In the discussion of monetary policy for the period ahead, most members agreed that the economic outlook had deteriorated by enough to warrant a Committee response at this meeting. While all felt that monetary policy could not completely address the various strains on the economy, most members thought that it could contribute importantly to better outcomes in terms of the Committee's dual mandate of maximum employment and price stability. In particular, some members expressed the view that additional accommodation was warranted because they expected the unemployment rate to remain well above, and inflation to be at or below, levels consistent with the Committee's mandate. Those viewing a shift toward more accommodative policy as appropriate generally agreed that a strengthening of the Committee's forward guidance regarding the federal funds rate, by being more explicit about the period over which the Committee expected the federal funds rate to remain exceptionally low, would be a measured response to the deterioration in the outlook over the intermeeting period. A few members felt that recent economic developments justified a more substantial move at this meeting, but they were willing to accept the stronger forward guidance as a step in the direction of additional accommodation. Three members dissented because they preferred to retain the forward guidance language employed in the June statement.

The Committee agreed to keep the target range for the federal funds rate at 0 to ¼ percent and to state that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. That anticipated path for the federal funds rate was viewed both as appropriate in light of most members' outlook for the economy and as generally consistent with some prescriptions for monetary policy based on historical and model-based analysis. In choosing to phrase the outlook for policy in terms of a time horizon, members also considered conditioning the outlook for the level of the federal funds rate on explicit numerical values for the unemployment rate or the inflation rate. Some members argued that doing so would establish greater clarity regarding the Committee's intentions and its likely reaction to future economic developments, while others raised questions about how an appropriate numerical value might be chosen. No such references were included in the statement for this meeting. One member expressed concern that the use of a specific date in the forward guidance would be seen by the public as an unconditional commitment, and it could undermine Committee credibility if a change in timing subsequently became appropriate. Most members, however, agreed that stating a conditional expectation for the level of the federal funds rate through mid-2013 provided useful guidance to the public, with some noting that such an indication did not remove the Committee's flexibility to adjust the policy rate earlier or later if economic conditions do not evolve as the Committee currently expects.

In the statement to be released following the meeting, members generally agreed that it was important to acknowledge that the recovery had been considerably slower than the Committee had expected. Although some of the slowdown in the first half of the year reflected transitory factors, most members now judged that only part of that weakness could be attributed to those factors. The Committee decided to note that the declines in energy and commodity prices from their recent peaks had led to a moderation of inflation and that longer-term inflation expectations remained stable. The Committee also characterized the economic outlook in terms of its statutory mandate and indicated that it expected the slower pace of economic expansion to result in an unemployment rate that would decline only gradually toward levels consistent with its dual mandate and that it saw the downside risks to the economic outlook as having increased. Most members also anticipated that inflation would settle, over coming quarters, at levels at or below those consistent with the Committee's mandate. The Committee noted that it had discussed the range of policy tools that were available to promote a stronger economic recovery in a context of price stability, and to indicate that those tools, including adjustments to the Committee's securities holdings, would be employed as appropriate.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee also directs the Desk to maintain its existing policy of reinvesting principal payments on all domestic securities in the System Open Market Account in Treasury securities in order to maintain the total face value of domestic securities at approximately $2.6 trillion. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing devel-

opments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 2:15 p.m.:

"Information received since the Federal Open Market Committee met in June indicates that economic growth so far this year has been considerably slower than the Committee had expected. Indicators suggest a deterioration in overall labor market conditions in recent months, and the unemployment rate has moved up. Household spending has flattened out, investment in nonresidential structures is still weak, and the housing sector remains depressed. However, business investment in equipment and software continues to expand. Temporary factors, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the tragic events in Japan, appear to account for only some of the recent weakness in economic activity. Inflation picked up earlier in the year, mainly reflecting higher prices for some commodities and imported goods, as well as the supply chain disruptions. More recently, inflation has moderated as prices of energy and some commodities have declined from their earlier peaks. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee now expects a somewhat slower pace of recovery over coming quarters than it did at the time of the previous meeting and anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, downside risks to the economic outlook have increased. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate further. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To promote the ongoing economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to keep the target range for the federal funds rate at 0 to ¼ percent. The Committee currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. The Committee also will maintain its existing policy of reinvesting principal payments from its securities holdings. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ these tools as appropriate."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser.

Messrs. Fisher, Kocherlakota, and Plosser dissented because they would have preferred to continue to describe economic conditions as likely to warrant exceptionally low levels for the federal funds rate for an "extended period," rather than characterizing that period as "at least through mid-2013." Mr. Fisher discussed the fragility of the U.S. economy but felt that it was chiefly nonmonetary factors, such as uncertainty about fiscal and regulatory initiatives, that were restraining domestic capital expenditures, job creation, and economic growth. He was concerned both that the Committee did not have enough information to be specific on the time interval over which it expected low rates to be maintained, and that, were it to do so, the Committee risked appearing overly responsive to the recent financial market volatility. Mr. Kocherlakota's perspective on the policy decision was shaped by his view that in November 2010, the Committee had chosen a level of accommodation that was well calibrated for the condition of the economy. Since November, inflation had risen and unemployment had fallen, and he did not believe that providing more monetary accommodation was the appropriate response to those changes in the economy. Mr. Plosser felt that the reference to 2013 might well be misinterpreted as suggesting that monetary policy was no longer contingent on how the economic outlook evolved. Although financial markets had been volatile and incoming information on growth and employment had been weaker than anticipated, he believed the statement conveyed an excessively negative assessment of the economy and that it was premature to undertake, or be perceived to signal, further policy accommodation. He also judged that the policy step would do little to improve near-term growth prospects, given the ongoing structural adjustments and external challenges faced by the U.S. economy.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, September 20–21, 2011. The meeting adjourned at 1:40 p.m. on August 9, 2011.

Videoconference Meeting of August 1

On August 1, 2011, the Committee met by videoconference to discuss issues associated with contingencies in the event that the Treasury was temporarily unable to meet its obligations because the statutory federal debt limit was not raised or in the event of a downgrade of the U.S. sovereign credit rating. The staff provided an update on the debt limit status, conditions in financial markets, plans that the Federal Reserve and the Treasury had developed regarding the processing of federal payments, potential implications for bank supervision and regulatory policies, and possible actions that the Federal Reserve could take if disruptions to market functioning posed a threat to the Federal Reserve's economic objectives. Participants generally anticipated that there would be no need to make changes to existing bank regulations, the operation of the discount window, or the conduct of open market operations. A number of participants emphasized that the Federal Reserve would continue to employ market values of securities in its transactions. With respect to potential policy actions, participants agreed that the appropriate response would depend importantly on the actual conditions in markets and should generally consist of standard operations. Some participants noted that such an approach would maintain the traditional separation of the Federal Reserve's actions from the Treasury's debt management decisions.

Notation Vote

By notation vote completed on August 29, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on August 9, 2011.

William B. English
Secretary

Meeting Held on September 20–21, 2011

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, September 20, 2011, at 10:30 a.m., and continued on Wednesday, September 21, 2011, at 9:00 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Christine Cumming, Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis and Boston, respectively

Esther L. George
First Vice President, Federal Reserve Bank of Kansas City

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Thomas C. Baxter
Deputy General Counsel

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Loretta J. Mester, Simon Potter, David Reifschneider, Harvey Rosenblum, and David W. Wilcox
Associate Economists

Brian Sack
Manager, System Open Market Account

Jennifer J. Johnson
Secretary of the Board, Office of the Secretary, Board of Governors

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation, Board of Governors

Nellie Liang
Director, Office of Financial Stability Policy and Research, Board of Governors

Robert deV. Frierson
Deputy Secretary, Office of the Secretary, Board of Governors

William Nelson
Deputy Director, Division of Monetary Affairs, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Charles S. Struckmeyer
Deputy Staff Director, Office of the Staff Director, Board of Governors

Seth B. Carpenter
Senior Associate Director, Division of Monetary Affairs, Board of Governors

Michael P. Leahy
Senior Associate Director, Division of International Finance, Board of Governors

Lawrence Slifman and William Wascher
Senior Associate Directors, Division of Research and Statistics, Board of Governors

Andrew T. Levin
Senior Adviser, Office of Board Members, Board of Governors

Stephen A. Meyer and Joyce K. Zickler
Senior Advisers, Division of Monetary Affairs, Board of Governors

Daniel M. Covitz and David E. Lebow
Associate Directors, Division of Research and Statistics, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

Penelope A. Beattie
Assistant to the Secretary, Office of the Secretary, Board of Governors

James M. Lyon
First Vice President, Federal Reserve Bank of Minneapolis

Jeff Fuhrer
Executive Vice President, Federal Reserve Bank of Boston

David Altig, Alan D. Barkema, Spencer Krane, Mark E. Schweitzer, Christopher J. Waller, and John A. Weinberg
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Kansas City, Chicago, Cleveland, St. Louis, and Richmond, respectively

Julie Ann Remache
Assistant Vice President, Federal Reserve Bank of New York

Eric T. Swanson
Senior Research Advisor, Federal Reserve Bank of San Francisco

Jonathan Heathcote
Senior Economist, Federal Reserve Bank of Minneapolis

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on August 9, 2011. He also reported on System open market operations, including the continuing reinvestment into longer-term Treasury securities of principal payments received on SOMA holdings of agency debt and agency-guaranteed mortgage-backed securities (MBS). By unanimous vote, the Committee ratified the Desk's domestic transactions over the intermeeting period.

Staff Presentation on Policy Tools

The staff gave a presentation on several tools that could be used, within the Committee's current policy framework, to provide additional monetary policy accommodation to support the economic recovery. The presentation first reviewed three options for managing the size and composition of the SOMA portfolio: a reinvestment maturity extension program, a SOMA portfolio maturity extension program, and a large-scale asset purchase program. Under the first of these options, the Federal Reserve would reinvest the principal payments it receives on its holdings of agency securities exclusively in long-term Treasury securities. Under the second option, the Committee would purchase long-term Treasury securities and sell the same amount of shorter-term Treasury securities; these transactions would significantly increase the average maturity of the SOMA portfolio, but the size of the Federal Reserve's balance sheet and the level of reserve balances would be largely unaffected in the near term. Under the third option, the Committee would purchase longer-term Treasury securities, increasing the size of its balance sheet and the supply of reserve balances. The staff also summarized a set of options for clarifying, for the public, the Committee's longer-run objectives under its dual mandate as well as the Committee's forward guidance about the likely future stance of monetary policy. The options focused on ways to elucidate the economic conditions that could warrant raising the level of short-term interest rates. Finally, the staff presentation summarized the potential implications of reducing the interest rate that the Federal Reserve pays on reserve balances that depository institutions hold in accounts at the Federal Reserve Banks (the IOR rate).

Meeting participants expressed a range of views on the potential efficacy of policy tools tied to the size and composition of the Federal Reserve's balance sheet. Many judged that these policies could provide additional monetary policy accommodation by lowering longer-term interest rates and easing financial conditions at a time when further reductions in the federal funds rate are infeasible. However, a number saw the potential effects on real economic activity as limited or only transitory, particularly in the current environment of balance sheet deleveraging, credit constraints, and household and business uncertainty about the economic outlook. Participants noted that a SOMA maturity extension program would not expand the Federal Reserve's balance sheet or the level of reserve balances, and that the scale of such a program was necessarily limited by the size of the Federal Reserve's holdings of shorter-term securities so that it could not be repeated to provide further stimulus. A number of participants saw large-scale asset purchases as potentially a more potent tool that should be retained as an option in the event that further policy action to support a stronger economic recovery was warranted. Some judged that large-scale asset purchases and the resulting expansion of the Federal Reserve's balance sheet would be more likely to raise inflation and inflation expectations than to stimulate economic activity and argued that such tools should be reserved for circumstances in which the risk of deflation was elevated. In commenting on the implications of a maturity extension program or another large-scale asset purchase program, several participants noted that the System should avoid holding a very large proportion of the outstanding stock of longer-term Treasury securities in its portfolio because the result could be a deterioration in market functioning. A number of participants suggested directing some purchases or reinvestments into agency MBS; however, a couple of participants saw such actions as unlikely to have benefits, or as a form of credit allocation.

Most participants indicated that they favored taking steps to increase further the transparency of monetary policy, including providing more information about the Committee's longer-run policy objectives and about the factors that influence the Committee's policy decisions. Participants generally agreed that a clear statement of the Committee's longer-run policy objectives could be helpful; some noted that it would also be useful to clarify the linkage between these longer-run objectives and the Committee's approach to setting the stance of monetary policy in the short and medium run. That said, a number of participants expressed concerns about the conceptual issues associated with establishing and communicating explicit longer-run objectives for the unemployment rate or other measures of labor market conditions, inasmuch as the long-run equilibrium levels of such measures are influenced importantly by nonmonetary factors, are subject to change over time, and are estimated with considerable uncertainty. In contrast, participants noted that the long-run level of inflation is determined primarily by monetary policy. Accordingly, many felt that if the Committee were to reach a consensus on more explicit statements of its longer-run objectives, it would need to provide an in-depth explanation to the public of how those objectives were determined and how they fit into the policy-making framework. Participants generally saw the Committee's post-meeting statements as not well suited to communicate fully the Committee's thinking about its objectives and its policy framework, and agreed that the Committee would need to use other means to communicate that information or to supplement information in the statement.

Most participants also indicated that they saw advantages in being more transparent about the conditionality in the Committee's forward guidance by providing more information about the economic conditions to which the guidance refers. They judged that such a step could make the Committee's forward guidance more effective and increase the likelihood that financial markets would respond to incoming economic information in ways that would help monetary policy achieve its goals. However, several participants saw a risk that any explicit statement of economic conditions specified in the Committee's forward guidance could be mistaken for a statement of its longer-run objectives. Others thought this risk of misinterpretation could be managed through careful communications. A number of participants suggested that the Committee's periodic Summary of Economic Projections could be used to provide more information about their views on the longer-run objectives and the likely evolution of monetary policy.

Participants discussed whether to reduce the IOR rate, weighing potential benefits and costs. A number of participants judged that a reduction would result in at least marginally lower money market rates and could help stimulate bank lending. Several noted that reducing the IOR rate could help signal the Committee's intention to keep the federal funds rate low. Some participants observed that keeping the IOR rate noticeably above the market rate on other safe, short-term instruments could be perceived as subsidizing some banking institutions. However, some others noted that a recent change in deposit insurance assessments had the effect of significantly reducing the net return that many banks receive from holding reserve balances. Moreover, many participants voiced concerns that reducing the IOR rate risked costly disruptions to money markets and to the intermediation of credit, and that the magnitude of such effects would be difficult to predict in advance. In addition, the federal funds market could contract as a result and the effective federal funds rate could become less reliably linked to other short-term interest rates. Participants generally agreed that they needed more information on the likely effects of a reduction in the IOR rate in order to judge its usefulness as a policy tool in the current environment.

Staff Review of the Economic Situation

The information reviewed at the September 20–21 meeting indicated that economic activity continued to expand at a slow pace and that labor market conditions remained weak. Consumer price inflation appeared to have moderated since earlier in the year, and measures of long-run inflation expectations remained stable.

Private nonfarm employment rose only slightly in August, and job gains were weak even after adjusting for the effects of a strike by communications workers during the month. Meanwhile, employment at state and local governments declined further, reflecting their tight budget conditions. The unemployment rate remained at 9.1 percent in August, and both long-duration unemployment and the share of workers employed part time for economic reasons were still elevated. Initial claims for unemployment insurance edged up, on net, over the previous few weeks, and many indicators of firms' hiring plans deteriorated somewhat in recent months.

Industrial production expanded solidly but unevenly in July and August, and the manufacturing capacity utilization rate moved up. Output increased markedly at both motor vehicle manufacturers and their upstream suppliers as the supply chain disruptions associated with the earthquake in Japan eased. In contrast, the pace of factory production softened among industries unlikely to have been affected by the supply disruptions. Motor vehicle assemblies were scheduled to rise noticeably in September and then increase further in the fourth quarter, but broader indicators of near-term manufacturing activity, such as the diffusion indexes of new orders from the national and regional manufacturing surveys, remained at levels consistent with only meager gains in output in the coming months.

Real consumer spending posted a solid gain in July, in part reflecting a rebound in motor vehicle purchases from their low level in the spring when the availability of some models was limited. However, nominal retail sales, excluding purchases at motor vehicles and parts outlets, only inched up in August, and sales of new light motor vehicles ticked down. Real disposable income edged lower in July, as gains in nominal income were offset by the rise in consumer prices. Consumer sentiment deteriorated significantly further in August and stayed downbeat in early September.

Activity in the housing market continued to be depressed by weak demand, uncertainty about future home prices, tight credit conditions for mortgages and construction loans, and a substantial inventory of foreclosed and distressed properties. Starts and permits for new single-family homes in July and August stayed near the very low levels seen since the middle of last year. Sales of new and existing homes remained subdued in recent months, and home prices edged down further.

Real business spending on equipment and software appeared to expand further. Nominal shipments of nondefense capital goods increased in July, and business purchases of new motor vehicles trended higher. New orders of nondefense capital goods continued to run ahead of shipments in July, and the expanding backlog of unfilled orders pointed toward further gains in outlays for business equipment in subsequent months. In contrast, survey measures of business conditions and sentiment remained at muted levels in August and September. Real business expenditures for office and commercial buildings moved up in recent months, but outlays were still at a very low level and continued to be restrained by high vacancy rates and tight credit conditions for construction loans. Meanwhile, spending for drilling and mining structures increased further. Businesses seemed to be adding to inventories at a more modest pace in July, as the restocking of motor vehicle inventories depleted by the earlier production disruptions was offset by slowing accumulation in other sectors. In most industries, inventories looked to be reasonably well aligned with sales.

Real federal government purchases appeared to increase in recent months as defense expenditures continued to rise from unusually low levels early in the year. At the state and local level, real government purchases seemed set to decline further as payrolls were reduced and construction spending decreased.

The nominal U.S. international trade deficit widened in June but narrowed significantly in July. Exports rose briskly in July, particularly in industrial supplies and capital goods, after having decreased in June. Imports moved down in both months, as declines in petroleum products—reflecting both lower prices and decreased volumes—more than offset large gains in automotive products following the easing of supply chain disruptions in Japan. Trade data for July suggested that net exports continued to boost U.S. real gross domestic product (GDP) growth in the third quarter.

Monthly U.S. consumer price inflation picked up in July and August after slowing in May and June, but remained a bit lower than earlier in the year. Consumer energy prices stepped up in July and August but only partially retraced their decline over the previous two months, and the increases in food prices were somewhat below the pace seen early in the year. The consumer price index excluding food and energy rose at about the same average monthly rate in July and August as in the second quarter. Near-term inflation expectations from the Thomson Reuters/University of Michigan Surveys of Consumers in August and September stayed well below the elevated level seen in the spring, and longer-term inflation expectations remained stable.

Available measures of labor compensation indicated that wage increases continued to be restrained by the large margin of slack in the labor market. Average hourly earnings for all employees posted a small gain, on net, over July and August, and their rate of increase from 12 months earlier remained subdued. Foreign economic growth declined in the second quarter. Growth slowed notably in Europe; economic activity also decelerated in the emerging market economies. Real GDP contracted in Canada due to a large decline in exports. Output also fell in Japan, reflecting the dislocations caused by the March earthquake. Part of the downshift in global economic growth appeared to have been driven by temporary supply chain disruptions caused by Japan's earthquake. Although the waning of these disruptions seemed to be supporting a rebound in foreign GDP growth in the third quarter, recent indicators suggested only sluggish gains in underlying economic activity. With the intensification of fiscal and financial stress in the euro area, measures of consumer and business confidence declined in August, and indicators of manufacturing activity in the region deteriorated. For many emerging market economies, the recent slowing in growth of economic activity was most evident in exports, industrial production, and other indicators of manufacturing activity. Inflation abroad eased in the second quarter as the effects of earlier increases in food and energy prices began to fade. More recently, however, increases in domestic food prices appeared to be pushing up consumer price inflation in some economies.

Staff Review of the Financial Situation

Financial markets were volatile over the intermeeting period as investors responded to mostly downbeat news on economic activity in the United States and abroad. Fluctuations in investors' level of concern about European fiscal and financial prospects also contributed to market volatility.

The expected path of the federal funds rate moved down appreciably over the intermeeting period. Investors initially focused on the firmer forward guidance in the August FOMC statement indicating that the Committee anticipated that economic conditions were likely to warrant exceptionally low levels of the federal funds rate at least through mid-2013. Over subsequent weeks, weak economic data contributed to rising expectations of additional monetary accommodation; those expectations and increasing concerns about the financial situation in Europe led to an appreciable decline in intermediate- and longer-term nominal Treasury yields. Partly in reaction to the softer economic outlook, measures of inflation compensation for the next 5 years as well as 5 to 10 years ahead derived from nominal and inflation-protected Treasury securities each fell to the low end of their ranges for this year.

Since early August, the equity prices of large U.S. financial institutions fell and their credit default swap (CDS) spreads widened. More-pronounced declines in equity prices and larger increases in CDS spreads occurred for some European financial institutions. Though many large European banks found it increasingly difficult, in recent weeks, to get unsecured dollar funding beyond the very short term, the conditions faced by U.S. financial institutions in these markets were little changed. In secured funding markets, term financing reportedly remained readily available for both domestic and European financial institutions through repurchase agreements backed by Treasury and agency collateral. However, some strains emerged late in the intermeeting period in the market for repurchase agreements backed by lower-quality, nontraditional collateral. In response to dollar funding pressures abroad, the Bank of England, the European Central Bank (ECB), and the Swiss National Bank announced that they would offer banks in their jurisdictions dollar loans for periods of approximately three months as well as continue to offer dollar loans for one-week periods; the Bank of Japan added to its previously announced program of three-month and seven-day dollar loans.

Broad stock price indexes were volatile but increased, on net, since the August FOMC meeting, following sharp declines in the days just preceding that meeting. Gross public equity issuance by nonfinancial firms weakened substantially in recent weeks, and a large number of planned initial public offerings were shelved amid the heightened market volatility.

Spreads of yields on investment- and speculative-grade corporate bonds over those on comparable-maturity Treasury securities rose significantly over the intermeeting period, reaching levels last registered in late 2009, and average bid prices in the secondary market for syndicated leveraged loans declined. Credit flows in August offered additional evidence that debt markets had become less hospitable to lower-rated nonfinancial firms. Bond issuance by speculative-grade firms nearly came to a halt, and the volume of new leveraged loans financed by institutional investors appeared to drop sharply after having moved down in July. However, net bond issuance by investment-grade companies remained robust in August despite wider spreads, and nonfinancial commercial paper outstanding increased slightly.

In the September 2011 Senior Credit Officer Opinion Survey on Dealer Financing Terms, dealers reported only small changes in credit terms across major classes of counterparties over the past three months. Respondents noted that the use of financial leverage by hedge funds decreased somewhat over the same period. Dealers also indicated that their clients' willingness to bear risk generally had declined somewhat; that was particularly true of hedge funds.

Financing conditions for commercial real estate remained weak. Issuance of commercial mortgage-backed securities (CMBS) slowed further in July and August, and investors appeared to demand greater compensation for risk. Prices of most types of commercial properties remained depressed despite a slight decline in vacancy rates in the second quarter. Delinquency rates on loans that back existing CMBS hovered at an elevated level in August, but delinquency rates on commercial real estate loans held by banks decreased in the second quarter.

Residential MBS yields and residential mortgage interest rates declined, on net, over the intermeeting period to historically low levels, but their spreads to yields on long-term Treasury securities increased. However, low mortgage rates spurred little refinancing activity, in part because of tight underwriting standards and low levels of home equity for many households. Residential mortgage debt contracted further in the second quarter, and the volume of mortgage applications to purchase homes moved down so far in the third quarter. Rates of serious mortgage delinquency continued to moderate but remained high, while the rate at which prime mortgages moved into delinquency stepped up, on balance, in recent months.

Consumer credit increased at a solid pace in July, as a sizable increase in nonrevolving credit—driven by a surge in federally funded student loans—more than offset a decrease in revolving credit. Issuance of consumer asset-backed securities moved down in August, but spreads on these securities remained low. Delinquency rates for several categories of consumer loans moved down further in recent months, with some reaching levels not seen since the 2008–09 recession began.

Core commercial bank loans—the sum of commercial and industrial (C&I), real estate, and consumer loans—expanded slightly in July and August. C&I loans grew strongly, consumer loans showed tepid growth, and real estate loans continued to decline. The upturn in lending was concentrated at large domestic and foreign institutions; at smaller banks, core loans declined in July and August at about the same pace as in recent quarters.

M2 surged in July and August, as investors and asset managers sought the relative safety and liquidity of bank deposits and other assets that make up the M2 aggregate. Notably, institutional investors, concerned about exposures of money funds to European financial institutions, shifted from prime money funds to bank deposits, and money fund managers accumulated sizable bank deposits in anticipation of potentially large redemptions by investors. In addition, retail investors evidently placed redemptions from equity and bond mutual funds into bank deposits and retail money market funds.

The foreign exchange value of the dollar increased over the intermeeting period, reflecting a flight to safety that also contributed to lower benchmark sovereign yields in Germany, the United Kingdom, and Canada. In contrast, the yield on two-year Greek sovereign bonds rose sharply as market participants became increasingly concerned that Greece might default on its sovereign debt. Equity prices in the euro area decreased over the intermeeting period, following sharp declines in early August. After falling steeply before the August FOMC meeting, emerging market equity prices were little changed, on net, over the period.

The European Central Bank continued to purchase, in the secondary market, sovereign debt of euro-area countries. Yields on Italian and Spanish debt, which declined following reported ECB purchases in early August, drifted higher during the intermeeting period. Prices of money market futures contracts indicated that monetary policy was expected to become more accommodative in both the euro area and the United Kingdom. The Swiss National Bank took several steps to ease monetary policy, including intervening in the foreign exchange market to counter further appreciation of its currency and eventually announcing that it is prepared to buy unlimited quantities of foreign currency to prevent the Swiss franc from trading in the foreign exchange market at a rate below 1.2 Swiss francs per euro. Citing concerns over the global economic outlook, the central bank of Brazil reduced its policy rate after having raised it several times earlier this year. In contrast, China continued to tighten its monetary policy, extending reserve requirements to a wider range of bank liabilities as it attempted to rein in off-balance-sheet lending by its banks.

Staff Economic Outlook

In the economic forecast prepared for the September FOMC meeting, the staff lowered its projection for the increase in real GDP in the second half of 2011 and in the medium term. The incoming data on household and business spending were about as expected, on balance, but labor market conditions and indicators of near-term economic activity, such as consumer and business sentiment, were weaker than anticipated. In addition, financial conditions deteriorated since the time of the previous forecast as investors pulled back from riskier assets. Nevertheless, the staff continued to forecast that economic activity would increase more rapidly in the second half of this year than over the first half, as supply chain disruptions in the motor vehicle sector eased. In the medium term, the staff still projected real GDP to accelerate gradually, supported by accommodative monetary policy, further increases in credit availability, and improvements in consumer and business confidence from their current low levels. The increase in real GDP was expected to be sufficient to reduce the unemployment rate only slowly over the projection period, and the jobless rate was anticipated to remain elevated at the end of 2013.

The staff's projection for inflation was little changed from its forecast at the time of the August FOMC meeting. The upward pressure on consumer prices from increases in import and commodity prices earlier in the year, along with the temporary boost to motor vehicle prices from low inventories, were expected to recede further in the coming quarters. With stable long-run inflation expectations and considerable slack in labor and product markets anticipated to persist over the forecast period, the staff continued to project that inflation would be subdued in 2012 and 2013.

Participants' Views on Current Conditions and the Economic Outlook

In their discussion of the economic situation and outlook, meeting participants agreed that the information received during the intermeeting period indicated that economic growth remained slow but did not suggest a contraction in activity. Temporary factors that had contributed to slower growth during the first half of the year had partly reversed, contributing to some rebound in final sales and production, particularly in the manufacturing sector where progress had been made in resolving supply chain disruptions. But stresses in global financial markets, sluggish growth in households' real incomes, and heightened uncertainty about economic prospects seemed to have contributed to lower consumer and business sentiment and to be weighing on economic growth. Recent indicators pointed to continuing weakness in overall labor market conditions, and the unemployment rate remained elevated. Inflation appeared to have moderated since earlier in the year as prices of energy and some commodities declined from their peaks, but inflation had not yet come down as much as participants had expected earlier this year. Labor costs remained subdued.

Looking ahead, participants continued to expect some pickup in the pace of recovery over coming quarters but anticipated that the unemployment rate would decline only gradually. They generally judged that risks to the growth outlook, including strains in global financial markets, were significant and tilted to the downside; moreover, slow growth left the recovery more vulnerable to negative shocks. With longer-term inflation expectations remaining stable and the effects of past increases in energy and commodity prices continuing to dissipate, most participants saw both core and headline inflation as likely to settle, over coming quarters, at or below the levels they see as most consistent with their dual mandate.

Participants continued to see the outlook for growth and inflation as more uncertain than usual.

Participants noted modest growth in consumer spending on average in recent months, with some rebound in purchases of new motor vehicles as manufacturers made progress in resolving supply chain disruptions and increased the availability of popular models. Surveys suggested that households were pessimistic about their future incomes, and consumer confidence had dropped to historically low levels. Low confidence, continuing efforts to repair balance sheets, and heightened caution in the face of an uncertain economic environment were seen as factors likely to weigh on household spending. Several participants pointed to depressed home prices and financial constraints, including still-tight credit conditions for many households, as also likely to restrain consumer spending for a time. However, household debt-service burdens had declined, indicating that there had been further progress in repairing household balance sheets.

Business sentiment had worsened, seemingly in response to weaker economic prospects and increased downside risks to the outlook for U.S. and global growth. Contacts at communications, technology, and transportation firms indicated that growth had slowed in those sectors; surveys also indicated that growth in the manufacturing sector had weakened during the summer. One participant suggested that hurricanes and subsequent flooding had contributed to the slowing in some parts of the country. In contrast, business contacts reported that commodity-related sectors such as energy, agriculture, and mining continued to show strong gains; tourism also appeared to be doing well. Exports remained a bright spot for U.S. manufacturers and commodity producers. Business investment in equipment and software had continued to expand in recent months, but some contacts expressed concern that firms would cut capital spending if their sales slowed further.

The housing sector remained depressed, with construction at very low levels and seen as likely to remain so given the weakness in new home sales and the continuing flow of foreclosed properties into the market. Though mortgage rates were very low, spreads between mortgage rates and yields on Treasury securities were unusually wide. Moreover, still-tight credit standards meant that many households were unable to qualify for loans to buy a home, and the drop in house prices in recent years left others unable to refinance an existing higher-rate mortgage. Nonresidential construction generally remained weak, apart from investment in extractive industries, and forward-looking indicators of nonresidential construction had dropped.

Meeting participants generally noted that overall labor market conditions had shown no improvement or had deteriorated in recent months and the unemployment rate remained elevated. Even after adjusting for the effects of strikes on reported payrolls, the employment report for August showed weak job gains. Moreover, both the average workweek and aggregate hours worked declined. Contacts reported that slower growth, depressed business confidence, and uncertainty about the economic outlook were restraining hiring as well as capital investment; many also cited uncertainty about regulatory and tax policies as contributing to businesses' reluctance to spend. Some business contacts reported that their firms had made contingency plans to reduce output and employment if demand for their products were to turn down. Participants generally agreed that sluggish job growth and the elevated unemployment rate reflected both weak demand for goods and services and a mismatch between the characteristics of the unemployed and the needs of the employers that currently have jobs available, but they had varying views about the relative importance of these two factors. Many participants judged that weak demand was of most importance, while a few argued that structural and geographic mismatches were key. A few commented that business contacts reported receiving large numbers of applications for relatively low-skilled positions but having difficulty finding and hiring candidates for some highly skilled positions. Several participants again noted that the exceptionally high level of long-duration unemployment could lead to permanent negative effects on the skills and employment prospects of those affected and so reduce the economy's longer-run productive potential.

Participants noted that financial markets were volatile over the intermeeting period and that financial conditions were strained at times, as investors reacted to the incoming economic data and to news about European fiscal and financial developments. Several participants argued that broader financial conditions had become less accommodative over the intermeeting period: Risk spreads had widened appreciably, likely reflecting a reduced willingness of investors to bear risk, a weaker outlook for growth in the United States and globally, and greater uncertainty about economic prospects. On the positive side, some participants noted that the reduction in leverage and increase in financial firms' liquidity cushions since the height of the financial crisis likely had attenuated the adverse effects of heightened risk aversion. Contacts in the banking sector reported that U.S. banks remained willing to lend to qualified customers, but that loan demand was weak. While noting that conditions in bank funding markets had tightened, particularly for European banks, participants observed that the capital and liquidity positions of U.S. banks had strengthened in recent quarters and that the credit quality of both business and household loans had continued to improve. Nonetheless, some large U.S. banks had seen further pressure on their stock prices and CDS spreads. Participants agreed that, if European policymakers did not respond effectively, European sovereign debt and banking problems could intensify, with potentially serious spillovers to the U.S. economy. However, it was noted that the ECB was providing ample liquidity to European banks, and that it had substantial capacity to provide additional liquidity through its lending facilities if necessary.

Most participants agreed that inflation appeared to have moderated in recent months compared with earlier in the year as prices of energy and some commodities declined from their peaks, though the moderation was not as substantial as many participants had expected. Longer-term inflation expectations had remained stable. Most participants anticipated that, with stable inflation expectations, significant slack in labor and product markets, slow wage growth, and little evidence of pricing power among firms, inflation was likely to decline moderately over time. Several suggested that slowing growth in the United States and abroad made a new surge in commodity prices unlikely. However, some noted that core as well as headline inflation had moved up, on balance, since last fall. A few suggested that the juxtaposition of higher core inflation and somewhat lower unemployment could mean that the degree of slack in labor markets and the level of potential output were lower than the Committee had thought. Some argued that the rise in core inflation from very low levels reflected the accommodative stance of monetary policy and indicated that the large-scale asset purchases the Committee undertook from November through June had been a successful response to the deflation risks of a year ago. Many participants judged that the risks to the outlook for inflation were roughly balanced. Some saw medium-run inflation risks as tilted to the downside, in light of persistent resource slack; some others argued that the accommodative stance of monetary policy and the upward trend in measures of core inflation this year suggested inflation risks were tilted to the upside. Participants generally judged that there was relatively little risk of deflation. One commented that surveys showed that forecasters saw a low likelihood of deflation; a second, however, noted that a measure of the probability of deflation calculated from prices of Treasury inflation-protected securities (TIPS) had declined as the Federal Reserve conducted its second large-scale asset purchase program but more recently had been rising.

Participants saw considerable uncertainty surrounding the outlook for a gradual pickup in economic growth. It was again noted that the cyclical impetus to economic expansion appeared to be weaker than in past recoveries, but that the reasons for the weakness were unclear, contributing to greater uncertainty about the economic outlook. Several commented that, with households and businesses seeking to reduce leverage rather than to borrow and with housing markets in distress, some of the normal mechanisms through which monetary policy actions are transmitted to the real economy appeared to be attenuated. Many participants saw significant downside risks to economic growth. While they did not anticipate a downturn in economic activity, several remarked that, with growth slow, the recovery was more vulnerable to adverse shocks. Risks included the possibility of more pronounced or more protracted deleveraging by households, the chance of a larger-than-expected near-term fiscal tightening, and potential spillovers to the United States if the financial situation in Europe were to worsen appreciably. Participants agreed to consider further how best to use their monetary policy and liquidity tools to deal with such shocks if they were to occur.

Committee Policy Action

In the discussion of monetary policy for the period ahead, most members agreed that the revisions to the economic outlook warranted some additional monetary policy accommodation to support a stronger recovery and to help ensure that inflation, over time, was at a level consistent with the Committee's dual mandate. While they recognized that monetary policy alone could not completely address the economy's ills, most members judged that additional accommodation could contribute importantly to better outcomes in terms of the Committee's dual mandate of maximum employment and price stability. Those viewing greater policy accommodation as appropriate at this meeting generally supported a maturity extension program that would combine asset purchases and sales to extend the average maturity of securities held in the SOMA without generating a substantial expansion of the Federal Reserve's balance sheet or reserve balances. Specifically, those members supported a program under which the Committee would announce its intention to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. They expected this program to put downward pressure on longer-term interest rates and to help make broader financial conditions more accommodative. While the scale of such a maturity extension program was necessarily limited by the amount of shorter-term securities in the SOMA portfolio, most members judged the action as appropriate, given economic conditions and the outlook. Two members said that current conditions and the outlook could justify stronger policy action, but they supported undertaking the maturity extension program at this meeting as it did not rule out additional steps at future meetings. Three members concluded that additional accommodation was not appropriate at this time. The Committee discussed whether to specify the parameters of the maturity extension program by stating its intention to complete the full set of transactions by June 2012 or by stating that it would undertake these transactions at a specified monthly pace. Members saw benefits to both approaches: The former would provide the public greater clarity about the likely scale of the program and the latter might allow the Committee greater flexibility to adjust the scale of the program in response to unexpected economic developments. A majority favored the first approach. Members noted, however, that the Committee will continue to regularly review the size and composition of its securities holdings and that it is prepared to adjust those holdings as appropriate.

Most members also supported a change in the Committee's reinvestment policy. To help support conditions in mortgage markets, the Committee decided to reinvest principal received from its holdings of agency debt and agency MBS in agency MBS rather than continuing to reinvest in longer-term Treasury securities as had been the Committee's practice for more than a year. The effect of this change will be to keep the SOMA's holdings of agency securities at an approximately constant level; under the previous practice, those holdings were declining on an ongoing basis. This change in reinvestment policy was expected to help reduce the spread between yields on mortgage-backed securities and those on comparable-maturity Treasury securities seen this year and so contribute to lower mortgage rates. Members also noted that the change in reinvestment policy could help prevent the shares of outstanding longer-term Treasury securities held by the Federal Reserve from reaching levels high enough to result in a deterioration in Treasury market functioning. One member who opposed the maturity extension program also opposed the change in reinvestment policy because he judged that it would not benefit housing markets. At the same time, the Committee decided to maintain its existing policy of rolling over maturing Treasury securities at auction.

The Committee also decided to keep the target range for the federal funds rate at 0 to ¼ percent and to reaffirm its anticipation that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. A couple of members noted that they would prefer to change the Committee's forward guidance to provide greater clarity about the economic conditions that would be likely to warrant maintaining exceptionally low levels of the target federal funds rate, but no decision was taken on this point.

The Committee agreed that it was important to acknowledge, in the statement to be released following the meeting, that economic growth remained slow and that indicators pointed to continuing weakness in overall labor market conditions. It also agreed to note that inflation appeared to have moderated since earlier in the year as prices of energy and some commodities had declined from their recent peaks, and that longer-term inflation expectations remained stable. Members generally continued to expect some pickup in the pace of the economic recovery over coming quarters but anticipated that the unemployment rate would decline only gradually and agreed that there were significant downside risks to the economic outlook, including strains in global financial markets. The Committee again anticipated that inflation would settle, over coming quarters, at levels at or below those consistent with the Committee's mandate as the effects of past energy and commodity price increases dissipate further.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to purchase, by the end of June 2012, Treasury securities with remaining maturities of approximately 6 years to 30 years with a total face value of $400 billion, and to sell Treasury securities with remaining maturities of 3 years or less with a total face value of $400 billion. The Committee also directs the Desk to maintain its existing policy of rolling over maturing Treasury securities into new issues and to reinvest principal payments on all agency debt and agency mortgage-backed securities in the System Open Market Account in agency mortgage-backed securities in order to maintain the total face value of domestic securities at approximately $2.6 trillion. The Committee directs the Desk to engage in dollar roll transactions as necessary to facilitate settlement of the Federal Reserve's agency MBS transactions. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 2:15 p.m.:

> "Information received since the Federal Open Market Committee met in August indicates that economic growth remains slow. Recent indicators point to continuing weakness in overall labor market conditions, and the unemployment rate remains elevated. Household spending has been increasing at only a modest pace in recent months despite some recovery in sales of motor vehicles as supply-chain disruptions eased. Investment in nonresidential structures is still weak, and the housing sector remains depressed. However, business investment in equipment and software continues to expand. Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their peaks. Longer-term inflation expectations have remained stable.
>
> Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect some pickup in the pace of recovery over coming quarters but anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate further. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.
>
> To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee decided today to extend the average maturity of its holdings of securities. The Committee intends to purchase, by the end of June 2012, $400 billion of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less. This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.
>
> To help support conditions in mortgage markets, the Committee will now reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. In addition, the Committee will maintain its existing policy of rolling over maturing Treasury securities at auction.
>
> The Committee also decided to keep the target range for the federal funds rate at 0 to ¼ percent and currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant excep-

tionally low levels for the federal funds rate at least through mid-2013.

The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools as appropriate."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: Richard W. Fisher, Narayana Kocherlakota, and Charles I. Plosser.

Messrs. Fisher, Kocherlakota, and Plosser dissented because they did not support additional policy accommodation at this time. Mr. Fisher saw a maturity extension program as providing few, if any, benefits in support of job creation or economic growth, while it could potentially constrain or complicate the timely removal of policy accommodation. In his view, any reduction in long-term Treasury rates resulting from this policy action would likely lead to further hoarding by savers, with counterproductive results on business and consumer confidence and spending behaviors. He felt that policymakers should instead focus their attention on improving the monetary policy transmission mechanism, particularly with regard to the activity of community banks, which are vital to small business lending and job creation. Mr. Kocherlakota's perspective on the policy decision was again shaped by his view that in November 2010, the Committee had chosen a level of accommodation that was well calibrated for the condition of the economy. Since November, inflation, and the one-year-ahead forecast for inflation, had risen, while unemployment, and the one-year-ahead forecast for unemployment, had fallen. He did not believe that providing more monetary accommodation was the appropriate response to those changes in the economy, given the current policy framework. Mr. Plosser felt that a maturity extension program would do little to improve near-term growth or employment, in light of the ongoing structural adjustments and fiscal challenges both in the United States and abroad. Moreover, in his view, with inflation continuing to run above earlier forecasts, such a program could risk adding unwanted inflationary pressures and complicate the eventual exit from the period of extraordinarily accommodative monetary policy.

Following the policy vote, the Manager of the System Open Market Account summarized how the Desk would implement the Committee's decisions. To implement the maturity extension program, the Desk would distribute purchases about evenly across nominal Treasury securities with 6 to 8 years to maturity, with 8 to 10 years to maturity, and with 10 to 30 years to maturity; the Desk would also buy a small amount of TIPS with remaining maturities of 6 to 30 years. This distribution would allocate a much larger share of purchases to longer maturities than was the case in the Committee's previous asset purchase programs. At the same time, the Desk would sell, from the SOMA portfolio, Treasury securities with remaining maturities of 3 months to 3 years. All Treasury purchases and sales would be conducted using competitive auctions. With respect to the MBS reinvestment program, the Desk would concentrate purchases in newly issued agency-backed MBS and would conduct purchases through a competitive bidding process.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, November 1–2, 2011. The meeting adjourned at 12:30 p.m. on September 21, 2011.

Secretary's Note: The following information regarding the June 21–22, 2011 FOMC meeting was inadvertently omitted from previous minutes. By unanimous vote at that meeting, the Committee ratified the Desk's domestic transactions since the April 26–27, 2011 meeting, and by notation vote completed on July 11, 2011, the Committee unanimously approved the minutes of the June 21–22 FOMC meeting.

William B. English
Secretary

Meeting Held on November 1–2, 2011

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, November 1, 2011, at 10:30 a.m. and continued on Wednesday, November 2, 2011, at 8:30 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Christine Cumming, Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard, Esther L. George, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

David W. Wilcox
Economist

James A. Clouse, Thomas A. Connors, Steven B. Kamin, Loretta J. Mester, Simon Potter, David Reifschneider, Harvey Rosenblum, Lawrence Slifman, Daniel G. Sullivan, and Kei-Mu Yi
Associate Economists

Brian Sack
Manager, System Open Market Account

Jennifer J. Johnson
Secretary of the Board, Office of the Secretary, Board of Governors

Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation, Board of Governors

Nellie Liang
Director, Office of Financial Stability Policy and Research, Board of Governors

Robert deV. Frierson
Deputy Secretary, Office of the Secretary, Board of Governors

William Nelson
Deputy Director, Division of Monetary Affairs, Board of Governors

Andrew T. Levin
Special Adviser to the Board, Office of Board Members, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Charles S. Struckmeyer
Deputy Staff Director, Office of the Staff Director, Board of Governors

Michael P. Leahy
Senior Associate Director, Division of International Finance, Board of Governors

William Wascher
Senior Associate Director, Division of Research and Statistics, Board of Governors

Ellen E. Meade
Senior Adviser, Division of Monetary Affairs, Board of Governors

Daniel M. Covitz and Michael T. Kiley[1]
Associate Directors, Division of Research and Statistics, Board of Governors

Christopher J. Erceg[1]
Deputy Associate Director, Division of International Finance, Board of Governors

Fabio M. Natalucci
Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Brian J. Gross[1]
Special Assistant to the Board, Office of Board Members, Board of Governors

David Lopez-Salido[1]
Assistant Director, Division of Monetary Affairs, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

Mark A. Carlson
Senior Economist, Division of Monetary Affairs, Board of Governors

Penelope A. Beattie
Assistant to the Secretary, Office of the Secretary, Board of Governors

Sarah G. Green
First Vice President, Federal Reserve Bank of Richmond

Glenn D. Rudebusch
Executive Vice President, Federal Reserve Bank of San Francisco

David Altig, Geoffrey Tootell, and Christopher J. Waller
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, and St. Louis, respectively

Todd E. Clark, Edward S. Knotek II, and Nathaniel Wuerffel
Vice Presidents, Federal Reserve Banks of Cleveland, Kansas City, and New York, respectively

Deborah L. Leonard
Assistant Vice President, Federal Reserve Bank of New York

Robert L. Hetzel
Senior Economist, Federal Reserve Bank of Richmond

[1] Attended the portion of the meeting relating to monetary policy strategies and communication.

By unanimous vote, the Committee selected David W. Wilcox to serve as Economist, and Lawrence Slifman to serve as Associate Economist, effective November 1, 2011, until the selection of their successors at the first regularly scheduled meeting of the Committee in 2012.

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign markets during the period since the Federal Open Market Committee (FOMC) met on September 20–21, 2011. He also discussed the developments in connection with the bankruptcy filing of MF Global Holdings Ltd. and its finance subsidiary, MF Global Finance USA Inc., and with the termination of MF Global Inc. as a primary dealer. The Manager reported on System open market operations, including the ongoing reinvestment into agency-guaranteed mortgage-backed securities (MBS) of principal payments received on SOMA holdings of agency debt and agency-guaranteed MBS as well as the operations related to the maturity extension program authorized at the September 20–21 FOMC meeting. By unanimous vote, the Committee ratified the Desk's domestic transactions over the intermeeting period. There were no intervention operations in foreign currencies for the System's account over the intermeeting period.

Monetary Policy Strategies and Communication

The staff gave a presentation on alternative monetary policy strategies, and meeting participants discussed those alternatives as well as potential approaches for enhancing the clarity of their public communications. No decision was made at this meeting to change the Committee's policy strategy or communications. It was noted that many central banks around the world pursue an explicit inflation objective, maintain flexibility to stabilize economic activity, and seek to communicate their forecasts and policy plans as clearly as possible. Many participants pointed to the merits of specifying an explicit longer-run inflation goal, but it was noted that such a step could be misperceived as placing greater weight on price stability than on maximum employment; consequently, some suggested that a numerical inflation goal would need to be set forth within a context that clearly underscored the Committee's commitment to fostering both parts of its dual mandate. More broadly, a majority of participants agreed that it could be beneficial to formulate and publish a statement that would elucidate the Committee's policy approach, and participants generally expressed interest in providing additional information to the public about the likely future path of the target federal funds rate. The Chairman asked the subcommittee on communications to give consideration to a possible statement of the Committee's longer-run goals and policy strategy, and he also encouraged the subcommittee to explore potential approaches for incorporating information about participants' assessments of appropriate monetary policy into the Summary of Economic Projections.

Committee participants shared their views regarding the potential merits and pitfalls of making conditional commitments regarding the future course of monetary policy. As noted in the staff briefing, economic theory and model simulations suggested that a policy strategy involving such commitments could foster better macroeconomic outcomes than a discretionary approach of reoptimizing policy at every meeting, so long as the public understood the central bank's strategy and believed that policymakers would follow through on those commitments. Some participants noted that conditional commitments might be particularly helpful in providing additional accommodation and mitigating downside risks when the policy rate is close to its effective lower bound, because a central bank can commit to a shallower interest rate trajectory than investors would expect if policymakers followed a purely discretionary approach. However, many pointed out that the implementation of such a strategy could pose substantial communication challenges and that the benefits would be diminished if the strategy was not fully credible. Indeed, one participant suggested that additional purchases of longer-term securities would be a clearer and more effective way to provide additional monetary accommodation when the federal funds rate was near its lower bound.

Given the potential pitfalls of pursuing commitment strategies extending far out into the future, many participants thought that the Committee should consider policies intended to accrue some of the gains from conditional commitments and to perform well in a wide range of alternative scenarios. In this vein, a number of participants expressed support for the possibility of clarifying the conditionality of the Committee's forward guidance about the trajectory of the federal funds rate through setting numerical thresholds for unemployment and inflation that would warrant exceptionally low levels for the policy rate. However, several participants noted that such thresholds could be confusing in the absence of a clear expression of the Committee's longer-term goals. Moreover, others suggested that such an approach could be problematic in light of significant uncertainties about the longer-run normal rate of unemployment. One participant pointed to those uncertainties as instead supporting the use of thresholds as a way of managing potential inflation risks associated with additional accommodation.

The Committee also considered policy strategies that would involve the use of an intermediate target such as nominal gross domestic product (GDP) or the price level. The staff presented model simulations that suggested that nominal GDP targeting could, in principle, be helpful in promoting a stronger economic recovery in a context of longer-run price stability. Other simulations suggested that the single-minded pursuit of a price-level target would not be very effective in fostering maximum sustainable employment; it was noted, however, that price-level targeting where the central bank maintained flexibility to stabilize economic activity over the short term could generate economic outcomes that would be more consistent with the dual mandate. More broadly, a number of participants expressed concern that switching to a new policy framework could heighten uncertainty about future monetary policy, risk unmooring longer-term inflation expectations, or fail to address risks to financial stability. Several participants observed that the efficacy of nominal GDP targeting depended crucially on some strong assumptions, including the premise that the Committee could make a credible commitment to maintaining such a strategy over a long time horizon and that policymakers would continue adhering to that strategy even in the face of a significant increase in inflation. In addition, some participants noted that such an approach would involve substantial operational hurdles, including the difficulty of specifying an appropriate target level. In light of the significant challenges associated with the adoption of such frameworks, participants agreed that it would not be advisable to make such a change under present circumstances.

Staff Review of the Economic Situation

The information reviewed at the November 1–2 meeting indicated that the pace of economic activity strengthened somewhat in the third quarter, reflecting in part a reversal of the temporary factors that weighed on economic growth in the first half of the year. However, labor market conditions continued to be weak. Overall consumer price inflation was more moderate than earlier in the year, as prices of energy and some commodities declined from their recent peaks. Inflation for other goods and services also appeared to have moderated, and measures of longer-run inflation expectations remained stable.

Private nonfarm employment rose modestly in September, boosted in part by the return of communications workers who were on strike in August. Nonetheless, the pace of private-sector job gains in the third quarter as a whole was less than it was in the first half of the year. Meanwhile, employment in the state and local government sector continued to trend lower. The unemployment rate held at 9.1 percent in September, and both long-duration unemployment and the share of workers employed part time for economic reasons were still high. Initial claims for unemployment insurance have edged down since the middle of September but have remained at a level consistent with only modest employment growth, and most indicators of businesses' hiring plans have showed no improvement.

Industrial production rose modestly in September, and the manufacturing capacity utilization rate edged up. Output in the motor vehicle–related sectors continued to step up following the disruptions associated with the earthquake in Japan earlier in the year, but the pace of factory production outside of those sectors was sluggish. Motor vehicle assemblies were scheduled to rise further in the fourth quarter, but broader indicators of near-term manufacturing activity, such as the diffusion indexes of new orders from the national and regional manufacturing surveys, remained at levels consistent with only modest increases in production in the coming months.

Real personal consumption expenditures (PCE) rose briskly in September but posted a more moderate gain for the third quarter as a whole. Motor vehicle purchases increased significantly in September to a level well above that in the spring (when availability of some models was limited by supply chain disruptions), and sales of new light motor vehicles stepped up further in October. However, real disposable income declined in the third quarter, as increases in consumer prices more than offset small gains in nominal income. Moreover, consumer sentiment continued to be downbeat in October.

Housing market activity remained very weak, held down by the large overhang of foreclosed and distressed properties along with limited demand in an environment of uncertainty about future home prices and tight underwriting standards for mortgage loans. Although starts and permits for new single-family homes edged up in September, they stayed near the depressed levels seen since the middle of last year. Sales of new and existing homes continued to be soft in recent months, and home prices trended lower.

Real business purchases of equipment and software expanded appreciably in the third quarter. Moreover, new orders for nondefense capital goods continued to run ahead of shipments in August and September; the buildup of unfilled orders pointed toward further increases in spending for business equipment in subsequent months. Nevertheless, survey measures of business conditions and sentiment in October suggested that firms remained cautious. Real business expenditures for nonresidential construction also rose appreciably in the third quarter, but spending was still at a relatively low level and continued to be held back by elevated vacancy rates and tight credit conditions for construction loans. In the third quarter, businesses increased their inventories at a much slower pace than in the second quarter, and inventory-to-sales ratios in most industries appeared to be in a comfortable range.

Real federal purchases increased in the third quarter, as defense expenditures continued to rise from unusually low levels early in the year, more than offsetting a decrease in nondefense spending. At the state and local level, real purchases declined in the third quarter at a noticeably slower rate than in the first half of the year as the pace of reductions in payrolls eased and construction spending rose slightly.

The U.S. international trade deficit was virtually the same in August as it was in July, as both exports and imports moved down only by small amounts. The decrease in exports reflected lower sales of automotive products and capital goods, which more than offset increases in exports of industrial supplies and consumer goods. The dip in imports was the result of lower purchases of capital goods, automotive products, and consumer goods, which outweighed an increase in petroleum imports. The advance release of the third-quarter data for the national income and product accounts showed real exports of goods and services expanding faster than real imports. As a result, net exports were estimated to have made a small positive contribution to real GDP growth in the third quarter, a contribution of about the same size as in the second quarter.

Overall U.S. consumer price inflation, as measured by the PCE price index, was more moderate in the third quarter than in the first half of the year. Consumer prices for food and energy increased last quarter at a slower pace than earlier in the year, and consumer prices excluding food and energy rose a bit less than in the preceding quarter. Near-term inflation expectations from the Thomson Reuters/University of Michigan Surveys of Consumers in October continued to be well below the elevated level seen in the spring, and longer-term inflation expectations in the survey remained stable.

Measures of labor compensation showed that wage increases continued to be subdued. The employment cost index increased at a modest rate over the year ending in the third quarter, and compensation per hour in the nonfarm business sector appeared to have decalerated somewhat last quarter. Similarly, the 12-month change in average hourly earnings for all employees remained subdued in September.

Foreign economic activity appeared to have largely recovered from the effects of the Japanese disaster in March, as production in Japan rebounded and supply disruptions waned. However, recent data pointed to considerable weakness in the euro-area economy. Elsewhere, indicators were somewhat more upbeat, with employment in Canada continuing to rise through September, while GDP growth in China over the year ending in the third quarter was a little less than in the first half of the year but still quite robust. Foreign inflation remained contained, although the reversal of earlier increases in energy prices appeared to be passing through to consumer price inflation relatively slowly in some countries.

Staff Review of the Financial Situation

Financial markets were quite volatile over the period since the September FOMC meeting. Investor sentiment was strongly influenced by prospects for Europe, as market participants remained highly attuned to developments regarding possible steps to contain the fiscal and banking problems there. Economic data releases that were, on balance, somewhat better than market participants expected provided some support to financial markets.

Longer-term Treasury yields declined appreciably following the release of the September FOMC statement. Investors reportedly viewed the Committee's assessment of the economic outlook as more downbeat than anticipated. In addition, the announcement that the Federal Reserve would lengthen the average maturity of its portfolio by purchasing longer-term Treasury securities and selling an equivalent amount of shorter-term Treasury securities reportedly contributed to the decline in longer-term yields on the day. Yields on current-coupon agency MBS also moved lower on the announcement that the Federal Reserve would begin to reinvest principal payments on agency securities in agency MBS. Over the following weeks, movements in yields were driven by shifts in investors' assessments of the ongoing efforts to address the European fiscal and banking situation and by somewhat stronger-than-expected U.S. economic data. On balance since the September FOMC meeting, Treasury yields on shorter-dated securities and the expected path of the federal funds rate implied by money market futures quotes were not much changed. Yields on Treasury securities with maturities beyond 10 years moved down. Measures of near-term inflation compensation derived from nominal and inflation-protected Treasury securities rose slightly over the intermeeting period, while similar measures of longer-term inflation compensation were about unchanged.

Credit default swap (CDS) spreads and equity prices of large U.S. banking organizations were again volatile over the period. Investor sentiment toward these financial institutions was strongly influenced by changes in investors' assessments of the risks associated with the European fiscal and banking problems and the exposure of various financial institutions to Europe. Third-quarter U.S. bank earnings reports generally met investors' expectations. On net, equity prices for U.S. banking firms were not much changed over the period since the last FOMC meeting, while their CDS spreads were a bit higher. European bank CDS spreads remained elevated, and these institutions continued to face somewhat strained conditions in short-term bank funding markets.

Although equity markets were volatile, broad U.S. equity price indexes ended the intermeeting period little changed. Earnings reports for nonfinancial firms generally came in somewhat better than investors expected and about in line with second-quarter levels. Gross public equity issuance by nonfinancial firms continued to be very weak in September and October, with a large number of firms shelving planned initial public offerings amid the volatility in equity markets.

Yields on investment- and speculative-grade corporate bonds edged lower, on net, over the period, leaving their spreads to Treasury securities slightly narrower. Credit flows for nonfinancial firms were mixed in September and October. The pace of bond financing by investment-grade nonfinancial corporations slowed some in October from its robust September pace, while bond issuance by speculative-grade firms was limited. Nonfinancial commercial paper outstanding posted solid growth in October. In the leveraged loan market, issuance financed by institutional investors slowed significantly in the third quarter.

Financing conditions for commercial real estate (CRE) markets appeared to have deteriorated in some respects. Issuance of commercial mortgage-backed securities (CMBS) slowed further in the third quarter amid widening CMBS spreads, and only a small number of deals were in the pipeline for the rest of the year. Prices of most types of commercial properties remained depressed, and aggregate vacancy and delinquency rates for commercial properties were close to their recent highs.

Interest rates on residential mortgages changed little, on net, over the intermeeting period but remained at historically low levels. The recent low rates appeared to have only a modest effect on the pace of mortgage refinancing, as tight underwriting standards and low home equity continued to limit the access of many households to the mortgage market. However, in October, the Federal Housing Finance Agency announced changes to the Home Affordable Refinance Program to expand eligibility and take-up among borrowers with mortgages backed by Fannie Mae and Freddie Mac. Indicators of home prices remained weak, reflecting a large inventory of unsold properties and modest demand for homes. The pace at which performing prime mortgages became newly delinquent rose over the summer but remained below last year's levels.

Consumer credit decreased in August. Growth in nonrevolving credit, which had been volatile due to a shift in the timing of student loan originations, stepped down from the pace seen earlier in the year but remained solid in recent months. Issuance of consumer credit asset-backed securities continued at a moderate pace through mid-October. Delinquency rates for several categories of consumer loans remained low, a reflection in part of tighter underwriting standards that shifted the composition of borrowers toward those with stronger credit histories.

Core commercial bank loans expanded slightly in the third quarter. Commercial and industrial (C&I) loans accelerated following the already strong increases seen over the first half of the year. That growth was concentrated among large domestic banks and non-European foreign institutions. Consumer loans on banks' books advanced modestly in the third quarter, ending a two-year string of quarterly declines. Closed-end residential mortgage loans held by banks also increased amid the modest pickup in refinancing activity, while CRE loans contracted. The October Senior Loan Officer Opinion Survey on Bank Lending Practices showed less net easing of lending standards by domestic banks than in the past few surveys. In particular, domestic banks reported little change in their standards on C&I loans over the third quarter, on net, compared with more widespread reports of easing in the previous several quarters. Demand for loans reportedly was little changed, on balance, over the third quarter.

M2 grew at a modest pace in September and October, well below the rapid rate seen in July and August. Some of the factors that contributed to M2 growth over the summer, such as concerns about European financial developments and equity market volatility, persisted and supported elevated levels of M2 deposits but did not trigger additional sizable inflows. The monetary base also grew moderately as its major components—reserve balances and currency—increased over the period.

Foreign financial markets remained volatile over the intermeeting period, and funding pressures for many European financial institutions continued. After falling sharply in August and early September, foreign equity prices rose, with stocks in the euro area outperforming those in most other economies. For most of the period, market participants seemed heartened by European leaders' efforts to address the fiscal and financial challenges present in the euro area, although the news late in the period on a possible Greek referendum sent stock prices down sharply. Benchmark sovereign yields increased over the period, but spreads of yields on 10-year sovereign bonds of the most vulnerable euro-area countries over yields on German bunds were little changed on net. Some reversal of safe-haven flows in October reportedly led the dollar to give back most of the gains it registered in late September, leaving the broad nominal foreign exchange value of the dollar little changed, on balance, relative to its level at the time of the September FOMC meeting. At the end of October, Japanese officials intervened in foreign exchange markets through sales of yen.

The first round of the three-month U.S. dollar auctions that major foreign central banks announced on September 15 was held in October; demand was quite limited, and only the European Central Bank (ECB) drew on its swap line with the Federal Reserve. Korea and Japan announced that they would increase the size and scope of their bilateral currency swap arrangements, expanding the size of their existing won–yen swap arrangement and establishing a $30 billion facility in which dollars could be swapped for either won or yen.

A number of central banks announced additional measures to stimulate economic activity. The Bank of England and Bank of Japan each announced expansions of their respective asset purchase programs, and the ECB announced that it would conduct two refinancing operations with maturities of slightly more than a year and launched a new covered bond purchase program. The central banks of Brazil, Indonesia, and Israel lowered their policy rates, citing a potential slowdown in global growth.

Staff Economic Outlook

With the recent data on spending, particularly for consumer expenditures and business outlays for capital goods and nonresidential construction, stronger than the staff anticipated at the time of the September FOMC meeting, the staff's near-term projection for the rate of increase in real GDP was revised up. However, other important near-term indicators of economic activity remained downbeat: Measures of consumer sentiment were still very low, business surveys pointed to continued caution by firms, conditions in the labor market remained weak, and gains in manufacturing production outside of the motor vehicle–related sectors were sluggish. Moreover, many of the factors that have been restraining the recovery, such as the large overhang of vacant houses, tight credit conditions, and elevated risk premiums, remained in place. Consequently, the staff's outlook for economic activity over the medium term was similar to the projection prepared for the September FOMC meeting. The staff continued to project that real GDP would accelerate gradually in 2012 and 2013, supported by accommodative monetary policy, further improvements in credit conditions, and a pickup in consumer and business sentiment from their current low levels. Over the forecast period, the increase in real GDP was projected to be sufficient to reduce the slack in product and labor markets only slowly, and the unemployment rate was expected to remain elevated at the end of 2013.

The staff's forecast for inflation was essentially unchanged from the projection prepared for the September FOMC meeting. The upward pressure on consumer prices from the rise in commodity and import prices early in the year was anticipated to ease further in the current quarter. With longer-run inflation expectations stable and significant slack anticipated to persist in labor and product markets, the staff continued to expect prices to rise at a subdued pace in 2012 and 2013.

Participants' Views on Current Conditions and the Economic Outlook

In conjunction with this FOMC meeting, all participants—the five members of the Board of Governors and the presidents of the 12 Federal Reserve Banks—provided projections of output growth, the unemployment rate, and inflation for each year from 2011 through 2014 and over the longer run. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks to the economy. Although participants had revised downward their projections for growth since their previous forecasts in June, they continued to anticipate that economic growth would pick up and the unemployment rate would decline gradually through 2014. They also continued to project that inflation would settle at or below levels consistent with the Committee's dual mandate. Participants' forecasts are described in more detail in the Summary of Economic Projections, which is attached as an addendum to these minutes.

In their discussion of the economic situation and outlook, meeting participants regarded the information received during the intermeeting period as indicating that economic growth had strengthened somewhat in the third quarter, reflecting in part a reversal of temporary factors that had weighed on the economic recovery in the first half of the year. Participants noted that global supply chain disruptions associated with the natural disaster in Japan had diminished, and that the prices of energy and some commodities had come down from their recent peaks, easing strains on household budgets and likely contributing to a somewhat stronger pace of consumer spending in recent months. More broadly, final demand from consumers and businesses was stronger than had been expected at the time of the September FOMC meeting. Nonetheless, most participants anticipated that the pace of economic growth would remain moderate over coming quarters. While they believed that the economic recovery would continue to be supported by accommodative monetary policy, ongoing improvements in households' and businesses' financial positions, and pent-up demand for goods and services, a number of factors were seen as likely to continue to restrain the pace of economic growth. Those included persistent weakness in the labor and housing markets, still-tight credit conditions for many households and small businesses, low consumer and business confidence, fiscal consolidation at all levels of government, and elevated volatility in financial markets. Moreover, the recovery was still subject to significant downside risks, including strains in global financial markets. With longer-term inflation expectations remaining stable, the effects of earlier increases in the prices of energy and other commodities continuing to wane, and low levels of resource utilization restraining increases in prices and wages, most participants anticipated that inflation would settle, over coming quarters, at or below levels they judged to be most consistent with their dual mandate.

In the household sector, incoming data on retail sales were somewhat stronger than expected, and participants reported scattered optimism among their contacts regarding the prospects for holiday spending. Some participants thought that the effects of balance sheet deleveraging might be running their course or that such effects could be less powerful than had been thought. Others noted that the recent pickup in consumer spending outpaced growth in after-tax incomes and was accompanied by a decline in the saving rate, raising doubts about its sustainability unless income growth picked up. In addition, households appeared to remain pessimistic about the prospects for their future income, the job market was still weak, consumer confidence was historically very low, and credit conditions for many households were still tight. The housing sector continued to be depressed, and some meeting participants indicated that the elevated supply of available homes and the overhang of foreclosures, together with limited access to mortgage credit, were continuing to put downward pressure on house prices and housing construction. A few participants noted that recent government initiatives aimed at helping high-loan-to-value borrowers refinance could be useful steps toward stabilizing the housing market.

Business contacts in many parts of the country were reported to be cautious and uncertain about the economic and political outlook and so remained reluctant to hire or expand capacity. However, production in the manufacturing, agriculture, and energy sectors continued to increase, and the auto sector was rebounding from earlier supply chain disruptions. In addition, businesses in a number of regions reported ongoing capital investment to increase productivity. Input cost pressures were said to have abated somewhat, while labor costs remained subdued. Overall, credit costs were low, and profits and balance sheets at nonfinancial corporations were healthy, with many firms continuing to hold very high levels of cash.

Despite some signs of improvement of late, the available indicators pointed to continued weakness in overall labor market conditions, and the unemployment rate remained elevated. Some participants suggested that the persistently high level of unemployment reflected the impact of structural factors, including mismatches between the skills of the unemployed and the skills demanded in sectors in which jobs were currently available. Consistent with this view, some business contacts reportedly were concerned about the low quality of many job applicants, while other contacts noted that workers with some specialized skills continued to be in short supply. However, other participants indicated that such concerns were not new and that much of the current elevated level of unemployment reflected cyclical factors, with one pointing to the lack of wage pressures as evidence. As a result, they expected that unemployment would fall back as the economy recovered. Some participants again warned that the exceptionally high level of long-term unemployment could ultimately lead to permanent negative effects on the skills and employment prospects of the unemployed.

Meeting participants observed that financial markets continued to be particularly volatile during the intermeeting period as investors responded to incoming economic data and to news regarding fiscal and financial developments in Europe. Liquidity in many markets worsened, in part because financial institutions more reliant on short-term funding markets reportedly pulled back from risk-taking and became somewhat less willing to make markets. Participants noted the announcement by European policymakers of a new package of measures to address Greece's fiscal situation as well as the vulnerabilities of European banks and sovereigns. However, participants indicated that many details of the new plan had not yet been worked out and that a number of important issues remained unresolved. Participants took note of the possible adverse effects on U.S. financial markets and the broader U.S. economy if European sovereign debt and banking problems intensified. Participants observed, however, that the capital and liquidity positions of U.S. banks had strengthened in recent quarters and that the credit quality of loans to businesses and households had improved further. Contacts in the banking sector reported that U.S. banks continued to be willing to extend loans to creditworthy borrowers, but loan demand remained weak and competition for such borrowers was putting pressure on net interest margins. It was noted that very low interest rates were negatively affecting pension funds and the profitability of the life insurance industry. Participants also discussed the events surrounding the bankruptcy filing of MF Global Holdings Ltd. and saw the financial stability implications of this development as limited to date.

Participants generally agreed that measures of total inflation appeared to have moderated since earlier in the year as prices of energy and some commodities declined from their peaks. Measures of core inflation also seemed to have declined in recent months, and longer-term inflation expectations remained well anchored. Nonetheless, some participants noted that core inflation had not come down as quickly or by as much as they had expected in light of the reduction in commodity prices, perhaps suggesting that the level of potential output was lower than had been thought. However, other participants pointed to the subdued pace of gains in labor costs as a factor damping inflation, and reports from contacts suggested that upward pressure on wages remained limited.

Regarding their overall outlook for economic activity, participants generally agreed that, even with the positive news received over the intermeeting period, the most probable outcome was a moderate pace of economic growth over the medium run with only a gradual decline in the unemployment rate. While some factors were seen as likely to support growth going forward—such as pent-up demand, improvements in household and business balance sheets, and accommodative monetary policy—participants observed that the pace of economic recovery would likely continue to be held down for some time by persistent headwinds. In particular, they pointed to very low levels of consumer and business confidence, further efforts by households to deleverage, cutbacks at all levels of government, elevated financial market volatility, still-tight credit conditions for some households and small businesses, and the ongoing weakness in the labor and housing markets. While recent incoming data suggested reduced odds that the economy would slide back into recession, participants still saw significant downside risks to the outlook for economic growth. Risks included potential spillovers to U.S. financial markets and institutions, and so to the broader U.S. economy, if the European debt and banking crisis were to worsen significantly. In addition, participants noted the risk of a larger-than-expected fiscal tightening and the possibility that structural problems in the housing market had attenuated the transmission of monetary policy actions to the real economy. It was also noted that the extended period of highly accommodative monetary policy could eventually lead to a buildup of financial imbalances. A few participants, however, mentioned the possibility that economic growth could be more rapid than currently expected, particularly if gains in output and employment led to a virtuous cycle of improvements in household balance sheets, increased confidence, and easier credit conditions.

With respect to the outlook for inflation, participants generally anticipated that inflation would recede further over coming quarters and would settle over the medium run at levels at or below those judged to be most consistent with the Committee's dual mandate. They pointed to the further dissipation of the effects of earlier increases in the prices of energy and some commodities, the significant slack in resource utilization, the continued subdued growth in labor compensation, and well-anchored inflation expectations as factors likely to contribute to the moderation in inflation over time. A number of participants saw the risks to the outlook for inflation as roughly balanced. A few participants felt that the continuation of the current stance of monetary policy, coupled with the possibility of a rebound in energy and commodity prices, posed some upside risks to inflation. Other participants instead saw inflation risks as tilted to the downside, in light of their expectations for persistent resource slack. It was noted that U.S. inflation had been influenced relatively more by commodity price fluctuations in recent years; because commodity prices reflect global economic conditions, U.S. inflation might be less affected by domestic factors and more linked to the global outlook than in the past.

Committee Policy Action

Members noted that information received over the intermeeting period pointed to somewhat stronger economic growth in the third quarter, partly reflecting a reversal of temporary factors that had depressed economic growth in the first half of the year. However, overall labor market conditions remained weak. Members generally anticipated that unemployment would decline only gradually from levels significantly above those that the Committee would expect to prevail in the longer run, with inflation likely to settle at levels at or below those consistent with the Committee's dual mandate. Accordingly, in the discussion of monetary policy for the period ahead, all Committee members agreed to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced in September. The Committee decided to maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency MBS in agency MBS and of rolling over maturing Treasury securities at auction. In addition, the Committee agreed to keep the target range for the federal funds rate at 0 to ¼ percent and to reiterate its expectation that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. A few members expressed interest in using language specifying a period of time during which the federal funds rate was expected to remain exceptionally low, rather than a calendar date, arguing that such language might be better to indicate a constant stance of monetary policy over time. However, members generally preferred to retain the existing forward guidance, at least for now. A few members indicated that they believed the economic outlook might warrant additional policy accommodation. However, it was noted that any such accommodation would likely be more effective if it were provided in the context of a future communications initiative, and most of these members agreed that they could support retention of the current policy stance at this meeting. One member dissented from the policy decision on the grounds that additional monetary policy accommodation was warranted at this time. With the Committee in the process of reviewing its monetary policy strategies and communication, and no additional accommodation being provided at this meeting, a few members indicated that they could support the Committee's decision even though they had not favored recent policy actions. The Committee reiterated that it will regularly review the size and composition of its securities holdings and that it is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in the context of price stability. With respect to the statement to be released following the meeting, members agreed that only relatively small changes were needed to reflect the modest improvement in the economic outlook and to note that the Committee would continue to implement its policy steps from recent meetings.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to continue the maturity extension program it began in September to purchase, by the end of June 2012, Treasury securities with remaining maturities of approximately 6 years to 30 years with a total face value of $400 billion, and to sell Treasury securities with remaining maturities of 3 years or less with a total face value of $400 billion. The Committee also directs the Desk to maintain its existing policies of rolling over maturing Treasury securities into new issues and of reinvesting principal payments on all agency debt and agency mortgage-backed securities in the System Open Market Account in agency mortgage-backed securities in order to maintain the total face value of domestic securities at approximately $2.6 trillion. The Committee directs the Desk to engage in dollar roll transactions as necessary to facilitate settlement of the Federal Reserve's agency MBS transactions. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 12:30 p.m.:

"Information received since the Federal Open Market Committee met in September indicates that economic growth strengthened somewhat in the third quarter, reflecting in part a reversal of the temporary factors that had weighed on growth earlier in the year. Nonetheless, recent indicators point to continuing weakness in overall labor market conditions, and the unemployment rate remains elevated. Household spending has increased at a somewhat faster pace in recent months. Business investment in equipment and software has continued to expand, but investment in nonresidential structures is still weak, and the housing sector remains depressed. Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their peaks. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect a moderate pace of economic growth over coming quarters and consequently anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Moreover, there are significant downside risks to the economic outlook, including strains in global financial markets. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate further. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee decided today to continue its program to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

The Committee also decided to keep the target range for the federal funds rate at 0 to ¼ percent and currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

The Committee will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools to promote a stronger economic recovery in a context of price stability."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Richard W. Fisher, Narayana Kocherlakota, Charles I. Plosser, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: Charles L. Evans.

Mr. Evans dissented because he saw the high unemployment rate and the outlook for only weak economic growth as calling for additional policy accommodation at this meeting. Moreover, the longer the current situation of low resource utilization lasted, the more the economy's longer-term growth potential could be impaired. Furthermore, given current policy, his outlook was for inflation to come in below levels consistent with the Committee's dual mandate, bolstering the case for additional monetary easing at this time. He also believed policies with more-explicit forward guidance about the economic conditions under which exceptionally low levels of the funds rate could be maintained would improve the prospects for growth and employment and, while possibly admitting somewhat higher inflation for a time, would still safeguard price stability.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 13, 2011. The meeting adjourned at 10:30 a.m. on November 2, 2011.

Notation Vote

By notation vote completed on October 11, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on September 20–21, 2011.

William B. English
Secretary

Addendum: Summary of Economic Projections

In conjunction with the November 1–2, 2011, Federal Open Market Committee (FOMC) meeting, the members of the Board of Governors and the presidents of the Federal Reserve Banks, all of whom participate in the deliberations of the FOMC, submitted projections for growth of real output, the unemployment rate, and inflation for the years 2011 to 2014 and over the longer run. The projections were based on information available at the time of the meeting and on each participant's assumptions about factors likely to affect economic outcomes, including his or her assessment of appropriate monetary policy. "Appropriate monetary policy" is defined as the future path of policy that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her interpretation of the Federal Reserve's dual objectives of maximum employment and stable prices. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge over time under appropriate monetary policy and in the absence of further shocks.

As depicted in **figure 1**, FOMC participants expected the economic recovery to continue at a moderate pace, with the growth of real gross domestic product (GDP) slowing this year compared with its pace in 2010 but then picking up gradually through 2014. With expectations that the pace of economic growth will modestly exceed participants' estimates of the longer-run sustainable rate of increase in real GDP, the unemployment rate is projected to decline only gradually over this projection period. As a result, participants anticipated that, at the end of 2014, the unemployment rate would remain well above their estimates of the unemployment rate that they see as consistent, over the longer run, with the Committee's dual mandate of maximum employment and price stability. Most participants anticipated that the factors underlying the noticeable rise in overall inflation in 2011 would be largely transitory and that inflation would move lower in 2012; thereafter, inflation was expected to remain at levels roughly consistent with or below rates that they see as consistent with the Committee's dual mandate. Participants generally viewed the rate of core inflation as likely to remain at or somewhat below its 2011 level throughout the projection period.

On balance, as indicated in **table 1**, participants anticipated somewhat slower economic growth and somewhat higher unemployment relative to their projections in June; they raised their projections for inflation in 2011 but left their projections for inflation from 2012 onward about unchanged since the June meeting. All of the participants made substantial downward revisions to their projections for GDP growth in 2011, and most marked down their projections for economic growth in 2012 and 2013; however, participants did not materially alter their expectations for the normal rate of economic growth that

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, November 2011
Percent

Variable	Central tendency[1]					Range[2]				
	2011	2012	2013	2014	Longer run	2011	2012	2013	2014	Longer run
Change in real GDP	1.6 to 1.7	2.5 to 2.9	3.0 to 3.5	3.0 to 3.9	2.4 to 2.7	1.6 to 1.8	2.3 to 3.5	2.7 to 4.0	2.7 to 4.5	2.2 to 3.0
June projection	2.7 to 2.9	3.3 to 3.7	3.5 to 4.2	n.a.	2.5 to 2.8	2.5 to 3.0	2.2 to 4.0	3.0 to 4.5	n.a.	2.4 to 3.0
Unemployment rate	9.0 to 9.1	8.5 to 8.7	7.8 to 8.2	6.8 to 7.7	5.2 to 6.0	8.9 to 9.1	8.1 to 8.9	7.5 to 8.4	6.5 to 8.0	5.0 to 6.0
June projection	8.6 to 8.9	7.8 to 8.2	7.0 to 7.5	n.a.	5.2 to 5.6	8.4 to 9.1	7.5 to 8.7	6.5 to 8.3	n.a.	5.0 to 6.0
PCE inflation	2.7 to 2.9	1.4 to 2.0	1.5 to 2.0	1.5 to 2.0	1.7 to 2.0	2.5 to 3.3	1.4 to 2.8	1.4 to 2.5	1.5 to 2.4	1.5 to 2.0
June projection	2.3 to 2.5	1.5 to 2.0	1.5 to 2.0	n.a.	1.7 to 2.0	2.1 to 3.5	1.2 to 2.8	1.3 to 2.5	n.a.	1.5 to 2.0
Core PCE inflation[3]	1.8 to 1.9	1.5 to 2.0	1.4 to 1.9	1.5 to 2.0		1.7 to 2.0	1.3 to 2.1	1.4 to 2.1	1.4 to 2.2	
June projection	1.5 to 1.8	1.4 to 2.0	1.4 to 2.0	n.a.		1.5 to 2.3	1.2 to 2.5	1.3 to 2.5	n.a.	

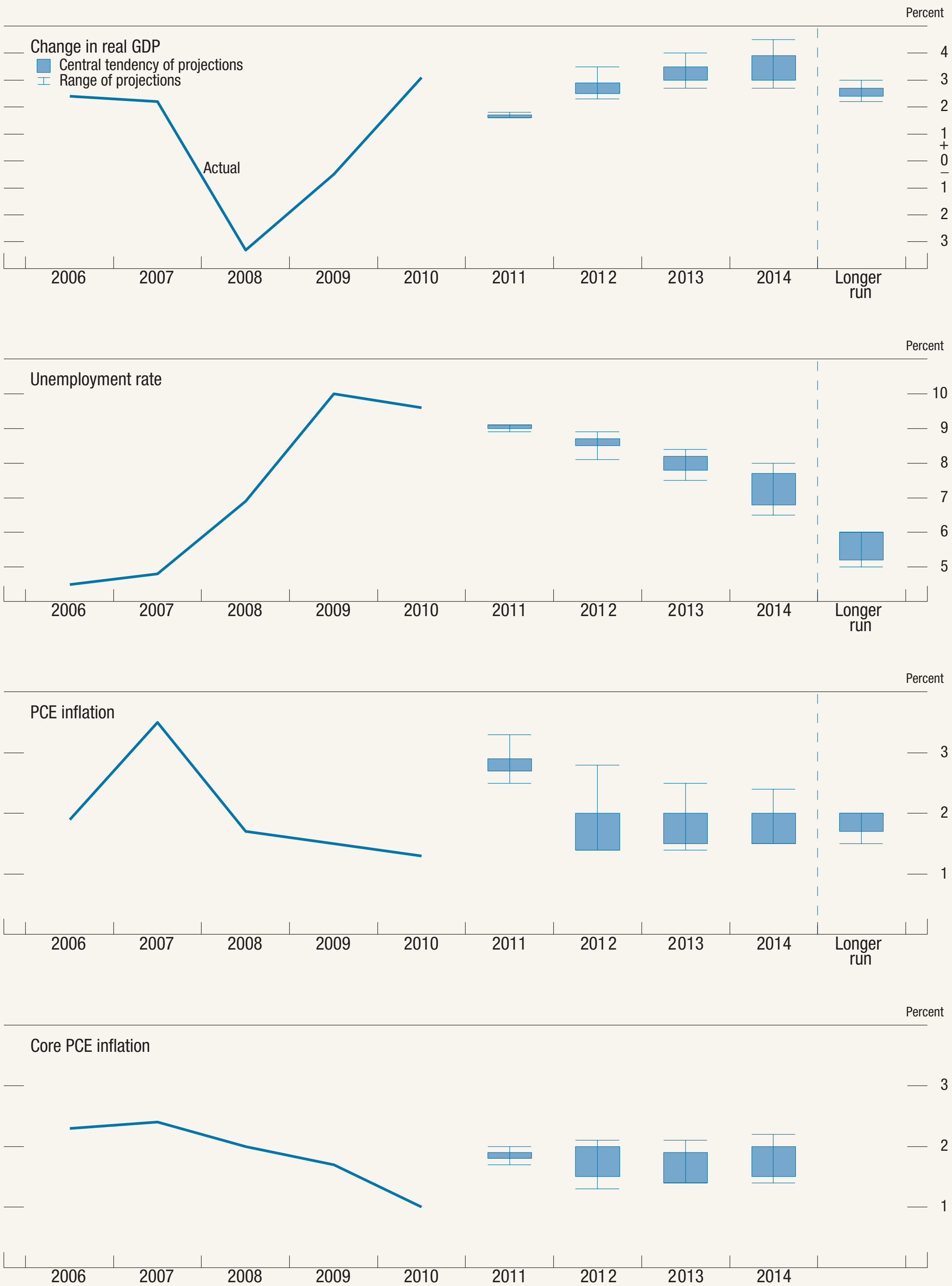
Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The June projections were made in conjunction with the meeting of the Federal Open Market Committee on June 21–22, 2011.

1 The central tendency excludes the three highest and three lowest projections for each variable in each year.

2 The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

3 Longer-run projections for core PCE inflation are not collected.

Figure 1. Central tendencies and ranges of economic projections, 2011–14 and over the longer run



Note: Definitions of variables are in the notes to table 1. The data for the actual values of the variables are annual.

would prevail in the longer run. Although participants continue to expect a gradual decline in the unemployment rate over time, most participants revised up their projections for the path of the unemployment rate over the forecast period, and some participants also raised their projections of the longer-run rate of unemployment compared with June. Participants' projections for overall and core inflation this year were slightly higher than in June, but their projections for 2012, 2013, and over the longer run were broadly similar to those made in June.

As indicated in figure 2, a sizable majority of participants continued to attach an unusually high level of uncertainty to their projections for economic growth, the unemployment rate, and inflation relative to historical norms. Most participants viewed the risks to output growth as being weighted to the downside and the risks to the unemployment rate as being weighted to the upside. Most participants saw the risks to overall and core inflation as broadly balanced.

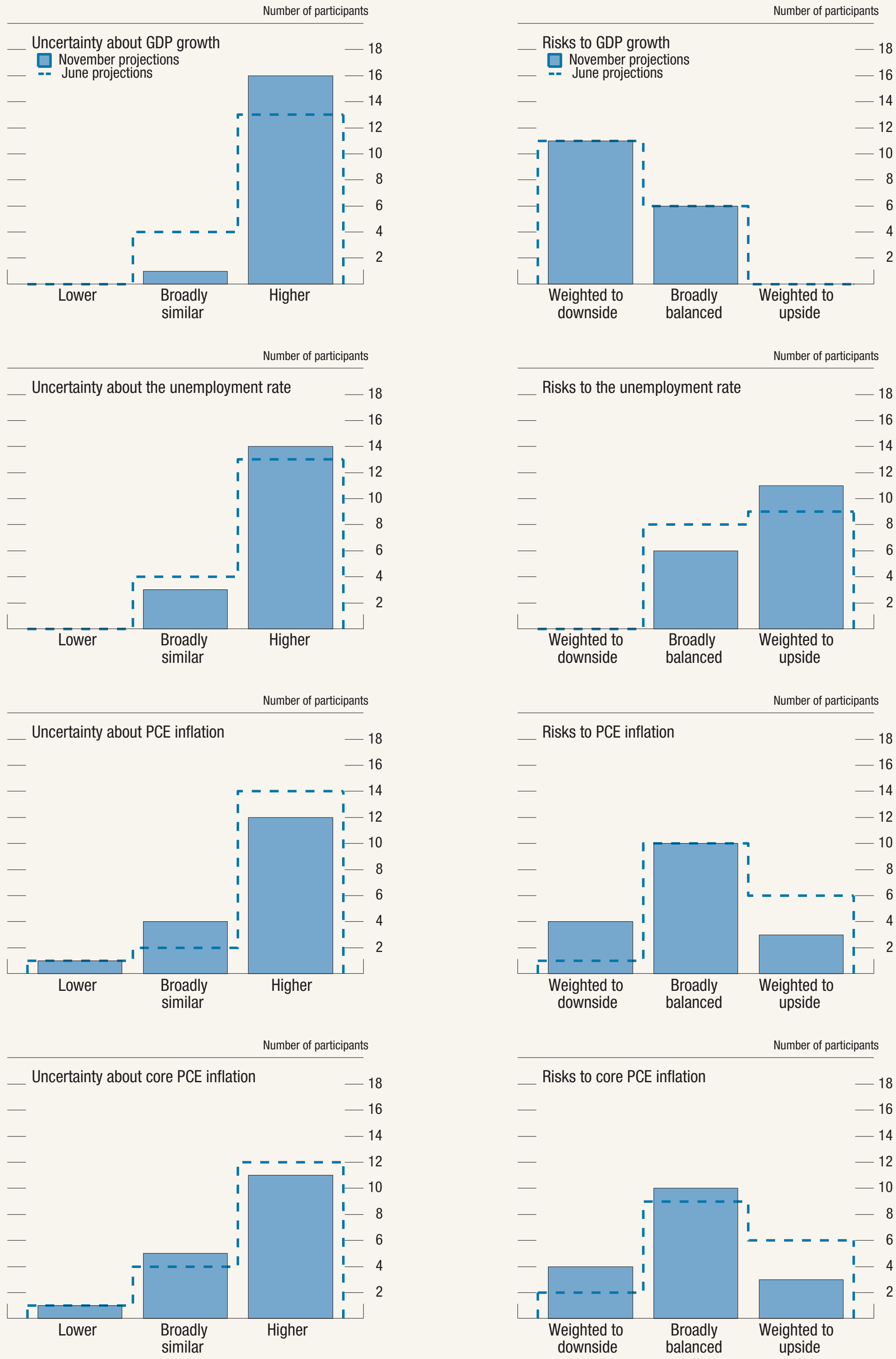
The Outlook

Participants marked their forecasts down significantly for real GDP growth in 2011, with the central tendency of their projections forming a narrow band from 1.6 to 1.7 percent, down from 2.7 to 2.9 percent in June. Participants stated that the downward revision reflected the body of economic data received since June, particularly the comprehensive annual revisions and the estimate of second-quarter GDP published by the Bureau of Economic Analysis, which showed that the expansion in real GDP in the first half of the year had been considerably slower than the participants had expected at the time of their June projections. More-recent data indicated that output growth strengthened during the third quarter, reflecting in part a reversal of the temporary factors that had weighed on real activity earlier in the year, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the disaster in Japan. However, several participants indicated that some of the factors contributing to the slowdown in GDP growth earlier in the year, including reduced spending by state and local governments, were likely to be more persistent. Participants also noted that heightened uncertainty regarding economic and financial developments, as well as low confidence among businesses and consumers, continued to restrain economic activity.

Looking further ahead, participants continued to expect a moderate pickup in the pace of the economic recovery over the next couple of years, albeit to growth rates somewhat below those previously projected. The central tendency of participants' projections for output growth in 2012 was 2.5 to 2.9 percent, followed by central tendencies of 3.0 to 3.5 percent in 2013 and 3.0 to 3.9 percent in 2014. Participants anticipated that the economic expansion would be supported by continued monetary policy accommodation, reduced commodity cost pressures, strengthening household balance sheets, and improving financial conditions. However, in downgrading the trajectory of their projections compared with those in June, participants cited a number of forces that were likely to restrain the pace of output growth over the next few years, including tighter fiscal policy at all levels of government, ongoing drag from the troubled housing sector, volatility in financial markets, and possibly reduced external demand. Many also pointed to the additional headwinds of still-tight credit conditions for some households and smaller businesses, weak consumer and business sentiment, persistently high unemployment, and slow income growth. In addition, some participants noted that although energy and commodity prices had fallen back, they remain at elevated levels that might weigh on spending for a time. The central tendency of participants' projections for the longer-run rate of real GDP growth, in the absence of further shocks, was 2.4 to 2.7 percent, a bit slower than projected in June.

In response to the ongoing weakness in labor market conditions and the downward revisions to their assessments of the economic outlook, participants marked up their forecasts for the unemployment rate over the forecast period. For the fourth quarter of this year, the central tendency of participants' projections rose to 9.0 to 9.1 percent from 8.6 to 8.9 percent reported in June. Similar upward revisions were made for 2012 and 2013, with the central tendencies of the unemployment rate projections for those years now at 8.5 to 8.7 percent and 7.8 to 8.2 percent, respectively. The central tendency of their unemployment rate projections for the end of 2014 was 6.8 to 7.7 percent, indicating expectations for an ongoing, gradual improvement in the employment situation, but one that continued to leave the unemployment rate well above the 5.2 to 6.0 percent central tendency of participants' estimates of the unemployment rate that would prevail over the longer run in the absence of further shocks. The upper bound of the central

Figure 2. Uncertainty and risks in economic projections



Note: For definitions of uncertainty and risks in economic projections, see the box "**Forecast Uncertainty**." Definitions of variables are in the general note to **table 1**.

tendency of participants' longer-run projections was higher than in June, although the range of participants' estimates was unchanged.

Participants noted that measures of consumer price inflation had increased this year relative to both their levels in 2010 and the projections made in June, reflecting in part higher prices of oil and other commodities that had larger effects than previously expected. The central tendency of their estimates for total personal consumption expenditures (PCE) inflation in 2011 rose to 2.7 to 2.9 percent compared with 2.3 to 2.5 percent in June. Most participants anticipated that the influence of higher commodity prices and supply chain disruptions from Japan would be temporary and that inflation pressures in the next several years would be subdued as commodity prices stabilized, inflation expectations remained well anchored, and large margins of slack in labor markets kept labor costs in check. As a result, the central tendency of participants' projections of total PCE inflation was about 1.5 to 2.0 percent in 2012, 2013, and 2014, similar to their forecasts in June and at or slightly below the 1.7 to 2.0 percent central tendency of their estimates of the longer-run, mandate-consistent rate of inflation. The central tendency of participants' projections of core PCE inflation in 2011 shifted up to 1.8 to 1.9 percent, compared with 1.5 to 1.8 percent in June, as some of this year's run-up in commodity prices passed through to core prices. However, the central tendencies of the projections of core inflation for the next three years were approximately 1.5 to 2.0 percent, essentially unchanged from their June levels and roughly similar to participants' projections for headline inflation.

Uncertainty and Risks

In their assessments of the uncertainty and risks associated with their projections, a substantial majority of participants continued to judge that the levels of uncertainty associated with their projections for economic growth, the unemployment rate, and inflation were greater than the average levels that had prevailed over the past 20 years.[2] They pointed to a number of factors that raised their assessments of uncertainty regarding output growth and unemployment, including concerns about the ongoing developments in Europe, the severity of the recent recession, and the pace at which the numerous financial and economic headwinds buffeting the economy will recede. However, slightly fewer participants reported a higher-than-average degree of uncertainty around their inflation projections than in June. Participants noted that uncertainties about the pace of economic recovery and the effects of the Federal Reserve's extraordinary monetary policy accommodation, as well as the timing of exit from it, were significant sources of uncertainty in the outlook for inflation. However, a number of participants highlighted that inflation currently remains anchored by stable longer-term inflation expectations.

Although several participants noted that the risks of a near-term recession had likely diminished, most participants continued to judge that the balance of risks to economic growth was weighted to the downside (that is, they judged that economic growth was more likely to be below their projection of its most likely outcome than above it). The remaining participants saw the risks as balanced. The most frequently cited downside risks to growth included possible financial market and economic spillovers from an intensification of the financial strains in Europe, vulnerabilities related to weak consumer and business confidence, the possible effects on spending of uncertainties about regulatory policy, and the potential consequences of larger-than-expected near-term fiscal consolidation. The risks surrounding participants' forecasts of the unemployment rate shifted higher, with a larger number of participants relative to June

Table 2. Average historical projection error ranges
Percentage points

Variable	2011	2012	2013	2014
Change in real GDP[1]	±0.6	±1.4	±1.7	±1.8
Unemployment rate[1]	±0.2	±0.9	±1.5	±1.8
Total consumer prices[2]	±0.5	±0.9	±1.0	±1.0

Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1991 through 2010 that were released in the fall by various private and government forecasters. As described in the box "Forecast Uncertainty," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. Further information is in David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November).

1 For definitions, refer to general note in table 1.

2 Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

2 Table 2 provides estimates of forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1991 to 2010. At the end of this summary, the box "Forecast Uncertainty" discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

viewing the risks to their projections as weighted to the upside, and the remaining participants seeing the risks as broadly balanced.

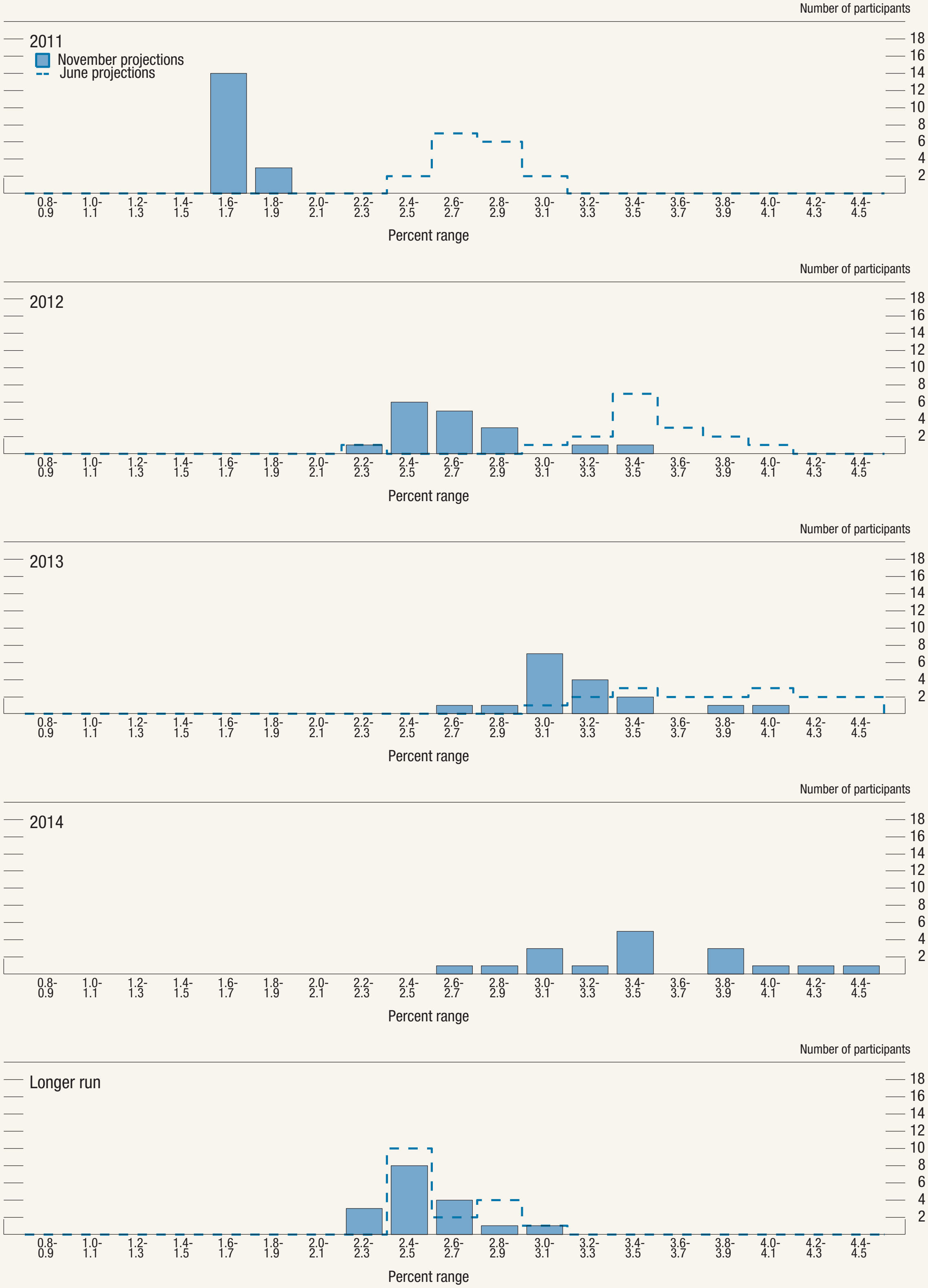
A majority of the participants continued to judge the risks to their projections of overall and core inflation to be broadly balanced. Compared with their assessments in June, a smaller number of participants viewed the risks to inflation as being weighted to the upside, and more participants indicated that the risks were weighted to the downside; the changes left the number of participants who saw a skew in either direction more evenly distributed. Some participants saw a risk that elevated resource slack could put more downward pressure on inflation than expected. Nevertheless, some participants noted the risk that commodity prices could experience renewed volatility or have a longer-lasting influence than expected. A few participants pointed to the possibility that the current highly accommodative stance of monetary policy, if it were maintained for longer than is appropriate, could lead to higher inflation expectations and actual inflation; some also thought that fiscal imbalances could have a similar effect.

Diversity of Views

Figures 3.A and 3.B provide further details on the diversity of participants' views regarding the likely outcomes for real GDP growth and the unemployment rate over the next few years and over the longer run. The dispersion in these projections continued to reflect differences in participants' assessments of many factors, including the underlying momentum in economic activity, appropriate future monetary policy and its effects on economic activity, the effects of the European situation, and the future path of U.S. fiscal policy. With much of the data for 2011 now in hand, the dispersion of participants' projections of output growth and the unemployment rate this year narrowed substantially relative to June. The range of participants' projections for these variables in 2012 and 2013 also narrowed somewhat; however, the range of projections for real GDP growth in each of those years shifted to the lower end of the range of their June projections, and the range of projections for the unemployment rate shifted to the higher end of the June distribution. The dispersion associated with participants' longer-run projections of output growth and the unemployment rate changed very little, although the dispersion of their projections in 2014 exceeded the dispersion of their longer-run ranges, suggesting greater agreement among policymakers about the economy's longer-run performance than the path of convergence toward it. A sizable majority of the participants judged that, in the absence of any additional shocks, the economy would converge fully to its longer-run rates of GDP growth, unemployment, and inflation within about five or six years; a few participants indicated that convergence might take a longer period of time, and one participant believed convergence could occur more rapidly.

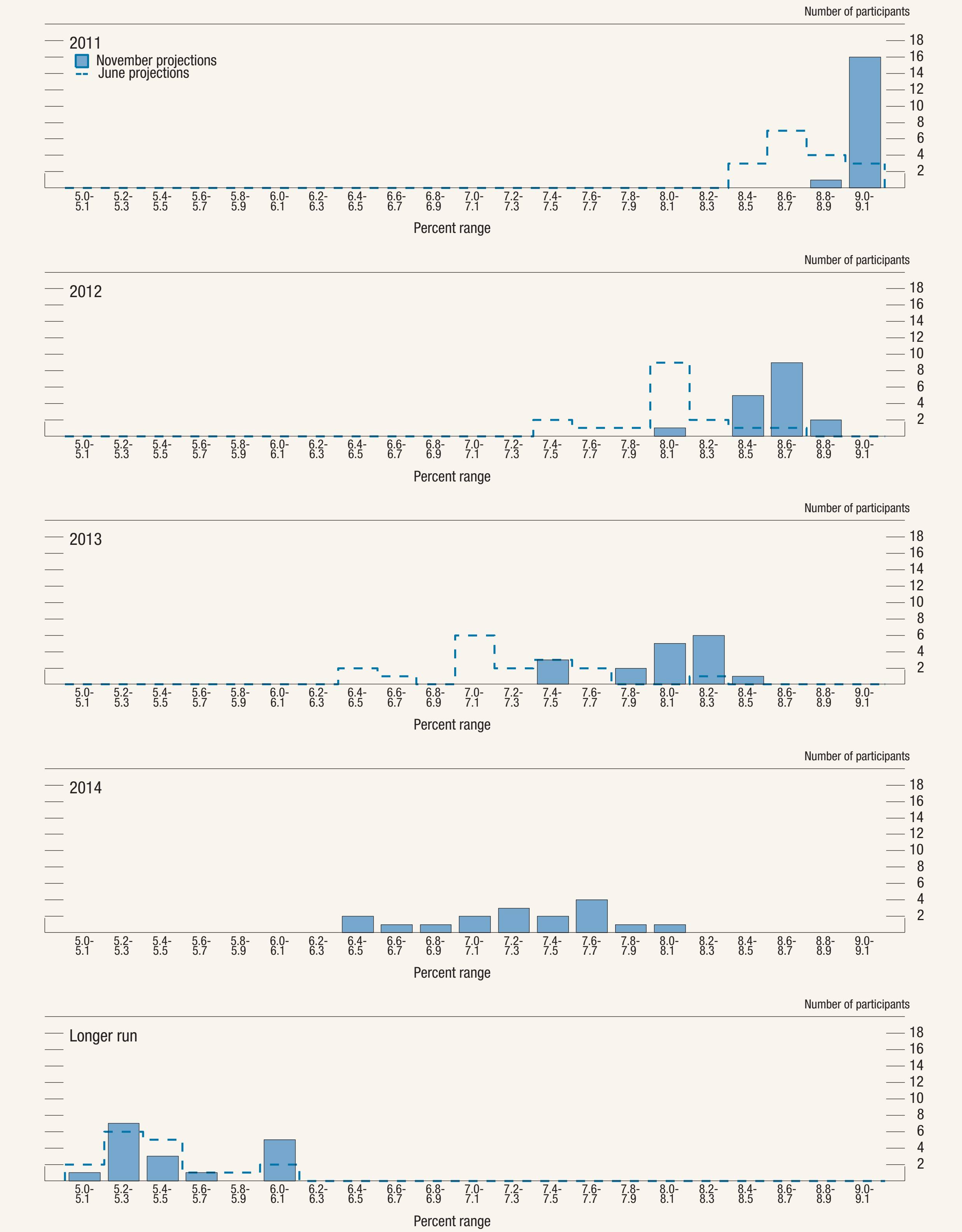
Figures 3.C and 3.D provide corresponding information about the diversity of participants' outlooks for inflation. The center of mass of the distributions of participants' projections for overall and core PCE inflation in 2011 shifted to the right relative to the ranges of these projections provided in June. The dispersion of projections for total PCE inflation in 2012 and 2013 changed little, although the top end of the range of participants' projections was somewhat higher than that of their projections for core inflation, suggesting that a few participants are concerned that elevated price increases for food and energy will persist for a time. The dispersion of projections for core inflation narrowed somewhat, driven predominantly by a decline in the upper end of the ranges. The ranges of inflation projections for 2014 were similar to those for 2012 and 2013. In general, the dispersion of participants' inflation forecasts for the next few years represented differences in judgments regarding the fundamental determinants of inflation, including the degree of resource slack and the extent to which resource slack influences inflation outcomes and expectations, as well as estimates of how the stance of monetary policy may influence inflation expectations. By contrast, the unchanged and relatively concentrated distribution of participants' projections for overall inflation over the longer run continued to reflect broad similarity in participants' assessments of the approximate level of inflation that is consistent with the Federal Reserve's dual objectives of maximum employment and price stability.

Figure 3.A. Distribution of participants' projections for the change in real GDP, 2011–14 and over the longer run



Note: Definitions of variables are in the general note to table 1.

Figure 3.B. Distribution of participants' projections for the unemployment rate, 2011–14 and over the longer run

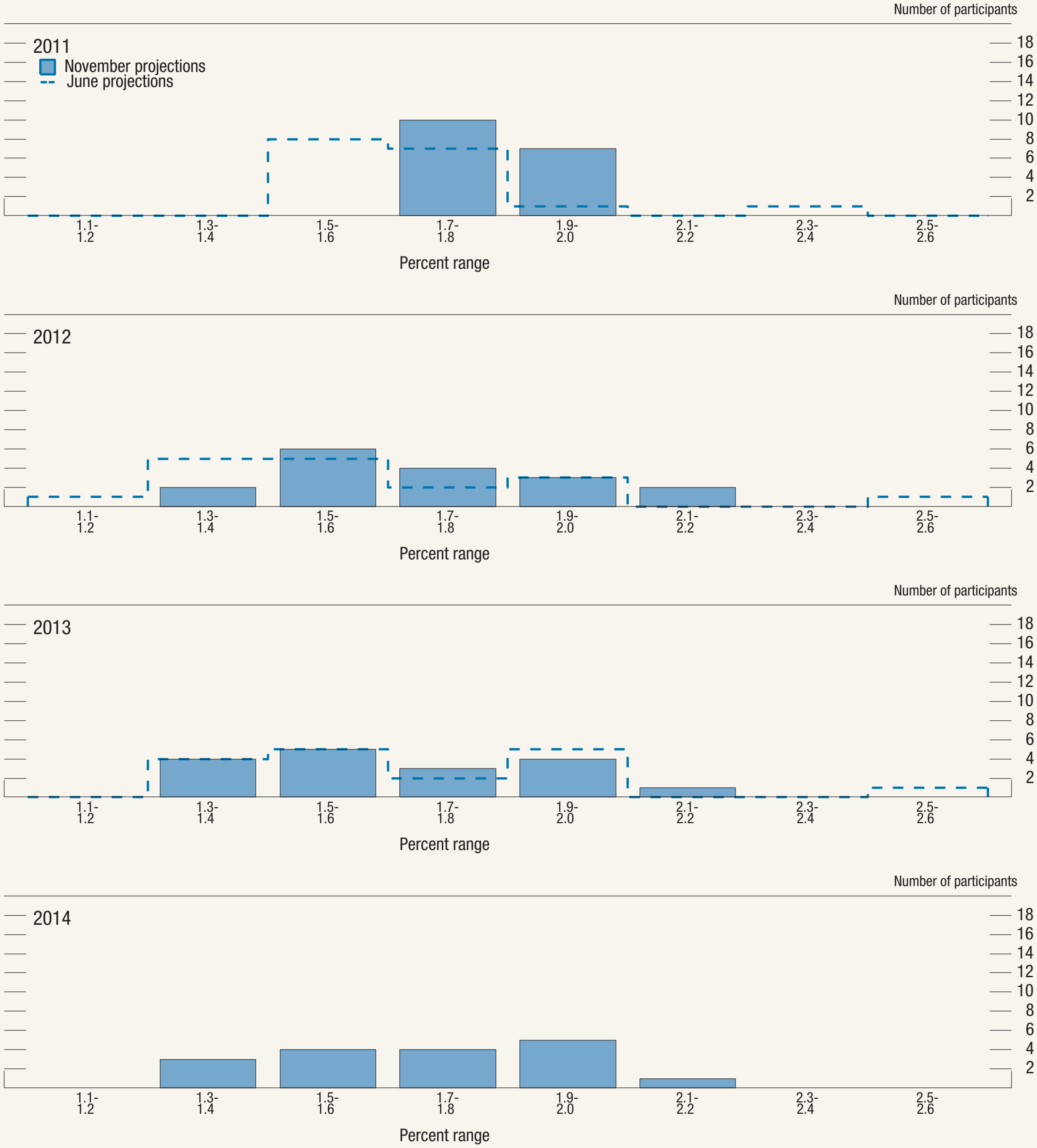


Note: Definitions of variables are in the general note to **table 1**.

Figure 3.C. Distribution of participants' projections for PCE inflation, 2011–14 and over the longer run

Note: Definitions of variables are in the general note to table 1.

Figure 3.D. Distribution of participants' projections for core PCE inflation, 2011–14



Note: Definitions of variables are in the general note to table 1.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world, and the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Reports* and those prepared by the Federal Reserve Board's staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 2.4 to 3.6 percent in the current year, 1.6 to 4.4 percent in the second year, 1.3 to 4.7 percent in the third year, and 1.2 to 4.8 percent in the fourth year. The corresponding 70 percent confidence intervals for overall inflation would be 1.5 to 2.5 percent in the current year, 1.1 to 2.9 percent in the second year, and 1.0 to 3.0 percent in the third and fourth years.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past, as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

Meeting Held on December 13, 2011

A joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System was held in the offices of the Board of Governors in Washington, D.C., on Tuesday, December 13, 2011, at 8:30 a.m.

Present

Ben Bernanke
Chairman

William C. Dudley
Vice Chairman

Elizabeth Duke

Charles L. Evans

Richard W. Fisher

Narayana Kocherlakota

Charles I. Plosser

Sarah Bloom Raskin

Daniel K. Tarullo

Janet L. Yellen

Christine Cumming, Jeffrey M. Lacker, Dennis P. Lockhart, Sandra Pianalto, and John C. Williams
Alternate Members of the Federal Open Market Committee

James Bullard, Esther L. George, and Eric Rosengren
Presidents of the Federal Reserve Banks of St. Louis, Kansas City, and Boston, respectively

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Thomas C. Baxter
Deputy General Counsel

Steven B. Kamin
Economist

David W. Wilcox
Economist

Thomas A. Connors, Loretta J. Mester, Simon Potter, David Reifschneider, Harvey Rosenblum, and Lawrence Slifman
Associate Economists

Brian Sack
Manager, System Open Market Account

Jennifer J. Johnson
Secretary of the Board, Office of the Secretary, Board of Governors

Robert deV. Frierson
Deputy Secretary, Office of the Secretary, Board of Governors

Maryann F. Hunter
Deputy Director, Division of Banking Supervision and Regulation, Board of Governors

William Wascher
Deputy Director, Division of Research and Statistics, Board of Governors

Andreas Lehnert
Deputy Director, Office of Financial Stability Policy and Research, Board of Governors

Andrew T. Levin
Special Adviser to the Board, Office of Board Members, Board of Governors

Linda Robertson
Assistant to the Board, Office of Board Members, Board of Governors

Seth B. Carpenter
Senior Associate Director, Division of Monetary Affairs, Board of Governors

Michael P. Leahy
Senior Associate Director, Division of International Finance, Board of Governors

Ellen E. Meade, Stephen A. Meyer, and Joyce K. Zickler
Senior Advisers, Division of Monetary Affairs, Board of Governors

Eric M. Engen, Michael T. Kiley, and Michael G. Palumbo
Associate Directors, Division of Research and Statistics, Board of Governors

David H. Small
Project Manager, Division of Monetary Affairs, Board of Governors

Penelope A. Beattie
Assistant to the Secretary, Office of the Secretary, Board of Governors

Gordon Werkema
First Vice President, Federal Reserve Bank of Chicago

Jeff Fuhrer and Mark S. Sniderman
Executive Vice Presidents, Federal Reserve Banks of Boston and Cleveland, respectively

David Altig, Alan D. Barkema, Richard P. Dzina, Spencer Krane, and Christopher J. Waller
Senior Vice Presidents, Federal Reserve Banks of Atlanta, Kansas City, New York, Chicago, and St. Louis, respectively

Mary C. Daly
Group Vice President, Federal Reserve Bank of San Francisco

Alexander L. Wolman
Senior Economist and Research Advisor, Federal Reserve Bank of Richmond

Samuel Schulhofer-Wohl
Senior Economist, Federal Reserve Bank of Minneapolis

By unanimous vote, the Committee selected Steven B. Kamin to serve as Economist until the selection of a successor at the first regularly scheduled meeting of the Committee in 2012.

Developments in Financial Markets and the Federal Reserve's Balance Sheet

The Manager of the System Open Market Account (SOMA) reported on developments in domestic and foreign financial markets during the period since the Federal Open Market Committee (FOMC) met on November 1–2, 2011. He also reported on System open market operations, including the ongoing reinvestment into agency-guaranteed mortgage-backed securities (MBS) of principal payments received on SOMA holdings of agency debt and agency-guaranteed MBS as well as the operations related to the maturity extension program authorized at the September 20–21 FOMC meeting. By unanimous vote, the Committee ratified the Desk's domestic transactions over the intermeeting period. There were no intervention operations in foreign currencies for the System's account over the intermeeting period.

Staff Review of the Economic Situation

The information reviewed at the December 13 meeting indicated that U.S. economic activity expanded moderately despite some apparent slowing in the growth of foreign economies and strains in global financial markets. Conditions in the labor market seemed to have improved somewhat, while overall consumer price inflation continued to be more modest than earlier in the year and measures of long-run inflation expectations remained stable.

The unemployment rate dropped to 8.6 percent in November, and private nonfarm employment continued to increase moderately during the past two months. Nevertheless, employment at state and local governments declined further, and both long-duration unemployment and the share of workers employed part time for economic reasons remained elevated. Initial claims for unemployment insurance moved down, on net, since early November but were still at a level consistent with only modest employment gains, and indicators of job openings and businesses' hiring plans were little changed.

Industrial production rose in October, reflecting in part a rebound in motor vehicle production from the effects of supply chain disruptions earlier in the year. Factory output outside of the motor vehicle sector also continued to rise, and the rate of manufacturing capacity utilization moved up. However, motor vehicle assemblies were scheduled to only edge higher, on balance, in the coming months, and broader indicators of manufacturing activity, such as the diffusion indexes of new orders from the national and regional manufacturing surveys, were at levels that suggested only modest increases in production in the near term.

Revised estimates indicated that households' real disposable income declined in the second and third quarters, and the net wealth of households decreased in the third quarter. Nonetheless, overall real personal consumption expenditures (PCE) rose modestly in October following significant gains in the previous month, as spending for consumer goods continued to increase at a strong pace while outlays for consumer services were roughly flat. In November, nominal retail sales, excluding purchases at motor vehicle and parts outlets, expanded further, and sales of light motor vehicles stepped up. But consumer sentiment was still at a subdued level in early December despite some improvement in recent months.

Activity in the housing market continued to be depressed by the substantial inventory of foreclosed and distressed properties and by weak demand that reflected tight credit conditions for mortgage loans and uncertainty about future home prices. Starts and permits for new single-family homes in October stayed around the low levels that prevailed since the middle of last year. Sales of new and existing homes remained slow in recent months, and home prices moved down further.

Real business spending on equipment and software seemed to be decelerating. Nominal orders and shipments of nondefense capital goods excluding aircraft edged down in October, and the slowing accumulation of unfilled orders suggested that increases in outlays for business equipment would be muted in subsequent months. Also, survey measures of business conditions and sentiment remained at relatively downbeat levels in November. Real business spending for nonresidential construction moved up in October but was still at a low level, reflecting high vacancy rates and restricted credit conditions for construction loans. Inventories in most industries looked to be reasonably well aligned with sales, although motor vehicle stocks continued to be lean.

In the government sector, real federal defense purchases appeared to have stepped down in October and November from their level in the third quarter. At the state and local level, real purchases seemed to be decreasing at a slower pace in recent months than earlier in the year.

The U.S. international trade deficit narrowed in October, as imports decreased more than exports. Declines in imports of petroleum products (reflecting lower prices and lesser volumes), non-oil industrial supplies, and automotive products more than offset increases in capital goods, consumer goods, and food. Reductions in exports of industrial supplies and consumer goods, led by a few particularly volatile components, outweighed the gains in capital goods.

Inflation continued to decrease relative to earlier in the year. Indeed, the PCE price index edged down in October. Consumer prices for energy decreased, and survey data indicated that gasoline prices declined further in November. Increases in consumer food prices in October were substantially slower than the average pace in the preceding months of this year. Consumer prices excluding food and energy also continued to rise at a more modest pace in October than earlier in the year. Near-term inflation expectations from the Thomson Reuters/University of Michigan Surveys of Consumers declined in early December, and longer-term inflation expectations remained stable.

Measures of labor compensation indicated that nominal wage gains continued to be subdued. Compensation per hour in the nonfarm business sector increased moderately over the year ending in the third quarter, while the 12-month change in average hourly earnings for all employees remained low in October and November. Unit labor costs edged up over the past four quarters.

Foreign economic growth, especially in the euro area, appeared to weaken in recent months. Real gross domestic product (GDP) in the euro area barely edged up in the third quarter. Moreover, industrial production in the region fell sharply in September, and indicators of manufacturing activity in October and November pointed to lower output. Measures of business and consumer confidence in the euro area continued to decline in recent months. In other advanced foreign economies, real GDP in Japan rebounded in the third quarter from the effects of the earthquake in March, and real GDP recovered in Canada as oil production picked up after several months of shutdowns; however, available indicators of manufacturing activity in both of these economies pointed to declines during the fourth quarter. Among emerging market economies, real GDP in Brazil was flat in the third quarter, while exports from China slowed in recent months, although Chinese domestic demand appeared to remain strong.

Staff Review of the Financial Situation

The risks associated with the fiscal and financial difficulties in Europe remained the focus of attention in financial markets over the intermeeting period and contributed to heightened volatility in a wide range of asset markets. Investor concerns about developments in Europe intensified early in the period but subsequently eased a bit amid signs that European authorities were moving toward agreement on a comprehensive framework to address fiscal and financial vulnerabilities and after the Federal Reserve and five other major central banks announced enhanced currency swap arrangements, including lower charges on existing dollar liquidity swap lines. Nevertheless, investors appeared to remain cautious.

Yields on nominal Treasury securities were little changed following the release of the November FOMC statement. Over the following weeks, movements in yields were reportedly driven by shifts in investors' assessments of the European situation and by U.S. economic data that were somewhat stronger than they expected. Both short-term nominal Treasury yields and the expected path of the federal funds rate implied by money market futures quotes were essentially unchanged, on balance, over the intermeeting period, while longer-dated Treasury yields ended the period slightly higher. Yields on current-coupon agency MBS also ended the period about unchanged. Indicators of inflation expectations derived from nominal and inflation-protected Treasury securities posted mixed changes, on net, over the period and remained at the low end of their recent ranges.

Early in the intermeeting period, conditions in short-term wholesale funding markets appeared to deteriorate somewhat. Following the six major central banks' currency swap announcement, some measures of short-term funding costs moderated, but they remained elevated. In dollar funding markets, the spread of the three-month London interbank offered rate (Libor) over the overnight index swap (OIS) rate of the same maturity widened noticeably during the intermeeting period. Some European financial institutions reportedly faced significant pressures in unsecured dollar funding markets. By contrast, in secured funding markets, spreads on asset-backed commercial paper were relatively steady for U.S. and most European-based issuers, and rates on repurchase agreements across various types of collateral were stable.

In the December 2011 Senior Credit Officer Opinion Survey on Dealer Financing Terms, dealers reported a moderate tightening of credit terms over the preceding three months on securities financing transactions and over-the-counter derivatives markets trades, particularly for financial counterparties. Dealers also noted that demand for funding all types of securities decreased over the same reference period.

Credit default swap (CDS) spreads and equity prices of large U.S. banking organizations remained volatile over the intermeeting period. While the S&P 500 index ended the period slightly higher, on net, equity prices for most major U.S. banking firms were lower and their CDS spreads widened. CDS spreads for European banks remained elevated as these institutions faced increasingly strained conditions in short-term funding markets. In the wake of the bankruptcy of MF Global, market participants also expressed renewed concerns about securities dealers that rely heavily on short-term wholesale funding markets, particularly those institutions not affiliated with commercial banking institutions.

Yields on investment-grade and speculative-grade corporate bonds rose, on balance, over the period, and their spreads over yields on comparable-maturity Treasury securities were somewhat wider. The debt of nonfinancial firms increased in November, with corporate bond issuance particularly robust, as some firms reportedly were eager to issue bonds before year-end. Nonfinancial commercial paper outstanding and commercial and industrial loans continued to expand at a moderate pace. In the leveraged loan market, the extension of loans stepped up somewhat in November but remained sluggish relative to its average pace earlier in the year.

Financing conditions for commercial real estate appeared to remain strained over the intermeeting period. Issuance of commercial mortgage-backed securities (CMBS) was light amid deteriorating liquidity conditions in the CMBS market. Prices of most types of commercial properties continued to be depressed, while both vacancy rates and delinquency rates for commercial properties stayed close to their recent highs.

Interest rates on residential mortgages were little changed, on net, over the intermeeting period and remained at historically low levels. But low mortgage rates appeared to have only modest effects on the rate of mortgage refinancing, likely because of tight underwriting standards and low levels of home equity. Indicators of home prices and the credit quality of older mortgage loans remained weak. The rate of newly delinquent prime mortgages—the pace at which mortgages transition from "current" to delinquent—seemed to have slowed, but overall delinquency rates on residential mortgages remained elevated. Market reaction to the announcements by Fannie Mae and Freddie Mac on November 15 regarding the expansion of the Home Affordable Refinance Program was limited.

Consumer credit rose slightly in the third quarter. The aggregate volume of credit card solicitations in recent months remained at levels comparable to those before the financial crisis in 2008, though the volume sent to low-income households was still well below the levels at that time. Meanwhile, consumer credit quality improved further in recent months, with delinquency rates on credit card loans declining nearly to historical lows and delinquency rates on nonrevolving credit at commercial banks retreating to pre-crisis levels. Issuance of consumer credit asset-backed securities increased substantially in November.

M2 expanded at a solid pace in November, likely reflecting increased demand for safe and liquid assets, given concerns over European financial developments. In part, offshore deposits, which are no longer excluded from the Federal Deposit Insurance Corporation assessment base, appeared to be shifting to onshore offices. In contrast, the monetary base declined in November. Although currency increased at a robust pace, reserve balances declined by more, reflecting a temporary decrease in the size of the SOMA as a result of lags in the settlement of MBS reinvestment transactions.

Over most of November, yields on many euro-area sovereign bonds—including those of Italy, Spain, Belgium, and France—along with yields on debt issued by the European Financial Stability Facility, rose sharply relative to the yield on German government bonds. But these spreads subsequently narrowed in anticipation of the European Union (EU) summit meeting on December 9 and in reaction to the swap announcement by the Federal Reserve and the other central banks on November 30. Near the end of the period, sovereign spreads widened again amid market participants' apparent concerns that the actions announced at the EU summit would prove to be less effective than they previously had anticipated. Spreads of yields on most peripheral euro-area countries' debt over yields on German debt ended the period higher on net. German sovereign yields increased as well.

Implied basis spreads from the foreign exchange swap market rose substantially over November, but reversed a portion of that increase immediately following the central banks' swap announcement. Against the background of higher dollar funding costs in the market and the reduction in the charge on dollar liquidity swaps, demand at the tender by the European Central Bank (ECB) of three-month dollar liquidity in December jumped to more than \$50 billion from less than \$500 million at the November auction. Euro funding pressures also moved higher over the period, with euro Libor–OIS spreads continuing to rise. In addition, maturities for repurchase agreements involving sovereign bonds of euro-area countries other than Germany reportedly shortened. Several European banks announced large declines in third-quarter profits, in part reflecting write-downs of their holdings of Greek sovereign debt. Equity prices in both advanced and emerging market economies fluctuated widely, with advanced country equities little changed, on net, and emerging market equities ending the period lower. The foreign exchange value of the dollar appreciated, on balance, over the intermeeting period.

With inflationary pressures waning and the downside risks to the global economic outlook increasing, some central banks eased policy. China's central bank cut its reserve requirements by 50 basis points, and the central bank of Brazil lowered its policy rate by the same amount. The ECB reduced its minimum bid rate by 25 basis points at both its November and December meetings, relaxed its collateral and reserve requirements, and stated that it would begin to offer three-year funds at fixed rates. As a precautionary measure, the Bank of England announced a new liquidity facility that will auction term sterling funds against a wide range of collateral.

Staff Economic Outlook

In the economic forecast prepared for the December FOMC meeting, the staff's projection for the increase in real GDP in the near term was little changed, as the recent data on spending, production, and the labor market were, on balance, in line with the staff's expectations at the time of the previous forecast. However, the medium-term projection for real GDP growth in the December forecast was lower than the one presented in November, primarily reflecting revisions to the staff's view regarding developments in Europe and their implications for the U.S. economy. Nonetheless, the staff continued to project that the pace of economic activity would pick up gradually in 2012 and 2013, supported by accommodative monetary policy, further increases in credit availability, and improvements in consumer and business sentiment. Over the forecast period, the gains in real GDP were anticipated to be sufficient to reduce the slack in product and labor markets only slowly, and the unemployment rate was expected to remain elevated at the end of 2013.

The staff's projection for inflation was little changed from the forecast prepared for the November FOMC meeting. The upward pressure on consumer prices from the increases in commodity and import prices earlier in the year was expected to continue to subside in the current quarter. With long-run inflation expectations stable and substantial slack in labor and product markets anticipated to persist over the forecast period, the staff continued to project that inflation would be subdued in 2012 and 2013.

Participants' Views on Current Conditions and the Economic Outlook

In their discussion of the economic situation and outlook, meeting participants agreed that the information received since their previous meeting indicated that economic activity was expanding at a moderate rate, notwithstanding some apparent slowing in global economic growth. Consumer spending continued to advance, but business fixed investment appeared to be decelerating, and home sales and construction remained at very low levels. Labor market conditions improved some in recent months, but the unemployment rate remained elevated despite a noticeable drop in November. Inflation moderated from the rates earlier in the year, and longer-term inflation expectations remained stable.

Regarding the economic outlook, participants continued to anticipate that economic activity would expand at a moderate rate in the coming quarters and that, consequently, the unemployment rate would decline only gradually. The factors that participants cited as likely to restrain the pace of the economic expansion included an expectation that financial markets would remain unsettled until the fiscal and banking issues in the euro area were more fully addressed. Other factors that were expected to weigh on the pace of economic activity were the slowdown of economic activity abroad, fiscal tightening in the United States, high levels of uncertainty among households and businesses, the weak housing market, and household deleveraging. In assessing the economic outlook, participants judged that strains in global financial markets continued to pose significant downside risks. With the rate of increase in economic activity anticipated to remain moderate, most participants expected that inflation would settle over coming quarters at or below levels consistent with their estimates of its longer-run mandate-consistent rate.

In discussing the household sector, meeting participants generally commented that consumer spending in recent months had been stronger than expected, and several reported cautious optimism among some of their business contacts about prospects for the holiday shopping season. A few participants thought that the recent strength in motor vehicle sales and other consumer spending could reflect pent-up demand from households for goods and services, and so thought that it might persist for a time. However, others noted that real disposable personal income had weakened and that households remained pessimistic about their income prospects and uncertain about the economic outlook. As a result, a number of those participants suggested that the recent stronger pace of consumer spending might not be sustained. Moreover, some participants mentioned that households were likely still adjusting to the loss of wealth over the past few years, which would weigh on consumer spending going forward. Participants generally saw few signs of recovery in the housing market, with house prices continuing to decline in most areas and the overhang of foreclosed and distressed properties still substantial. Several participants observed that the ongoing weakness in the housing market came despite low borrowing rates and government initiatives to resolve problems in the foreclosure process. However, one participant noted that some homebuilders were reporting that land prices were edging up and that financing was available from nontraditional sources, suggesting that conditions in the housing market could be improving.

Reports from business contacts indicated that, in addition to the rise in consumer spending, activity in the manufacturing, energy, and agriculture sectors continued to advance in recent months. Nonetheless, businesses generally reported that they remained cautious regarding capital spending and hiring because of a high level of uncertainty about the economic outlook and the political environment. In particular, some contacts raised concerns about the uncertain fiscal outlook in the United States or the possible drag on sales and production from an economic slowdown abroad, while others cited uncertainty about the cost implications of potential changes in regulatory policies. Several participants noted that their contacts had ready access to credit at attractive rates. However, some participants continued to view credit as tight, particularly in mortgage markets or among small businesses in their Districts that were facing difficulties meeting collateral requirements and obtaining bank loans.

A number of recent indicators showed some improvement in labor market conditions: Payroll employment had posted moderate gains for five months, new claims for unemployment insurance had drifted lower, and the unemployment rate had turned down. One participant noted that the series of upward revisions to the initial estimates of payroll employment in recent months was an encouraging sign of sustained hiring, although several participants remarked that they saw the labor market as still improving only slowly. Others indicated that because part of the recent decline in the jobless rate was associated with a reduction in labor force participation, the drop in the unemployment rate likely overstated the overall improvement in the labor market. Moreover, unemployment, particularly longer-term unemployment, remained high, and the number of involuntary part-time workers was still elevated. Some participants again expressed concern that the persistence of high levels of long-duration unemployment and the underutilization of the workforce could eventually lead to a loss of skills and an erosion of potential output. Another participant suggested that the unemployment rate was a more useful indicator of cyclical labor market developments than the level of employment relative to the size of the population, which was more likely to be influenced by structural changes in labor demand and supply. Participants expressed a range of views on the current extent of slack in the labor market. It was noted that because of factors including ongoing changes in the composition of available jobs and workers' skills, some part of the increase in unemployment since the beginning of the recession had been structural rather than cyclical. Others pointed out that the very modest increases in labor compensation of late suggested that underutilization of labor was still significant.

Meeting participants observed that financial markets remained volatile over the intermeeting period in large part because of developments in Europe. Participants noted the recent moves by the European authorities to strengthen their commitment to fiscal discipline and to provide greater resources to backstop sovereign debt issuance. But many anticipated that further efforts to implement and perhaps to augment these policies would be necessary to fully resolve the area's fiscal and financial problems and commented that financial markets would remain focused on the situation in Europe as it evolves. It was noted that the changes to the central bank currency swap lines announced in late November helped to ease dollar funding conditions facing European institutions, but such conditions were still strained. However, participants generally saw little evidence of significant new constraints on credit availability for domestic borrowers. The balance sheets of most U.S. banks appeared to have improved somewhat, and domestic banks reported increases in commercial lending, even as some European lenders were pulling back. Several participants commented on strains affecting some community banks, which reportedly had led to tighter credit conditions for their small business clients.

Participants observed that inflation had moderated in recent months as the effects of the earlier run-up in commodity prices subsided. Retail prices of gasoline had declined, and prices of non-oil imported goods had softened. In addition, labor compensation had risen only slowly, and productivity continued to rise. Some business contacts suggested that pricing pressures had diminished. Longer-run inflation expectations were still well anchored. Most participants anticipated that inflation would continue to moderate. Although some energy prices had recently increased, many participants judged that the favorable trends in commodity prices might persist in the near term, particularly in light of softer global activity, and one noted that expanded crop production, if realized, would hold down agricultural prices. More broadly, many participants judged that the moderate expansion in economic activity that they were projecting and the associated gradual reduction in the current wide margins of slack in labor and product markets would be consistent with subdued inflation going forward. Indeed, some expressed the concern that, with the persistence of considerable resource slack, inflation might run below mandate-consistent levels for some time. However, a couple of participants noted that the rate of inflation over the past year had not fallen as much as would be expected if the gap in resource utilization were large, suggesting that the level of potential output was lower than some current estimates. Some participants were concerned that inflation could rise as the recovery continued, and some business contacts had reported that producers expected to see an increase in pricing power over time. A few participants argued that maintaining a highly accommodative stance of monetary policy over the medium run would erode the stability of inflation expectations.

Committee Policy Action

Members viewed the information on U.S. economic activity received over the intermeeting period as suggesting that the economy was expanding moderately. While overall labor market conditions had improved some in recent months, the unemployment rate remained elevated relative to levels that the Committee anticipated would prevail in the longer run. Inflation had moderated, and longer-term inflation expectations remained stable. However, available indicators pointed to some slowing in the pace of economic growth in Europe and in some emerging market economies. Members continued to expect a moderate pace of economic growth over coming quarters, with the unemployment rate declining only gradually toward levels consistent with the Committee's dual mandate. Strains in global financial markets continued to pose significant downside risks to economic activity. Members also anticipated that inflation would settle, over coming quarters, at levels at or below those consistent with the dual mandate.

In their discussion of monetary policy for the period ahead, Committee members generally agreed that their overall assessments of the economic outlook had not changed greatly since their previous meeting. As a result, almost all members agreed to maintain the existing stance of monetary policy at this meeting. In particular, they agreed to continue the program of extending the average maturity of the Federal Reserve's holdings of securities as announced in September, to retain the existing policies regarding the reinvestment of principal payments from Federal Reserve holdings of securities, and to keep the target range for the federal funds rate at 0 to ¼ percent. With regard to the forward guidance to be included in the statement to be released following the meeting, several members noted that the reference to mid-2013 might need to be adjusted before long. A number of members noted their dissatisfaction with the Committee's current approach for communicating its views regarding the appropriate path for monetary policy, and looked forward to considering possible enhancements to the Committee's communications. For now, however, the Committee agreed to reiterate its anticipation that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. A number of members indicated that current and prospective economic conditions could well warrant additional policy accommodation, but they believed that any additional actions would be more effective if accompanied by enhanced communication about the Committee's longer-run economic goals and policy framework. A few others continued to judge that maintaining the current degree of policy accommodation beyond the near term would likely be inappropriate given their outlook for economic activity and inflation, or questioned the efficacy of additional monetary policy actions in light of the nonmonetary headwinds restraining the recovery. For this meeting, almost all members were willing to support maintaining the existing policy stance while emphasizing the importance of carefully monitoring economic developments given the uncertainties and risks attending the outlook. One member preferred to undertake additional accommodation at this meeting and dissented from the policy decision.

With respect to the statement, members agreed that only relatively small modifications were needed to reflect the modest changes to economic conditions seen in the recent data and to note that the Committee would continue to implement its policy steps from recent meetings.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee seeks conditions in reserve markets consistent with federal funds trading in a range from 0 to ¼ percent. The Committee directs the Desk to continue the maturity extension program it began in September to purchase, by the end of June 2012, Treasury securities with remaining maturities of approximately 6 years to 30 years with a total face value of $400 billion, and to sell Treasury securities with remaining maturities of 3 years or less with a total face value of $400 billion. The Committee also directs the Desk to maintain its existing policies of rolling over maturing Treasury securities into new issues and of reinvesting principal payments on all agency debt and agency mortgage-backed securities in the System Open Market Account in agency mortgage-backed securities in order to maintain the total face value of domestic securities at approximately $2.6 trillion. The Committee directs the Desk to engage in dollar roll transactions as necessary to facilitate settlement of the Federal Reserve's agency MBS transactions. The System Open Market Account Manager and the Secretary will keep the Committee informed of ongoing developments regarding the System's balance sheet that could affect the

attainment over time of the Committee's objectives of maximum employment and price stability."

The vote encompassed approval of the statement below to be released at 2:15 p.m.:

"Information received since the Federal Open Market Committee met in November suggests that the economy has been expanding moderately, notwithstanding some apparent slowing in global growth. While indicators point to some improvement in overall labor market conditions, the unemployment rate remains elevated. Household spending has continued to advance, but business fixed investment appears to be increasing less rapidly and the housing sector remains depressed. Inflation has moderated since earlier in the year, and longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee continues to expect a moderate pace of economic growth over coming quarters and consequently anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee decided today to continue its program to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

The Committee also decided to keep the target range for the federal funds rate at 0 to ¼ percent and currently anticipates that economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.

The Committee will continue to assess the economic outlook in light of incoming information and is prepared to employ its tools to promote a stronger economic recovery in a context of price stability."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Richard W. Fisher, Narayana Kocherlakota, Charles I. Plosser, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: Charles L. Evans.

Mr. Evans dissented because he continued to view additional policy accommodation as appropriate in circumstances where his outlook was for growth to be too slow to make sufficient progress in reducing the unemployment rate and for inflation to drop below levels consistent with the Committee's dual mandate. He continued to support the use of more-explicit forward guidance about the economic conditions under which the federal funds rate could be maintained in its current range, and he suggested that the Committee also consider additional asset purchases.

Monetary Policy Communications

After the Committee's vote, participants turned to a further consideration of ways in which the Committee might enhance the clarity and transparency of its public communications. The subcommittee on communications recommended an approach for incorporating information about participants' projections of appropriate future monetary policy into the Summary of Economic Projections (SEP), which the FOMC releases four times each year. In the SEP, participants' projections for economic growth, unemployment, and inflation are conditioned on their individual assessments of the path of monetary policy that is most likely to be consistent with the Federal Reserve's statutory mandate to promote maximum employment and price stability, but information about those assessments has not been included in the SEP.

A staff briefing described the details of the subcommittee's recommended approach and compared it with those taken by several other central banks. Most participants agreed that adding their projections of the target federal funds rate to the economic projections already provided in the SEP would help the public better understand the Committee's monetary policy decisions and the ways in which those decisions depend on members' assessments of economic and financial conditions. One participant suggested that the economic projections would be more understandable if they were based on a common interest rate path. Another suggested that it would be preferable to publish a consensus policy projection of the entire Committee. Some participants expressed concern that publishing information about participants' individual policy projections could confuse the public; for example, they saw an appreciable risk that the public could mistakenly interpret participants' projections of the target federal funds rate as signaling the Committee's intention to follow a specific policy path rather than as indicating members' conditional projections for the federal funds rate given their expectations regarding future economic developments. Most participants viewed these concerns as manageable; several noted that participants would have opportunities to explain their projections and policy views in speeches and other forms of communication. Nonetheless, some participants did not see providing policy projections as a useful step at this time.

At the conclusion of their discussion, participants decided to incorporate information about their projections of appropriate monetary policy into the SEP beginning in January. Specifically, the SEP will include information about participants' projections of the appropriate level of the target federal funds rate in the fourth quarter of the current year and the next few calendar years, and over the longer run; the SEP also will report participants' current projections of the likely timing of the first increase in the target rate given their projections of future economic conditions. An accompanying narrative will describe the key factors underlying those assessments as well as qualitative information regarding participants' expectations for the Federal Reserve's balance sheet. A number of participants suggested further enhancements to the SEP; the Chairman asked the subcommittee to explore such enhancements over coming months.

Following up on the Committee's discussion of policy frameworks at its November meeting, the subcommittee on communications presented a draft statement of the Committee's longer-run goals and policy strategy. Participants generally agreed that issuing such a statement could be helpful in enhancing the transparency and accountability of monetary policy and in facilitating well-informed decisionmaking by households and businesses, and thus in enhancing the Committee's ability to promote the goals specified in its statutory mandate in the face of significant economic disturbances. However, a couple of participants expressed the concern that a statement that was sufficiently nuanced to capture the diversity of views on the Committee might not, in fact, enhance public understanding of the Committee's actions and intentions. Participants commented on the draft statement, and the Chairman encouraged the subcommittee to make adjustments to the draft and to present a revised version for the Committee's further consideration in January.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, January 24–25, 2012. The meeting adjourned at 4:00 p.m. on December 13, 2011.

Videoconference Meeting of November 28

On November 28, 2011, the Committee met by videoconference to discuss a proposal to amend and augment the Federal Reserve's temporary liquidity swap arrangements with foreign central banks in light of strains in global financial markets. The proposal included a six-month extension of the sunset date and a 50 basis point reduction in the pricing on the existing liquidity swap arrangements with the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, and the Swiss National Bank, as well as the establishment, as a contingency measure, of swap arrangements that would allow the Federal Reserve to provide liquidity in the currencies of the foreign central banks should the need arise. The proposal was aimed at helping to ease strains in financial markets and thereby to mitigate the effects of such strains on the supply of credit to U.S. households and businesses, in support of the economic recovery.

The staff provided briefings on financial and economic developments in Europe. In recent weeks, financial markets appeared to have become increasingly concerned that a timely resolution of the European sovereign debt situation might not occur despite the measures that authorities there announced in

October; pressures on European sovereign debt markets had increased, and conditions in European funding markets had deteriorated appreciably. The greater financial stress appeared likely to damp economic activity in the euro area and could pose a risk to the economic recovery in the United States.

Meeting participants discussed a range of considerations surrounding the proposed changes to the swap arrangements. Most participants agreed that such changes would represent an important demonstration of the commitment of the Federal Reserve and the other central banks to work together to support the global financial system. Some participants indicated that, although they did not anticipate that usage would necessarily be heavy, they felt that lower pricing on the existing swap lines could reduce the possible stigma associated with the use of the lines by financial institutions borrowing dollars from the foreign central banks, and so would contribute to improved functioning in dollar funding markets in Europe and elsewhere. A few noted that the risks associated with the swap lines were low because the Federal Reserve's counterparties would be the foreign central banks themselves, and the foreign central banks would be responsible for the loans to banks in their jurisdictions. However, some participants commented that the proposed changes to the swap lines would not by themselves address the need for additional policy action by European authorities. Several participants questioned whether the changes to the swap lines were necessary at this time and worried that such changes could be seen as suggesting greater concern about financial strains than was warranted. It was also noted that the proposed reduction in pricing of the existing swap arrangements could put the cost of dollar borrowing from foreign central banks below the Federal Reserve's primary credit rate and that non-U.S. banks might be perceived to have an advantage in meeting their short-term funding needs as a result. However, U.S. banks did not face difficulties obtaining liquidity in short-term funding markets, and some participants felt that a cut in the primary credit rate at the present time might incorrectly be seen as suggesting concern about U.S. financial conditions.

At the conclusion of the discussion, all but one member agreed to support the changes to the existing swap line arrangements and the establishment of the new foreign currency swap agreements and approved the following resolution:

> "The Federal Open Market Committee directs the Federal Reserve Bank of New York to extend the existing temporary reciprocal currency arrangements ("swap arrangements") for the System Open Market Account with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank through February 1, 2013.
>
> In addition, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to enter into additional swap arrangements for the System Open Market Account with the Bank of Canada, Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank to support the provision by the Federal Reserve of liquidity in Canadian dollars, British pounds, Japanese yen, euros, and Swiss francs. The swap arrangements for provision of liquidity in each of those currencies shall be subject to the same size limits, if any, currently in force for the swap arrangements for provision of liquidity in U.S. dollars to that foreign central bank. These arrangements shall terminate on February 1, 2013. Requests for drawings on the foreign currency swap lines and distribution of the proceeds to U.S. financial institutions shall be initiated by the appropriate Reserve Bank and approved by the Chairman in consultation with the Foreign Currency Subcommittee. The Foreign Currency Subcommittee will consult with the Federal Open Market Committee prior to the initial drawing on the foreign currency swap lines if possible under the circumstances then prevailing.
>
> The Chairman shall establish the rates on the swap arrangements by mutual agreement with the foreign central banks and in consultation with the Foreign Currency Subcommittee. He shall keep the Federal Open Market Committee informed, and the rates shall be consistent with principles discussed with and guidance provided by the Committee."

Voting for this action: Ben Bernanke, William C. Dudley, Elizabeth Duke, Charles L. Evans, Richard W. Fisher, Narayana Kocherlakota, Sarah Bloom Raskin, Daniel K. Tarullo, and Janet L. Yellen.

Voting against this action: Jeffrey M. Lacker.

Mr. Lacker voted as alternate member for Mr. Plosser at this meeting. Mr. Lacker dissented because of his opposition to arrangements that support Federal Reserve lending in foreign currencies, which he viewed as amounting to fiscal policy. He also opposed lowering the interest rate on swap arrangements to below the primary credit rate.

Notation Vote

By notation vote completed on November 21, 2011, the Committee unanimously approved the minutes of the FOMC meeting held on November 1–2, 2011.

William B. English
Secretary

Litigation

During 2011, the Board of Governors was a party in 12 lawsuits or appeals filed that year and was a party in 10 other cases pending from previous years, for a total of 22 cases. In 2010, the Board had been a party in a total of 15 cases. As of December 31, 2011, 11 cases were pending.

Estate of Deleon v. Board of Governors, No. 11-cv-1538 (N.D. New York, filed December 30, 2011), is a complaint involving failure to address a consumer complaint at a regulated bank.

Haller v. U.S. Department of Housing and Urban Development et al., No 11-cv-881 MRB-KLL (S.D. Ohio, filed December 16, 2011), is an action arising out of a mortgage foreclosure.

Farrell v. Geithner et al., No. 12-cv-0026 (M.D. Florida, filed in state court December 15, 2011; notice of removal filed January 19, 2012), is an action relating to a tax lien.

NACS et al. v. Board of Governors, No. 11-cv-2075(RJL) (D. District of Columbia, filed November 22, 2011), is a challenge to regulations issued pursuant to section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to debit card fees.

Handy v. Bernanke, No. 12-1207 (Fourth Circuit, filed February 3, 2012), is an appeal of an order of the district court for the Eastern District of Virginia dismissing an action relating to employment at the Federal Reserve Bank of Richmond.

CitiMortgage, Inc. v. Kokolis, No. 11-cv-2933-RBH (D. South Carolina, filed in state court August 5, 2011; notice of removal filed October 27, 2011), is a third-party complaint against the Board and the United States Department of the Treasury by the defendant in a mortgage foreclosure action.

First Citizens Banks and Trust Co. v. Spirakis, No. 11-cv-2895-RBH (D. South Carolina, filed in state court August 5, 2011; notice of removal filed October 24, 2011), is a third-party complaint against the Board and the United States Department of the Treasury by the defendant in a mortgage foreclosure action.

Perry v. Bernanke, No. 11-cv-1246(RWR) (D. District of Columbia, filed July 7, 2011), is an employment discrimination action.

Barragan v. Board of Governors, No. 11-cv-0696 CAS-(JCx) (C.D. California, filed May 3, 2011), is a Freedom of Information Act case.

National Association of Mortgage Brokers v. Board of Governors, No. 11-cv-506(BEH) (D. District of Columbia, filed March 8, 2011), was a challenge to a provision of Regulation Z affecting mortgage loan originators. On March 30, 2011, the district court denied the plaintiff's motions for a temporary restraining order and preliminary injunction (773 F. Supp. 2d 151). On April 5, 2011, the United States Court of Appeals for the District of Columbia Circuit denied the plaintiff's motion for an emergency stay of the effective date of the regulation. On May 20, 2011, the case was dismissed by stipulation of the parties.

National Association of Independent Housing Professionals, Inc. v. Board of Governors, No 11-cv-489(BEH) (D. District of Columbia, filed March 7, 2011), was a challenge to a provision of Regulation Z affecting mortgage loan originators. On March 30, 2011, the district court denied the plaintiff's motions for a temporary restraining order and preliminary injunction (773 F. Supp. 2d 151). On April 5, 2011, the United States Court of Appeals for the District of Columbia Circuit denied the plaintiff's motion for an emergency stay of the effective date of the regulation. On April 21, 2011, the plaintiff voluntarily dismissed the action.

Murray v. Board of Governors, No. 11-1063 (Sixth Circuit, filed January 14, 2011), is an appeal of a district court order (763 F. Supp. 2d 860) granting summary judgment to the Board on a challenge to the constitutionality of federal expenditures relating to American International Group (AIG).

McKinley v. Board of Governors, No. 10-5353 (District of Columbia Circuit, filed October 22, 2010), was an appeal from an order of the district court granting the Board's motion for summary judgment in a Freedom of Information Act case (744 F. Supp. 2d 128). On June 3, 2011, the court of appeals affirmed the district court's order (647 F.3d 331). On January 12, 2012, the Supreme Court denied certiorari.

TCF National Bank v. Bernanke, No. 10-4149 (D. South Dakota, filed October 12, 2010), was a challenge to the constitutionality of section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. On April 25, 2011, the district court denied the plaintiff's motion for a preliminary injunction, and on June 29, 2011, the Eighth Circuit Court of Appeals affirmed the denial (643 F.3d 1158). On June 30, 2011, the plaintiff voluntarily dismissed the action.

Qader v. Federal Reserve Board, No. 10-3696 (Second Circuit, filed August 18, 2010), was an appeal of the district court's dismissal of an action arising out of the appellant's dispute with a bank. On March 3, 2011, the court of appeals dismissed the appeal.

McKinley v. Board of Governors, No. 10-00751 (D. District of Columbia, filed May 11, 2010), is a Freedom of Information Act case.

Fox News Network v. Board of Governors, No. 10-3320 (S.D. New York, filed April 20, 2010), was a Freedom of Information Act case. On August 4, 2011, the case was dismissed on the parties' motion.

Gold Anti-Trust Action Committee, Inc. v. Board of Governors, No. 09-2436 (D. District of Columbia, filed December 30, 2009), was a Freedom of Information Act case. On February 3, 2011, the district court granted in part and denied in part the Board's motion for summary judgment, and on February 18, 2011, the court entered judgment for the Board.

Judicial Watch, Inc. v. Board of Governors, No. 09-2138 (D. District of Columbia, filed November 13, 2009), was a Freedom of Information Act case. On March 29, 2011, the district court granted the Board's motion for summary judgment.

Bloomberg, L.P. v. Board of Governors, 09-4083 (Second Circuit, filed October 1, 2009), was an appeal of a judgment for Bloomberg, L.P. in a Freedom of Information Act case (649 F. Supp. 2d 262). On March 19, 2010, the court of appeals affirmed the district court's judgment (601 F.3d 143). On October 26, 2010, The Clearing House, which had intervened in the case, filed a petition for a writ of certiorari with the United States Supreme Court (No. 10-543). On March 21, 2011, the Supreme Court denied certiorari.

Fox News Network v. Board of Governors, No. 09-3795 (Second Circuit, filed September 9, 2009), was an appeal of a judgment for the Board in a Freedom of Information Act case (639 F. Supp. 2d 384). On March 19, 2010, the court of appeals vacated the district court's judgment and remanded the matter to the district court (601 F.3d 158). On November 18, 2010, The Clearing House, which had intervened in the case, filed a petition for a writ of certiorari with the United States Supreme Court (No. 10-660). On March 21, 2011, the Supreme Court denied certiorari.

Artis v. Greenspan, No. 01-cv-0400 (D. District of Columbia, filed February 22, 2001), is an employment discrimination action.

Statistical Tables

Table 1. Federal Reserve open market transactions, 2011

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
U.S. Treasury securities[1]													
Outright transactions[2]													
Treasury bills													
Gross purchases	0	0	0	0	0	0	0	0	0	0	0	0	0
Gross sales	0	0	0	0	0	0	0	0	0	0	0	0	0
Exchanges	13,931	18,423	20,841	18,423	18,423	24,361	18,423	18,423	22,204	18,423	18,423	39,349	249,647
For new bills	13,931	18,423	20,841	18,423	18,423	24,361	18,423	18,423	22,204	18,423	18,423	39,349	249,647
Redemptions	0	0	0	0	0	0	0	0	0	0	0	0	0
Others within 1 year													
Gross purchases	0	0	0	0	0	0	0	0	0	0	0	0	0
Gross sales	0	0	0	0	0	0	0	0	0	9,227	13,241	12,284	34,752
Maturity shifts	0	0	0	0	0	0	0	0	0	0	0	0	0
Exchanges	0	0	0	0	0	0	0	0	0	0	0	0	0
Redemptions	0	0	0	0	0	0	0	0	0	0	0	0	0
1 to 5 years													
Gross purchases	40,763	39,888	64,230	31,007	49,593	35,548	8,286	4,779	7,168	0	0	0	281,262
Gross sales	0	0	0	0	0	0	0	0	0	36,493	22,510	40,304	99,307
Maturity shifts	0	0	0	0	0	0	0	0	0	0	0	0	0
Exchanges	0	0	0	0	0	0	0	0	0	0	0	0	0
5 to 10 years													
Gross purchases	61,090	49,120	42,568	38,675	51,728	46,137	9,163	8,143	3,946	28,155	28,911	28,598	396,234
Gross sales	0	0	0	0	0	0	0	0	0	0	0	0	0
Maturity shifts	0	0	0	0	0	0	0	0	0	0	0	0	0
Exchanges	0	0	0	0	0	0	0	0	0	0	0	0	0
More than 10 years													
Gross purchases	5,099	9,687	5,586	9,568	7,735	6,586	869	860	1,260	15,586	16,019	15,629	94,484
Gross sales	0	0	0	0	0	0	0	0	0	0	0	0	0
Maturity shifts	0	0	0	0	0	0	0	0	0	0	0	0	0
Discount notes	0	0	0	0	0	0	0	0	0	0	0	0	0
All maturities													
Gross purchases	106,952	98,695	112,384	79,250	109,056	88,271	18,318	13,782	12,374	43,741	44,930	44,227	771,980
Gross sales	0	0	0	0	0	0	0	0	0	45,720	35,751	52,588	134,059
Redemptions	0	0	0	0	0	0	0	0	0	0	0	0	0
Net change in U.S. Treasury securities	106,952	98,695	112,384	79,250	109,056	88,271	18,318	13,782	12,374	-1,979	9,179	-8,361	637,921
Federal agency obligations													
Outright transactions[2]													
Gross purchases	0	0	0	0	0	0	0	0	0	0	0	0	0
Gross sales	0	0	0	0	0	0	0	0	0	0	0	0	0
Redemptions	2,836	1,375	10,754	7,377	6,025	2,389	4,269	2,659	1,508	600	1,759	1,915	43,466
Net change in federal agency obligations	-2,836	-1,375	-10,754	-7,377	-6,025	-2,389	-4,269	-2,659	-1,508	-600	-1,759	-1,915	-43,466
Mortgage-backed securities[3]													
Net settlements[2]													
Net change in mortgage-backed securities	-27,064	-16,145	-11,777	-10,134	-9,166	-9,002	-11,569	-12,340	-14,062	-21,622	-22,209	10,632	-154,458

(continued on next page)

Table 1.—*continued*

Type of security and transaction	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
Temporary transactions													
Repurchase agreements[4]													
Gross purchases	0	0	0	0	0	0	0	0	0	0	0	0	0
Gross sales	0	0	0	0	0	0	0	0	0	0	0	0	0
Reverse repurchase agreements[4]													
Gross purchases	1,149,923	1,121,253	1,375,612	1,199,626	1,184,367	1,393,194	1,331,469	2,050,172	1,992,384	1,600,224	1,849,913	1,841,898	18,090,035
Gross sales	1,151,355	1,119,280	1,380,281	1,201,149	1,185,025	1,406,222	1,330,845	2,085,031	1,971,962	1,598,526	1,860,456	1,848,830	18,138,962
Net change in temporary transactions	-1,431	1,973	-4,670	-1,523	-657	-13,029	624	-34,859	20,422	1,697	-10,543	-6,932	-48,928
Total net change in System Open Market Account	**75,621**	**83,148**	**85,183**	**60,216**	**93,208**	**63,851**	**3,104**	**-36,076**	**17,226**	**-22,504**	**-25,332**	**-6,576**	**391,069**

Note: Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

1 Transactions exclude changes in compensation for the effects of inflation on the principal of inflation-indexed securities. Transactions include the rollover of inflation compensation into new securities.

2 Excludes the effect of temporary transactions—repurchase agreements and reverse repurchase agreements.

3 Guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. Monthly net change in face value of the securities held, which is the remaining principal balance of the underlying mortgages.

4 Cash value of agreements, which are collateralized by U.S. Treasury securities, federal agency debt securities, and mortgage-backed securities.

Table 2. Federal Reserve Bank holdings of U.S. Treasury and federal agency securities, December 31, 2009–11
Millions of dollars

Description	December 31			Change	
	2011	2010	2009	2010 to 2011	2009 to 2010
U.S. Treasury securities					
Held outright[1]	**1,663,446**	**1,021,493**	**776,588**	**641,953**	**244,905**
By remaining maturity					
Bills					
1–90 days	18,423	18,423	18,423	0	0
91 days to 1 year	0	0	0	0	0
Notes and bonds					
1 year or less[2]	114,829	**70,449**	72,818	44,380	**-2,369**
More than 1 year through 5 years	649,698	439,594	326,874	210,104	112,720
More than 5 years through 10 years	649,913	333,955	213,720	315,958	120,235
More than 10 years	230,583	159,072	144,753	71,511	14,319
By type					
Bills	18,423	18,423	18,423	0	0
Notes	1,286,344	773,285	568,323	513,059	204,962
Bonds	358,679	229,786	189,843	128,893	39,943
Federal agency securities					
Held outright[1]	**103,994**	**147,460**	**159,879**	**-43,466**	**-12,419**
By remaining maturity					
Discount notes					
1–90 days	0	0	0	0	0
91 days to 1 year	0	0	0	0	0
Coupons					
1 year or less	27,211	43,466	24,642	-16,255	18,824
More than 1 year through 5 years	60,603	71,050	99,402	-10,447	-28,352
More than 5 years though 10 years	13,833	30,597	33,788	-16,764	-3,191
More than 10 years	2,347	2,347	2,047	0	300
By type					
Discount notes	0	0	0	0	0
Coupons	103,994	147,460	159,879	-43,466	-12,419
By issuer					
Federal Home Loan Mortgage Corporation	45,126	57,515	61,769	-12,389	-4,254
Federal National Mortgage Association	39,707	58,568	63,662	-18,861	-5,094
Federal Home Loan Banks	19,161	31,377	34,448	-12,216	-3,071
Mortgage-backed securities[3]					
Held outright[1]	**837,683**	**992,141**	**908,371**	**-154,458**	**83,770**
By remaining maturity					
1 year or less	0	0	0	0	0
More than 1 year through 5 years	13	24	12	-11	12
More than 5 years though 10 years	34	20	20	14	0
More than 10 years	837,636	992,097	908,340	-154,461	83,757
By issuer					
Federal Home Loan Mortgage Corporation	289,537	346,959	304,964	-57,422	41,995
Federal National Mortgage Association	460,910	547,545	513,398	-86,635	34,147
Government National Mortgage Association	87,237	97,637	90,010	-10,400	7,627
Temporary transactions					
Repurchase agreements[4]	**0**	**0**	**0**	**0**	**0**
Reverse repurchase agreements[4]	**99,900**	**59,703**	**77,732**	**40,197**	**-18,029**
Foreign official and international accounts	99,900	59,703	77,732	40,197	-18,029
Dealers	0	0	0	0	0

Note: Components may not sum to totals because of rounding.

[1] Excludes the effect of temporary transactions—repurchase agreements and reverse repurchase agreements.

[2] Amounts in bold are restatements due to changes in previously reported data.

[3] Guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae.

[4] Cash value of agreements, which are collateralized by U.S. Treasury securities, federal agency debt securities, and mortgage-backed securities.

Table 3. Federal Reserve Bank interest rates on loans to depository institutions, December 31, 2011
Percent

Reserve Bank	Primary credit	Secondary credit	Seasonal credit
All banks	0.75	1.25	0.30

Note: For details on rate changes over the course of 2011, see the section on discount rates in the chapter "Record of Policy Actions of the Board of Governors" on page 165. *Primary credit* is available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition in the judgment of the lending Federal Reserve Bank. *Secondary credit* is available in appropriate circumstances to depository institutions that do not qualify for primary credit. *Seasonal credit* is available to help relatively small depository institutions meet regular seasonal needs for funds that arise from a clear pattern of intra-yearly movements in their deposits and loans. The discount rate on seasonal credit takes into account rates charged by market sources of funds and is reestablished on the first business day of each two-week reserve maintenance period.

Table 4. Reserve requirements of depository institutions, December 31, 2011

Type of deposit	Requirements	
	Percentage of deposits	Effective date
Net transaction accounts[1]		
\$0 million–\$11.5 million[2]	0	12/29/2011
More than \$11.5 million–\$71.0 million[3]	3	12/29/2011
More than \$71.0 million	10	12/29/2011
Nonpersonal time deposits	0	12/27/1990
Eurocurrency liabilities	0	12/27/1990

Note: Required reserves must be held in the form of vault cash and, if vault cash is insufficient, also in the form of a deposit with a Federal Reserve Bank. An institution must hold that deposit directly with a Reserve Bank or with another institution in a pass-through relationship. Reserve requirements are imposed on commercial banks, savings banks, savings and loan associations, credit unions, U.S. branches and agencies of foreign banks, Edge corporations, and agreement corporations.

1 Total transaction accounts consist of demand deposits, automatic transfer service (ATS) accounts, NOW accounts, share draft accounts, telephone or preauthorized transfer accounts, ineligible acceptances, and affiliate-issued obligations maturing in seven days or less. Net transaction accounts are total transaction accounts less amounts due from other depository institutions and less cash items in the process of collection.

For a more detailed description of these deposit types, see Form FR 2900.

2 The amount of net transaction accounts subject to a reserve requirement ratio of 0 percent (the "exemption amount") is adjusted each year by statute. The exemption amount is adjusted upward by 80 percent of the previous year's (June 30 to June 30) rate of increase in total reservable liabilities at all depository institutions. No adjustment is made in the event of a decrease in such liabilities.

3 The amount of net transaction accounts subject to a reserve requirement ratio of 3 percent is the "low reserve tranche." By statute, the upper limit of the low reserve tranche is adjusted each year by 80 percent of the previous year's (June 30 to June 30) rate of increase or decrease in net transaction accounts held by all depository institutions.

Table 5. Banking offices and banks affiliated with bank holding companies in the United States, December 31, 2010 and 2011

Type of office	Total	Commercial banks[1]						State-chartered savings banks
		Total	Member			Nonmember		
			Total	National	State			
All banking offices								
Banks								
Number, Dec. 31, 2010	**6,821**	**6,505**	**2,193**	**1,368**	**825**	**4,312**		**316**
Changes during 2011								
New banks	19	15	6	3	3	9		4
Banks converted into branches	-152	-149	-58	-37	-21	-91		-3
Ceased banking operations[2]	-125	-107	-29	-16	-13	-78		-18
Other[3]	0	0	8	-19	27	-8		0
Net change	-258	-241	-73	-69	-4	-168		-17
Number, Dec. 31, 2011	**6,563**	**6,264**	**2,120**	**1,299**	**821**	**4,144**		**299**
Branches and additional offices								
Number, Dec. 31, 2010	**83,676**	**80,970**	**57,520**	**43,161**	**14,359**	**23,450**		**2,706**
Changes during 2011								
New branches	1,843	1,791	1,328	1,066	262	463		52
Banks converted to branches	152	150	70	37	33	80		2
Discontinued[2]	-1,592	-1,433	-980	-743	-237	-453		-159
Other[3]	0	77	273	152	121	-196		-77
Net change	403	585	691	512	179	-106		-182
Number, Dec. 31, 2011	**84,079**	**81,555**	**58,211**	**43,673**	**14,538**	**23,344**		**2,524**
Banks affiliated with bank holding companies								
Banks								
Number, Dec. 31, 2010	**5,518**	**5,396**	**1,929**	**1,199**	**730**	**3,467**		**122**
Changes during 2011								
BHC-affiliated new banks	42	36	10	5	5	26		6
Banks converted into branches	-136	-135	-56	-36	-20	-79		-1
Ceased banking operations[2]	-96	-95	-26	-15	-11	-69		-1
Other[3]	0	0	3	-17	20	-3		0
Net change	-190	-194	-69	-63	-6	-125		4
Number, Dec. 31, 2011	**5,328**	**5,202**	**1,860**	**1,136**	**724**	**3,342**		**126**

Note: Includes banks, banking offices, and bank holding companies in U.S. territories and possessions (affiliated insular areas).

1 For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act, as amended, which is implemented by Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is defined as an insured bank in section 3(h) of the FDIC Act.

2 Institutions that no longer meet the Regulation Y definition of a bank.

3 Interclass changes and sales of branches.

Table 6A. Reserves of depository institutions, Federal Reserve Bank credit, and related items, year-end 1984–2011 and month-end 2011

Millions of dollars

Period	Factors supplying reserve funds								
	Federal Reserve Bank credit outstanding						Gold stock	Special drawing rights certificate account	Treasury currency outstanding[4]
	Securities held outright[1]	Repurchase agreements[2]	Loans and other credit extensions[3]	Float	Other Federal Reserve assets	Total			
1984	167,612	2,015	3,577	833	12,347	186,384	11,096	4,618	16,418
1985	186,025	5,223	3,060	988	15,302	210,598	11,090	4,718	17,075
1986	205,454	16,005	1,565	1,261	17,475	241,760	11,084	5,018	17,567
1987	226,459	4,961	3,815	811	15,837	251,883	11,078	5,018	18,177
1988	240,628	6,861	2,170	1,286	18,803	269,748	11,060	5,018	18,799
1989	233,300	2,117	481	1,093	39,631	276,622	11,059	8,518	19,628
1990	241,431	18,354	190	2,222	39,897	302,091	11,058	10,018	20,402
1991	272,531	15,898	218	731	34,567	323,945	11,059	10,018	21,014
1992	300,423	8,094	675	3,253	30,020	342,464	11,056	8,018	21,447
1993	336,654	13,212	94	909	33,035	383,904	11,053	8,018	22,095
1994	368,156	10,590	223	-716	33,634	411,887	11,051	8,018	22,994
1995	380,831	13,862	135	107	33,303	428,239	11,050	10,168	24,003
1996	393,132	21,583	85	4,296	32,896	451,992	11,048	9,718	24,966
1997	431,420	23,840	2,035	719	31,452	489,466	11,047	9,200	25,543
1998	452,478	30,376	17	1,636	36,966	521,475	11,046	9,200	26,270
1999	478,144	140,640	233	-237	35,321	654,100	11,048	6,200	28,013
2000	511,833	43,375	110	901	36,467	592,686	11,046	2,200	31,643
2001	551,685	50,250	34	-23	37,658	639,604	11,045	2,200	33,017
2002	629,416	39,500	40	418	39,083	708,457	11,043	2,200	34,597
2003	666,665	43,750	62	-319	40,847	751,005	11,043	2,200	35,468
2004	717,819	33,000	43	925	42,219	794,007	11,045	2,200	36,434
2005	744,215	46,750	72	885	39,611	831,532	11,043	2,200	36,540
2006	778,915	40,750	67	-333	39,895	859,294	11,041	2,200	38,206
2007	740,611	46,500	72,636	-19	41,799	901,528	11,041	2,200	38,681
2008	495,629	80,000	1,605,848	-1,494	43,553	2,223,537	11,041	2,200	38,674
2009[r]	1,844,838	0	281,095	-2,097	92,811	2,216,647	11,041	5,200	42,691
2010[r]	2,161,094	0	138,311	-1,421	110,267	2,408,252	11,041	5,200	43,542
2011	2,605,124	0	144,098	-631	152,647	2,901,238	11,041	5,200	44,264
Jan	2,238,303	0	88,584	-1,408	116,138	2,441,616	11,041	5,200	43,697
Feb	2,319,840	0	86,310	-1,412	115,392	2,520,130	11,041	5,200	43,738
Mar	2,410,096	0	84,433	-1,380	120,020	2,613,169	11,041	5,200	43,790
Apr	2,472,316	0	83,351	-911	127,670	2,682,426	11,041	5,200	43,854
May	2,567,251	0	78,812	-1,232	125,999	2,770,829	11,041	5,200	43,888
Jun	2,645,095	0	74,267	-917	132,605	2,851,051	11,041	5,200	43,953
Jul	2,647,926	0	65,239	-855	136,675	2,848,986	11,041	5,200	43,995
Aug	2,646,834	0	62,147	-1,158	129,652	2,837,475	11,041	5,200	44,034
Sep	2,643,811	0	59,352	-769	131,340	2,833,735	11,041	5,200	44,082
Oct	2,619,746	0	54,009	-674	140,451	2,813,532	11,041	5,200	44,138
Nov	2,604,999	0	50,879	-1,004	142,221	2,797,095	11,041	5,200	44,194
Dec	2,605,124	0	144,098	-631	152,647	2,901,238	11,041	5,200	44,264

Note: Components may not sum to totals because of rounding.

1 Includes U.S. Treasury securities, federal agency debt securities, and mortgage-backed securities. U.S. Treasury securities and federal agency debt securities include securities lent to dealers, which are fully collateralized by U.S. Treasury securities, federal agency securities, and other highly rated debt securities.

2 Cash value of agreements, which are collateralized by U.S. Treasury securities, federal agency debt securities, and agency mortgage-backed securities.

3 Refer to "Table 6B. Loans and other credit extensions, by type, year-end 1984–2011 and month-end 2011" on page 318 for detail.

4 Includes currency and coin (other than gold) issued directly by the U.S. Treasury. The largest components are fractional and dollar coins. For details refer to "U.S. Currency and Coin Outstanding and in Circulation," *Treasury Bulletin*.

Table 6A.—*continued*

Period	Factors absorbing reserve funds										Reserve balances with Federal Reserve Banks
	Currency in circulation	Reverse repurchase agreements[5]	Treasury cash holdings[6]	Deposits with Federal Reserve Banks, other than reserve balances					Required clearing balances	Other Federal Reserve liabilities and capital[7]	
				Term deposits	Treasury general account	Treasury supplementary financing account	Foreign	Other			
1984	183,796	0	513	...	5,316	...	253	867	1,126	5,952	20,693
1985	197,488	0	550	...	9,351	...	480	1,041	1,490	5,940	27,141
1986	211,995	0	447	...	7,588	...	287	917	1,812	6,088	46,295
1987	230,205	0	454	...	5,313	...	244	1,027	1,687	7,129	40,097
1988	247,649	0	395	...	8,656	...	347	548	1,605	7,683	37,742
1989	260,456	0	450	...	6,217	...	589	1,298	1,618	8,486	36,713
1990	286,963	0	561	...	8,960	...	369	528	1,960	8,147	36,081
1991	307,756	0	636	...	17,697	...	968	1,869	3,946	8,113	25,051
1992	334,701	0	508	...	7,492	...	206	653	5,897	7,984	25,544
1993	365,271	0	377	...	14,809	...	386	636	6,332	9,292	27,967
1994	403,843	0	335	...	7,161	...	250	1,143	4,196	11,959	25,061
1995	424,244	0	270	...	5,979	...	386	2,113	5,167	12,342	22,960
1996	450,648	0	249	...	7,742	...	167	1,178	6,601	13,829	17,310
1997	482,327	0	225	...	5,444	...	457	1,171	6,684	15,500	23,447
1998	517,484	0	85	...	6,086	...	167	1,869	6,780	16,354	19,164
1999	628,359	0	109	...	28,402	...	71	1,644	7,481	17,256	16,039
2000	593,694	0	450	...	5,149	...	216	2,478	6,332	17,962	11,295
2001	643,301	0	425	...	6,645	...	61	1,356	8,525	17,083	8,469
2002	687,518	21,091	367	...	4,420	...	136	1,266	10,534	18,977	11,988
2003	724,187	25,652	321	...	5,723	...	162	995	11,829	19,793	11,054
2004	754,877	30,783	270	...	5,912	...	80	1,285	9,963	26,378	14,137
2005	794,014	30,505	202	...	4,573	...	83	2,144	8,651	30,466	10,678
2006	820,176	29,615	252	...	4,708	...	98	972	6,842	36,231	11,847
2007	828,938	43,985	259	...	16,120	...	96	1,830	6,614	41,622	13,986
2008	889,898	88,352	259	...	106,123	259,325	1,365	21,221	4,387	48,921	855,599
2009[r]	928,249	77,732	239	...	186,632	5,001	2,411	35,262	3,020	63,219	973,814
2010[r]	982,750	59,703	177	0	140,773	199,964	3,337	13,631	2,374	99,602	965,724
2011	1,075,886	99,900	128	0	85,737	0	125	64,909	2,485	72,766	1,559,805
Jan	977,661	61,134	176	0	147,189	199,963	117	481	2,352	71,365	1,041,116
Feb	997,006	59,161	185	5,070	88,632	99,980	125	473	2,320	73,761	1,253,396
Mar	1,005,315	62,171	209	0	111,203	5,000	123	10,329	2,511	71,870	1,404,470
Apr	1,013,395	59,533	163	5,081	99,447	5,000	134	2,510	2,546	76,114	1,478,598
May	1,025,110	60,191	144	0	112,645	5,000	646	335	2,544	74,836	1,549,509
Jun	1,028,953	70,309	147	0	130,130	5,000	360	7,431	2,533	72,976	1,593,405
Jul	1,030,498	69,685	113	5,088	65,172	0	138	54,657	2,490	69,421	1,611,959
Aug	1,037,767	104,544	126	0	42,481	0	2,675	47,654	2,475	70,570	1,589,458
Sep	1,037,564	84,123	124	5,077	56,284	0	2,627	44,953	2,514	70,799	1,589,993
Oct	1,046,036	82,425	124	0	97,285	0	126	40,026	2,507	68,493	1,536,888
Nov	1,062,291	92,968	108	5,055	85,605	0	165	52,831	2,503	71,214	1,484,789
Dec	1,075,886	99,900	128	0	85,737	0	125	64,909	2,485	72,766	1,559,805

[5] Cash value of agreements, which are collateralized by U.S. Treasury securities, federal agency debt securities, and agency mortgage-backed securities.

[6] Coin and paper currency held by the Treasury.

[7] In 2010, includes funds from American International Group, Inc. asset dispositions, held as agent.

...Not applicable.

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Table 6B. Loans and other credit extensions, by type, year-end 1984–2011 and month-end 2011

Millions of dollars

Period	Total loans and other credit extensions	Term auction credit	Other loans					Net portfolio holdings of						Preferred interests in AIA/ALICO LLCs[10]	Central bank liquidity swaps[11]
			Primary, secondary, and seasonal credit[1]	Primary dealer and other broker-dealer credit[2]	AMLF[3]	TALF[4]	AIG[5]	CPFF LLC[6]	MMIFF LLC[7]	Maiden Lane LLC[8]	Maiden Lane II LLC[8]	Maiden Lane III LLC[8]	TALF LLC[9]		
1984	3,577	…	3,577	…	…	…	…	…	…	…	…	…	…	…	…
1985	3,060	…	3,060	…	…	…	…	…	…	…	…	…	…	…	…
1986	1,565	…	1,565	…	…	…	…	…	…	…	…	…	…	…	…
1987	3,815	…	3,815	…	…	…	…	…	…	…	…	…	…	…	…
1988	2,170	…	2,170	…	…	…	…	…	…	…	…	…	…	…	…
1989	481	…	481	…	…	…	…	…	…	…	…	…	…	…	…
1990	190	…	190	…	…	…	…	…	…	…	…	…	…	…	…
1991	218	…	218	…	…	…	…	…	…	…	…	…	…	…	…
1992	675	…	675	…	…	…	…	…	…	…	…	…	…	…	…
1993	94	…	94	…	…	…	…	…	…	…	…	…	…	…	…
1994	223	…	223	…	…	…	…	…	…	…	…	…	…	…	…
1995	135	…	135	…	…	…	…	…	…	…	…	…	…	…	…
1996	85	…	85	…	…	…	…	…	…	…	…	…	…	…	…
1997	2,035	…	2,035	…	…	…	…	…	…	…	…	…	…	…	…
1998	17	…	17	…	…	…	…	…	…	…	…	…	…	…	…
1999	233	…	233	…	…	…	…	…	…	…	…	…	…	…	…
2000	110	…	110	…	…	…	…	…	…	…	…	…	…	…	…
2001	34	…	34	…	…	…	…	…	…	…	…	…	…	…	…
2002	40	…	40	…	…	…	…	…	…	…	…	…	…	…	…
2003	62	…	62	…	…	…	…	…	…	…	…	…	…	…	…
2004	43	…	43	…	…	…	…	…	…	…	…	…	…	…	…
2005	72	…	72	…	…	…	…	…	…	…	…	…	…	…	…
2006	67	…	67	…	…	…	…	…	…	…	…	…	…	…	…
2007	72,636	40,000	8,636	…	…	…	…	…	…	…	…	…	…	…	24,000
2008	1,605,848	450,219	93,791	37,404	23,765	…	38,914	334,102	0	27,023	20,117	26,785	…	…	553,728
2009	281,095	75,918	20,700	0	0	47,532	22,184	14,064	…	26,701	15,659	22,661	298	25,106	10,272
2010	138,311	0	221	…	…	24,703	19,953	…	…	26,967	16,198	23,143	665	26,385	75
2011	144,098	0	196	…	…	9,013	…	…	…	7,232	9,280	17,744	811	…	99,823
Jan	88,584	0	50	…	…	22,898	…	…	…	26,431	16,004	22,444	686	…	70
Feb	86,310	0	81	…	…	20,488	…	…	…	26,056	16,086	22,826	703	…	70
Mar	84,433	0	58	…	…	19,208	…	…	…	25,579	15,941	22,928	718	…	0
Apr	83,351	0	27	…	…	16,713	…	…	…	24,767	16,543	24,568	733	…	0
May	78,812	0	117	…	…	14,033	…	…	…	24,519	15,011	24,386	746	…	0
Jun	74,267	0	120	…	…	12,755	…	…	…	23,852	12,538	24,245	757	…	0
Jul	65,239	0	80	…	…	11,881	…	…	…	20,823	10,226	21,462	767	…	0
Aug	62,147	0	111	…	…	11,595	…	…	…	18,230	10,109	21,327	775	…	0
Sep	59,352	0	110	…	…	11,303	…	…	…	15,482	9,999	21,173	785	…	500
Oct	54,009	0	67	…	…	10,856	…	…	…	12,944	9,474	18,020	794	…	1,853
Nov	50,879	0	130	…	…	9,691	…	…	…	10,629	9,379	17,845	803	…	2,401
Dec	144,098	0	196	…	…	9,013	…	…	…	7,232	9,280	17,744	811	…	99,823

Note: Components may not sum to totals because of rounding.

1 Prior to 2003, category was "Adjustment, extended, and seasonal credit."

2 Includes credit extended through the Primary Dealer Credit Facility (PDCF) and credit extended to certain other broker-dealers. The PDCF was dissolved in February 2010.

3 Includes credit extended through the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF). The AMLF was dissolved in February 2010.

4 Includes credit extended by the Federal Reserve Bank of New York (FRBNY) to eligible borrowers through the Term Asset-Backed Securities Loan Facility (TALF), net of unamortized deferred administrative fees. The TALF was discontinued in June 2010.

5 Credit extended to American International Group, Inc. (AIG) includes outstanding principal and capitalized interest net of unamortized deferred commitment fees and allowance for loan restructuring. Excludes credit extended to consolidated LLCs. Upon the closing of the AIG recapitalization plan in January 2011, the credit extended to AIG by the FRBNY under the revolving credit facility was repaid in full.

6 Net portfolio holdings of Commercial Paper Funding Facility (CPFF) LLC. The CPFF was discontinued in February 2010.

7 Net portfolio holdings of Money Market Investor Funding Facility (MMIFF) LLC. The MMIFF was discontinued in October 2009.

8 Net portfolio holdings at fair value.

9 Net portfolio holdings of TALF LLC, a limited liability company formed to purchase and manage any asset-backed securities that might be surrendered by a TALF borrower or otherwise claimed by the FRBNY in connection with its enforcement rights to the TALF collateral.

10 Preferred interests in AIA Aurora LLC and ALICO Holdings LLC at book value. After the closing of the AIG recapitalization plan, the Federal Reserve was paid in full for its preferred interests in the special purpose vehicles AIA Aurora LLC and ALICO Holdings LLC.

11 Dollar value of foreign currency held under these agreements valued at the exchange rate to be used when the foreign currency is returned to the foreign central bank. This exchange rate equals the market exchange rate used when the foreign currency was acquired from the foreign central bank.

…Not applicable.

Table 6C. Reserves of depository institutions, Federal Reserve Bank credit, and related items, year-end 1918–1983
Millions of dollars

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
1918	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922	436	0	618	78	273	0	1,405	3,642	...	1,958
1923	80	54	723	27	355	0	1,238	3,957	...	2,009
1924	536	4	320	52	390	0	1,302	4,212	...	2,025
1925	367	8	643	63	378	0	1,459	4,112	...	1,977
1926	312	3	637	45	384	0	1,381	4,205	...	1,991
1927	560	57	582	63	393	0	1,655	4,092	...	2,006
1928	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929	488	23	632	34	405	0	1,583	3,997	...	2,022
1930	686	43	251	21	372	0	1,373	4,306	...	2,027
1931	775	42	638	20	378	0	1,853	4,173	...	2,035
1932	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945	24,262	0	249	578	2	0	25,091	20,065	...	4,339
1946	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949	18,885	0	78	534	2	0	19,499	24,427	...	4,598
1950	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311
1960	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961	28,722	159	130	2,300	51	0	31,362	16,889	...	5,585
1962	30,478	342	38	2,903	110	0	33,871	15,978	...	5,567
1963	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405
1965	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969	57,154	0	183	3,440	64	2,743	63,584	10,367	...	6,852
1970	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147

(continued on next page)

Table 6C.—*continued*

Period	Factors supplying reserve funds									
	Federal Reserve Bank credit outstanding							Gold stock[6]	Special drawing rights certificate account	Treasury currency outstanding[7]
	Securities held outright[1]	Repurchase agreements[2]	Loans	Float[3]	All other[4]	Other Federal Reserve assets[5]	Total			
1971	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982	144,544	4,293	717	2,735	1,480	9,890	163,659	11,148	4,618	13,786
1983	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732

Note: For a description of figures and discussion of their significance, see *Banking and Monetary Statistics*, 1941–1970 (Board of Governors of the Federal Reserve System, 1976), pp. 507–23. Components may not sum to totals because of rounding.

1 In 1969 and thereafter, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions. On September 29, 1971, and thereafter, includes federal agency issues bought outright.

2 On December 1, 1966, and thereafter, includes federal agency obligations held under repurchase agreements.

3 In 1960 and thereafter, figures reflect a minor change in concept; refer to *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4 Principally acceptances and, until August 21, 1959, industrial loans, the authority for which expired on that date.

5 For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as "Other Federal Reserve accounts;" thereafter, "Other Federal Reserve assets'' and "Other Federal Reserve liabilities and capital'' are shown separately.

6 Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7 Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details refer to "U.S. Currency and Coin Outstanding and in Circulation,'' *Treasury Bulletin*.

Table 6C. Reserves of depository institutions, Federal Reserve Bank credit, and related items, year-end 1918–1983—*continued*
Millions of dollars

Period	Factors absorbing reserve funds								Member bank reserves[9]			
	Currency in circulation	Treasury cash holdings[8]	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11,12]
			Treasury	Foreign	Other							
1918	4,951	288	51	96	25	118	0	0	1,636	…	1,585	51
1919	5,091	385	31	73	28	208	0	0	1,890	…	1,822	68
1920	5,325	218	57	5	18	298	0	0	1,781	…	…	…
1921	4,403	214	96	12	15	285	0	0	1,753	…	1,654	99
1922	4,530	225	11	3	26	276	0	0	1,934	…	…	…
1923	4,757	213	38	4	19	275	0	0	1,898	…	1,884	14
1924	4,760	211	51	19	20	258	0	0	2,220	…	2,161	59
1925	4,817	203	16	8	21	272	0	0	2,212	…	2,256	-44
1926	4,808	201	17	46	19	293	0	0	2,194	…	2,250	-56
1927	4,716	208	18	5	21	301	0	0	2,487	…	2,424	63
1928	4,686	202	23	6	21	348	0	0	2,389	…	2,430	-41
1929	4,578	216	29	6	24	393	0	0	2,355	…	2,428	-73
1930	4,603	211	19	6	22	375	0	0	2,471	…	2,375	96
1931	5,360	222	54	79	31	354	0	0	1,961	…	1,994	-33
1932	5,388	272	8	19	24	355	0	0	2,509	…	1,933	576
1933	5,519	284	3	4	128	360	0	0	2,729	…	1,870	859
1934	5,536	3,029	121	20	169	241	0	0	4,096	…	2,282	1,814
1935	5,882	2,566	544	29	226	253	0	0	5,587	…	2,743	2,844
1936	6,543	2,376	244	99	160	261	0	0	6,606	…	4,622	1,984
1937	6,550	3,619	142	172	235	263	0	0	7,027	…	5,815	1,212
1938	6,856	2,706	923	199	242	260	0	0	8,724	…	5,519	3,205
1939	7,598	2,409	634	397	256	251	0	0	11,653	…	6,444	5,209
1940	8,732	2,213	368	1,133	599	284	0	0	14,026	…	7,411	6,615
1941	11,160	2,215	867	774	586	291	0	0	12,450	…	9,365	3,085
1942	15,410	2,193	799	793	485	256	0	0	13,117	…	11,129	1,988
1943	20,449	2,303	579	1,360	356	339	0	0	12,886	…	11,650	1,236
1944	25,307	2,375	440	1,204	394	402	0	0	14,373	…	12,748	1,625
1945	28,515	2,287	977	862	446	495	0	0	15,915	…	14,457	1,458
1946	28,952	2,272	393	508	314	607	0	0	16,139	…	15,577	562
1947	28,868	1,336	870	392	569	563	0	0	17,899	…	16,400	1,499
1948	28,224	1,325	1123	642	547	590	0	0	20,479	…	19,277	1,202
1949	27,600	1,312	821	767	750	706	0	0	16,568	…	15,550	1,018
1950	27,741	1,293	668	895	565	714	0	0	17,681	…	16,509	1,172
1951	29,206	1,270	247	526	363	746	0	0	20,056	…	19,667	389
1952	30,433	1,270	389	550	455	777	0	0	19,950	…	20,520	-570
1953	30,781	761	346	423	493	839	0	0	20,160	…	19,397	763
1954	30,509	796	563	490	441	907	0	0	18,876	…	18,618	258
1955	31,158	767	394	402	554	925	0	0	19,005	…	18,903	102
1956	31,790	775	441	322	426	901	0	0	19,059	…	19,089	-30
1957	31,834	761	481	356	246	998	0	0	19,034	…	19,091	-57
1958	32,193	683	358	272	391	1,122	0	0	18,504	…	18,574	-70
1959	32,591	391	504	345	694	841	0	0	18,174	310	18,619	-135
1960	32,869	377	485	217	533	941	0	0	17,081	2,544	18,988	637
1961	33,918	422	465	279	320	1,044	0	0	17,387	2,823	20,114	96
1962	35,338	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
1963	37,692	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
1964	39,619	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574
1965	42,056	760	668	150	355	211	0	0	18,447	4,163	22,848	-238
1966	44,663	1,176	416	174	588	-147	0	0	19,779	4,310	24,321	-232
1967	47,226	1,344	1,123	135	653	-773	0	0	21,092	4,631	25,905	-182
1968	50,961	695	703	216	747	-1,353	0	0	21,818	4,921	27,439	-700
1969	53,950	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	-901

(continued on next page)

Table 6C.—*continued*

Period	Factors absorbing reserve funds								Member bank reserves[9]			
	Currency in circulation	Treasury cash holdings[8]	Deposits with Federal Reserve Banks, other than reserve balances			Other Federal Reserve accounts[5]	Required clearing balances	Other Federal Reserve liabilities and capital[5]	With Federal Reserve Banks	Currency and coin[10]	Required[11]	Excess[11,12]
			Treasury	Foreign	Other							
1970	57,093	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	-460
1971	61,068	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
1972	66,516	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98
1973	72,497	317	2,542	251	1,149[13]	0	0	2,669	27,060	6,781	35,268	-1,360
1974	79,743	185	3,113	418	1,275[13]	0	0	2,935	25,843	7,370	37,011	-3,798
1975	86,547	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	-1,103[14]
1976	93,717	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	-1,535
1977	103,811	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	-1,265
1978	114,645	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	-893
1979	125,600	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	-2,835
1980	136,829	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
1981	144,774	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	-1,442
1982	154,908	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
1983	171,935	479	3,661	191	851	0	1013	5,392	20,413	17,821	39,179	-945

8 Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9 In November 1979 and thereafter, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. On November 13, 1980, and thereafter, includes reserves of all depository institutions.

10 Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter, all was allowed.

11 Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Since September 12, 1968, the amount has been based on close-of-business figures for the reserve period two weeks before the report date.

12 For the week ending November 15, 1972, and thereafter, includes $450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, $279; Q2, $172; Q3, $112; Q4, $84; 1974—Q1, $67; Q2, $58. The transition period ended with the second quarter of 1974.

13 For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint. As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves is no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14 Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy, effective November 19, 1975.

. . .Not applicable.

Table 7. Principal assets and liabilities of insured commercial banks, by class of bank, June 30, 2011 and 2010

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
2011					
Assets					
Loans and investments	8,431,588	6,805,939	5,573,006	1,232,932	1,625,649
Loans, gross	6,038,565	4,786,100	3,957,080	829,020	1,252,465
Net	6,036,503	4,785,022	3,956,264	828,759	1,251,481
Investments	2,393,023	2,019,839	1,615,926	403,913	373,184
U.S. Treasury and federal agency securities	379,648	288,725	220,571	68,153	90,923
Other	2,013,375	1,731,114	1,395,355	335,759	282,261
Cash assets, total	972,635	831,788	624,444	207,344	140,847
Liabilities					
Deposits, total	7,259,832	5,799,843	4,704,505	1,095,338	1,459,989
Interbank	126,612	103,494	83,765	19,729	23,118
Other transactions	1,022,402	805,413	598,686	206,728	216,989
Other nontransactions	6,110,817	4,890,936	4,022,054	868,882	1,219,881
Equity capital	1,382,502	1,156,734	947,848	208,887	225,768
Number of banks	6,384	2,155	1,347	808	4,229
2010					
Assets					
Loans and investments	8,371,801	6,787,197	5,624,413	1,162,784	1,584,605
Loans, gross	6,165,112	4,915,308	4,094,863	820,445	1,249,804
Net	6,164,923	4,915,121	4,094,732	820,390	1,249,802
Investments	2,206,689	1,871,888	1,529,550	342,338	334,801
U.S. Treasury and federal agency securities	401,552	304,475	251,340	53,135	97,077
Other	1,805,138	1,567,413	1,278,210	289,204	237,724
Cash assets, total	758,748	605,277	470,459	134,818	153,470
Liabilities					
Deposits, total	6,715,615	5,284,410	4,304,167	980,243	1,431,205
Interbank	104,002	81,377	64,552	16,825	22,625
Other transactions	805,822	609,825	470,208	139,616	195,997
Other nontransactions	5,805,791	4,593,208	3,769,406	823,802	1,212,583
Equity capital	1,336,929	1,128,279	929,954	198,326	208,650
Number of banks	6,649	2,248	1,425	823	4,401

Note: Includes U.S.-insured commercial banks located in the United States but not U.S.-insured commercial banks operating in U.S. territories or possessions. Data are domestic assets and liabilities (except for those components reported on a consolidated basis only). Components may not sum to totals because of rounding. Data for 2010 have been revised.

Table 8. Initial margin requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only[1]
1934, Oct. 1	25–45	…	…
1936, Feb. 1	25–55	…	…
1936, Apr. 1	55	…	…
1937, Nov. 1	40	…	50
1945, Feb. 5	50	…	50
1945, July 5	75	…	75
1946, Jan. 21	100	…	100
1947, Feb. 1	75	…	75
1949, Mar. 3	50	…	50
1951, Jan. 17	75	…	75
1953, Feb. 20	50	…	50
1955, Jan. 4	60	…	60
1955, Apr. 23	70	…	70
1958, Jan. 16	50	…	50
1958, Aug. 5	70	…	70
1958, Oct. 16	90	…	90
1960, July 28	70	…	70
1962, July 10	50	…	50
1963, Nov. 6	70	…	70
1968, Mar. 11	70	50	70
1968, June 8	80	60	80
1970, May 6	65	50	65
1971, Dec. 6	55	50	55
1972, Nov. 24	65	50	65
1974, Jan. 3	50	50	50

Note: These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit that may be extended for the purpose of purchasing or carrying margin securities (as defined in the regulations) when the loan is collateralized by such securities. The margin requirement, expressed as a percentage, is the difference between the market value of the securities being purchased or carried (100 percent) and the maximum loan value of the collateral as prescribed by the Board. Regulation T was adopted effective October 1, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged into Regulation U, effective April 1, 1998.

1 From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

…Not applicable.

Table 9A. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2011 and 2010
Millions of dollars

Item	Total		Boston		New York		Philadelphia		Cleveland		Richmond	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
Assets												
Gold certificate account	11,037	11,037	390	369	3,866	4,038	432	404	450	463	872	846
Special drawing rights certificate account	5,200	5,200	196	196	1,818	1,818	210	210	237	237	412	412
Coin	2,306	2,180	53	47	80	71	160	172	174	164	409	354
Loans and securities												
Primary, secondary, and seasonal loans	196	221	2	1	9	36	0	0	0	0	5	61
Term Asset-Backed Securities Loan Facility[1]	9,022	24,732	…	…	9,022	24,732	…	…	…	…	…	…
Credit extended to American International Group, Inc., net[2]	…	20,603	…	…	…	20,603	…	…	…	…	…	…
Treasury securities, bought outright[3]	1,663,446	1,021,493	40,898	25,851	773,574	416,823	56,983	23,855	44,933	34,706	192,111	116,337
Government-sponsored enterprise debt securities, bought outright[3]	103,994	147,460	2,557	3,732	48,362	60,171	3,562	3,444	2,809	5,010	12,010	16,794
Federal agency and government-sponsored enterprise mortgage-backed securities, bought outright	837,683	992,141	20,596	25,108	389,559	404,846	28,696	23,169	22,628	33,709	96,744	112,994
Total loans and securities	2,614,341	2,206,650	64,053	54,691	1,220,525	927,212	89,241	50,468	70,370	73,425	300,870	246,186
Net portfolio holdings of consolidated variable interest entities[4]	35,693	68,666	…	…	35,693	68,666	…	…	…	…	…	…
Preferred interests[5]	…	26,385	…	…	…	26,385	…	…	…	…	…	…
Foreign currency denominated assets[6]	25,950	26,049	897	959	7,516	7,560	2,514	2,847	1,925	1,941	5,321	7,253
Central bank liquidity swaps[7]	99,823	75	3,450	3	28,912	22	9,669	8	7,405	6	20,469	21
Other assets												
Items in process of collection	363	510	11	10	0	0	53	74	59	89	4	8
Bank premises	2,185	2,228	122	126	261	258	67	69	125	140	233	240
All other assets[8]	124,440	81,910	3,085	2,096	57,681	33,400	4,276	1,933	3,372	2,784	14,437	9,372
Interdistrict settlement account	0	0	35,147	4,414	274,474	225,756	-28,084	12,749	-4,966	-15,854	-123,650	-62,496
Total assets	**2,921,337**	**2,430,890**	**107,403**	**62,912**	**1,630,826**	**1,295,186**	**78,539**	**68,932**	**79,150**	**63,395**	**219,377**	**202,195**
Liabilities												
Federal Reserve notes outstanding	1,205,888	1,121,643	44,207	41,012	427,406	383,595	45,940	45,360	54,131	45,905	94,381	89,693
Less: Notes held by Federal Reserve Bank	171,836	180,082	4,275	4,714	50,541	64,698	6,177	4,826	9,085	7,304	10,670	12,999
Federal Reserve notes outstanding, net	1,034,052	941,561	39,932	36,297	376,865	318,897	39,763	40,533	45,046	38,601	83,711	76,694
Securities sold under agreements to repurchase[9]	99,900	59,703	2,456	1,511	46,458	24,362	3,422	1,394	2,699	2,028	11,537	6,800
Deposits												
Depository institutions	1,562,253	968,052	62,799	22,935	1,024,868	536,589	30,250	21,083	26,962	18,152	111,913	105,026
Treasury, general account	85,737	140,773	…	…	85,737	140,773	…	…	…	…	…	…

(continued on next page)

Table 9A.—*continued*

Item	Total		Boston		New York		Philadelphia		Cleveland		Richmond	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
Treasury, supplementary financing account[10]	0	199,964	…	…	0	199,964	…	…	…	…	…	…
Foreign, official accounts	125	3,337	1	1	97	3,308	4	4	3	3	8	11
Other[11]	64,909	13,630	27	5	64,754	13,461	4	1	0	1	81	63
Total deposits	1,713,023	1,325,756	62,827	22,942	1,175,456	894,095	30,257	21,088	26,965	18,156	112,002	105,101
Other liabilities												
Funds from American International Group, Inc. asset disposition, held as agent[12]	…	26,896	…	…	…	26,896	…	…	…	…	…	…
Interest on Federal Reserve notes due to U.S. Treasury[13]	900	5,124	51	90	-378	1,877	78	334	81	26	240	2,041
Deferred credit items	994	1,931	58	71	3	10	109	271	142	410	19	74
Consolidated variable interest entities[14]	10,535	10,972	…	…	10,535	10,972	…	…	…	…	…	…
All other liabilities[15]	8,134	5,899	193	168	4,533	2,712	243	173	240	239	739	608
Total liabilities	**2,867,539**	**2,377,842**	**105,517**	**61,079**	**1,613,472**	**1,279,822**	**73,872**	**63,794**	**75,173**	**59,460**	**208,249**	**191,318**
Capital accounts												
Capital paid in	26,899	26,524	943	917	8,677	7,682	2,333	2,569	1,989	1,968	5,564	5,439
Surplus (including accumulated other comprehensive loss)	26,899	26,524	943	917	8,677	7,682	2,333	2,569	1,989	1,968	5,564	5,439
Total liabilities and capital accounts	**2,921,337**	**2,430,890**	**107,403**	**62,912**	**1,630,826**	**1,295,186**	**78,539**	**68,932**	**79,150**	**63,395**	**219,377**	**202,195**

Note: Components may not sum to totals because of rounding.

1 Includes remaining principal balance. Term Asset-Backed Securities Loan Facility (TALF) loans are recorded at fair value, and the fair value adjustment as of December 31 is reported in "All other assets."

2 Includes outstanding principal and capitalized interest net of unamortized deferred commitment fees and allowance for loan restructuring. Excludes credit extended to Maiden Lane II LLC and Maiden Lane III LLC. On September 30, 2010, American International Group, Inc. (AIG) announced an agreement with the U.S. Department of the Treasury, the Federal Reserve Bank of New York (FRBNY), and the trustees of the AIG Credit Facility Trust on a recapitalization plan designed to accelerate repayment of its obligations to American taxpayers. The plan resulted in the full repayment and termination of the Reserve Bank's AIG credit facility.

3 Includes securities loaned—fully collateralized by U.S. Treasury securities, other investment-grade securities, and collateral eligible for tri-party repurchase agreements pledged with Federal Reserve Banks.

4 The FRBNY is the primary beneficiary of TALF LLC, Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC and, as a result, the accounts and results of operations of these entities are included in the combined financial statements of the Federal Reserve Banks. For additional details, see "Table 6. Key financial data for consolidated limited liability companies" on page 147.

5 In March 2009, the FRBNY received preferred interests in two special purpose vehicles, AIA Aurora LLC and ALICO Holdings LLC, in exchange for the reduction of the outstanding balance of revolving credit provided to AIG. The preferred interests are recorded at cost. As a result of the closing of the AIG recapitalization plan on January 14, 2011, AIG paid the FRBNY in full for its preferred interests in AIA LLC and ALICO LLC, including accrued dividends.

6 Valued daily at market exchange rates.

7 Dollar value of foreign currency held under these agreements valued at the exchange rate to be used when the foreign currency is returned to the foreign central bank. This exchange rate equals the market exchange rate used when the foreign currency was acquired from the foreign central bank.

8 Includes premiums on securities, accrued interest, the fair value adjustment for TALF loans, and depository institution overdrafts.

9 Contract amount of agreements.

10 Represents amounts deposited by the U.S. Treasury that result from a temporary supplementary program that offsets, in part, the reserve impact of the Reserve Banks' lending and liquidity initiatives.

11 Includes deposits of government-sponsored enterprises, the Consumer Financial Protection Bureau, and international organizations. These deposits are primarily held by the FRBNY.

12 Pending the closing of the recapitalization plan announced by AIG on September 30, 2010, the cash proceeds from the disposition of certain AIG assets were held by the FRBNY as agent. At the closing of the recapitalization plan, which occurred January 14, 2011, the proceeds were used first to repay in full the credit extended to AIG by the FRBNY under the revolving credit facility and then to redeem a portion of the FRBNY's preferred interests in ALICO Holdings LLC (preferred interests).

13 Represents the estimated weekly remittances to U.S. Treasury as interest on Federal Reserve notes or, in those cases where the Reserve Bank's net earnings are not sufficient to equate surplus to capital paid-in, the deferred asset for interest on Federal Reserve notes. The amounts on this line are calculated in accordance with Board of Governors policy, which requires the Federal Reserve Banks to remit residual earnings to the U.S. Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and the amount necessary to equate surplus with capital paid-in.

14 The other beneficial interest holder related to the TALF LLC is the U.S. Treasury; to Maiden Lane LLC, it is JPMorgan Chase; and to Maiden Lane II and Maiden Lane III LLCs, it is AIG.

15 Includes discounts on securities, accrued benefit costs.

…Not applicable.

Table 9A. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2011 and 2010—*continued*
Millions of dollars

Item	Atlanta		Chicago		St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
Assets														
Gold certificate account	1,394	1,385	854	887	319	324	197	203	318	296	728	652	1,217	1,170
Special drawing rights certificate account	654	654	424	424	150	150	90	90	153	153	282	282	574	574
Coin	205	188	332	336	35	35	60	60	176	161	241	239	381	353
Loans and securities														
Primary, secondary, and seasonal loans	0	14	17	79	0	2	5	8	11	7	132	0	15	14
Term Asset-Backed Securities Loan Facility[1]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
Credit extended to American International Group, Inc., net[2]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
Treasury securities, bought outright[3]	123,665	96,661	98,785	77,007	31,484	26,312	25,565	13,984	44,249	35,041	65,789	42,893	165,411	112,023
Government-sponsored enterprise debt securities, bought outright[3]	7,731	13,954	6,176	11,116	1,968	3,798	1,598	2,019	2,766	5,058	4,113	6,192	10,341	16,171
Federal agency and government-sponsored enterprise mortgage-backed securities, bought outright	62,276	93,884	49,746	74,794	15,855	25,556	12,874	13,582	22,283	34,034	33,130	41,660	83,298	108,804
Total loans and securities	193,672	204,513	154,723	162,996	49,307	55,668	40,041	29,593	69,309	74,141	103,165	90,745	259,065	237,013
Net portfolio holdings of consolidated variable interest entities[4]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
Preferred interests[5]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
Foreign currency denominated assets[6]	1,487	1,606	657	629	211	244	802	723	234	213	393	358	3,993	1,714
Central bank liquidity swaps[7]	5,720	5	2,529	2	814	1	3,083	2	899	1	1,512	1	15,361	5
Other assets														
Items in process of collection	31	149	19	40	5	12	15	69	6	16	17	21	143	22
Bank premises	214	218	206	209	134	136	105	107	259	265	245	247	213	214
All other assets[8]	9,275	7,741	7,376	6,134	2,385	2,126	1,945	1,143	3,318	2,805	4,939	3,447	12,350	8,930
Interdistrict settlement account	-44,538	-48,131	-5,416	-31,780	-8,856	-18,011	-19,268	-8,382	-17,589	-14,671	1,679	-3,007	-58,932	-40,587
Total assets	**168,114**	**168,328**	**161,706**	**139,878**	**44,504**	**40,685**	**27,070**	**23,607**	**57,081**	**63,379**	**113,201**	**92,985**	**234,366**	**209,407**
Liabilities														
Federal Reserve notes outstanding	145,803	142,659	88,894	86,072	33,916	32,240	20,976	19,855	34,479	33,041	80,188	76,154	135,566	126,059
Less: Notes held by Federal Reserve Bank	29,109	20,851	11,962	12,147	4,018	4,381	5,087	5,781	3,418	3,560	11,931	11,980	25,563	26,839
Federal Reserve notes outstanding, net	116,694	121,807	76,932	73,925	29,899	27,858	15,889	14,074	31,061	29,481	68,258	64,174	110,003	99,219
Securities sold under agreements to repurchase[9]	7,427	5,650	5,933	4,501	1,891	1,538	1,535	817	2,657	2,048	3,951	2,507	9,934	6,547
Deposits														
Depository institutions	40,223	37,040	76,732	59,416	12,012	10,492	9,046	6,657	22,542	31,063	39,705	25,112	105,201	94,486
Treasury, general account	…	…	…	…	…	…	…	…	…	…	…	…	…	…

(continued on next page)

Table 9A.—*continued*

Item	Atlanta		Chicago		St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011	2010
Treasury, supplementary financing account[10]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
Foreign, official accounts	2	2	1	1	0	0	1	1	0	0	1	1	6	3
Other[11]	2	2	35	26	0	56	0	3	4	4	1	0	1	8
Total deposits	40,227	37,044	76,767	59,443	12,013	10,548	9,048	6,662	22,546	31,067	39,707	25,113	105,208	94,497
Other liabilities														
Funds from American International Group, Inc. asset disposition, held as agent[12]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
Interest on Federal Reserve notes due to U.S. Treasury[13]	171	248	170	118	53	69	34	37	63	56	88	69	248	158
Deferred credit items	57	98	56	151	36	67	194	263	38	81	45	73	237	361
Consolidated variable interest entities[14]	…	…	…	…	…	…	…	…	…	…	…	…	…	…
All other liabilities[15]	462	440	413	395	173	173	149	116	182	169	290	245	516	461
Total liabilities	**165,037**	**165,288**	**160,271**	**138,534**	**44,064**	**40,253**	**26,851**	**21,969**	**56,546**	**62,902**	**112,339**	**92,181**	**226,147**	**201,244**
Capital accounts														
Capital paid in	1,538	1,520	718	672	220	216	110	819	268	239	431	402	4,109	4,082
Surplus (including accumulated other comprehensive loss)	1,538	1,520	718	672	220	216	110	819	268	239	431	402	4,109	4,082
Total liabilities and capital accounts	**168,114**	**168,328**	**161,706**	**139,878**	**44,504**	**40,685**	**27,070**	**23,607**	**57,081**	**63,379**	**113,201**	**92,985**	**234,366**	**209,407**

Note: Components may not sum to totals because of rounding.

1 Includes remaining principal balance. Term Asset-Backed Securities Loan Facility (TALF) loans are recorded at fair value, and the fair value adjustment as of December 31 is reported in “All other assets.”

2 Includes outstanding principal and capitalized interest net of unamortized deferred commitment fees and allowance for loan restructuring. Excludes credit extended to Maiden Lane II LLC and Maiden Lane III LLC. On September 30, 2010, American International Group, Inc. (AIG) announced an agreement with the U.S. Department of the Treasury, the Federal Reserve Bank of New York (FRBNY), and the trustees of the AIG Credit Facility Trust on a recapitalization plan designed to accelerate repayment of its obligations to American taxpayers. The plan resulted in the full repayment and termination of the Reserve Bank’s AIG credit facility.

3 Includes securities loaned—fully collateralized by U.S. Treasury securities, other investment-grade securities, and collateral eligible for tri-party repurchase agreements pledged with Federal Reserve Banks.

4 The FRBNY is the primary beneficiary of TALF LLC, Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC and, as a result, the accounts and results of operations of these entities are included in the combined financial statements of the Federal Reserve Banks. For additional details, see “Table 6. Key financial data for consolidated limited liability companies” on page 147.

5 In March 2009, the FRBNY received preferred interests in two special purpose vehicles, AIA Aurora LLC and ALICO Holdings LLC, in exchange for the reduction of the outstanding balance of revolving credit provided to AIG. The preferred interests are recorded at cost. As a result of the closing of the AIG recapitalization plan on January 14, 2011, AIG paid the FRBNY in full for its preferred interests in AIA LLC and ALICO LLC, including accrued dividends.

6 Valued daily at market exchange rates.

7 Dollar value of foreign currency held under these agreements valued at the exchange rate to be used when the foreign currency is returned to the foreign central bank. This exchange rate equals the market exchange rate used when the foreign currency was acquired from the foreign central bank.

8 Includes premiums on securities, accrued interest, the fair value adjustment for TALF loans, and depository institution overdrafts.

9 Contract amount of agreements.

10 Represents amounts deposited by the U.S. Treasury that result from a temporary supplementary program that offsets, in part, the reserve impact of the Reserve Banks’ lending and liquidity initiatives.

11 Includes deposits of government-sponsored enterprises, the Consumer Financial Protection Bureau, and international organizations. These deposits are primarily held by the FRBNY.

12 Pending the closing of the recapitalization plan announced by AIG on September 30, 2010, the cash proceeds from the disposition of certain AIG assets were held by the FRBNY as agent. At the closing of the recapitalization plan, which occurred January 14, 2011, the proceeds were used first to repay in full the credit extended to AIG by the FRBNY under the revolving credit facility and then to redeem a portion of the FRBNY’s preferred interests in ALICO Holdings LLC (preferred interests).

13 Represents the estimated weekly remittances to U.S. Treasury as interest on Federal Reserve notes or, in those cases where the Reserve Bank’s net earnings are not sufficient to equate surplus to capital paid-in, the deferred asset for interest on Federal Reserve notes. The amounts on this line are calculated in accordance with Board of Governors policy, which requires the Federal Reserve Banks to remit residual earnings to the U.S. Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and the amount necessary to equate surplus with capital paid-in.

14 The other beneficial interest holder related to the TALF LLC is the U.S. Treasury; to Maiden Lane LLC, it is JPMorgan Chase; and to Maiden Lane II and Maiden Lane III LLCs, it is AIG.

15 Includes discounts on securities, accrued benefit costs.

…Not applicable.

Table 9B. Statement of Condition of the Federal Reserve Banks, December 31, 2011 and 2010
Supplemental information—collateral held against Federal Reserve notes: Federal Reserve agents' accounts
Millions of dollars

Item	2011	2010
Federal Reserve notes outstanding	1,205,888	1,121,643
Less: Notes held by Federal Reserve Banks not subject to collateralization	171,836	180,082
Collateralized Federal Reserve notes	**1,034,052**	**941,561**
Collateral for Federal Reserve notes		
Gold certificate account	11,037	11,037
Special drawing rights certificate account	5,200	5,200
U.S. Treasury securities[1]	1,017,815	925,324
Total collateral	**1,034,052**	**941,561**

1 Face value. Includes compensation to adjust for the effect of inflation on the original face value of inflation-indexed securities.

Table 10. Income and expenses of the Federal Reserve Banks, by Bank, 2011
Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland	Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
Current income													
Interest income													
Primary, secondary, and seasonal loans	266	8	73	14	2	9	13	47	16	32	22	11	19
Term Asset-Backed Securities Loan Facility	264,683	…	264,683	…	…	…	…	…	…	…	…	…	…
American International Group, Inc., net	408,716	…	408,716	…	…	…	…	…	…	…	…	…	…
Total loan interest income	673,665	8	673,472	14	2	9	13	47	16	32	22	11	19
Treasury securities	42,256,692	1,046,318	19,067,611	1,335,902	1,212,747	4,863,828	3,349,186	2,673,278	869,743	632,232	1,202,932	1,696,245	4,306,670
Government-sponsored enterprise debt securities	3,053,680	75,771	1,365,356	94,135	89,174	351,132	246,501	196,712	64,358	45,318	88,628	123,117	313,476
Federal agency and government-sponsored enterprise mortgage-backed securities	38,281,682	949,615	17,137,660	1,184,160	1,115,320	4,402,469	3,082,647	2,460,075	804,265	568,744	1,108,198	1,542,519	3,926,010
Foreign currency denominated assets	248,871	8,638	72,092	24,311	18,466	52,239	14,333	6,286	2,048	7,636	2,227	3,747	36,848
Central bank liquidity swaps[1]	34,521	1,193	9,998	3,345	2,561	7,083	1,979	875	281	1,066	311	523	5,307
Total SOMA interest income	83,875,446	2,081,535	37,652,717	2,641,853	2,438,268	9,676,751	6,694,646	5,337,226	1,740,695	1,254,996	2,402,296	3,366,151	8,588,311
Total interest income	84,549,110	2,081,543	38,326,188	2,641,867	2,438,270	9,676,760	6,694,659	5,337,273	1,740,711	1,255,028	2,402,318	3,366,162	8,588,330
Priced services	477,371	…	74,543	…	…	…	327,082	75,746	…	…	…	…	…
Compensation received for services provided[2]	198,931	15,629	2,816	1,248	24,877	18,900	457	21,352	3,277	51,884	38,780	9,344	10,368
Securities lending fees	13,194	327	5,889	405	386	1,517	1,068	853	279	196	384	532	1,356
Other income	2,760	6	2,569	18	3	20	31	38	8	5	9	26	26
Total other income	692,256	15,962	85,817	1,671	25,266	20,437	328,638	97,989	3,564	52,085	39,173	9,902	11,750
Total current income	**85,241,366**	**2,097,505**	**38,412,008**	**2,643,537**	**2,463,537**	**9,697,197**	**7,023,297**	**5,435,260**	**1,744,276**	**1,307,114**	**2,441,491**	**3,376,064**	**8,600,081**
Current expenses													
Interest expense on securities sold under agreements to repurchase	44,000	1,096	19,362	1,297	1,323	5,051	3,663	2,922	965	644	1,319	1,787	4,573
Interest on reserves[3]	3,764,908	57,356	2,491,731	122,441	54,503	267,780	109,420	174,634	30,103	23,108	58,209	83,625	292,000
Interest on term deposits[4]	6,266	20	2,747	939	5	1,251	2	534	47	51	36	13	620
Earnings credits costs	1,351	91	153	74	52	101	81	128	30	37	102	99	404
Personnel													
Salaries and other personnel expenses	1,757,419	90,640	425,187	78,549	96,887	257,125	144,237	130,131	86,157	85,685	109,225	95,611	157,984
Retirement and other benefits	576,690	26,901	127,326	26,908	47,166	80,627	48,659	44,691	28,287	28,019	34,345	34,378	49,382
Net periodic pension expense[5]	525,284	764	513,248	1,061	429	1,404	1,563	1,726	15	1,146	1,463	798	1,667
Administrative													
Fees	174,405	3,129	44,144	7,559	3,878	64,880	18,539	8,096	12,663	2,563	2,048	2,817	4,090
Travel	85,138	2,898	12,506	3,156	4,975	14,004	9,093	9,551	5,265	3,496	5,883	4,801	9,511
Postage and other shipping costs	18,445	369	961	310	2,121	712	5,788	368	767	752	949	2,154	3,193
Communications	45,753	984	5,537	736	810	26,736	1,785	1,787	1,179	1,574	1,300	1,746	1,579
Materials and supplies	64,626	4,741	22,509	5,862	2,300	5,884	5,158	3,742	2,515	1,620	2,601	4,046	3,648
Building													
Taxes on real estate	42,015	5,843	7,903	1,746	1,564	2,728	3,332	3,376	688	3,445	3,489	3,476	4,425
Property depreciation	126,221	10,574	20,653	5,612	9,337	14,310	9,808	15,091	7,629	4,090	7,802	10,916	10,401
Utilities	39,936	4,030	8,345	2,356	2,100	4,379	3,733	2,109	1,715	1,833	2,105	4,056	3,175
Rent	48,625	302	22,793	856	21	21,144	172	967	989	264	662	191	264
Other building	55,851	4,996	7,724	3,696	3,286	5,329	4,387	7,443	2,090	2,361	1,895	9,024	3,619

(continued on next page)

Table 10.—*continued*

Item	Total	Boston	New York	Philadelphia	Cleveland	Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
Equipment/software													
Purchases	35,214	3,711	6,709	1,461	1,077	6,900	2,593	2,857	1,428	1,452	2,223	1,982	2,822
Rentals	3,849	287	1,708	238	338	134	495	459	22	10	15	41	102
Depreciation	87,677	5,280	10,140	4,863	3,019	36,157	4,835	5,164	3,006	1,827	4,095	3,873	5,419
Repairs and maintenance	61,297	4,372	6,190	3,041	2,696	19,626	6,822	3,821	1,688	1,519	2,388	3,333	5,802
Software	155,393	5,171	31,660	9,251	4,447	58,809	12,729	3,913	2,633	4,734	5,793	9,811	6,443
Other expenses													
Compensation paid for service costs incurred[2]	198,931	…	32,537	…	…	…	158,247	8,146	…	…	…	…	…
Other expenses	72,534	12,805	69,539	10,969	5,613	-251,970	40,109	52,884	67,922	19,646	6,541	20,720	17,755
Recoveries	-141,710	-17,833	-18,509	-4,720	-5,064	-40,939	-11,407	-10,603	-4,430	-1,930	-6,478	-13,617	-6,179
Expenses capitalized[6]	-48,127	-4,445	-17,344	-2,733	-2,651	3,712	-2,154	-1,482	-2,982	-6,168	-4,284	-549	-7,047
Total current expenses	**7,801,991**	**224,082**	**3,855,459**	**285,528**	**240,231**	**605,874**	**581,689**	**472,456**	**250,390**	**181,778**	**243,725**	**285,132**	**575,651**
Reimbursements	-485,348	-32,563	-114,677	-35,424	-51,670	-46,013	-15,914	-4,665	-105,413	-28,435	-15,808	-22,903	-11,861
Net expenses	7,316,643	191,519	3,740,782	250,104	188,561	559,861	565,775	467,791	144,977	153,343	227,917	262,228	563,791
Profit and loss													
Current net income	77,924,723	1,905,986	34,671,225	2,393,433	2,274,976	9,137,336	6,457,522	4,967,469	1,599,299	1,153,771	2,213,574	3,113,836	8,036,290
Additions to (+) and deductions from (-) current net income													
Profit on sales of Treasury securities	2,258,051	55,517	1,050,091	77,351	60,995	260,782	167,869	134,095	42,738	34,703	60,066	89,306	224,538
Profit on sales of federal agency and government-sponsored enterprise mortgage-backed securities	9,709	239	4,515	333	262	1,121	722	577	184	149	258	384	965
Foreign currency gains (losses)	151,969	5,338	43,984	15,181	11,291	33,861	8,872	3,809	1,284	4,582	1,338	2,252	20,177
Dividends on preferred interests	46,987	…	46,987	…	…	…	…	…	…	…	…	…	…
Term Asset-Backed Securities Loan Facility unrealized losses[7]	-83,835	…	-83,835	…	…	…	…	…	…	…	…	…	…
Net income from consolidated variable interest entities[8]	-356,570	…	-356,570	…	…	…	…	…	…	…	…	…	…
Other additions	61,670	9	61,333	120	1	6	73	32	2	3	29	27	35
Total additions	2,087,981	61,103	766,504	92,986	72,549	295,770	177,536	138,513	44,208	39,437	61,691	91,970	245,715
Other deductions	-71,983	-1	-61,301	0	-10,270	0	0	0	0	0	0	0	-411
Total deductions	-71,983	-1	-61,301	0	-10,270	0	0	0	0	0	0	0	-411
Net addition to (+) current net income	2,015,998	61,102	705,203	92,986	62,279	295,770	177,536	138,513	44,208	39,437	61,691	91,970	245,304
Cost of unreimbursed Treasury services	8	…	8	…	…	…	…	…	…	…	…	…	…
Assessments by Board													
Board expenditures[9]	472,300	16,376	137,231	44,028	35,128	98,054	26,627	11,924	3,897	14,606	4,453	7,047	72,929
Cost of currency	648,798	31,741	129,494	34,543	34,468	54,337	95,116	61,114	19,591	12,526	22,845	60,551	92,471
Consumer Financial Protection Bureau[10]	241,712	8,547	71,301	22,013	18,189	50,738	13,724	6,428	2,046	5,010	2,361	3,608	37,747
Office of Financial Research[10]	40,000	1,435	11,917	3,650	3,034	8,475	2,279	1,108	344	471	396	600	6,292
Net income before distributions	78,537,904	1,908,989	35,026,478	2,382,185	2,246,436	9,221,502	6,497,313	5,025,408	1,617,629	1,160,595	2,245,209	3,133,999	8,072,155
Change in funded status of benefit plans	-1,161,848	621	-1,129,118	-1,490	25,406	-17,256	-11,612	-5,715	-1,210	-7,471	-6,834	-8,303	1,131
Comprehensive income before distributions	77,376,056	1,909,610	33,897,360	2,380,695	2,271,842	9,204,246	6,485,701	5,019,693	1,616,419	1,153,124	2,238,375	3,125,696	8,073,286
Dividends paid	1,577,284	55,639	470,489	143,799	118,576	330,244	89,753	42,456	13,266	27,962	15,562	23,656	245,884

(continued on next page)

Table 10.—*continued*

Item	Total	Boston	New York	Philadelphia	Cleveland	Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
Payments to U.S. Treasury (interest on Federal Reserve notes)	75,423,597	1,827,617	32,432,120	2,472,979	2,132,131	8,748,635	6,377,838	4,931,572	1,599,321	1,834,696	2,194,032	3,073,008	7,799,648
Transferred to/from surplus and change in accumulated other comprehensive income	375,175	26,354	994,754	-236,082	21,135	125,368	18,109	45,666	3,834	-709,531	28,782	29,029	27,755
Surplus, January 1	26,524,057	916,618	7,682,284	2,569,208	1,967,519	5,438,856	1,519,966	671,991	216,166	819,267	238,767	401,849	4,081,565
Surplus, December 31	26,899,231	942,973	8,677,037	2,333,126	1,988,654	5,564,224	1,538,076	717,658	219,999	109,736	267,550	430,878	4,109,320

Note: Components may not sum to totals because of rounding.

1 Represents interest income recognized on swap agreements with foreign central banks.

2 The Federal Reserve Bank of Atlanta (FRBA) has overall responsibility for managing the Reserve Banks' provision of check and automated clearinghouse (ACH) services and recognizes total System revenue for these services. The Federal Reserve Bank of New York (FRBNY) has overall responsibility for managing the Reserve Banks' provision of Fedwire funds transfer and securities transfer services, and recognizes the total System revenue for these services. The Federal Reserve Bank of Chicago (FRBC) has overall responsibility for managing the Reserve Banks' provision of electronic access services to depository institutions, and recognizes the total System revenue for these services. The FRBA, the FRBNY, and the FRBC compensate the other Reserve Banks for the costs incurred in providing these services.

3 In October 2008, the Reserve Banks began to pay interest to depository institutions on qualifying balances held at the Federal Reserve Banks.

4 In April 2010, the Reserve Banks began to pay interest on term deposits under the Term Deposit Facility.

5 Reflects the effect of the Financial Accounting Standards Board's Codification Topic (ASC 715) Compensation - Retirement Benefits. The System Retirement Plan for employees is recorded on behalf of the System on the books of the FRBNY. Net pension expense for the System, which was $495,447 thousand, is recorded in the books of the FRBNY. The Retirement Benefit Equalization Plan and the Supplemental Employee Retirement Plan are recorded by each Federal Reserve Bank.

6 Includes expenses for labor and materials capitalized and depreciated or amortized as charges to activities in the periods benefited.

7 Represents the valuation adjustment for Term Asset-Backed Securities Loan Facility (TALF) loans, which are recorded at fair value. In addition to the valuation adjustment, earnings on TALF loans include interest income of $265 million, and the FRBNY's allocated share of TALF LLC's net income.

8 Represents the portion of the consolidated variable interest entities' net income recorded by the FRBNY. The amount includes interest income, interest expenses, realized and unrealized gains and losses, and professional fees.

9 For additional details, see the "Board of Governors Financial Statements" on page 340 in the "Federal Reserve System Audits" section of this report.

10 The Board of Governors assesses the Reserve Banks to fund the operations of the Consumer Financial Protection Bureau and Office of Financial Research. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances as of the most recent quarter.

…Not applicable.

Table 11. Income and expenses of the Federal Reserve Banks, 1914–2011

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (-)[1]	Assessments by the Board of Governors			Change in funded status of benefit plans	Dividends paid	Distributions to the U.S. Treasury		Transferred to/from surplus[4]	Transferred to/from surplus and change in accumulated other comprehensive income[5]
				Board expenditures	Costs of currency	Consumer Financial Protection Bureau and Office of Financial Research[2]			Statutory transfers[3]	Interest on Federal Reserve notes		
All banks												
1914–15	2,173	2,018	6	302	…	…	…	217	…	…	…	…
1916	5,218	2,082	-193	192	…	…	…	1,743	…	…	…	…
1917	16,128	4,922	-1,387	238	…	…	…	6,804	1,134	…	…	1,134
1918	67,584	10,577	-3,909	383	…	…	…	5,541	…	…	…	48,334
1919	102,381	18,745	-4,673	595	…	…	…	5,012	2,704	…	…	70,652
1920	181,297	27,549	-3,744	710	…	…	…	5,654	60,725	…	…	82,916
1921	122,866	33,722	-6,315	741	…	…	…	6,120	59,974	…	…	15,993
1922	50,499	28,837	-4,442	723	…	…	…	6,307	10,851	…	…	-660
1923	50,709	29,062	-8,233	703	…	…	…	6,553	3,613	…	…	2,546
1924	38,340	27,768	-6,191	663	…	…	…	6,682	114	…	…	-3,078
1925	41,801	26,819	-4,823	709	…	…	…	6,916	59	…	…	2,474
1926	47,600	24,914	-3,638	722	1,714	…	…	7,329	818	…	…	8,464
1927	43,024	24,894	-2,457	779	1,845	…	…	7,755	250	…	…	5,044
1928	64,053	25,401	-5,026	698	806	…	…	8,458	2,585	…	…	21,079
1929	70,955	25,810	-4,862	782	3,099	…	…	9,584	4,283	…	…	22,536
1930	36,424	25,358	-93	810	2,176	…	…	10,269	17	…	…	-2,298
1931	29,701	24,843	311	719	1,479	…	…	10,030	…	…	…	-7,058
1932	50,019	24,457	-1,413	729	1,106	…	…	9,282	2,011	…	…	11,021
1933	49,487	25,918	-12,307	800	2,505	…	…	8,874	…	…	…	-917
1934	48,903	26,844	-4,430	1,372	1,026	…	…	8,782	…	…	-60	6,510
1935	42,752	28,695	-1,737	1,406	1,477	…	…	8,505	298	…	28	607
1936	37,901	26,016	486	1,680	2,178	…	…	7,830	227	…	103	353
1937	41,233	25,295	-1,631	1,748	1,757	…	…	7,941	177	…	67	2,616
1938	36,261	25,557	2,232	1,725	1,630	…	…	8,019	120	…	-419	1,862
1939	38,501	25,669	2,390	1,621	1,356	…	…	8,110	25	…	-426	4,534
1940	43,538	25,951	11,488	1,704	1,511	…	…	8,215	82	…	-54	17,617
1941	41,380	28,536	721	1,840	2,588	…	…	8,430	141	…	-4	571
1942	52,663	32,051	-1,568	1,746	4,826	…	…	8,669	198	…	50	3,554
1943	69,306	35,794	23,768	2,416	5,336	…	…	8,911	245	…	135	40,327
1944	104,392	39,659	3,222	2,296	7,220	…	…	9,500	327	…	201	48,410
1945	142,210	41,666	-830	2,341	4,710	…	…	10,183	248	…	262	81,970
1946	150,385	50,493	-626	2,260	4,482	…	…	10,962	67	…	28	81,467
1947	158,656	58,191	1,973	2,640	4,562	…	…	11,523	36	75,284	87	8,366
1948	304,161	64,280	-34,318	3,244	5,186	…	…	11,920	…	166,690	…	18,523
1949	316,537	67,931	-12,122	3,243	6,304	…	…	12,329	…	193,146	…	21,462
1950	275,839	69,822	36,294	3,434	7,316	…	…	13,083	…	196,629	…	21,849
1951	394,656	83,793	-2,128	4,095	7,581	…	…	13,865	…	254,874	…	28,321
1952	456,060	92,051	1,584	4,122	8,521	…	…	14,682	…	291,935	…	46,334
1953	513,037	98,493	-1,059	4,100	10,922	…	…	15,558	…	342,568	…	40,337
1954	438,486	99,068	-134	4,175	6,490	…	…	16,442	…	276,289	…	35,888
1955	412,488	101,159	-265	4,194	4,707	…	…	17,712	…	251,741	…	32,710
1956	595,649	110,240	-23	5,340	5,603	…	…	18,905	…	401,556	…	53,983
1957	763,348	117,932	-7,141	7,508	6,374	…	…	20,081	…	542,708	…	61,604
1958	742,068	125,831	124	5,917	5,973	…	…	21,197	…	524,059	…	59,215
1959	886,226	131,848	98,247	6,471	6,384	…	…	22,722	…	910,650	…	-93,601
1960	1,103,385	139,894	13,875	6,534	7,455	…	…	23,948	…	896,816	…	42,613
1961	941,648	148,254	3,482	6,265	6,756	…	…	25,570	…	687,393	…	70,892
1962	1,048,508	161,451	-56	6,655	8,030	…	…	27,412	…	799,366	…	45,538
1963	1,151,120	169,638	615	7,573	10,063	…	…	28,912	…	879,685	…	55,864
1964	1,343,747	171,511	726	8,655	17,230	…	…	30,782	…	1,582,119	…	-465,823

(continued on next page)

Table 11.—*continued*

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (-)[1]	Assessments by the Board of Governors			Change in funded status of benefit plans	Dividends paid	Distributions to the U.S. Treasury		Transferred to/from surplus[4]	Transferred to/from surplus and change in accumulated other comprehensive income[5]
				Board expenditures	Costs of currency	Consumer Financial Protection Bureau and Office of Financial Research[2]			Statutory transfers[3]	Interest on Federal Reserve notes		
1965	1,559,484	172,111	1,022	8,576	23,603	…	…	32,352	…	1,296,810	…	27,054
1966	1,908,500	178,212	996	9,022	20,167	…	…	33,696	…	1,649,455	…	18,944
1967	2,190,404	190,561	2,094	10,770	18,790	…	…	35,027	…	1,907,498	…	29,851
1968	2,764,446	207,678	8,520	14,198	20,474	…	…	36,959	…	2,463,629	…	30,027
1969	3,373,361	237,828	-558	15,020	22,126	…	…	39,237	…	3,019,161	…	39,432
1970	3,877,218	276,572	11,442	21,228	23,574	…	…	41,137	…	3,493,571	…	32,580
1971	3,723,370	319,608	94,266	32,634	24,943	…	…	43,488	…	3,356,560	…	40,403
1972	3,792,335	347,917	-49,616	35,234	31,455	…	…	46,184	…	3,231,268	…	50,661
1973	5,016,769	416,879	-80,653	44,412	33,826	…	…	49,140	…	4,340,680	…	51,178
1974	6,280,091	476,235	-78,487	41,117	30,190	…	…	52,580	…	5,549,999	…	51,483
1975	6,257,937	514,359	-202,370	33,577	37,130	…	…	54,610	…	5,382,064	…	33,828
1976	6,623,220	558,129	7,311	41,828	48,819	…	…	57,351	…	5,870,463	…	53,940
1977	6,891,317	568,851	-177,033	47,366	55,008	…	…	60,182	…	5,937,148	…	45,728
1978	8,455,309	592,558	-633,123	53,322	60,059	…	…	63,280	…	7,005,779	…	47,268
1979	10,310,148	625,168	-151,148	50,530	68,391	…	…	67,194	…	9,278,576	…	69,141
1980	12,802,319	718,033	-115,386	62,231	73,124	…	…	70,355	…	11,706,370	…	56,821
1981	15,508,350	814,190	-372,879	63,163	82,924	…	…	74,574	…	14,023,723	…	76,897
1982	16,517,385	926,034	-68,833	61,813	98,441	…	…	79,352	…	15,204,591	…	78,320
1983	16,068,362	1,023,678	-400,366	71,551	152,135	…	…	85,152	…	14,228,816	…	106,663
1984	18,068,821	1,102,444	-412,943	82,116	162,606	…	…	92,620	…	16,054,095	…	161,996
1985	18,131,983	1,127,744	1,301,624	77,378	173,739	…	…	103,029	…	17,796,464	…	155,253
1986	17,464,528	1,156,868	1,975,893	97,338	180,780	…	…	109,588	…	17,803,895	…	91,954
1987	17,633,012	1,146,911	1,796,594	81,870	170,675	…	…	117,499	…	17,738,880	…	173,771
1988	19,526,431	1,205,960	-516,910	84,411	164,245	…	…	125,616	…	17,364,319	…	64,971
1989	22,249,276	1,332,161	1,254,613	89,580	175,044	…	…	129,885	…	21,646,417	…	130,802
1990	23,476,604	1,349,726	2,099,328	103,752	193,007	…	…	140,758	…	23,608,398	…	180,292
1991	22,553,002	1,429,322	405,729	109,631	261,316	…	…	152,553	…	20,777,552	…	228,356
1992	20,235,028	1,474,531	-987,788	128,955	295,401	…	…	171,763	…	16,774,477	…	402,114
1993	18,914,251	1,657,800	-230,268	140,466	355,947	…	…	195,422	…	15,986,765	…	347,583
1994	20,910,742	1,795,328	2,363,862	146,866	368,187	…	…	212,090	…	20,470,011	…	282,122
1995	25,395,148	1,818,416	857,788	161,348	370,203	…	…	230,527	…	23,389,367	…	283,075
1996	25,164,303	1,947,861	-1,676,716	162,642	402,517	…	…	255,884	5,517,716	14,565,624	…	635,343
1997	26,917,213	1,976,453	-2,611,570	174,407	364,454	…	…	299,652	20,658,972	0	…	831,705
1998	28,149,477	1,833,436	1,906,037	178,009	408,544	…	…	343,014	17,785,942	8,774,994	…	731,575
1999	29,346,836	1,852,162	-533,557	213,790	484,959	…	…	373,579	…	25,409,736	…	479,053
2000	33,963,992	1,971,688	-1,500,027	188,067	435,838	…	…	409,614	…	25,343,892	…	4,114,865
2001	31,870,721	2,084,708	-1,117,435	295,056	338,537	…	…	428,183	…	27,089,222	…	517,580
2002	26,760,113	2,227,078	2,149,328	205,111	429,568	…	…	483,596	…	24,495,490	…	1,068,598
2003	23,792,725	2,462,658	2,481,127	297,020	508,144	…	…	517,705	…	22,021,528	…	466,796
2004	23,539,942	2,238,705	917,870	272,331	503,784	…	…	582,402	…	18,078,003	…	2,782,587
2005	30,729,357	2,889,544	-3,576,903	265,742	477,087	…	…	780,863	…	21,467,545	…	1,271,672
2006	38,410,427	3,263,844	-158,846	301,014	491,962	…	…	871,255	…	29,051,678	…	4,271,828
2007	42,576,025	3,510,206	198,417	296,125	576,306	…	324,481	992,353	…	34,598,401	…	3,125,533
2008	41,045,582	4,870,374	3,340,628	352,291	500,372	…	-3,158,808	1,189,626	…	31,688,688	…	2,626,053
2009	54,463,121	5,978,795	4,820,204	386,400	502,044	…	1,006,813	1,428,202	…	47,430,237	…	4,564,460
2010	79,300,937	6,270,420	9,745,562	422,200	622,846	42,286	45,881	1,582,785	…	79,268,124	…	883,724
2011	85,241,366	7,316,643	2,015,991	472,300	648,798	281,712	-1,161,848	1,577,284	…	75,423,597	…	375,175
Total, 1914–2011	1,013,516,673	81,293,694	24,162,598	6,634,116	11,682,378	323,998	-2,943,481	15,509,027	44,113,958	842,337,007	-4	32,841,620[6]

(continued on next page)

Table 11.—*continued*

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (-)[1]	Assessments by the Board of Governors			Change in funded status of benefit plans	Dividends paid	Distributions to the U.S. Treasury		Transferred to/from surplus[4]	Transferred to/from surplus and change in accumulated other comprehensive income[5]
				Board expenditures	Costs of currency	Consumer Financial Protection Bureau and Office of Financial Research[2]			Statutory transfers[3]	Interest on Federal Reserve notes		
Aggregate for each Bank, 1914–2011												
Boston	46,947,974	4,359,466	248,233	280,175	665,947	11,482	-3,537	665,682	2,579,504	37,493,178	135	1,137,099
New York	377,118,874	19,363,714[7]	14,383,390	1,697,136	3,382,271	95,523	-2,975,497	4,069,788	17,307,161	331,503,863	-433	11,107,744
Philadelphia	35,486,633	3,696,388	784,512	401,143	532,806	30,193	-1,657	1,109,090	1,312,118	26,688,434	291	2,499,030
Cleveland	53,160,100	4,205,309	781,601	482,260	656,025	24,305	10,638	1,133,016	2,827,043	42,327,277	-10	2,297,115
Richmond	82,127,076	7,194,566	2,340,583	1,156,055	982,680	69,344	23,749	3,060,219	3,083,928	62,299,820	-72	6,644,868
Atlanta	69,902,828	10,268,228	1,180,568	483,346	1,070,915	18,524	889	1,068,158	2,713,230	53,603,143	5	1,858,735
Chicago	108,619,877	8,361,554	1,275,368	594,311	1,272,716	8,552	-5,831	1,160,316	4,593,811	92,761,812	12	1,136,328
St. Louis	32,370,085	3,262,984	257,816	133,317	417,332	2,764	9,645	270,564	1,833,837	26,373,031	-27	343,746
Minneapolis	17,192,213	3,286,608	306,445	185,929	222,590	6,703	-3,031	405,489	416,227	12,704,193	65	267,829
Kansas City	35,347,013	4,451,567	353,783	165,416	432,612	3,098	-10,542	312,367	1,249,703	28,685,531	-9	389,969
Dallas	44,520,056	4,556,382	651,328	246,880	617,417	4,813	6,074	449,440	1,510,802	37,192,789	55	598,874
San Francisco	110,723,944	8,286,933	1,598,974	808,149	1,429,065	48,697	5,617	1,804,899	4,686,594	90,703,935	-17	4,560,284
Total	**1,013,516,673**	**81,293,694**	**24,162,598**	**6,634,116**	**11,682,378**	**323,998**	**-2,943,481**	**15,509,027**	**44,113,958**	**842,337,007**	**-4**	**32,841,620**

Note: Components may not sum to totals because of rounding.

1 For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2 Starting in 2010, as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Board of Governors began assessing the Reserve Banks to fund the operations of the Consumer Financial Protection Bureau and Office of Financial Research. These assessments are allocated to the Reserve Banks based on each Reserve Bank's capital and surplus balances as of the most recent quarter.

3 Represents transfers made as a franchise tax from 1917 through 1932; transfers made under section 13b of the Federal Reserve Act from 1935 through 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

4 Transfers are made under section 13b of the Federal Reserve Act.

5 Transfers are made under section 7 of the Federal Reserve Act. Beginning in 2006, accumulated other comprehensive income is reported as a component of surplus.

6 The $32,841,620 thousand transferred to surplus was reduced by direct charges of $500 thousand for charge-off on Bank premises (1927); $139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934); $4 thousand net upon elimination of section 13b surplus (1958); and $106,000 thousand (1996), $107,000 thousand (1997), and $3,752,000 thousand (2000) transferred to the Treasury as statutorily required; and $1,848,716 thousand related to the implementation of SFAS No. 158 (2006) and was increased by a transfer of $11,131 thousand from reserves for contingencies (1955), leaving a balance of $26,899,231 thousand on December 31, 2011.

7 This amount is reduced by $4,593,077 thousand for expenses of the System Retirement Plan. See note 5, "Table 10. Income and expenses of the Federal Reserve Banks, by Bank, 2011" on page 330.

…Not applicable.

Table 12. Operations in principal departments of the Federal Reserve Banks, 2008–11

Operation	2011	2010	2009	2008
Millions of pieces				
Currency processed	32,249	32,143	31,891	33,256
Currency destroyed	4,813	5,948	6,049	6,517
Coin received	59,756	62,345	65,349	64,438
Checks handled				
U.S. government checks[1]	159	185	202	269
Postal money orders	113	121	131	146
Commercial	6,780	7,712	8,585	9,545
Securities transfers[2]	19	20	21	25
Funds transfers[3]	127	125	125	131
Automated clearinghouse transactions				
Commercial	10,349	10,233	9,966	10,040
Government	1,305	1,222	1,195	1,132
Millions of dollars				
Currency processed	576,442	569,249	561,013	604,882
Currency destroyed	81,943	120,049	92,708	148,460
Coin received	5,929	6,014	6,288	6,286
Checks handled				
U.S. government checks[1]	241,817	292,261	311,667	316,713
Postal money orders	22,220	23,210	23,675	25,544
Commercial	9,899,770	11,066,409	13,758,963	15,216,147
Securities transfers[2]	291,823,993	320,123,901	295,741,666	419,347,256
Funds transfers[3]	663,837,575	608,325,851	631,127,108	754,974,633
Automated clearinghouse transactions				
Commercial	17,801,549	16,941,077	15,418,718	15,662,805
Government	4,534,707	4,426,808	4,297,071	4,008,022

1 Includes government checks handled electronically (electronic checks).

2 Data on securities transfers do not include reversals.

3 Data on funds transfers do not include non-value transfers.

Table 13. Number and annual salaries of officers and employees of the Federal Reserve Banks, December 31, 2011

Federal Reserve Bank (including branches)	President[1]	Other officers		Employees			Total	
	Annual salary (dollars)[2]	Number	Annual salaries (dollars)[2]	Number		Annual salaries (dollars)[2]	Number	Annual salaries (dollars)[2]
				Full-time	Part-time			
Boston	350,400	63	12,787,567	809	30	71,319,707	903	84,457,674
New York	410,780	435	99,572,258	2,573	37	269,269,544	3,046	369,252,582
Philadelphia	350,400	58	10,232,763	759	23	57,859,212	841	68,442,374
Cleveland	347,400	54	9,771,600	982	20	66,340,988	1,057	76,459,988
Richmond	347,400	79	13,697,600	1,340	26	102,685,209	1,446	116,730,209
Atlanta	314,400	83	16,139,830	1,434	19	109,786,315	1,537	126,240,545
Chicago	350,400	98	18,094,760	1,223	45	103,988,873	1,367	122,434,033
St. Louis	281,300	75	13,795,540	843	29	62,525,370	948	76,602,210
Minneapolis	313,500	51	8,972,725	949	44	67,721,083	1,045	77,007,308
Kansas City	323,200	73	13,204,700	1,135	16	76,035,677	1,225	89,563,577
Dallas	350,400	59	10,295,104	1,044	10	71,807,913	1,114	82,453,417
San Francisco	367,500	77	16,335,031	1,435	23	128,903,369	1,536	145,605,900
Federal Reserve Information Technology	…	47	8,541,725	953	7	93,864,052	1,007	102,405,777
Office of Employee Benefits	…	12	2,801,400	35	1	3,598,355	48	6,399,755
Total	4,107,080	1,264	254,242,603	15,514	330	1,285,705,666	17,120	1,544,055,349

Note: Components may not sum to totals because of rounding.

1 Appointment salaries of presidents are normally 85 percent of the salary-range midpoint (an 85 compa-ratio), with the exception of the New York Reserve Bank president, whose appointment salary normally is set at a 95 compa-ratio. The Board has discretion to approve a higher starting salary if requested by a Reserve Bank's board of directors.

No incumbent president received a salary increase in 2011. Under the Board's normal policy, during years in which there is no pay freeze, on January 1 each year, all presidents receive salary increases equal to the percentage increase in the midpoint of their respective salary ranges. In addition, on every third-year anniversary of his or her initial appointment (through year 9), each president receives a salary increase that results in a compa-ratio as follows: year 3: 95 (for the New York Bank: 105); year 6: 105 (New York: 115); year 9: 115 (New York: 125).

There are tiered salary ranges for Reserve Bank officers, including presidents, reflecting differences in the costs of labor in the head-office cities. The Board reviews Reserve Bank officer salary ranges and Reserve Bank placement in the salary tiers annually. Salaries for Reserve Bank officers, including presidents, are limited by compensation caps established for each tier. The current caps, which have remained unchanged from 2010, are $431,300 for tier 1; $419,600 for tier 2; and $400,000 for tier 3. In 2011, New York and San Francisco were in tier 1, which had a range midpoint for presidents' salaries of $432,400. Boston, Philadelphia, Chicago, Minneapolis, and Dallas were in tier 2, which had a midpoint for presidents' salaries of $368,800. Cleveland, Richmond, Atlanta, St. Louis, and Kansas City were in tier 3, which had a midpoint for presidents' salaries of $330,900. As noted above, salary midpoints are used to calculate presidents' compa-ratios.

2 Annualized salary liability (excluding outside agency costs) based on salaries in effect on December 31, 2011.

…Not applicable.

Table 14. Acquisition costs and net book value of the premises of the Federal Reserve Banks and Branches, December 31, 2011
Thousands of dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate[3]
	Land	Buildings (including vaults)[1]	Building machinery and equipment	Total[2]		
Boston	27,293	167,607	30,506	225,406	122,304	…
New York	21,412	352,825	79,383	453,620	260,908	…
Philadelphia	8,146	105,496	17,892	131,533	67,295	…
Cleveland	4,219	126,971	25,783	156,973	99,629	…
Cincinnati	3,100	28,105	16,857	48,063	20,126	…
Pittsburgh	2,548	19,638	16,830	39,017	5,767	…
Richmond	31,631	152,749	49,610	233,990	152,694	…
Baltimore	7,917	39,863	12,845	60,624	36,517	…
Charlotte	7,884	43,543	13,506	64,933	43,366	…
Atlanta	22,995	152,920	18,219	194,135	150,805	…
Birmingham	5,347	13,056	1,465	19,868	10,773	…
Jacksonville	1,779	23,293	4,658	29,730	16,830	…
Nashville	0	0	0	0	0	3,718
New Orleans	3,785	12,571	5,499	21,854	11,115	…
Miami	4,254	28,815	6,490	39,559	24,401	…
Chicago	4,512	203,887	24,369	232,768	121,723	…
Detroit	12,329	74,023	11,292	97,643	84,532	…
St. Louis	9,377	139,216	15,230	163,823	122,832	…
Memphis	2,472	15,000	5,160	22,632	11,211	…
Minneapolis	15,522	108,679	16,082	140,283	95,785	…
Helena	2,890	10,335	1,571	14,795	9,328	…
Kansas City	38,320	198,804	27,459	264,583	242,690	…
Denver	3,694	9,900	6,306	19,899	9,562	…
Omaha	3,559	7,692	1,985	13,236	6,322	…
Dallas	37,085	121,794	31,758	190,637	122,502	…
El Paso	262	3,683	1,843	5,788	835	…
Houston	25,119	104,023	9,020	138,162	117,816	7,204
San Antonio	826	8,043	2,969	11,838	4,064	…
San Francisco	20,988	114,579	28,230	163,797	91,259	…
Los Angeles	6,306	74,852	20,149	101,307	56,169	…
Salt Lake City	1,294	5,180	1,401	7,875	2,677	…
Seattle	13,101	49,970	6,744	69,815	63,138	3,400
Total	**349,971**	**2,521,162**	**513,823**	**3,384,956**	**2,184,975**	**14,322**

Note: Components may not sum to totals because of rounding.

1 Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2 Excludes charge-offs of $17,699 thousand before 1952.

3 Includes real estate held pending sale.

…Not applicable.

Federal Reserve System Audits

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review.

The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General.

The Reserve Banks' financial statements are audited annually by an independent outside auditor retained by the Board of Governors. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board's examination includes a wide range of ongoing oversight activities conducted on site and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

The OIG also conducts audits, reviews, and investigations relating to the Board's programs and operations as well as to Board functions delegated to the Reserve Banks, and Federal Reserve operations are also subject to review by the Government Accountability Office.

Board of Governors Financial Statements

The financial statements of the Board of Governors for 2011 and 2010 were audited by Deloitte & Touche LLP, independent auditors.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 8, 2012

MANAGEMENT'S ASSERTION

To the Committee on Board Affairs:

The management of the Board of Governors of the Federal Reserve System ("the Board") is responsible for the preparation and fair presentation of the balance sheet as of December 31, 2011, and for the related statement of revenues and expenses and changes in cumulative results of operations, and cash flows for the year then ended (the "Financial Statements"). The Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States of America and, as such, include some amounts which are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with generally accepted accounting principles and include all disclosures necessary for such presentation.

Board management is also responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Committee on Board Affairs regarding the preparation of the Financial Statements in accordance with accounting principles generally accepted in the United States of America. The Board's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Board; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of Financial Statements in accordance with generally accepted accounting principles, and that the Board's receipts and expenditures are being made only in accordance with authorizations of its management; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Board's assets that could have a material effect on the Financial Statements.

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

Board management assessed its internal control over financial reporting reflected in the Financial Statements based upon the criteria established in the *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on this assessment, we believe that the Board has maintained effective internal control over financial reporting as it relates to its Financial Statements.

Richard A. Anderson
Chief Operating Officer

William L. Mitchell
Chief Financial Officer

Deloitte.

INDEPENDENT AUDITORS' REPORT

To the Board of Governors of the Federal Reserve System:

Washington, D.C.

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the "Board") as of December 31, 2011 and 2010, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States), auditing standards of the Public Company Accounting Oversight Board (United States), and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Board of Governors of the Federal Reserve System as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Board's internal control over financial reporting as of December 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 8, 2012 expressed an unqualified opinion on the Board's internal control over financial reporting.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 8, 2012, on our tests of the Board's compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte + Touche LLP

March 8, 2012
McLean, VA

Deloitte.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Governors of the Federal Reserve System:

Washington, D.C.

We have audited the internal control over financial reporting of the Board of Governors of the Federal Reserve System (the "Board") as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Board's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Assertion report. Our responsibility is to express an opinion on the Board's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

In our opinion, the Board maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), generally accepted auditing standards as established by the Auditing Standards Board (United States), and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the accompanying balance sheet, statements of revenues and expenses and changes in cumulative results of operations, and cash flows as of and for the year ended December 31, 2011 of the Board and our report dated March 8, 2012 expressed an unqualified opinion on those financial statements.

Deloitte + Touche LLP

March 8, 2012
McLean, VA

Board of Governors of the Federal Reserve System Balance Sheets

	As of December 31,	
	2011	2010
Assets		
Current Assets:		
Cash	$ 73,592,126	$ 55,142,632
Accounts receivable – net	5,433,087	3,234,076
Prepaid expenses and other assets	3,338,770	2,657,914
Total current assets	82,363,983	61,034,622
Noncurrent Assets:		
Property, equipment, and software – net	181,903,601	156,767,186
Other assets	476,795	576,659
Total noncurrent assets	182,380,396	157,343,845
Total	$264,744,379	$218,378,467
Liabilities and Cumulative Results of Operations		
Current Liabilities:		
Accounts payable and accrued liabilities	$ 25,686,787	$ 15,403,521
Accrued payroll and related taxes	18,616,534	21,894,036
Accrued annual leave	27,281,750	26,337,190
Capital lease payable	237,479	544,878
Unearned revenues and other liabilities	872,868	556,846
Total current liabilities	72,695,418	64,736,471
Long-Term Liabilities:		
Capital lease payable	–	237,479
Accumulated retirement benefit obligation	27,485,712	21,979,219
Accumulated postretirement benefit obligation	11,799,079	10,219,672
Accumulated postemployment benefit obligation	11,145,144	13,813,254
Other long-term liabilities	20,261,325	3,545,936
Total long-term liabilities	70,691,260	49,795,560
Total liabilities	143,386,678	114,532,031
Cumulative Results of Operations:		
Fund balance	138,451,243	118,473,958
Accumulated other comprehensive income (loss)	(17,093,542)	(14,627,522)
Total cumulative results of operations	121,357,701	103,846,436
Total	$264,744,379	$218,378,467

See notes to financial statements.

Board of Governors of the Federal Reserve System Statements of Revenues and Expenses and Changes in Cumulative Results of Operations

	For the years ended December 31,	
	2011	2010
Board Operating Revenues:		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$472,300,000	$422,200,000
Other revenues	6,555,903	8,693,489
Total operating revenues	478,855,903	430,893,489
Board Operating Expenses:		
Salaries	274,866,723	268,168,023
Retirement and insurance	58,186,546	56,788,740
Contractual services and professional fees	37,486,707	48,698,913
Depreciation, amortization, and net gains or losses on disposals	19,496,451	15,865,704
Utilities	8,736,997	8,628,394
Travel	14,583,555	10,847,795
Software	9,399,273	8,057,580
Postage and supplies	10,760,230	7,100,302
Repairs and maintenance	4,774,395	3,384,994
Printing and binding	2,345,881	2,240,489
Other expenses	18,241,860	16,316,499
Total operating expenses	458,878,618	446,097,433
Results of operations	19,977,285	(15,203,944)
Currency Costs:		
Assessments levied or to be levied on Federal Reserve Banks for currency costs	650,010,597	622,858,648
Expenses for costs related to currency	650,010,597	622,858,648
Currency assessments over (under) expenses	–	–
Bureau of Consumer Financial Protection (Bureau):		
Assessments levied on the Federal Reserve Banks for the Bureau	241,711,564	32,770,000
Transfers to the Bureau	241,711,564	32,770,000
Bureau assessments over (under) transfers	–	–
Office of Financial Research (Office):		
Assessments levied on the Federal Reserve Banks for the Office	40,000,000	9,515,944
Transfers to the Office	40,000,000	9,515,944
Office assessments over (under) transfers	–	–
Total results of operations	$ 19,977,285	$ (15,203,944)
Cumulative results of operations – Beginning of year	$103,846,436	$124,510,797
Other Comprehensive Income:		
Amortization of prior service (credit) cost	507,786	518,195
Amortization of net actuarial (gain) loss	653,874	576,736
Net actuarial gain (loss) arising during the year	(3,627,680)	(6,555,348)
Total other comprehensive income (loss)	(2,466,020)	(5,460,417)
Cumulative results of operations – End of year	$121,357,701	$103,846,436

See notes to financial statements.

Board of Governors of the Federal Reserve System Statements of Cash Flows

	For the years ended December 31,	
	2011	2010
Cash Flows from Operating Activities:		
Results of operations	$ 19,977,285	$(15,203,944)
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and amortization	19,015,100	15,877,105
Net loss (gain) on disposal of property and equipment	481,351	(11,401)
Other additional non-cash adjustments to results of operations	351,867	658,587
(Increase) decrease in assets:		
Accounts receivable, prepaid expenses and other assets	(2,780,003)	730,143
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	5,340,020	(822,981)
Accrued payroll and related taxes	(3,277,502)	10,953,052
Accrued annual leave	944,560	1,516,146
Unearned revenues and other liabilities	316,022	(2,425,783)
Net retirement benefit obligation	4,128,953	3,911,348
Net postretirement benefit obligation	490,927	501,415
Net postemployment benefit obligation	(2,668,110)	(650,711)
Other long-term liabilities	298,191	3,130,612
Net cash provided by (used in) operating activities	42,618,661	18,163,588
Cash Flows from Investing Activities:		
Capital expenditures	(23,585,868)	(17,296,078)
Net cash provided by (used in) investing activities	(23,585,868)	(17,296,078)
Cash Flows from Financing Activities:		
Capital lease payments	(583,299)	(517,709)
Net cash provided by (used in) financing activities	(583,299)	(517,709)
Net Increase (Decrease) in Cash	18,449,494	349,801
Cash balance – Beginning of year	55,142,632	54,792,831
Cash balance – End of year	$ 73,592,126	$ 55,142,632

See **notes to financial statements**.

Board of Governors of the Federal Reserve System Notes to Financial Statements as of and for the Years ended December 31, 2011 and 2010

(1) Structure

The Federal Reserve System (the System) was established by Congress in 1913 and consists of the Board of Governors (the Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Federal Reserve Banks, was established as a federal government agency and is supported by primarily Washington, D.C. based staff numbering approximately 2,300, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act (the Act) to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Federal Reserve Bank and a consolidated statement for all of the Federal Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Federal Reserve Banks. Therefore, the accompanying financial statements include only the results of operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

The Dodd-Frank Wall Street Reform and Consumer Financial Protection Act of 2010 (Dodd-Frank Act) established the Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the System and designated the Board's Office of Inspector General (OIG) as the OIG for the Bureau. As required by the Dodd-Frank Act, the Board transferred certain responsibilities to the Bureau in July 2011. The Dodd-Frank Act also created the Financial Stability Oversight Council (FSOC) of which the Chairman of the Board is a member, as well as the Office of Financial Research (Office) within the U.S. Department of the Treasury to provide support to the FSOC and the member agencies. The Dodd-Frank Act requires that the Board provide funding for the FSOC and the Office until July 2012. Section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board or the System; the Board has also determined that neither the FSOC nor the Office should be consolidated in the Board's financial statements. Accordingly, the Board's financial statements do not include financial data of the Bureau, the FSOC, or the Office other than the funding that the Board is required by the Dodd-Frank Act to provide.

(2) Operations and Services

The Board's responsibilities require thorough analysis of domestic and international financial and economic developments. The Board carries out those responsibilities in conjunction with the Federal Reserve Banks and the Federal Open Market Committee. The Board also supervises and regulates the operations of the Federal Reserve Banks and exercises broad responsibility in the nation's payments system. Policy regarding open market operations is established by the Federal Open Market Committee. However, the Board has sole authority over changes in reserve requirements, and it must approve any change in the discount rate initiated by a Federal Reserve Bank. The Board also plays a major role in the supervision and regulation of the U.S. banking system. It has supervisory responsibilities for state-chartered banks that are members of the Federal Reserve System, bank holding companies, savings and loan holding companies, foreign activities of member banks, U.S. activities of foreign banks, and any systemically important nonbank financial companies that are designated by the FSOC. Although the Dodd-Frank Act gave the Bureau general rule-writing responsibility for Federal consumer financial laws, the Board retains rule-writing responsibility under the Community Reinvestment Act and other specific statutory provisions. The Board also enforces the requirements of Federal consumer financial laws for state member banks with assets of $10 billion or less. In addition, the Board enforces certain other consumer laws at all state member banks, regardless of size.

(3) Significant Accounting Policies

Basis of Accounting — The Board prepares its financial statements in accordance with accounting principles generally accepted in the United States (GAAP).

Revenues — The Federal Reserve Act authorizes the Board to levy an assessment on the Federal Reserve Banks to fund its operations. The Board levies the assessment based on each Federal Reserve Bank's capital and surplus balances as of December 31 of the prior year.

Assessments to Fund the Bureau and the Office — The Board assesses the Federal Reserve Banks for the funds transferred to the Bureau and the Office based on each Federal Reserve Bank's capital and surplus balances. These assessments and transfers are reported separately from the Board's operating activities in the Board's Statements of Revenues and Expenses and Changes in Cumulative Results of Operations.

Assessments for Supervisory and Regulatory Responsibilities — Section 318(c) of the Dodd-Frank Act requires that "the Board shall collect a total amount of assessments, fees, or other charges from the companies described in paragraph (2) that is equal to the total expenses the Board estimates are necessary or appropriate to carry out the supervisory and regulatory responsibilities of the Board with respect to such companies." The companies described in paragraph (2) are those bank holding companies and savings and loan holding companies with total consolidated assets of $50 billion or more, and any systemically important nonbank financial companies that are designated by the FSOC.

As of December 31, 2011, the Board has not issued rulemaking regarding this new responsibility, and does not currently anticipate finalizing any such rulemaking until later in 2012. As such, sufficient information is not available to determine a reasonable estimate of the fees that it may eventually collect under this section of the Dodd-Frank Act. Therefore, the Board has not accrued receivables or recognized revenues in the 2011 financial statements related to this new responsibility.

Currency Costs — The Board issues the nation's currency (in the form of Federal Reserve notes), and the Federal Reserve Banks distribute currency and coin through depository institutions. The Board incurs expenses and assesses the Federal Reserve Banks for the expenses related to producing, issuing, and retiring Federal Reserve notes as well as providing educational services. The assessment is allocated based on each Federal Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the prior year. These expenses and assessments are reported separately from the

Board's operating activities in the Board's Statements of Revenues and Expenses and Changes in Cumulative Results of Operations.

Allowance for Doubtful Accounts — Accounts receivable are shown net of the allowance for doubtful accounts. Accounts receivable considered uncollectible are charged against the allowance account in the year they are deemed uncollectible. The allowance for doubtful accounts is adjusted monthly, based upon a review of outstanding receivables.

Property, Equipment, and Software — The Board's property, buildings, equipment, and software are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated on a straight-line basis over the estimated useful lives of the assets, which range from three to ten years for furniture and equipment, ten to fifty years for building equipment and structures, and two to ten years for software. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation or amortization are removed and any gain or loss is recognized. Construction in process include costs incurred for short-term and long-term projects that have not been placed into service. The majority of the balance represents long-term building enhancement projects.

The Board's internally developed software projects are each recorded at cost and capitalized and amortized over the project's useful life as required by the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 350-40 *Intangibles-Goodwill and Other – Internal Use Software*.

Art Collections — The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by FASB ASC Topic 605 *Revenue Recognition*, the cost of collections purchased by the Board is charged to expense in the year purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

Deferred Rent — The leases contain scheduled rent increases over the term of the lease. As required by FASB ASC Topic 840 *Leases*, rent abatements, lease incentives, and scheduled rent increases must be considered in determining the annual rent expense to be recognized. The deferred rent represents the difference between the actual lease payments and the rent expense recognized.

Lease incentives impact deferred rent, are reflected as non-cash transactions in the Cash Flow from Operating Activities section within the Cash Flow Statement, and are discussed in the leases footnote. The other non-cash transaction within this section of the Cash Flow Statement relates to a donated asset discussed in the currency footnote.

Estimates — The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(4) Property, Equipment, and Software

The following is a summary of the components of the Board's property, equipment, and software, at cost, net of accumulated depreciation and amortization as of December 31, 2011 and 2010:

	As of December 31,	
	2011	2010
Land	$ 18,640,314	$ 18,640,314
Buildings and Improvements	195,869,546	163,868,033
Construction in process	13,952,693	4,810,307
Furniture and Equipment	66,604,104	68,037,574
Software in Use	27,091,292	24,244,811
Software in Process	1,384,526	1,985,544
Vehicles	521,419	255,159
Other Intangible assets	496,675	496,675
Subtotal	324,560,569	282,338,417
Less accumulated depreciation and amortization	(142,656,968)	(125,571,231)
Property, equipment, and software – net	$ 181,903,601	$ 156,767,186

(5) Leases

Capital Leases — The Board entered into capital leases in 2008 and 2009. Furniture and equipment includes $2,086,000 under capital leases in both 2011 and 2010. Accumulated depreciation includes $1,852,000 and $1,319,000 under capital leases as of 2011 and 2010, respectively.

The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2011, are as follows:

	Amount
Total minimum lease payments for 2012	$ 421,924
Less amount representing maintenance	(183,112)
Net minimum lease payments	238,812
Less amount representing interest	(1,333)
Present value of net minimum lease payments	237,479
Less current maturities of capital lease payments	(237,479)
Long-term capital lease obligations	$ –

Operating Leases — The Board has entered into several operating leases to secure office, training and warehouse space. Minimum annual payments under the operating leases having an initial or remaining non-cancelable lease term in excess of one year at December 31, 2011, are as follows:

Years Ending December 31,	
2012	$ 12,459,159
2013	14,572,539
2014	14,950,511
2015	15,393,532
After 2015	86,694,634
	$144,070,375

Rental expenses under the operating leases were $6,093,000 and $6,882,000 for the years ended December 31, 2011 and 2010, respectively.

The Board leases and subleases space, primarily to other governmental agencies. The revenues collected for these leases from the governmental agencies were $480,000 and $1,937,000 in 2011 and 2010, respectively.

Deferred Rent — Other long-term liabilities include deferred rent of $19,733,000 and 3,051,000 for the years ended December 31, 2011 and 2010, respectively. The 2011 ending balance includes non-cash lease incentives of $16,417,000.

(6) Accumulated Retirement Benefits

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (the System Plan). The System Plan provides retirement benefits to employees of the Board, the Federal Reserve Banks, the Office of Employee Benefits of the Federal Reserve System (OEB), and certain employees of the Bureau. Under the Dodd-Frank Act, newly hired employees of the Bureau are eligible to participate in the System Plan and transferees from other governmental organizations can elect to participate in the System Plan. The Federal Reserve Bank of New York (FRBNY), on behalf of the System, recognizes the net assets and costs associated with the System Plan in its financial statements. During the year ended December 31, 2011, certain costs associated with the System Plan were reimbursed by the Bureau. Costs associated with the System Plan were not redistributed to participating employers during the year ended December 31, 2010.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers. In 2011, the System made $420 million in contributions to the System Plan; the contributions may be adjusted upon completion of the 2012 actuarial valuation. The Board was not assessed a contribution for 2011.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Activity for the BEP as of December 31, 2011 and 2010, is summarized in the following tables:

	2011	2010
Change in projected benefit obligation:		
Benefit obligation – beginning of year	$11,933,435	$ 5,900,567
Service cost	1,456,457	1,359,828
Interest cost	602,381	545,688
Plan participants' contributions	–	–
Actuarial (gain) loss	567,091	4,155,013
Gross benefits paid	(35,438)	(27,661)
Transfers to CFPB	(376,740)	–
Benefit obligation – end of year	$14,147,186	$11,933,435
Accumulated benefit obligation – end of year	$ 2,351,832	$ 1,686,998

(continued on next page)

Table—*continued*

	2011	2010
Weighted-average assumptions used to determine benefit obligation as of December 31:		
Discount rate	4.50 %	5.50 %
Rate of compensation increase	5.00 %	5.00 %
Change in plan assets:		
Fair value of plan assets – beginning of year	$ –	$ –
Employer contributions	35,438	27,661
Plan participants' contributions	–	–
Gross benefits paid	(35,438)	(27,661)
Fair value of plan assets – end of year	$ –	$ –
Funded status:		
Reconciliation of funded status – end of year:		
Fair value of plan assets	$ –	$ –
Benefit obligations	14,147,186	11,933,435
Funded status	(14,147,186)	(11,933,435)
Amount recognized – end of year	$(14,147,186)	$(11,933,435)
Amounts recognized in the statements of financial position consist of:		
Asset	$ –	$ –
Liability	(14,147,186)	(11,933,435)
Net amount recognized	$(14,147,186)	$(11,933,435)
Amounts recognized in accumulated other comprehensive income consist of:		
Net actuarial loss (gain)	$ 5,535,793	$ 5,575,910
Prior service cost (credit)	699,952	701,833
Net amount recognized	$ 6,235,745	$ 6,277,743

Expected cash flows:	
Expected employer contributions – 2012	$ 67,738
Expected benefit payments:*	
2012	$ 67,738
2013	78,622
2014	88,824
2015	99,039
2016	114,703
2017–2021	776,755

* Expected benefit payments to be made from System assets.

	2011	2010
Components of net periodic benefit cost:		
Service cost	$1,456,457	$1,359,828
Interest cost	602,381	545,688
Expected return on plan assets	–	–
Amortization:		
Actuarial (gain) loss	230,468	287,957
Prior service (credit) cost	1,881	12,290
Net periodic benefit cost (credit)	$2,291,187	$2,205,763
Weighted-average assumptions used to determine net periodic benefit cost:		
Discount rate	5.50 %	6.00 %
Rate of compensation increase	5.00 %	5.00 %
Other changes in plan assets and benefit obligations recognized in other comprehensive income:		
Current year actuarial (gain) loss	$ 190,351	$4,155,013
Amortization of prior service credit (cost)	(1,881)	(12,290)
Amortization of actuarial gain (loss)	(230,468)	(287,957)
Total recognized in other comprehensive (income) loss	$ (41,998)	$3,854,766
Total recognized in net periodic benefit cost and other comprehensive income	$2,249,189	$6,060,529

Estimated amounts that will be amortized from accumulated other comprehensive income into net periodic benefit cost (credit) in 2012 are shown below:

Net actuarial (gain) loss	$424,241
Prior service (credit) cost	78,985
Total	$503,226

On October 30, 2008, the Board approved a non-qualified plan for Officers of the Board. The retirement benefits covered under the Pension Enhancement Plan (PEP) (formerly the Board Officer Pension Enhancement) increases the pension benefit calculation from 1.8% above the Social Security integration level to 2.0%. Activity for the PEP as of December 31, 2011 and 2010, is summarized in the following tables:

	2011	2010
Change in projected benefit obligation:		
Benefit obligation – beginning of year	$ 9,949,637	$ 7,120,820
Service cost	489,236	409,007
Interest cost	589,888	493,780
Plan participants' contributions	–	–
Actuarial (gain) loss	2,401,971	1,935,668
Gross benefits paid	(57,124)	(9,638)
Transfers to CFPB	(123,399)	–
Benefit obligation – end of year	$ 13,250,209	$ 9,949,637
Accumulated benefit obligation – end of year	$ 10,000,174	$ 7,063,653
Weighted-average assumptions used to determine benefit obligation as of December 31:		
Discount rate	4.50 %	5.50 %
Rate of compensation increase	5.00 %	5.00 %
Change in plan assets:		
Fair value of plan assets – beginning of year	$ –	$ –
Employer contributions	57,124	9,638
Plan participants' contributions	–	–
Gross benefits paid	(57,124)	(9,638)
Fair value of plan assets – end of year	$ –	$ –
Funded status:		
Reconciliation of funded status – end of year:		
Fair value of plan assets	$ –	$ –
Benefit obligations	13,250,209	9,949,637
Funded status	(13,250,209)	(9,949,637)
Amount recognized – end of year	$(13,250,209)	$(9,949,637)
Amounts recognized in the statements of financial position consist of:		
Asset	$ –	$ –
Liability	(13,250,209)	(9,949,637)
Net amount recognized	$(13,250,209)	$(9,949,637)
Amounts recognized in accumulated other comprehensive income consist of:		
Net actuarial loss (gain)	$ 5,416,792	$ 3,465,859
Prior service cost (credit)	2,711,883	3,243,278
Net amount recognized	$ 8,128,675	$ 6,709,137

Expected cash flows:	
Expected employer contributions – 2012	$ 97,485
Expected benefit payments:*	
2012	$ 97,485
2013	151,288
2014	213,417
2015	279,210
2016	344,635
2017–2021	2,877,198

* Expected benefit payments to be made from System assets.

	2011	2010
Components of net periodic benefit cost:		
Service cost	$ 489,236	$ 409,007
Interest cost	589,888	493,780
Expected return on plan assets	–	–
Amortization:		
Actuarial (gain) loss	327,639	212,555
Prior service (credit) cost	531,395	531,395
Net periodic benefit cost (credit)	$1,938,158	$1,646,737
Weighted-average assumptions used to determine net periodic benefit cost:		
Discount rate	5.50 %	6.00 %
Rate of compensation increase	5.00 %	5.00 %
Other changes in plan assets and benefit obligations recognized in other comprehensive income:		
Current year actuarial (gain) loss	$2,278,572	$1,935,668
Amortization of prior service credit (cost)	(531,395)	(531,395)
Amortization of actuarial gain (loss)	(327,639)	(212,555)
Total recognized in other comprehensive (income) loss	$1,419,538	$1,191,718
Total recognized in net periodic benefit cost and other comprehensive income	$3,357,696	$2,838,455

Estimated amounts that will be amortized from accumulated other comprehensive income into net periodic benefit cost (credit) in 2012 are shown below:

Net actuarial (gain) loss	$ 486,710
Prior service (credit) cost	531,395
Total	$1,018,105

The total accumulated retirement benefit obligation includes a liability for a supplemental retirement agreement and a benefits equalization plan under the Federal Reserve System's Thrift Plan. The total obligation as of December 31, 2011 and 2010 is summarized in the following table:

	2011	2010
Accumulated retirement benefit obligation:		
Benefit obligation – BEP	$14,147,186	$11,933,435
Benefit obligation – PEP	13,250,209	9,949,637
Additional benefit obligations	88,317	96,147
Total accumulated retirement benefit obligation	$27,485,712	$21,979,219

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). These defined benefit plans are administered by the U.S. Office of Personnel Management, which determines the required employer contribution levels. The Board's contributions to these plans totaled $523,000 and $452,000 in 2011 and 2010, respectively. The Board has no liability for future payments to retirees under these programs and is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan or Roth 401(k). Board contributions to members' accounts were $17,699,000 and $16,695,000 in 2011 and 2010, respectively.

(7) Accumulated Postretirement Benefits

The Board provides certain life insurance programs for its active employees and retirees. Activity as of December 31, 2011 and 2010, is summarized in the following tables:

	2011	2010
Change in projected benefit obligation:		
Benefit obligation – beginning of year	$ 10,219,672	$ 9,304,324
Service cost	186,268	188,357
Interest cost	529,161	532,592
Plan participants' contributions	–	–
Actuarial (gain) loss	1,158,757	464,667
Gross benefits paid	(294,779)	(270,268)
Benefit obligation – end of year	$ 11,799,079	$ 10,219,672
Weighted-average assumptions used to determine benefit obligation as of December 31 – discount rate	4.50 %	5.25 %
Change in plan assets:		
Fair value of plan assets – beginning of year	$ –	$ –
Employer contributions	294,779	270,268
Gross benefits paid	(294,779)	(270,268)
Fair value of plan assets – end of year	$ –	$ –
Funded status:		
Reconciliation of funded status – end of year:		
Fair value of plan assets	$ –	$ –
Benefit obligations	11,799,079	10,219,672
Funded status	(11,799,079)	(10,219,672)
Amount recognized – end of year	$(11,799,079)	$(10,219,672)
Amounts recognized in the statements of financial position consist of:		
Asset	$ –	$ –
Liability	(11,799,079)	(10,219,672)
Net amount recognized	$(11,799,079)	$(10,219,672)
Amounts recognized in accumulated other comprehensive income consist of:		
Net actuarial loss (gain)	$ 2,980,166	$ 1,917,176
Prior service cost (credit)	(251,044)	(276,534)
Net amount recognized	$ 2,729,122	$ 1,640,642

Expected cash flows:	
Expected employer contributions – 2012	$ 349,523
Expected benefit payments:*	
2012	$ 349,523
2013	375,715
2014	404,358
2015	431,631
2016	462,469
2017–2021	2,714,234

* Expected benefit payments to be made from System assets.

	2011	2010
Components of net periodic benefit cost:		
Service cost	$ 186,268	$ 188,357
Interest cost	529,161	532,592
Expected return on plan assets	–	–
Amortization:		
Actuarial (gain) loss	95,767	76,224
Prior service (credit) cost	(25,490)	(25,490)
Net periodic benefit cost (credit)	$ 785,706	$ 771,683
Weighted-average assumptions used to determine net periodic benefit cost – discount rate	5.25 %	5.75 %
Other changes in plan assets and benefit obligations recognized in other comprehensive income:		
Current year actuarial (gain) loss	$1,158,757	$ 464,667
Amortization of prior service credit (cost)	25,490	25,490
Amortization of actuarial gain (loss)	(95,767)	$ (76,224)
Total recognized in other comprehensive (income) loss	$1,088,480	$ 413,933
Total recognized in net periodic benefit cost and other comprehensive income	$1,874,186	$1,185,616

Estimated amounts that will be amortized from accumulated other comprehensive income into net periodic benefit cost (credit) in 2012 are shown below:

Net actuarial (gain) loss	$221,302
Prior service (credit) cost	(25,490)
Total	$195,812

(8) Accumulated Postemployment Benefits

The Board provides certain postemployment benefits to eligible former or inactive employees and their dependents during the period subsequent to employment but prior to retirement. Postemployment costs were actuarially determined using a December 31 measurement date and discount rates of 2.25% and 3.50% as of December 31, 2011 and 2010, respectively. The net periodic postemployment benefit cost (credit) recognized by the Board as of December 31, 2011 and 2010, were ($1,606,000) and $701,000, respectively.

(9) Accumulated Other Comprehensive Income (Loss)

A reconciliation of beginning and ending balances of accumulated other comprehensive income (loss) for the years ended December 31, 2011 and 2010, is as follows:

	Amount Related to Defined Benefit Retirement Plans	Amount Related to Postretirement Benefits Other Than Pensions	Total Accumulated Other Comprehensive Income (Loss)
Balance – January 1, 2010	$ (7,940,396)	$(1,226,709)	$ (9,167,105)
Change in funded status of benefit plans:			
Amortization of prior service (credit) costs	543,685	(25,490)	518,195
Amortization of net actuarial (gain) loss	500,512	76,224	576,736
Net actuarial gain (loss) arising during the year	(6,090,681)	(464,667)	(6,555,348)
Change in funded status of benefit plans – other comprehensive income (loss)	(5,046,484)	(413,933)	(5,460,417)
Balance – December 31, 2010	(12,986,880)	(1,640,642)	(14,627,522)
Change in funded status of benefit plans:			
Amortization of prior service (credit) costs	533,276	(25,490)	507,786
Amortization of net actuarial (gain) loss	558,107	95,767	653,874
Net actuarial gain (loss) arising during the year	(2,468,923)	(1,158,757)	(3,627,680)
Change in funded status of benefit plans – other comprehensive income (loss)	(1,377,540)	(1,088,480)	(2,466,020)
Balance – December 31, 2011	$(14,364,420)	$(2,729,122)	$(17,093,542)

Additional detail regarding the classification of accumulated other comprehensive income (loss) is included in Notes 6 and 7.

(10) Federal Reserve Banks

The Board performs certain functions for the Federal Reserve Banks in conjunction with its responsibilities for the System, and the Federal Reserve Banks provide certain administrative functions for the Board. The Board assesses the Federal Reserve Banks for its operating expenses, to include expenses related to its currency responsibilities, as well as for the funding the Board is required to provide to the Bureau and the Office. Activity related to the Board and Federal Reserve Banks as of December 31, 2011 and 2010, is summarized in the following table:

	2011	2010
Assessments levied or to be levied on Federal Reserve Banks for:		
Currency expenses	$ 650,010,597	$ 622,858,648
Operating expenses of the Board	472,300,000	422,200,000
Operating expenses of the Bureau	241,711,564	32,770,000
Operating expenses of the Office	40,000,000	9,515,944
Total Assessments levied or to be levied on Federal Reserve Banks	$1,404,022,161	$1,087,344,592
Board expenses charged to the Federal Reserve Banks for data processing	$ 406,421	$ 483,512
Federal Reserve Bank expenses charged to the Board:		
Data processing and communication	$ 788,910	$ 919,889
Contingency site	1,211,362	1,254,331
Total Federal Reserve Bank expenses charged to the Board	$ 2,000,272	$ 2,174,220
Net transactions with Federal Reserve Banks	$1,402,428,310	$1,085,653,884
Accounts receivable due from the Federal Reserve Banks	$ 2,501,565	$ 856,685
Accounts payable due to the Federal Reserve Banks	$ 16,358	$ –

The Board also contracted for audit services on behalf of entities that are included in the combined financial statements of the Federal Reserve Banks. The entities reimburse the Board for the cost of the audit services. The Board accrued liabilities of $293,000 and $322,000 in audit services and recorded receivables of $500,000 and $322,000 from the entities as of December 31, 2011 and 2010, respectively.

(11) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the Council), and currently performs certain management functions for the Council. The five agencies that are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and the Bureau of Consumer Financial Protection.

The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council, as of December 31, 2011 and 2010, is summarized in the following table:

	2011	2010
Council expenses charged to the Board:		
Assessments for operating expenses	$ 137,421	$ 126,469
Assessments for examiner education	810,459	672,153
Central Data Repository	1,113,255	1,202,704
Uniform Bank Performance Report	117,215	154,877
Total Council expenses charged to the Board	$2,178,350	$2,156,203
Board expenses charged to the Council:		
Data processing related services	$4,164,479	$4,897,107
Administrative services	281,000	245,000
Total Board expenses charged to the Council	$4,445,479	$5,142,107
Accounts receivable due from the Council	$ 494,234	$ 579,792
Accounts payable due to the Council	$ 132,539	290,047

(12) The Office of Employee Benefits of the Federal Reserve System

The Office of Employee Benefits of the Federal Reserve System (OEB) administers certain System benefit programs on behalf of the Board and the Federal Reserve Banks, and costs associated with the OEB's activities are assessed to the Board and Federal Reserve Banks. The Board was assessed $2,596,000 and $2,371,000 as of December 31, 2011 and 2010, respectively.

(13) The Bureau of Consumer Financial Protection

Sec. 1017 of the Dodd-Frank Act requires the Board to fund the Bureau from the combined earnings of the Federal Reserve System, the amount of which is determined by the Director of the Bureau to be reasonably necessary to carry out the authorities of the Bureau under Federal consumer financial law, taking into account such other sums made available to the Bureau from the preceding year (or quarter of such year).

Beginning July 2011, the Dodd-Frank Act limits the amount to be transferred each fiscal year to a fixed percentage of the System's total operating expenses. The Board received and processed funding requests for the Bureau totaling $241,711,564 and $32,770,000 during calendar years 2011 and 2010, respectively. These requests do not include funding related to the operations of the OIG. The Board and the Bureau are in the process of evaluating the impact of the OIG's dual responsibilities on future funding requests.

As part of the transfer of responsibilities from the Board to the Bureau, certain Board staff were transferred to the Bureau during 2011. The Board will continue to administer certain non-retirement benefits for all transferred Board employees through July 20, 2012.

(14) The Office of Financial Research

Sec. 155(c) of the Dodd-Frank Act requires the Board to provide an amount sufficient to cover the expenses of the Office for the 2-year period following the date of the enactment (July 21, 2010). The expenses of the FSOC are included in the expenses of the Office. The Board received and processed funding requests for the Office totaling $40,000,000 and $9,515,944 during 2011 and 2010, respectively.

(15) Currency

The Bureau of Engraving and Printing (BEP) is the sole supplier for currency printing and also provides currency retirement services. During 2011, the Board assumed greater responsibility for education and quality assurance services associated with currency. The currency costs incurred by the Board as of December 31, 2011 and 2010, are reflected in the following table:

	2011	2010
Expenses related to BEP services:		
Printing	$623,214,300	$598,238,821
Retirement	3,475,244	3,513,538
Subtotal related to BEP services	$626,689,544	$601,752,359
Other currency expenses:		
Shipping	$ 15,728,046	$ 16,900,584
Research and development	4,486,525	4,205,705
Quality assurance services	2,992,053	–
Education services	114,429	–
Subtotal other currency expenses	$ 23,321,053	$ 21,106,289
Total currency expenses	$650,010,597	$622,858,648

In October 2011, the Board received web software from the BEP for the education services the Board is managing as part of its currency responsibilities. The fair market value of the donated asset as of December 31, 2011 was $50,000.

(16) Commitments and Contingencies

Commitments — The Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Council, to fund a portion of the enhancements and maintenance fees for a central data repository project that requires maintenance through 2013. The estimated Board expense to support this effort is $2 million for the remaining option period.

Litigation and Contingent Liabilities — The Board is subject to contingent liabilities which arise from litigation cases and various business contracts. These contingent liabilities arise in the normal course of operations and their ultimate disposition is unknown. Based on information currently available to management, it is management's opinion that the expected outcome of these matters, in the aggregate, will not have a materially adverse effect on the financial statements.

(17) Subsequent Events

There were no subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2011. Subsequent events were evaluated through March 8, 2012, which is the date the financial statements were available to be issued.

Deloitte.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Board of Governors of the Federal Reserve System:

Washington, D.C.

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the "Board") as of and for the year ended December 31, 2011, and have issued our report thereon dated March 8, 2012. We conducted our audit in accordance generally accepted auditing standards as established by the Auditing Standards Board (United States), auditing standards of the Public Company Accounting Oversight Board (United States), and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In accordance with standards of the Public Company Accounting Oversight Board (United States) and *Government Auditing Standards*, we have also issued our report dated March 8, 2012, on our tests of the Board's internal control over financial reporting. The purpose of that report is to describe the scope and the results of that testing. That report is an integral part of an audit performed in accordance with standards of the Public Company Accounting Oversight Board (United States) and *Government Auditing Standards* and should be considered in assessing the results of our audit.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Board's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

Deloitte + Touche LLP

March 8, 2012
McLean, VA

Federal Reserve Banks Combined Financial Statements

The combined financial statement of the Federal Reserve Banks were audited by Deloitte & Touche LLP, independent auditors, for the years ended December 31, 2011 and 2010.

Deloitte.

INDEPENDENT AUDITOR'S REPORT

To the Board of Governors of the Federal Reserve System and the Boards of Directors of the Federal Reserve Banks:

We have audited the accompanying Combined Statements of Condition of the Federal Reserve Banks (the "Reserve Banks") as of December 31, 2011 and 2010, and the related Combined Statements of Income and Comprehensive Income, and of Changes in Capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. These Combined Financial Statements are the responsibility of the Division of Reserve Bank Operations and Payment System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Reserve Banks are not required to have, nor were we engaged to perform, an audit of their internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Reserve Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 4 to the Combined Financial Statements, these Combined Financial Statements were prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as set forth in the *Financial Accounting Manual for Federal Reserve Banks,* which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such Combined Financial Statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 4.

In our opinion, such Combined Financial Statements present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2011 and 2010, and the combined results of their operations for the years then ended, on the basis of accounting described in Note 4.

Deloitte & Touche LLP

March 20, 2012
Washington, DC

The Federal Reserve Banks

Abbreviations

ABCP	Asset-backed commercial paper
ABS	Asset-backed securities
ACH	Automated clearinghouse
AIA	American International Assurance Company Ltd.
AIG	American International Group, Inc.
AIG Trust	AIG Credit Facility Trust
AIGFP	AIG Financial Products Corp.
ALICO	American Life Insurance Company
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BEP	Benefit Equalization Retirement Plan
Bureau	Bureau of Consumer Financial Protection
CDO	Collateralized debt obligation
CDS	Credit default swaps
CIP	Committee on Investment Performance (related to System Retirement Plan)
CMBS	Commercial mortgage-backed securities
CPFF	Commercial Paper Funding Facility
FAM	*Financial Accounting Manual for Federal Reserve Banks*
FASB	Financial Accounting Standards Board
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
FOMC	Federal Open Market Committee
FRBA	Federal Reserve Bank of Atlanta
FRBC	Federal Reserve Bank of Cleveland
FRBNY	Federal Reserve Bank of New York
FRBSF	Federal Reserve Bank of San Francisco
GAAP	Accounting principles generally accepted in the United States of America
GSE	Government-sponsored enterprise
IMF	International Monetary Fund
IRS	Interest rate swaps
JPMC	JPMorgan Chase & Co.
Libor	London interbank offered rate
LLC	Limited liability company
MBS	Mortgage-backed securities
ML	Maiden Lane LLC
ML II	Maiden Lane II LLC
ML III	Maiden Lane III LLC

MTM	Mark-to-market
OEB	Office of Employee Benefits of the Federal Reserve System
OFR	Office of Financial Research
PDCF	Primary Dealer Credit Facility
RMBS	Residential mortgage-backed securities
SBA	Small Business Administration
SDR	Special drawing rights
SERP	Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks
SOMA	System Open Market Account
STRIP	Separate Trading of Registered Interest and Principal of Securities
TAF	Term Auction Facility
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
TBA	To be announced
TCE	Transitional Credit Extension
TDF	Term Deposit Facility
TRS	Total return swap agreement
TOP	Term Securities Lending Facility Options Program
TSLF	Term Securities Lending Facility
VIE	Variable interest entity

Federal Reserve Banks Combined Statements of Condition as of December 31, 2011 and December 31, 2010
(in millions)

	2011	2010
Assets		
Gold certificates	$ 11,037	$ 11,037
Special drawing rights certificates	5,200	5,200
Coin	2,306	2,180
Loans:		
Depository institutions	196	221
Term Asset-Backed Securities Loan Facility (measured at fair value)	9,059	24,853
American International Group, Inc., net	–	20,603
System Open Market Account:		
Treasury securities, net	1,750,277	1,066,952
Government-sponsored enterprise debt securities, net	107,828	152,972
Federal agency and government-sponsored enterprise mortgage-backed securities, net	848,258	1,004,695
Foreign currency denominated assets, net	25,950	26,049
Central bank liquidity swaps	99,823	75
Investments held by consolidated variable interest entities (of which $35,593 and $68,469 is measured at fair value as of December 31, 2011 and 2010, respectively)	35,693	68,666
Preferred interests	–	26,385
Accrued interest receivable	19,710	14,231
Bank premises and equipment, net	2,549	2,613
Items in process of collection	273	374
Other assets	711	738
Total assets	$2,918,870	$2,427,844
Liabilities and Capital		
Federal Reserve notes outstanding, net	$1,034,052	$ 941,561
System Open Market Account:		
Securities sold under agreements to repurchase	99,900	59,703
Other liabilities	1,368	–
Consolidated variable interest entities:		
Beneficial interest in consolidated variable interest entities (measured at fair value)	9,845	10,051
Other liabilities (of which $106 and $203 is measured at fair value as of December 31, 2011 and 2010, respectively)	690	921
Deposits:		
Depository institutions	1,562,253	968,052
Treasury, general account	85,737	140,773
Treasury, supplementary financing account	–	199,964
Other deposits	65,034	16,967
Funds from American International Group, Inc. asset dispositions, held as agent	–	26,896
Interest payable to depository institutions	178	113
Accrued benefit costs	3,952	2,597
Deferred credit items	904	1,794
Accrued interest on Federal Reserve notes	900	5,124
Other liabilities	259	280
Total liabilities	2,865,072	2,374,796
Capital paid-in	26,899	26,524
Surplus (including accumulated other comprehensive loss of $4,792 and $3,630 at December 31, 2011 and 2010, respectively)	26,899	26,524
Total capital	53,798	53,048
Total liabilities and capital	$2,918,870	$2,427,844

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

Federal Reserve Banks Combined Statements of Income and Comprehensive Income for the years ended December 31, 2011 and December 31, 2010
(in millions)

	2011	2010
Interest Income		
Loans:		
Depository institutions	$ –	$ 50
Term Asset-Backed Securities Loan Facility	265	750
American International Group, Inc., net	409	2,728
System Open Market Account:		
Treasury securities, net	42,257	26,373
Government-sponsored enterprise debt securities, net	3,053	3,510
Federal agency and government-sponsored enterprise mortgage-backed securities, net	38,281	44,839
Foreign currency denominated assets, net	249	223
Central bank liquidity swaps	34	12
Investments held by consolidated variable interest entities	3,429	4,440
Total interest income	87,977	82,925
Interest Expense		
System Open Market Account:		
Securities sold under agreements to repurchase	44	94
Beneficial interest in consolidated variable interest entities	285	277
Deposits:		
Depository institutions	3,765	2,680
Term Deposit Facility	6	4
Total interest expense	4,100	3,055
Net interest income	83,877	79,870
Non-Interest Income		
Term Asset-Backed Securities Loan Facility, unrealized losses	(84)	(436)
System Open Market Account:		
Treasury securities gains, net	2,258	–
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	10	782
Foreign currency gains, net	152	554
Consolidated variable interest entities:		
Investments held by consolidated variable interest entities (losses) gains, net	(3,920)	8,180
Beneficial interest in consolidated variable interest entities gains (losses), net	491	(4,679)
Dividends on preferred interests	47	1,279
Income from services	477	567
Reimbursable services to government agencies	485	457
Other	134	187
Total non-interest income	50	6,891
Operating Expenses		
Salaries and benefits	2,811	2,722
Occupancy	312	297
Equipment	188	180
Assessments:		
Board of Governors operating expenses and currency costs	1,121	1,045
Bureau of Consumer Financial Protection	242	33
Office of Financial Research	40	10
Professional fees related to consolidated variable interest entities	71	104
Other	604	681
Total operating expenses	5,389	5,072
Net income prior to distribution	78,538	81,689
Change in prior service costs related to benefit plans	46	110
Change in actuarial losses related benefit plans	(1,208)	(64)
Comprehensive income prior to distribution	$77,376	$81,735
Distribution of comprehensive income:		
Dividends paid to member banks	$ 1,577	$ 1,583
Transferred to surplus and change in accumulated other comprehensive loss	375	884
Payments to Treasury as interest on Federal Reserve notes	75,424	79,268
Total distribution	$77,376	$81,735

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

Federal Reserve Banks Combined Statements of Changes in Capital for the years ended December 31, 2011 and December 31, 2010
(in millions, except share data)

	Capital paid-in	Surplus			Total capital
		Net income retained	Accumulated other comprehensive loss	Total surplus	
Balance at January 1, 2010 (512,806,659 shares)	$25,640	$29,316	$(3,676)	$25,640	$51,280
Net change in capital stock issued (17,674,477 shares)	884	–	–	–	884
Transferred to surplus and change in accumulated other comprehensive income	–	838	46	884	884
Balance at December 31, 2010 (530,481,136 shares)	$26,524	$30,154	$(3,630)	$26,524	$53,048
Net change in capital stock issued (7,503,485 shares)	375	–	–	–	375
Transferred to surplus and change in accumulated other comprehensive loss	–	1,537	(1,162)	375	375
Balance at December 31, 2011 (537,984,621 shares)	$26,899	$31,691	$(4,792)	$26,899	$53,798

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

(1) Structure

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) 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.

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

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

(2) Operations and Services

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

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

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

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes the FRBNY to conduct operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out the System's central bank responsibilities. Specifically, the FOMC authorizes and directs the FRBNY to hold balances of, and to execute spot and forward foreign exchange and securities contracts for, 14 foreign currencies and to invest such foreign currency holdings, while maintaining adequate liquidity. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico in the maximum amounts of \$2 billion and \$3 billion, respectively, and to warehouse foreign currencies for the Treasury and the Exchange Stabilization Fund.

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

(3) Financial Stability Activities

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

Large-Scale Asset Purchase Programs and Reinvestment of Principal Payments

On March 18, 2009, the FOMC authorized and directed the FRBNY to purchase \$300 billion of longer-term Treasury securities to help improve conditions in private credit markets. The FRBNY began the purchases of these Treasury securities in March 2009 and completed them in October 2009. On August 10, 2010, the FOMC announced that the Federal Reserve would maintain the level of domestic securities holdings in the SOMA portfolio by reinvesting principal payments from

GSE debt securities and federal agency and GSE MBS in longer-term Treasury securities. On November 3, 2010, the FOMC announced its intention to expand the SOMA portfolio holdings of longer-term Treasury securities by an additional $600 billion and completed these purchases in June 2011. On June 22, 2011, the FOMC announced that the Federal Reserve would maintain its existing policy of reinvesting principal payments from all domestic securities in Treasury securities. On September 21, 2011, the FOMC announced that the Federal Reserve intends to purchase, by the end of June 2012, $400 billion par value of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less, of which $133 billion has been purchased and $134 billion sold as of December 31, 2011. In addition, the FOMC announced that it will maintain its existing policy of rolling over maturing Treasury securities at auction and, rather than reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in Treasury securities, such payments will be reinvested in federal agency and GSE MBS.

The FOMC authorized and directed the FRBNY to purchase GSE debt securities and federal agency and GSE MBS, with a goal to provide support to mortgage and housing markets and to foster improved conditions in financial markets more generally. The FRBNY was authorized to purchase up to $175 billion in fixed-rate, non-callable GSE debt securities and $1.25 trillion in fixed-rate federal agency and GSE MBS. Purchases of GSE debt securities began in November 2008, and purchases of federal agency and GSE MBS began in January 2009. The FRBNY completed the purchases of GSE debt securities and federal agency and GSE MBS in March 2010. The settlement of all federal agency and GSE MBS transactions was completed by August 2010. As discussed above, on September 21, 2011, the FOMC announced that the Federal Reserve will begin to reinvest principal payments from its holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS.

Central Bank Liquidity Swaps

The FOMC authorized and directed the FRBNY to establish central bank liquidity swap arrangements, which could be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements.

In May 2010, U.S. dollar liquidity swap arrangements were re-authorized with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank through January 2011. Subsequently, these arrangements were extended through February 1, 2013. There is no specified limit to the amount that may be drawn by the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank under these swap arrangements; the Bank of Canada may draw up to $30 billion under the swap arrangement with the FRBNY. In addition to the central bank liquidity swap arrangements, the FOMC has authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico, as discussed in Note 2.

Foreign currency liquidity swap arrangements were authorized with 4 foreign central banks and provided the Reserve Banks with the capacity to offer foreign currency liquidity to U.S. depository institutions. The authorization for these swap arrangements expired on February 1, 2010. In November 2011, as a contingency measure, the FOMC agreed to establish temporary bilateral liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank so that liquidity can be provided in any of their currencies if necessary. The swap lines are authorized until February 1, 2013.

Lending to Depository Institutions

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

Lending to Primary Dealers

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

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

The Primary Dealer Credit Facility (PDCF) was designed to improve the ability of primary dealers to provide financing to participants in the securitization markets. Primary dealers could obtain secured overnight financing under the PDCF in the form of repurchase transactions. The authorization for the PDCF expired on February 1, 2010, and the last loan matured on May 13, 2009.

The Transitional Credit Extension (TCE) program provided liquidity support through secured loans to broker-dealers that were in the process of transitioning to the bank holding company structure. The authorization for the TCE program expired on February 1, 2010, and the last loan matured on April 29, 2009.

Other Lending Facilities

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

The Commercial Paper Funding Facility (CPFF program) enhanced the liquidity of the commercial paper market in the United States by increasing the availability of term commercial paper funding to issuers and by providing greater assurance to both issuers and investors that issuers would be able to roll over their maturing commercial paper. The authorization to purchase high-quality commercial paper through the CPFF program expired on February 1, 2010. The Commercial Paper Funding Facility LLC (CPFF) was a Delaware limited liability company formed on October 14, 2008, in connection with the implementation of the CPFF program, to purchase eligible three-month unsecured commercial paper and ABCP directly from eligible issuers using the proceeds of loans made to CPFF by the FRBNY. The FRBNY's loans to CPFF were eliminated in consolidation of CPFF into the combined financial statements. The last commercial paper purchased by the CPFF matured on April 26, 2010, and the CPFF was dissolved on August 30, 2010.

The Term Asset-Backed Securities Loan Facility (TALF) assisted financial markets in accommodating the credit needs of consumers and businesses of all sizes by facilitating the issuance of asset-backed securities (ABS) collateralized by a variety of consumer and business loans. The Board of Governors authorized the offering of TALF loans collateralized by newly-issued ABS and legacy commercial mortgage-backed securities (CMBS) until March 31, 2010, and TALF loans collateralized by newly-issued CMBS until June 30, 2010. Under the TALF, the FRBNY was authorized to lend up to $200 billion to eligible borrowers.

TALF loans have maturities of up to five years and are secured by eligible collateral, with the FRBNY having lent an amount equal to the value of the collateral, as determined by the FRBNY, less a margin. Loan proceeds were disbursed to the borrower contingent on receipt by the FRBNY's custodian of the eligible collateral, an administrative fee, and, if applicable, a margin.

The TALF loans were extended on a nonrecourse basis. If the borrower does not repay the loan, the FRBNY will enforce its rights in the collateral and may sell the collateral to TALF LLC, a Delaware limited liability company, established on February 4, 2009, for the purpose of purchasing such assets. As of December 31, 2011, the FRBNY has not enforced its rights to the collateral because there have been no defaults.

Pursuant to a put agreement with the FRBNY, TALF LLC has committed to purchase assets that secure a TALF loan at a price equal to the principal amount outstanding plus accrued but unpaid interest, regardless of the fair value of the collateral. Funding for the TALF LLC's purchases of these securities is derived first through the fees received by TALF LLC from the FRBNY for this commitment and any interest earned on its investments. In the event that such funding proves insufficient for the asset purchases that TALF LLC has committed to make under the put agreement, the Treasury committed to lend up to $20 billion, and on March 25, 2009, the Treasury funded $100 million. On July 19, 2010, this commitment was reduced to $4.3 billion to reflect the fact that only $43 billion of TALF loans were outstanding when the program closed to new lending on June 30, 2010. Any Treasury loan to TALF LLC bears interest at a rate of the one-month London interbank offered rate (Libor) plus 300 basis points. In addition to the Treasury's commitment, the FRBNY committed, as a senior lender, to lend up to $180 billion to TALF LLC if it needed the funding to purchase assets pursuant to the put agreement. The FRBNY's maximum exposure was subsequently reduced to $38.7 billion when the program closed to new lending. Any loan that the FRBNY makes to TALF LLC would be senior to any Treasury loan and would bear interest at a rate of the one-month Libor plus 100 basis points. To the extent that Treasury and the FRBNY have extended credit to TALF LLC, their loans are secured by all of the assets of TALF LLC. The FRBNY is the managing member and the controlling party of TALF LLC and will remain the controlling party as long as it retains an economic interest in TALF LLC. After TALF LLC has paid all operating expenses and principal due to the FRBNY, the remaining proceeds of the portfolio holdings will be distributed in the following order: principal due to the Treasury, interest due to the FRBNY, and interest due to the Treasury. Any residual cash flows will be shared between the FRBNY, which will receive 10 percent, and the Treasury, which will receive 90 percent.

Support for Specific Institutions

The Bear Stearns Companies, Inc.

To facilitate the merger of The Bear Stearns Companies, Inc. (Bear Stearns) and JPMorgan Chase & Co. (JPMC), the FRBNY extended credit to Maiden Lane LLC (ML) in June 2008. ML is a Delaware limited liability company formed by the FRBNY to acquire certain assets of Bear Stearns and to manage those assets over time, in order to maximize the potential for the repayment of the credit extended to ML and to minimize disruption to the financial markets. The assets acquired by ML were valued at $29.9 billion as of March 14, 2008, the date that the FRBNY committed to the transaction, and largely consisted of federal agency and GSE MBS, non-agency residential mortgage-backed securities (RMBS), commercial and residential mortgage loans, and derivatives and associated hedges.

The FRBNY extended a senior loan of approximately $28.8 billion and JPMC extended a subordinated loan of $1.15 billion to finance the acquisition of the assets. The loans are collateralized by all of the assets of ML through a pledge to the collateral agent. The FRBNY is the sole and managing member and the controlling party of ML and will remain as such as long as the FRBNY retains an economic interest in ML. The interest rate on the senior loan is the primary credit rate in effect from time to time. The interest rate on the JPMC subordinated loan is the primary credit rate plus 450 basis points. JPMC bears losses associated with the portfolio through its subordinated loan plus accrued interest on the loan. Once the principal and interest are paid, residual gains, if any, will be allocated to the FRBNY. The two-year accumulation period that followed the closing date for ML ended on June 26, 2010. Consistent with the terms of the ML transaction, the distributions of the proceeds realized on the asset portfolio held by ML, after payment of certain fees and expenses, now occur on a monthly basis unless otherwise directed by the Federal Reserve.

American International Group, Inc.

In September 2008, the Board of Governors authorized the FRBNY to lend to American International Group, Inc. (AIG). Initially, the FRBNY provided AIG with a revolving line of credit collateralized by the pledge of a substantial portion of the assets of AIG. Under the provisions of the original agreement, the FRBNY was authorized to lend up to $85 billion to AIG for two years at the three-month Libor, with a floor of 350 basis points, plus 850 basis points. In addition, the FRBNY assessed AIG a one-time commitment fee of 200 basis points on the full amount of the commitment and a fee of 850 basis points per annum on the undrawn credit line. A condition of the credit agreement was that AIG would issue to a trust, for the sole benefit of the fiscal treasury, preferred shares convertible to approximately 78 percent of the issued and outstanding shares of the common stock of AIG. The AIG Credit Facility Trust (AIG Trust) was formed January 16, 2009, and the preferred shares were issued to the AIG Trust on March 4, 2009. The AIG Trust had three independent trustees who controlled the AIG Trust's voting and consent rights. The FRBNY could not exercise voting or consent rights.

The Board and the Treasury announced a restructuring of the government's financial support to AIG in November 2008. As part of the restructuring, the Treasury purchased $40 billion of newly-issued AIG preferred shares under the Troubled Asset Relief Program (TARP). The majority of the TARP funds were used to pay down AIG's debt to the FRBNY. In addition, the terms of the original credit agreement were modified to reduce the revolving line of credit to $60 billion;

reduce the interest rate to the three-month Libor with a floor of 350 basis points, plus 300 basis points; reduce the fee on undrawn funds to 75 basis points; and extend the term of the agreement to five years. The other material terms of the funding were unchanged. These revised terms were more consistent with terms generally available to other entities with similar credit risk.

Concurrent with the November 2008 restructuring of its financial support to AIG, the FRBNY established two limited liability companies (LLCs). The FRBNY extended credit to Maiden Lane II LLC (ML II), a Delaware limited liability company formed to purchase non-agency RMBS from the reinvestment pool of the securities lending portfolios of several regulated U.S. insurance subsidiaries of AIG. ML II borrowed $19.5 billion from the FRBNY and used the proceeds to purchase non-agency RMBS that had an approximate fair value of $20.8 billion as of October 31, 2008, from AIG's domestic insurance subsidiaries. The FRBNY is the sole and managing member and the controlling party of ML II and will remain as the controlling party as long as the FRBNY retains an economic interest in ML II. As part of the agreement, the AIG subsidiaries also received from ML II a fixed deferred purchase price of up to $1.0 billion, plus interest on any such fixed deferred purchase price outstanding. The interest rate on the FRBNY's senior loan is one-month Libor plus 100 basis points, and the interest rate on the fixed deferred purchase price is one-month Libor plus 300 basis points. After ML II has first paid the FRBNY's senior loan, including accrued and unpaid interest, and then the fixed deferred purchase price in full, including accrued and unpaid interest, any net proceeds will be divided between the FRBNY, which is entitled to receive five-sixths, and the AIG subsidiaries, which are entitled to receive one-sixth. The FRBNY's loan and the fixed deferred purchase price payable to the AIG subsidiaries are collateralized by all of the assets of ML II through a pledge to the collateral agent.

On March 30, 2011, the Federal Reserve announced that the FRBNY, through its investment manager, BlackRock Solutions, would dispose of the securities in the ML II portfolio individually and in segments through a competitive sales process over time as market conditions warrant. During the year ended December 31, 2011, a total of nine bid list auctions were conducted and assets with a total current face amount of $9.96 billion were sold. Subsequent to December 31, 2011, the Federal Reserve sold the remaining securities in the ML II portfolio through a competitive bidding process, as discussed in Note 17.

The FRBNY also extended credit to Maiden Lane III LLC (ML III), a Delaware limited liability company formed to purchase ABS collateralized debt obligations (CDOs) from certain third-party counterparties of AIG Financial Products Corp. (AIGFP). In connection with the acquisitions, the third-party counterparties agreed to terminate their related credit default swap (CDS) contracts with AIGFP. ML III borrowed approximately $24.3 billion from the FRBNY, and AIG provided an equity contribution of $5 billion to ML III. The proceeds were used to purchase ABS CDOs with a fair value of $29.6 billion. The counterparties received $26.8 billion net of principal, interest received, and finance charges paid. ML III also made a payment to AIGFP of $2.5 billion, representing the return of excess collateral previously posted by AIGFP with the counterparties. The FRBNY is the managing member and the controlling party of ML III and will remain as the controlling party as long as the FRBNY retains an economic interest in ML III. Net proceeds received by ML III will first be applied to repay the FRBNY's senior loan plus interest at one-month Libor plus 100 basis points. After the FRBNY is paid in full, the equity investor is entitled to receive its pro rata share of the equity contribution plus interest at the one-month Libor plus 300 basis points. After ML III has paid the FRBNY's senior loan and the equity contribution in full, the FRBNY will be entitled to receive 67 percent of any additional net proceeds received by ML III as a contingent interest on the senior loan and the equity investor will be entitled to receive its pro rata share of 33 percent of any net proceeds received by ML III as contingent distributions on its equity interest. The FRBNY's senior loan is collateralized by all of the assets of ML III through a pledge to the collateral agent.

On April 17, 2009, the FRBNY, as part of the U.S. government's commitment to the orderly restructuring of AIG over time, in the face of continuing market dislocations, further restructured the AIG loan by eliminating the 350 basis-point floor on the Libor used to calculate the interest rate on the loan. After this restructuring, the interest rate on the modified loan was equal to the three-month Libor plus 300 basis points.

On December 1, 2009, the FRBNY's commitment to lend to AIG was reduced to $35 billion from $60 billion when the outstanding balance of the FRBNY's loan to AIG was reduced by $25 billion in exchange for a liquidation preference of nonvoting perpetual preferred interests in two LLCs. AIG created two LLCs to hold, directly or indirectly, all of the outstanding common stock of American Life Insurance Company (ALICO) and American International Assurance Company Ltd. (AIA), two life insurance holding company subsidiaries of AIG. The FRBNY was to be paid a 5 percent cumulative dividend on its nonvoting preferred interests through September 22, 2013, and a 9 percent cumulative dividend thereafter. Although the FRBNY had certain governance rights to protect its interests, AIG retained control of the LLCs and the underlying operating companies. The initial value of the FRBNY's preferred interests as of December 1, 2009, was $16 billion for the AIA Aurora LLC (AIA LLC) and $9 billion for the ALICO Holdings LLC (ALICO LLC), which represented a percentage of the fair market value of AIA and ALICO, respectively.

On September 30, 2010, AIG announced an agreement with the Treasury, FRBNY, and the trustees of the AIG Trust on a comprehensive recapitalization plan designed to repay all its obligations to American taxpayers. The agreement included an accelerated repayment of the outstanding balance of the FRBNY revolving line of credit including all accrued interest and fees, termination of that facility, the repayment of the FRBNY's preferred interests in AIA LLC and ALICO LLC, and the conversion of the AIG preferred stock then owned by the Treasury and the AIG Trust into common equity of AIG.

Prior to the closing of the recapitalization plan, the cash proceeds from certain AIG asset dispositions were held by the FRBNY as agent. On October 29, 2010, AIG completed the initial public offering of AIA, successfully obtaining a listing on the Hong Kong Stock Exchange and raising total gross proceeds of $20.5 billion. On November 1, 2010, AIG completed the sale of ALICO to MetLife, initially announced on March 8, 2010, for approximately $15.5 billion, including $6.8 billion in cash and the remainder in equity and equity-linked securities of MetLife.

On January 14, 2011, upon closing of the recapitalization plan, the cash proceeds from certain asset dispositions, specifically the initial public offering of AIA and the sale of ALICO, were used first to repay in full the revolving line of credit extended to AIG by the FRBNY, including accrued interest and fees, and then to redeem a portion of the FRBNY's preferred interests in ALICO LLC taken earlier by the FRBNY in satisfaction of a portion of the revolving line of credit. The remaining FRBNY preferred interests in ALICO LLC and AIA LLC, valued at approximately $20 billion, were purchased by AIG through a draw on the Treasury's Series F preferred stock commitment and then transferred by AIG to the Treasury as partial consideration for the transfer to AIG of all outstanding Series F shares. In addition, the FRBNY's commitment to lend any funds under the revolving line of credit was terminated.

(4) Significant Accounting Policies

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

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

In addition, the Reserve Banks do not present a Combined Statement of Cash Flows as required by GAAP because the liquidity and cash position of the Reserve Banks are not a primary concern given the Reserve Banks' unique powers and responsibilities as a central bank. Other information regarding the Reserve Banks' activities is provided in, or may be derived from, the Combined Statements of Condition, Income and Comprehensive Income, and Changes in Capital, and the accompanying notes to the financial statements. There are no other significant differences, other than those described above, between the policies outlined in the FAM and GAAP.

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

a. Consolidation

The combined financial statements include the accounts and results of operations of the Reserve Banks as well as several variable interest entities (VIEs), which include ML, ML II, ML III, CPFF, and TALF LLC. The consolidation of the VIEs was assessed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 810 (ASC 810) *Consolidation*, which requires a VIE to be consolidated by its controlling financial interest holder. Intercompany balances and transactions have been eliminated in consolidation.

A Reserve Bank consolidates a VIE if it has a controlling financial interest, which is defined as the power to direct the significant economic activities of the entity and the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the VIE. To determine whether it is the controlling financial interest holder of a VIE, the Reserve Bank evaluates the VIE's design, capital structure, and relationships with the variable interest holders. The Reserve Bank reconsiders whether it has a controlling financial interest in a VIE, as required by ASC 810, at each reporting date.

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

b. Gold and Special Drawing Rights Certificates

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

SDR certificates are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. SDRs are recorded by the Bank at original cost. There were no SDR transactions during the years ended December 31, 2011 and 2010.

c. Coin

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

d. Loans

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

The FRBNY records the TALF loans at fair value in accordance with the fair value option provisions of FASB ASC Topic 825 (ASC 825) *Financial Instruments*. Unrealized gains (losses) on TALF loans that are recorded at fair value are reported as "Non-interest income: Term Asset-Backed Securities Loan Facility, unrealized losses" in the Combined Statements of Income and Comprehensive Income. The interest income on TALF loans is recognized based on the contracted rate and is reported as a component of "Interest Income: Term Asset-Backed Securities Loan Facility" in the Combined Statements of Income and Comprehensive Income. Administrative fees paid by borrowers at the initiation of each TALF loan, which are recognized as incurred and not deferred, are reported as a component of "Non-interest income: Other" in the Combined Statements of Income and Comprehensive Income.

The loan to AIG is reported at the outstanding principal balance net of unamortized administrative and commitment fees, and interest income is recognized on an accrual basis. Loan administrative and commitment fees are deferred and amortized on a straight-line basis, rather than using the interest method required by GAAP, over the term of the loan or commitment period. This method results in an interest amount that approximates the amount determined using the interest method.

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

Impaired loans include loans that have been modified in debt restructurings involving borrowers experiencing financial difficulties. The allowance for loan restructuring is determined by discounting the restructured cash flows using the original effective interest rate for the loan. Unless the borrower can demonstrate that it can meet the restructured terms, the Reserve Banks discontinue recognizing interest income. Performance prior to the restructuring, or significant events that coincide with the restructuring, are considered in assessing whether the borrower can meet the new terms.

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

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are settled through a triparty arrangement. In a triparty arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the FRBNY and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the FRBNY for each class and maturity of acceptable collateral. Collateral designated by the FRBNY as acceptable under repurchase transactions primarily includes Treasury securities (including Treasury Inflation-Protected Securities and Separate Trading of Registered Interest and Principal of Securities (STRIP) Treasury securities); direct obligations of several federal and GSE-related agencies, including Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and pass-through MBS of Fannie Mae, Freddie Mac, and Government National Mortgage Association. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction.

The FRBNY may engage in sales of securities under agreements to repurchase (reverse repurchase transactions) with primary dealers and, beginning August 2010, with selected money market funds. The list of eligible counterparties was subsequently expanded to include GSEs, effective in May 2011, and bank and savings institutions, effective in July 2011. These reverse repurchase transactions may be executed through a triparty arrangement as an open market operation, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international account holders as part of a service offering. Reverse repurchase agreements are collateralized by a pledge of an amount of Treasury securities, GSE debt securities, and federal agency and GSE MBS that are held in the SOMA. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest expense is recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities sold under agreements to repurchase" and the related accrued interest payable is reported as a component of "Other liabilities" in the Combined Statements of Condition.

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers to facilitate the effective functioning of the domestic securities markets. The amortized cost basis of securities lent continue to be reported in "Treasury securities, net" or "Government-sponsored enterprise debt securities, net," as appropriate, in the Combined Statements of Condition. Overnight securities lending transactions are fully collateralized by Treasury securities that have fair values in excess of the securities lent. The FRBNYcharges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Non-interest income: Other" in the Combined Statements of Income and Comprehensive Income.

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

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

Interest income on Treasury securities, GSE debt securities, and foreign currency denominated assets comprising the SOMA is accrued on a straight-line basis. Interest income on federal agency and GSE MBS is accrued using the interest method and includes amortization of premiums, accretion of discounts, and gains or losses associated with principal paydowns. Premiums and discounts related to federal agency and GSE MBS are amortized over the term of the security to stated maturity, and the amortization of premiums and accretion of discounts are accelerated when principal payments are received. Gains and losses resulting from sales of securities are determined by specific issue based on average cost. Treasury securities, GSE debt securities, and federal agency and GSE MBS are reported net of premiums and discounts in the Combined Statements of Condition and interest income on those securities is reported net of the amortization of premiums and accretion of discounts in the Combined Statements of Income and Comprehensive Income.

In addition to outright purchases of federal agency and GSE MBS that are held in the SOMA, the FRBNYenters into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell "to be announced" (TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. In 2010, the FRBNY also executed a limited number of TBA MBS coupon swap transactions, which involve a simultaneous sale of a TBA MBS and purchase of another TBA MBS of a different coupon rate. During the year-ended December 31, 2010, the FRBNY's participation in the dollar roll and coupon swap markets furthered the MBS purchase program goals of providing support to the mortgage and housing markets and of fostering improved conditions in financial markets more generally. During the year-ended December 31, 2011, the FRBNY executed dollar rolls primarily to facilitate settlement. The FRBNY accounts for outstanding commitments under dollar roll and coupon swaps as purchases or sales on a settlement-date basis. Net gains resulting from dollar roll and coupon swap transactions are reported as "Non-interest income: System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Combined Statements of Income and Comprehensive Income.

Foreign currency denominated assets, which can include foreign currency deposits, securities purchased under agreements to resell, and government debt instruments, are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on foreign currency denominated assets are reported as "Non-interest income: System Open Market Account: Foreign currency gains, net" in the Combined Statements of Income and Comprehensive Income.

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

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

The FRBNY is authorized to hold foreign currency working balances and execute foreign exchange contracts to facilitate international payments and currency transactions it makes on behalf of foreign central bank and U.S. official institution customers. These foreign currency working balances and contracts are not related to the FRBNY's monetary policy operations. Foreign currency working balances are reported as a component of "Other assets" in the Combined Statements of Condition and the related foreign currency valuation gains and losses that result from the daily revaluation of the foreign currency working balances and contracts are reported as a component of "Non-interest income: Other" in the Combined Statements of Income and Comprehensive Income.

g. Central Bank Liquidity Swaps

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

Central bank liquidity swaps activity, including the related income and expense, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The foreign currency amounts associated with these central bank liquidity swap arrangements are revalued daily at current foreign currency market exchange rates.

U.S. dollar liquidity swaps

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

The foreign central bank compensates the FRBNY based on the foreign currency amounts it holds for the FRBNY. The FRBNY recognizes compensation during the term of the swap transaction, which is reported as "Interest income: System Open Market Account: Central bank liquidity swaps" in the Combined Statements of Income and Comprehensive Income.

Foreign currency liquidity swaps

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

h. Investments Held by Consolidated Variable Interest Entities

The investments held by consolidated VIEs include investments in federal agency and GSE MBS, non-agency RMBS, commercial and residential real estate mortgage loans, CDOs, commercial paper, other investment securities, other real estate owned, and derivatives and associated hedges. Investments are reported as "Investments held by consolidated variable interest entities" in the Combined Statements of Condition. These investments are accounted for and classified as follows:

- ML's investments in debt securities are accounted for in accordance with FASB ASC Topic 320 (ASC 320) *Investments – Debt and Equity Securities* and ML elected the fair value option for all eligible assets and liabilities in accordance with ASC 825. Other financial instruments, including swap contracts and other derivatives instruments in ML, are recorded at fair value in accordance with FASB ASC Topic 815 (ASC 815) *Derivatives and Hedging*.
- ML II and ML III qualify as nonregistered investment companies under the provisions of FASB ASC Topic 946 (ASC 946) *Financial Services – Investment Companies* and, therefore, all investments are recorded at fair value in accordance with ASC 946.
- TALF LLC follows the guidance in ASC 320 when accounting for any acquired ABS investments, and has elected the fair value option for all eligible assets in accordance with ASC 825.

i. Preferred Interests

The FRBNY presents its preferred interests in AIA LLC and ALICO LLC at cost consistent with ASC 320. The 5 percent cumulative dividends accrued by the FRBNY on the preferred interests are reported as "Non-interest income: Dividends on preferred interests" in the Combined Statements of Income and Comprehensive Income. On a quarterly basis, the accrued dividends were capitalized and increased the recorded cost of the FRBNY's preferred interests in AIA LLC and ALICO LLC.

j. Bank Premises, Equipment, and Software

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

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

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

k. Federal Reserve Notes

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

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

"Federal Reserve notes outstanding, net" in the Combined Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Reserve Banks' currency holdings of $172 billion and $180 billion at December 31, 2011 and 2010, respectively.

At December 31, 2011 and 2010, all Federal Reserve notes issued to the Reserve Banks were fully collateralized. At December 31, 2011, all gold certificates, all special drawing right certificates, and $1,018 billion of domestic securities held in the SOMA were pledged as collateral. At December 31, 2011, no investments denominated in foreign currencies were pledged as collateral.

l. Beneficial Interest in Consolidated Variable Interest Entities

ML, ML II, and ML III have outstanding senior and subordinated financial interests, inclusive of a fixed deferred purchase price in ML II and an equity contribution in ML III, and TALF LLC has an outstanding financial interest. Upon issuance of the financial interests, ML, ML II, ML III, and TALF LLC each elected to measure these obligations at fair value in accordance with ASC 825. Principal, interest, and changes in fair value on the senior financial interest, which were extended by the FRBNY, are eliminated in consolidation. The financial interests are recorded at fair value as "Beneficial interest in consolidated variable interest entities" in the Combined Statements of Condition. Interest expense and changes in fair value of the financial interest are recorded in "Interest expense: Beneficial interest in consolidated variable interest entities" and "Non-interest income: Beneficial interest in consolidated variable interest entities gains (losses), net," respectively, in the Combined Statements of Income and Comprehensive Income.

m. Deposits

Depository Institutions

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

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as "Interest payable to depository institutions" in the Combined Statements of Condition. There were no deposits held by the Reserve Banks under the TDF at December 31, 2011 and 2010.

Treasury

The Treasury general account is the primary operational account of the Treasury and is held at the FRBNY.

The Treasury's temporary supplementary financing program consists of a series of Treasury bill auctions, in addition to Treasury's standard borrowing program. The proceeds of this debt are held in an account at the FRBNY that is separate from the Treasury's general account, and this separate account is reported as "Treasury, supplementary financing account" in the Combined Statements of Condition. The purpose of placing funds in this account is to drain reserves from the banking system and partially offset the reserve impact of the Reserve Banks' lending and liquidity initiatives.

Other

Other deposits include foreign central bank and foreign government deposits held at the FRBNY. Other deposits also include GSE deposits held by the Reserve Banks.

n. Funds from American International Group, Inc. asset dispositions, held as agent

Prior to the closing of the AIG recapitalization plan discussed in Note 3, the cash proceeds from certain AIG asset dispositions were held by the FRBNY as agent.

o. Items in Process of Collection and Deferred Credit Items

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

p. Capital Paid-in

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

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

q. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in. On a daily basis, surplus is adjusted to equate the balance to capital paid-in. Accumulated other comprehensive income is reported as a component of "Surplus" in the Combined Statements of Condition and the Combined Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 13, 14, and 15.

r. Interest on Federal Reserve Notes

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

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

s. Income and Costs Related to Treasury Services

When directed by the Secretary of the Treasury, the Reserve Banks are required by the Federal Reserve Act to serve as fiscal agent and depositary of the United States Government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2011 and 2010, the Reserve Banks were reimbursed for all services provided to the Treasury as its fiscal agent.

t. Assessments

The Board of Governors assesses the Reserve Banks to fund its operations, the operations of the Bureau and, for a two-year period following the July 21, 2010 effective date of the Dodd-Frank Act, the OFR. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances as of December 31 of the prior year for the Board of Governors' operations and as of the most recent quarter for the Bureau and OFR operations. The Board of Governors also assesses each Reserve Bank for the expenses incurred by the Treasury to produce and retire Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the prior year.

During the period prior to the Bureau transfer date of July 21, 2011, there was no limit on the funding provided to the Bureau and assessed to the Reserve Banks; the Board of Governors was required to provide the amount estimated by the Secretary of the Treasury needed to carry out the authorities granted to the Bureau under the Dodd-Frank Act and other federal law. The Dodd-Frank Act requires that, after the transfer date, the Board of Governors fund the Bureau in an amount not to exceed a fixed percentage of the total operating expenses of the System as reported in the Board of Governors' 2009 annual report, which totaled \$4.98 billion. The fixed percentage of total 2009 operating expenses of the System is 10 percent (\$498.0 million) for 2011, 11 percent (\$547.8 million) for 2012, and 12 percent (\$597.6 million) for 2013. After 2013, the amount will be adjusted in accordance with the provisions of the Dodd-Frank Act. The Reserve Banks' assessment for Bureau funding is reported as "Assessments: Bureau of Consumer Financial Protection" in the Combined Statements of Income and Comprehensive Income.

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

u. Fair Value

Certain assets and liabilities reported on the Reserve Banks' Combined Statements of Condition are measured at fair value in accordance with ASC 820, including TALF loans, investments and beneficial interests of the consolidated VIEs, and assets of the Retirement Plan for Employees of the System. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes a three-level fair value hierarchy that distinguishes between assumptions developed using market data obtained from independent sources (observable inputs) and the Reserve Bank's assumptions developed using the best information available in the circumstances (unobservable inputs). The three levels established by ASC 820 are described as follows:

- Level 1 – Valuation is based on quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 – Valuation is based on model-based techniques that use significant inputs and assumptions not observable in the market. These unobservable inputs and assumptions reflect the Reserve Bank's estimates of inputs and assumptions that market participants would use in pricing the assets and liabilities. Valuation techniques include the use of option pricing models, discounted cash flow models, and similar techniques.

The inputs or methodology used for valuing assets and liabilities are not necessarily an indication of the risk associated with those assets and liabilities.

v. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Reserve Banks' real property taxes were $42 million and $41 million for the years ended December 31, 2011 and 2010, respectively, and are reported as a component of "Operating expenses: Occupancy" in the Combined Statements of Income and Comprehensive Income.

w. Restructuring Charges

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

Note 16 describes the Reserve Banks' restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain Reserve Banks' assets are discussed in Note 11. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY and discussed in Note 13. Costs and liabilities associated with enhanced postretirement benefits are discussed in Note 14.

x. Recently Issued Accounting Standards

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, *Fair Value Measurements and Disclosures* (Topic 820): *Improving Disclosures about Fair Value Measurements*. New requirements for disclosure of information about transfers among the hierarchy's classifications and the level of disaggregation of classes of assets were effective for the Reserve Banks for the year beginning on January 1, 2010, and the required disclosures are included where applicable in Note 5, Note 9, and Note 13. Other required disclosures include the gross presentation of purchases, sales, issuances, and settlements in the reconciliation for Level

3 fair value measurements, which were effective for the Reserve Banks for the year beginning on January 1, 2011 and are included in Note 9.

In July 2010, the FASB issued ASU 2010–20, *Receivables* (Topic 310)*:Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires additional disclosures about the allowance for credit losses and the credit quality of loan portfolios. The additional disclosures include a roll-forward of the allowance for credit losses on a disaggregated basis and more information, by type of receivable, on credit quality indicators, including the amount of certain past-due receivables and troubled debt restructurings and significant purchases and sales. The adoption of this update is effective for the Reserve Banks for the year ended December 31, 2011, and did not have a material effect on the Reserve Banks' combined financial statements.

In April 2011, the FASB issued ASU 2011–02, *Receivables* (Topic 310): *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which clarifies accounting for troubled debt restructurings, specifically clarifying creditor concessions and financial difficulties experienced by borrowers. This update is effective for the Reserve Banks for the year ending December 31, 2012, and is not expected to have a material effect on the Reserve Banks' combined financial statements.

In April 2011, the FASB issued ASU 2011–03, *Transfers and Servicing* (Topic 860): *Reconsideration of Effective Control for Repurchase Agreements*, which reconsidered the effective control for repurchase agreements. This update prescribes when the Reserve Banks may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. This determination is based, in part, on whether the Reserve Banks have maintained effective control over the transferred financial assets. This update is effective for the Reserve Banks for the year ending December 31, 2012, and is not expected to have a material effect on the Reserve Banks' combined financial statements.

In May 2011, the FASB issued ASU 2011–04, *Fair Value Measurement* (Topic 820): *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. This update will result in common fair value measurement and disclosure requirements for GAAP and International Financial Reporting Standards. In addition, this update requires additional disclosures for fair value measurements categorized as Level 3, including quantitative information about the unobservable inputs and assumptions used in the fair value measurement, a description of the valuation policies and procedures, and a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs. In addition, disclosure of the amounts and reasons for all transfers in and out of Level 1 and Level 2 will be required. This update is effective for the Bank for the year ending December 31, 2012, and is not expected to have a material effect on the Reserve Banks' combined financial statements.

In June 2011, the FASB issued ASU 2011–05, *Comprehensive Income* (Topic 220): *Presentation of Comprehensive Income*, which requires a reporting entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. The update is intended to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items by presenting the components reported in other comprehensive income. The Reserve Banks have adopted the update in this ASU effective for the year ended December 31, 2011, and the required presentation is reflected in the Reserve Banks' combined financial statements.

In December 2011, the FASB issued ASU 2011–11, *Balance Sheet* (Topic 210): *Disclosures about Offsetting Assets and Liabilities*. This update will require a reporting entity to present enhanced disclosures for financial instruments and derivative instruments that are offset or subject to master netting agreements or similar such agreements. This update is effective for the Reserve Banks for the year ending December 31, 2013, and is not expected to have a material effect on the Reserve Banks' combined financial statements.

In December 2011, the FASB issued ASU 2011–12, *Comprehensive Income* (Topic 220): *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011–05.* This update indefinitely defers the requirements of ASU 2011–05 related to presentation of reclassification adjustments.

(5) Loans

The remaining maturity distribution of loans outstanding at December 31, 2011, and total loans outstanding at December 31, 2010, was as follows (in millions):

	2011					2010
	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total	Total
Loans to depository institutions	$189	$7	$ –	$ –	$ 196	$ 221
TALF loans, fair value	–	1	4,373	4,685	9,059	24,853
AIG loan, net	–	–	–	–	–	20,603

Loans to Depository Institutions

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

Primary, secondary, and seasonal loans are collateralized to the satisfaction of each Reserve Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans; Treasury securities; GSE debt securities; foreign sovereign debt; municipal, corporate, and state and local government obligations; asset-backed securities (ABS); corporate bonds; commercial paper; and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value that is deemed appropriate by each Reserve Bank, which is typically fair value reduced by a margin. Loans to depository institutions are monitored daily to ensure that borrowers continue to meet eligibility requirements for these programs. The financial condition of borrowers is monitored by each Reserve Bank and, if a borrower no longer qualifies for these programs, the Reserve Bank will generally request full repayment of the outstanding loan or, for primary or seasonal loans, may convert the loan to a secondary credit loan. Collateral levels are reviewed daily against outstanding obligations and borrowers that no longer have sufficient collateral to support outstanding loans are required to provide additional collateral or to make partial or full repayment.

TALF

TALF loans are nonrecourse loans secured by eligible collateral. Each TALF loan has a three-year maturity, except loans secured by Small Business Administration (SBA) Pool Certificates, loans secured by SBA Development Company Participation Certificates, or ABS backed by student loans or commercial mortgage loans, which have a five-year maturity if the borrower so elects.

The FRBNY has elected the fair value option for all TALF loans in accordance with ASC 825. Recording all TALF loans at fair value, rather than at the remaining principal amount outstanding, improves accounting consistency and provides the most appropriate presentation on the financial statements by matching the change in fair value of TALF loans, the related put agreement with TALF LLC, and the valuation of the beneficial interests in TALF LLC. Information regarding the TALF LLC's assets and liabilities is presented in Note 9.

In certain cases in which there is limited activity around inputs to the valuation, loans are classified within Level 3 of the valuation hierarchy. Because external price information was not available, market-based models were used to determine the fair value of the TALF loans. The fair value of the TALF loans was determined by valuing the future cash flows from loan interest income and the estimated fair value losses associated with collateral that may be put to the FRBNY. The valuation model takes into account a range of outcomes on TALF loan repayments, market prices of the collateral, risk premiums estimated using market prices, and the volatilities of market-risk factors. Other methodologies employed or assumptions made in determining fair value could result in an amount that differs significantly from the amount reported.

The following table presents the TALF loans at fair value as of December 31 by ASC 820 hierarchy (in millions):

	2011	2010
Level 3 total fair value	$9,059	$24,853

The following table presents a reconciliation of TALF loans measured at fair value using significant unobservable inputs (Level 3) during the years ended December 31, 2011 and 2010 (in millions):

	TALF loans
Fair value at January 1, 2010	$ 48,183
Net loans originated	9,484
Loan repayments and prepayments	(32,378)
Total realized and unrealized losses	(436)
Fair value at December 31, 2010	$ 24,853
Loan repayments and prepayments	(15,710)
Total realized and unrealized gains (losses)	(84)
Fair value at December 31, 2011	$ 9,059

The fair value of TALF loans reported in the Combined Statements of Condition as of December 31, 2011 and 2010, includes $37 million and $121 million in unrealized gains, respectively. FRBNY attributes substantially all changes in fair value of nonrecourse loans to changes in instrument-specific credit spreads.

Eligible collateral includes U.S. dollar-denominated ABS that are backed by auto loans, student loans, credit card loans, equipment loans, floorplan loans, insurance premium financial loans, loans guaranteed by the SBA, residential mortgage servicing advances, or commercial mortgage loans. The following table presents the collateral concentration and maturity distribution for the remaining outstanding TALF loans, measured at fair value, as of December 31, 2011 (in millions):

Collateral type[1]	Time to maturity			
	16–90 days	91 days to 1 year	Over 1 year to 4 years	Total
Student loan	$–	$ 23	$1,937	$1,960
Credit card	–	2,326	80	2,406
CMBS	–	578	1,454	2,032
Floorplan	–	533	430	963
Auto	1	374	36	411
SBAs	–	113	221	334
Other[2]	–	426	527	953
Total	$1	$4,373	$4,685	$9,059

1 All credit ratings are AAA unless otherwise indicated.
2 Includes equipment loans, insurance premium financial loans, and residential mortgage servicing advances.

The aggregate remaining principal amount outstanding on TALF loans as of December 31, 2011 and 2010, was $9,013 million and $24,703 million, respectively.

At December 31, 2011 and 2010, no TALF loans were over 90 days past due or on nonaccrual status.

Earnings reported by the FRBNY related to the TALF include interest income and unrealized gains and losses on TALF loans as well as the FRBNY's allocated share of the TALF LLC's net income. Additional information regarding the income of the TALF LLC is presented in Note 9. The following table presents the components of TALF earnings recorded by the FRBNY for the years ended December 31 (in millions):

	2011	2010
Interest income	$265	$ 750
Administrative fee income	–	13
Unrealized losses	(84)	(436)
Total income on TALF loans	$181	$ 327
Allocated share of TALF LLC	(48)	71
Earnings of TALF	$133	$ 398

AIG Loan, Net

As a result of the closing of the AIG recapitalization plan on January 14, 2011, AIG repaid the FRBNY in full for all outstanding draws under the revolving line of credit and the related accrued interest, capitalized interest, and capitalized commitment fees. The remaining amount of the unamortized deferred commitment fees were recognized and the allowance for loan restructuring as of the closing of the recapitalization was fully accreted into interest income at that date.

The following table presents the components of the AIG loan at December 31 (in millions):

Loan components	2011	2010
Line of credit drawn	$–	$14,621
Capitalized interest	–	4,663
Capitalized commitment fees	–	1,700
AIG loan, gross	$–	$20,984
Unamortized deferred commitment fees	–	(335)
Allowance for loan restructuring, net	–	(46)
AIG loan, net	$–	$20,603

The fair value of the AIG revolving line of credit provided by the FRBNY, based on estimated and actual draws and repayments, was not materially different from the net amount reported in the Combined Statements of Condition as of December 31, 2010.

The activity related to the allowance for AIG loan restructuring for the years-ended December 31 was as follows (in millions):

	2011	2010
Allowance for loan restructuring January 1	$(46)	$(1,488)
Adjustments to the allowance	46	1,442
Allowance for loan restructuring December 31	$ –	$ (46)

The allowance for loan restructuring represented the economic effect of the reduction of the interest rate on loans the FRBNY made to AIG prior to April 17, 2009, as part of the loan restructuring that occurred on that date. The restructuring charges were recovered over the remaining term of the related loan as adjustments to the allowance, which resulted from periodic evaluations and are reported as a component of "Interest income: American International Group, Inc., net" in the Combined Statements of Income and Comprehensive Income. The average balance of the loans to AIG under the revolving line of credit, net of the allowance for restructuring, during the years ended December 31, 2011 and 2010, was $711 million and $22,874 million, respectively.

Allowance for Loan Loss

At December 31, 2011 and 2010, the Reserve Banks did not have any impaired loans and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2011 and 2010.

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

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA.

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

	2011				
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	$ 18,423	$ –	$ –	$ 18,423	$ 18,423
Notes	1,286,344	26,806	(1,233)	1,311,917	1,389,429
Bonds	358,679	61,347	(89)	419,937	508,694
Total Treasury securities	$1,663,446	$88,153	$(1,322)	$1,750,277	$1,916,546
GSE debt securities	$ 103,994	$ 3,847	$ (13)	$ 107,828	$ 114,238
Federal agency and GSE MBS	$ 837,683	$11,617	$(1,042)	$ 848,258	$ 895,495

	2010				
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	$ 18,423	$ –	$ (1)	$ 18,422	$ 18,422
Notes	773,284	14,056	(765)	786,575	804,703
Bonds	229,786	32,739	(570)	261,955	289,757
Total Treasury securities	$1,021,493	$46,795	$(1,336)	$1,066,952	$1,112,882
GSE debt securities	$ 147,460	$ 5,532	$ (20)	$ 152,972	$ 156,780
Federal agency and GSE MBS	$ 992,141	$14,106	$(1,552)	$1,004,695	$1,026,003

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

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

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

Distribution of MBS holdings by coupon rate	2011		2010	
	Amortized cost	Fair value	Amortized cost	Fair value
3.0%	$ 1,313	$ 1,336	$ –	$ –
3.5%	19,415	19,660	341	352
4.0%	161,481	169,763	167,675	168,403
4.5%	406,465	431,171	497,672	508,798
5.0%	182,497	192,664	231,420	237,545
5.5%	66,795	70,064	93,119	95,873
6.0%	9,152	9,616	12,910	13,376
6.5%	1,140	1,221	1,558	1,656
Total	$848,258	$895,495	$1,004,695	$1,026,003

There were no transactions related to securities purchased under agreements to resell during the years ended December 31, 2011 and 2010. Financial information related to securities sold under agreements to repurchase for the years ended December 31 was as follows (in millions):

	2011	2010
Contract amount outstanding, end of year	$ 99,900	$59,703
Average daily amount outstanding, during the year	72,227	58,476
Maximum balance outstanding, during the year	124,512	77,732
Treasury securities pledged (par value), end of year	86,089	43,642
Treasury securities pledged (market value), end of year	99,900	59,703

The contract amounts for securities sold under agreements to repurchase approximate fair value. FRBNY executes transactions for the purchase of securities under agreements to resell primarily to temporarily add reserve balances to the banking system. Conversely, transactions to sell securities under agreements to repurchase are executed to temporarily drain reserve balances from the banking system and as part of a service offering to foreign official and international account holders.

The remaining maturity distribution of Treasury securities, GSE debt securities, federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase at December 31, 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Over 5 years to 10 years	Over 10 years	Total
Treasury securities (par value)	$16,246	$27,107	$89,899	$649,698	$649,913	$230,583	$1,663,446
GSE debt securities (par value)	2,496	5,020	19,695	60,603	13,833	2,347	103,994
Federal agency and GSE MBS (par value)[1]	–	–	–	13	34	837,636	837,683
Securities sold under agreements to repurchase (contract amount)	99,900	–	–	–	–	–	99,900

[1] The par amount shown for Federal agency and GSE MBS is the remaining principal balance of the underlying mortgages.

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities at December 31, 2011, which differs from the stated maturity primarily because it factors in scheduled payments and prepayment assumptions, is approximately 2.4 years.

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

	Amortized cost		Par value	
	2011	2010	2011	2010
Treasury securities	$15,121	$22,627	$13,978	$22,081
GSE debt securities	1,276	1,686	1,216	1,610

The FRBNY enters into commitments to buy Treasury and GSE debt securities and records the related securities on a settlement-date basis. As of December 31, 2011, the total purchase price of Treasury securities under outstanding commitments was $3,200 million. These commitments had contractual settlement dates extending through January 3, 2012. As of December 31, 2011, the fair value of Treasury securities under outstanding purchase commitments was $3,208 million.

The FRBNY enters into commitments to buy and sell federal agency and GSE MBS and records the related securities on a settlement-date basis. As of December 31, 2011, the total purchase price of the federal agency and GSE MBS under outstanding purchase commitments was $41,503 million, of which $513 million was related to dollar roll transactions. As of December 31, 2011, the total sales price of the federal agency and GSE MBS under outstanding sales commitments was $4,430 million, all of which was related to dollar roll transactions. These commitments, which had contractual settlement dates extending through February 2012, are for the purchase and sale of TBA MBS for which the number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. As of December 31, 2011, the fair value of federal agency and GSE MBS purchases and sales, net under outstanding commitments was $41,873 million and $4,473 million, respectively. These commitments are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY requires the posting of cash collateral for commitments as part of the risk management practices used to mitigate the counterparty credit risk.

Other liabilities, which are related to federal agency and GSE MBS purchases and sales, includes the FRBNY's obligation to return cash margin posted by counterparties as collateral under commitments to purchase and sell federal agency and GSE MBS. In addition, other liabilities includes obligations that arise from the failure of a seller to deliver securities to the FRBNY on the settlement date. Although the FRBNY has ownership of and records its investments in the MBS as of the contractual settlement date, it is not obligated to make payment until the securities are delivered, and the amount included in other liabilities represents the FRBNY's obligation to pay for the securities when delivered. The amount of other liabilities held in the SOMA at December 31 was as follows (in millions):

	2011	2010
Cash margin	$1,271	$–
Obligations from MBS transaction fails	97	–
Total	$1,368	$–

During the years ended December 31, 2011 and 2010, the Reserve Banks recorded net gains from federal agency and GSE MBS transactions of $10 million and $782 million, respectively. These net gains are reported as "Non-interest income: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Combined Statements of Income and Comprehensive Income.

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the year ended December 31, 2011, is summarized as follows (in millions):

	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance at December 31, 2010	$ 18,422	$ 786,575	$261,955	$1,066,952	$152,972	$1,004,695
Purchases[1]	239,487	731,252	161,876	1,132,615	–	42,145
Sales[1]	–	(137,733)	–	(137,733)	–	–
Realized gains, net[2]	–	2,258	–	2,258	–	–
Principal payments and maturities	(239,494)	(67,273)	–	(306,767)	(43,466)	(195,413)
Amortization of premiums and discounts	8	(4,445)	(4,985)	(9,422)	(1,678)	(3,169)
Inflation adjustment of inflation on inflation-indexed securities	–	1,283	1,091	2,374	–	–
Balance at December 31, 2011	$ 18,423	$1,311,917	$419,937	$1,750,277	$107,828	$ 848,258
Supplemental information – par value of transactions:						
Purchases	$ 239,494	$ 713,878	$127,802	$1,081,174	$ –	$ 40,955
Sales	–	(134,829)	–	(134,829)	–	–

[1] Purchases and sales are reported on a settlement-date basis and include payments and receipts related to principal, premiums, discounts, and inflation compensation included in the basis of inflation-indexed securities. The amount reported as sales also includes realized gains, net.

[2] Adjustment for realized gains, net is required because these amounts do not affect the reported amount of the related securities. Excludes realized gains and losses that result from net settled MBS TBA transactions.

(7) Foreign Currency Denominated Assets

The FRBNY holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments of Germany, France, and Japan. These foreign government debt instruments are guaranteed as to principal and interest by the issuing foreign governments. In addition, the FRBNY enters into transactions to purchase Euro-denominated government debt securities under agreements to resell for which the accepted collateral is the debt instruments issued by the governments of Belgium, France, Germany, Italy, the Netherlands, and Spain.

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

	2011	2010
Euro:		
Foreign currency deposits	$ 9,367	$ 7,057
Securities purchased under agreements to resell	–	2,467
German government debt instruments	1,885	1,849
French government debt instruments	2,635	2,754
Japanese yen:		
Foreign currency deposits	3,985	3,883
Japanese government debt instruments	8,078	8,039
Total	$25,950	$26,049

At December 31, 2011 and 2010, the fair value of foreign currency denominated assets, including accrued interest, was $26,116 million and $26,213 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to Treasury securities, GSE debt securities, and federal agency and GSE MBS discussed in Note 6, unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. The fair value is presented solely for informational purposes.

The remaining maturity distribution of foreign currency denominated assets at December 31, 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total
Euro	$5,352	$2,933	$2,115	$3,487	$13,887
Japanese yen	4,180	662	3,143	4,078	12,063
Total	$9,532	$3,595	$5,258	$7,565	$25,950

At December 31, 2011 and 2010, the authorized warehousing facility was $5 billion, with no balance outstanding.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2011 and 2010.

There were no foreign exchange contracts related to open market operations outstanding as of December 31, 2011.

The FRBNY enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2011, there were $216 million of outstanding commitments to purchase Euro-denominated government debt instruments. These securities settled on January 4, 2012, and replaced Euro-denominated government debt instruments held in the SOMA that matured on that date. As of December 31, 2011, the fair value of Euro-denominated government debt instruments under outstanding commitments was $216 million.

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

Foreign currency working balances held and foreign exchange contracts executed by the FRBNY to facilitate its international payments and currency transactions it made on behalf of foreign central banks and U.S. official institution customers were not material as of December 31, 2011 and 2010.

(8) Central Bank Liquidity Swaps

U.S. Dollar Liquidity Swaps

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2011 and 2010, was $99,823 million and $75 million, respectively.

The remaining maturity distribution of U.S. dollar liquidity swaps at December 31, 2011, and total U.S. dollar liquidity swaps outstanding at December 31, 2010, was as follows (in millions):

	2011			2010
	Within 15 days	16 days to 90 days	Total	Total
Euro	$34,357	$51,080	$85,437	$75
Japanese yen	9,035	4,956	13,991	–
Swiss franc	320	75	395	–
Total	$43,712	$56,111	$99,823	$75

Foreign Currency Liquidity Swaps

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2011 and 2010.

(9) Investments Held By Consolidated Variable Interest Entities

a. Summary Information for Consolidated Variable Interest Entities

The total assets of consolidated VIEs, including cash, cash equivalents, and accrued interest, at December 31 were as follows (in millions):

	2011	2010
ML	$ 7,805	$27,961
ML II	9,257	16,457
ML III	17,820	23,583
TALF LLC	811	665
Total	$35,693	$68,666

The FRBNY's approximate maximum exposure to loss at December 31, 2011 and 2010, was $24,606 million and $55,434 million, respectively. These estimates incorporate potential losses associated with assets recorded on the FRBNY's Statement of Condition, net of the fair value of subordinated interests (beneficial interest in consolidated VIEs).

The classification of significant assets and liabilities of the consolidated VIEs at December 31 was as follows (in millions):

	2011	2010
Assets:		
CDOs	$17,854	$23,112
Non-agency RMBS	10,903	18,360
Federal agency and GSE MBS	440	16,842
Commercial mortgage loans	2,861	5,130
Swap contracts	657	851
Residential mortgage loans	378	603
Other investments	1,358	587
Subtotal	$34,451	$65,485
Cash, cash equivalents, and accrued interest receivable	1,242	3,181
Total investments held by consolidated VIEs	$35,693	$68,666
Liabilities:		
Beneficial interest in consolidated VIEs	$ 9,845	$10,051
Other liabilities[1]	$ 690	$ 921

[1] The amount reported as "Consolidated variable interest entities: Other liabilities" in the Combined Statements of Condition includes $554 million and $695 million related to cash collateral received on swap contracts at December 31, 2011 and 2010, respectively. The amount also includes accrued interest and accrued other expenses.

Total realized and unrealized gains (losses), net for the year ended December 31, 2011, were as follows (in millions):

	Total portfolio holdings realized gains (losses)	Fair value changes unrealized gains (losses)	Total portfolio holdings realized/ unrealized gains (losses)
CDOs	$ (60)	$(3,278)	$(3,338)
Non-agency RMBS	227	(1,084)	(857)
Federal agency and GSE MBS	1,221	(895)	326
Commercial mortgage loans[1]	(368)	407	39
Residential mortgage loans[1]	(312)	263	(49)
Swap contracts	(258)	225	(33)
Other investments	29	3	32
Other assets	(51)	11	(40)
Total	$ 428	$(4,348)	$(3,920)

1 Substantially all unrealized gains (losses) on the commercial and residential mortgage loans are attributable to changes in instrument-specific credit risk.

Total realized and unrealized gains (losses), net for the year ended December 31, 2010, were as follows (in millions):

	Total portfolio holdings realized gains (losses)	Fair value changes unrealized gains (losses)	Total portfolio holdings realized/ unrealized gains (losses)
CDOs	$ 52	$3,201	$3,253
Non-agency RMBS	108	3,082	3,190
Federal agency and GSE MBS	291	320	611
Commercial mortgage loans[1]	(879)	2,319	1,440
Residential mortgage loans[1]	(86)	197	111
Swap contracts	(150)	(255)	(405)
Other investments	53	103	156
Other assets	(203)	27	(176)
Total	$(814)	$8,994	$8,180

1 Substantially all unrealized gains (losses) on the commercial and residential mortgage loans are attributable to changes in instrument-specific credit risk.

The net income (loss) attributable to ML, ML II, ML III, and TALF LLC for the year ended December 31, 2011, was as follows (in millions):

	ML	ML II	ML III	TALF LLC	Total
Interest income:					
Portfolio interest income	$ 808	$ 609	$ 2,012	$ –	$ 3,429
Less: Interest expense	70	36	175	4	285
Net interest income	738	573	1,837	(4)	3,144
Non-interest income:					
Portfolio holdings gains (losses)	434	(991)	(3,363)	–	(3,920)
Less: Unrealized gains (losses) on beneficial interest in consolidated VIEs	(114)	91	558	(44)[1]	491
Net non-interest income (loss)	320	(900)	(2,805)	(44)	(3,429)
Total net interest income and non-interest income	1,058	(327)	(968)	(48)	(285)
Less: Professional fees	43	8	20	–	71
Net income (loss) attributable to consolidated VIEs	$1,015	$(335)	$ (988)	$(48)[2]	$ (356)

1 The TALF LLC's unrealized loss on beneficial interest represents Treasury's financial interest in the net income of TALF LLC for the year ended December 31, 2011.

2 Additional information regarding TALF-related income recorded by the Bank is presented in Note 5.

The net income (loss) attributable to ML, ML II, ML III, CPFF, and TALF LLC for the year ended December 31, 2010, was as follows (in millions):

	ML	ML II	ML III	CPFF	TALF LLC	Total
Interest income:						
Portfolio interest income	$ 1,133	$ 794	$ 2,299	$213	$ 1	$ 4,440
Less: Interest expense	66	34	173	–	4	277
Net interest income	1,067	760	2,126	213	(3)	4,163
Non-interest income:						
Portfolio holdings gains	2,571	2,467	3,141	1	–	8,180
Unrealized gains (losses) on beneficial interest in consolidated VIEs	(1,135)	(1,353)	(2,266)	–	75[1]	(4,679)
Net non-interest income	1,436	1,114	875	1	75	3,501
Total net interest income and non-interest income	2,503	1,874	3,001	214	72	7,664
Less: Professional fees	69	10	22	2	1	104
Net income (loss) attributable to consolidated VIEs	$ 2,434	$ 1,864	$ 2,979	$212	$71[2]	$ 7,560

[1] The TALF LLC's unrealized gain on beneficial interest represents Treasury's financial interest in the net income of TALF LLC for the year ended December 31, 2010.

[2] Additional information regarding TALF-related income recorded by the Bank is presented in Note 5.

Following is a summary of the consolidated VIEs' subordinated financial interest for the years ended December 31, 2011 and 2010 (in millions):

	ML subordinated loan	ML II deferred purchase price	ML III equity contribution	TALF financial interest	Total
Fair value, January 31, 2010	$ –	$ –	$4,294	$801	$ 5,095
Interest accrued and capitalized	66	34	173	4	277
Unrealized (gain)/loss	1,135	1,353	2,266	(75)	4,679
Fair value, December 31, 2010	$1,201	$1,387	$6,733	$730	$10,051
Interest accrued and capitalized	70	36	175	4	285
Unrealized (gain)/loss	114	(91)	(558)	44	(491)
Fair value, at December 31, 2011	$1,385	$1,332	$6,350	$778	$ 9,845

b. Maiden Lane LLC

ML's investment portfolio consists primarily of federal agency and GSE MBS, non-agency RMBS, commercial and residential mortgage loans, and derivatives and associated hedges. Following is a description of the significant holdings at December 31, 2011, and the associated credit risk for each holding:

i. Debt Securities

Federal agency and GSE MBS represent fractional ownership interests in RMBS guaranteed by federal agencies and GSEs. The rate of delinquencies and defaults on the underlying residential mortgage loans and the aggregate amount of the resulting losses will be affected by a number of factors, including general economic conditions, particularly those in the area where the related mortgaged property is located; the level of the borrower's equity in the mortgaged property; and the individual financial circumstances of the borrower. Changes in economic conditions, including delinquencies and defaults on assets underlying these securities, can affect the securities' value, income, and liquidity.

ML's non-agency RMBS investment portfolio is subject to varying levels of credit, interest rate, general market, and concentration risk. Credit-related risk on non-agency RMBS arises from losses due to delinquencies and defaults by borrowers on the underlying mortgage loans and breaches by originators and servicers of their obligations under the underlying documentation pursuant to which the non-agency RMBS were issued. The rate of delinquencies and defaults on residential mortgage loans and the aggregate amount of the resulting losses will be affected by a number of factors, including general economic conditions, particularly those in the area where the related mortgaged property is located; the level of the borrower's equity in the mortgaged property; and the individual financial circumstances of the borrower. Changes in economic conditions, including delinquencies and defaults on the underlying mortgages, can affect the value, income, and liquidity.

The rate of interest payable on certain non-agency RMBS may be set or effectively capped at the weighted average net coupon of the underlying mortgage loans themselves, often referred to as an "available funds cap." As a result of this cap, the return to ML on such non-agency RMBS is dependent on the relative timing and rate of delinquencies and prepayments of mortgage loans bearing a higher interest rate.

As of December 31, 2011, approximately 37.9 percent and 12.5 percent of the properties collateralizing the non-agency RMBS held by ML were located in California and Florida, respectively, based on the total unpaid principal balance of the underlying loans.

The fair value of any particular non-agency RMBS asset may be subject to substantial variation. The entire market or particular instruments traded on a market may decline in value, even if projected cash flow or other factors improve, because the prices of such instruments are subject to numerous other factors that have little or no correlation to the performance of a particular instrument. Adverse developments in the non-agency RMBS market could have a considerable effect on ML because of its investment concentration in non-agency RMBS.

At December 31, 2011, the ratings breakdown of the $3,313 million of debt securities, which are recorded at fair value in the ML portfolio as a percentage of aggregate fair value of all securities in the portfolio was as follows:

Security Type:[2]	Ratings[1,4]						
	AAA	AA+ to AA-	A+ to A-	BBB+ to BBB-	BB+ and lower[5]	Government/ agency	Total
Federal agency and GSE MBS	–	–	–	–	–	13.3%	13.3%
Non-agency RMBS	0.3%	0.6%	0.7%	0.6%	44.2%	–	46.4%
Other[3]	2.6%	1.9%	1.2%	6.1%	6.8%	21.8%	40.3%
Total	2.9%	2.4%	1.9%	6.7%	51.0%	35.1%	100.0%

1 Lowest of all ratings is used for the purposes of this table if rated by two or more nationally recognized statistical rating organizations.

2 This table excludes ML's commercial and residential mortgage loans, swaps, and other derivative contracts.

3 Includes $702 million of short-term investments and $380 million of CDOs.

4 Rows and columns may not total due to rounding.

5 BB+ and lower includes debt securities that were not rated by a nationally recognized statistical rating organization as of December 31, 2011.

ii. Commercial and Residential Mortgage Loans

Commercial and residential mortgage loans are subject to a high degree of credit risk because of exposure to loss from loan defaults. Default rates are subject to a wide variety of factors, including, but not limited to, property performance, property management, supply and demand, construction trends, consumer behavior, regional economic conditions, interest rates, and other factors.

The performance profile for the commercial and residential mortgage loans at December 31, 2011, was as follows (in millions):

	Unpaid principal balance	Fair value	Fair value as a percentage of unpaid principal balance
Performing loans:			
Commercial	$3,705	$2,790	75.3%
Residential	618	335	54.2%
Subtotal	4,323	3,125	72.3%
Non-performing/Non-accrual loans:[1]			
Commercial	126	71	56.3%
Residential	119	43	36.1%
Subtotal	245	114	46.5%
Total:			
Commercial	3,831	2,861	74.7%
Residential	737	378	51.3%
Total loans	$4,568	$3,239	70.9%

[1] Non-performing/non-accrual loans include loans with payments past due greater than 90 days.

The following table summarizes the state in which residential mortgage loans are collateralized and the property types of the commercial mortgage loans held in the ML portfolio at December 31, 2011:

	Concentration of unpaid principal balances	
	Residential	Commercial[2]
By state:		
California	37.6%	
Florida	7.5%	
Other[1]	54.9%	
Total	100.0%	
By property:		
Hospitality		74.7%
Office		18.0%
Other[2]		7.3%
Total		100.0%

[1] No other individual state or property type comprises more than 5 percent of the total.
[2] One borrower represents approximately 43 percent of total unpaid principal balance of the commercial mortgage loan portfolio.

Commercial mortgage loans held by ML are composed of different levels of subordination with respect to the underlying properties, and relative to each other. Senior mortgage loans are secured property loans evidenced by a first mortgage that is senior to any subordinate or mezzanine financing. Subordinate mortgage interests, sometimes known as B Notes, are loans evidenced by a junior note or a junior participation in a mortgage loan. Mezzanine loans are loans made to the direct or indirect owner of the property-owning entity. Mezzanine loans are not secured by a mortgage on the property but rather by a pledge of the mezzanine borrower's direct or indirect ownership interest in the property-owning entity.

The following table summarizes commercial mortgage loans held by ML at December 31, 2011 (in millions):

Loan type	Unpaid principal balances	Concentration of unpaid principal balances
Senior mortgage loan	$2,695	70.3%
Subordinate mortgage interests	74	2.0%
Mezzanine loans	1,062	27.7%
Total	$3,831	100.0%

As discussed in Note 17, subsequent to December 31, 2011, the total unpaid principal balance was reduced by $1.6 billion due to the sale of commercial mortgage loans held by ML.

iii. Derivative Instruments

Derivative contracts are instruments, such as futures and options or swap contracts, that derive their value from underlying assets, indexes, reference rates, or a combination of these factors. The ML portfolio includes various derivative financial instruments, primarily consisting of a total return swap agreement with JPMC (TRS). ML and JPMC entered into the TRS with reference obligations representing single-name CDS primarily on RMBS and CMBS, and interest rate swaps (IRS) with various market participants, including JPMC. ML, through its investment manager, currently manages the CDS contracts within the TRS as a runoff portfolio and may unwind, amend, or novate reference obligations on an ongoing basis.

ML enters into additional derivative contracts consisting of futures and IRS to economically hedge its exposure to interest rates. For 2011, there were 144 trades executed as IRS. All derivatives are recorded at fair value in accordance with ASC 815. None of the derivatives held by ML are designated as hedging instruments for accounting purposes.

On an ongoing basis, ML pledges collateral for credit or liquidity related shortfalls based on 20 percent of the notional amount of sold CDS protection and 10 percent of the present value of future premiums on purchased CDS protection. Failure to post this collateral constitutes a TRS event of default. Separately, ML and JPMC engage in bilateral posting of collateral to cover the net mark-to-market (MTM) variations in the swap portfolio. ML nets the collateral received from JPMC from the bilateral MTM posting only to the extent that the reference obligations indicate JPMC as the original counterparty to Bear Stearns on March 14, 2008. The values of ML's cash equivalents, purchased by the re-hypothecation of cash collateral associated with the TRS, was $0.8 billion for each of the years ended December 31, 2011 and December 31, 2010. In addition, ML has pledged $0.6 billion and $1.0 billion of federal agency and GSE MBS and U.S. Treasury notes to JPMC as of December 31, 2011 and 2010, respectively.

The following risks are associated with the derivative instruments held by ML as part of the TRS agreement with JPMC as well as any derivatives outside of the TRS:

Market Risk

CDS are agreements that provide protection for the buyer against the loss of principal and, in some cases, interest on a bond or loan in case of a default by the issuer. The nature of a credit event is established by the protection buyer and protection seller at the inception of a transaction, and such events include bankruptcy, insolvency, or failure to meet payment obligations when due. The buyer of the CDS pays a premium in return for payment protection upon the occurrence, if any, of a credit event. Upon the occurrence of a triggering credit event, the maximum potential amount of future payments the seller could be required to make under a CDS is equal to the notional amount of the contract. Such future payments could be reduced or offset by amounts recovered under recourse or by collateral provisions outlined in the contract, including seizure and liquidation of collateral pledged by the buyer. ML's derivatives portfolio consists of purchased credit protection and sold credit protection with differing underlying referenced names that do not necessarily offset.

IRS obligate two parties to exchange one or more payments typically calculated with reference to fixed or periodically reset rates of interest applied to a specified notional principal amount. Notional principal is the amount to which interest rates are applied to determine the payment streams under IRS. Such notional principal amounts often are used to express the volume of these transactions but are not actually exchanged between the counterparties.

Futures contracts are agreements to buy and sell financial instruments for a set price on a future date. Initial margin deposits are made upon entering into futures contracts in the form of cash or securities. During the period that a futures contract is open, changes in the value of the contract are recorded as unrealized gains or losses by revaluing the contracts daily to reflect the market value of the contract at the end of each day's trading. Variation margin payments are paid or received, depending upon whether unrealized gains or losses result. When the contract is closed, ML will record a realized gain or loss equal to the difference between the proceeds from (or cost of) the closing transaction and ML's cost basis in the contract. The use of futures transactions involves the risk of imperfect correlation in movements in the price of futures contracts, interest rates, and the underlying hedged assets. ML is also at risk of not being able to enter into a closing transaction for the futures contract because of an illiquid secondary market. ML had no pledged cash collateral related to future contracts as of December 31, 2011, and $18 million of cash collateral as of December 31, 2010.

Credit Risk

Credit risk is the risk of financial loss resulting from failure by a counterparty to meet its contractual obligations to ML. This can be caused by factors directly related to the counterparty, such as business or management. Taking collateral is the most common way to mitigate credit risk. ML takes financial collateral in the form of cash and marketable securities to cover JPMC counterparty risk as part of the TRS agreement with JPMC as well as the over-the-counter derivatives activities outside of the TRS.

The following table summarizes the notional amounts of derivative contracts outstanding as of December 31, 2011 and 2010 (in millions):

	Notional amounts[1]	
	2011	2010
Interest rate contracts:		
IRS[2]	$ –	$4,130
Futures and options on futures[3]	–	–
Credit derivatives:		
CDS[4]	3,940	5,856
Total	$3,940	$9,986

[1] These amounts represent the sum of gross long and gross short notional derivative contracts. The change in notional amounts is representative of the volume of activity for the year ended December 31, 2011.

[2] There were no IRS contracts outstanding as of December 31, 2011, and 39 IRS contracts outstanding as of December 31, 2010.

[3] Futures and options relate to contract equivalents and not gross notional amounts. The reported notional amount of futures and options as of December 31, 2010 has been corrected. The previously reported 2010 futures and options were reported at $18 million. The revised 2010 futures and options are reported at $18 thousand.

[4] There were 979 and 1,361 CDS contracts outstanding as of December 2011 and 2010, respectively.

The following table summarizes the fair value of derivative instruments by contract type on a gross basis as of December 31, 2011 and 2010, which is reported as a component of "Investments held by consolidated variable interest entities" in the Combined Statements of Condition (in millions):

	2011		2010	
	Gross derivative assets	Gross derivative liabilities	Gross derivative assets	Gross derivative liabilities
Interest rate contracts:				
IRS	$ –	$ –	$ 9	$ 229
Futures and options on futures	–	–	4	2
Credit derivatives:				
CDS[1]	1,630	791	2,317	1,347
Counterparty netting	(685)	(685)	(1,375)	(1,374)
Cash collateral	(288)	–	(100)	–
Total	$ 657	$ 106	$ 855	$ 204

[1] CDS fair values as of December 31, 2011 for assets and liabilities include interest receivables of $22 million and payables of $13 million. CDS fair values as of December 31, 2010 for assets and liabilities includes interest receivables of $39 million and payables of $28 million.

The table below summarizes certain information regarding protection sold through CDS as of December 31 (in millions):

Credit ratings of the reference obligation	Maximum potential payout/notional							
	2011						2010	
	Years to maturity					Fair value	Total	Fair value
	1 year or less	After 1 year through 3 years	After 3 years through 5 years	After 5 years	Total	Asset/ (liability)		Asset/ (liability)
Investment grade (AAA to BBB-)	$ –	$ –	$–	$ 92	$ 92	$ (14)	$ 120	$ (23)
Non-investment grade	150	100	–	904	1,154	(763)	1,824	(1,284)
Total credit protection sold	$150	$100	$–	$996	$1,246	$(777)	$1,944	$(1,307)

The table below summarizes certain information regarding protection bought through CDS as of December 31 (in millions):

Credit ratings of the reference obligation	Maximum potential recovery/notional							
	2011						2010	
	Years to maturity					Fair value	Total	Fair value
	1 year or less	After 1 year through 3 years	After 3 years through 5 years	After 5 years	Total	Asset/ (liability)		Asset/ (liability)
Investment grade (AAA to BBB-)	$ 5	$ –	$ 7	$ 158	$ 170	$ 46	$ 263	$ 76
Non-investment grade	351	100	22	2,052	2,525	1,562	3,648	2,190
Total credit protection bought	$356	$100	$29	$2,210	$2,695	$1,608	$3,911	$2,266

Other Assets

Other assets are primarily composed of other real estate owned of approximately $12 million.

c. Maiden Lane II LLC

ML II's investments in non-agency RMBS are subject to varying levels of credit, interest rate, general market, and concentration risk. Credit-related risk on non-agency RMBS arises from losses due to delinquencies and defaults by borrowers on the underlying residential mortgage loans and breaches by originators and servicers of their obligations under the underlying documentation pursuant to which the non-agency RMBS are issued. The rate of delinquencies and defaults on residential mortgage loans and the aggregate amount of the resulting losses will be affected by a number of factors, including general economic conditions, particularly those in the area where the related mortgaged property is located; the level of the borrower's equity in the mortgaged property; and the individual financial circumstances of the borrower.

The rate of interest payable on certain non-agency RMBS may be set or effectively capped at the weighted average net coupon of the underlying residential mortgage loans themselves, often referred to as an "available funds cap." As a result of this cap, the return to the holder of such non-agency RMBS is dependent on the relative timing and rate of delinquencies and prepayments of mortgage loans bearing a higher rate of interest.

The fair value of any particular non-agency RMBS asset may be subject to substantial variation. The entire market or particular instruments traded on a market may decline in value, even if projected cash flow or other factors improve, because the prices of such instruments are subject to numerous other factors that have little or no correlation to the performance of a particular instrument. Adverse developments in the non-agency RMBS market could have a considerable effect on ML II because of its investment concentration in non-agency RMBS.

At December 31, 2011, the type and rating composition of the ML II's $9,105 million non-agency RMBS portfolio, recorded at fair value, as a percentage of aggregate fair value, were as follows:

Asset Type:	Rating[1,3]					
	AAA	AA+ to AA-	A+ to A-	BBB+ to BBB-	BB+ and lower	Total
Alt-A ARM	–	1.1%	1.1%	0.2%	21.6%	23.9%
Subprime	3.9%	3.2%	1.6%	1.0%	49.5%	59.2%
Option ARM	–	–	–	–	5.9%	5.9%
Other[2]	–	0.8%	1.6%	–	8.7%	11.0%
Total	3.9%	5.0%	4.3%	1.2%	85.7%	100.0%

1 Lowest of all ratings is used for the purpose of this table if rated by two or more nationally recognized statistical rating organizations.

2 Includes all asset types that, individually, represent less than 5% of aggregate portfolio fair value.

3 Rows and columns may not total due to rounding.

At December 31, 2011, approximately 29 percent and 13 percent of the properties collateralizing the non-agency RMBS held by ML II were located in California and Florida, respectively, based on the geographical location data available for the underlying loans by aggregate unpaid principal balance.

d. Maiden Lane III LLC

The primary holdings within ML III are ABS CDOs. An ABS CDO is a security issued by a bankruptcy-remote entity that is backed by a diversified pool of debt securities, which in the case of ML III are primarily RMBS and CMBS. The cash flows of ABS CDOs can be split into multiple segments, called "tranches," which vary in risk profile and yield. The junior tranches bear the initial risk of loss, followed by the more senior tranches. The ABS CDOs in the ML III portfolio represent senior tranches. Because they are shielded from defaults by the subordinated tranches, senior tranches typically have higher credit ratings and lower yields than the underlying securities, and will often receive investment-grade ratings from one or more of the nationally recognized rating agencies. Despite the protection afforded by the subordinated tranches, senior tranches can experience substantial losses from actual defaults on the underlying non-agency RMBS or CMBS.

ML III's investment in CMBS and RMBS contain varying levels of credit, interest rate, liquidity, and concentration risk. Credit-related risk arises from losses due to delinquencies and defaults by borrowers on the underlying mortgage loans and breaches by originators and servicers of their obligations under the underlying documentation pursuant to which the securities are issued. The rate of delinquencies and defaults on residential and commercial mortgage loans and the aggregate amount of the resulting losses will be affected by a number of factors, including general economic conditions, particularly those in the area where the related mortgaged property is located; the level of the borrower's equity in the mortgaged property; and the individual financial circumstances of the borrower. Adverse developments in the RMBS and CMBS markets could have a considerable effect on ML III because of its investment concentration in CDOs backed by CMBS and RMBS.

At December 31, 2011, the investment type/vintage and rating composition of ML III's $17,735 million portfolio, recorded at fair value, as a percentage of aggregate fair value of all securities in the portfolio was as follows:

	Rating[1,2,3]						
	AAA	AA+ to AA-	A+ to A-	BBB+ to BBB-	BB+ and lower	Not rated[4]	Total
ABS CDOs:							
High-grade ABS CDOs	**–**	**–**	**–**	**–**	**60.7%**	**2.7%**	**63.4%**
Pre-2005	–	–	–	–	20.5%	0.8%	21.3%
2005	–	–	–	–	28.3%	1.9%	30.2%
2006	–	–	–	–	5.4%	–	5.4%
2007	–	–	–	–	6.4%	–	6.4%
Mezzanine ABS CDOs	**–**	**–**	**–**	**–**	**8.0%**	**0.2%**	**8.2%**
Pre-2005	–	–	–	–	4.5%	0.2%	4.7%
2005	–	–	–	–	3.0%	–	3.0%
2006	–	–	–	–	–	–	–
2007	–	–	–	–	0.6%	–	0.6%
Commercial Real-Estate CDOs	**–**	**–**	**–**	**–**	**27.0%**	**–**	**27.0%**
Pre-2005	–	–	–	–	3.5%	–	3.5%
2005	–	–	–	–	–	–	–
2006	–	–	–	–	–	–	–
2007	–	–	–	–	23.4%	–	23.4%
RMBS, CMBS, & Other:	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**1.0%**	**–**	**1.5%**
Pre-2005	–	–	–	–	0.1%	–	0.2%
2005	0.1%	0.1%	0.1%	0.1%	0.8%	–	1.2%
2006	–	–	–	–	0.1%	–	0.1%
2007	–	–	–	–	–	–	–
Total investments	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**96.7%**	**2.9%**	**100.0%**

1 Lowest of all ratings was used for the purpose of this table if rated by two or more nationally recognized statistical rating organizations.

2 The year of issuance with the highest concentration of underlying assets as measured by outstanding principal balance determines the vintage of the CDO.

3 Rows and columns may not total due to rounding.

4 Not rated by a nationally recognized statistical rating organization as of December 31, 2011.

e. TALF LLC

Cash receipts resulting from the put option fees paid to TALF LLC and proceeds from the Treasury's loan are invested in the following types of U.S. dollar-denominated short-term investments and cash equivalents eligible for purchase by the LLC: (1) U.S. Treasury securities, (2) federal agency securities that are senior, negotiable debt obligations of Fannie Mae, Freddie Mac, Federal Home Loan Banks, and Federal Farm Credit Banks, which have a fixed rate of interest, (3) repurchase agreements that are collateralized by Treasury and federal agency securities and fixed-rate agency mortgage-backed securities, and (4) money market mutual funds registered with the Securities and Exchange Commission and regulated under Rule 2a-7 of the Investment Company Act that invest exclusively in U.S. Treasury and federal agency securities. Cash may also be invested in a demand interest-bearing account held at the Bank of New York Mellon.

f. Fair Value Measurement

The consolidated VIEs have adopted ASC 820 and ASC 825 and have elected the fair value option for all securities and commercial and residential mortgages held by ML and TALF LLC. ML II and ML III qualify as nonregistered investment companies under the provisions of ASC 946 and, therefore, all investments are recorded at fair value in accordance with ASC 820. In addition, the FRBNY has elected to record the beneficial interests in ML, ML II, ML III, and TALF LLC at fair value.

The accounting and classification of these investments appropriately reflect the VIEs' and the FRBNY's intent with respect to the purpose of the investments and most closely reflect the amount of the assets available to liquidate the entities' obligations.

i. Determination of Fair Value

The consolidated VIEs value their investments on the basis of the last available bid prices or current market quotations provided by dealers or pricing services selected by the designated investment managers. To determine the value of a particular investment, pricing services may use information on transactions in such investments; quotations from dealers; pricing metrics; market transactions in comparable investments; relationships observed in the market between investments; and calculated yield measures based on valuation methodologies commonly employed in the market for such investments.

Market quotations may not represent fair value in circumstances in which the investment manager believes that facts and circumstances applicable to an issuer, a seller, a purchaser, or the market for a particular security result in the current market quotations reflecting an inaccurate fair value of the security. To determine fair value, the investment manager applies proprietary valuation models that use collateral performance scenarios and pricing metrics derived from the reported performance of the universe of bonds with similar characteristics as well as the observable market.

Because of the uncertainty inherent in determining the fair value of investments that do not have a readily available fair value, the fair value of these investments may differ significantly from the values that would have been reported if a readily available fair value had existed for these investments and may differ materially from the values that may ultimately be realized.

The fair value of the liability for the beneficial interests of consolidated VIEs is estimated based upon the fair value of the underlying assets held by the VIEs. The holders of these beneficial interests do not have recourse to the general credit of the FRBNY.

ii. Valuation Methodologies for Level 3 Assets and Liabilities

In certain cases in which there is limited activity around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. For example, in valuing CDOs, certain collateralized mortgage obligations, and commercial and residential mortgage loans, the determination of fair value is based on collateral performance scenarios. These valuations also incorporate pricing metrics derived from the reported performance of the universe of bonds and from observations and estimates of market data. Because external price information is not available, market-based models are used to value these securities. Key inputs to the model may include market spreads or yield estimates for comparable instruments, data for each credit rating, valuation estimates for underlying property collateral, projected cash flows, and other relevant contractual features. Because there is lack of observable pricing, securities and investment loans that are carried at fair value are classified within Level 3.

The following tables present the financial instruments recorded in VIEs at fair value as of December 31 by ASC 820 hierarchy (in millions):

	2011				
	Level 1	Level 2	Level 3	Netting[1]	Total fair value
Assets:					
CDOs	$ –	$ 167	$17,687	$ –	$17,854
Non-agency RMBS	–	5,493	5,410	–	10,903
Federal agency and GSE MBS	–	440	–	–	440
Commercial mortgage loans	–	1,464	1,397	–	2,861
Cash equivalents	1,171	–	–	–	1,171
Swap contracts	–	–	1,630	(973)	657
Residential mortgage loans	–	–	378	–	378
Other investments	1,095	126	108	–	1,329
Total assets	$2,266	$7,690	$26,610	$(973)	$35,593
Liabilities:					
Beneficial interest in consolidated VIEs	$ –	$ –	$ 9,845	$ –	$ 9,845
Swap contracts	–	–	791	(685)	106
Total liabilities	$ –	$ –	$10,636	$(685)	$ 9,951

[1] Derivative receivables and payables and the related cash collateral received and paid are shown net when a master netting agreement exists.

	2010				
	Level 1	Level 2	Level 3	Netting[1]	Total fair value
Assets:					
CDOs	$ –	$ 301	$22,811	$ –	$23,112
Non-agency RMBS	–	11,551	6,809	–	18,360
Federal agency and GSE MBS	–	16,812	30	–	16,842
Commercial mortgage loans	–	3,199	1,931	–	5,130
Cash equivalents	3,003	–	–	–	3,003
Swap contracts	–	9	2,317	(1,475)	851
Residential mortgage loans	–	–	603	–	603
Other investments	85	400	79	–	564
Other assets	–	4	–	–	4
Total assets	$3,088	$32,276	$34,580	$(1,475)	$68,469
Liabilities:					
Beneficial interest in consolidated VIEs	$ –	$ –	$10,051	$ –	$10,051
Swap contracts	–	229	1,347	(1,375)	201
Other liabilities	2	–	–	–	2
Total liabilities	$ 2	$ 229	$11,398	$(1,375)	$10,254

[1] Derivative receivables and payables and the related cash collateral received and paid are shown net when a master netting agreement exists.

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2011 (in millions). Unrealized gains and losses related to those assets still held at December 31, 2011, are reported as a component of "Investments held by consolidated variable interest entities gains/(losses), net" in the Combined Statements of Income and Comprehensive Income.

	2011						
	Fair value December 31, 2010	Purchases, sales, and settlements, net	Net realized/ unrealized gains (losses)	Gross transfers in[1,2,3]	Gross transfers out[1,2,3]	Fair value December 31, 2011	Change in unrealized gains/(losses) related to financial instruments held at December 31, 2011
Assets:							
CDOs	$22,811	$(1,889)	$(3,351)	$ 116	$ –	$17,687	$(3,297)
Non-agency RMBS	6,809	(2,891)	(483)	4,066	(2,091)	5,410	(725)
Commercial mortgage loans	1,931	(626)	92	–	–	1,397	65
Residential mortgage loans	603	(175)	(50)	–	–	378	263
Federal agency and GSE MBS	30	(28)	(2)	–	–	–	–
Other investments	79	(29)	(2)	94	(34)	108	(9)
Total assets	$32,263	$(5,638)	$(3,796)	$4,276	$(2,125)	$24,980	$(3,703)
Net swap contracts[4]	$ 970	$ (235)	$ 104	$ –	$ –	$ 839	$ 83
Liabilities:							
Beneficial interest in consolidated VIEs	$10,051	285[5]	$ (491)	$ –	$ –	$ 9,845	$ 491

1 The amount of transfers is based on the fair values of the transferred assets at the beginning of the reporting period.

2 There were no significant transfers between Level 1 and Level 2 during the year ended December 31, 2011.

3 Non-agency RMBS, with a December 31, 2010, fair value of $2,091 million, were transferred from Level 3 to Level 2 because they are valued at December 31, 2011, based on quoted prices in non-active markets (Level 2). These investments were valued in the prior year on non-observable model based inputs (Level 3). There were also non-agency RMBS, CDOs, and other investments for which valuation inputs became less observable during the year ended December 31, 2011, which resulted in $4,066 million, $116 million, and $94 million, respectively, in transfers from Level 2 to Level 3. There were no other significant transfers between Level 2 and Level 3 during the current year.

4 Level 3 derivative assets and liabilities are presented net for purposes of this table.

5 Includes $285 million in capitalized interest.

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2010 (in millions). Unrealized gains and losses related to those assets still held at December 31, 2010, are reported as a component of "Investments held by consolidated variable interest entities gains/(losses), net" in the Combined Statements of Income and Comprehensive Income.

	2010						
	Fair value December 31, 2009	Purchases, sales, and settlements, net	Net realized/ unrealized gains (losses)	Gross transfers in[1,2,3,4]	Gross transfers out[1,2,3,4]	Fair value December 31, 2010	Change in unrealized gains (losses) related to financial instruments held at December 31, 2010
Assets:							
CDOs[7]	$22,200	$(2,474)	$3,096	$ –	$ (11)	$22,811	$3,043
Non-agency RMBS[7]	8,300	(1,046)	1,144	2,791	(4,380)	6,809	1,044
Commercial mortgage loans	4,025	(335)	681	–	(2,440)	1,931	542
Residential mortgage loans	583	(91)	111	–	–	603	197
Federal agency and GSE MBS	24	(34)	2	62	(24)	30	2
Other investments	23	(39)	65	30	–	79	11
Total assets	$35,155	$(4,019)	$5,099	$2,883	$(6,855)	$32,263	$4,839
Net swap contracts[5]	$ 1,456	$ (325)	$ (161)	$ –	$ –	$ 970	$ (137)
Liabilities:							
Beneficial interest in consolidated VIEs	$ 5,095	$ 277[6]	$4,679	$ –	$ –	$10,051	$4,679

1 The amount of transfers is based on the fair values of the transferred assets at the beginning of the reporting period.

2 There were no significant transfers between Level 1 and Level 2 during the year ended December 31, 2010.

3 Commercial mortgage loans, with a December 31, 2009 fair value of $2,440 million, were transferred from Level 3 to Level 2 because they are valued at December 31, 2010 based on quoted prices for identical or similar instruments in non-active markets (Level 2). These investments were valued in the prior year based on non-observable inputs (Level 3).

4 Non-agency RMBS, with a December 31, 2009 fair value of $3,830 million, were transferred from Level 3 to Level 2 because they are valued at December 31, 2010 based on quoted prices in non-active markets (Level 2). These investments were valued in the prior year on non-observable model based inputs (Level 3). There were also certain non-agency RMBS for which valuation inputs became less observable during the year ended December 31, 2010 which resulted in $2,647 million in transfers from Level 2 to Level 3. There were no other significant transfers between Level 2 and Level 3 during the year.

5 Level 3 derivative assets and liabilities are presented net for purposes of this table.

6 Includes $277 million in capitalized interest.

7 Investments with a fair value of $209 million as of December 31, 2009 were reclassified from CDOs to Non-agency RMBS.

The following tables present the gross components of purchases, sales, and settlements, net, shown above for the years ended December 31, 2011 and 2010 (in millions):

	2011			
	Purchases	Sales	Settlements[2]	Purchases, sales, and settlements, net
Assets:				
CDOs	$ –	$ (6)	$(1,883)	$(1,889)
Non-agency RMBS	–	(1,978)	(913)	(2,891)
Commercial mortgage loans	–	(557)	(69)	(626)
Residential mortgage loans	–	(97)	(78)	(175)
Federal agency and GSE MBS	–	(17)	(11)	(28)
Other investments	2	(21)	(10)	(29)
Total assets	$ 2	$(2,676)	$(2,964)	$(5,638)
Net swap contracts	$ –	$ (48)	$ (187)	$ (235)
Liabilities:				
Beneficial interest in consolidated VIEs	$285	$ –	$ –	$ 285

	2010[1]			
	Purchases	Sales	Settlements[2]	Purchases, sales, and settlements, net
Assets:				
CDOs	$ –	$(184)	$(2,290)	$(2,474)
Non-agency RMBS	–	(8)	(1,038)	(1,046)
Commercial mortgage loans	–	(269)	(66)	(335)
Residential mortgage loans	–	–	(91)	(91)
Federal agency and GSE MBS	–	–	(34)	(34)
Other investments	16	(1)	(54)	(39)
Total assets	$ 16	$(462)	$(3,573)	$(4,019)
Net swap contracts	$ –	$ (19)	$ (306)	$ (325)
Liabilities:				
Beneficial interest in consolidated VIEs	$277	$ –	$ –	$ 277

1 The Bank chose to include the gross presentation of purchases, sales, and settlements in the reconciliation for Level 3 fair value measurements as of December 31, 2010, though not specifically required, so as to provide a more consistent presentation to the format seen for the Level 3 fair value measurements as of December 31, 2011.

2 Includes paydowns.

g. Professional Fees

The consolidated VIEs have recorded costs for professional services provided, among others, by several nationally recognized institutions that serve as investment managers, administrators, and custodians for the VIEs' assets. The fees charged by the investment managers, custodians, administrators, auditors, attorneys, and other service providers, are recorded in "Professional fees related to consolidated variable interest entities" in the Combined Statements of Income and Comprehensive Income.

(10) Non-consolidated Variable Interest Entities

In December 2009, the FRBNY received preferred interests in two VIEs, AIA LLC and ALICO LLC. As a result of the closing of the AIG recapitalization plan on January 14, 2011, AIG paid FRBNY in full for its preferred interests in AIA LLC and ALICO LLC, including accrued dividends. The FRBNY did not previously consolidate these VIEs because it did not have a controlling financial interest. The recorded value of the FRBNY's preferred interests, including capitalized dividends, was $16,866 million for AIA LLC and $9,499 million for ALICO LLC at December 31, 2010. The FRBNY's preferred interests and capitalized dividends are reported as "Preferred interests" and dividends receivable are reported as a component of "Other Assets" in the Combined Statements of Condition.

(11) Bank Premises, Equipment, and Software

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

	2011	2010
Bank premises and equipment:		
Land and land improvements	$ 350	$ 350
Buildings	2,494	2,436
Building machinery and equipment	514	511
Construction in progress	27	31
Furniture and equipment	1,042	1,034
Subtotal	4,427	4,362
Accumulated depreciation	(1,878)	(1,749)
Bank premises and equipment, net	$ 2,549	$ 2,613
Depreciation expense, for the years ended December 31	$ 213	$ 204

Bank premises and equipment at December 31 included the following amounts for capitalized leases (in millions):

	2011	2010
Leased premises and equipment under capital leases	$ 24	$18
Accumulated depreciation	(13)	(8)
Leased premises and equipment under capital leases, net	$ 11	$10
Depreciation expense related to leased premises and equipment under capital leases	$ 5	$ 3

The Reserve Banks lease space to outside tenants with remaining lease terms ranging from 1 to 13 years. Rental income from such leases was $32 million and $34 million for the years ended December 31, 2011 and 2010, respectively, and is reported as a component of "Non-interest income: Other" in the Combined Statements of Income and Comprehensive Income. Future minimum lease payments that the Reserve Banks will receive under noncancelable lease agreements in existence at December 31, 2011, are as follows (in millions):

2012	$ 26
2013	23
2014	25
2015	21
2016	16
Thereafter	31
Total	$142

The Reserve Banks had capitalized software assets, net of amortization, of $165 million and $146 million at December 31, 2011 and 2010, respectively. Amortization expense was $54 million for each of the years ended December 31, 2011 and 2010. Capitalized software assets are reported as a component of "Other assets" in the Combined Statements of Condition and the related amortization is reported as a component of "Operating expenses: Other" in the Combined Statements of Income and Comprehensive Income.

The Federal Reserve Bank of Cleveland recorded asset impairment losses of $12 million for the year ended December 31, 2011. Losses were determined using fair values based on quoted fair values or other valuation techniques. A $10 million loss, related to building and land, and building machinery and equipment, is reported as a component of "Operating expenses: Other" and a $2 million loss, related to building and land improvements, is reported as a component of "Operating expenses: Occupancy" in the Combined Statements of Income and Comprehensive Income.

The Federal Reserve Bank of Atlanta (FRBA) recorded asset impairment losses of $1 million for the year ended December 31, 2011. Losses were determined using fair values based on quoted fair values or other valuation techniques and are reported as a component of "Operating expenses: Equipment" in the Combined Statements of Income and Comprehensive Income.

In 2008, after relocating operations to a new facility, the Federal Reserve Bank of San Francisco (FRBSF) classified its former Seattle branch office building as held for sale, and the building is reported at fair value as a component of "Other assets" in the Combined Statements of Condition. During the year ended December 31, 2010, the FRBSF recorded an adjustment of $6.7 million, based on an appraised valuation, to the fair value of the building and reported the charge as a component of "Operating expenses: Other" in the Combined Statements of Income and Comprehensive Income.

(12) Commitments and Contingencies

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

At December 31, 2011, the Reserve Banks were obligated under noncancelable leases for premises and equipment with remaining terms ranging from 1 to approximately 12 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indexes.

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 $29 million and $30 million for the years ended December 31, 2011 and 2010, respectively.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2011, are as follows (in millions):

2012	$ 13
2013	13
2014	12
2015	11
2016	11
Thereafter	74
Future minimum rental payments[1]	$134

[1] On February 28, 2012, the FRBNY completed the purchase of the building located at 33 Maiden Lane, New York, NY for $207.5 million. The FRBNY was previously leasing space in the building, and future minimum rental payments for the leased space reported in the table above were $108 million.

At December 31, 2011, the Reserve Banks had unrecorded unconditional purchase commitments and long-term obligations extending through the year 2022 with a remaining fixed commitment of $298 million. Purchases of $25 million and $54 million were made against these commitments during 2011 and 2010, respectively. These commitments are for maintenance of currency processing machines and have variable and/or fixed components. The variable portion of the commitments is for additional services above the fixed contractual service limits. The fixed payments for the next five years under these commitments are as follows (in millions):

2012	$ 3
2013	56
2014	28
2015	25
2016	25

At December 31, 2011, the Federal Reserve Bank of Richmond had commitments of approximately $8 million for the construction and acquisition of an air handling unit at its Richmond building. Expected fixed payments were $4 million for each of the years ended December 31, 2012 and 2013.

The Reserve Banks are 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 legal actions and claims will be resolved without material adverse effect on the financial position or results of operations of the Reserve Banks.

Other Commitments

In support of financial market stability activities, the Reserve Bank entered into commitments to provide financial assistance to financial institutions. The contractual amounts shown below are the Reserve Banks' maximum exposures to loss in the event that the commitments are fully funded and there is a default by the borrower or total loss in value of pledged collateral. Total commitments at December 31, 2011 and 2010, were as follows (in millions):

	2011		2010	
	Contractual amount	Unfunded amount	Contractual amount	Unfunded amount
Secured revolving line of credit (AIG)	$ –	$ –	$24,512	$9,891
Commercial loan commitments (ML)	61	61	72	72
Additional loan commitments (ML)[1]	18	18	9	9
Total	$79	$79	$24,593	$9,972

[1] In 2011, there is additional restricted cash totaling $18 million that may be required to be advanced by ML for property level expenses or improvements.

The contractual amount of the commitment related to the AIG secured revolving line of credit represents the maximum commitment at December 31, 2010, to lend to AIG and the unfunded amount represents the maximum commitment reduced by draws outstanding. As a result of the closing of the AIG recapitalization plan on January 14, 2011, the revolving line of credit was paid in full, including interest and fees, and FRBNY's commitment to lend any further funds was terminated.

The undrawn portion of the FRBNY's commercial loan commitments relates to commercial mortgage loan commitments acquired by ML.

(13) Retirement and Thrift Plans

Retirement Plans

The Reserve Banks currently offer three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System (OEB) participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). Under the Dodd-Frank Act, newly hired Bureau employees are eligible to participate in the System Plan and transferees from other governmental organizations can elect to participate in the System Plan. In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (BEP) and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks (SERP).

The System Plan provides retirement benefits to employees of the Reserve Banks, Board of Governors, OEB, and certain employees of the Bureau. The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its combined financial statements. During the year ended December 31, 2011, certain costs associated with the System Plan were reimbursed by the Bureau. During the year ended December 31, 2010, costs associated with the System Plan were not reimbursed by other participating employers.

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

	2011	2010
Estimated actuarial present value of projected benefit obligation at January 1	$ 8,258	$7,364
Service cost-benefits earned during the period	258	223
Interest cost on projected benefit obligation	461	450
Actuarial loss	1,427	508
Contributions by plan participants	6	9
Special termination benefits	10	11
Benefits paid	(315)	(307)
Plan amendments	93	–
Estimated actuarial present value of projected benefit obligation at December 31	$10,198	$8,258

Following is a reconciliation showing the beginning and ending balance of the System Plan assets, the funded status, and the prepaid (accrued) pension benefit costs (in millions):

	2011	2010
Estimated plan assets at January 1 (of which $6,998 and $6,252 is measured at fair value as of January 1, 2011 and 2010, respectively)	$ 7,273	$ 6,281
Actual return on plan assets	649	710
Contributions by the employer	435	580
Contributions by plan participants	6	9
Benefits paid	(315)	(307)
Estimated plan assets at December 31 (of which $7,977 and $6,998 is measured at fair value as of January 1, 2011 and 2010, respectively)	$ 8,048	$ 7,273
Funded status and accrued pension benefit costs	$(2,150)	$ (985)
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	$ (739)	$ (771)
Net actuarial loss	(3,710)	(2,589)
Total accumulated other comprehensive loss	$(4,449)	$(3,360)

During the year ended December 31, 2011, the Bureau funded $14.4 million for its employees who transferred into the System Plan. All other employer contributions during the years ended December 31, 2011 and 2010 were funded by FRBNY on behalf of the System.

Accrued pension benefit costs are reported as a component of "Accrued benefit costs," in the Combined Statements of Condition.

The accumulated benefit obligation for the System Plan, which differs from the estimated actuarial present value of projected benefit obligation because it is based on current rather than future compensation levels, was $8,803 million and $7,136 million at December 31, 2011 and 2010, respectively.

The weighted-average assumptions used in developing the accumulated pension benefit obligation for the System Plan as of December 31 were as follows:

	2011	2010
Discount rate	4.50%	5.50%
Rate of compensation increase	5.00%	5.00%

Net periodic benefit expenses for the years ended December 31, 2011 and 2010, were actuarially determined using a January 1 measurement date. The weighted-average assumptions used in developing net periodic benefit expenses for the System Plan for the years were as follows:

	2011	2010
Discount rate	5.50%	6.00%
Expected asset return	7.25%	7.75%
Rate of compensation increase	5.00%	5.00%

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows necessary to pay the System Plan's benefits when due. The expected long-term rate of return on assets is an estimate that is based on a combination of factors, including the System Plan's asset allocation strategy and historical returns; surveys of expected rates of return for other entities' plans; a projected return for equities and fixed income investments based on real interest rates, inflation expectations, and equity risk premiums; and surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit expense (credit) for the System Plan for the years ended December 31 are shown below (in millions):

	2011	2010
Service cost-benefits earned during the period	$ 258	$ 223
Interest cost on accumulated benefit obligation	461	450
Amortization of prior service cost	110	112
Amortization of net loss	187	188
Expected return on plan assets	(531)	(491)
Net periodic pension benefit expense	485	482
Special termination benefits	10	11
Total periodic pension benefit expense	$ 495	$ 493

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic pension benefit expense in 2012 are shown below:

Prior service cost	$116
Net actuarial loss	287
Total	$403

The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in Note 16.

Following is a summary of expected benefit payments, excluding enhanced retirement benefits (in millions):

	Expected benefit payments
2012	$ 351
2013	375
2014	398
2015	422
2016	446
2017–2021	2,616
Total	$4,608

The System's Committee on Investment Performance (CIP) is responsible for establishing investment policies, selecting investment managers, and monitoring the investment managers' compliance with its policies. The CIP is supported by staff in the OEB in carrying out these responsibilities. At December 31, 2011, the System Plan's assets were held in five investment vehicles: two actively managed long-duration fixed income portfolios, an indexed U.S. equity fund, an indexed non-U.S. developed-markets equity fund, and a money market fund.

The diversification of the Plan's investments is designed to limit concentration of risk and the risk of loss related to an individual asset class. The two long-duration fixed income portfolios are separate accounts benchmarked to a custom benchmark of 55 percent Barclays Long Credit Index and 45 percent Citigroup 15+ years Treasury STRIP Index, which was selected as a proxy for the liabilities of the Plan. Although these portfolios are both actively managed, the guidelines are designed to limit portfolio deviations from the benchmark. The indexed U.S.

equity fund is intended to track the overall U.S. equity market across market capitalizations. The indexed non-U.S. developed markets equity fund is intended to track the Morgan Stanley Capital International (MSCI) Emerging Markets Index, Europe, Australia, Far East plus Canada Index, which includes stocks from 23 markets deemed by MSCI to be "developed markets." Finally, the money market fund, which invests in high-quality money market securities, is the repository for cash balances and adheres to a constant dollar methodology.

Permitted and prohibited investments, including the use of derivatives, are defined in either the trust agreement (for commingled index vehicles) or the investment guidelines (for the three separate accounts). The CIP reviews the trust agreement and approves all investment guidelines as part of the selection of each investment to ensure that the trust agreement is consistent with the CIP's investment objectives for the System Plan's assets.

The System Plan's policy weight and actual asset allocations at December 31, by asset category, are as follows:

	Policy weight	Actual Asset Allocations	
		2011	2010
U.S. equities	40.0%	39.0%	45.4%
International equities	15.0%	13.8%	12.6%
Fixed income	45.0%	46.6%	41.7%
Cash	0.0%	0.6%	0.3%
Total	100.0%	100.0%	100.0%

Employer contributions to the System Plan may be determined using different assumptions than those required for financial reporting. The System Plan's actuarial funding method is expected to produce a recommended annual funding range between $750 and $800 million. In 2012, the System plans to make monthly contributions of $65 million and will reevaluate the monthly contributions upon completion of the 2012 actuarial valuation. The Reserve Banks' projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2011 and 2010, and for the years then ended, were not material.

The System Plan's investments are reported at fair value as required by ASC 820. ASC 820 establishes a three-level fair value hierarchy that distinguishes between market participant assumptions developed using market data obtained from independent sources (observable inputs) and the Reserve Banks' assumptions about market participant assumptions developed using the best information available in the circumstances (unobservable inputs).

Determination of Fair Value

The System Plan's investments are valued on the basis of the last available bid prices or current market quotations provided by dealers, or pricing services. To determine the value of a particular investment, pricing services may use information on transactions in such investments; quotations from dealers; pricing metrics; market transactions in comparable investments; relationships observed in the market between investments; and calculated yield measures based on valuation methodologies commonly employed in the market for such investments.

Because of the uncertainty inherent in determining the fair value of investments that do not have a readily available fair value, the fair value of these investments may differ significantly from the values that would have been reported if a readily available fair value had existed for these investments and may differ materially from the values that may ultimately be realized.

The following tables present the financial instruments recorded at fair value as of December 31 by ASC 820 hierarchy (in millions):

Description	2011			
	Level 1	Level 2	Level 3	Total
Short-term investments	$ 31	$ 29	$–	$ 60
Treasury and Federal agency securities	1,685	14	–	1,699
Other fixed income securities	–	1,962	–	1,962
Commingled funds	–	4,256	–	4,256
Total	$1,716	$6,261	$–	$7,977

There were no transfers between Level 1 and Level 2 during the year.

Description	2010			
	Level 1	Level 2	Level 3	Total
Short-term investments	$ –	$ 30	$–	$ 30
Treasury and Federal agency securities	1,065	39	–	1,104
Other fixed income securities	–	644	–	644
Commingled funds	–	5,220	–	5,220
Total	$1,065	$5,933	$–	$6,998

There were no transfers between Level 1 and Level 2 during the year.

The System Plan enters into futures contracts, traded on regulated exchanges, to manage certain risks and to maintain appropriate market exposure in meeting the investment objectives of the System Plan. The System Plan bears the market risk that arises from any unfavorable changes in the value of the securities or indexes underlying these futures contracts. The use of futures contracts involves, to varying degrees, elements of market risk in excess of the amount recorded in the Combined Statements of Condition. The guidelines established by the CIP further reduce risk by limiting the net futures positions, for most fund managers, to 15 percent of the market value of the advisor's portfolio. No limit has been established on the futures positions of the liability-driven investments because the fund manager only executes Treasury futures.

At December 31, 2011 and 2010, a portion of short-term investments was available for futures trading. There were $6 million and $1 million of Treasury securities pledged as collateral for the years ended December 31, 2011 and 2010, respectively.

Thrift Plan

Employees of the Reserve Banks participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks match 100 percent of the first 6 percent of employee contributions from the date of hire and provide an automatic employer contribution of 1 percent of eligible pay. The Reserve Banks' Thrift Plan contributions totaled $96 million and $94 million for the years ended December 31, 2011 and 2010, respectively, and are reported as a component of "Operating expenses: Salaries and benefits" in the Combined Statements of Income and Comprehensive Income.

(14) Postretirement Benefits Other Than Retirement Plans and Postemployment Benefits

Postretirement Benefits Other Than Retirement Plans

In addition to the Reserve Banks' 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 Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets.

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

	2011	2010
Accumulated postretirement benefit obligation at January 1	$1,358	$1,324
Service cost benefits earned during the period	49	47
Interest cost on accumulated benefit obligation	72	76
Net actuarial loss (gain)	114	(9)
Curtailment gain	(7)	–
Special termination benefits loss	1	1
Contributions by plan participants	21	18
Benefits paid	(86)	(88)
Medicare Part D subsidies	5	5
Plan amendments	(21)	(16)
Accumulated postretirement benefit obligation at December 31	$1,506	$1,358

At December 31, 2011 and 2010, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 4.50 percent and 5.25 percent, respectively.

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

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

	2011	2010
Fair value of plan assets at January 1	$ –	$ –
Contributions by the employer	60	65
Contributions by plan participants	21	18
Benefits paid	(86)	(88)
Medicare Part D subsidies	5	5
Fair value of plan assets at December 31	$ –	$ –
Unfunded obligation and accrued postretirement benefit cost	$1,506	$1,358
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	$ 45	$ 31
Net actuarial (loss)	(388)	(301)
Total accumulated other comprehensive loss	$ (343)	$ (270)

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

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

	2011	2010
Health-care cost trend rate assumed for next year	7.50%	8.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2017	2017

Assumed health-care cost trend rates have a significant effect on the amounts reported for health-care plans. A 1 percentage point change in assumed health-care cost trend rates would have the following effects for the year ended December 31, 2011 (in millions):

	1 percentage point increase	1 percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 19	$ (15)
Effect on accumulated postretirement benefit obligation	182	(154)

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

	2011	2010
Service cost-benefits earned during the period	$ 49	$ 47
Interest cost on accumulated benefit obligation	72	76
Amortization of prior service cost	(7)	(18)
Amortization of net actuarial loss	21	28
Total periodic expense	135	133
Special termination benefits loss	1	1
Net periodic postretirement benefit expense	$136	$134

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2012 are shown below:

Prior service cost	$(10)
Net actuarial loss	30
Total	$ 20

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2011 and 2010, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.25 percent and 5.75 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of “Operating expenses: Salaries and benefits” in the Combined Statements of Income and Comprehensive Income.

The recognition of special termination benefit losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in Note 16.

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

Federal Medicare Part D subsidy receipts were $4.2 million and $4.3 million in the years ended December 31, 2011 and 2010, respectively. Expected receipts in 2012, related to benefits paid in the years ended December 31, 2011 and 2010, were $2.5 million and $1.0 million, respectively.

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

	Without subsidy	With subsidy
2012	$ 77	$ 72
2013	81	75
2014	84	78
2015	88	81
2016	92	84
2017–2021	522	470
Total	$944	$860

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2011 and 2010, were $157 million and $146 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Combined Statements of Condition. Net periodic postemployment benefit expense included in operating expenses was $27 million and $11 million for 2011 and 2010, respectively, and is recorded as a component of "Operating expenses: Salaries and benefits" in the Combined Statements of Income and Comprehensive Income.

(15) Accumulated Other Comprehensive Income and Other Comprehensive Income

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

	Amount related to defined benefit retirement plan	Amount related to postretirement benefits other than retirement plans	Total accumulated other comprehensive income (loss)
Balance at January 1, 2010	$(3,371)	$(305)	$(3,676)
Change in funded status of benefit plans:			
Prior service costs arising during the year	–	16	16
Amortization of prior service cost	112	(18)	94
Change in prior service costs related to benefit plans	112	(2)	110
Net actuarial (loss) gain arising during the year	(289)	9	(280)
Amortization of net actuarial loss	188	28	216
Change in actuarial (loss) gain related to benefit plans	(101)	37	(64)
Change in funded status of benefit plans – other comprehensive income	11	35	46
Balance at December 31, 2010	$(3,360)	$(270)	$(3,630)
Change in funded status of benefit plans:			
Prior service costs arising during the year	(78)	22	(56)
Amortization of prior service cost	110	(8)	102
Change in prior service costs related to benefit plans	32	14	46
Net actuarial (loss) arising during the year	(1,308)	(108)	(1,416)
Amortization of net actuarial loss	187	21	208
Change in actuarial (losses) related to benefit plans	(1,121)	(87)	(1,208)
Change in funded status of benefit plans – other comprehensive (loss)	(1,089)	(73)	(1,162)
Balance at December 31, 2011	$(4,449)	$(343)	$(4,792)

Additional detail regarding the classification of accumulated other comprehensive loss is included in Notes 13 and 14.

(16) Business Restructuring Charges

Before 2010, the Reserve Banks announced the acceleration of their check restructuring initiatives to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure consolidated operations into two regional Reserve Bank processing sites; one in Cleveland, for paper check processing, and one in Atlanta, for electronic check processing.

In 2010, the Reserve Banks announced the consolidation of some of their currency processing operations. As a result of this initiative, currency processing operations performed by two Reserve Bank Branch offices were consolidated into other offices.

In 2011, the U.S. Treasury announced a restructuring initiative to consolidate the Treasury Retail Securities (TRS) operations. As a result of this initiative, TRS operations performed by the Federal Reserve Bank of Cleveland (FRBC) were consolidated into the Federal Reserve Bank of Minneapolis. Additional announcements in 2011 included the consolidation of paper check processing, performed by the FRBC, into the FRBA.

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

	2011 restructuring plans	2010 restructuring plans	2009 and prior restructuring plans	Total
Information related to restructuring plans as of December 31, 2011:				
Total expected costs related to restructuring activity	$ 11	$ 3	$ 47	$ 61
Expected completion date	2012	2011	2012	
Reconciliation of liability balances:				
Balance at January 1, 2010	$ –	$ –	$ 19	$ 19
Employee separation costs	–	3	–	3
Contract termination costs	–	–	1	1
Adjustments	–	–	(2)	(2)
Payments	–	–	(11)	(11)
Balance at December 31, 2010	$ –	$ 3	$ 7	$ 10
Employee separation costs	11	1	–	12
Adjustments	(1)	–	(2)	(3)
Payments	(4)	(2)	(2)	(8)
Balance at December 31, 2011	$ 6	$ 2	$ 3	$ 11

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

Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Operating expenses: Other" in the Combined Statements of Income and Comprehensive Income.

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

Restructuring costs associated with the impairment of certain Reserve Bank assets, including software, buildings, leasehold improvements, furniture, and equipment, are discussed in Note 11.

(17) Subsequent Events

Subsequent to December 31, 2011, the FRBNY, through a series of three competitive bidding processes, sold the remaining ML II portfolio assets with a total unpaid principal balance of $19.2 billion. The sales proceeds received exceeded the fair value of the assets as of December 31, 2011 by $1.2 billion. Proceeds from these sales were used to fully repay the FRBNY's senior loan plus accrued interest and the fixed deferred purchase price plus accrued interest, and will provide residual income that will be distributed in accordance with the ML II agreements.

Also subsequent to December 31, 2011, the FRBNY, through a series of competitive bidding processes, sold or entered into an agreement to sell ML's interest in a senior commercial mortgage loan and has sold the majority of ML's mezzanine loan participation interests, with an aggregated unpaid principal balance of $1.6 billion as of December 31, 2011.

On February 28, 2012, the FRBNY completed the purchase of the building located at 33 Maiden Lane, New York, NY for $207.5 million. The FRBNY was previously leasing space in the building, as discussed in Note 12.

There were no other subsequent events that require adjustments to or disclosures in the combined financial statements as of December 31, 2011. Subsequent events were evaluated through March 20, 2012, which is the date that the combined financial statements were issued.

Office of Inspector General Activities

The Office of Inspector General (OIG) for the Federal Reserve Board, which is also the OIG for the Consumer Financial Protection Bureau, operates in accordance with the Inspector General Act of 1978, as amended. The OIG conducts activities and makes recommendations to promote economy and efficiency; enhance policies and procedures; and prevent and detect waste, fraud, and abuse in Board programs and operations, including functions that the Board has delegated to the Federal Reserve Banks. Accordingly, the OIG plans and conducts audits, inspections, evaluations, investigations, and other reviews relating to Board and Board-delegated programs and operations. It also retains an independent auditor to annually audit the Board's and the Federal Financial Institutions Examination Council's financial statements. In addition, the OIG keeps the Congress and the Board of Governors fully informed about serious abuses and deficiencies.

During 2011, the OIG completed 19 audits, inspections, and evaluations (**table 1**) and conducted a number of follow-up reviews to evaluate action taken on prior recommendations. Due to the sensitive nature of some of the material, certain reports were only issued internally to the Board, as indicated. OIG investigative work resulted in three indictments, five convictions, and two terminations, as well as $103,365,895 in criminal fines and restitution. Nineteen investigations were closed during the year. The OIG also issued two semiannual reports to Congress and performed approximately 80 reviews of legislation and regulations related to the operations of the Board and/or the OIG.

For more information, visit the OIG website at www.federalreserve.gov/oig/.

Table 1. OIG audit, inspection, and evaluation reports issued in 2011

Report title	Month issued
Joint Response by the Inspectors General of the Department of the Treasury and the Board of Governors of the Federal Reserve System to a Request for Information Concerning the Bureau of Consumer Financial Protection	January
Board Financial Statements and Independent Auditors' Report, December 31, 2010 and 2009	February
Federal Financial Institutions Examination Council Financial Statements and Independent Auditors' Report, December 31, 2010 and 2009	February
Review of the Joint Implementation Plan for the Transfer of Office of Thrift Supervision Functions	March
Review of the Failure of Independent Bankers' Bank	March
Audit of the Board's Transportation Subsidy Program	March
Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings	June
Review of CFPB Implementation Planning Activities	July
Material Loss Review of First Community Bank	August
Status of the Transfer of Office of Thrift Supervision Functions	September
Review of the Failure of Pierce Commercial Bank	September
Security Control Review of the Visitor Registration System (Internal Report)	September
Evaluation of Prompt Regulatory Action Implementation	September
Summary Analysis of Failed Bank Reviews	September
Audit of the Board's Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act	September
Audit of the Board's Information Security Program	November
Audit of the Bureau of Consumer Financial Protection's Information Security Program	November
Material Loss Review of Park Avenue Bank	November
Review of the Failure of Legacy Bank	December

Government Accountability Office Reviews

The Federal Banking Agency Audit Act (Pub. L. No. 95–320) authorizes the Government Accountability Office (GAO) to audit certain aspects of Federal Reserve System operations. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) directs GAO to conduct additional audits with respect to these operations. For example, under the Dodd-Frank Act, GAO completed a one-time audit of the existing credit facilities established by the Federal Reserve under section 13(3) of the Federal Reserve Act between December 1, 2007, and July 21, 2010.

In 2011, the GAO completed 27 projects that involved the Federal Reserve (table 1). These included several detailed and extensive audits of Federal Reserve operations such as a review of the Federal Reserve's activities with respect to providing assistance to AIG, a review of the Federal Reserve's activities with respect to the creation of various emergency lending facilities during the financial crisis, and a review of Reserve Bank governance. At the end of 2011, 18 projects begun in either 2010 or 2011 remained active and had not reached completion (table 2).

Table 1. Reports completed during 2011

Report title	Report number	Month issued (2011)
Troubled Asset Relief Program: Third Quarter 2010 Update of Government Assistance Provided to AIG and Description of Recent Execution of Recapitalization Plan	GAO-11-46	January
Troubled Asset Relief Program: Status of Programs and Implementation of GAO Recommendations	GAO-11-74	January
Payday Lending: Federal Law Enforcement Uses a Multilayered Approach to Identify Employees in Financial Distress	GAO-11-147	January
Credit Cards: Consumer Costs for Debt Protection Products Can Be Substantial Relative to Benefits but Are Not a Focus of Regulatory Oversight	GAO-11-311	March
401(K) Plans: Certain Investments Options and Practices That May Restrict Withdrawals Not Widely Understood	GAO-11-291	March
U.S. Coins: Replacing the $1 Note with a $1 Coin Would Provide a Financial Benefit to the Government	GAO-11-281	March
Federal Reserve Banks: Areas for Improvement in Information Systems Controls	GAO-11-447R	March
Federal Reserve System: Truth in Lending	GAO-11-620R	May
Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight	GAO-11-433	May
Banking Regulation: Enhanced Guidance on Commercial Real Estate Risks Needed	GAO-11-489	May
Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness	GAO-11-612	June
Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows	GAO-11-613	July
Securities and Exchange Commission: Existing Post-Employment Controls Could Be Further Strengthened	GAO-11-654	July
Residential Appraisals: Opportunities to Enhance Oversight of an Evolving Industry	GAO-11-653	July
Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented	GAO-11-529	July
Bankruptcy: Complex financial Institutions and International Coordination Pose Challenges	GAO-11-707	July
Mortgage Reform: Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market	GAO-11-656	July
Troubled Asset Relief Program: The Government's Exposure to AIG Following the Company's Recapitalization	GAO-11-716	July
Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance	GAO-11-696	July
Federal Reserve System: Debit Card Interchange Fees and Routing	GAO-11-895R	August
Federal Reserve System: Debit Card Interchange Fees and Routing	GAO-11-896R	August
Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.	GAO-11-616	October
Federal Reserve Bank Governance: Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency	GAO-12-18	October
Financial Audit: Bureau of the Public Debt's Fiscal Years 2011 and 2010 Schedules of Federal Debt	GAO-12-164	November
Dodd-Frank Regulations: Implementation Could Benefit from Additional Analyses and Coordination	GAO-12-151	November
Vacant Properties: Growing Number Increases Communities' Costs and Challenges	GAO-12-34	November
Small Business Lending Fund: Additional Actions Needed to Improve Transparency and Accountability	GAO-12-183	December

Table 2. Projects active at year-end 2011

Subject of project	Month initiated
Bank Holding Company Act: Characteristics and regulation of exempt institutions and the implications of removing exemptions	October 2010
Real estate appraisals: Appraisal subcommittee needs to improve monitoring procedure	December 2010
Capital requirements applicable to U.S. banks and savings and loan intermediate holding companies of foreign banks	December 2010
Municipal securities: Overview of market structure, pricing, and regulation	March 2011
Mortgage foreclosure	March 2011
401(k) service providers abroad	April 2011
Dodd-Frank Act: Hybrid capital instruments and small institution access to capital	May 2011
Capital purchase program (TARP)	May 2011
Federal financial literacy programs	June 2011
Debt buybacks	August 2011
Duplications and overlaps in federal housing programs	August 2011
Enforcement of the Servicemembers Civil Relief Act	August 2011
Update of AIG indicators	August 2011
Financial company bankruptcies	September 2011
Automated teller machine industry	November 2011
U.S. coins: Alternative scenarios suggest different benefits and losses from replacing the $1 note with a $1 coin	November 2011
Benefits and costs of the Dodd-Frank Act	November 2011
Financial Stability Oversight Council and Office of Financial Research operations	December 2011

Federal Reserve System Organization

Congress designed the Federal Reserve System to give it a broad perspective on the economy and on economic activity in all parts of the nation. As such, the System is composed of a central, governmental agency—the Board of Governors—in Washington, D.C., and 12 regional Federal Reserve Banks. This section lists key officials across the System, including the Board of Governors, its officers, Federal Open Market Committee members, several System councils, and Federal Reserve Bank and Branch directors and officers.

BOARD OF GOVERNORS

Members

The Board of Governors of the Federal Reserve System is composed of seven members, who are nominated by the President and confirmed by the Senate. The Chairman and the Vice Chairman of the Board are also named by the President from among the members and are confirmed by the Senate. Two positions on the Board are currently vacant. For a full listing of Board members from 1913 through the present, visit www.federalreserve.gov/bios/boardmembership.htm.

Ben S. Bernanke
Chairman

Janet L. Yellen
Vice Chair

Kevin M. Warsh
(resigned April 2, 2011)

Elizabeth A. Duke

Daniel K. Tarullo

Sarah Bloom Raskin

Divisions and Officers

Thirteen divisions support and carry out the mission of the Board of Governors, which is based in Washington, D.C.

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Director

Linda L. Robertson
Assistant to the Board

Rosanna Pianalto-Cameron
Assistant to the Board

David W. Skidmore
Assistant to the Board

Brian J. Gross
Special Assistant to the Board for Congressional Liaison

Lucretia M. Boyer
Special Assistant to the Board for Public Information

Winthrop P. Hambley
Senior Adviser

Andrew T. Levin
Special Adviser to the Board

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Associate General Counsel

Katherine H. Wheatley
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Assistant General Counsel

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Assistant General Counsel

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Assistant General Counsel

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Associate Director

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Assistant Director

Beth Ann Wilson
Assistant Director

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Jane Haltmaier
Senior Adviser

John H. Rogers
Senior Adviser

Sally M. Davies
Adviser

Office of Financial Stability Policy and Research

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Director

Andreas W. Lehnert
Deputy Director

Seth F. Wheeler
Chief of Staff

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Deputy Director

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Deputy Director

William Nelson
Deputy Director

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Senior Associate Director

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Deputy Associate Director

Gretchen C. Weinbach
Deputy Associate Director

Egon Zakrajsek
Deputy Associate Director

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Assistant Director

Margaret G. DeBoer
Assistant Director

Jane E. Ihrig
Assistant Director

J. David Lopez-Salido
Assistant Director

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Assistant Director

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Senior Adviser

Mary T. Hoffman
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David L. Reifschneider
Deputy Director

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Deputy Director

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Deputy Director

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Associate Director

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Associate Director

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Associate Director

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Sandra A. Cannon
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Joshua Gallin
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Diana Hancock
Deputy Associate Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

John J. Stevens
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Lawrence Silfman
Senior Adviser

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Senior Associate Director

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Senior Associate Director

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Senior Associate Director

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Senior Associate Director

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Senior Associate Director

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Betsy Cross
Associate Director

Nida Davis
Associate Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

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Assistant Director

Sarkis Yoghourtdjian
Assistant Director

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Senior Adviser

William F. Treacy
Adviser

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Assistant Director

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Office of Staff Director

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Staff Director

Charles S. Struckmeyer
Deputy Staff Director

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Diversity and Inclusion Programs Director

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Senior Adviser

Adrienne D. Hurt
Adviser

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Deputy Director

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Deputy Director

William L. Mitchell
Deputy Director

Christine M. Fields
Associate Director

Charles F. O'Malley
Associate Director

James R. Riesz
Associate Director

Marie S. Savoy
Associate Director

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Associate Director

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Assistant Director

Jeffrey R. Peirce
Assistant Director

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Assistant Director

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Assistant Director

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Special Adviser

Christopher J. Suma
Special Adviser

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Deputy Director

Sharon L. Mowry
Deputy Director

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Deputy Associate Director

Susan F. Marycz
Deputy Associate Director

Raymond Romero
Deputy Associate Director

Kofi A. Sapong
Deputy Associate Director

William Dennison
Assistant Director

Glenn S. Eskow
Assistant Director

Marietta Murphy
Assistant Director

Kassandra Arana Quimby
Assistant Director

Sheryl Lynn Warren
Assistant Director

Rajasekhar R. Yelisetty
Assistant Director

Po Kyung Kim
Senior Adviser

Tillena G. Clark
Adviser

Office of Inspector General

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Inspector General

Jacqueline M. Becker
Associate Inspector General

Anthony J. Castaldo
Associate Inspector General

Elise M. Ennis
Associate Inspector General

Andrew Patchan Jr.
Associate Inspector General

Harvey Witherspoon
Associate Inspector General

Federal Open Market Committee

The Federal Open Market Committee is made up of the seven members of the Board of Governors; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. During 2011, the Federal Open Market Committee held eight regularly scheduled meetings and two conference calls (see "Minutes of Federal Open Market Committee Meetings").

Members

Ben S. Bernanke
Chairman, Board of Governors

William C. Dudley
Vice Chairman, President, Federal Reserve Bank of New York

Elizabeth A. Duke
Member, Board of Governors

Charles L. Evans
President, Federal Reserve Bank of Chicago

Richard W. Fisher
President, Federal Reserve Bank of Dallas

Narayana Kocherlakota
President, Federal Reserve Bank of Minneapolis

Charles I. Plosser
President, Federal Reserve Bank of Philadelphia

Sarah Bloom Raskin
Member, Board of Governors

Daniel K. Tarullo
Member, Board of Governors

Kevin M. Warsh
Member, Board of Governors
(through March 2011)

Janet L. Yellen
Member, Board of Governors

Alternate Members

Christine M. Cumming
First Vice President, Federal Reserve Bank of New York

Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

Dennis P. Lockhart
President, Federal Reserve Bank of Atlanta

Sandra Pianalto
President, Federal Reserve Bank of Cleveland

John C. Williams
President, Federal Reserve Bank of San Francisco

Officers

William B. English
Secretary and Economist

Deborah J. Danker
Deputy Secretary

Matthew M. Luecke
Assistant Secretary

David W. Skidmore
Assistant Secretary

Michelle A. Smith
Assistant Secretary

Scott G. Alvarez
General Counsel

Thomas C. Baxter
Deputy General Counsel

Richard M. Ashton
Assistant General Counsel

Steven B. Kamin
Economist (as of December 2011; previously, Associate Economist)

Nathan Sheets
Economist (through August 2011)

David J. Stockton
Economist (through June 2011)

David W. Wilcox
Economist (as of November 2011; previously, Associate Economist)

James A. Clouse
Associate Economist

Thomas A. Connors
Associate Economist

Loretta J. Mester
Associate Economist

Simon Potter
Associate Economist

David Reifschneider
Associate Economist

Harvey Rosenblum
Associate Economist

Lawrence Slifman
Associate Economist
(as of November 2011)

Daniel G. Sullivan
Associate Economist

Kei-Mu Yi
Associate Economist

Brian Sack
Manager,
System Open Market Account

Board of Governors Advisory Councils

The Federal Reserve System uses advisory committees in carrying out its varied responsibilities. Three of these committees advise the Board of Governors directly: the Federal Advisory Council, the Consumer Advisory Council, and the Community Depository Institutions Advisory Council. These councils, whose members are drawn from each of the 12 Federal Reserve Districts, meet two to four times a year. The individual Reserve Banks have advisory committees as well, including thrift institutions advisory committees, small business committees, and agricultural advisory committees. Moreover, officials from all Reserve Banks meet periodically in various committees. To learn more, visit www.federalreserve.gov/aboutthefed/advisorydefault.htm.

Federal Advisory Council

The Federal Advisory Council—a statutory body established under the Federal Reserve Act—consults with and advises the Board of Governors on all matters within the Board's jurisdiction. It is composed of one representative from each Federal Reserve District, chosen by the Reserve Bank in that District. The Federal Reserve Act requires the council to meet in Washington, D.C., at least four times a year. Three members of the council serve as its president, vice president, and secretary. In 2011, it met on February 3–4, May 12–13, September 1–2, and December 1–2. The council met with the Board on February 4, May 13, September 2, and December 2, 2011.

Members

District 1
Joseph L. Hooley
Chairman, President, and Chief Executive Officer, State Street Corporation, Boston, MA

District 2
Vikram Pandit
Chief Executive Officer, Citigroup, Inc., New York, NY

District 3
Bharat B. Masrani
President and Chief Executive Officer, TD Bank, Cherry Hill, NJ

District 4
James E. Rohr
Chairman and Chief Executive Officer, The PNC Financial Services Group, Inc., Pittsburgh, PA

District 5
Richard D. Fairbank
Chairman and Chief Executive Officer, Capital One Financial Corporation, McLean, VA

District 6
Daryl G. Byrd
President and Chief Executive Officer, IBERIABANK Corporation, Lafayette, LA

District 7
David W. Nelms
Chairman and Chief Executive Officer, Discover Financial Services, Riverwoods, IL

District 8
Bryan Jordan
Chairman, President, and Chief Executive Officer, First Horizon National Corporation, Memphis, TN

District 9
Richard K. Davis
Chairman, President, and Chief Executive Officer, U.S. Bancorp, Minneapolis, MN

District 10
Stanley A. Lybarger
President and Chief Executive Officer, Bank of Oklahoma, National Association, Tulsa, OK

District 11
Richard W. Evans Jr.
Chairman and Chief Executive Officer, Cullen/Frost Bankers Inc., San Antonio, TX

District 12
Russell Goldsmith
Chairman and Chief Executive Officer, City National Bank, Beverly Hills, CA

Officers

Robert P. Kelly
President
(resigned September 2011)

Russell Goldsmith
Vice President

James E. Annable
Secretary

Consumer Advisory Council

The Consumer Advisory Council—a statutory body established pursuant to the 1976 amendments to the Equal Credit Opportunity Act—advises the Board of Governors on consumer financial services. Its members, who are appointed by the Board, are academics, state and local government officials, and representatives of the financial services industry and of consumer and community interests. In 2011, the Council met with the Board on March 10 and June 16.

Members

Nancy Andrews
President and Chief Executive Officer, Low Income Investment Fund, San Francisco, CA

Maeve Elise Brown
Executive Director, Housing and Economic Rights Advocates, Oakland, CA

Paula Bryant-Ellis
Senior Vice President, Community Development Banking Group, BOK Financial Corporation, Tulsa, OK

Joanne Budde
President and Chief Executive Officer, Consumer Credit Counseling Service of San Francisco, San Francisco, CA

Barrett Burns
President and Chief Executive Officer, VantageScore Solutions, LLC, Stamford, CT

John P. Carey
Chief Administrative Officer, Consumer Banking, North America, Citigroup, New York, NY

Tino Diaz
Managing Director and Chief Executive Officer, CharisPros – Mortgage Center, Miami, FL

Kerry Doi
President and Chief Executive Officer, Pacific Asian Consortium in Employment, Los Angeles, CA

Susan Ehrlich
President, Sears Financial Services, Sears Holding Corporation, Hoffman Estates, IL

Betsy Flynn
Chief Executive Officer, President, and Chairman, Community Financial Services Bank, Benton, KY

Josh Fuhrman
Senior Vice President of Programs and Policy, Homeownership Preservation Foundation, Minneapolis, MN

Patricia Garcia Duarte
President and Chief Executive Officer, Neighborhood Housing Services of Phoenix, Phoenix, AZ

Ira Goldstein
Director, Policy Solutions, The Reinvestment Fund, Philadelphia, PA

Mike Griffin
Senior Vice President, KeyBank, N.A., Cleveland, OH

James Gutierrez
Chief Executive Officer, Progreso Financiero, Mountain View, CA

Clinton Gwin
President, Pathway Lending, Nashville, TN

Brian Hudson Sr.
Executive Director and Chief Executive Officer, Pennsylvania Housing Finance Agency, Harrisburg, PA

Kirsten Keefe
Senior Staff Attorney, Empire Justice Center, Albany, NY

Larry B. Litton Jr.
President and Chief Executive Officer, Litton Loan Servicing LP, Houston, TX

Mike Long
Executive Vice President and Chief Credit Officer, UW Credit Union, Madison, WI

Andy Navarrete
Senior Vice President, Chief Counsel–National Lending, Capital One Financial Corporation, McLean, VA

Dory Rand
President, Woodstock Institute, Chicago, IL

Rashmi Rangan
Executive Director, Delaware Community Reinvestment Action Council, Newark, DE

Phyllis Salowe-Kaye
Executive Director, New Jersey Citizen Action, Newark, NJ

Mark Wiseman
Former Principal Assistant Attorney General, Consumer Protection Section, Ohio Attorney General's Office, Cleveland, OH

Jonathan Zinman
Associate Professor of Economics, Dartmouth College, Hanover, NH

Officers

Jim Park
Council Chair, Chief Executive Officer, New Vista Asset Management, San Diego, CA

Mary Tingerthal
Council Vice Chair, Commissioner, Minnesota Housing Finance Agency, St. Paul, MH

Community Depository Institutions Advisory Council

The Community Depository Advisory Council advises the Board of Governors on the economy, leading conditions, and other issues. Members are selected from representatives of banks, thrift institutions, and credit unions serving on local advisory councils at the 12 Federal Reserve Banks. One member of each of the Reserve Bank councils serves on the Community Depository Institutions Advisory Council, which meets twice a year with the Federal Reserve Board in Washington.

Members

Howard T. Boyle
President and Chief Executive Officer, Home Savings Bank, Kent, OH

Barrie G. Christman
Chairman, Principal Bank, Des Moines, IA

John V. Evans, Jr.
Chief Executive Officer, CapStar Bank, Nashville, TN

Richard J. Green
Chief Executive Officer, Firstrust Bank, Conshohocken, PA

Kay M. Hoveland
President and Chief Executive Officer, Kaiser Federal Bank and K-Fed Bancorp, Covina, CA *(resigned June 2011)*

Peter G. Humphrey
President and Chief Executive Officer, Five Star Bank and Financial Institutions, Inc., Warsaw, NY

Peter J. Johnson
President and Chief Executive Officer, American Federal Savings Bank, Helena, MT

Michael Kloiber
President and Chief Executive Officer, Tinker Federal Credit Union, Tinker Air Force Base, OK

Charles H. Majors
Chairman and Chief Executive Officer, American National Bank, Danville, VA

Randy M. Smith
Chief Executive Officer and President, Randolph-Brooks Federal Credit Union, Universal City, TX

William T. Stapleton
President and Chief Executive Officer, Northampton Cooperative Bank, Northampton, MA

Dennis M. Terry
President and Chief Executive Officer, First Clover Leaf Bank, Edwardsville, IL

Claire W. Tucker
President and Chief Executive Officer, CapStar Bank, Nashville, TN

Randy M. Smith
Chief Executive Officer and President, Randolph-Brooks Federal Credit Union, Universal City, TX

Officer

Barrie G. Christman
President

Federal Reserve Bank Branches

To carry out the day-to-day operations of the Federal Reserve System, the nation has been divided into 12 Federal Reserve Districts, each with a Reserve Bank. As required by the Federal Reserve Act of 1913, each of the Reserve Banks is supervised by a board of directors who are familiar with economic and credit conditions in the District. Similarly, each of the 24 Reserve Bank Branches has a board of directors who are familiar with conditions in the area encompassed by the Branch.

Reserve Bank and Branch Directors

Each Federal Reserve Bank has a nine-member board with three different classes of directors: three Class A directors, who are nominated and elected by the member banks in that District to represent the stockholding banks; three Class B directors, who are nominated and elected by the member banks to represent the public; and three Class C directors, who are appointed by the Board of Governors to represent the public. Class B and Class C directors are selected with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers. For the election of Class A and Class B directors, the member banks of each Federal Reserve District are classified into three groups. Each group, which is comprised of banks with similar capitalization, elects one Class A director and one Class B director. Directors are elected or appointed to three-year terms on a rotating basis so, barring any unexpected resignations, one position becomes available for each class of director each year. Annually, the Board of Governors designates one Class C director to serve as chair, and another Class C director to serve as deputy chair, of each Reserve Bank board.

Pursuant to the Federal Reserve Act, Class B and Class C directors may not be officers, directors, or employees of any bank, and Class C directors may not hold stock in any bank. In order to give full and meaningful effect to these restrictions, as well as the requirement that Class B and Class C directors be selected with consideration for sectors of the economy beyond banking, it is the Board's policy that Class B and Class C directors may not be affiliated with, and Class C directors may not hold stock in, certain other institutions that are also subject to the System's supervision.

Each Federal Reserve Bank Branch also has a board with either five or seven directors. A majority of the Branch directors are appointed by the Federal Reserve Bank, with the remaining directors appointed by the Board of Governors. Branch directors appointed by the Reserve Bank are subject to the same eligibility requirements as Class A or Class B directors. Board-appointed Branch directors must meet the same requirements as Class B directors.

For more information on Reserve Bank and Branch directors, see www.federalreserve.gov/generalinfo/listdirectors.

The directors of the Banks and Branches are listed below. For each director, the class of directorship, the director's principal business, and the expiration date of the director's term are shown.

District 1–Boston

Class A

Kathryn G. Underwood, 2011
President and Chief Executive Officer, Ledyard National Bank, Hanover, NH

David A. Lentini, 2012
Chairman and Chief Executive Officer, The Connecticut Bank and Trust Company, Hartford, CT

Richard E. Holbrook, 2013
Chairman and Chief Executive Officer, Eastern Bank, Boston, MA

Class B

Vacancy, 2011

William D. Nordhaus, 2012
Sterling Professor of Economics, Yale University, New Haven, CT

John F. Fish, 2013
Chief Executive Officer, Suffolk Construction Company, Inc., Boston, MA

Class C

Henri A. Termeer, 2011
Former Chairman, President, and Chief Executive Officer, Genzyme Corporation, Cambridge, MA

Catherine D'Amato, 2012
President and Chief Executive Officer, The Greater Boston Food Bank, Boston, MA

Kirk A. Sykes, 2013
President, Urban Strategy America Fund, L.P., Boston, MA

District 2–New York

Class A

Charles V. Wait, 2011
President, Chief Executive Officer, and Chairman, The Adirondack Trust Company, Saratoga Springs, NY

James Dimon, 2012
Chairman and Chief Executive Officer, JPMorgan Chase & Co., New York, NY

Richard L. Carrión, 2013
Chairman, President, and Chief Executive Officer, Popular, Inc., San Juan, PR

Class B

Terry J. Lundgren, 2011
Chairman, President, and Chief Executive Officer, Macy's, Inc., New York, NY

Glenn H. Hutchins, 2012
Co-Founder and Co-Chief Executive, Silver Lake, New York, NY

James S. Tisch, 2013
President and Chief Executive Officer, Loews Corporation, New York, NY

Class C

Emily K. Rafferty, 2011
President, The Metropolitan Museum of Art, New York, NY

Lee C. Bollinger, 2012
President, Columbia University, New York, NY

Kathryn S. Wylde, 2013
President and Chief Executive Officer, Partnership for New York City, New York, NY

District 3–Philadelphia

Class A

Frederick C. Peters, 2011
Chairman and Chief Executive Officer, Bryn Mawr Trust Company, Bryn Mawr, PA

Aaron L. Groff, Jr., 2012
Chairman, President, and Chief Executive Officer, Ephrata National Bank, Ephrata, PA

R. Scott Smith, 2013
Chairman and Chief Executive Officer, Fulton Financial Corporation, Lancaster, PA

Class B

Michael F. Camardo, 2011
Retired Executive Vice President, Lockheed Martin ITS, Cherry Hill, NJ

Deborah M. Fretz, 2012
Retired President and Chief Executive Officer, Sunoco Logistics Partners, Philadelphia, PA

Keith S. Campbell, 2013
Chairman, Mannington Mills, Inc., Salem, NJ

Class C

Charles P. Pizzi, 2011
Retired President and Chief Executive Officer, Tasty Baking Company, Philadelphia, PA

James E. Nevels, 2012
Chairman, The Swarthmore Group, Philadelphia, PA

Jeremy Nowak, 2013
President, William Penn Foundation, Philadelphia, PA

District 4–Cleveland

Class A

Charlotte W. Martin, 2011
President and Chief Executive Officer, Great Lakes Bankers Bank, Worthington, OH

C. Daniel DeLawder, 2012
Chairman and Chief Executive Officer, Park National Bank, Newark, OH

Paul G. Greig, 2013
Chairman, President, and Chief Executive Officer, FirstMerit Corp., Akron, OH

Class B

Tilmon F. Brown, 2011
President and Chief Executive Officer, New Horizons Baking Company, Norwalk, OH

Susan Tomasky, 2012
Retired President, AEP Transmission, Columbus, OH

Harold Keller, 2013
President, Ohio Capital Corporation for Housing, Columbus, OH

Class C

Alfred M. Rankin, Jr., 2011
Chairman, President, and Chief Executive Officer, NACCO Industries, Inc., Cleveland, OH

Richard K. Smucker, 2012
Chief Executive Officer, The J.M. Smucker Company, Orrville, OH

Christopher M. Connor, 2013
Chairman and Chief Executive Officer, The Sherwin-Williams Company, Cleveland, OH

Cincinnati Branch

Appointed by the Federal Reserve Bank

Gregory B. Kenny, 2011
President and Chief Executive Officer, General Cable Corporation, Highland Heights, KY

Janet B. Reid, 2011
Managing Partner and Director, Global Novations, LLC, Cincinnati, OH

Donald E. Bloomer, 2012
President and Chief Executive Officer, Citizens National Bank, Somerset, KY

Austin W. Keyser, 2013
Midwest Senior Field Representative, AFL-CIO, McDermott, OH

Appointed by the Board of Governors

James M. Anderson, 2011
Advisor to the President, Cincinnati Children's Hospital Medical Center, Cincinnati, OH

Daniel B. Cunningham, 2012
President and Chief Executive Officer, Long-Stanton Group, Cincinnati, OH

Peter S. Strange, 2013
Chairman, Messer, Inc., Cincinnati, OH

Pittsburgh Branch

Appointed by the Federal Reserve Bank

Howard W. Hanna III, 2011
Chairman and Chief Executive Officer, Howard Hanna Real Estate Services, Pittsburgh, PA

Petra Mitchell, 2011
President, Catalyst Connection, Pittsburgh, PA

Grant Oliphant, 2012
President and Chief Executive Officer, The Pittsburgh Foundation, Pittsburgh, PA

Todd D. Brice, 2013
President and Chief Executive Officer, S&T Bancorp, Inc., Indiana, PA

Appointed by the Board of Governors

Sunil T. Wadhwani, 2011
Chairman and Co-Founder, iGATE Corporation, Pittsburgh, PA

Robert A. Paul, 2012
Chairman and Chief Executive Officer, Ampco-Pittsburgh Corporation, Pittsburgh, PA

Glenn R. Mahone, 2013
Partner and Attorney at Law, Reed Smith LLP, Pittsburgh, PA

District 5–Richmond

Class A

Kelly S. King, 2011
Chief Executive Officer, BB&T Corporation, Winston-Salem, NC

Richard J. Morgan, 2012
President and Chief Executive Officer, CommerceFirst Bank, Annapolis, MD

Alan L. Brill, 2013
President and Chief Executive Officer, Capon Valley Bank, Wardensville, WV

Class B

Dana S. Boole, 2011
President and Chief Executive Officer, Community Affordable Housing Equity Corporation, Raleigh, NC

Wilbur E. Johnson, 2012
Managing Partner, Young Clement Rivers, LLP, Charleston, SC

Patrick C. Graney III, 2013
Maxum East Regional President, Maxum Petroleum, Belle, WV

Class C

Linda D. Rabbitt, 2011
Chairman and Chief Executive Officer, Rand Construction Corporation, Washington, DC

Russell C. Lindner, 2012
Chairman and Chief Executive Officer, The Forge Company, Washington, DC

Margaret E. McDermid, 2013
Senior Vice President and Chief Information Officer, Dominion Resources, Inc., Richmond, VA

Baltimore Branch

Appointed by the Federal Reserve Bank

Biana J. Arentz, 2011
President and Chief Executive Officer, Hemingway's Inc., Stevensville, MD

James T. Brady, 2012
Managing Director–Mid-Atlantic, Ballantrae International, Ltd., Ijamsville, MD

Anita G. Newcomb, 2012
President and Managing Director, A.G. Newcomb & Co., Columbia, MD

William B. Grant, 2013
Chairman, President, and Chief Executive Officer, First United Corp. and First United Bank & Trust, Oakland, MD

Appointed by the Board of Governors

Jenny G. Morgan, 2011
President and Chief Executive Officer, basys, inc., Linthicum, MD

Ronald Blackwell, 2012
Chief Economist, AFL-CIO, Washington, DC

Samuel L. Ross, 2013
Chief Executive Officer, Bon Secours Baltimore Health System, Baltimore, MD

Charlotte Branch

Appointed by the Federal Reserve Bank

James H. Speed, Jr., 2011
President and Chief Executive Officer, North Carolina Mutual Life Insurance Company, Durham, NC

Lucia Z. Griffith, 2012
Chief Executive Officer and Principal, METRO Landmarks, Charlotte, NC

John S. Kreighbaum, 2012
President and Chief Executive Officer, Carolina Premier Bank and Premara Financial, Inc., Charlotte, NC

Robert R. Hill, Jr., 2013
President and Chief Executive Officer, SCBT Financial Corporation, Columbia, SC

Appointed by the Board of Governors

Linda L. Dolny, 2011
Former President, PML Associates, Inc., Greenwood, SC

David J. Zimmerman, 2012
President, Southern Shows, Inc., Charlotte, NC

Claude C. Lilly, 2013
Dean, Clemson University, College of Business and Behavioral Science, Clemson, SC

District 6–Atlanta

Class A

James M. Wells III, 2011
Executive Chairman, SunTrust Banks, Inc., Atlanta, GA

Rudy E. Schupp, 2012
President and Chief Executive Officer, 1st United Bank, West Palm Beach, FL

T. Anthony Humphries, 2013
President and Chief Executive Officer, NobleBank & Trust, N.A., Anniston, AL

Class B

Renée Lewis Glover, 2011
President and Chief Executive Officer, Atlanta Housing Authority, Atlanta, GA

Clarence Otis, Jr., 2012
Chairman and Chief Executive Officer, Darden Restaurants, Inc., Orlando, FL

José S. Suguet, 2013
Chairman, President, and Chief Executive Officer, Pan-American Life Insurance Group, New Orleans, LA

Class C

Thomas I. Barkin, 2011
Director, McKinsey & Company, Atlanta, GA

Richard H. Anderson, 2012
Chief Executive Officer, Delta Air Lines, Inc., Atlanta, GA

Carol B. Tomé, 2013
Chief Financial Officer and Executive Vice President, The Home Depot, Atlanta, GA

Birmingham Branch

Appointed by the Federal Reserve Bank

Macke B. Mauldin, 2011
President, Bank Independent, Sheffield, AL

John A. Langloh, 2012
President and Chief Executive Officer, United Way of Central Alabama, Birmingham, AL

James K. Lyons, 2012
Director and Chief Executive Officer, Alabama State Port Authority, Mobile, AL

C. Richard Moore, Jr., 2013
Chairman, President, and Chief Executive Officer, Peoples Southern Bank, Clanton, AL

Appointed by the Board of Governors

Thomas R. Stanton, 2011
Chairman and Chief Executive Officer, ADTRAN, Inc., Huntsville, AL

F. Michael Reilly, 2012
Chairman, President, and Chief Executive Officer, Randall-Reilly Publishing Co., LLC, Tuscaloosa, AL

Howard Leroy Nicholson, 2013
Director, Alabama AFL-CIO LIFT, Montgomery, AL

Jacksonville Branch

Appointed by the Federal Reserve Bank

Hugh F. Dailey, 2011
President and Chief Executive Officer, Community Bank & Trust of Florida, Ocala, FL

Oscar J. Horton, 2012
President, Sun State International Trucks, LLC, Tampa, FL

D. Kevin Jones, 2012
President and Chief Executive Officer, MIDFLORIDA Credit Union, Lakeland, FL

Carolyn M. Fennell, 2013
Director of Public Affairs, Greater Orlando Aviation Authority, Orlando International Airport, Orlando, FL

Appointed by the Board of Governors

Lynda L. Weatherman, 2011
President and Chief Executive Officer, Economic Development Commission of Florida's Space Coast, Rockledge, FL

Leerie T. Jenkins, Jr., 2012
Chairman and Chief Executive Officer, Reynolds, Smith and Hills, Inc., Jacksonville, FL

Vacancy, 2013

Miami Branch

Appointed by the Federal Reserve Bank

Walter Banks, 2011
President, Lago Mar Resort and Club, Fort Lauderdale, FL

Thomas H. Shea, 2011
Chief Executive Officer, Florida/Caribbean Region, Right Management, Fort Lauderdale, FL

Leonard L. Abess, 2012
Chairman and Chief Executive Officer, ThinkLAB Ventures, LLC, Miami, FL

Gary L. Tice, 2013
Chairman and Chief Executive Officer, First National Bank of the Gulf Coast, Naples, FL

Appointed by the Board of Governors

W. Cody Estes, Sr., 2011
President and Owner, Estes Citrus, Inc., Vero Beach, FL

Eduardo J. Padrón, 2012
President, Miami Dade College, Miami, FL

Michael J. Jackson, 2013
Chairman and Chief Executive Officer, AutoNation, Inc., Fort Lauderdale, FL

Nashville Branch

Appointed by the Federal Reserve Bank

Dan W. Hogan, 2011
Chairman, Fifth Third Bank, Tennessee, Nashville, TN

Cordia W. Harrington, 2012
Chief Executive Officer, Tennessee Bun Company, Nashville, TN

Jennifer S. Banner, 2012
Chief Executive Officer, Schaad Companies, LLC, Knoxville, TN

William Y. Carroll, Jr., 2013
President and Chief Executive Officer, SmartBank, Pigeon Forge, TN

Appointed by the Board of Governors

Richard Q. Ford, 2011
Chairman and Chief Executive Officer, The Sage Group, Nashville, TN

William J. Krueger, 2012
Vice Chairman, Nissan Americas, Nissan North America, Inc., Franklin, TN

Kathleen Calligan, 2013
Chief Executive Officer, Better Business Bureau Middle Tennessee, Nashville, TN

New Orleans Branch

Appointed by the Federal Reserve Bank

R. King Milling, 2011
Member, Board of Directors, Hancock Holding Company and Whitney Bank, New Orleans, LA

Matthew G. Stuller Sr., 2012
Chairman and Chief Executive Officer, Stuller, Inc., Lafayette, LA

E. Renae Conley, 2012
Executive Vice President, Human Resources and Administration, Entergy Corporation, New Orleans, LA

Gerard R. Host, 2013
President and Chief Executive Officer, Trustmark National Bank, Jackson, MS

Appointed by the Board of Governors

T. Lee Robinson, Jr., 2011
President, OHC, Inc., Mobile, AL

Robert S. Boh, 2012
President and Chief Executive Officer, Boh Bros. Construction Co., LLC, New Orleans, LA

Terrie P. Sterling, 2013
Executive Vice President and Chief Operating Officer, Our Lady of the Lake Regional Medical Center, Baton Rouge, LA

District 7–Chicago

Class A

Frederick H. Waddell, 2011
Chairman and Chief Executive Officer, Northern Trust Corporation and The Northern Trust Company, Chicago, IL

Stephen J. Goodenow, 2012
Chairman and Chief Executive Officer, Bank Midwest, Spirit Lake, IA

Mark C. Hewitt, 2013
President and Chief Executive Officer, Clear Lake Bank & Trust Company, Clear Lake, IA

Class B

Nelda J. Connors, 2011
Chairwoman and Chief Executive Officer, Pine Grove Holdings, LLC, Chicago, IL

Terry Mazany, 2012
President and Chief Executive Officer, The Chicago Community Trust, Chicago, IL

Ann D. Murtlow, 2013
Former President and Chief Executive Officer, Indianapolis Power & Light Company, Indianapolis, IN

Class C

Jeffrey A. Joerres, 2011
Chairman and Chief Executive Officer, Manpower Group, Milwaukee, WI

William C. Foote, 2012
Retired Chairman, USG Corporation, Chicago, IL

Vacancy, 2013

Detroit Branch

Appointed by the Federal Reserve Bank

Mark T. Gaffney, 2011
Former President, Michigan AFL-CIO, Lansing, MI

Brian C. Walker, 2011
President and Chief Executive Officer, Herman Miller, Inc., Zeeland, MI

Sheilah P. Clay, 2012
President and Chief Executive Officer, Neighborhood Service Organization, Detroit, MI

Nancy M. Schlichting, 2013
Chief Executive Officer, Henry Ford Health System, Detroit, MI

Appointed by the Board of Governors

Timothy M. Manganello, 2011
Chairman and Chief Executive Officer, BorgWarner Inc., Auburn Hills, MI

Lou Anna K. Simon, 2012
President, Michigan State University, East Lansing, MI

Carl T. Camden, 2013
President and Chief Executive Officer, Kelly Services, Inc., Troy, MI

District 8–St. Louis

Class A

J. Thomas May, 2011
Chairman and Chief Executive Officer, Simmons First National Corporation, Pine Bluff, AR

William E. Chappel, 2012
President and Chief Executive Officer, The First National Bank, Vandalia, IL

Robert G. Jones, 2013
President and Chief Executive Officer, Old National Bancorp, Evansville, IN

Class B

Gregory M. Duckett, 2011
Senior Vice President and Corporate Counsel, Baptist Memorial Health Care Corporation, Memphis, TN

Sonja Yates Hubbard, 2012
Chief Executive Officer, E-Z Mart Stores, Inc., Texarkana, TX

Cal McCastlain, 2013
Partner, Dover Dixon Horne PLLC, Little Rock, AR

Class C

Ward M. Klein, 2011
Chief Executive Officer, Energizer Holdings, Inc., St. Louis, MO

Steven H. Lipstein, 2012
President and Chief Executive Officer, BJC HealthCare, St. Louis, MO

Sharon D. Fiehler, 2013
Executive Vice President and Chief Administrative Officer, Peabody Energy, St. Louis, MO

Little Rock Branch

Appointed by the Federal Reserve Bank

Phillip N. Baldwin, 2011
President and Chief Executive Officer, Southern Bancorp, Arkadelphia, AR

Robert A. Young III, 2011
Chairman, Arkansas Best Corporation, Fort Smith, AR

William C. Scholl, 2012
President, First Security Bancorp, Searcy, AR

Michael A. Cook, 2013
Vice President and Assistant Treasurer, Wal-Mart Stores, Inc., Bentonville, AR

Appointed by the Board of Governors

Ray C. Dillon, 2011
President and Chief Executive Officer, Deltic Timber Corporation, El Dorado, AR

C. Sam Walls, 2012
Chief Executive Officer, Arkansas Capital Corporation, Little Rock, AR

Kaleybra Mitchell Morehead, 2013,
Vice President for College Affairs/Advancement, Southeast Arkansas College, Pine Bluff, AR

Louisville Branch

Appointed by the Federal Reserve Bank

John C. Schroeder, 2011
President, Wabash Plastics, Inc., Evansville, IN

Kevin Shurn, 2011
President and Owner, Superior Maintenance Co., Elizabethtown, KY

Jon A. Lawson, 2012
President, Chief Executive Officer and Chairman, Bank of Ohio County, Beaver Dam, KY

David P. Heintzman, 2013,
Chairman and Chief Executive Officer, Stock Yards Bank & Trust Company, Louisville, KY

Appointed by the Board of Governors

Gerald R. Martin, 2011
Managing Member, River Hill Capital, LLC, Louisville, KY

Barbara Ann Popp, 2012
Chief Executive Officer, Schuler Bauer Real Estate Services, New Albany, IN

Gary A. Ransdell, 2013
President, Western Kentucky University, Bowling Green, KY

Memphis Branch

Appointed by the Federal Reserve Bank

Clyde Warren Nunn, 2011
Chairman and President, Security Bancorp of TN, Inc., Halls, TN

Susan S. Stephenson, 2011
Co-Chairman and President, Independent Bank, Memphis, TN

Allegra C. Brigham, 2012
Interim President, Mississippi University for Women, Columbus, MS

Mark P. Fowler, 2013
Vice Chairman, Liberty Bank of Arkansas, Jonesboro, AR

Appointed by the Board of Governors

Lawrence C. Long, 2011
Partner, St. Rest Planting Co., Indianola, MS

Charlie E. Thomas, III, 2012
Regional Director of External & Legislative Affairs, AT&T Tennessee, Memphis, TN

Charles S. Blatteis, 2013
Managing Member, Blatteis Law Firm, PLLC, Memphis, TN

District 9–Minneapolis

Class A

Michael J. O'Meara, 2011
Chairman, Peoples Bank of Wisconsin, Eau Claire, WI

Richard L. Westra, 2012
President and Chief Executive Officer, Dacotah Bank and Dacotah Banks, Inc., Aberdeen, SD

Julie Causey, 2013
Chairman, Western Bank, St. Paul, MN

Class B

Howard A. Dahl, 2011
President and Chief Executive Officer, AGCO-Amity, AGCO J.V. L.L.C., Fargo, ND

William J. Shorma, 2012
President, Rush Co/Strategic Rail Systems SRS, Springfield, SD

Lawrence R. Simkins, 2013
President, The Washington Corporations, Missoula, MT

Class C

John W. Marvin, 2011
Chairman and Chief Executive Officer, Marvin Windows and Doors, Warroad, MN

Randall J. Hogan, 2012
Chairman and Chief Executive Officer, Pentair, Incorporated, Minneapolis, MN

Mary K. Brainerd, 2013
President and Chief Executive Officer, HealthPartners, Minneapolis, MN

Helena Branch

Appointed by the Federal Reserve Bank

John L. Franklin, 2011
President and Chief Executive Officer, 1st Bank, Sidney, MT

Timothy J. Bartz, 2012
Chairman, Anderson ZurMuehlen & Company, P.C., Helena, MT

Thomas R. Swenson, 2013
President and Chief Executive Officer, Bank of Montana and Bancorp of Montana Holding Company, Missoula, MT

Appointed by the Board of Governors

David B. Solberg, 2011
Owner, Seven Blackfoot Ranch Company, Billings, MT

Joseph F. McDonald, 2012
President Emeritus, Salish Kootenai College, Pablo, MT

District 10–Kansas City

Class A

John A. Ikard, 2011
President and Chief Executive Officer, FirstBank Holding Company, Lakewood, CO

David W. Brownback, 2012
President and Chief Executive Officer, Citizens State Bank & Trust Company, Ellsworth, KS

Max T. Wake, 2013
President, Jones National Bank & Trust Co., Seward, NE

Class B

Richard K. Ratcliffe, 2011
Chairman, Ratcliffe's Inc., Weatherford, OK

John T. Stout, Jr., 2012
Chief Executive Officer, Plaza Belmont Management Group LLC, Shawnee Mission, KS

Mark Gordon, 2013
Owner, Merlin Ranch, Buffalo, WY

Class C

Lu M. Córdova, 2011
Chief Executive Officer, Corlund Industries, LLC.; *President and General Manager*, Almacen Storage Group, Boulder, CO

Paul DeBruce, 2012
Chief Executive Officer and Founder, DeBruce Grain, Inc., Kansas City, MO

Terry L. Moore, 2013
President, Omaha Federation of Labor, AFL-CIO, Omaha, NE

Denver Branch

Appointed by the Federal Reserve Bank

Bruce K. Alexander, 2011
President and Chief Executive Officer, Vectra Bank Colorado, Denver, CO

Charles H. Brown III, 2012
President, C.H. Brown Co., Wheatland, WY

Anne Haines Yatskowitz, 2012
President and Chief Executive Officer, ACCION New Mexico–Arizona–Colorado, Albuquerque, NM

Mark A. Zaback, 2013
President and Chief Executive Officer, Jonah Bank of Wyoming, Casper, WY

Appointed by the Board of Governors

Larissa L. Herda, 2011
Chair, Chief Executive Officer, and President, tw telecom inc., Littleton, CO

Barbara Mowry, 2012
Chief Executive Officer, GoreCreek Advisors, Greenwood Village, CO

Margaret M. Kelly, 2013
Chief Executive Officer, RE/MAX, LLC, Denver, CO

Oklahoma City Branch

Appointed by the Federal Reserve Bank

K. Vasudevan, 2011
Chairman and Founder, Service & Technology Corporation, Bartlesville, OK

Rose M. Washington, 2012
Executive Director, Tulsa Economic Development Corporation, Tulsa, OK

Jacqueline R. Fiegel, 2013
Senior Executive Vice President and Chief Operating Officer, Coppermark Bank, Oklahoma City, OK

Douglas E. Tippens, 2013
President and Chief Executive Officer, Bank of Commerce, Yukon, OK

Appointed by the Board of Governors

James D. Dunn, 2011
Chair, MillCreek Lumber & Supply Co., Tulsa, OK

Vacancy, 2012

Steven C. Agee, 2013
Dean and Professor of Economics, Meinders School of Business, Oklahoma City University, Oklahoma City, OK

Omaha Branch

Appointed by the Federal Reserve Bank

Mark A. Sutko, 2011
President and Chief Executive Officer, Platte Valley State Bank, Kearney, NE

Todd S. Adams, 2012
Chief Executive Officer, Adams Bank & Trust, Ogallala, NE

James L. Thom, 2012
Vice President, T-L Irrigation Co., Hastings, NE

JoAnn M. Martin, 2013
Chair, President, and Chief Executive Officer, Ameritas Life Insurance Corp., Lincoln, NE

Appointed by the Board of Governors

James C. Farrell, 2011
President and Chief Executive Officer, Farmers National Company, Omaha, NE

G. Richard Russell, 2012
President and Chief Executive Officer, Millard Lumber Inc., Omaha, NE

Natalia J. Peart, 2013
Chief Executive Officer, Women's Center for Advancement, Omaha, NE

District 11–Dallas

Class A

George F. Jones, Jr., 2011
Chief Executive Officer, Texas Capital Bank, Dallas, TX

Pete Cook, 2012
Chief Executive Officer, First National Bank in Alamogordo, Alamogordo, NM

Joe Kim King, 2013
Chief Executive Officer and Chairman of the Board, Texas Country Bancshares, Inc., Brady, TX

Class B

James B. Bexley, 2011
Professor, Finance, Sam Houston State University, Huntsville, TX

Margaret H. Jordan, 2012
President and Chief Executive Officer, Dallas Medical Resource, Dallas, TX

Elton M. Hyder, 2013
President, The EMH Corporation, Fort Worth, TX

Class C

Renu Khator, 2011
Chancellor/President, University of Houston, Houston, TX

Myron E. Ullman III, 2012
Executive Chairman, J.C. Penney Company, Inc., Plano, TX

Herbert D. Kelleher, 2013
Founder and Chairman Emeritus, Southwest Airlines, Dallas, TX

D. Kirk Edwards, 2012
President, MacLondon Royalty Company, Odessa, TX

Cindy J. Ramos-Davidson, 2013
President and Chief Executive Officer, El Paso Hispanic Chamber of Commerce, El Paso, TX

El Paso Branch

Appointed by the Federal Reserve Bank

Laura M. Conniff, 2011
Qualifying Broker, Mathers Realty, Inc., Las Cruces, NM

Martha I. Dickason, 2011
President, dmDickason Personnel Services, El Paso, TX

Robert Nachtmann, 2012
Dean and Professor of Finance, University of Texas at El Paso, El Paso, TX

Larry L. Patton, 2013
President and Chief Executive Officer, Bank of the West, El Paso, TX

Appointed by the Board of Governors

Robert E. McKnight, Jr., 2011
Owner, McKnight Ranch Company, Fort Davis, TX

Houston Branch

Appointed by the Federal Reserve Bank

Kirk S. Hachigian, 2011
Chairman and Chief Executive Officer, Cooper Industries, Ltd., Houston, TX

Ann B. Stern, 2011
Executive Vice President, Texas Children's Hospital, Houston, TX

Paul B. Murphy, Jr., 2012
President and Chief Executive Officer, Cadence Bank, Houston, TX

Gerald B. Smith, 2013
Chairman and Chief Executive Officer, Smith, Graham & Company Investment Advisors, L.P., Houston, TX

Appointed by the Board of Governors

Paul W. Hobby, 2011
Chairman and Managing Partner, Genesis Park, LP, Houston, TX

Jorge A. Bermudez, 2012
President and Chief Executive Officer, Byebrook Group, College Station, TX

Greg L. Armstrong, 2013
Chairman and Chief Executive Officer, Plains All American Pipeline, L.P., Houston, TX

San Antonio Branch

Appointed by the Federal Reserve Bank

Ygnacio D. Garza, 2011
CPA, Long Chilton LLP, Brownsville, TX

Guillermo F. Trevino, 2011
President, Southern Distributing, Laredo, TX

Thomas E. Dobson, 2012
Chairman and Chief Executive Officer, Whataburger Restaurants, LP, San Antonio, TX

Josue Robles, 2013
President and Chief Executive Officer, USAA, San Antonio, TX

Appointed by the Board of Governors

Steven R. Vandegrift, 2011
Founder and President, SRV Holdings, Austin, TX

Catherine M. Burzik, 2012
President and Chief Executive Officer, Kinetic Concepts, Inc., San Antonio, TX

Curtis V. Anastasio, 2013
President and Chief Executive Officer, NuStar Energy L.P., San Antonio, TX

District 12–San Francisco

Class A

Dann H. Bowman, 2011
President and Chief Executive Officer, Chino Commercial Bank, N.A., Chino, CA

Kenneth P. Wilcox, 2012
Chairman, Silicon Valley Bank, Santa Clara, CA

Betsy Lawer, 2013
Vice Chair, First National Bank Alaska, Anchorage, AK

Class B

Karla S. Chambers, 2011
Vice President and Co-Owner, Stahlbush Island Farms, Inc., Corvallis, OR

Blake W. Nordstrom, 2012
President, Nordstrom, Inc., Seattle, WA

Nicole C. Taylor, 2013
President and Chief Executive Officer, East Bay Community Foundation, Oakland, CA

Class C

Douglas W. Shorenstein, 2011
Chairman and Chief Executive Officer, Shorenstein Properties LLC, San Francisco, CA

William D. Jones, 2012
President and Chief Executive Officer, City Scene Management Company, San Diego, CA

Patricia E. Yarrington, 2013
Vice President and Chief Financial Officer, Chevron Corporation, San Ramon, CA

Los Angeles Branch

Appointed by the Federal Reserve Bank

Keith E. Smith, 2011
President and Chief Executive Officer, Boyd Gaming Corporation, Las Vegas, NV

John C. Molina, 2012
Chief Financial Officer, Molina Healthcare, Inc., Long Beach, CA

Joseph C. Berenato, 2012
Chairman of the Board, Ducommun Incorporated, Carson, CA

David I. Rainer, 2013
Chairman, President, and Chief Executive Officer, California United Bank, Encino, CA

Appointed by the Board of Governors

Ann E. Sewill, 2011
President, Community Foundation Land Trust, California Community Foundation, Los Angeles, CA

Andrew J. Sale, 2012
Partner, Retail, Consumer Products and Media & Entertainment Leader–West Region, Ernst & Young LLP, Los Angeles, CA

Grace Evans Cherashore, 2013
President and Chief Executive Officer, Evans Hotels, San Diego, CA

Portland Branch

Appointed by the Federal Reserve Bank

Robert C. Hale, 2011
Chief Executive Officer, Hale Companies, Hermiston, OR

Peggy Y. Fowler, 2011
Retired Chief Executive Officer and President, Portland General Electric, Portland, OR

Megan F. Clubb, 2012
President and Chief Executive Officer, Baker Boyer National Bank, Walla Walla, WA

Roger W. Hinshaw, 2013
President, Oregon and SW Washington, Bank of America Oregon, N.A., Portland, OR

Appointed by the Board of Governors

Roderick C. Wendt, 2011
Chief Executive Officer, JELD-WEN, inc., Klamath Falls, OR

David Y. Chen, 2012
Chief Executive Officer, Equilibrium Capital Group LLC, Portland, OR

Joseph E. Robertson, Jr., M.D., 2013
President, Oregon Health & Science University, Portland, OR

Salt Lake City Branch

Appointed by the Federal Reserve Bank

Damon G. Miller, 2011
Utah Market President, U.S. Bank, Salt Lake City, UT

Robert A. Hatch, 2011
President, Regence BlueCross BlueShield of Utah, Salt Lake City, UT

Carol Carter, 2012
President and Chief Executive Officer, Industrial Compressor Products, Inc., Park City, UT

Albert T. Wada, 2013
Chairman and Chief Executive Officer, Wada Farms, Inc., Pingree, ID

Appointed by the Board of Governors

Clark D. Ivory, 2011
Chief Executive Officer, Ivory Homes, Ltd., Salt Lake City, UT

Bradley J. Wiskirchen, 2012
Chief Executive Officer, Keynetics, Inc., Boise, ID

Scott L. Hymas, 2013
Chief Executive Officer, RC Willey, Salt Lake City, UT

Seattle Branch

Appointed by the Federal Reserve Bank

Scott L. Morris, 2011
Chairman, President, and Chief Executive Officer, Avista Corporation, Spokane, WA

Patrick G. Yalung, 2011
Regional President, Washington, Wells Fargo Bank, N.A., Seattle, WA

Henry L. (Skip) Kotkins, Jr., 2012
Chairman and Chief Executive Officer, Skyway Luggage Company, Seattle, WA

Richard Galanti, 2013
Executive Vice President and Chief Financial Officer, Costco Wholesale Corporation, Issaquah, WA

Appointed by the Board of Governors

Ada M. Healey, 2011
Vice President, Real Estate, Vulcan Inc., Seattle, WA

Mary O. McWilliams, 2012
Executive Director, Puget Sound Health Alliance, Seattle, WA

Vacancy, 2013

Reserve Bank and Branch Officers

As mentioned, each Federal Reserve Bank and its branches has a board of directors. The officers of each Bank and Branch are drawn from this pool of directors. Specifically, two directors of each Reserve Bank are designated by the Board of Governors as chair[1] and deputy chair, respectively, of their nine-member board. Each Reserve Bank also has a president and first vice president, who are appointed by the board of directors of the Bank, subject to approval by the Board of Governors. Additionally, each District Branch also has a chair, who is selected from among those Branch directors appointed by the Board of Governors.

Boston

Henri A. Termeer, *Chair*

Kirk A. Sykes, *Deputy Chair*

Eric S. Rosengren, *President*

Kenneth C. Montgomery, *First Vice President*

New York

Lee C. Bollinger, *Chair*

Kathryn S. Wylde, *Deputy Chair*

William C. Dudley, *President*

Christine M. Cumming, *First Vice President*

Additional office at East Rutherford, NJ

Philadelphia

Charles P. Pizzi, *Chair*

Jeremy Nowak, *Deputy Chair*

Charles I. Plosser, *President*

D. Blake Prichard, *First Vice President*

Cleveland

Alfred M. Rankin, Jr., *Chair*

Richard K. Smucker, *Deputy Chair*

Sandra Pianalto, *President*

Gregory Stefani, *First Vice President*

Cincinnati

James M. Anderson, *Chair*

LaVaughn M. Henry, *Senior Regional Officer*

Pittsburgh

Sunil T. Wadhwani, *Chair*

Robert B. Schaub, *Senior Regional Officer*

Richmond

Margaret E. McDermid, *Chair*

Linda D. Rabbitt, *Deputy Chair*

Jeffrey M. Lacker, *President*

Sarah G. Green, *First Vice President*

Baltimore

Ronald Blackwell, *Chair*

David E. Beck, *Officer in Charge*

Charlotte

Claude C. Lilly, *Chair*

Matthew A. Martin, *Officer in Charge*

Atlanta

Carol B. Tomé, *Chair*

Thomas I. Barkin, *Deputy Chair*

Dennis P. Lockhart, *President*

Marie C. Gooding, *First Vice President*

Birmingham

Thomas R. Stanton, *Chair*

Lesley McClure, *Vice President and Regional Executive*

Jacksonville

Lynda L. Weatherman, *Chair*

Christopher L. Oakley, *Vice President and Regional Executive*

Miami

W. Cody Estes Sr., *Chair*

Juan del Busto, *Vice President and Regional Executive*

Nashville

Richard Q. Ford, *Chair*

Lee C. Jones, *Vice President and Regional Executive*

New Orleans

Robert S. Boh, *Chair*

Robert J. Musso, *Senior Vice President and Regional Executive*

Chicago

William C. Foote, *Chair*

Vacancy, *Deputy Chair*

Charles L. Evans, *President*

Gordon Werkema, *First Vice President*

Additional office at Des Moines, IA, and at Midway at Bedford Park, IL.

[1] The chair of a Federal Reserve Bank serves, by statute, as Federal Reserve agent.

Detroit

Timothy M. Manganello, *Chair*

Robert Wiley, *Officer in Charge*

St. Louis

Steven H. Lipstein, *Chair*
Ward M. Klein, *Deputy Chair*
James Bullard, *President*
David A. Sapenaro, *First Vice President*

Little Rock

Kaleybra Mitchell Morehead, *Chair*

Robert A. Hopkins, *Officer in Charge*

Louisville

Gary A. Ransdell, *Chair*

Maria Gerwing Hampton, *Officer in Charge*

Memphis

Lawrence C. Long, *Chair*

Martha Perine Beard, *Officer in Charge*

Minneapolis

John W. Marvin, *Chair*
Mary K. Brainerd, *Deputy Chair*
Narayana R. Kocherlakota, *President*
James M. Lyon, *First Vice President*

Helena

Joseph F. McDonald, *Chair*

R. Paul Drake, *Officer in Charge*

Kansas City

Paul DeBruce, *Chair*
Lu M. Córdova , *Deputy Chair*
Esther L. George, *President*
Vacancy, *First Vice President*

Denver

Barbara Mowry, *Chair*

Mark C. Snead, *Officer in Charge*

Oklahoma City

Steven C. Agee, *Chair*

Chad R. Wilkerson, *Officer in Charge*

Omaha

James C. Farrell, *Chair*

Jason R. Henderson, *Officer in Charge*

Dallas

Herbert D. Kelleher, *Chair*
Myron E. Ullman III, *Deputy Chair*
Richard W. Fisher, *President*
Helen E. Holcomb, *First Vice President*

El Paso

D. Kirk Edwards, *Chair*

Robert W. Gilmer, *Officer in Charge*

Houston

Paul W. Hobby, *Chair*

Daron D. Peschel, *Officer in Charge*

San Antonio

Steven R. Vandegrift, *Chair*

Blake Hastings, *Officer in Charge*

San Francisco

Douglas W. Shorenstein, *Chair*
Patricia E. Yarrington, *Deputy Chair*
John C. Williams, *President*
John F. Moore, *First Vice President*

Additional office at Phoenix, AZ.

Los Angeles

Grace Evans Cherashore, *Chair*

Mark L. Mullinix, *Officer in Charge*

Portland

David Y. Chen, *Chair*

Steven H. Walker, *Officer in Charge*

Salt Lake City

Scott L. Hymas, *Chair*

Robin A. Rockwood, *Officer in Charge*

Seattle

Mary O. McWilliams, *Chair*

Mark A. Gould, *Officer in Charge*

Officer Conferences

A number of the officers of each Bank also serve on councils that examine issues of importance to their districts.

Conference of Chairs

The chairs of the Federal Reserve Banks are organized into the Conference of Chairs, which meets to consider matters of common interest and to consult with and advise the Board of Governors. Such meetings, also attended by the deputy chairs, were held in Washington, D.C., on May 24 and 25 and November 15 and 16, 2011. The conference's executive committee members for 2011 and 2012 are listed below.

Conference of Chairs Executive Committee–2011

Charles P. Pizzi, *Chair*,
Federal Reserve Bank of Philadelphia

Alfred M. Rankin, Jr., *Vice Chair*
Federal Reserve Bank of Cleveland

Herbert D. Kelleher, *Member*,
Federal Reserve Bank of Dallas

Conference of Chairs Executive Committee–2012

Alfred M. Rankin, Jr., *Chair*,
Federal Reserve Bank of Cleveland

Herbert D. Kelleher, *Vice Chair*,
Federal Reserve Bank of Dallas

Mary K. Brainerd, *Member*,
Federal Reserve Bank of Minneapolis

Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to identify, define, and deliberate issues of strategic significance to the Federal Reserve System; to consider matters of common interest; and to consult with and advise the Board of Governors. Conference officers for 2011 are listed below.

Conference of Presidents–2011

Richard W. Fisher, *Chair*,
Federal Reserve Bank of Dallas

Charles I. Plosser, *Vice Chair*,
Federal Reserve Bank of Philadelphia

Harvey R. Mitchell, *Secretary*,
Federal Reserve Bank of Dallas

Frank J. Doto,
Assistant Secretary,
Federal Reserve Bank of Philadelphia

Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters. Conference officers for 2011 are listed below.[2]

Conference of First Vice Presidents–2011

Sally Green, *Chair,*
Federal Reserve Bank of
Richmond

Esther L. George,[3] *Vice Chair,*
Federal Reserve Bank of
Kansas City

Anne C. Gossweiler, *Secretary,*
Federal Reserve Bank of
Richmond

W. Todd Mackey,[4]
Assistant Secretary,
Federal Reserve Bank of
Kansas City

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[2] On December 1, 2011, the conference elected Blake Prichard, Federal Reserve Bank of Philadelphia, as chair for 2012–13, and Kenneth Montgomery, Federal Reserve Bank of Boston, as vice chair. The conference also elected Thomas Lombardo, Federal Reserve Bank of Philadelphia, as secretary, and Jeanne MacNevin, Federal Reserve Bank of Boston, as assistant secretary.

[3] Ms. George became president and chief executive officer of the Federal Reserve Bank of Kansas City on October 1, 2011. The conference elected Blake Prichard as vice chair on November 4, 2011.

[4] The conference elected Thomas Lombardo as assistant secretary on November 4, 2011.

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