Checkpoint

The Federal Reserve's Role in Ensuring Safety, Soundness and Competitiveness in a Consolidating Banking Industry

FEDERAL RESERVE BANK OF ST. LOUIS | 2006 ANNUAL REPORT

FEDERAL RESERVE BANK OF ST. LOUIS

Annual Report

2006

Not What You Might Expect

Banking mergers and acquisitions have occurred throughout our nation's history. Over the past two decades, they have led to an unprecedented reduction in the number of banking institutions. Despite fears to the contrary, institutions remain safe and sound, and the industry is as competitive as ever in local markets. The Federal Reserve works to ensure and enforce such outcomes in order to keep stability and confidence high within the banking industry.

William Poole
President and CEO
Federal Reserve Bank of St. Louis

America's banking landscape has changed dramatically over the past 20 years. The change started with banks being allowed to branch unfettered within state borders. The process expanded to banks being allowed, for the first time in our nation's history, to branch unrestricted across state borders. Permitting intrastate and interstate banking and branching led to thousands of mergers and acquisitions in the industry. Today, the number of banking organizations is about half of what it was in the 1980s. Still, thousands of banks remain, some as very large, multistate organizations and many others as small or moderate-sized institutions. All the while, new banks are created each year.

With so many banks disappearing, you might believe that banking competition must also be disappearing. But this is actually not the case. Fewer banks overall does not have to mean less banking competition in your neighborhood or mine. In fact, one of the Federal Reserve's jobs is to make sure that banking competition stays vigorous in local markets, even as the industry consolidates.

You might also believe that the consolidation trend has caused some banks to jeopardize their safety and soundness. This, too, is certainly not the case. Another of the Fed's jobs is to make certain that banks remain safe and sound, and that they are complying with all laws and regulations, even as the industry consolidates.

This year's annual report describes the role we play in monitoring, evaluating and overseeing mergers and acquisitions in the banking industry to ensure that consolidation occurs in an orderly and regulated manner. That is, we will describe how we act as a "checkpoint" on the road of an evolving banking landscape.

There was a time when American banking was quite different than it is today. In the 19th and early 20th centuries, our banking system was a model of active competition among tens of thousands of small banks. Unfortunately, our environment of many small, independent banks prevented these institutions from achieving maximum efficiency, and the system turned out to be fragile. Some banks failed, even in relatively good economic times. Many failed when economic conditions deteriorated. The Great Depression resulted in almost half of all U.S. banks failing, which devastated the economy. This period in U.S. history illustrates vividly that the number of banking institutions reveals little about the effectiveness or efficiency of the banking industry.

Although the total number of institutions has recently been dropping, these declines, fueled chiefly by intrastate and interstate banking and branching, have enabled banks to structure themselves more efficiently than ever before. No merger or acquisition, however, can proceed without the Federal Reserve or another regulator first reviewing, adjusting and, ultimately, approving or denying it.

Our annual report examines this less well-known, but very important, role that the Federal Reserve plays in making sure that such mergers and acquisitions do not endanger a bank's safety and soundness, compliance with laws and regulations, or the level of banking competition that is vital to economic welfare. Our goal is to make certain that the banking industry evolves in a way that preserves the benefits of competition and ensures a safe and sound banking system. So, even if your bank has changed owners three times in the past two years, rest assured that the Fed (or another regulator) has scrutinized each transaction to make sure that the best interests of the industry, the local market, the bank and you are upheld.

I. Introduction

“What’s Happening to All the Banks around Here?”

It seems to be happening all the time, and everywhere. You can't help but notice. It has probably already occurred in your town. You open the newspaper one morning, and the headline glares at you: "Another Local Bank Is Sold!" Sometimes you recognize the buyer—a bank in town that you've heard of or an out-of-town bank that, well, everyone has heard of. Other times, though, the buyer is unfamiliar. All you know is that yet another bank is going to have a new owner.

You read further into the article. It says that the same buyer bought another bank in town a little more than a year ago. You ask yourself, "What's happening to all the banks around here?"

You recall a litany of other recent headlines—other transactions. You remember that Magna Bank became Union Planters, which then became Regions. Boatmen's became NationsBank, which became Bank of America. Mark Twain became Mercantile, which became Firstar, which then became U.S. Bank. Allegiant became National City; National Bank of Commerce and NBC Bank both became SunTrust …

You begin to wonder if competition among banks is disappearing. And, by the way, isn't the government supposed to do something about this?

"Government," in this case, actually refers to the Federal Reserve System, which has jurisdiction over many of the banking industry's merger and acquisition proposals. The St. Louis Fed is one of the 12 banks in the Federal Reserve, which is one of four primary federal regulators of depository institutions. The other regulators are the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp. and the Office of Thrift Supervision. Another federal agency, the National Credit Union Administration, regulates credit unions, which are very similar to depository institutions in some ways. Beyond the four primary regulators, the Department of Justice and the Federal Trade Commission are also responsible for enforcing the nation's antitrust laws.

So, is the Fed doing anything about all the banking mergers and acquisitions that are taking place? Yes. We thoroughly review and analyze proposed banking combinations, whether or not they make front-page news, to ensure that they satisfy all of the requirements set out in the antitrust and banking laws. The provisions cover financial condition, managerial resources, anti-money laundering safeguards, community convenience and needs, and competition, and they are spelled out in

detailed regulations so that everyone knows what they are up-front. Only after all of these requirements have been met to our satisfaction can we approve any deal.

Why do we go through such a thorough process for each transaction? Why do we care? On one level, we do it because the law requires us to. But there is a deeper reason, a more fundamental financial reason that explains why we should be, and are, involved. As the nation's central bank, the Federal Reserve is responsible for maintaining financial stability—that is, ensuring both the ongoing and smooth functioning of the nation's payments systems and financial markets, and a steady supply of credit to qualified borrowers—and the banking system plays a vital role in such stability. We pay attention to any shock that potentially affects the banking industry's normal operations in the financial and payments markets. It should, therefore, not be surprising that the Fed is heavily responsible and accountable for monitoring, evaluating and overseeing the banking industry's consolidation process.

This essay will examine the methods we employ to ensure that this process takes place in a regulated and orderly manner. We will demonstrate that the Federal Reserve operates as a checkpoint on the road of consolidation. But first, let's take a closer look at exactly what banking consolidation is and how it has changed the nation's banking landscape.

FEDERAL BANKING REGULATORS

AGENCY		REGULATES
Federal Reserve System	Fed	Bank holding companies and state-chartered commercial banks that are Fed members
Office of the Comptroller of the Currency	OCC	Commercial banks with national charters
Federal Deposit Insurance Corp.	FDIC	State-chartered commercial banks that are not Fed members
Office of Thrift Supervision	OTS	Thrifts
National Credit Union Administration	NCUA	Credit unions
Department of Justice	DOJ	Enforces all of the nation's antitrust laws
Federal Trade Commission	FTC	Enforces all of the nation's antitrust laws

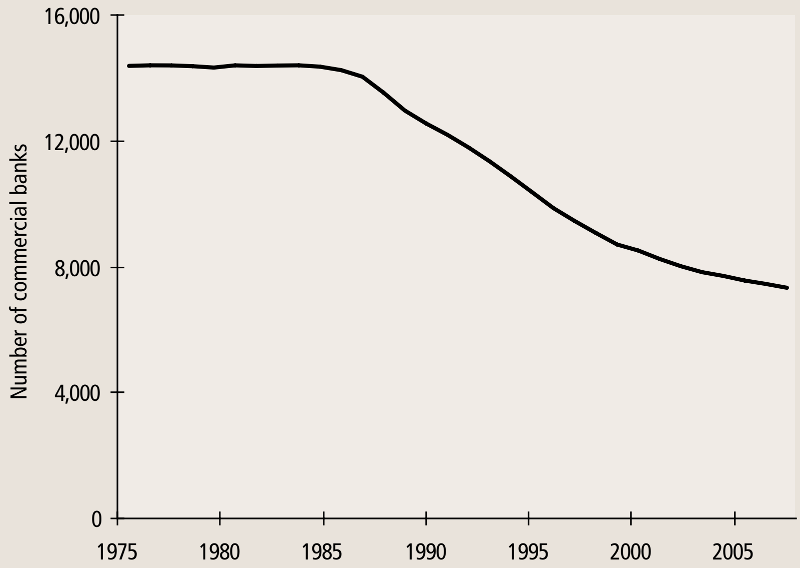
II. The Consolidation Conundrum

Can Fewer Banks Actually Lead to More Banking Competition?

Appearances Can Be Deceiving

Figures 1 and 2 reveal that even though the number of banks has declined over the past two decades, banking competition in local markets has actually increased. Remember, lower market concentration means higher competition.

Figure 1
The Declining Number of Commercial Banks in the United States



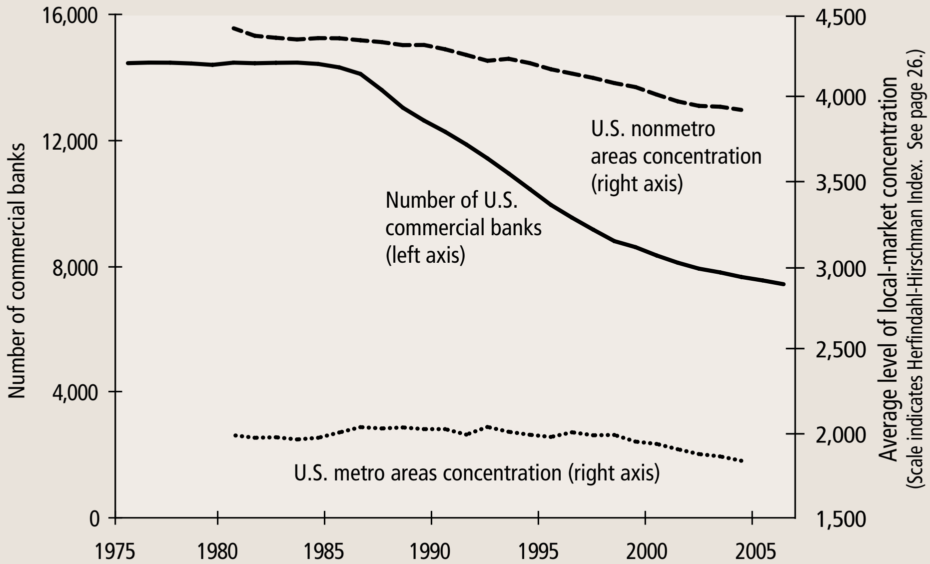
Source: Federal Deposit Insurance Corporation, Quarterly Banking Profile

Although banking mergers and acquisitions have occurred throughout U.S. history, the wholesale decline in the number of banking institutions—or consolidation in the U.S. banking industry—is a more recent phenomenon. As illustrated in Figure 1, the total number of commercial banks in the United States, which had been relatively steady through the 1970s and mid-1980s, has now shrunk to about half of what it was just 20 years ago—from more than 14,000 banks in 1986 to fewer than 8,000 in 2006. The total number of savings institutions (also known as thrifts, savings banks, or savings and loan associations), though not displayed in the figure, has followed an even more dramatic path—shrinking from almost 3,700 thrifts in 1986 to fewer than 1,300 in 2006, or about a third of the 1986 level.

All told, these figures mean that more than 6,000 banks (and about 2,400 thrifts) have disappeared over the 20-year period. Indeed, "What's happening to all the banks around here?" is an appropriate question. It's not a huge leap to conclude that this trend must have led to more concentration—that is, less competition—in banking. The reality, however, is quite different.

As shown in Figure 2, at the same time the total number of U.S. commercial banks was declining, a common measure of banking market concentration shows that the average levels of deposit-market concentration in U.S. metropolitan areas and nonmetropolitan areas (that is, counties not in metro areas) were ***also declining***

Figure 2
Declining Average Level of Local Market Concentration in U.S. Metropolitan and Nonmetropolitan Areas



Sources: Number of commercial banks: Federal Deposit Insurance Corporation, Quarterly Banking Profile; Indexes of concentration: FDIC Summary of Deposits and Board of Governors

moderately. In other words, as the total number of institutions was declining, banking competition in both metropolitan and rural areas was actually starting to increase. How can this be?

We can answer this question by pointing to a fundamental industry tenet: Banks compete for customers in local markets. Although some people or small businesses look beyond their local areas for certain financial services—for example, large-denomination time deposits or investment products—surveys and research continue to show that customers predominantly choose banks near where they live or work. Households and small businesses almost exclusively get financial services like checking or other transaction accounts (their primary account) and small-business loans from local financial firms, most often from banks, though sometimes from a thrift or credit union. Regardless of the type of institution, however, the underlying fact still holds: The institution of choice is in the customer's neighborhood. Thus, when we talk about banking competition and the effect of consolidation on it, we need to examine what is happening in local banking markets, not national or statewide markets. To better understand how local banking markets explain the consolidation conundrum, see "Thinking Nationally, Competing Locally," a sidebar series that begins on page 13.

Banks compete for customers in local markets. Although some people or small businesses look beyond their local areas for certain financial services—for example, large-denomination time deposits or investment products—surveys and research continue to show that customers predominantly choose banks near where they live or work.

In addition, at the same time the banking industry has been losing institutions, it has been making huge advancements in technology, dramatically changing how customers access their bank accounts. Moreover, changes to interstate branching laws have allowed banks to open branches where they couldn't before. Let's examine these effects a bit more closely.

Improved Accessibility Due to Technology

During the period over which the total number of banking institutions was declining, tremendous technological advances were taking place in the industry that, today, we

sometimes take for granted. ATMs give customers access to their accounts and to cash 24 hours a day, and ATM networks have made it possible for banks to locate machines away from branches, all vastly improving customer convenience and accessibility. ATM networks have also enabled smaller banks to give their customers access to any machine on the network, whether owned by the bank or not. Furthermore, ATM availability has increased dramatically since 1986, when there were about 64,000 machines nationwide. By 2004, that number had climbed to upwards of 383,000 units.

Today, many ATM features are found on bank web sites. Online, a customer is able to access his or her accounts, perform a multitude of transactions and, in many cases, pay bills. In such an environment, even a small institution can compete with a much larger one. Some banks have even taken the step of offering Internet-only accounts, which are paying higher interest rates to depositors. It's not a big step from here to Internet-only banks—that is, banks without any brick-and-mortar offices for customers to visit. A few Internet-only banks exist already.

A Historic First: Interstate Branching

While the total number of independent banking institutions has declined, the number of branches has skyrocketed—from about 66,000 in 1986 to almost 86,000 in 2006. Part of this increase comes from the introduction of unrestricted nationwide interstate branching, which was permitted for the first time in the mid-1990s. Interstate branching has allowed banks to streamline their organizations like never before, opening the door to a new type of bank—one that can operate offices in many different states simultaneously, all as branches of one bank under one bank charter. Previously, the same institution would have had to manage offices in different states as separate banks, each with its own bank charter. In addition, interstate branching, by allowing numerous banking organizations to eliminate many managerial and other back-office redundancies, has improved organizations' overall operating efficiency. And although these mergers have reduced the overall number of institutions, they have had no effect on the number of branches.

Combine interstate branching with the technological advances mentioned above, and you end up with a very different banking landscape than 20 years ago, one in which hundreds of multistate banks span regions of the country or even the entire nation. The modern environment gives customers more access points to banking products and services than ever before.

At the same time, the law that permitted interstate branching also restricted any bank from purchasing another if, in the end, it would control more than 10 percent of total U.S. deposits. This prohibition, however, does not prevent a bank from having more than 10 percent of national deposits if the increase occurs through its own growth. So far, only Bank of America has come close to that 10-percent mark—at the end of the first quarter of 2007, it controlled about 9 percent of U.S. deposits. JPMorgan Chase, the second largest institution, trailed Bank of America with 7.1 percent of U.S. deposits, followed by Wachovia with 5.8 percent. State laws also cap the share of total deposits any institution can control in a state, though the thresholds are often between 25 percent and 30 percent.

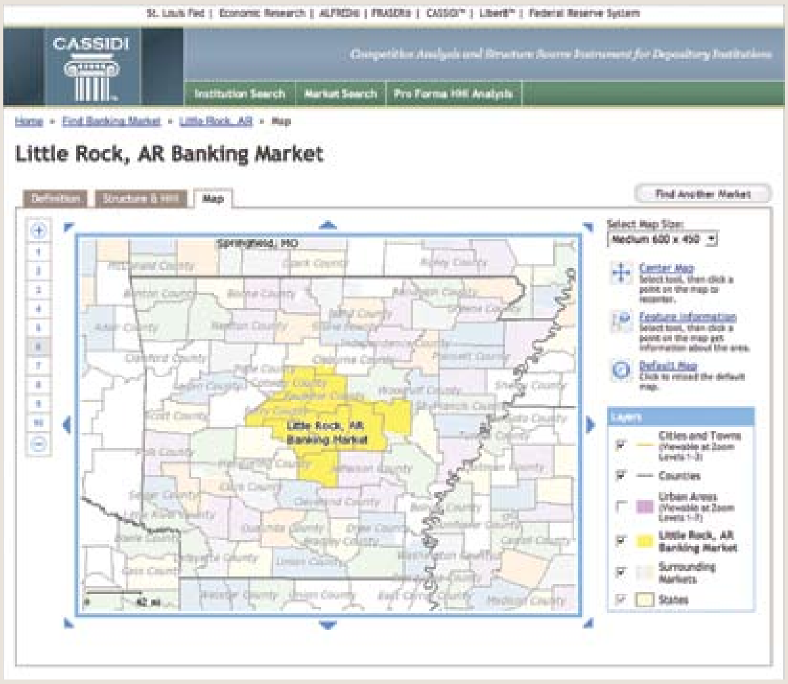
Thinking Nationally, Competing Locally

How Does the Fed Define Local Banking Markets?

Each of the 12 Federal Reserve banks, in consultation with the Board of Governors of the Federal Reserve System, is responsible for defining the boundaries of local banking markets within its district. The other federal banking regulators usually use these definitions when analyzing a merger or acquisition application.

A local banking market is an economically integrated area that includes and surrounds a central city or large town. Often, banking markets are based on metropolitan or similar areas in urban regions, and on counties in rural regions. Local economic and demographic data—such as commuting patterns, locations of large employers and retailers, and other information that could demonstrate an economic tie or separation between two areas—are then used to enlarge or shrink the size of the market from the base.

To date, more than 1,500 banking markets have been defined in the United States, covering almost all parts of the country. These definitions are always subject to change as local areas grow or shrink, however. For help in finding a banking market definition, you can visit CASSIDI™, an application on the St. Louis Fed's web site that includes all market definitions in the country and interactive maps for many of them. Visit **http://cassidi.stlouisfed.org**. (See sidebar on page 29.)

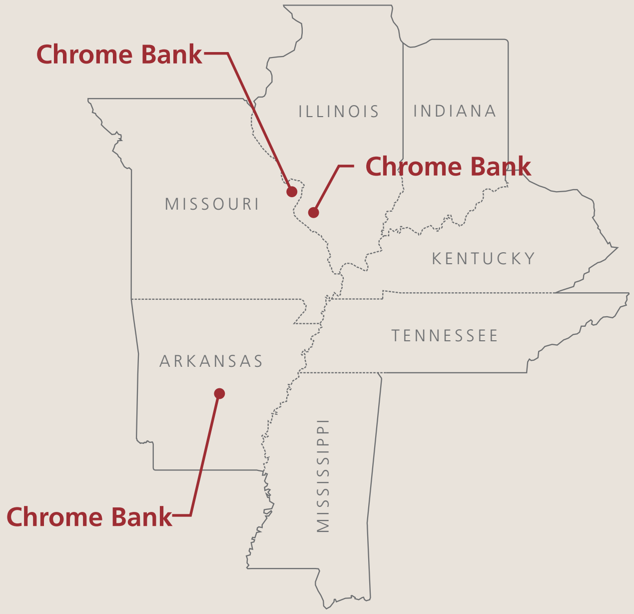


Thinking Nationally, Competing Locally

Inside the Numbers: Fewer Banks, Not Necessarily Fewer Offices

We've already seen that one of the effects of interstate branching is fewer banking institutions overall; this reduction, however, does not translate into fewer offices in local markets. Suppose, for example, **Chrome Bank** has offices in **St. Louis**, **Carbondale, Ill.**, and **Little Rock, Ark.** Although the name above the door is the same, before interstate branching was allowed, these were three separate banks because of branching restrictions. That is, there were three institutions and three offices. After interstate branching, though, the three banks could be combined into one. Now, there is one institution, but still three offices. These types of mergers have no effect on local banking competition even though the total number of institutions goes down.

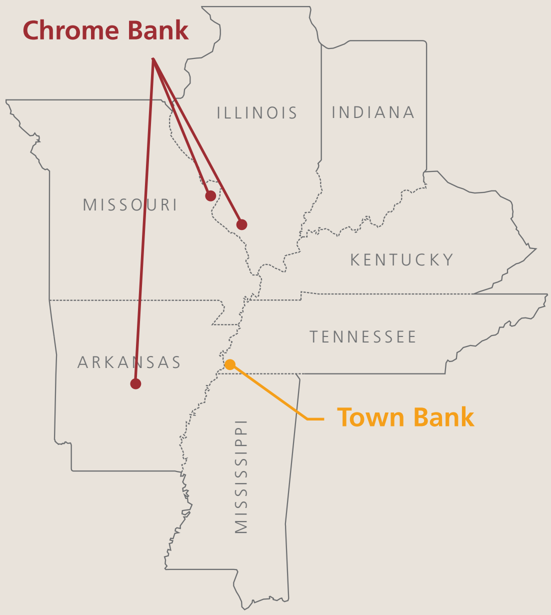
Before Interstate Branching



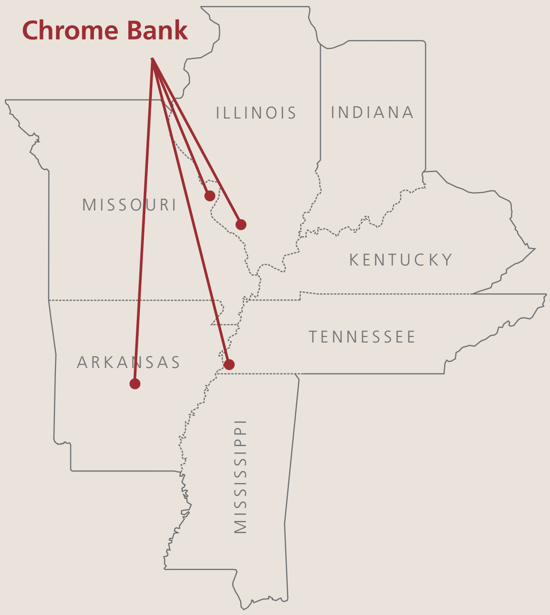
After Interstate Branching

Another type of transaction could have **Chrome Bank** buying **Town Bank**, which has one office located in **Memphis, Tenn.** Before the transaction, there were two institutions and four offices. After the transaction, there will be one institution, but still four offices. Again, we see that although the overall number of institutions has declined, there has been no effect on local competition. All that has happened in Memphis is that Town Bank has become Chrome Bank. Many of these types of transactions have occurred over the past 20 years too. All the while, many small banks have started up in numerous communities, adding to local competition. The "crazy-quilt banking system" example on pages 16-17 further illustrates these principles in a simple way.

Before Transaction



After Transaction



Thinking Nationally, Competing Locally

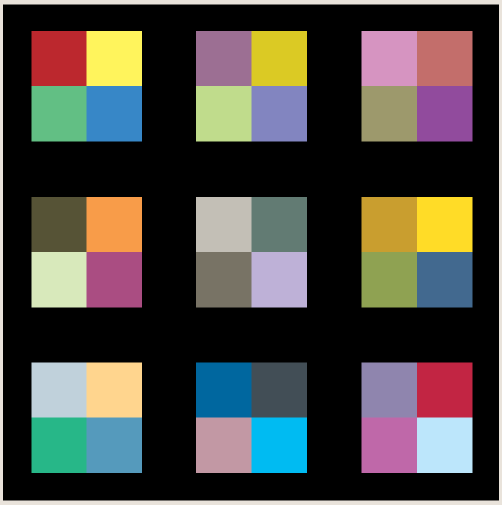
A Crazy-Quilt Banking System Consolidates

To illustrate how the number of independent banks nationwide can decrease, while the average number of banks in each local market stays the same or increases, think about the patterns and colors in a quilt. Suppose we represent the U.S. national banking market as a huge quilt. Each two-by-two group of squares within the quilts below corresponds to a local banking market. These are separated from each other by black lines, representing the distinctness of local markets. Each individual colored square stands for a bank or one of its branches. The identities of banks are differentiated by their colors. Changes in the colors of the quilt represent the changing structure of the U.S. banking market.

Before interstate branching was allowed, U.S. banking was composed largely of single-market banks. The quilt representing this situation consists of colored squares, each of which appears only once. There are 36 different banks and 36 different colors. That is, each unique bank in a local market also is unique in the larger, national market. Each local market has four competing banks; this simple statistic can be used as a measure of local banking competition.

Since interstate branching has been allowed and thousands of bank mergers have taken place, the U.S. banking market today is composed of both multimarket and single-market banks. Multimarket banks appear in many local markets. Single-market banks appear in only one local market.

Before Interstate Branching Allowed



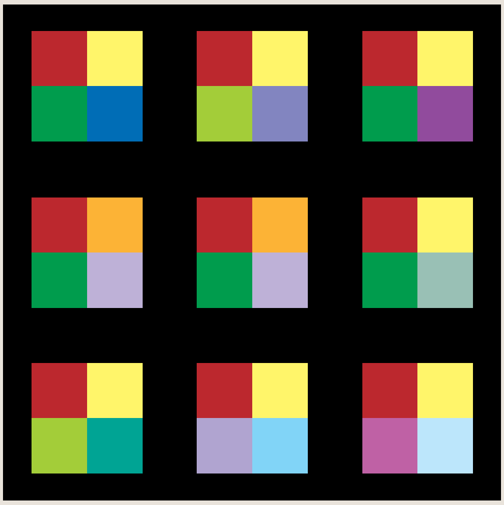
The quilt representing this situation consists of some colored squares that appear many times—for example, red appears nine times, yellow appears seven times, dark green appears five times, etc.—while other colors appear only once (for example, sky blue). There now are 14 different banks, down from 36. So, the banking system as a whole has undergone a significant consolidation. But each local market still consists of four competing banks; so, local market competition remains unchanged.

The key point of this illustration is that even though many mergers have occurred and there now are far fewer independent banks—represented by fewer unique colors in the quilt—each local banking market has four competing banks (four different colors), just as before. Thus, bank mergers need not decrease competition in local markets as long as the specific mergers that take place are controlled.

For example, the bank represented by a red square probably would not be allowed to acquire another bank in any local market, while the bank represented by yellow probably would be allowed to acquire another bank only in one of the local markets in which it does not already appear, and so on. Even a single-market bank (represented by sky blue) probably would be prohibited from acquiring another bank in its own local market, though it likely would be allowed to buy another bank in any other market.

The quilts illustrate the Fed's attempt to balance competing goals in our bank-merger policy—namely, to allow efficiency-enhancing bank mergers to occur across local banking markets without sacrificing the benefits of competition within each local banking market.

After Interstate Branching Allowed



III. Eagle Eye

How the Fed's Regulation Ensures the Safety and Soundness of Newly Combined Banking Organizations


FEDERAL RESERVE

Not all banking deals are the same. Transactions take two basic forms. In the more direct combination, at least two banks merge to form one institution. The primary federal banking regulatory agency with responsibility for the "surviving" bank must approve these transactions. (See box on page 7.) If the surviving bank has a state charter, then the state regulatory agency must also approve the transaction.

The other common form of combination involves an existing bank holding company acquiring a bank. The Federal Reserve, as sole federal regulator of bank holding companies, must approve all of these transactions. Some states also require state approval of these acquisitions. In addition, some states require banks to have been operating for a minimum number of years before another bank or bank holding company can buy it—known as a "minimum-age requirement"—further restricting some transactions.

Regardless of the type of combination and which banking regulatory agency has primary responsibility for the transaction, all proposals must meet the following standards:

- **Financial condition:** An applicant must be in at least satisfactory financial condition, both before and after the transaction;
- **Managerial resources:** An applicant must have adequate managerial resources to operate the new, larger institution in a safe and sound manner;
- **Anti-money laundering safeguards:** An applicant must have in place adequate systems for preventing money laundering and must be capable of extending these safeguards to the new, larger banking organization;
- **Convenience and needs of the communities served by the applicant and target:** A proposed transaction must be likely to make banking services more convenient and to meet the financial needs of the communities served; and
- **Competition:** A proposed transaction must not reduce competition in any local banking market by an unacceptable degree.

Each application, therefore, goes through a multistep process that covers each of the above areas. The first four criteria ensure the safety, soundness and service orientation of banks and the banking system. The last requirement—competition—ensures that banks operate in locally competitive markets. We will cover competition in detail in Part IV of this essay.

Although it is true that the Fed approves nearly all proposals it evaluates—giving rise to the impression that we merely rubber-stamp banking merger and acquisition applications—approval comes only after an exhaustive process during which we keep a keen eye out for apparent and, sometimes, hidden weaknesses that could lead the proposal to fail one of the criteria. To avoid any unforeseen obstacles in the process, applicants often contact us before filing an application. Doing so enables us to point out areas that could be troublesome during the actual application process. Lesser problems most often can be addressed through committed actions documented in the process. If problems are severe or not correctable in a reasonably short time frame, then the applicant typically is asked to delay the proposed transaction until it has corrected the problem and demonstrated improvement. In this way, the Fed uses its "moral suasion" to discourage flawed proposals, which benefits us and applicants because it enables all parties to address weaknesses before the process officially begins.

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So, what exactly is the Fed looking for when examining applications for each of the first four criteria? And how are we fulfilling our role?

Financial Factors

The applicant and the resulting combined institution of a proposed transaction must be judged as satisfactory with respect to relevant financial factors. These factors are the same as those reviewed during a bank examination—capital adequacy, asset quality, profitability, liquidity and sensitivity to market risk. Equally important for a transaction involving a holding company acquisition of a bank is cash flow. The company must demonstrate its ability to generate sufficient cash from operations to cover principal and interest payments on debt incurred from the acquisition, as well as its other operating expenses.

We develop an overall picture of the strengths and weaknesses of the combining banking organizations by reviewing examination reports, periodic financial reports, information provided in the application, and other available data. We project this information to portray the financial profile of the consolidated organization. Financial weaknesses or deficiencies that are determined in the analysis of the proposal must be addressed before the Federal Reserve approves the application. Some financial issues, such as a capital deficiency, might be addressed by raising more equity capital. Other weaknesses, such as poor loan quality or an imbalanced asset/liability mix, are not easy to fix in a short period of time. Banks can sometimes address deficiencies of this type with commitments to policy changes or specific actions focused on the weakness.

Notwithstanding a solid commitment that would be expected to improve a problem area, the Federal Reserve normally will require some evidence that the proposed action has had the intended effect. Improvement usually must be demonstrated before we approve a transaction.

That's not to say that any weakness must be corrected or requires improvement before the Fed approves the proposed transaction. For example, when the acquiring institution is in satisfactory financial condition, but the target institution is financially weak, the size and financial strength of the acquiring entity is a favorable consideration that can offset weaknesses in the target institution.

Managerial Factors

As with the analysis of financial factors, each transaction involving the combination of banking organizations must undergo a management assessment, which considers the competence, experience and integrity of the officers, directors and principal shareholders of the acquiring organization. However, the process of judging officers and directors and their ability to operate the consolidated institution lacks the objectivity that comes with the review of financial data, including trend analysis and peer comparison.

We often can learn something about a bank's management by reading previous examination reports. Feedback from other regulators, who may have knowledge of relevant factors not covered in reports, also helps to clarify the management picture. This information might come through a letter responding to a request for comments on a pending application, or informally through a telephone call. For some banking combinations, we may require certain officers, directors and principal shareholders to undergo a background check. In this process, we ask law enforcement agencies to provide any unfavorable information that they may have on an individual.

As with financial weaknesses, managerial deficiencies must be addressed or corrected before an application is approved. Again, this can occur through informal discussions and actions taken before the submission of the application or through an action plan as part of the formal proposal.

Occasionally, even though each institution involved in a proposed banking combination has effective management, the larger and more complex resulting institution

could end up being beyond the managerial capacity of the existing officers and directors. In such a case, the Fed might require additional management staffing as a condition of approval.

Combating Money Laundering

The USA PATRIOT Act of 2001 introduced additional strong measures to prevent, detect and prosecute international money laundering. Among other things, the PATRIOT Act requires federal banking regulatory agencies to take into consideration a banking organization's effectiveness in combating money laundering activities when that banking organization files a merger or acquisition application. This assessment involves a review of the banking organization's policies and procedures to detect and prevent money laundering.

Minor weaknesses in an anti-money laundering program often can be addressed during the application process. However, if significant program weaknesses exist, then the acquiring banking organization may be required to demonstrate verifiable improvement over a period of time before being allowed to expand through combination.

Convenience and Needs

The Federal Reserve is required to assess whether a proposed banking combination would likely have any adverse effect on the convenience and needs of the communities served by the banking organizations. This assessment focuses on the availability and manner in which banks provide products and services to customers. Closing cost-inefficient branches of the resulting organization is one possible way in which customers' convenience and banking needs could be negatively affected.

Assessing convenience and needs also involves taking into account the acquiring organization's and the target institution's records of meeting the credit needs of their communities, including low- and moderate-income neighborhoods, as required under the Community Reinvestment Act (CRA). The Federal Reserve expects an acquiring organization to have an established record of satisfactory CRA performance before it files an application. A satisfactory CRA record for the target institution is also important. A less-than-satisfactory CRA examination rating on the part of the acquiring institution or the target can present an obstacle to approval.

IV. Competition Is Critical

How the Fed's Analysis Keeps Markets from Becoming Too Concentrated

When evaluating a proposed banking merger or acquisition for its potential effects on competition, we need to know how it will affect competition in every banking market in which both the applicant and target have branches. Each market is evaluated individually. Thus, for example, in any one of the more prominent mergers highlighted in Part I, literally dozens of banking markets were analyzed to ensure that the antitrust competition requirements were met in each of them.

The Before and After of Competition

After we determine which banking markets are involved in a proposal, we have to examine how each market will change if the proposal is allowed to proceed. To make this determination, we need to know what each market looks like before and after the combination. We start by building a picture of each market using bank deposit data.

We mentioned earlier that checking or other transaction accounts are the primary accounts customers have with their banks. From this information, we can infer that deposit information is a reasonable measure of a bank's presence in a market. Using branch-level deposit data, we can calculate a bank's total deposits and share of deposits in a market. For thrifts, we normally include only half of their deposits because thrifts do not offer all of the same products and services that banks do, particularly to businesses. In other words, thrifts are not "perfect substitutes" for banks. If a bank holding company owns several banks in the same market, then the deposits of the sister institutions are pooled together to determine the bank holding company's market share. Finally, credit union deposits are not normally included in a market's deposit calculation. Being membership organizations, credit unions offer their products and services only to certain groups of people, and these products and services are often quite limited when compared with those offered by banks and thrifts. That said, we may include a particular credit union's deposits in the calculation if substantial evidence supports their inclusion. One piece of such evidence would be that the credit union offers a wide range of consumer banking products. In addition, the credit union should have liberal membership rules (typically, at least 70 percent of market residents must be eligible for membership), and it should have easily accessible street-level branches.

Once we have market shares for all institutions in the market, we can take the next step and determine the market's concentration. To do this, we use a tool called the Herfindahl-Hirschman Index (more commonly referred to as HHI).

To calculate HHI, we simply square all the market shares (expressed as percentages) and add up the squared numbers. This sum is a number between zero and 10,000:

The smaller the HHI number is, the less concentrated the market is (the more competition there is among banks in the market), and the less likely any one bank is able to exert much control in the market. For example, if a market has only one bank, it would have a 100 percent market share, and HHI would equal 10,000, or 100^2 x 1. If, instead, there are 100 banks in a market with 1 percent market share each, HHI would then equal 100, or 1^2 x 100. To make this calculation even easier, CASSIDI performs it for you for any banking market in the nation. (See sidebar on page 29.)

To determine if a deal will satisfy the antitrust requirements, we need to look at the buyer's market share after the transaction and the market's HHI before and after the combination. If the "after"-market HHI is not above a certain level and the increase in the market HHI caused by the deal is not above a certain level, then the deal satisfies the Justice Department's merger guidelines. (See box at right.) Specifically, the department generally will not challenge a banking proposal unless the after-market HHI exceeds 1,800 points AND the increase in HHI resulting from the deal exceeds 200 points. This is often called the "1,800/200" rule and is unique to banking. Other industries are allowed only a 50-point increase in HHI when it is above 1,800 points. The difference is that the Justice Department recognizes that banks face competition from a variety of other financial providers, such as thrifts, credit unions and other types of financial firms. Allowing banking markets the leeway of a 200-point change in HHI accounts for the "expanded" competition banks face.

Merger Guidelines

The Justice Department divides the spectrum of market concentration as measured by the HHI into three regions that can be broadly characterized as unconcentrated (HHI below 1,000), moderately concentrated (HHI between 1,000 and 1,800), and highly concentrated (HHI above 1,800). For a banking transaction not to require stricter economic scrutiny in a particular market, the transaction cannot both increase HHI by more than 200 points AND result in a highly concentrated market (a final HHI greater than 1,800 points).

In addition to the Justice Department's rules, the Federal Reserve also will typically not allow a bank to buy its way to more than 35 percent of any banking market's total deposits. Although similar in structure to the national- and state-level deposit share caps mentioned earlier, this market-level threshold is a Federal Reserve policy, not a law, and exceeding it triggers a closer examination of the market's economic circumstances, not rejection of the proposal. As with the national- and state-level caps, banks can grow their way to controlling more than 35 percent of a market's total deposits.

What if the Picture Is Not Clear?

If one or more of the banking markets in a transaction do not satisfy the 1,800/200 rule, does that then mean the transaction cannot go through? No, not automatically. What it does mean, though, is that we will need to investigate those markets further to find out if perhaps other important factors aren't being picked up by the HHI calculation. One of the first items we'll look at is the number of other banks remaining in the market and each one's market share after the deal. We'll also want to know if any new banks have opened in the market recently and if deposit, income and population growth in the area have been relatively strong when compared with similar areas in the rest of the state. We'll look to see if a thrift in this market has been aggressively pursuing business customers, making its share of loans to businesses look more similar to other banks than to other thrifts. If so, we may end up including all of that savings institution's deposits rather than just half in the market's deposit calculation. Or, there may be a credit union in the market that has a storefront like a bank or thrift and opens its doors to most people in the area. If so, we may end up including a portion of its deposits in the market's deposit

calculation. We would also need to know if the bank being bought is in trouble, perhaps even on the verge of shutting down. We can then use some or all of this information to demonstrate that factors are at play in the market that are not being captured by the HHI, and, when these factors are considered, the deal will not end up substantially lessening competition in the banking market.

At times, though, a market's current concentration and the potential increase from a deal are just too large for some of these other economic factors to overcome. In such cases, the buyer may offer (or we may require the buyer) to sell branches to other banks in an attempt to keep a local market's HHI increase to below 200 points. This process, known as "divestiture," has become increasingly common over the past decade or so, and many institutions, particularly those engaging in large transactions, now come to the table with divestiture plans already laid out.

Competitive Analysis In Action—The Real World

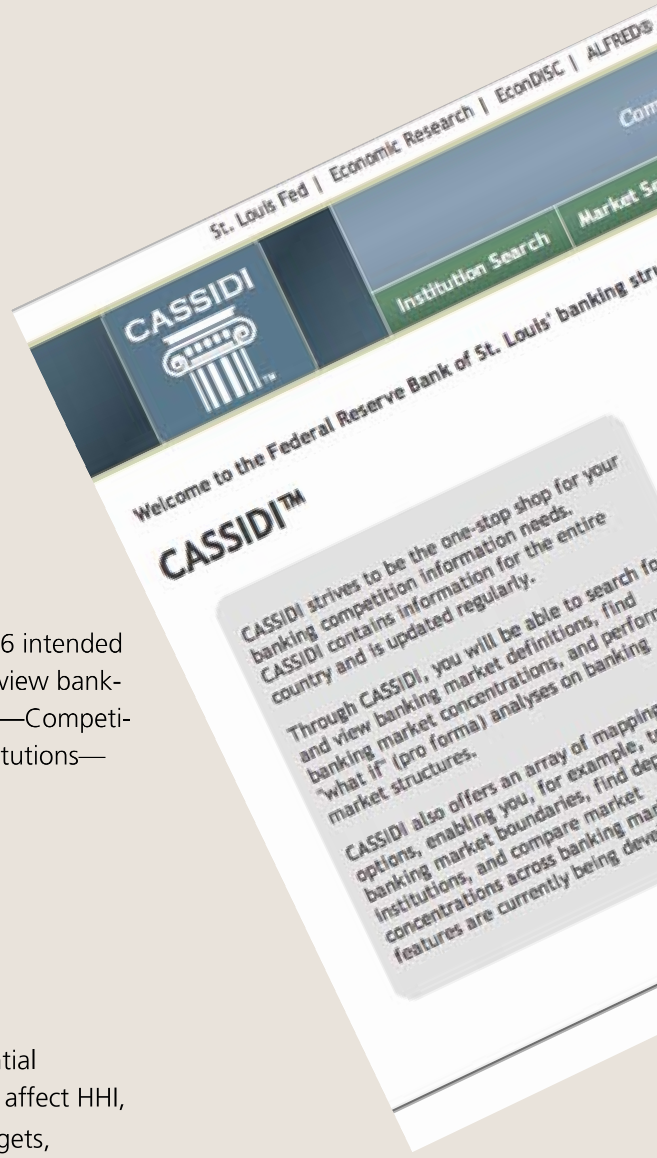
To get a feel for how a competitive analysis might actually play out, let's look at a recent real-world acquisition—Regions Bank's purchase of AmSouth Bank. Before the deal, Regions was the 21st largest bank in the nation (based on total assets) and controlled less than 1 percent of national deposits. It operated branches in 16 states. AmSouth was the 27th largest bank in the country and also controlled less than 1 percent of national deposits. It operated branches in seven states. After the deal, Regions became the 13th largest bank in the country and controlled less than 2 percent of national deposits.

Regions and AmSouth had branches in 67 common banking markets across seven states: Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi and Tennessee. A competitive analysis like that described above was conducted for each of these 67 local banking markets. In 42 of them, the 1,800/200 rule was satisfied without divestitures or any further market examinations. That left 25 markets in which the 1,800/200 rule was violated and/or Regions' after-market share exceeded 35 percent. Each would require divestiture, further examination or both. In 12 of these 25 banking markets, divestitures of AmSouth branches were enough to satisfy the 1,800/200 rule.

The remaining 13 markets required further examinations because, even after accounting for any proposed divestitures, they fell outside the 1,800/200 guidelines and/or Regions' after-market share exceeded 35 percent. Credit-union deposits played a role in countering the initial HHI analysis in 11 of these markets, and thrifts in three markets were considered full competitors with commercial banks. In addition, new bank openings in the recent past, strong income, population and deposit growth relative to surrounding areas, and the number and strength of the remaining competitors in all 13 markets contributed to the final decision to approve the application. Thus, the initial HHI analysis did not fully explain the actual competitive picture in these markets. When all was said and done, the information gathered and actions taken were sufficient to conclude that the deal would not have a significantly adverse effect on competition in any of the banking markets. The acquisition was approved in October 2006. Read more about the outcome of this case at www.federalreserve.gov/boarddocs/press/orders/2006/20061020/attachment.pdf.

CASSIDI™

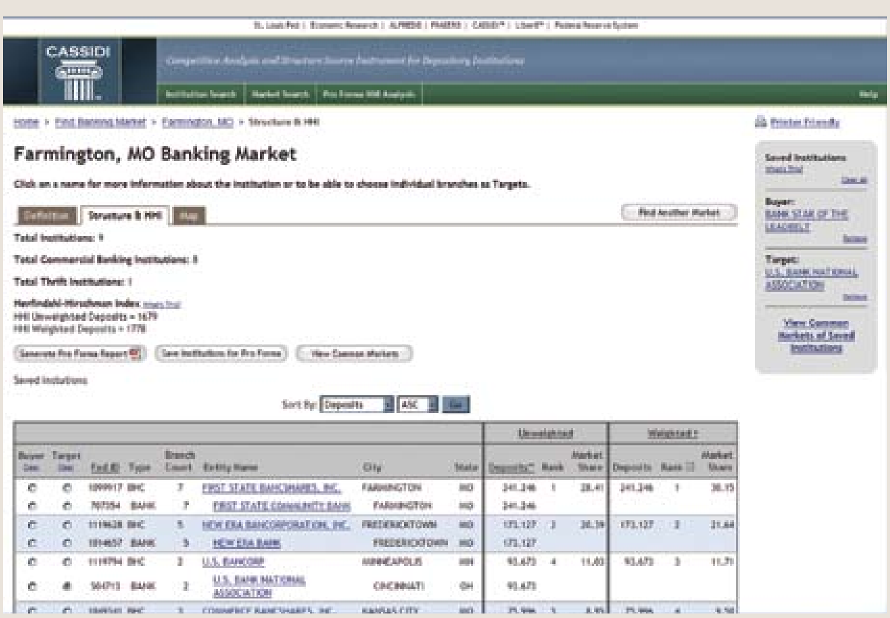
St. Louis Fed Offers Online Way To Get Banking Competition Information



The Federal Reserve Bank of St. Louis launched a web site in 2006 intended to give bankers, consultants and the public a convenient way to view banking competition information. The application is called CASSIDI™—Competitive Analysis and Structure Source Instrument for Depository Institutions—and is accessible at **http://cassidi.stlouisfed.org**.

A free application, CASSIDI allows users to:

- view banking market definitions for any part of the country,
- search for information in a user-friendly format,
- benefit from regular updates as market structures change,
- explore "what if" (pro forma) scenarios by seeing how a potential transaction might change a banking market's concentration or affect HHI,
- select whole institutions or individual branches as potential targets,
- look up geographic and depository information for all institutions and their branches, and
- view maps of many banking markets throughout the United States.



V. Conclusion

Before reading this essay, the average person most likely assumed that consolidation in the U.S. banking industry, which has been the norm for the past two decades, has reduced banking competition. This view is understandable because, over the past 20 years, mergers and acquisitions have cut the number of banking organizations to about half of its previous level. But a look at local banking markets—where banking competition actually takes place—tells a different story: Users of banking services still have many choices among competing providers. Today's institutions have about 20,000 more branches than all of the banking organizations in the 1980s. And because of interstate branching, customers are likely to find banks with branches in many states across a region or even across the country. Technologies that either did not exist or were in their infancy two decades ago—for example, online banking and ATMs—now offer customers access to their accounts every moment of the day.

Such dramatic changes in so relatively short a period naturally raise concerns about the safety and soundness of banking organizations and about the state of banking competition. The Federal Reserve, however, is responsible for ensuring—even as the banking industry consolidates—that institutions remain safe and sound, that they comply with all applicable laws and regulations, and that local banking markets remain vigorously competitive. To accomplish these goals, we (or one of the other primary federal regulators) review, adjust and, ultimately, approve or deny every application for a banking merger or acquisition to make certain that it satisfies all of the requirements set out in the antitrust laws. The requirements include financial condition, managerial resources, anti-money laundering safeguards, community convenience and needs, and local banking market competition. Only after we are satisfied that all of the requirements have been met can we approve a transaction. By engaging in such a thorough evaluation, we are indeed fulfilling our role of operating as a checkpoint in the banking consolidation process.

Thank You
(retiring board members)

We bid farewell and express our gratitude to those members of the Eighth District boards of directors who retired in 2006. Our appreciation and best wishes go out to the following:

LITTLE ROCK
Stephen M. Erixon
Raymond E. Skelton

LOUISVILLE
Norman E. Pfau Jr.

MEMPHIS
J.W. Gibson II
Russell Gwatney

ST. LOUIS
Walter L. Metcalfe Jr.

We also extend our deepest sympathies to the family and friends of Cornelius A. Martin, Louisville chairman, who passed away in 2006.

Little Rock

C. Sam Walls
Chairman
CEO
Arkansas Capital Corp.
Little Rock, Ark.

Phillip N. Baldwin
President and CEO
Southern Bancorp
Arkadelphia, Ark.

Sonja Yates Hubbard
CEO
E-Z Mart Stores Inc.
Texarkana, Texas

Cal McCastlain
Partner
Pender & McCastlain P.A.
Little Rock, Ark.

Sharon Priest
Executive Director
Downtown Little Rock Partnership
Little Rock, Ark.

William C. Scholl
President
First Security Bancorp
Searcy, Ark.

Robert A. Young III
Chairman
Arkansas Best Corp.
Fort Smith, Ark.

Louisville

John L. Huber
Chairman
President and CEO
Louisville Water Co.
Louisville, Ky.

Gordon B. Guess
Chairman, President and CEO
The Peoples Bank
Marion, Ky.

Barbara Ann Popp
CEO
Schuler Bauer Real Estate Services
New Albany, Ind.

Gary A. Ransdell
President
Western Kentucky University
Bowling Green, Ky.

John C. Schroeder
President
Wabash Plastics Inc.
Evansville, Ind.

L. Clark Taylor Jr.
CEO
Ephraim McDowell Health
Danville, Ky.

Steven E. Trager
Chairman and CEO
Republic Bank & Trust Co.
Louisville, Ky.

Memphis

Meredith B. Allen
Chairman
Vice President, Marketing
Staple Cotton Cooperative Association
Greenwood, Miss.

Charles S. Blatteis
Member (Partner)
The Bogatin Law Firm PLC
Memphis, Tenn.

Nick Clark
Partner
Clark & Clark
Memphis, Tenn.

Levon Mathews
Director of Sales
Regions Morgan Keegan Private Banking
Memphis, Tenn.

Thomas G. Miller
President
Southern Hardware Co. Inc.
West Helena, Ark.

David P. Rumbarger Jr.
President and CEO
Community Development Foundation
Tupelo, Miss.

Hunter Simmons
President and CEO
First South Bank
Jackson, Tenn.

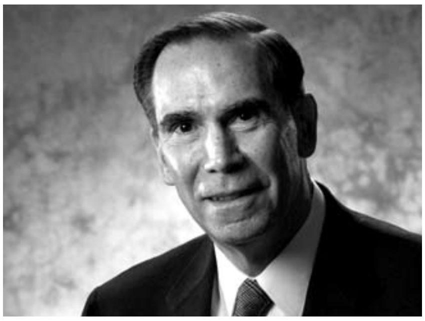
St. Louis

Irl F. Engelhardt
Chairman
Chairman
Peabody Energy
St. Louis

Cynthia J. Brinkley
Deputy Chairman
President
AT&T Missouri
St. Louis

Paul T. Combs
President
Baker Implement Co.
Kennett, Mo.

Steven H. Lipstein
President and CEO
BJC HealthCare
St. Louis



Lewis F. Mallory Jr.
Chairman and CEO
Cadence Financial Corp.
Starkville, Miss.

J. Thomas May
Chairman and CEO
Simmons First National Corp.
Pine Bluff, Ark.

David R. Pirsein
President and CEO
First National Bank in Pinckneyville
Pinckneyville, Ill.

A. Rogers Yarnell II
President
Yarnell Ice Cream Co. Inc.
Searcy, Ark.

Little Rock | Agribusiness

At top, from left:

Bert Greenwalt, Ph.D.
Arkansas State University
State University, Ark.

Ted Huber
Huber's Orchard & Winery
Starlight, Ind.

Cal McCastlain
Pender & McCastlain P.A.
Little Rock, Ark.

(Mr. McCastlain is now a member of Little Rock's Board of Directors; he has been replaced by Keith Glover.)

John King III
King Farms
Helena, Ark.

At bottom, from left:

Dr. Leonard Guarraia
World Agricultural Forum
St. Louis

Richard Jameson
Jameson Farms
Brownsville, Tenn.

(not pictured)
Keith Glover
Producers Rice Mill
Stuttgart, Ark.

(not pictured)
Tim Gallagher
Bunge North America Inc.
St. Louis

(not pictured)
Dr. David Williams
Burkmann Feeds
Danville, Ky.

Louisville | Health Care

At top, from left:

Stephen A. Williams
Norton Healthcare
Louisville, Ky.

Calvin Anderson
Blue Cross Blue Shield of Tennessee
Memphis, Tenn.

At bottom, from left:

Russell D. Harrington Jr.
Baptist Health
Little Rock, Ark.

Sister Mary Jean Ryan
SSM Health Care System
St. Louis

Jeffrey B. Bringardner
Humana Inc.
Louisville, Ky.

(not pictured)
Bob Gordon
Baptist Memorial
Health Care
Memphis, Tenn.

(not pictured)
Dean Kappel
Mid-America
Transplant Services
St. Louis

(not pictured)
Dick Pierson
University of Arkansas
for Medical Sciences
Little Rock, Ark.

Memphis | Transportation

At top, from left:

Kirk Thompson
J.B. Hunt Transport Services Inc.
Lowell, Ark.

T. Michael Glenn
FedEx Corp.
Memphis, Tenn.

Dennis Oakley
Bruce Oakley Inc.
North Little Rock, Ark.

Joseph Tracy
Dot Transportation Inc.
Mt. Sterling, Ill.

At bottom, from left:

Mark Knoy
MEMCO Barge Line
Chesterfield, Mo.

Phil Trenary
Pinnacle Airlines Inc.
Memphis, Tenn.

(not pictured)
Charlie W. Johnson
C.W. Johnson Xpress
Louisville, Ky.

(not pictured)
Robert L. Lekites
UPS
Louisville, Ky.

St. Louis | Real Estate

At top, from left:

Kevin Huchingson
Colliers Dickson Flake
Little Rock, Ark.

William Mitchell
Memphis Area
Associations of Realtors
Memphis, Tenn.

David Price
Whittaker Builders Inc.
St. Louis

Greg Kozicz
Alberici Constructors
St. Louis

At bottom, from left:

John J. Miranda
Pinnacle Properties of
Louisville LLC.
Louisville, Ky.

Mary Singer
CRESA Partners Memphis
Memphis, Tenn.

E. Phillip Scherer III
Commercial Kentucky Inc.
Louisville, Ky.

(not pictured)

Jack R. McCray
Bank of the Ozarks
Little Rock, Ark.

MANAGEMENT COMMITTEE

William Poole
President and CEO

Dave Sapenaro
First Vice President and COO

Mary Karr
Senior Vice President

Robert Rasche
Senior Vice President

Judie Courtney
Senior Vice President

Karl Ashman
Senior Vice President

Julie Stackhouse
Senior Vice President

The Federal Reserve Bank of St. Louis ended 2006 and entered 2007 with a full charge of momentum. However one chooses to define it, 2006 was a successful year for us—whether it was our economists expanding their published research and number of presentations, the continued management of the Fed's Treasury services by our Treasury Relations and Support Office (TRSO), or our check operations exceeding revenue projections at lower-than-expected costs.

The St. Louis Fed in 2006 met all 25 key objectives in its strategic plan, all three Bank-wide financial objectives and one of two organizational climate objectives. We also met 34 of 45 key operating measures, many of which continue to have stretch targets. The Bank's total expenses came in under budget by 4.2 percent or $9.2 million. Our employees actively contributed to more than 100 System and District initiatives.

What follows are highlights of the District's 2006 accomplishments:

Research/Monetary Policy

- Continued strong economic research program and high publication and citation rate. The number of peer-reviewed journal articles published or accepted for publication was 62, up from 58 in 2005.
- Provided excellent support for the Bank's public programs through research on topics of interest to community leaders and through research presentations.
- Enhanced online economic information and implemented an online bank structural data information system (CASSIDI). Overall, Research's web pages were visited more than 60 million times during 2006, up more than 40 percent from the preceding year.

Supervision, Credit and Center for Online Learning

- Completed all mandated bank examinations in a timely manner and received excellent Board of Governors operations examination.
- Raised the Bank's visibility to bankers and increased the supervisory portfolio of state member banks from 85 to 94 banks.
- Continued to increase the volume of work for the Center for Online Learning, a recognized Fed System leader in the area of online training.

U.S. Treasury Support

- Received high marks from the U.S. Treasury for services and support provided on numerous Treasury revenue collection and cash management programs. The Treasury rated the Bank a 4.8 on a 1 to 5 satisfaction scale.
- Met 19 of 22 local Treasury objectives and stayed within the budget caps for 14 of 18 business lines. Budget overruns were all approved ahead of time by the Treasury. Local Treasury services were rated a 4.5 by the Treasury.
- Assisted the Federal Reserve System in completing 82 of 88 key Treasury business objectives, while underrunning the budget by $7.6 million, or 2.3 percent.

Financial Services

- Met seven of eight Retail Payments Office check performance targets, a large improvement from 2005, and significantly improved the Memphis check operation.
- Met seven of 10 cash performance targets and provided significant System leadership in cash services.

Administration

- Made substantial progress on facilities projects, including beginning construction of a new tower and renovations of cafeteria and conference facilities.
- Completed numerous human resources initiatives related to key areas of focus for the Bank—leadership and staff development, diversity, and compensation.
- Provided significant System leadership in the financial management, information technology (problem management), support services (physical security) and human resources (employee benefits, HR automation) functions.

Legal, Public and Community Affairs

- Continued to expand the District's outreach through additional economic education and community development programs, as well as local boards of directors engagement.
- Enhanced the Bank's monetary policy input programs in support of the Bank's president. Industry Councils, a new vehicle for gathering and sharing economic data with key business and community leaders, were established in all four zones.
- Continued to provide editorial and graphic design services to other Reserve banks for publications and web sites.

Organizational Initiatives

- Customer Service: The District continued its efforts to sustain a service-oriented culture. As a result, all divisions exceeded customer service targets.
- Innovation: To support the Bank's organizational value of innovation, the Bank implemented an online idea repository yielding 64 new ideas; seven were implemented, and 37 are in process.
- Staff Development: Human Resources completed several initiatives to further leadership and staff development. In addition, a new behavioral competency model was introduced to employees in 2006.
- Employee Communications: Several communications channels were reassessed or refined in 2006, and new electronic channels of communication were further explored.
- Enterprise Risk Management (ERM): The Bank enhanced the SOX (now AS2) and ERM programs in 2006 by working more closely with business areas to streamline data collection and assessment. Most business areas now discuss risks during regular management meetings throughout the year, and the type of risk information collected has been streamlined, resulting in more timely risk profile updates.

Financial Statements

For the years ended December 31, 2006 and 2005

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

TO THE BOARD OF DIRECTORS:

March 5, 2007

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

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

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

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

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

Federal Reserve Bank of St. Louis

William Poole

William Poole, President and Chief Executive Officer

David A. Sapenaro

David A. Sapenaro, First Vice President and Chief Operating Officer

Marilyn K. Corona

Marilyn K. Corona, Vice President, Chief Financial Officer

**TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
AND THE BOARD OF DIRECTORS OF THE FEDERAL RESERVE BANK OF ST. LOUIS**

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

Financial statements

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

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

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

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

Internal control over financial reporting

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

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

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

PricewaterhouseCoopers LLP

March 12, 2007

STATEMENTS OF CONDITION

(*in millions*)

	As of December 31,	
	2006	**2005**
ASSETS		
Gold certificates	$ 328	$ 327
Special drawing rights certificates	71	71
Coin	40	43
Items in process of collection	196	216
U.S. government securities, net	24,897	23,279
Investments denominated in foreign currencies	223	379
Accrued interest receivable	214	181
Interdistrict settlement account	1,807	2,010
Bank premises and equipment, net	96	87
Other assets	45	54
Total assets	**$ 27,917**	**$ 26,647**
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	$ 25,994	$ 24,602
Securities sold under agreements to repurchase	941	947
Deposits:		
Depository institutions	434	482
Other deposits	7	3
Deferred credit items	103	151
Interest on Federal Reserve notes due to U.S. Treasury	16	106
Accrued benefit costs	80	57
Other liabilities	10	11
Total liabilities	**$ 27,585**	**$ 26,359**
Capital:		
Capital paid-in	166	144
Surplus (including accumulated other comprehensive loss of $21 million at December 31, 2006)	166	144
Total capital	**332**	**288**
Total liabilities and capital	**$ 27,917**	**$ 26,647**

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

FEDERAL RESERVE BANK OF ST. LOUIS

STATEMENTS OF INCOME

(*in millions*)

	For the year ended December 31, 2006	2005
Interest income:		
Interest on U.S. government securities	$1,112	$ 861
Interest on investments denominated in foreign currencies	4	6
Interest on loans to depository institutions	1	1
Total interest income	**1,117**	**868**
Interest expense:		
Interest expense on securities sold under agreements to repurchase	42	25
Net interest income	**1,075**	**843**
Other operating income:		
Compensation received for services provided	22	22
Reimbursable services to government agencies	116	112
Foreign currency gains (losses), net	13	(57)
Other income	2	3
Total other operating income	**153**	**80**
Operating expenses:		
Salaries and other benefits	94	89
Occupancy expense	10	10
Equipment expense	8	7
Assessments by the Board of Governors	20	22
Other expenses	107	103
Total operating expenses	**239**	**231**
Net income prior to distribution	**$ 989**	**$ 692**
Distribution of net income:		
Dividends paid to member banks	$ 10	$ 16
Transferred to/(from) surplus	43	(92)
Payments to U.S. Treasury as interest on Federal Reserve notes	936	768
Total distribution	**$ 989**	**$ 692**

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

FEDERAL RESERVE BANK OF ST. LOUIS

STATEMENTS OF CHANGES IN CAPITAL

for the years ended December 31, 2006, and December 31, 2005

(*in millions*)

		Surplus			
	Capital Paid-In	**Net Income Retained**	**Accumulated Other Comprehensive Loss**	**Total Surplus**	**Total Capital**
Balance at January 1, 2005 (4.7 million shares)	$ 236	$ 236	$ –	$ 236	$ 472
Net change in capital stock redeemed (1.8 million shares)	(92)	–	–	–	(92)
Transferred from surplus	–	(92)	–	(92)	(92)
Balance at December 31, 2005 (2.9 million shares)	$ 144	$ 144	$ –	$ 144	$ 288
Net change in capital stock issued (0.4 million shares)	22	–	–	–	22
Transferred to surplus	–	43	–	43	43
Adjustment to initially apply FASB Statement No. 158	–	–	(21)	(21)	(21)
Balance at December 31, 2006 (3.3 million shares)	**$ 166**	**$ 187**	**$ (21)**	**$ 166**	**$ 332**

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

NOTE 1

STRUCTURE

The Federal Reserve Bank of St. Louis ("Bank") is part of the Federal Reserve System ("System") and one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Little Rock, Louisville and Memphis serve the Eighth Federal Reserve District, which includes Arkansas, and portions of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee.

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

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

NOTE 2

OPERATIONS AND SERVICES

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

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

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

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

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include operation of the Treasury Relations and Support Office and the Treasury Relations and Systems Support Department, which provide services to the U.S. Treasury. These services include: relationship management, strategic consulting, and oversight for fiscal and payments related projects for the Federal Reserve System; and operational support for the Treasury's tax collection, cash management and collateral monitoring.

During 2005, the Federal Reserve Bank of Atlanta ("FRBA") was assigned the overall responsibility for managing the Reserve Banks' provision of check services to depository institutions, and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006 this policy was extended to the ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. This compensation is reported as a component of "Compensation received for services provided", and the Bank would have reported $22 million as compensation received for services provided had this policy been in place in 2005 for ACH, Fedwire funds transfer, and securities transfer services.

NOTE 3

SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

A. GOLD AND SPECIAL DRAWING RIGHTS CERTIFICATES

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

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

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

B. LOANS TO DEPOSITORY INSTITUTIONS

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Outstanding loans are evaluated for collectibility. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review and determination by the Board of Governors. There were no outstanding loans to depository institutions at December 31, 2006 and 2005.

C. U.S. GOVERNMENT SECURITIES AND INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

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

D. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND SECURITIES LENDING

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

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

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

E. FX SWAP ARRANGEMENTS AND WAREHOUSING AGREEMENTS

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

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

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

F. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

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

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

G. INTERDISTRICT SETTLEMENT ACCOUNT

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

H. FEDERAL RESERVE NOTES

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

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

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of $3,175 million and $3,494 million at December 31, 2006 and 2005, respectively.

I. ITEMS IN PROCESS OF COLLECTION AND DEFERRED CREDIT ITEMS

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

J. CAPITAL PAID-IN

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

K. SURPLUS

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

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

L. INTEREST ON FEDERAL RESERVE NOTES

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

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

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

M. INCOME AND COSTS RELATED TO U.S. TREASURY SERVICES

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

N. ASSESSMENTS BY THE BOARD OF GOVERNORS

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

O. TAXES

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

P. RESTRUCTURING CHARGES

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

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

NOTE 4

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

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 3.177 percent and 3.103 percent at December 31, 2006 and 2005, respectively.
The Bank's allocated share of U.S. Government securities, net, held in the SOMA at December 31, was as follows (in millions):

	2006	2005
Par value:		
U.S. government:		
Bills	$ 8,801	$ 8,418
Notes	12,784	11,795
Bonds	3,162	2,881
Total par value	**24,747**	**23,094**
Unamortized premiums	277	273
Unaccreted discounts	(127)	(88)
Total allocated to the Bank	**$ 24,897**	**$ 23,279**

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $25,287 million and $23,815 million, respectively, as determined by reference to quoted prices for identical securities.

Q. IMPLEMENTATION OF FASB STATEMENT NO. 158, EMPLOYERS' ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS

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

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Accrued benefit costs	59	21	80
Total liabilities	**$ 27,564**	**$ 21**	**$ 27,585**
Surplus	187	(21)	166
Total capital	**$ 353**	**(21)**	**$ 332**

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

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

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was $29,615 million and $30,505 million, respectively, of which $941 million and $947 million were allocated to the Bank. The total par value of the SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 and 2005 was $29,676 million and $30,559 million, respectively, of which $943 million and $948 million was allocated to the Bank. The contract amount for securities sold under agreements to repurchase approximates fair value.

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

	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 1,290	$ 941
16 days to 90 days	5,747	
91 days to 1 year	5,882	
Over 1 year to 5 years	7,122	
Over 5 years to 10 years	2,149	
Over 10 years	2,557	
Total allocated to the Bank	**$ 24,747**	**$ 941**

At December 31, 2006 and 2005, U.S. government securities with par values of $6,855 million and $3,776 million, respectively, were loaned from the SOMA, of which $218 million and $117 million, respectively, were allocated to the Bank.

NOTE 5

INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

The Bank's allocated share of investments denominated in foreign currencies was approximately 1.089 percent and 2.002 percent at December 31, 2006 and 2005, respectively. The Bank's allocated share of investments denominated in foreign currencies, including accrued interest, valued at foreign currency market exchange rates at December 31, was as follows (in millions):

	2006	2005
European Union Euro:		
Foreign currency deposits	$ 68	$ 109
Securities purchased under agreements to resell	24	39
Government debt instruments	45	71
Japanese Yen:		
Foreign currency deposits	28	52
Government debt instruments	58	108
Total allocated to the Bank	**$ 223**	**$ 379**

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $222 million and $380 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

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

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

	European Euro	Japanese Yen	Total
Within 15 days	$ 48	$ 28	$ 76
16 days to 90 days	26	13	39
91 days to 1 year	27	24	51
Over 1 year to 5 years	36	21	57
Total allocated to the Bank	**$ 137**	**$ 86**	**$ 223**

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

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

NOTE 6

BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2006	2005
Bank premises and equipment:		
Land	$ 11	$ 11
Buildings	69	67
Building machinery and equipment	18	17
Construction in progress	18	7
Furniture and equipment	43	46
Subtotal	159	148
Accumulated depreciation	(63)	(61)
Bank premises and equipment, net	$ 96	87
Depreciation expense, for the year ended December 31	**$ 8**	**$ 8**

The Bank leases space to outside tenants with lease terms of less than one year. Rental income from such leases was immaterial for the years ended December 31, 2006 and 2005. Future minimum payments under agreements in existence at December 31, 2006 were immaterial.

The Bank has capitalized software assets, net of amortization, of $8 million and $11 million at December 31, 2006 and 2005, respectively. Amortization expense was $3 million for each of the years ended December 31, 2006 and 2005. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses". Software assets of $3 million were written off in 2006. The majority of the write-offs were reimbursed by the Department of the Treasury.

The Bank's restructuring plan, as discussed in Note 11, resulted in the impairment of a building asset. An asset impairment loss of $1 million for the period ending December 31, 2006, was determined using fair values based on quoted market values or other valuation techniques and is reported as a component of "Other expenses". This impairment represents a further write down of the Little Rock facility, which is available for sale and reported as a component of "Other assets". The Bank had no impairment losses in 2005.

NOTE 7

COMMITMENTS AND CONTINGENCIES

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

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $2 million for each of the years ended December 31, 2006 and 2005, respectively. Certain of the Bank's leases have options to renew.

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

	Operating
2007	$ 789
2008	417
2009	430
2010	75
Future minimum rental payments	**$ 1,711**

At December 31, 2006, there were no other material commitments or long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2006 or 2005.

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

NOTE 8

RETIREMENT AND THRIFT PLANS

RETIREMENT PLANS

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

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

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at

December 31, 2006 and 2005, and for the years then ended, were not material.

THRIFT PLAN

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $3 million for each of the years ended December 31, 2006 and 2005, and are reported as a component of "Salaries and other benefits" in the Statements of Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

NOTE 9

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

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

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

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

	2006	2005
Accumulated postretirement benefit obligation at January 1	$ 66.2	$ 55.6
Service cost-benefits earned during the period	1.7	1.6
Interest cost on accumulated benefit obligation	3.3	3.4
Actuarial loss	19.9	8.4
Contributions by plan participants	0.5	0.4
Benefits paid	(3.3)	(3.2)
Plan amendments	(15.3)	–
Accumulated postretirement benefit obligation at December 31	**$ 73.0**	**$ 66.2**

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

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

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

	2006	2005
Fair value of plan assets at January 1	$ –	$ –
Contributions by employer	2.8	2.8
Contributions by plan participants	0.5	0.4
Benefits paid	(3.3)	(3.2)
Fair value of plan assets at December 31	**$ –**	**$ –**
Unfunded postretirement benefit obligation	**$ 73.0**	$ 66.2
Unrecognized prior service cost		$ 3.3
Unrecognized net actuarial loss		(18.7)
Accrued postretirement benefit cost		**$ 50.8**
Amounts included in accumulated other comprehensive loss are show below (in millions):		
Prior service cost	$ 15.1	
Net actuarial loss	(36.3)	
Total accumulated other comprehensive loss	**$ (21.2)**	

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

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

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

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

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 0.5	$ (0.5)
Effect on accumulated postretirement benefit obligation	5.5	(5.8)

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

	2006	2005
Service cost-benefits earned during the period	$ 1.7	$ 1.6
Interest cost on accumulated benefit obligation	3.3	3.4
Amortization of prior service cost	(3.4)	(0.5)
Recognized net actuarial loss	2.3	0.9
Total periodic expense	3.9	5.4
Net periodic postretirement benefit expense	**$ 3.9**	**$ 5.4**
Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2007 are shown below (in millions):		
Prior service cost	$ (3.4)	
Actuarial loss	4.1	
Total	**$ 0.7**	

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

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

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare ("Medicare Part D") and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided under the Bank's plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation.

There were no receipts of federal Medicare subsidies in the year ended December 31, 2006. Expected receipts in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are $301 thousand.

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

	Without Subsidy	With Subsidy
2007	$ 3.9	$ 3.5
2008	4.2	3.8
2009	4.5	4.0
2010	4.7	4.3
2011	5.2	4.6
2012-2016	30.2	26.7
Total	**$ 52.7**	**$ 46.9**

POSTEMPLOYMENT BENEFITS

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2006 and 2005 were $5 million for each year. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses were $213 thousand and $1 million, respectively, and are recorded as a component of "Salaries and other benefits" in the Statements of Income.

NOTE 10

ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Amount Related to Postretirement Benefits other than Pensions
Balance at December 31, 2005	$ –
Adjustment to initially apply FASB Statement No. 158	(21)
Balance at December 31, 2006	**$ (21)**

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

NOTE 11

BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check, check adjustment and cash operations and staff reductions in various functions of the Bank. In 2006, additional consolidation and restructuring initiatives were announced in the check adjustment operations. These actions resulted in the following business restructuring charges (in millions):

			Year-ended 12/31/2006		
	Total Estimated Costs	**Accrued Liability 12/31/2005**	**Total Charges**	**Total Paid**	**Accrued Liability 12/31/2006**
Employee separation	$ 4.5	$ –	$ 0.4	$ –	$ 0.4
Other	0.4	–	–	–	–
Total	**$ 4.9**	**$ –**	**$ 0.4**	**$ –**	**$ 0.4**

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 186, including 11 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of "Salaries and other benefits" in the Statements of Income. Restructuring costs associated with the impairment of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment, are discussed in Note 6.

The Bank anticipates substantially completing its announced plans by May 2007.

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