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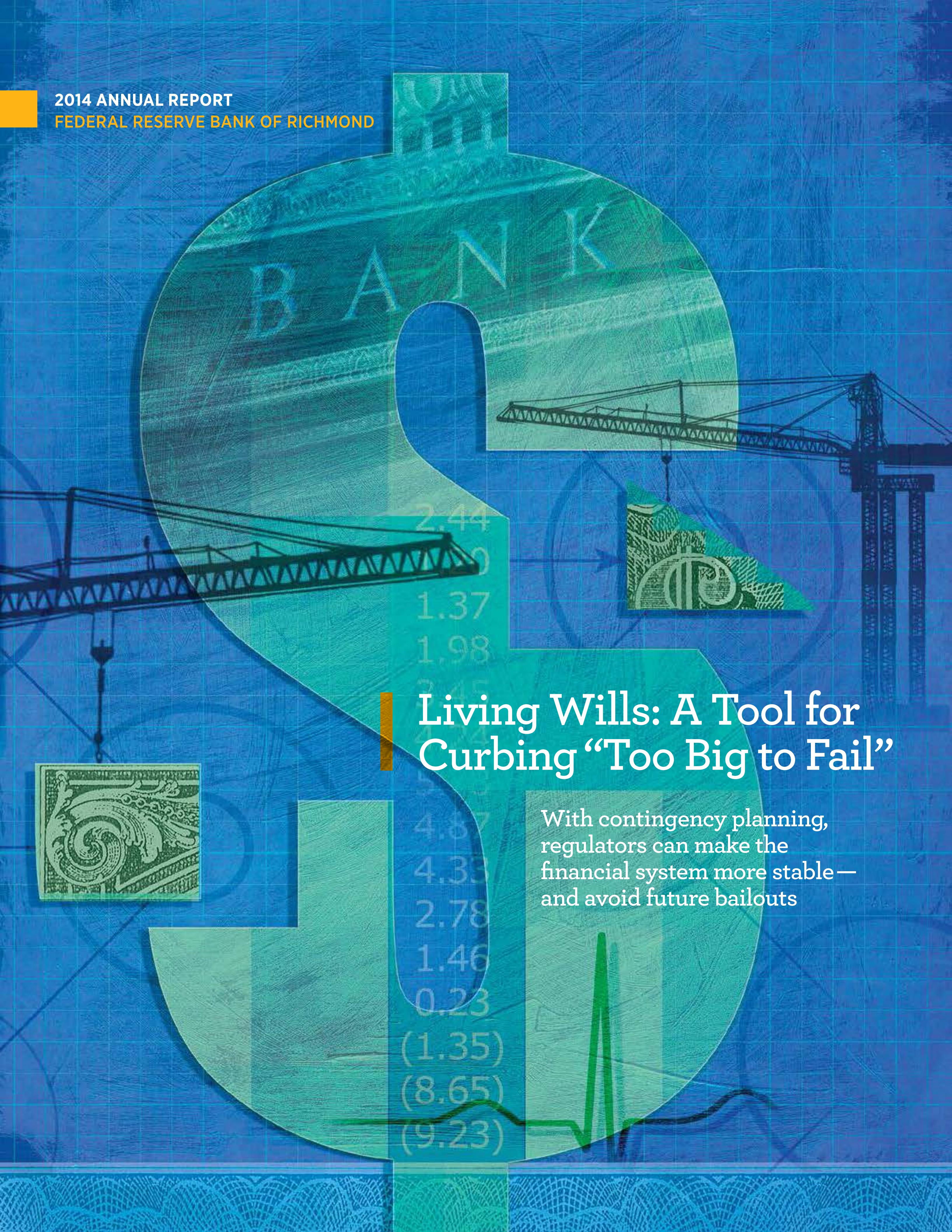

Living Wills: A Tool for Curbing "Too Big to Fail"

With contingency planning, regulators can make the financial system more stable—and avoid future bailouts

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A Commitment to Financial Stability

PHOTO: MICHAEL BATTS

Jeffrey M. Lacker
President

More than six years after the financial crisis of 2007–08, policymakers, regulators, and researchers are still wrestling with how best to prevent a similar crisis in the future. The primary legislative response was the Dodd-Frank Act of 2010, which contains a number of constraints on risk-taking by financial institutions, such as stronger capital and liquidity requirements and periodic stress-testing. Such constraints are important, but, as Arantxa Jarque and David A. Price explore in this year's essay, they do not solve the fundamental problem of institutions that are perceived as "too big to fail." Instead, we must find a way to make regulators and policymakers commit in advance to not provide rescues—expensive, taxpayer-funded rescues—to firms in times of distress. Such commitment is essential for reducing moral hazard and realigning the incentives of financial market participants. The Dodd-Frank Act created an effective tool to achieve this goal: resolution plans, or "living wills."

A living will is a detailed plan that explains how a financial institution could be wound down under the U.S. Bankruptcy Code without threatening the rest of the financial system or requiring government assistance. Under the Dodd-Frank Act, large banks and other systemically important firms are required to submit these plans on an annual basis for review by the Fed and the Federal Deposit Insurance Corporation (FDIC).

How can living wills help solve the "too big to fail" problem? As Jarque and Price explain, the problem stems from a series of rescues and other interventions by the Fed and the FDIC dating back to the 1970s. These interventions created widespread expectations of government support if a large financial institution were to become troubled. These expectations dampened incentives to contain risk-taking, thus encouraging higher leverage and more reliance on short-term funding. Over time, this cycle of rescue and failure has made our financial markets more fragile.

Living wills can help put an end to this cycle by making bankruptcy a viable alternative to bailouts for large financial firms. Bankruptcy is preferable to our current ad hoc system of rescues for a number of reasons. First, bankruptcy, with clearly defined rules and safeguards for the treatment of creditors, can provide more consistent and predictable outcomes. In addition, a bankruptcy proceeding can help prevent individual creditors from pursuing individual remedies—that is, from starting a "run" that would destroy the firm's value. Finally, in modern economies we generally presume that competitive forces drive parties toward financial arrangements that are relatively efficient, given the rules of the system they face. The bankruptcy system reinforces this beneficial feature of competitive markets, since the deadweight costs are borne exclusively by the firm's creditors and other stakeholders. The result is a collective interest, ex ante, in avoiding behaviors that would make the firm excessively vulnerable to financial distress.

Certainly, as Jarque and Price note, there are challenges to resolving a large financial firm through the bankruptcy code. One challenge could be the substantial liquidity needs of large financial firms. Other types of firms generally rely on a type of short-term financing known as "debtor-in-possession" (DIP) financing to see them through a bankruptcy proceeding. But for a variety of reasons, lenders might be unable or unwilling to meet the DIP financing needs of a large financial firm.

Another challenge is the complexity of our largest financial institutions, some of which have thousands of subsidiaries. If such a firm becomes distressed, regulators might want to separate the parts of the institution that perform "critical functions" for the rest of the market and arrange for them to be taken over by another institution. The more subsidiaries there are, the more difficult it may be to tease apart their relationships. In addition, bankruptcy courts could be constrained by the existence of vital shared services that are operated by one subsidiary but relied on by others.

Living wills can actually help us address these challenges. That's because when regulators review the living wills, they don't have to take the firms' current size and structure as given. If the Fed and the FDIC jointly determine that a plan would not credibly resolve a firm through bankruptcy, the firm must submit a revised plan. If the revised plan still isn't credible, regulators can require more capital, increase liquidity requirements, or restrict the growth, activities, or operations of the firm. They can even require firms to make divestitures.

The Dodd-Frank Act created another method of resolving large financial firms, the Orderly Liquidation Authority, or OLA. The OLA gives the FDIC the ability, with the agreement of other financial regulators, to take a firm into receivership. The FDIC also has access to a line of credit from the U.S. Treasury to make payments to creditors or to guarantee the liabilities of the failed firm.

While the OLA is intended to supplant bailouts, it retains many of the critical flaws of pre-crisis practices. For example, the Act gives the FDIC the discretion to pay some creditors more than they would obtain in bankruptcy. This creates additional uncertainty for creditors about their returns and potentially allows funds to be channeled to favored creditor classes. In addition, the ability of the FDIC to inject Treasury funds means that market participants will likely expect at least some creditors to be protected from losses, thus perpetuating the dynamic we saw play out before and during the crisis.

Resolution planning for large, complex financial firms is difficult, painstaking work. But living wills are the most effective path toward restoring market discipline and dismantling the expectations that have created "too big to fail." As Jarque and Price's thoughtful analysis demonstrates, the potential costs of living wills are far outweighed by the benefits to us all of fostering a stable and resilient financial system.

Jeffrey M. Lacker
President


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Living Wills: A Tool for Curbing "Too Big to Fail"

With contingency planning, regulators can make the financial system more stable—and avoid future bailouts

By Arantxa Jarque and David A. Price

Although the financial crisis of 2007–08 is gradually receding into history, policymakers and the public are still concerned about avoiding a repetition of the crisis. At issue is not only the economic dislocation that arose from the crisis, but also the public bailouts of major financial institutions such as Bear Stearns and AIG that became financially distressed and were then considered "too big to fail."

These rescues—seen by many as a distasteful brew of private risk-taking and socialized losses—seem to have been in part the outcome of an expectation that policymakers brought about with a series of rescue operations and other interventions going back to the 1970s. Two examples of these are the Fed's support for Continental Illinois National Bank and Trust Co. in 1984 and the Fed's use of its "good offices" to save the hedge fund Long-Term Capital Management in 1998. Such actions are likely to have created a belief in the markets that some institutions are, in fact, too big to fail. Hence, despite an intention to stabilize the financial system, the implied promise of rescue may have actually induced fragility in financial markets through a circle of rescue and failure:

- Policymakers, concerned that the failure of certain institutions would have costly effects on society, intervened to rescue them,
- leading creditors to expect future interventions in support of such institutions in the event of trouble,
- reducing the incentives of creditors to monitor the risk-taking of those institutions and appropriately price for risk,
- leading to excessive risk-taking that caused the failure of several of those institutions in the 2007–08 crisis,
- spurring another round of rescue interventions.

In short, the expectation of a bailout changed risk-taking behavior, a phenomenon known as "moral hazard." What this cycle means is that policymakers who want to avoid bailouts similar to those of the financial crisis should try to commit in advance not to rescue financial firms. This is hard to do because the costs to the economy of letting a major institution fail are uncertain. As part of the effort to make such a commitment credible, regulators need a strengthened understanding of, and control over, the characteristics of those institutions that may make them difficult to resolve in bankruptcy if they fail.

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the elimination of bailouts was among its goals. One of the many measures in the Act was the creation of a new tool—known as resolution plans, or "living wills"—aimed at helping policymakers work toward the objective of making the largest and most complex financial institutions resolvable without public assistance if they become financially distressed. These institutions, known as systemically important financial institutions, or SIFIs, are the ones that the policymaking community perceives as posing a risk to the rest of the system if they fail. (They include both bank holding companies, such as Bank of America, and nonbank institutions, such as the insurer AIG.) The provisions of Dodd-Frank on living wills give financial regulators the authority to require these firms to submit a resolution plan to be followed in the event of severe financial distress. On an annual basis, all SIFIs must submit detailed plans to the Fed and the Federal Deposit Insurance Corporation (FDIC).

But living wills don't stop with planning and disclosure. If the Fed and the FDIC find that a plan does not set out a credible path to resolving the firm without public support, they can, if need be, require the firm to increase its capital or liquidity, limit its growth, activities, or operations, and even divest assets to make such resolution a credible option in the future.

Thus, with living wills, Congress has put a tool in regulators' hands that may be critical to curbing rescue pressures. In this essay, we will argue that while the Dodd-Frank Act's limitations on bailouts and its enhanced regulation of safety and soundness are significant steps toward limiting rescues, they leave further work to be done, and living wills can help us do this work. We will look at why living wills, properly implemented, make unassisted bankruptcy a more attractive option for policymakers—and why there are good reasons for bankruptcy to be the preferred route for resolving large distressed institutions. Finally, we will discuss several important obstacles that remain in the project of establishing a credible commitment not to rescue the largest and most complex firms, along with some promising approaches to overcoming them.

Committing not to Rescue

What makes living wills an especially powerful tool is that they can assist policymakers in establishing credibility—in particular, a credible commitment not to rescue.

The word "credibility" here refers to a concept that economists call dynamic consistency or time consistency. It sounds technical, but in its simplest form, it isn't. Roughly speaking, time consistency problems arise when your present self wants to bind your future self to do something that may turn out to be contrary to the wishes of your future self. Our present self sets an alarm clock; our future self doesn't want to get up in the morning. Many of us learned Homer's story of Odysseus and the Sirens, who used music to lure sailors into wrecking their ships. Odysseus, who wanted to hear the Sirens' music, solved his time consistency problem by ordering his sailors to plug their ears with wax, to tie him to the mast, and to keep him tied no matter how much he asked to be let go.

What does this have to do with "too big to fail"? The answer is that policymakers can sometimes best serve financial stability by tying themselves to the mast—committing themselves not to take certain actions—and ensuring that everyone knows. Here, as noted above, to align the incentives of market participants and bring about market discipline, policymakers must make clear that they will not rescue failing institutions during a crisis no matter how tempting bailouts

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might appear to be once a crisis occurs.[1] By requiring firms to create living wills, regulators aim to improve the outcomes for the financial system and the economy when they resolve a firm without assistance—so the temptation of a bailout won't be there to start with.

In monetary policy, the importance of time consistency problems has been understood for a long time. In the 1970s, Americans experienced not only high inflation, but unemployment and inflation rising together. After years of failed approaches such as wage and price policies and stop-and-go monetary policy, Fed Chair Paul Volcker brought, and kept, inflation down with a Fed policy based on a credible commitment to act against inflation. He responded first with a sustained tightening of monetary policy, despite the serious recession that predictably resulted, and then with a determination to act if inflation appeared to rise again, notwithstanding the costs of such action. The Fed has continued to show determination to act against inflation, a policy that has led markets to expect inflation to remain low.[2]

The credibility that the Fed earned during the Volcker era—and that it has maintained since—has been crucial to the price stability that the nation has enjoyed for more than 30 years. To bring about greater stability in financial institutions, policymakers must now establish credibility with respect to rescues of financial institutions.

Dodd-Frank Tried to Fix the Rescue Problem, But Didn't

The Dodd-Frank reform law was a significant effort to bring about this credibility and thereby put an end to bailouts. One of its sponsors, former Rep. Barney Frank (D-Mass.), remarked at a conference last year, "We did, I believe, the maximum that you could do legally to make clear that if a large financial institution incurs debts it cannot pay, it is out of business and no taxpayer money can be used."

As Frank noted, the law does not allow the direct use of tax funds for rescues.[3] Then why isn't that the end of the issue?

The reason is that Congress stopped short of the larger goal of taking away the possibility of ad hoc support. Such support can still come from another source. Although the Dodd-Frank Act presents unassisted bankruptcy as the preferred option, the Act gives regulators the power to resolve large financial firms in distress through an administrative process known as orderly liquidation if they conclude that unassisted failure would threaten financial stability. The power to do so, known as Orderly Liquidation Authority (OLA), provides a side door through which regulators can provide funds to the distressed firm.

That door is the Orderly Liquidation Fund, a mechanism giving the FDIC the ability to borrow from the Treasury to pay creditors of a firm being resolved under OLA. Subject to various restrictions, Dodd-Frank allows the FDIC to borrow so it can make loans to or guarantee obligations of a covered financial company or a bridge financial company during the orderly liquidation process, including obligations to unsecured general creditors. If the FDIC cannot later recover all the money from the distressed institution, it can levy an assessment on large financial firms to ensure that the borrowings are repaid. Thus, although the process does not draw money from general treasury funds, it is a source of money for rescues.[4]

What the existence of this mechanism means is that, in the absence of a contrary signal from regulators, markets are likely to expect that at least some creditors of SIFIs will be protected from loss. The possibility of an assessment following a major failure could stimulate industry-sponsored arrangements of self-regulation, arrangements that have sometimes arisen in U.S. banking.[5] But the net effect of the Orderly Liquidation Fund is likely to be that the moral hazard problem prevails.

In addition to the Orderly Liquidation Fund, other public financing mechanisms still exist. Among these are the Fed's power to lend to private entities in "unusual and exigent circumstances." The Dodd-Frank Act did narrow the latter power, known as "section 13(3) lending," by requiring that it take place only as part of a program with broad-based eligibility, but this does not eliminate the problem of moral hazard with respect to such lending. Moreover, even without lending powers or other rescue powers already established by law, regulators could—in the absence of a commitment not to bail out distressed firms—go to Congress in the midst of a crisis to seek such authority, much as they did in connection with the Troubled Asset Relief Program, or TARP, created by emergency legislation in 2008.

But do financial markets really pay attention to such possibilities? The answer appears to be yes; early evidence suggests that moral hazard in financial markets remained with us following enactment of the Dodd-Frank law. One way of considering this is to look at how much the largest financial institutions pay to borrow money compared with other institutions; if the largest institutions are paying less on a risk-adjusted basis, the difference reflects investors' expectations of a rescue in the event of distress. In a 2013 paper, Viral Acharya of New York University, Deniz Anginer of Virginia Tech, and Joseph Warburton of Syracuse University analyzed bond credit spreads of 567 financial institutions and found that the passage of the Act does not appear to have reduced expectations of public support for the largest institutions.[6]

Another way of considering the question is to look at the risk-taking behavior of the institutions themselves. This is, in general, a difficult task, and little systematic evidence has been gathered on the effect of Dodd-Frank in this area. One recent attempt is a 2014 article in the *Journal of Financial Stability.* Two researchers, Magdalena Ignatowski and Josef Korte of Goethe University Frankfurt, studied the risk-taking of U.S. banks and bank holding companies using their regulatory filings and other financial reports, as well as mortgage loan information from Home Mortgage Disclosure Act filings. They concluded that the institutions did reduce their risk-taking in response to Dodd-Frank—except for the largest, most systemically important ones, whose risk-taking does not seem to have changed. Although this study necessarily relies on approximate measures of risk-taking that may have been affected by other policies and by the state of the economy following the financial crisis, it suggests that the too-big-to-fail expectation may still be guiding some decisions of the largest financial institutions.[7]

In short, while the Dodd-Frank Act's barrier against bailouts from the general treasury was a good start, more must be done to establish a credible commitment not to rescue. One way we can do so is with the tool that Dodd-Frank itself gave us—living wills.

What We Want to See in Living Wills

The value—and costliness—of living wills is easier to understand if you know what goes into them. They are required to include, among other things, information on all of the firm's business units and subsidiaries and their dependencies on each other, its material off-balance-sheet obligations, its key internal reports, and its management information systems and the operations and business lines that they support. Beyond these inventory-like information requirements, of which there are scores, the living wills also must include the firm's detailed strategic plan for rapid and orderly resolution in the event of distress. What will be the firm's capital needs and how will it meet them? How does the firm determine the market values of its business lines and asset holdings? How long will the steps of the plan take to carry out?[8] This information would be helpful to a bankruptcy trustee and to potential lenders or acquirers.

The Fed and the FDIC are engaged in a back-and-forth process with SIFIs to push the firms to produce living wills that accurately reflect the firms' current state of resolvability as well as highlighting where further progress is needed. This iterative process is necessary because living wills are a new concept. The first wave of living wills came from 11 large banking organizations, which were required to file their first annual plans in mid-2012 and to file revised plans the following year. The agencies have publicly noted some common shortcomings of the plans. Among these were unrealistic or inadequately supported assumptions about the likely behavior of customers, counterparties, and investors when the institution is in distress and the failure to identify the kinds of changes in the firms' structures and practices needed.[9]

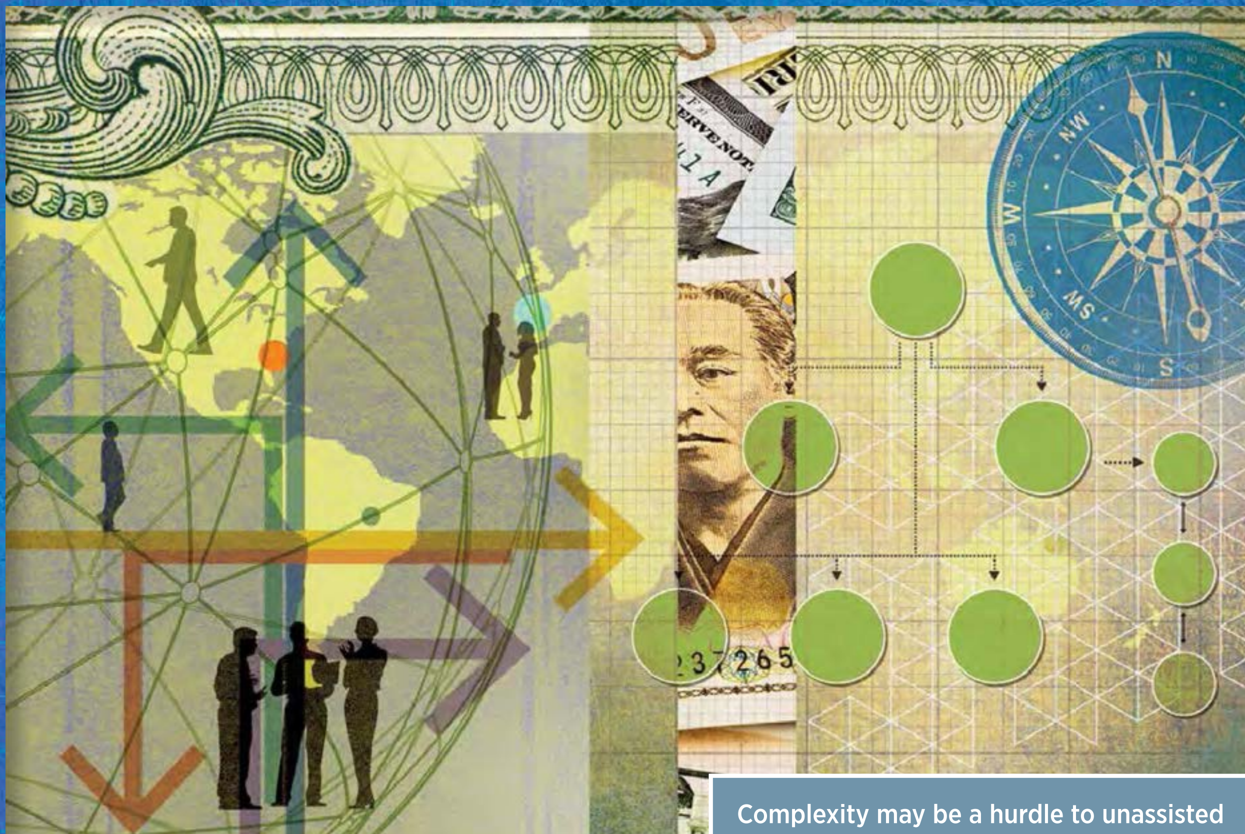
At the same time that the agencies are giving guidance to the SIFIs, they are also trying to understand better what a firm needs to look like—in terms of liquidity, complexity, and other factors—to be resolvable without public assistance in a realistic economic scenario.

It's new and difficult terrain for both institutions and regulators. (We'll come back to the challenges later.) But the benefits of achieving greater market discipline seem likely to justify these costs.

Virtues of Bankruptcy

The existence of a living will that sets out a credible path to resolving the firm without public support makes it more plausible that regulators would actually opt for bankruptcy rather than feeling forced to mount a rescue.

Even though the word "bankruptcy" does not bring warm feelings to most of us, unassisted bankruptcy has benefits over an administrative procedure such as OLA. Bankruptcy differs from OLA in a number of ways that are helpful to the task of establishing market discipline. One difference is in the way that the two are triggered. Bankruptcy protection is sought by the institution itself based on its inability to raise money to operate (or, in some cases, by unpaid creditors), while OLA is triggered by regulators whose motivations in a particular case may be uncertain and may be distinct from the financial issues at stake. For example, regulators with political accountability may



Complexity may be a hurdle to unassisted resolution because of the difficulty separating the parts of the institution that are most important to the stability of the overall financial system.

have an incentive to forbear from instituting proceedings until after an election; alternatively, if financial institutions have political power, they may be able to prevail upon regulators to use the discretion afforded by OLA in a manner favorable to them.[10]

Additionally, creditors in bankruptcy have more certainty about their priority; they generally get the priority that they contracted for when they granted credit to the institution. In OLA, on the other hand, the agency carrying out the resolution process—the FDIC—has the discretion to pay a creditor more than bankruptcy priority rules would dictate if it believes doing so is "necessary or appropriate to minimize losses."[11]

Finally, and most importantly, a bankruptcy court does not have access to a pre-existing pool of money to pay out to creditors—unlike the OLA process with its Orderly Liquidation Fund. Even though the Orderly Liquidation Fund does not come from taxpayers, its existence makes a rescue, and therefore moral hazard, more probable.

While the bankruptcy process, like any resolution process, is imperfect, the experience with the 2008 bankruptcy of Lehman Brothers has been a source of insight into what may be the main difficulties of bankruptcy in the case of a distressed SIFI and the mistakes to avoid. As of March 2014, Lehman's unsecured creditors had recovered an average of 28 percent of the value of their allowed claims—lower than historical norms but higher than initially expected. This figure was likely boosted by the Fed's provision of short-term lending to Lehman's broker-dealer subsidiary for less than a week and by other support to financial markets by the Fed and the Treasury Department. At the same time, it is reasonable to assume that the recovery was depressed by Lehman's lack of resolution planning.[12]

Given the magnitude of these losses, a natural question is why creditors of firms such as Lehman were not already demanding resolution plans before and during the crisis. We consider this question in the next section.

Why Didn't Markets Already Demand Living Wills?

In theory, a good living will should benefit the firm by lowering its cost of funding. Because a living will sets out information that creditors would value, such as its complementarities and interconnections and its financing needs, creditors should be willing to lend money more cheaply to firms that have one in place. So why was action by regulators needed to bring them about?

Certainly, living wills are costly. The creation and revising of living wills requires the time of firms' employees, as well as legal and consulting fees. The Fed and the FDIC have estimated that the process of initially creating the living will, together with the process of obtaining approval, will require 5,500 to 10,200 hours of staff time per institution.[13] (The lower figure is for institutions that are predominantly banking companies, from whom less detail is required.) Beyond the cost of producing the living wills, the changes needed to make a firm resolvable—that is, easy to liquidate in an efficient manner—may be highly costly. These changes may include, as we will see, major revisions in debt structure and organization.

Given these costs, shareholders considering the creation of living wills would need to evaluate the savings in financing costs that a good living will was likely to bring about. In a world with public guarantees through either implied expectations or explicit deposit insurance or both, lenders will not demand a premium for complexity that makes firms more difficult to resolve—and hence creating living wills would entail significant costs and no benefits. Moreover, even without government support, if the failure of a SIFI is believed to hurt the stability of financial markets through fire sales of assets or payment disruptions, then private lenders would be less concerned about failure than society as a whole—since the institution and its creditors do not bear the full damage that the failure would induce in the rest of the economy. For both of these reasons, we would expect financial markets not to demand living wills, or not ones of sufficient quality.

Living Wills in Orderly Liquidation

At least in the short run, policymakers may continue to be drawn to administrative resolution and ad hoc support despite the benefits of bankruptcy. This could happen if policymakers are fearful about the possible systemic effects of letting a SIFI be resolved through unassisted bankruptcy. To the extent that policymakers want to retain OLA in their toolkit during a transitional period, living wills can still have significant value.

Living wills give regulators the authority to shape firms in ways that will make them less likely to need assistance during any resolution process, whether the process takes place within bankruptcy or OLA. Additionally, as an article published in 2011 by the FDIC has noted, if a SIFI became financially distressed and policymakers opted to use OLA, the living will would likely prove useful to the FDIC during the resolution process.[14]

The level of complexity revealed by living wills can also be used by regulators as a tool in itself. For example, a group of a dozen highly accomplished financial economists, known as the Squam Lake Group for the location of its first meeting in New Hampshire in 2008, has suggested that capital requirements and limits on short-term debt could be set on the basis of the level of complexity indicated by the living wills. Such uses of the complexity information are another potential benefit of living wills that would apply regardless of resolution regime.[15]

Challenges Ahead

The cycle of moral hazard, crisis, and intervention tells us that to avoid future bailouts and to improve stability, the better form of resolution is unassisted bankruptcy. For regulators who must oversee the transition of firms to resolvability, whether through unassisted bankruptcy or OLA, there are significant challenges to be dealt with. We consider some of the most prominent ones below.

Challenge 1: Short-Term Financing

One of the challenges facing policymakers is that SIFIs in their present form have large liquidity needs. By definition, SIFIs tend to be very large firms, and there is limited experience with resolving financial firms of such a scale. The largest bank resolution by regulators so far, that of Washington Mutual in September 2008, involved assets of $302 billion; the bankruptcy of Lehman Brothers, the largest bankruptcy in history, involved assets of $639 billion. In contrast, the distress of one of the largest SIFIs would involve assets of more than $1 trillion. Also, financial firms in general tend to have high short-term liquidity needs to the extent that their business models are based on maturity mismatch (for example, accepting deposits that can be withdrawn on demand and using them to fund long-term loans). Both the size and the typical financial structure of SIFIs, then, pose an obstacle to their unassisted resolution.

When firms other than SIFIs are in bankruptcy, they meet their short-term financing needs through "debtor-in-possession," or DIP, financing. This type of financing, which must be approved by the bankruptcy court, is generally senior to the firm's already-existing debt. The firm's creditors nonetheless are often willing to approve DIP financing because it keeps the firm in operation. The question is, would a failing SIFI be able to obtain sufficient DIP financing to see it through the bankruptcy process?

By virtue of its size, a SIFI relying heavily on maturity mismatch could have DIP financing needs without precedent—needs that lenders might not be willing or able to meet, especially if the distress occurs during a time of market crisis. Given this challenge, even strong proponents of bankruptcy as a means of resolving SIFIs, such as the Resolution Project at Stanford University's Hoover Institution, hold that while a reformed bankruptcy procedure may improve the unassisted resolution of SIFIs, it should not rule out the possibility of government-provided DIP financing in some instances.[16]

How, then, can living wills help policymakers maintain a credible commitment not to provide financing—that is, not to rescue the firm?

The answer lies in the fact that the approval process for living wills does not require regulators to take the existing operations of a firm as given. The combination of a very large institutional size and heavy reliance on maturity mismatch is not essential to financial markets. When reviewing living wills, regulators may determine that if a SIFI wishes to retain its large scale, it will need to reduce its reliance on short-term liabilities. Alternatively, if the firm believes that the costs of reducing its maturity transformation would be unacceptable, it could instead make itself smaller by shutting down certain business lines or, more likely, spinning them off. Ease of resolution should play, together with safety and soundness considerations, a critical role in determining what constitutes acceptable practice in financial intermediation.

Other regulatory initiatives may also move large institutions toward less use of short-term funding; these include efforts dealing with capital and liquidity requirements. The focus in the living wills process is somewhat different, however: While safety and soundness regulations may limit short-term financing with the objective of preventing the failure of a financial institution, the living wills process addresses the expected need for DIP financing once the failure has happened.

Once policymakers have established a commitment not to rescue firms in distress, and that commitment is widely perceived as credible, that commitment in itself will reduce the need for DIP financing. The lack of a safety net would cause the price of debt to become more sensitive to the amount of maturity transformation, leading SIFIs to restrain their reliance on short-term funding.

Challenge 2: Organizational Complexity

Another potential obstacle to making institutions resolvable is that they may have highly complex structures. One simple measure of this complexity is the sheer number of entities within today's institutions: In 2012, six U.S. bank holding companies had more than 1,000 subsidiaries, up from only one such firm in 1991. Four of them had more than 2,000 subsidiaries.[17]

The rise in complexity has come from a number of sources that have contributed to growth in firm size and diversification. Among these have been cost advantages to large financial firms from technological scale economies, the pursuit of regulatory arbitrage (for example, moving activities into the nonbanking sector), the pursuit of favorable tax treatment, the rise of asset securitization, and significant industry consolidation.[18] Moreover, both globalization and the elimination of legal restrictions within the United States on expansion across state lines has helped banking institutions grow to a point where it is profitable for them to expand into nonbank financial services.[19] Finally, the industry consolidated during the financial crisis as regulators arranged for distressed institutions to be acquired.

Why might complexity matter? One reason that complexity may be a hurdle to unassisted resolution is that regulators might want to separate the parts of the institution that are most important to the stability of the overall financial system and arrange for those to be taken over by another institution. Regulators refer to the functions of a firm that they believe to be highly important to the operation of markets as "critical functions." Such functions might include clearing and settlement services, for example. The larger the number of subsidiaries, the more challenging it may be to untangle their relationships and to single out which ones perform critical functions. In addition, when bankruptcy courts resolve a large, complex institution, their options may be constrained to some degree by the existence of critical shared services—for example, information systems that are run by one entity but relied on by other entities within the firm.

As with the challenge of short-term funding, to the extent that regulators believe complexity may stand in the way of unassisted resolution, the Dodd-Frank Act gives them the power to take action: They can require SIFIs to reduce their complexity. They might, for example, direct the firm to spin off lines of business, consolidate subsidiaries, or duplicate certain functions to make some entities more self-sufficient. In doing so, regulators should seek to strike the right balance, as changes of this nature will involve adjustment costs and perhaps forgoing economies of scope and scale. (A different case would be one where complexity has been driven by the pursuit of tax advantages; in this case, the increased taxes that may result from undoing that complexity should not be a concern to financial regulators.)

Market forces should also prove helpful. Like the amount of maturity mismatch, the degree of complexity may itself be partly a result of the expectation of support. Once regulators have established the credibility of their commitment not to rescue, debtholders will have an incentive to monitor institutions for excessive complexity that might reduce their ability to recover their money in a bankruptcy proceeding.

Challenge 3: Cross-Border Issues

One aspect of the complexity of systemically important institutions is that they often operate across numerous national boundaries. For example, at the time Lehman Brothers failed in 2008, it had activities in 40 or more countries, leading to insolvency proceedings around the world.[20]

In a sense, the existence of cross-border difficulties is nothing new to financial regulators. All large international institutions are already subject to supervision by regulators in multiple countries. What is different here is that while supervision of these institutions is an everyday event, resolution of them is a rarity, leaving room for uncertainty about what a cross-border resolution would look like.

The possibility of multiple proceedings may be a problem when different entities within an institution,

A high level of transparency in the living wills brings credibility to the review process and helps assure the markets of the resolvability of each institution.

under the jurisdiction of different countries, are interdependent. Authorities in country A may have control over significant financial or operational assets of a subsidiary in country A needed by another subsidiary in country B. Although the optimal approach from a collective point of view is for authorities in all countries to cooperate to maximize the value of the institution as a whole, the incentives facing authorities are likely different than this. Regulators in a country where the firm's assets are located may have an incentive to exercise control of those assets to pay for losses occurring within its borders. (But regulators will not necessarily act in such a manner; for example, the Fed's rescue of AIG in 2008 partly benefitted foreign parties, while U.S. taxpayers bore all the risk.)

Beyond the possible differences in incentives, multiple insolvency proceedings may give rise to difficult practical issues. The proceedings may be subject to inconsistent legal regimes in different countries. Regulators in one country may have difficulty learning about an institution's foreign-based operations. When resolution takes place within bankruptcy proceedings, cross-border coordination could be still more challenging because courts may be less apt than administrative agencies to coordinate internationally; cross-border cooperation among courts, when it occurs, typically occurs on a case-by-case basis, while financial regulators have had experience cooperating broadly on issues, including resolution policy.

Part of the answer to these concerns about multiple proceedings may be found in the notion of country-level separability—that is, making sure the local operations of an institution are resolvable independently of its foreign-based entities. The more self-contained and self-supporting an institution's operations within a country can become, the less cross-border issues will arise in the resolution process, and the more credibly regulators can commit to a no-bailout policy. As with the issue of short-term funding, regulators are already working on separability outside the context of living wills; for example, a rule issued by the Fed in February 2014 requires large foreign banking organizations operating in the United States to establish an intermediate holding company over their U.S. subsidiaries.[21]

To be sure, separability comes at a cost, limiting the adaptability of the institution in how it uses its resources and where it positions them. Nonetheless, such costs will probably be necessary to some degree to keep cross-border issues in resolution reasonably manageable.

Challenge 4: Transparency

Even if SIFIs achieve a financing structure and an organizational structure that make them resolvable, this outcome will not lead to market discipline if market participants do not believe that it has happened. If markets do not believe that institutions will be resolvable in the event of distress, then the credibility of policymakers' commitment not to rescue will be reduced. Another challenge for regulators, then, is deciding whether markets will accept the agencies' own determinations about resolvability—or whether markets will need to see some of the underlying facts for themselves. In other words, regulators need to decide how much transparency in living wills is desirable.

When an institution submits a proposed living will to the Fed and the FDIC, the institution itself designates the material that will be included in the publicly released section of the document, subject to the requirements and approval of the agencies. In the view of some, the outcome of this process has generally been a minimal level of public disclosure. Indeed, a study of the living wills submitted in 2012 found that most institutions "took full advantage of their discretion to maintain confidentiality of information that is crucial to understanding how easily they could be resolved."[22] This is consistent with financial firms wishing to disclose publicly as little as possible about their strategies and operations.

The right level of public transparency for living wills is an open question. The treatment of public disclosure by regulators so far has been influenced by the longtime concern for maintaining the confidentiality of proprietary information in the supervision process. At the same time, as we noted earlier, the concern for maintaining confidentiality of proprietary information must be weighed against the need for a meaningful level of disclosure about the firm's ability to be resolved without assistance. Moreover, in a democracy, voters arguably have a legitimate interest in transparency so they can assess the progress made in stabilizing the financial system.

Changes may be in store. The Fed and the FDIC stated in August 2014 that they are jointly "committed to finding an appropriate balance between transparency and confidentiality of proprietary and supervisory information in the resolution plans" and that they will be working with SIFIs "to explore ways to enhance public transparency of future plan submissions."[23]

Conclusion

Living wills promise to be highly useful complements to safety and soundness regulation. While there is significant work to be done and there are challenges to overcome, the reward, if we do our jobs well, will be a more stable economic environment for businesses and individuals.

Arantxa Jarque is an economist and David A. Price is senior editor at the Federal Reserve Bank of Richmond. The authors would like to thank Kartik Athreya, Huberto Ennis, Keith Goodwin, Matt Steiger, John Walter, John Weinberg, and Lisa White for helpful comments.

The views expressed are those of the authors and not necessarily those of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Endnotes

1. Federal Reserve Bank of Richmond research has explored the role of credibility and market expectations in curbing public rescues of financial institutions. See, for example, Goodfriend and Lacker (1999); Athreya (2009); Grochulski (2011); Haltom and Lacker (2013); and Lacker (2014).
2. See Goodfriend (1996). Regarding some earlier such episodes, see Sargent (1982).
3. Dodd-Frank Act § 214, 12. U.S.C. § 5394
4. Price (2011)
5. Calomiris (1990)
6. Acharya, Anginer, and Warburton (2013)
7. Ignatowski and Korte (2014)
8. 12 C.F.R. § 243.4
9. Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (2014); Hoenig (2014)
10. Imai (2009); Brown and Dinç (2005); Kane (1990)
11. Pellerin and Walter (2012)
12. Fleming and Sarkar (2014)
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14. FDIC (2011), pp. 10-11, 12
15. Squam Lake Working Group on Financial Regulation (2009)
16. Jackson (2014), p. 17
17. Avraham, Selvaggi, and Vickery (2012)
18. Avgouleas, Goodhart, and Schoenmaker (2013); Cetorelli, McAndrews, and Traina (2014); Hughes and Mester (2013)
19. Cetorelli, McAndrews, and Traina (2014)
20. Carmassi and Herring (2013)
21. Board of Governors of the Federal Reserve System. February 18, 2014. "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations." *Federal Register* 79 (59): 17239–17338.
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Industry Action to Address Future of Payments

PHOTO: MICHAEL BATTS

Mark L. Mullinix
First Vice President and
Chief Operating Officer

Today, the Federal Reserve's operator role in payments is significant and encompasses Reserve Banks providing payments services to depository and other institutions and serving as fiscal agents and depositories for the United States government and other entities. Broadly speaking, Fed banks distribute the nation's currency and coin; offer priced services that include transferring funds and securities, collecting checks, and operating an automated clearinghouse (ACH) service; and provide a multilateral national settlement service.

From a public policy standpoint, in 2012 the Fed announced its desire to engage the payments industry with the aim of improving the speed, efficiency, safety, and accessibility of the U.S. payment system from "end-to-end." This new focus marked a notable shift in approach as Reserve Banks had previously focused primarily on interbank payments activity.

Increasingly, consumers and businesses have expressed preferences for faster payments and strengthened authorization and authentication across payments methods and channels given the proliferation of threats of fraud and data breaches. Our engagement with large and small businesses, emerging payments firms, card networks, payment processors, consumers, and financial services providers surfaced important issues and led to the public release of the Fed's 2013 "Payment System Improvement–Public Consultation Paper." The paper identified gaps to be addressed and opportunities for improving the U.S. payment system. The consultation paper also spawned end-user research to better understand specific industry feedback regarding payment attributes such as speed and security. This work concluded in 2014 and resulted in the January 2015 release of "Strategies for Improving the U.S. Payment System," which summarizes the call to action for industry stakeholders to come together to improve the U.S. payment system.

The Fed's role in the payment system is aimed at promoting the integrity and efficiency of the payment mechanism and ensuring Reserve Banks provide services to all depository institutions equitably and in the spirit of competitive fairness. From a policy standpoint, if the Fed engages in any new, or changes any existing payment service, the following conditions must all be met: The service must achieve full cost recovery in the long run; the Fed must reasonably expect the service to yield a clear, public benefit; and the service should be one that other providers alone cannot be expected to provide with reasonable effectiveness, scope, and equity.

The criteria outlined above were developed before many technological advances that are now in wide use. So, engagement with the industry demands that we consider applying these criteria to new ideas and in new ways. For example, when discussing identifying a fast, secure, and efficient method to improve end-to-end payments, how does the Fed ensure equitable provision to all institutions and payments end users? What was once a finite market of financial institutions has expanded significantly as nonbank payments providers now operate in the payment value chain. And, if other providers cannot or will not provide a service with reasonable effectiveness, scope, and equity, what is the appropriate policy response for the Fed?

The Fed does not take potential modifications to or changes in our payment system role lightly. Thus, when exploring new possibilities or opportunities, the

Board of Governors of the Federal Reserve System is required to conduct competitive-impact analyses to understand what, if any, direct and/or material impact the operations of the Fed would have on the ability of other service providers to engage in similar services.

The Federal Reserve has established five desired outcomes of its industry engagement to improve the U.S. payment system:

- **Speed:** A ubiquitous, safe, faster electronic solution(s) for making a broad variety of business and personal payments, supported by a flexible and cost-effective means for payment clearing and settlement groups to settle their positions rapidly and with finality.
- **Security:** U.S. payment system security that remains very strong, with public confidence that remains high, and protections and incident response that keeps pace with the rapidly evolving and expanding threat environment.
- **Efficiency:** Greater proportion of payments originated and received electronically to reduce the average end-to-end (societal) costs of payment transactions and enable innovative payment services that deliver improved value to consumers and businesses.
- **Cross-border Reach:** Better choices for U.S. consumers and businesses to send and receive convenient, cost-effective, and timely cross-border payments.
- **Collaboration**: Needed payment system improvements are collectively identified and embraced by a broad array of payment participants, with material progress in implementing them.

Collaboration with the financial services industry is critical to the success of any payment strategy pursued by the Federal Reserve. NACHA (The Electronic Payments Association) has also been engaged to better understand the needs of consumers in payments. NACHA is exploring gaps in the current payment system, including check writing, converting businesses to electronic payments, and moving closer to the delivery of real-time payments, among others. Specifically, NACHA is giving its attention to the implementation of same-day settlement for ACH transactions. In October 2014, The Clearing House (TCH) and its members announced a multiyear initiative to build a real-time payment system. The work of the Federal Reserve has been informed by TCH efforts, and it is encouraging to see these and other efforts taking aim at the same objective: to improve the end-to-end speed of payments in the United States.

Implementing faster payments capabilities is no easy task and will take the collaboration and engagement of all payments industry stakeholders. As noted in the strategies paper, learning from the industry is essential to identifying potential approaches for payment system improvement that the Fed may pursue.

Efforts in 2015 will include the work of two task forces—one to focus on faster payments and the other on payment security. The industry members of these panels will assess alternative approaches for delivering faster and more secure payments.

In spite of these recent constructive efforts by industry participants and the Fed, the payments industry and environment continue to change and evolve—and so we know that this effort will not be easy. Nonetheless, the Fed remains committed to improving the U.S. payment system with industry-wide assistance through stakeholder participation in the task forces, by seeking feedback, and through the dedicated individual action of payments providers and firms. I encourage you to visit https://fedpaymentsimprovement.org to learn more about this effort and to stay abreast of new developments and ways to get involved.

Mark L. Mullinix
First Vice President and Chief Operating Officer

Fifth District Economic Expansion Strengthened in 2014

Introduction

In most markets and across most sectors, economic activity in the Fifth Federal Reserve District picked up in 2014. Although the government sector continued to be a drag on the economy, particularly in the northern part of the District, private sector firms were generally optimistic about current and future demand. Growth in the housing sector slowed—and residential construction remained something of a disappointment for many in the housing industry—but commercial real estate activity picked up across most segments. Labor markets showed clear signs of tightening, although wage growth remained spotty. Of course, the strength of economic activity varied by region. Areas such as Asheville, N.C., and Charleston, S.C., continued to expand across economic sectors, while coal mining areas in southwest Virginia and West Virginia, and areas more dependent on federal government spending, lagged.

Labor Markets

Fifth District labor markets generally tightened in 2014, with reports of hiring across a number of industries. Overall, employment in the Fifth District grew 1.8 percent in the year, as the District added 245,000 net new jobs, although this still fell short of the national 2.3 percent employment growth. There were also sizable differences among jurisdictions. The District of Columbia, Maryland, and Virginia all grew more slowly than the United States (1.1 percent, 1.5 percent, and 1.0 percent, respectively) while growth in North Carolina and South Carolina exceeded that of the nation (2.7 percent and 2.5 percent, respectively). Employment in West Virginia actually contracted by 0.1 percent in 2014. Nonetheless, by the end of 2014, all states in the Fifth District exceeded their pre-recession (December 2007) employment level.

The professional and business services industry is extremely important in the Fifth District economy. It accounts for 15.4 percent of District employment, exceeded only by the government sector and the trade, transportation, and utilities industry that account for 19 percent and 17.3 percent of employment, respectively. Professional and business services firms contributed almost 30 percent of the net job gains in 2014. (The remainder of the gains spanned industries.) The professional and business services industry also played a large role in North and South Carolina's employment expansion in 2014. In North Carolina, just over 30 percent of the 110,200 net jobs gained in the year were in professional and business services—a 6.0 percent expansion in that industry. In South Carolina, professional and business services accounted for a little more than 23 percent of the 49,000 net jobs gained in the year—a 4.5 percent increase. Meanwhile, although the professional and business services industry comprises a higher share of employment in Virginia than in any other state in the Fifth District, the industry in Virginia grew only 0.6 percent in 2014. In Maryland, the industry grew only 2.1 percent. Why the slow growth in professional and business services employment in the northern part of the District? This is primarily related to retrenchment and overall uncertainty in federal government contracting, which is discussed in more detail below.

The unemployment rate in the Fifth District fell from 6.2 percent in December 2013 to 5.5 percent in December 2014—ending the year just slightly below the national 5.6 percent rate. Although the unemployment rate in the District is declining, the labor force participation rate has also been falling and, by the end of the year, was at its lowest recorded rate of 62.0 percent. Unemployment rates mostly declined across the District in the year: D.C. fell to 7.7 percent, Maryland fell to 5.5 percent, North Carolina fell to 5.4 percent, South Carolina rose to 6.6 percent, Virginia fell to 4.8 percent, and West Virginia fell to 5.9 percent.

There continued to be reports of hiring in a variety of industries, although more among hourly and lower-skilled workers. Contacts across the District also described turnover among lower-skilled employees throughout the year. Reports of difficulty finding workers with the appropriate soft and hard skills continued, with a particular need for workers in information technology, engineering, skilled manufacturing, distribution and warehousing, trucking, construction, management, and, in some areas, hospitality and recreation. There were very few reports of rising wages, although upward pressure on wages intensified in certain areas and among certain professions.

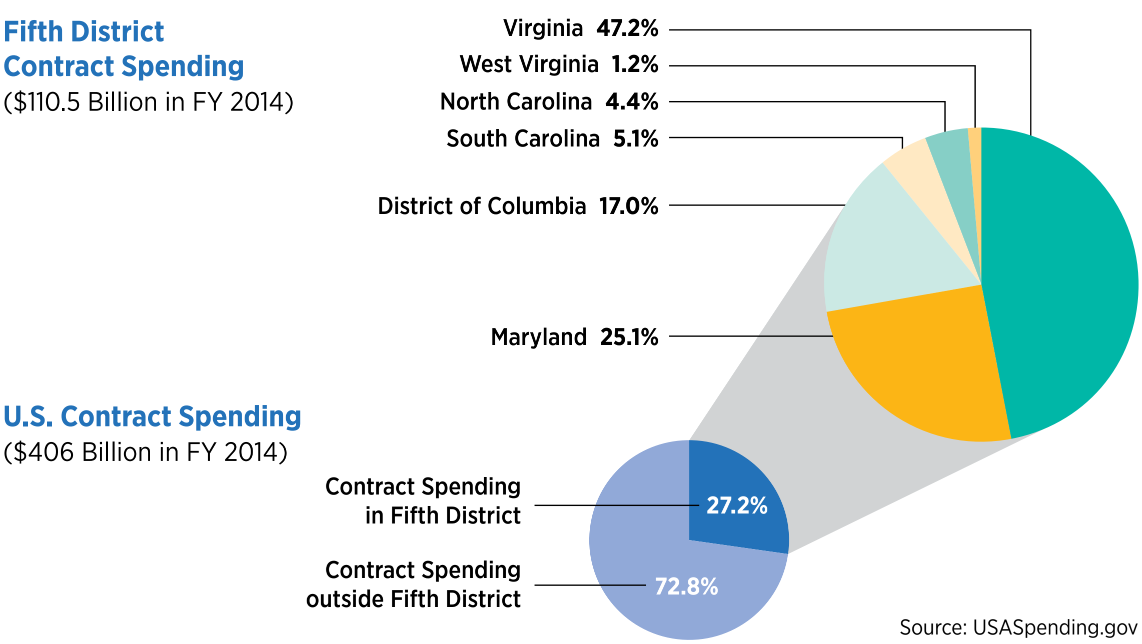
Government Contracting

The Fifth District as a whole accounted for over $110.5 billion federal contract dollars in fiscal year 2014, or 27.2 percent of the national total. Within that, 47.2 percent went to Virginia and 25.1 percent to Maryland. In fact, in fiscal year 2014, Virginia had the largest share of federal contract dollars of any state in the union and Maryland had the fourth-largest share. Contract spending has been declining, however. In the Fifth District, contract spending in fiscal year 2014 was 9.2 percent below its peak in 2010, with spending in D.C. 11.8 percent below its peak in 2010 and spending in Virginia 13.3 percent below its peak in 2011. (Spending in Maryland has remained more constant.)

Business Conditions

The District manufacturing sector expanded more consistently in 2014 than in recent years. Winter weather slowed activity in the first few months of the year, with storms causing shipment delays and plant closures that resulted in lost wages, hours, and production. But the spring brought the improvement that manufacturers

Federal Contract Spending in the Fifth District



Source: USASpending.gov

anticipated. The Federal Reserve Bank of Richmond maintains a composite manufacturing index based on the Bank's *Fifth District Survey of Manufacturing Activity*. It is a diffusion index, meaning that a positive reading indicates that the share of firms reporting expansion exceeds the share of firms reporting contraction. This index was above zero for all but two months (February and March) of 2014. The index was particularly strong in the autumn months with the reading of 20 in October among the highest in the index's history. The composite index was driven up by reports of increases in shipments, in the volume of new orders, and in the number of employees. Although there were scattered negative reports throughout the year, business activity—particularly in the second half of the year—was positive for manufacturing industries as diverse as furniture, electrical components, textiles, food, automotive, chemicals, packaging materials, electrical products, machinery, and medical equipment. Only manufacturing related to defense was consistently downbeat, although in many months construction related to residential building was not as strong as hoped or expected.

Port activity continued to be strong, particularly in the ports of Charleston, S.C., and Norfolk, Va., spurred by expanded manufacturing activity in those regions. Import growth continued to outpace export growth. In general, exports and imports of forest products, grains, soybeans, and heavy machinery/autos grew robustly, while there was some reduced growth in activity related to residential building and coal exports were weak. Domestically, the coal industry suffered further in 2014, both from the low prices of natural gas that enticed companies—particularly utilities—toward gas and away from coal, and from the pressure that power companies are experiencing from impending environmental regulation.

Retail activity had a strong year in 2014, according to the retail revenues index generated from the Bank's *Fifth District Survey of Service Sector Activity*. The index, which tends to be volatile, was above zero in all but one month (June) of 2014, and in May the index hit its highest reading (49) in its more than 20-year history. Reports on retail activity were strong in areas such as cars (used and new), furniture, hardware, discount sales, sporting goods, groceries, and equipment. However, the strength of retail activity varied by region of the District and all retailers expressed continued concern about the effect of the expansion in online sales on brick and mortar stores.

Reports on the non-retail service sector were also generally positive, but in a way that was more consistent with the past few years. Although the non-retail revenues diffusion index never fell below zero in 2014, it did have three months (January, February, and April) at zero and a few more months close to zero. Anecdotes from District services firms were generally positive, particularly after the harsh winter weather at the beginning of the year passed. Tourist activity was reportedly strong throughout the year and throughout the District.

Real Estate

The housing market recovery in the Fifth District continued, but generally slowed, in 2014. According to the CoreLogic Information Solutions house price index, house price growth in the District decelerated, but home values still appreciated 1.6 percent in 2014, continuing the year-over-year house price growth in the District that has persisted since February 2012. As it has for almost three years now, price growth in the nation as a whole—while also slowing—exceeded that in the District; in 2014, house prices in the United States grew 5.0 percent. At the jurisdiction level, only Maryland reported a year-over-year house price decline (0.5 percent) in December 2014. Contacts across the District also reported moderate growth in housing, with mild increases in sales, prices, and foot traffic and generally declining inventory levels. The number (and share) of mortgages in delinquency and in foreclosure also continued to decline in 2014, as it has been doing quite steadily, across states, for the past few years.

Across the housing industry, there were reports that growth in 2014 was positive but not up to expectations for the year. This was particularly true for builders. There was some new construction, but on the whole, residential construction activity remained slow. Nonetheless, activity in residential permit levels, while volatile, continued to trend upward. The total number of new housing units permitted in 2014 was 0.8 percent above the number in 2013. Most of the growth came from permits for multifamily buildings: The number of single-family home permits issued was 0.2 percent below the number issued in 2013.

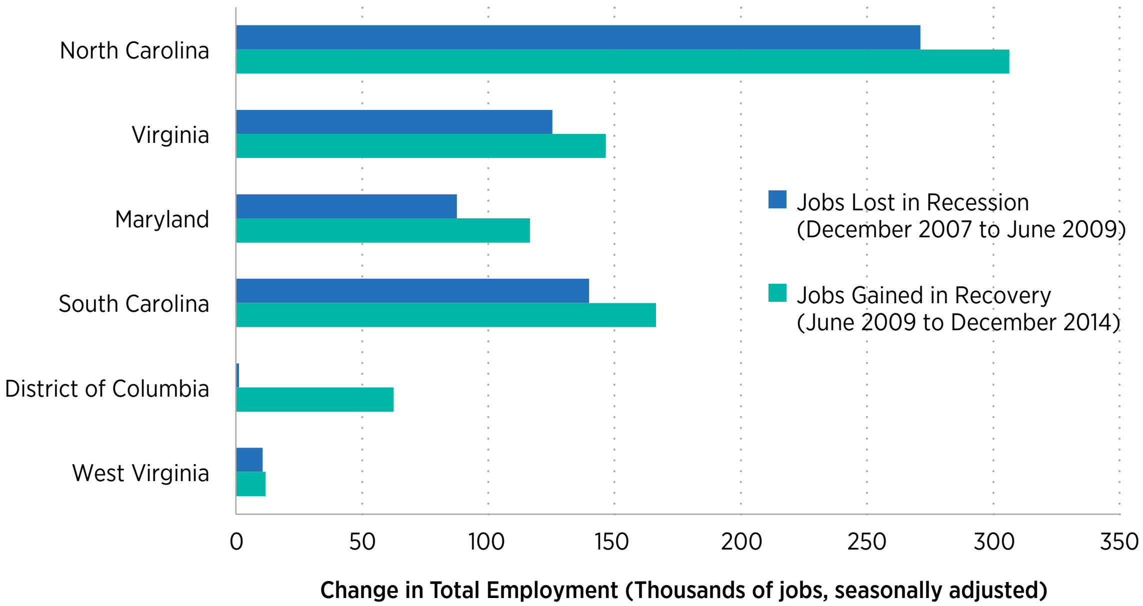
Although residential growth slowed throughout the year, commercial activity seemed to pick up. Contacts reported increased sales and leasing, with particular strength in office (primarily Class A office space), industrial, and certain retail space. In retail, expansion in free-standing space and grocery-anchored space appeared to be the most robust. The multifamily market also remained active throughout the year. In most markets, commercial Realtors noted stable rental rates, declining vacancy rates, increased absorption, and decreased concessions.

Banking Conditions

Fifth District banking conditions improved during 2014; however, banks continued to face a challenging environment due to compressed net interest margins resulting from a low interest rate environment. In spite of these challenges, banks still managed to increase profitability while improving asset quality and maintaining strong capital ratios.

Overall, balance sheets expanded modestly at Fifth District banks as evidenced by median asset and loan growth of 3.6 and 5.3 percent, respectively. Asset growth primarily occurred by way of increases to cash, securities, and loans. Commercial and industrial real estate lending continued to be the largest contributors to District loan growth. Loan growth in these sectors was primarily driven by large- and medium-sized banks. Small community banks continued to focus on residential mortgage lending as large banks slowed lending in this category after a wave of refinance

Job Losses and Gains in the Fifth District



Source: Bureau of Labor Statistics/Haver

Better Understanding Our Local Economies

PHOTO: LARRY CAIN

Twice a year, leaders of the Federal Reserve Bank of Richmond hold regional forums in communities across the Fifth District to learn more about the local economies. The forums also help Bank leaders learn more about emerging issues within the District through the exchange of information, knowledge, and perspectives, which helps inform the Bank's research, policy analysis, and decision-making. In the photo, Matthew Martin (left), Charlotte regional executive and senior vice president of Outreach, discusses issues at the regional forum in Asheville, N.C., with Jon Wehrli, a plant manager at Eaton Electrical. To view a brief video about the 2014 regional forums, please go to https://youtu.be/E9CweyKDRcU.

activity in previous years. Despite historically high levels, median annual nonperforming loan balances declined by 27 percent during the year. Improvements in asset quality allowed provision levels to fall to their lowest in over a decade, contributing to increased earnings. A majority of District banks, 54 percent, reported improved year-over-year earnings and the percent of banks reporting positive returns increased to 92.6 percent at the end of 2014 from 87.3 percent at the end of 2013. Capital levels continued to hold strong in the District as evidenced by increased risk-based capital ratios. Increases in surplus and undivided profits led to improved equity capital at 81 percent of Fifth District banks.

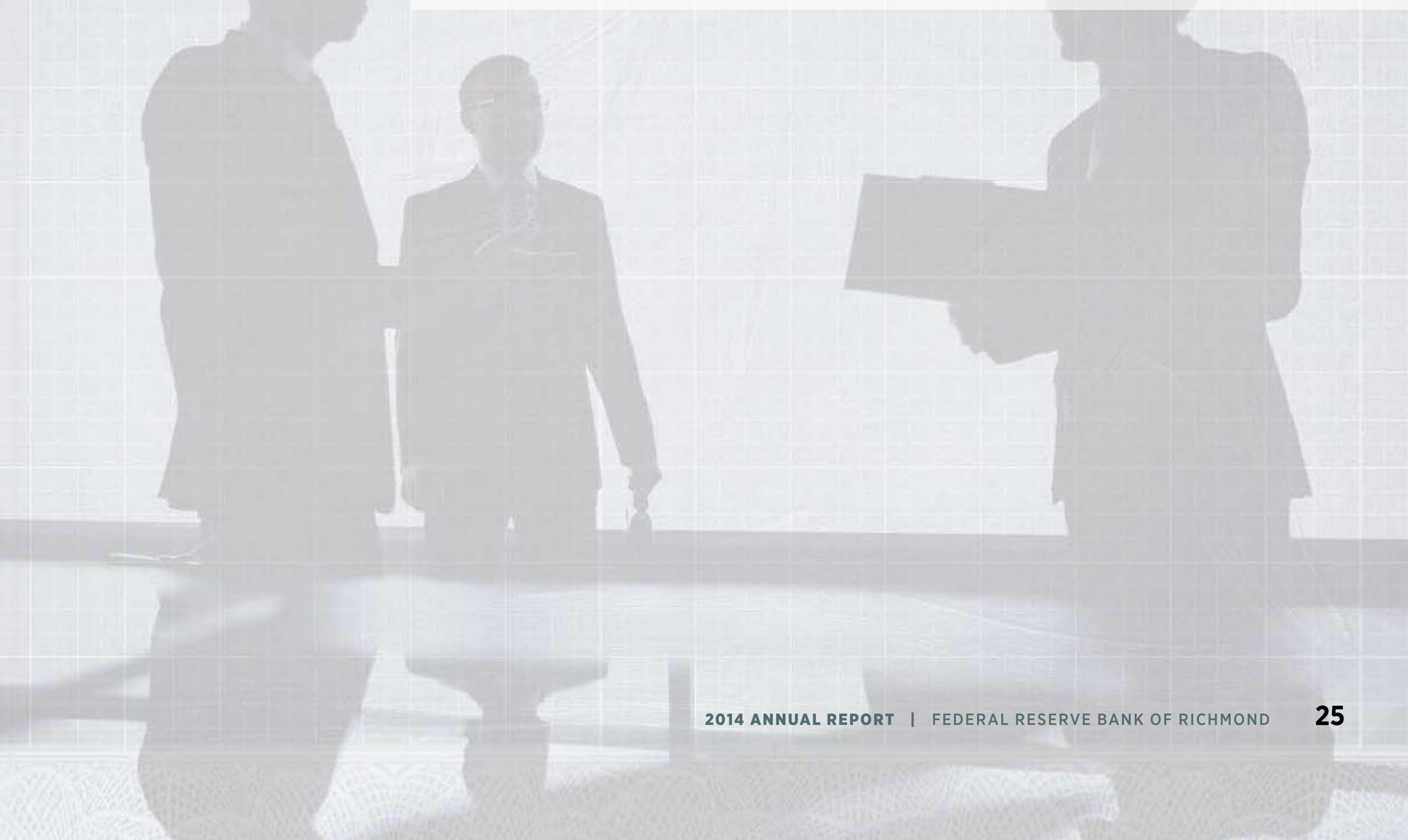
Liquidity remained solid for Fifth District banks as core deposits continued to be the primary source of funding. Despite two years of declining liquid asset ratios, tepid loan growth and new liquidity coverage ratio requirements at large banks bolstered liquid asset levels. Additionally, while Fifth District banks continued to expand their deposit bases, principally in interest-bearing deposits and reduced reliance on non-core funding, bank-funding strategies may shift given an eventual change in the interest rate environment.

Conclusion

On the whole, 2014 was a year of continued economic recovery and progress in the Fifth Federal Reserve District. Although residential real estate growth slowed, other sectors picked up, with increased business investment, expanding commercial real estate activity, and tightening labor markets. Government continued to be a drag on activity, but some of the economic uncertainty appeared to lift from private firms in most sectors of the economy and in most regions of the Fifth District.

Economic (nonbanking) data accurate as of March 20, 2015.

Boards, Councils, Officers, and Senior Professionals



Federal Reserve Bank of Richmond Board of Directors

The Bank's board of directors oversees management of the Bank and its Fifth District offices, provides timely business and economic information, participates in the formulation of national monetary and credit policies, and serves as a link between the Federal Reserve System and the private sector. Six directors are elected by banks in the Fifth District that are members of the Federal Reserve System, and three are appointed by the Board of Governors. Directors who are not bankers appoint the Bank's president and first vice president with approval from the Board of Governors.

The Bank's board of directors annually appoints the Fifth District's representative to the Federal Advisory Council, which consists of one member from each of the 12 Federal Reserve Districts. The council meets four times a year with the Board of Governors to consult on business conditions and issues related to the banking industry.

Baltimore and Charlotte Branches Boards of Directors

The Bank's Baltimore and Charlotte branches have separate boards that oversee operations at their respective locations and, like the Richmond Board, contribute to policymaking and provide timely business and economic information about the District. Four directors on each of these boards are appointed by the Richmond directors, and three are appointed by the Board of Governors.

Community Depository Institutions Advisory Council

Created in 2011, the Bank's Community Depository Institutions Advisory Council advises the Bank's management and the Board of Governors on the economy, lending conditions, and other issues from the perspective of banks, thrifts, and credit unions with total assets under $10 billion. The council's members are appointed by the Bank's president.

Community Investment Council

Established in 2011, the Community Investment Council advises the Bank's management about emerging issues and trends in communities across the Fifth District, including low- and moderate-income neighborhoods in urban and rural areas. The council's members are appointed by the Bank's president.

Payments Advisory Council

Created in 1978, the Payments Advisory Council serves as a forum for communication with financial institutions about financial services provided by the Federal Reserve. The council helps the Bank respond to the evolving needs of its banking constituency. Council members are appointed by the Bank's first vice president.

Listings of boards and councils include members and titles as of December 31, 2014, unless otherwise noted.

Thank You

Thank you to those directors who have completed their service: Marshall O. Larsen, Linda D. Rabbitt, and Edward L. Willingham, IV of the Richmond Board; Richard Bernstein and Jenny G. Morgan of the Baltimore Board; and Robert R. Hill, Jr., and John S. Kreighbaum of the Charlotte Board.

The Bank also welcomes seven new directors: Robert R. Hill, Jr., Thomas C. Nelson, and Kathy J. Warden have joined the Richmond Board; Susan J. Ganz and Austin J. Slater, Jr., have joined the Baltimore Board; and Michael C. Crapps and Mark L. Williamson have joined the Charlotte Board.

Board of Directors,
Federal Reserve Bank of Richmond

First row, from the left: Margaret G. Lewis, Linda D. Rabbitt, C. Richard Miller, Jr.;
Second row: Charles R. Patton, Brad E. Schwartz, Marshall O. Larsen;
Third row: Edward L. Willingham, IV, Wilbur E. Johnson, Russell C. Lindner

FEDERAL ADVISORY COUNCIL REPRESENTATIVE

Kelly S. King
Chairman and Chief Executive Officer
BB&T Corporation
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Second row: Anita G. Newcomb, Samuel L. Ross, Jenny G. Morgan;
Third row: Christopher J. Estes, Stephen R. Sleigh

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In 2014, Jan Roche served as the Fifth District's representative on the Community Depository Institutions Advisory Council at the Federal Reserve's Board of Governors.

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Third row: Steve Stone, Adrian S. Johnson, Tina Giorgio;
Fourth row: Ronald L. Bowling, Chad Harmon; ***Last row:*** Martin W. Patterson

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State Employees Credit Union of Maryland
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Note: The council's membership year runs from June 1 to May 31, but this listing includes all members who served during 2014.

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Federal Reserve System Historian

Pierre-Daniel G. Sarte
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Zhu Wang
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Roy H. Webb
Policy Advisor

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D. Keith Maglinger
Large Bank Principal Examiner

Nada Mora
Senior Financial Economist

Hemangini R. Parekh
Large Bank Principal Examiner

Stanley F. Poszywak
Risk and Policy Team Leader

Todd M. Ryan
Large Complex Banking Organization Deputy Central Point of Contact

Steven D. Sanderford
Large Bank Principal Examiner

David C. Schwartz
Large Bank Principal Examiner

Phillip C. Watts
Large Complex Banking Organization Central Point of Contact

Listings include officers, senior professionals, and titles as of December 31, 2014.

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First row: Lyn McDermid;
Second row, from left: Scott Furman, William Barouski;
Third row: Robert Turner, Paul Maguire, Kathryn Smith;
Last row: Karen Pennell, Matthew Larson

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Kathryn Smith
Senior Vice President and Chief Client Services Officer

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Michael T. Shaughnessy
Chief Application Integration Engineer

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Business Architect

Devin D. Gordon
Business Architect

Robert B. Klank
Business Architect

Donald H. Larmee
Business Architect

Poorav K. Shah
Business Architect

Listings include officers, senior professionals, and titles as of December 31, 2014.

Financial Statements

STATEMENT OF AUDITOR INDEPENDENCE

The Federal Reserve Board engaged Deloitte & Touche LLP (D&T) to audit the 2014 combined and individual financial statements of the Reserve Banks and Maiden Lane LLC.[1]

In 2014, D&T also conducted audits of internal controls over financial reporting for each of the Reserve Banks. Fees for D&T's services totaled $7 million, of which $0.4 million was for the audit of Maiden Lane LLC. To ensure auditor independence, the Board requires that D&T be independent in all matters relating to the audits. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2014, the Bank did not engage D&T for any non-audit services.

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[1] In addition, D&T audited the Office of Employee Benefits of the Federal Reserve System (OEB), the Retirement Plan for Employees of the Federal Reserve System (System Plan), and the Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The System Plan and the Thrift Plan provide retirement benefits to employees of the Board, the Federal Reserve Banks, the OEB, and the Consumer Financial Protection Bureau.

Management's Report on Internal Control Over Financial Reporting
March 11, 2015

To the Board of Directors:

The management of the Federal Reserve Bank of Richmond (Bank) is responsible for the preparation and fair presentation of the Statements of Condition as of December 31, 2014 and 2013, and the Statements of Income and Comprehensive Income, and Statements of Changes in Capital for the years then ended (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 as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), and, as such, include some amounts that 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 FAM 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. The Bank's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with the FAM. The Bank'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 Bank's assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with FAM, and that the Bank's receipts and expenditures are being made only in accordance with authorizations of its management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Bank's assets that could have a material effect on its financial statements.

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 based upon the criteria established in the *Internal Control - Integrated Framework (2013)* 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.

Federal Reserve Bank of Richmond

Jeffrey M. Lacker President	**Mark L. Mullinix** First Vice President and Chief Operating Officer	**Michael L. Wilder** Group Vice President and Principal Financial Officer

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying financial statements of the Federal Reserve Bank of Richmond ("FRB Richmond"), which are comprised of the statements of condition as of December 31, 2014 and 2013, and the related statements of income and comprehensive income, and of changes in capital for the years then ended, and the related notes to the financial statements. We also have audited the FRB Richmond's internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Management's Responsibility

The FRB Richmond's management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles established by the Board of Governors of the Federal Reserve System (the "Board") as described in Note 3 to the financial statements. The Board has determined that this basis of accounting is an acceptable basis for the preparation of the FRB Richmond's financial statements in the circumstances. The FRB Richmond's management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. The FRB Richmond's management is also responsible for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on the FRB Richmond's internal control over financial reporting based on our audits. We conducted our audits of the financial statements in accordance with auditing standards generally accepted in the United States of America and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States) (the "PCAOB") and we conducted our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants and in accordance with the auditing standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of the financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the FRB Richmond's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of the financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. An audit of internal control over financial reporting involves obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Definition of Internal Control Over Financial Reporting

The FRB Richmond's internal control over financial reporting is a process designed by, or under the supervision of, the FRB Richmond's principal executive and principal financial officers, or persons performing similar functions, and effected by the FRB Richmond's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board. The FRB Richmond's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the FRB Richmond; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the accounting principles established by the Board, and that receipts and expenditures of the FRB Richmond are being made only in accordance with authorizations of management and directors of the FRB Richmond; and (3) provide reasonable assurance regarding prevention or timely detection and correction of unauthorized acquisition, use, or disposition of the FRB Richmond's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Control Over Financial Reporting

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

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FRB Richmond as of December 31, 2014 and 2013, and the results of its operations for the years then ended in accordance with the basis of accounting described in Note 3 to the financial statements. Also, in our opinion, the FRB Richmond maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Basis of Accounting

We draw attention to Note 3 to the financial statements, which describes the basis of accounting. The FRB Richmond has prepared these financial statements in conformity with accounting principles established by the Board, as set forth in the *Financial Accounting Manual for Federal Reserve Banks,* which is a basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the accounting principles established by the Board and accounting principles generally accepted in the United States of America are also described in Note 3 to the financial statements. Our opinion is not modified with respect to this matter.

Deloitte + Touche LLP

Deloitte & Touche LLP
March 11, 2015
Richmond, Virginia

STATEMENTS OF CONDITION

(in millions)

As of December 31,	2014	2013
Assets		
Gold certificates	$ 824	$ 856
Special drawing rights certificates	412	412
Coin	307	335
Loans to depository institutions	1	1
System Open Market Account:		
Treasury securities, net (of which $623 and $1,067 is lent as of December 31, 2014 and 2013, respectively)	145,106	146,712
Government-sponsored enterprise debt securities, net (of which $35 and $68 is lent as of December 31, 2014 and 2013, respectively)	2,235	3,676
Federal agency and government-sponsored enterprise mortgage-backed securities, net	99,993	95,377
Foreign currency denominated investments, net	4,358	4,982
Central bank liquidity swaps	319	57
Accrued interest receivable	1,446	1,474
Other assets	2	—
Bank premises and equipment, net	349	353
Other assets	115	122
Total assets	**$ 255,467**	**$ 254,357**
Liabilities and Capital		
Federal Reserve notes outstanding, net	$ 91,935	$ 95,718
System Open Market Account:		
Securities sold under agreements to repurchase	28,495	19,645
Other liabilities	46	83
Deposits:		
Depository institutions	118,097	94,182
Other deposits	100	113
Interest payable to depository institutions	6	4
Accrued benefit costs	308	263
Accrued remittances to the Treasury	28	192
Interdistrict settlement account	3,289	32,634
Other liabilities	49	51
Total liabilities	**242,353**	**242,885**
Capital paid-in	6,557	5,736
Surplus (including accumulated other comprehensive loss of $52 and $26 at December 31, 2014 and 2013, respectively)	6,557	5,736
Total capital	**13,114**	**11,472**
Total liabilities and capital	**$ 255,467**	**$ 254,357**

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

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(in millions)

For the years ended December 31,	2014	2013
Interest income		
System Open Market Account:		
Treasury securities, net	$ 3,622	$ 3,328
Government-sponsored enterprise debt securities, net	92	141
Federal agency and government-sponsored enterprise mortgage-backed securities, net	2,950	2,359
Foreign currency denominated investments, net	16	20
Central bank liquidity swaps	—	5
Total interest income	**6,680**	**5,853**
Interest expense		
System Open Market Account:		
Securities sold under agreements to repurchase	7	4
Deposits:		
Depository institutions	297	215
Term Deposit Facility	1	—
Total interest expense	**305**	**219**
Net interest income	**6,375**	**5,634**
Non-interest loss		
System Open Market Account:		
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	5	3
Foreign currency translation losses, net	(606)	(264)
Other	1	1
Compensation received for service costs provided	15	20
Reimbursable services to government agencies	50	49
Other	3	4
Total non-interest loss	**(532)**	**(187)**
Operating expenses		
Salaries and benefits	422	403
Occupancy	50	50
Equipment	73	71
Other	(181)	(159)
Assessments:		
Board of Governors operating expenses and currency costs	187	184
Bureau of Consumer Financial Protection	116	118
Total operating expenses	**667**	**667**
Net income before providing for remittances to the Treasury	5,176	4,780
Earnings remittances to the Treasury	3,974	4,496
Net income	**1,202**	**284**
Change in prior service costs related to benefit plans	(4)	(4)
Change in actuarial losses related to benefit plans	(22)	55
Total other comprehensive (loss) income	**(26)**	**51**
Comprehensive income	**$ 1,176**	**$ 335**

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

STATEMENTS OF CHANGES IN CAPITAL

(in millions, except share data)

For the years ended December 31, 2014, and December 31, 2013	Capital paid—in	Surplus: Net income retained	Surplus: Accumulated other comprehensive loss	Surplus: Total surplus	Total capital
Balance at December 31, 2012 (114,918,989 shares)	$ 5,746	$ 5,823	$ (77)	$ 5,746	$ 11,492
Net change in capital stock redeemed (196,231 shares)	(10)	—	—	—	(10)
Comprehensive income:					
Net income	—	284	—	284	284
Other comprehensive income	—	—	51	51	51
Dividends on capital stock	—	(345)	—	(345)	(345)
Net change in capital	**(10)**	**(61)**	**51**	**(10)**	**(20)**
Balance at December 31, 2013 (114,722,758 shares)	$ 5,736	$ 5,762	$ (26)	$ 5,736	$ 11,472
Net change in capital stock issued (16,418,000 shares)	821	—	—	—	821
Comprehensive income:					
Net income	—	1,202	—	1,202	1,202
Other comprehensive loss	—	—	(26)	(26)	(26)
Dividends on capital stock	—	(355)	—	(355)	(355)
Net change in capital	**821**	**847**	**(26)**	**821**	**1,642**
Balance at December 31, 2014 (131,140,758 shares)	**$ 6,557**	**$ 6,609**	**$ (52)**	**$ 6,557**	**$ 13,114**

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

NOTES TO FINANCIAL STATEMENTS

1 Structure

The Federal Reserve Bank of Richmond (Bank) is part of the Federal Reserve System (System) and is one of the 12 Federal Reserve Banks (Reserve Banks) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the Fifth Federal Reserve District, which includes Maryland, North Carolina, South Carolina, Virginia, District of Columbia, and portions of West Virginia.

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 nationally chartered banks and any state-chartered banks that apply and are approved for membership. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

In addition to the 12 Reserve Banks, the System also consists, in part, of the Board of Governors and the Federal Open Market Committee (FOMC). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY), and, on a rotating basis, four other Reserve Bank presidents.

2 Operations and Services

The Reserve Banks perform a variety of services and operations. These functions include participating in formulating and conducting monetary policy; participating in the payment system, including transfers of funds, automated clearinghouse (ACH) operations, and check collection; distributing coin and currency; performing fiscal agency functions for the U.S. Department of the Treasury (Treasury), certain federal agencies, and other entities; serving as the federal government's bank; providing short-term loans to depository institutions; providing loans to participants in programs or facilities with broad-based eligibility in unusual and exigent circumstances; serving consumers and communities by providing educational materials and information regarding financial consumer protection rights and laws and information on community development programs and activities; and supervising bank holding companies, state member banks, savings and loan holding companies, U.S. offices of foreign banking organizations, and designated financial market utilities pursuant to authority delegated by the Board of Governors. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The FOMC, in conducting monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and issues authorizations and directives to the FRBNY to execute transactions. The FOMC authorizes and directs the FRBNY to conduct operations in domestic markets, including the direct purchase and sale of Treasury securities, government-sponsored enterprise (GSE) debt securities, and federal agency and GSE mortgage-backed securities (MBS); the purchase of these securities under agreements to resell; and the sale of these securities under agreements to repurchase. The FRBNY holds the resulting securities and agreements in a portfolio known as the System Open Market Account (SOMA). The FRBNY is authorized and directed to lend the Treasury securities and GSE debt securities that are held in the SOMA.

To be prepared to counter disorderly conditions in foreign exchange markets or to meet other needs specified by the FOMC to carry out the System's central bank responsibilities, the FOMC has authorized and directed the FRBNY to execute spot and forward foreign exchange transactions in 14 foreign currencies, to hold balances in those currencies, and to invest such foreign currency holdings, while maintaining adequate liquidity. The FRBNY holds these securities and obligations in the SOMA. The FOMC has also authorized the FRBNY to maintain reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico in the maximum amounts of $2 billion and $3 billion, respectively, and to warehouse foreign currencies for the Treasury and the Exchange Stabilization Fund in the maximum amount of $5 billion.

Because of the global character of bank funding markets, the System has at times coordinated with other central banks to provide liquidity. The FOMC authorized and directed the FRBNY to establish U.S. dollar liquidity and reciprocal foreign currency liquidity swap lines with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank. The FRBNY holds amounts outstanding under these swap lines in the SOMA. These swap lines, which were originally established as temporary arrangements, were converted to standing arrangements on October 31, 2013, and will remain in place until further notice.

Although the Reserve Banks are separate legal entities, they collaborate on the delivery of certain services to achieve greater efficiency and effectiveness. This collaboration takes the form of centralized operations and product or function offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are reimbursed for costs incurred in providing services to other Reserve Banks. Major services provided by the Bank on behalf of the System for which the costs were not reimbursed by the other Reserve Banks include Standard Cash Automation, Currency Technology Office, IT Transformation Initiatives, Enterprise-wide Security Projects, Enterprise Security Operations Coordination, the Payroll Central Business Administration Function, Daylight Overdraft Reporting and Pricing, and the National Procurement Office. Costs are, however, redistributed to the other Reserve Banks for computing and support services the Bank provides for the System. The Bank's total reimbursement for these services was $348 million and $335 million for the years ended December 31, 2014 and 2013, respectively, and is included in "Operating expenses: Other" on the Statements of Income and Comprehensive Income.

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. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), which is issued by the Board of Governors. The Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the FAM. The financial statements have been prepared in accordance with the FAM.

Limited differences exist between the accounting principles and practices in the FAM and accounting principles generally accepted in the United States of America (GAAP), due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank and given the System's unique responsibility to conduct monetary policy. The primary differences are the presentation of all SOMA securities holdings at amortized cost, adjusted for credit impairment, if any, the recording of all SOMA securities on a settlement-date basis, and the use of straight-line amortization for Treasury securities, GSE debt securities, and foreign currency denominated investments. Amortized cost, rather than the fair value presentation, more appropriately reflects the financial position associated with the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. Although the application of fair value measurements to the securities holdings may result in values substantially greater or less than their carrying values, these unrealized changes in value have no direct effect on the quantity of reserves available to the banking system or on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold before maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, fair values, earnings, and gains or losses resulting from the sale of such securities and currencies are incidental to open market operations and do not motivate decisions related to policy or open market activities. Accounting for these securities on a settlement-date basis, rather than the trade-date basis required by GAAP, better reflects the timing of the transaction's effect on the quantity of reserves in the banking system. The cost bases of Treasury securities, GSE debt securities, and foreign government debt instruments are adjusted for amortization of premiums or accretion of discounts on a straight-line basis, rather than using the interest method required by GAAP.

In addition, the Bank does not present a Statement of Cash Flows as required by GAAP because the liquidity and cash position of the Bank are not a primary concern given the Reserve Bank's unique powers and responsibilities as a central bank. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income and Comprehensive Income, and Changes in Capital, and the accompanying notes to the financial statements. Other than those described above, there are no significant differences between the policies outlined in the FAM and GAAP.

Preparing the financial statements in conformity with the FAM requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

In 2014, the description of certain line items presented in the Statements of Condition and the Statements of Income and Comprehensive Income have been revised to better reflect the nature of these items. Amounts related to these line items were not changed from the prior year, only the nomenclature for the line item was revised, as further noted below:

- The line item "System Open Market Account: Other investments" has been revised in the Statements of Condition to "System Open Market Account: Other assets."
- The line item "System Open Market Account: Foreign currency denominated assets, net" has been revised in the Statements of Income and Comprehensive Income to "System Open Market Account: Foreign currency denominated investments, net."

Certain amounts relating to the prior year have been reclassified in the Statements of Income and Comprehensive Income to conform to the current year presentation. $1 million previously reported for the year ended December 31, 2013, as "Non-interest loss: Other" has been reclassified into a new line titled "Non-interest loss: System Open Market Account: Other."

Significant accounts and accounting policies are explained below.

a. Consolidation

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the System that has supervisory authority over some institutions previously supervised by the Reserve Banks in connection with those institutions' compliance with consumer protection statutes. Section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board of Governors or the System. The Board of Governors funds the Bureau through assessments on the Reserve Banks as required by the Dodd-Frank Act. The Reserve Banks reviewed the law and evaluated the design of and their relationship to the Bureau and determined that it should not be consolidated in the Bank's financial statements.

b. Gold and Special Drawing Rights Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks. Upon authorization, the Reserve Banks acquire gold certificates by crediting equivalent amounts in dollars to the account established for the Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold owned by the Treasury. The Treasury may reacquire the gold certificates at any time, and the Reserve Banks must deliver them to the Treasury. At such time, the Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 per fine troy ounce. Gold certificates are recorded by the Banks at original cost. The Board of Governors allocates the gold certificates among the Reserve Banks once a year based on each Reserve Bank's average Federal Reserve notes outstanding during the preceding 12 months.

Special drawing rights (SDR) are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the Treasury, for the purpose of financing SDR acquisitions or for financing exchange-stabilization operations. At the time SDR certificate transactions occur, the Board of Governors allocates the SDR certificates among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding calendar year. SDR certificates are recorded by the Banks at original cost. There were no SDR certificate transactions during the years ended December 31, 2014 and 2013.

c. Coin

The amount reported as coin in the Statements of Condition represents the face value of all United States coin held by the Bank. The Bank buys coin at face value from the U.S. Mint in order to fill depository institution orders.

d. Loans

Loans to depository institutions are reported at their outstanding principal balances and interest income is recognized on an accrual basis.

Loans are impaired when current information and events indicate that it is probable that the Bank will not receive the principal and interest that are due in accordance with the contractual terms of the loan agreement. Impaired loans are evaluated to determine whether an allowance for loan loss is required. The Bank has developed procedures for assessing the adequacy of any allowance for loan losses using all available information to identify incurred losses. This assessment includes monitoring information obtained from banking supervisors, borrowers, and other sources to assess the credit condition of the borrowers and, as appropriate, evaluating collateral values. Generally, the Bank would discontinue recognizing interest income on impaired loans until the borrower's repayment performance demonstrates principal and interest would be received in accordance with the terms of the loan agreement. If the Bank discontinues recording interest on an impaired loan, cash payments are first applied to principal until the loan balance is reduced to zero; subsequent payments are applied as recoveries of amounts previously deemed uncollectible, if any, and then as interest income.

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

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are typically settled through a tri-party arrangement. In a tri-party arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the FRBNY and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the FRBNY for each class and maturity of acceptable collateral. Collateral designated by the FRBNY as acceptable under repurchase transactions primarily includes Treasury securities (including Treasury Inflation-Protected Securities, Separate Trading of Registered Interest and Principal of Securities Treasury securities, and Treasury Floating Rate Notes (FRN)); direct obligations of several federal and GSE-related agencies, including Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal Home Loan Banks; and pass-through federal agency and GSE MBS. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities purchased under agreements to resell" and the related accrued interest receivable is reported as a component of "System Open Market Account: Accrued interest receivable" in the Statements of Condition.

The FRBNY may engage in sales of securities under agreements to repurchase with primary dealers and with a set of expanded counterparties, which includes banks, savings associations, GSEs, and domestic money market funds (overnight and term reverse repurchase agreements). These reverse repurchase transactions, are settled through a tri-party arrangement, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international account holders as part of a service offering. Reverse repurchase agreements are collateralized by a pledge of an amount of Treasury securities, GSE debt securities, or federal agency and GSE MBS that are held in the SOMA. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest expense is recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities sold under agreements to repurchase" and the related accrued interest payable is reported as a component of "System Open Market Account: Other liabilities" in the Statements of Condition.

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers, typically overnight, to facilitate the effective functioning of the domestic securities markets. The amortized cost basis of securities lent continues to be reported as "System Open Market Account: Treasury securities, net" and "System Open Market Account: Government-sponsored enterprise debt securities, net," as appropriate, in the Statements of Condition. Securities lending transactions are fully collateralized by Treasury securities based on the fair values of the securities lent increased by a margin determined by the FRBNY. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Non-interest loss: System Open Market Account: Other" in the Statements of Income and Comprehensive Income.

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

f. Treasury Securities, Government-Sponsored Enterprise Debt Securities, Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities, Foreign Currency Denominated Investments, and Warehousing Agreements

Interest income on Treasury securities, GSE debt securities, and foreign currency denominated investments included in the SOMA is accrued using the straight-line method. Interest income on federal agency and GSE MBS is accrued using the interest method and includes amortization of premiums, accretion of discounts, and gains or losses associated with principal paydowns. Premiums and discounts related to federal agency and GSE MBS are amortized or accreted over the term of the security to stated maturity, and the amortization of premiums and accretion of discounts are accelerated when principal payments are received. Gains and losses resulting from sales of securities are determined by specific issue based on average cost. Treasury securities, GSE debt securities, and federal agency and GSE MBS are reported net of premiums and discounts in the Statements of Condition and interest income on those securities is reported net of the amortization of premiums and accretion of discounts in the Statements of Income and Comprehensive Income.

In addition to outright purchases of federal agency and GSE MBS that are held in the SOMA, the FRBNY enters into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell "to be announced"

(TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. During the years ended December 31, 2014 and 2013, the FRBNY executed dollar rolls to facilitate settlement of outstanding purchases of federal agency and GSE MBS. The FRBNY accounts for dollar rolls as purchases or sales on a settlement-date basis. In addition, TBA MBS transactions may be paired off or assigned prior to settlement. Net gains resulting from these MBS transactions are reported as "Non-interest loss: System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

Foreign currency denominated investments, which can include foreign currency deposits, securities purchased under agreements to resell, and government debt instruments, are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Foreign currency translation gains and losses that result from the daily revaluation of foreign currency denominated investments are reported as "Non-interest loss: System Open Market Account: Foreign currency translation losses, net" in the Statements of Income and Comprehensive Income.

Because the FRBNY enters into commitments to buy Treasury securities, federal agency and GSE MBS, and foreign government debt instruments and records the related securities on a settlement-date basis in accordance with the FAM, the related outstanding commitments are not reflected in the Statements of Condition.

Activity related to Treasury securities, GSE debt securities, and federal agency and GSE MBS, including the premiums, discounts, and realized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in the second quarter of each year. Activity related to foreign currency denominated investments, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to the Reserve Banks' aggregate capital and surplus at the preceding December 31.

Warehousing is an arrangement under which the FOMC has approved the exchange, at the request of the Treasury, of U.S. dollars for foreign currencies held by the Treasury over a limited period. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury for financing purchases of foreign currencies and related international operations. Warehousing agreements are valued daily at current market exchange rates. Activity related to these agreements is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to the Reserve Banks' aggregate capital and surplus at the preceding December 31.

g. Central Bank Liquidity Swaps

Central bank liquidity swaps, which are transacted between the FRBNY and a foreign central bank, can be structured as either U.S. dollar or foreign currency liquidity swap arrangements.

Central bank liquidity swaps activity, including the related income and expense, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to the Reserve Banks' aggregate capital and surplus at the preceding December 31. The foreign currency amounts associated with these central bank liquidity swap arrangements are revalued daily at current foreign currency market exchange rates.

U.S. dollar liquidity swaps

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

The foreign central bank compensates the FRBNY based on the amount outstanding and the rate under the swap agreement. The Bank's allocated portion of the amount of compensation received during the term of the swap transaction is reported as "Interest income: System Open Market Account: Central bank liquidity swaps" in the Statements of Income and Comprehensive Income.

Foreign currency liquidity swaps

The structure of foreign currency liquidity swap transactions involves the transfer by the FRBNY, at the prevailing market exchange rate, of a specified amount of U.S. dollars to an account for the foreign central bank in exchange for its currency. The foreign currency amounts that the FRBNY receives are recorded as a liability.

h. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 2 to 50 years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

Costs incurred to acquire software are capitalized based on the purchase price. Costs incurred during the application development stage to develop internal-use software are capitalized based on the cost of direct services and materials associated with designing, coding, installing, and testing the software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which generally range from two to five years. Maintenance costs and minor replacements related to software are charged to operating expense in the year incurred.

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

i. Interdistrict Settlement Account

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

An annual settlement of the interdistrict settlement account occurs in the second quarter of each year. As a result of the annual settlement, the balance in each Bank's interdistrict settlement account is adjusted by an amount equal to the average balance in the account during the previous 12-month period ended March 31. An equal and offsetting adjustment is made to each Bank's allocated portion of SOMA assets and liabilities.

j. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes, which are identified as issued to a specific Reserve Bank, must be fully collateralized. All of the Bank's assets are eligible to be pledged as collateral. The collateral value is equal to the book value of the collateral tendered with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities sold under agreements to repurchase is deducted from the eligible collateral value.

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $11,153 million and $8,774 million at December 31, 2014 and 2013, respectively.

At December 31, 2014 and 2013, all Federal Reserve notes outstanding, reduced by the Reserve Bank's currency holdings, were fully collateralized. At December 31, 2014, all gold certificates, all special drawing rights certificates, and $1,282 billion of domestic securities held in the SOMA were pledged as collateral. At December 31, 2014, no investments denominated in foreign currencies were pledged as collateral.

k. Deposits

Depository Institutions

Depository institutions' deposits represent the reserve and service-related balances in the accounts that depository institutions hold at the Bank. The interest rates paid on required reserve balances and excess balances are determined by the Board of Governors, based on an FOMC-established target range for the federal funds rate. Interest payable is reported as a component of "Interest payable to depository institutions" in the Statements of Condition.

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as a component of "Interest payable to depository institutions" in the Statements of Condition. There were no deposits held by the Bank under the TDF at December 31, 2014 and 2013.

Other

Other deposits include the Bank's allocated portion of foreign central bank and foreign government deposits held at the FRBNY.

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

By law, each Reserve Bank is required to pay each member bank an annual dividend of six percent on the paid-in capital stock. This cumulative dividend is paid semiannually.

m. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in. On a daily basis, surplus is adjusted to equate the balance to capital paid-in. Accumulated other comprehensive income is reported as a component of "Surplus" in the Statements of Condition and the Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9 and 10.

n. Remittances to the Treasury

The Board of Governors requires the Reserve Banks to transfer excess earnings to the Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. Currently, remittances to the Treasury are made on a weekly basis. This amount is reported as "Earnings remittances to the Treasury" in the Statements of Income and Comprehensive Income. The amount due to the Treasury is reported as "Accrued remittances to the Treasury" in the Statements of Condition. See Note 12 for additional information on earnings remittances to the Treasury.

If earnings during the year are not sufficient to provide for the costs of operations, payment of dividends, and equating surplus and capital paid-in, remittances to the Treasury are suspended. A deferred asset is recorded that represents the amount of net earnings a Reserve Bank will need to realize before remittances to the Treasury resume. This deferred asset is periodically reviewed for impairment.

o. Income and Costs Related to Treasury Services

When directed by the Secretary of the Treasury, the Bank is required by the Federal Reserve Act to serve as fiscal agent and depositary of the United States Government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2014 and 2013, the Bank was reimbursed for all services provided to the Treasury as its fiscal agent.

p. Compensation Received for Service Costs Provided

The Federal Reserve Bank of Atlanta has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions, the FRBNY has overall responsibility for managing the Reserve Banks' provision of Fedwire funds and securities services, and the Federal Reserve Bank of Chicago has overall responsibility for managing the Reserve Banks' provision of electronic access services to depository institutions. The Reserve Bank that has overall responsibility for managing these services recognizes the related total System revenue in its Statements of Income and Comprehensive Income. The Bank is compensated for costs incurred to provide these services by the Reserve Banks responsible for managing these services and reports this compensation as "Non-interest loss: Compensation received for service costs provided" in its Statements of Income and Comprehensive Income.

q. Assessments

The Board of Governors assesses the Reserve Banks to fund its operations and the operations of the Bureau. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances. The Board of Governors also assesses each Reserve Bank for expenses related to producing, issuing, and retiring Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the prior year.

The Dodd-Frank Act requires that, after the transfer of its responsibilities to the Bureau on July 21, 2011, the Board of Governors fund the Bureau in an amount not to exceed a fixed percentage of the total operating expenses of the System as reported in the Board of Governors' 2009 annual report, which totaled $4.98 billion. After 2013, the amount will be adjusted annually in accordance with the provisions of the Dodd-Frank Act. The percentage of total operating expenses of the System for the years ended December 31, 2014 and 2013, was 12.22 percent ($608.4 million) and 12 percent ($597.6 million), respectively. The Bank's assessment for Bureau funding is reported as "Assessments: Bureau of Consumer Financial Protection" in the Statements of Income and Comprehensive Income.

r. 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 and $3 million for the years ended December 31, 2014 and 2013, respectively, and are reported as a component of "Operating expenses: Occupancy" in the Statements of Income and Comprehensive Income.

s. Restructuring Charges

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

In 2014, the Treasury announced plans to consolidate the provision of substantially all fiscal agent services for the U.S. Treasury at the Federal Reserve Bank of Cleveland, the Federal Reserve Bank of Kansas City, the FRBNY, and the Federal Reserve Bank of St. Louis. The implementation plan associated with this consolidation is expected to be completed in 2018.

Note 11 describes the Bank's restructuring initiatives and provides information about the costs and liabilities associated with employee separations. 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.

The Bank had no significant restructuring activities in 2013.

t. Recently Issued Accounting Standards

In April 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-08, *Presentation of Financial Statements* (Topic 205) *and Property, Plant, and Equipment* (Topic 360): *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*. This update changes the requirements for reporting discontinued operations, which may include a component of an entity or a group of components of an entity, or a business or nonprofit activity. This update is effective for the Bank for the year ending December 31, 2015, and is not expected to have a material effect on the Bank's financial statements.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606). This update was issued to create common revenue recognition guidance for U.S. GAAP and International Financial Reporting Standards. The guidance is applicable to all contracts for the transfer of goods or services regardless of industry or type of transaction. This update requires recognition of revenue in a manner that reflects the consideration that the entity expects to receive in return for the transfer of goods or services to customers. This update is effective for the Bank for the year ending December 31, 2018, and is not expected to have a material effect on the Bank's financial statements.

In June 2014, the FASB issued ASU 2014-11, *Transfer and Servicing* (Topic 860): *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. This update requires changes in the accounting for repurchase to maturity transactions and repurchase financing transactions. Additionally, this update provides guidance for the disclosures for certain transfers of financial assets accounted for as sales, where the transferor retains substantially all of the exposure to economic return on the transferred financial asset; and repurchase agreements, securities lending transactions, and repurchase to maturity transactions that are accounted for as secured borrowings. This update is effective for the Bank for the year ending December 31, 2015, and is not expected to have a material effect on the Bank's financial statements.

4 Loans

Loans to Depository Institutions

The Bank offers primary, secondary, and seasonal loans to eligible borrowers, and each program has its own interest rate. Interest is accrued using the applicable interest rate established at least every 14 days by the Bank's board of directors, subject to review and determination by the Board of Governors. Primary and secondary loans are extended on a short-term basis, typically overnight, whereas seasonal loans may be extended for a period of up to nine months.

Primary, secondary, and seasonal loans are collateralized to the satisfaction of the Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans; Treasury securities; GSE debt securities; foreign sovereign debt; municipal, corporate, and state and local government obligations; asset-backed securities; corporate bonds; commercial paper; and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value that is deemed appropriate by the Bank, which is typically fair value reduced by a margin. Loans to depository institutions are monitored daily to ensure that borrowers continue to meet eligibility requirements for these programs. If a borrower no longer qualifies for these programs, the Bank will generally request full repayment of the outstanding loan or, for primary or seasonal loans, may convert the loan to a secondary credit loan. Collateral levels are reviewed daily against outstanding obligations, and borrowers that no longer have sufficient collateral to support outstanding loans are required to provide additional collateral or to make partial or full repayment.

Loans to depository institutions were $1 million for each of the years ended December 31, 2014 and 2013, with a remaining maturity within 15 days.

At December 31, 2014 and 2013, the Bank did not have any loans that were impaired, restructured, past due, or on non-accrual status, and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2014 and 2013.

5 System Open Market Account

a. Domestic Securities Holdings

The FRBNY conducts domestic open market operations and, on behalf of the Reserve Banks, holds the resulting securities in the SOMA.

During the years ended December 31, 2014 and 2013, the FRBNY continued the purchase of Treasury securities and federal agency and GSE MBS under the large-scale asset purchase programs authorized by the FOMC. In September 2011, the FOMC announced that the Federal Reserve would reinvest principal payments from the SOMA portfolio holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS. In June 2012, the FOMC announced that it would continue this reinvestment policy. In September 2012, the FOMC announced that the Federal Reserve would purchase additional federal agency and GSE MBS at a pace of $40 billion per month. In December 2012, the FOMC announced that the Federal Reserve would also purchase longer-term Treasury securities initially at a pace of $45 billion per month after its program to extend the average maturity of its holdings of Treasury securities was completed in 2012. In December 2013, the FOMC announced that it would slow the pace of its additional asset purchases. In October 2014, the FOMC concluded its asset purchase program while maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction.

The Bank's allocated share of activity related to domestic open market operations was 5.589 percent and 6.218 percent at December 31, 2014 and 2013, respectively.

The Bank's allocated share of Treasury securities, GSE debt securities, and federal agency and GSE MBS, net, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

	2014			
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost
Notes	$ 91,378	$ 1,547	$ (431)	$ 92,494
Bonds	46,189	6,965	(542)	52,612
Total Treasury securities	**$ 137,567**	**$ 8,512**	**$ (973)**	**$ 145,106**
GSE debt securities	**$ 2,162**	**$ 73**	**$ —**	**$ 2,235**
Federal agency and GSE MBS	**$ 97,073**	**$ 2,975**	**$ (55)**	**$ 99,993**

	2013			
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost
Notes	$ 91,246	$ 2,076	$ (354)	$ 92,968
Bonds	46,098	7,993	(347)	53,744
Total Treasury securities	**$ 137,344**	**$ 10,069**	**$ (701)**	**$ 146,712**
GSE debt securities	**$ 3,558**	**$ 118**	**$ —**	**$ 3,676**
Federal agency and GSE MBS	**$ 92,659**	**$ 2,785**	**$ (67)**	**$ 95,377**

The FRBNY enters into transactions for the purchase of securities under agreements to resell and transactions to sell securities under agreements to repurchase as part of its monetary policy activities. These operations are for the purpose of further assessing the appropriate structure of such operations in supporting the implementation of monetary policy during normalization. In addition, transactions to sell securities under agreements to repurchase are entered into as part of a service offering to foreign official and international account holders.

There were no material transactions related to securities purchased under agreements to resell during the years ended December 31, 2014 and 2013. Financial information related to securities sold under agreements to repurchase for the years ended December 31 was as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2014	2013	2014	2013
Overnight and term reverse repurchase agreements:				
Contract amount outstanding, end of year	$ 22,172	$ 12,297	$ 396,705	$ 197,755
Average daily amount outstanding, during the year	7,428	259	130,281	4,161
Maximum balance outstanding, during the year	22,172	12,297	396,705	197,755
Securities pledged (par value), end of year	20,413	11,692	365,235	188,028
Securities pledged (market value), end of year	22,275	12,233	398,540	196,726
Foreign official and international accounts:				
Contract amount outstanding, end of year	$ 6,323	$ 7,348	$ 113,132	$ 118,169
Average daily amount outstanding, during the year	5,925	6,180	102,968	95,520
Maximum balance outstanding, during the year	7,348	7,629	122,232	118,169
Securities pledged (par value), end of year	6,056	7,612	108,355	122,424
Securities pledged (market value), end of year	6,323	7,348	113,132	118,175
Total contract amount outstanding, end of year	**$ 28,495**	**$ 19,645**	**$ 509,837**	**$ 315,924**

Securities pledged as collateral, at December 31, 2014 and 2013, consisted solely of Treasury securities.

The remaining maturity distribution of Treasury securities, GSE debt securities, federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2014 and 2013, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Over 5 years to 10 years	Over 10 years	Total
December 31, 2014:							
Treasury securities (par value)	$ —	$ —	$ 197	$ 62,202	$ 38,376	$ 36,792	$ 137,567
GSE debt securities (par value)	61	40	220	1,710	—	131	2,162
Federal agency and GSE MBS (par value)[1]	—	—	—	1	361	96,711	97,073
Securities sold under agreements to repurchase (contract amount)	28,495	—	—	—	—	—	28,495
December 31, 2013:							
Treasury securities (par value)	$ —	$ 19	$ 11	$ 47,464	$ 53,768	$ 36,082	$ 137,344
GSE debt securities (par value)	144	470	539	2,255	4	146	3,558
Federal agency and GSE MBS (par value)[1]	—	—	—	—	158	92,501	92,659
Securities sold under agreements to repurchase (contract amount)	19,645	—	—	—	—	—	19,645

[1] The par amount shown for federal agency and GSE MBS is the remaining principal balance of the securities.

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities, which differs from the stated maturity primarily because it factors in scheduled payments and prepayment assumptions, was approximately 5.7 and 6.5 years as of December 31, 2014 and 2013, respectively.

The amortized cost and par value of Treasury securities and GSE debt securities that were loaned from the SOMA under securities lending agreements, at December 31 were as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2014	2013	2014	2013
Treasury securities (amortized cost)	$ 623	$ 1,067	$ 11,144	$ 17,153
Treasury securities (par value)	565	961	10,105	15,447
GSE debt securities (amortized cost)	35	68	633	1,099
GSE debt securities (par value)	34	66	616	1,055

The FRBNY enters into commitments to buy and sell Treasury securities and records the related securities on a settlement-date basis. As of December 31, 2014, there were no outstanding commitments.

The FRBNY enters into commitments to buy and sell federal agency and GSE MBS and records the related securities on a settlement-date basis. As of December 31, 2014, the total purchase price of the federal agency and GSE MBS under outstanding purchase commitments was $28,692 million, none of which was related to dollar rolls. The total purchase price of outstanding purchase commitments allocated to the Bank was $1,604 million, none of which was related to dollar rolls. As of December 31, 2014, there were no outstanding sales commitments for federal agency and GSE MBS. These commitments, which had contractual settlement dates extending through January 2015, are principally for the purchase of TBA MBS for which the number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. These commitments are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY requires the posting of cash collateral for MBS commitments as part of its risk management practices used to mitigate the counterparty credit risk.

Other assets consists primarily of cash and short-term investments related to the federal agency and GSE MBS portfolio. Other liabilities, which are primarily related to federal agency and GSE MBS purchases and sales, includes the FRBNY's obligation to return cash margin posted by counterparties as collateral under commitments to purchase and sell federal agency and GSE MBS. In addition, other liabilities includes obligations that arise from the failure of a seller to deliver MBS to the FRBNY on the settlement date. Although the FRBNY has ownership of and records its investments in the MBS as of the contractual settlement date, it is not obligated to make payment until the securities are delivered, and the amount included in other liabilities represents the FRBNY's obligation to pay for the securities when delivered. The amount of other assets and other liabilities allocated to the Bank and held in the SOMA at December 31 was as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2014	2013	2014	2013
Other assets:				
MBS portfolio related cash and short-term investments	$ 2	$ —	$ 28	$ 1
Other	—	—	1	1
Total other assets	**$ 2**	**$ —**	**$ 29**	**$ 2**
Other liabilities:				
Cash margin	$ 44	$ 82	$ 793	$ 1,320
Obligations from MBS transaction fails	2	1	30	11
Other	—	—	7	—
Total other liabilities	**$ 46**	**$ 83**	**$ 830**	**$ 1,331**

Accrued interest receivable on domestic securities holdings was $25,561 million and $23,405 million as of December 31, 2014 and 2013, respectively, of which $1,429 million and $1,455 million, respectively, was allocated to the Bank. These amounts are reported as a component of "System Open Market Account: Accrued interest receivable" in the Statements of Condition.

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the years ended December 31, 2014 and 2013, is summarized as follows (in millions):

	Allocated to the Bank				
	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance at December 31, 2012	$ 81,294	$ 47,468	$ 128,762	$ 5,657	$ 67,636
Purchases[1]	23,249	13,396	36,645	—	56,417
Sales[1]	—	—	—	—	—
Realized gains, net[2]	—	—	—	—	—
Principal payments and maturities	(1)	—	(1)	(1,259)	(17,839)
Amortization of premiums and accretion of discounts, net	(390)	(613)	(1,003)	(52)	(454)
Inflation adjustment on inflation-indexed securities	18	40	58	—	—
Annual reallocation adjustment[3]	(11,202)	(6,547)	(17,749)	(670)	(10,383)
Balance at December 31, 2013	$ 92,968	$ 53,744	$ 146,712	$ 3,676	$ 95,377
Purchases[1]	9,712	5,030	14,742	—	27,038
Sales[1]	—	—	—	—	(2)
Realized gains, net[2]	—	—	—	—	—
Principal payments and maturities	(28)	—	(28)	(1,098)	(11,630)
Amortization of premiums and accretion of discounts, net	(319)	(583)	(902)	(34)	(411)
Inflation adjustment on inflation-indexed securities	28	75	103	—	—
Annual reallocation adjustment[3]	(9,867)	(5,654)	(15,521)	(309)	(10,379)
Balance at December 31, 2014	$ 92,494	$ 52,612	$ 145,106	$ 2,235	$ 99,993
Year-ended December 31, 2013					
Supplemental information—par value of transactions:					
Purchases[4]	$ 23,080	$ 11,969	$ 35,049	$ —	$ 54,627
Sales	—	—	—	—	—
Year-ended December 31, 2014					
Supplemental information—par value of transactions:					
Purchases[4]	$ 9,847	$ 4,920	$ 14,767	$ —	$ 26,129
Sales	—	—	—	—	(2)

[1] Purchases and sales may include payments and receipts related to principal, premiums, discounts, and inflation compensation adjustments to the basis of inflation-indexed securities. The amount reported as sales includes the realized gains and losses on such transactions. Purchases and sales exclude MBS TBA transactions that are settled on a net basis.

[2] Realized gains, net offset the amount of realized gains and losses included in the reported sales amount.

[3] Reflects the annual adjustment to the Bank's allocated portion of the related SOMA securities that results from the annual settlement of the interdistrict settlement account, as discussed in Note 3i.

[4] Includes inflation compensation.

	Total SOMA				
	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance at December 31, 2012	$ 1,142,219	$ 666,969	$ 1,809,188	$ 79,479	$ 950,321
Purchases[1]	358,656	206,208	564,864	—	864,537
Sales[1]	—	—	—	—	—
Realized gains, net[2]	—	—	—	—	—
Principal payments and maturities	(21)	—	(21)	(19,562)	(273,990)
Amortization of premiums and accretion of discounts, net	(6,024)	(9,503)	(15,527)	(795)	(7,008)
Inflation adjustment on inflation-indexed securities	285	645	930	—	—
Balance at December 31, 2013	$ 1,495,115	$ 864,319	$ 2,359,434	$ 59,122	$ 1,533,860
Purchases[1]	165,306	85,826	251,132	—	466,384
Sales[1]	—	—	—	—	(29)
Realized gains, net[2]	—	—	—	—	—
Principal payments and maturities	(475)	—	(475)	(18,544)	(203,933)
Amortization of premiums and accretion of discounts, net	(5,545)	(10,132)	(15,677)	(588)	(7,199)
Inflation adjustment on inflation-indexed securities	500	1,327	1,827	—	—
Balance at December 31, 2014	$ 1,654,901	$ 941,340	$ 2,596,241	$ 39,990	$ 1,789,083
Year-ended December 31, 2013					
Supplemental information—par value of transactions:					
Purchases[3]	$ 356,766	$ 184,956	$ 541,722	$ —	$ 837,490
Sales	—	—	—	—	—
Year-ended December 31, 2014					
Supplemental information—par value of transactions:					
Purchases[3]	$ 167,497	$ 83,739	$ 251,236	$ —	$ 450,633
Sales	—	—	—	—	(29)

[1] Purchases and sales may include payments and receipts related to principal, premiums, discounts, and inflation compensation adjustments to the basis of inflation-indexed securities. The amount reported as sales includes the realized gains and losses on such transactions. Purchases and sales exclude MBS TBA transactions that are settled on a net basis.

[2] Realized gains, net offset the amount of realized gains and losses included in the reported sales amount.

[3] Includes inflation compensation.

b. Foreign Currency Denominated Investments

The FRBNY conducts foreign currency operations and, on behalf of the Reserve Banks, holds the resulting foreign currency denominated investments in the SOMA.

The FRBNY holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments of Germany, France, and Japan. These foreign government debt instruments are backed by the full faith and credit of the issuing foreign governments. In addition, the FRBNY enters into transactions to purchase Euro-denominated government debt securities under agreements to resell for which the accepted collateral is the debt instruments issued by the governments of Belgium, France, Germany, Italy, the Netherlands, and Spain, which are backed by the full faith and credit of those issuing governments.

The Bank's allocated share of activity related to foreign currency operations was 20.853 percent and 21.001 percent at December 31, 2014 and 2013, respectively.

Information about foreign currency denominated investments valued at amortized cost and foreign currency market exchange rates at December 31 was as follows (in millions):

	Allocated to Bank		Total SOMA	
	2014	2013	2014	2013
Euro:				
Foreign currency deposits	$ 1,446	$ 1,581	$ 6,936	$ 7,530
Securities purchased under agreements to resell	—	535	—	2,549
German government debt instruments	520	503	2,494	2,396
French government debt instruments	769	504	3,687	2,397
Japanese yen:				
Foreign currency deposits	537	615	2,576	2,927
Japanese government debt instruments	1,086	1,244	5,207	5,925
Total	**$ 4,358**	**$ 4,982**	**$ 20,900**	**$ 23,724**

Accrued interest receivable on foreign currency denominated investments was $83 million and $88 million as of December 31, 2014 and 2013, respectively, of which $17 million and $18 million, respectively, was allocated to the Bank. These amounts are reported as a component of "System Open Market Account: Accrued interest receivable" in the Statements of Condition.

The remaining maturity distribution of foreign currency denominated investments that were allocated to the Bank at December 31, 2014 and 2013, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total
December 31, 2014:					
Euro	$ 758	$ 586	$ 343	$ 1,048	$ 2,735
Japanese yen	575	82	321	645	1,623
Total	**$ 1,333**	**$ 668**	**$ 664**	**$ 1,693**	**$ 4,358**
December 31, 2013:					
Euro	$ 1,478	$ 378	$ 454	$ 813	$ 3,123
Japanese yen	654	80	393	732	1,859
Total	**$ 2,132**	**$ 458**	**$ 847**	**$ 1,545**	**$ 4,982**

There were no foreign exchange contracts related to open market operations outstanding as of December 31, 2014.

The FRBNY enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2014, there were $137 million of outstanding commitments to purchase foreign government debt instruments, of which $29 million was allocated to the Bank. These securities settled on January 5, 2015, and replaced Euro-denominated government debt instruments held in the SOMA that matured on that date. During 2014, there were purchases and maturities of foreign government debt instruments of $5,494 million and $3,337 million, respectively, of which $1,147 million and $697 million, respectively, were allocated to the Bank. There were no sales of foreign government debt instruments in 2014.

In connection with its foreign currency activities, the FRBNY may enter into transactions that are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY controls these risks by obtaining credit approvals, establishing transaction limits, receiving collateral in some cases, and performing monitoring procedures.

At December 31, 2014 and 2013, there was no balance outstanding under the authorized warehousing facility.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2014 and 2013.

Foreign currency working balances held and foreign exchange contracts executed by the Bank to facilitate its international payments and currency transactions it made on behalf of foreign central banks and U.S. official institution customers were not material as of December 31, 2014 and 2013.

c. Central Bank Liquidity Swaps

U.S. Dollar Liquidity Swaps

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 20.853 percent and 21.001 percent at December 31, 2014 and 2013, respectively.

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2014 and 2013, was $1,528 million and $272 million, respectively, of which $319 million and $57 million, respectively, was allocated to the Bank.

The remaining maturity distribution of U.S. dollar liquidity swaps that were allocated to the Bank at December 31 was as follows (in millions):

	2014			2013		
	Within 15 days	16 days to 90 days	Total	Within 15 days	16 days to 90 days	Total
Euro	$ —	$ —	$ —	$ 24	$ 33	$ 57
Japanese yen	319	—	319	—	—	—
Total	**$ 319**	**$ —**	**$ 319**	**$ 24**	**$ 33**	**$ 57**

Foreign Currency Liquidity Swaps

At December 31, 2014 and 2013, there was no balance outstanding related to foreign currency liquidity swaps.

d. Fair Value of SOMA Assets and Liabilities

The fair value amounts below are presented solely for informational purposes. Although the fair value of SOMA security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. Because SOMA securities are recorded at amortized cost, cumulative unrealized gains (losses) are not recognized in the Statements of Condition and the changes in cumulative unrealized gains (losses) are not recognized in the Statements of Income and Comprehensive Income.

The fair value of the Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign government debt instruments in the SOMA's holdings is subject to market risk, arising from movements in market variables such as interest rates and credit risk. The fair value of federal agency and GSE MBS is also affected by the expected rate of prepayments of mortgage loans underlying the securities. The fair value of foreign government debt instruments is also affected by currency risk. Based on evaluations performed as of December 31, 2014, there are no credit impairments of SOMA securities holdings.

The following table presents the amortized cost, fair value, and cumulative unrealized gains (losses) on the Treasury securities, GSE debt securities, and federal agency and GSE MBS held in the SOMA at December 31 (in millions):

	Allocated to the Bank					
	2014			2013		
	Amortized cost	Fair value	Cumulative unrealized gains	Amortized cost	Fair value	Cumulative unrealized gains (losses)
Treasury securities:						
Notes	$ 92,494	$ 94,085	$ 1,591	$ 92,968	$ 93,209	$ 241
Bonds	52,612	58,848	6,236	53,744	52,377	(1,367)
Total Treasury securities	$ 145,106	$ 152,933	$ 7,827	$ 146,712	$ 145,586	$ (1,126)
GSE debt securities	2,235	2,375	140	3,676	3,870	194
Federal agency and GSE MBS	99,993	101,752	1,759	95,377	92,996	(2,381)
Total domestic SOMA portfolio securities holdings	**$ 247,334**	**$ 257,060**	**$ 9,726**	**$ 245,765**	**$ 242,452**	**$ (3,313)**
Memorandum—Commitments for:						
Purchases of Treasury securities	$ —	$ —	$ —	$ —	$ —	$ —
Purchases of Federal agency and GSE MBS	1,604	1,610	6	3,690	3,677	(13)
Sales of Federal agency and GSE MBS	—	—	—	—	—	—

	Total SOMA					
	2014			2013		
	Amortized cost	Fair value	Cumulative unrealized gains	Amortized cost	Fair value	Cumulative unrealized gains (losses)
Treasury securities:						
Notes	$ 1,654,901	$ 1,683,377	$ 28,476	$ 1,495,115	$ 1,499,000	$ 3,885
Bonds	941,340	1,052,916	111,576	864,319	842,336	(21,983)
Total Treasury securities	$ 2,596,241	$ 2,736,293	$ 140,052	$ 2,359,434	$ 2,341,336	$ (18,098)
GSE debt securities	39,990	42,499	2,509	59,122	62,236	3,114
Federal agency and GSE MBS	1,789,083	1,820,544	31,461	1,533,860	1,495,572	(38,288)
Total domestic SOMA portfolio securities holdings	**$ 4,425,314**	**$ 4,599,336**	**$ 174,022**	**$ 3,952,416**	**$ 3,899,144**	**$ (53,272)**
Memorandum—Commitments for:						
Purchases of Treasury securities	$ —	$ —	$ —	$ —	$ —	$ —
Purchases of Federal agency and GSE MBS	28,692	28,803	111	59,350	59,129	(221)
Sales of Federal agency and GSE MBS	—	—	—	—	—	—

The fair value of Treasury securities and GSE debt securities was determined using pricing services that provide market consensus prices based on indicative quotes from various market participants. The fair value of federal agency and GSE MBS was determined using a pricing service that utilizes a model-based approach that considers observable inputs for similar securities.

The cost basis of securities purchased under agreements to resell, securities sold under agreements to repurchase, and other investments held in the SOMA domestic portfolio approximate fair value.

At December 31, 2014 and 2013, the fair value of foreign currency denominated investments was $20,996 million and $23,802 million, respectively, of which $4,378 million and $4,999 million, respectively, was allocated to the Bank. The fair value of foreign government debt instruments was determined using pricing services that provide market consensus prices based on indicative quotes from various market participants. The fair value of foreign currency deposits and securities purchased under agreements to resell was determined by reference to market interest rates.

The following table provides additional information on the amortized cost and fair values of the federal agency and GSE MBS portfolio at December 31 (in millions):

	2014		2013	
Distribution of MBS holdings by coupon rate	Amortized cost	Fair value	Amortized cost	Fair value
Allocated to the Bank:				
2.0%	$ 715	$ 705	$ 882	$ 841
2.5%	6,406	6,342	7,700	7,366
3.0%	28,688	28,296	32,447	30,113
3.5%	26,900	27,352	21,744	21,039
4.0%	23,924	24,659	14,317	14,371
4.5%	8,712	9,381	11,555	12,155
5.0%	3,663	3,953	5,179	5,470
5.5%	851	918	1,337	1,413
6.0%	118	128	190	200
6.5%	16	18	26	28
Total	**$ 99,993**	**$ 101,752**	**$ 95,377**	**$ 92,996**
Total SOMA:				
2.0%	$ 12,788	$ 12,618	$ 14,191	$ 13,529
2.5%	114,609	113,468	123,832	118,458
3.0%	513,289	506,280	521,809	484,275
3.5%	481,305	489,390	349,689	338,357
4.0%	428,047	441,204	230,256	231,113
4.5%	155,867	167,844	185,825	195,481
5.0%	65,544	70,719	83,290	87,968
5.5%	15,232	16,414	21,496	22,718
6.0%	2,110	2,287	3,051	3,225
6.5%	292	320	421	448
Total	**$ 1,789,083**	**$ 1,820,544**	**$ 1,533,860**	**$ 1,495,572**

The following tables present the realized gains (losses) and the change in the cumulative unrealized gains (losses) related to SOMA domestic securities holdings during the years ended December 31, 2014 and 2013 (in millions):

Allocated to Bank				
	2014		2013	
	Realized gains[1]	Change in cumulative unrealized gains (losses)[2]	Realized gains[1]	Change in cumulative unrealized gains (losses)[2]
Treasury securities	$ —	$ 9,173	$ —	$ (11,342)
GSE debt securities	—	(34)	—	(154)
Federal agency and GSE MBS	5	4,056	3	(5,144)
Total	**$ 5**	**$ 13,195**	**$ 3**	**$ (16,640)**

Total SOMA				
	2014		2013	
	Realized gains[1]	Change in cumulative unrealized gains (losses)[2]	Realized gains[1]	Change in cumulative unrealized gains (losses)[2]
Treasury securities	$ —	$ 158,150	$ —	$ (183,225)
GSE debt securities	—	(605)	—	(2,411)
Federal agency and GSE MBS	81	69,749	51	(81,957)
Total	**$ 81**	**$ 227,294**	**$ 51**	**$ (267,593)**

[1] Realized gains are reported in "Non-interest loss: System Open Market Account" in the Statements of Income and Comprehensive Income.

[2] Because SOMA securities are recorded at amoritized cost, the change in the cumulative unrealized gains (losses) is not reported in the Statements of Income and Comprehensive Income.

The amount of change in cumulative unrealized gains (losses) position, net, related to foreign currency denominated investments was a gain of $18 million and a loss of $90 million for the years ended December 31, 2014 and 2013, respectively, of which $4 million and $19 million, respectively, were allocated to the Bank.

Accounting Standards Codification (ASC) Topic 820 (ASC 820) defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes a three-level fair value hierarchy that distinguishes between assumptions developed using market data obtained from independent sources (observable inputs) and the Bank's assumptions developed using the best information available in the circumstances (unobservable inputs). The three levels established by ASC 820 are described as follows:

- Level 1—Valuation is based on quoted prices for identical instruments traded in active markets.
- Level 2—Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3—Valuation is based on model-based techniques that use significant inputs and assumptions not observable in the market. These unobservable inputs and assumptions reflect the Bank's estimates of inputs and assumptions that market participants would use in pricing the assets and liabilities. Valuation techniques include the use of option pricing models, discounted cash flow models, and similar techniques.

Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign government debt instruments are classified as Level 2 within the ASC 820 hierarchy because the fair values are based on indicative quotes and other observable inputs obtained from independent pricing services. The fair value hierarchy level of SOMA financial assets is not necessarily an indication of the risk associated with those assets.

6 Bank Premises, Equipment, and Software

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

	2014	2013
Bank premises and equipment:		
Land and land improvements	$ 48	$ 48
Buildings	247	244
Building machinery and equipment	86	84
Construction in progress	2	2
Furniture and equipment	373	353
Subtotal	**756**	**731**
Accumulated depreciation	(407)	(378)
Bank premises and equipment, net	**$ 349**	**$ 353**
Depreciation expense, for the years ended December 31	**$ 53**	**$ 51**

Bank premises and equipment at December 31 included the following amounts for capitalized leases (in millions):

	2014	2013
Leased premises and equipment under capital leases	$ 26	$ 27
Accumulated depreciation	(20)	(18)
Leased premises and equipment under capital leases, net	**$ 6**	**$ 9**
Depreciation expense related to leased premises and equipment under capital leases, for the years ended December 31	**$ 6**	**$ 6**

The Bank leases space to outside tenants with remaining lease terms ranging from one to five years. Rental income from such leases was $1.2 million and $1.5 million for the years ended December 31, 2014 and 2013, respectively, and is reported as a component of "Non-interest loss: Other" in the Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2014, are as follows (in thousands):

2015	$ 876
2016	824
2017	455
2018	157
2019	46
Total	**$ 2,358**

The Bank had capitalized software assets, net of amortization, of $35 million for each of the years ended December 31, 2014 and 2013. Amortization expense was $17 million and $18 million for the years ended December 31, 2014 and 2013, respectively. Capitalized software assets are reported as a component of "Other assets" in the Statements of Condition and the related amortization is reported as a component of "Operating expenses: Other" in the Statements of Income and Comprehensive Income.

7 Commitments and Contingencies

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

At December 31, 2014, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms of approximately one year.

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 $380 thousand and $423 thousand for the years ended December 31, 2014 and 2013, respectively. Certain of the Bank's leases have options to renew.

At December 31, 2014, the Bank has no future minimum lease payments under noncancelable operating leases, net of sublease rentals.

At December 31, 2014, there were no material unrecorded unconditional purchase commitments or obligations in excess of one year.

Under the Insurance Agreement of the Reserve Banks, each of the Reserve Banks has agreed to bear, on a per-incident basis, a share of certain losses in excess of 1 percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2014 and 2013.

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 legal actions and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

8 Retirement and Thrift Plans

Retirement Plans

The Bank currently offers three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). Under the Dodd-Frank Act, newly hired Bureau employees are eligible to participate in the System Plan. In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (BEP) and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks (SERP).

The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its consolidated financial statements. During the years ended December 31, 2014 and 2013, certain costs associated with the System Plan were reimbursed by the Bureau.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2014 and 2013, and for the years then ended, were not material.

Thrift Plan

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Bank matches 100 percent of the first 6 percent of employee contributions from the date of hire and provides an automatic employer contribution of 1 percent of eligible pay. The Bank's Thrift Plan contributions totaled $17 million and $16 million for the years ended December 31, 2014 and 2013, respectively, and are reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

9 Postretirement Benefits Other Than Retirement Plans and Postemployment Benefits

Postretirement Benefits Other Than Retirement Plans

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

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

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

	2014	2013
Accumulated postretirement benefit obligation at January 1	$ 233.2	$ 265.2
Service cost benefits earned during the period	11.7	14.1
Interest cost on accumulated benefit obligation	11.7	10.1
Net actuarial loss (gain)	24.4	(47.3)
Contributions by plan participants	3.0	2.9
Benefits paid	(11.1)	(11.7)
Medicare Part D subsidies	0.7	0.7
Plan amendments	—	(0.8)
Accumulated postretirement benefit obligation at December 31	**$ 273.6**	**$ 233.2**

At December 31, 2014 and 2013, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 3.96 percent and 4.79 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. The System Plan discount rate assumption setting convention uses an unrounded rate.

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

	2014	2013
Fair value of plan assets at January 1	$ —	$ —
Contributions by the employer	7.4	8.1
Contributions by plan participants	3.0	2.9
Benefits paid	(11.1)	(11.7)
Medicare Part D subsidies	0.7	0.7
Fair value of plan assets at December 31	**$ —**	**$ —**
Unfunded obligation and accrued postretirement benefit cost	**$ 273.6**	**$ 233.2**
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	$ 5.7	$ 9.6
Net actuarial loss	(58.1)	(35.4)
Total accumulated other comprehensive loss	**$ (52.4)**	**$ (25.8)**

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

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

	2014	2013
Health-care cost trend rate assumed for next year	6.60%	7.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate trend rate	2019	2019

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, 2014 (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	$ 5.6	$ (4.3)
Effect on accumulated postretirement benefit obligation	46.6	(37.4)

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

	2014	2013
Service cost-benefits earned during the period	$ 11.7	$ 14.1
Interest cost on accumulated benefit obligation	11.7	10.1
Amortization of prior service cost	(4.0)	(4.2)
Amortization of net actuarial loss	1.9	7.7
Net periodic postretirement benefit expense	**$ 21.3**	**$ 27.7**

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2015 are shown below:

Prior service cost	$ (3.6)
Net actuarial loss	3.5
Total	**$ (0.1)**

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2014 and 2013, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 4.79 percent and 3.75 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive 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 are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit expense.

Federal Medicare Part D subsidy receipts were $725 thousand and $525 thousand in the years ended December 31, 2014 and 2013, respectively. Expected receipts in 2015, related to benefits paid in the years ended December 31, 2014 and 2013, are $344 thousand.

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

	Without subsidy	With subsidy
2015	$ 9.8	$ 9.1
2016	10.2	9.5
2017	10.9	10.1
2018	11.8	10.8
2019	12.7	11.6
2020–2024	77.2	70.3
Total	**$ 132.6**	**$ 121.4**

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical, dental, and vision insurance; survivor income; disability benefits; and self-insured workers' compensation expenses. The accrued postemployment benefit costs recognized by the Bank at December 31, 2014 and 2013, were $23 million and $22 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2014 and 2013 operating expenses were $5 million and $2 million, respectively, and are recorded as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

10 Accumulated Other Comprehensive Income And Other Comprehensive Income

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive loss as of December 31 (in millions):

	2014	2013
	Amount related to postretirement benefits other than retirement plans	Amount related to postretirement benefits other than retirement plans
Balance at January 1	$ (26)	$ (77)
Change in funded status of benefit plans:		
Amortization of prior service cost	(4)[1]	(4)[1]
Change in prior service costs related to benefit plans	(4)	(4)
Net actuarial (loss) gain arising during the year	(24)	47
Amortization of net actuarial loss	2[1]	8[1]
Change in actuarial losses related to benefit plans	(22)	55
Change in funded status of benefit plans—other comprehensive (loss) income	(26)	51
Balance at December 31	**$ (52)**	**$ (26)**

[1] Reclassification is reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

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

11 Business Restructuring Charges

In 2014, the Treasury announced a plan to consolidate the number of Reserve Banks providing fiscal agent services to the Treasury from ten to four. As a result of this initiative, the Automated Standard Application for Payments operations and the International Treasury Services operations performed by the Bank will be transitioned to the Federal Reserve Bank of Kansas City; the Intragovernmental Payments and Collections operations performed by the Bank will be transitioned to the Federal Reserve Bank of St. Louis; and the Direct Voucher Service operations performed by the Bank will be transitioned to the Federal Reserve Bank of Cleveland.

The Bank had no business restructuring charges in 2013.

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

	2014 restructuring plans
Information related to restructuring plans as of December 31, 2014:	
Total expected costs related to restructuring activity	$ 6.0
Estimated future costs related to restructuring activity	1.6
Expected completion date	July 2017
Reconciliation of liability balances:	
Balance at December 31, 2013	$ —
Employee separation costs	4.4
Payments	(0.1)
Balance at December 31, 2014	**$ 4.3**

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

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8.

12 Distribution of Comprehensive Income

In accordance with Board policy, Reserve Banks remit excess earnings, after providing for dividends and the amount necessary to equate surplus with capital paid-in, to the U.S. Treasury as earnings remittances to the Treasury. The following table presents the distribution of the Bank's comprehensive income in accordance with the Board's policy for the years ended December 31 (in millions):

	2014	2013
Dividends on capital stock	$ 355	$ 345
Transfer to (from) surplus—amount required to equate surplus with capital paid-in	821	(10)
Earnings remittances to the Treasury	3,974	4,496
Total distribution	**$ 5,150**	**$ 4,831**

13 Subsequent Events

There were no subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2014. Subsequent events were evaluated through March 11, 2015, which is the date that the financial statements were available to be issued.

ABBREVIATIONS

ACH	Automated clearinghouse
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BEP	Benefit Equalization Retirement Plan
Bureau	Bureau of Consumer Financial Protection
FAM	*Financial Accounting Manual for Federal Reserve Banks*
FASB	Financial Accounting Standards Board
FOMC	Federal Open Market Committee
FRBNY	Federal Reserve Bank of New York
FRN	Floating rate notes
GAAP	Accounting principles generally accepted in the United States of America
GSE	Government-sponsored enterprise
IMF	International Monetary Fund
MBS	Mortgage-backed securities
SDR	Special drawing rights
SERP	Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks
SOMA	System Open Market Account
TBA	To be announced
TDF	Term Deposit Facility

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Fifth Federal Reserve District Offices

RICHMOND

701 East Byrd Street
Richmond, Virginia 23219
(804) 697-8000

BALTIMORE

502 South Sharp Street
Baltimore, Maryland 21201
(410) 576-3300

CHARLOTTE

530 East Trade Street
Charlotte, North Carolina 28202
(704) 358-2100

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