

Federal Reserve Bank of Richmond • 2005 ANNUAL REPORT



**Borrowing by
U.S. Households**

Mission

As a regional Reserve Bank, we work within the Federal Reserve System to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payments systems. In doing so, we inspire trust and confidence in the U.S. financial system.

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We will excel at everything we do, and make unique and important contributions to the Federal Reserve System's mission.

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“ The **expansion of retail credit** has brought **distinct benefits** to American consumers. At a fundamental level, the **purpose of credit** is to allow people to choose a **spending pattern** that is **smoother over time** than their income stream.”

Jeffrey M. Lacker speaking at the North Carolina Bankers Association
109th Annual Convention • June 14, 2005



Jeffrey M. Lacker

The U.S. economy turned in a strong performance in 2005, with overall output and incomes expanding at a fairly brisk pace, while prices remained relatively stable. A major contributor to economic growth was consumer spending, despite a sluggish fourth quarter in which spending on high-dollar durable goods, in particular, fell sharply from the previous period. The American consumer, it seems clear, remains at the center of the current economic expansion.

But not everyone is convinced that this is a positive development. Some worry that households are getting in over their heads, spending freely with little thought about the future. A quick glance at some of the data seemingly confirms this belief. For instance, in 2004 the ratio of all consumer debt to disposable personal income was about 108 percent. That number has grown pretty steadily over the past

fifty years. It stood at 35 percent in 1952, grew to roughly 60 percent in the 1960s and 1970s, and then continued sharply upward from the 1980s to present.

Does this mean that households are in for a rude awakening down the road? To answer that question, we need to consider why the debt-to-income ratio has grown. First, let's consider the debt side of the equation. It has been driven, in large measure, by the growth in mortgage debt. Since most people do not buy homes with cash but finance them, growth in homeownership tends to increase mortgage debt. And, indeed, homeownership has been rising, from 55 percent in 1950 to 69 percent in 2005. Also, we would expect mortgage debt to increase if the prices of homes increased. That, too, has occurred, especially since the mid-1990s. Put the two together, and it's not surprising that household debt has been on the rise.

Let's turn to income. It has a major effect on people's willingness to borrow. In particular, a household's beliefs about income

growth will largely determine how much debt it is willing to incur. During periods of relatively stagnant real income

growth—such as the 1970s—the debt-to-income ratio remains pretty stable, as people tend to be cautious about taking on debt. During periods of relatively robust income growth—such as the mid-1990s to present—the debt-to-income ratio often rises, as people grow optimistic about their future ability to repay debt.

This describes the demand side for credit. At the same time, there have been major changes in the supply side. Technological improvements have made it easier for lenders to assess the creditworthiness of borrowers and to tailor loan terms accordingly. Most borrowers have been made better off by these changes. They have seen a reduction in the cost of borrowing or an increase in access to credit.

In addition, the credit market has become more competitive. New lenders have entered, driving down interest-rate spreads. Part of the increase

in competition can also be attributed to technological improvements. For instance, thirty years ago,

if a household wanted a mortgage loan, it almost certainly borrowed from a local institution. Now, consumers can search from a nationwide pool

of potential lenders. Increased competition has helped drive down average borrowing costs.

So when you look at the landscape as a whole, it's not surprising that demand for credit has increased as supply has become more accessible and affordable. Consumers, on average, can borrow more efficiently than in the past. We shouldn't dismiss concerns about the rising debt-to-income ratio, but we must understand the factors that have contributed to its growth. The actions of consumers appear much more rational than at first blush.

Credit market developments have been something that I and others at this Bank have been thinking about a lot recently. Last summer, I addressed both the North Carolina and Virginia Bankers Associations on the topic of "retail financial innovation." In those talks, I cautioned against steps to stifle

“When you look at the landscape as a whole, it's not surprising that **demand for credit** has **increased** as **supply** has become **more accessible and affordable**.”



the expansion of new financial products. Those products, like many others, can be abused—both by consumers and lenders. Consumers can take on more debt than they ought to, and lenders can prey on people who are not financially savvy. Indeed, given the complexity of today's financial instruments, even those who *are* financially savvy can have difficulty evaluating borrowing options. But for the great majority of people—across all income groups—innovation in the financial industry has brought significant benefits.

As the essay in this year's Annual Report stresses, the expansion in retail credit has allowed consumers to more easily smooth consumption over their lifetimes. People can borrow when they are young, pay down that debt and save during the peak earning years, and draw upon their savings in retirement. Such smoothing helps people to consume in a relatively consistent, predictable fashion throughout their lives, rather than enjoying a few fat years sandwiched between many lean ones. New financial instruments have also helped people who suffer one-time shocks to their income stream. For instance, those who become sick and are temporarily unable to work can more easily sustain that shock through borrowing than before, knowing that they will be able to repay the debt when they return to work.

Overall, I'm convinced that retail financial innovation has improved most people's lives. It's no panacea, to be sure. There are cases where new financial products are not particularly useful. For instance, many people suffering systematic shocks to their income, such as those employed in industries that are in decline and unlikely to rebound, will be unable to borrow to smooth their consumption in the pattern just described. And there are cases where households will make borrowing decisions that will have negative outcomes. But borrowing, by definition, is a forward-looking activity. As such, we should not judge credit market decisions based upon their results alone, good or bad. Rather, we should judge them from the perspective of the borrower. Does a particular financial instrument present a household with a distribution of outcomes that, on average, is better than in its absence? If so, that instrument serves an important social purpose. I think that an examination of the evidence will find that most new financial instruments meet that standard.

Jeffrey M. Lacker • President

BORROWING

BY U.S. HOUSEHOLDS



by John A. Weinberg • Senior Vice President and Director of Research

Wherever one turns these days, one seems to run into comments about the financial condition of the American household. Most of these comments refer to sources of increasing stress on the American consumer, from the historically low household savings rate to the historically high rates of bankruptcy and debt delinquency. On top of all this, demographic trends are raising the prospect of having to finance the coming retirement of the baby boom generation. These conditions have led some to question the ability of consumer spending to hold up under such growing financial stress. Credit markets and consumers' use of credit products take a central place in this picture. Stories in the popular business press have taken the view that consumer debt will represent a drag on consumption growth in 2006, as the burden of making payments on debt limits households' abilities to make other purchases.¹

Debt and credit are value-laden terms that evoke distinct images in people’s minds. Indeed, cultural historian Lendol Calder has noted the seemingly contradictory value judgments that run through American cultural attitudes about borrowing.² “Credit” is seen as a good thing, in that it allows the household financial flexibility in meeting its consumption needs. On the other hand, “debt” is typically viewed as bad, because it represents a lack of self-discipline and holds the household hostage to its past choices. And so we have what appears to be a paradox. The ability to borrow is both liberating and constraining—a path to both rising wealth and the poorhouse.

Another way to view this seeming paradox is to think of “credit” and “debt” from two different vantage points. “Credit” typically refers to the moment when a borrower has access to funds made available by a lender. From this vantage point, it is a tool to help households achieve their desired levels of consumption. “Debt,” on the other hand, is an after-the-fact concept, referring to the amount owed. We see this dichotomy in contemporary discussions of credit markets. The expansion of access to credit for households previously thought to be sharply constrained in their ability to borrow is a stated goal of public policy. On the other hand, the financial stress facing some heavily indebted households is seen by many as a problem requiring a public policy solution.

This essay explores the use of credit by U.S. households. The first section describes some facts concerning consumer borrowing and its growth in recent decades. The following sections present some of the economics of household borrowing, beginning with an explanation of the role of borrowing in helping a household to meet its consumption goals over time, and then using that perspective to interpret the facts. This perspective generally does not support the view that consumer debt causes future weakness in consumption growth at the macroeconomic level.

This essay’s initial focus is on averages and aggregates, examining trends in total borrowing by U.S. households and assessing those trends from the point of view of the typical or average household. While this perspective is appropriate for thinking about broad trends in credit markets, it can mask the fact that market changes can have different impacts on different people. Indeed, these differences are often important to the way people think about public policy toward credit markets. A look at more disaggregated data, in fact, reveals that much of the expansion of credit that has occurred in recent decades has come in the lower brackets of the income distribution. Accordingly, the essay will address the question of whether the economics of borrowing by lower-income individuals is significantly different from the general economics of credit. **(continued)**

■■■ TRENDS IN CONSUMER CREDIT

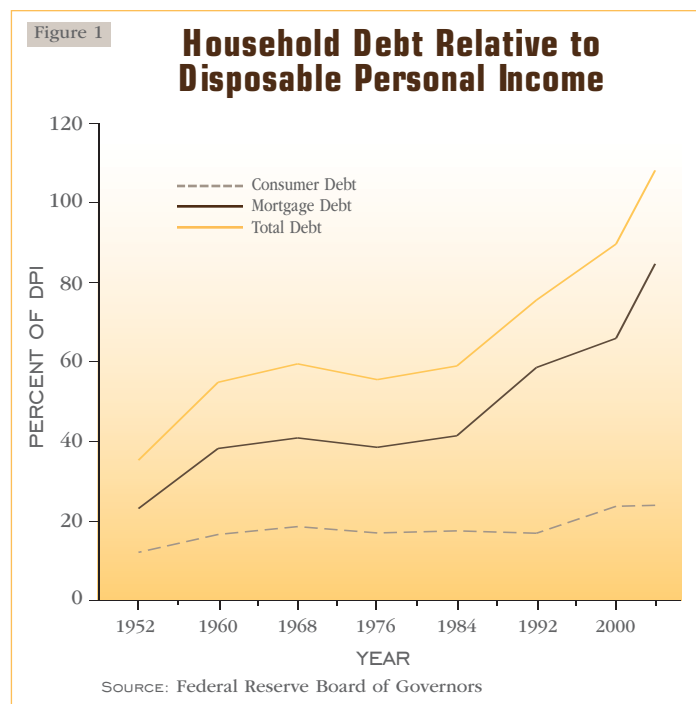
How indebted are U.S. consumers? In 2004, the ratio of all consumer debt to disposable personal income was about 108 percent. The bulk of this debt, 84 percent of income, was in the form of mortgage debt, with the remaining 24 percent in revolving and non-revolving consumer credit. Historically, the debt-to-income ratio has shown steady growth over much of the last half-century as is shown in Figure 1. Total debt to income stood at about 35 percent in 1952 and rose to around 50 percent by 1960. It then fluctuated between 55 and 60 percent for much of the 1960s and 1970s, before beginning a sustained increase in the mid-1980s. But by far the largest share of this growth has been in the mortgage portion of household credit, which was 23 percent of income in 1952. By contrast, nonmortgage consumer credit roughly doubled in this fifty-year period, going from 12 to 24 percent.

As is apparent, a very large part of the increase in household debt since the 1950s has been the rise of mortgage debt. To some extent, this rise in mortgage debt does not represent the typical homeowner borrowing more against the house that he or she owns. Rather, part of this increase is due to a steadily rising rate of homeownership, which went from 55 percent of U.S. households in 1950 to 69 percent in 2005. Another source of this increase is growth in the value of housing assets owned by consumers. Especially in the 1990s, the median value of privately owned homes grew faster than median income. Still, households have generally increased the share of their homeownership financed by mortgage debt.

Growth in the use of credit has been widespread among U.S. households. While borrowing by households in all income ranges has grown, this growth has been the most pronounced among households with medium and low levels of income. Also, while disparities in borrowing behavior continue to exist between minority and nonminority households, those disparities have tended to decline. This type of disaggregated information comes primarily from the Federal Reserve Board's Survey of Consumer Finances (SCF), which is conducted every three years. An analysis of trends for households in different ethnic and income groups was conducted

by Raphael Bostic.³ Trends for people at different income levels are discussed later in this essay.

Does rising debt to income mean that the typical household's debt burden has risen? The debt burden of a household is usually measured by the payments on its debts relative to its income. Given the wide variety of terms on retail credit—from fixed term, fixed interest rate mortgages to open-ended lines of credit with variable rates—specification of the “payments” used to determine the burden of servicing one's debts is not straightforward. But the two main determinants of a household's repayment obligation are the amount of debt and the interest rates charged. So, while a precise measurement of the payment burden would require detailed data on loan characteristics at a very disaggregated level, it is possible to construct a rough estimate from aggregate data. Dean Maki provides one such estimated time series of the aggregate debt burden of U.S. households.⁴ For the time period covered in that series, from 1980 to 2000, the payment burden fluctuates around an average level of about 13 percent. The debt-service burden tends to rise during expansions and fall during recessions. This pattern reflects two other facts. First, interest rates tend to rise in expansions and fall in recessions. But, perhaps more importantly, the growth rate of consumer credit is





also procyclical, with credit growing more rapidly in expansions, on average.

The burden households face in servicing their debts, together with the pattern of growth in those debts, focuses attention on the “credit is good, but debt is bad” dichotomy. Does the data on household debt suggest more that “credit” acts as a tool for managing consumption growth or that the burden of “debt” constrains consumption growth, as is suggested in the popular

media. Making this distinction empirically is difficult, since both these forces may be at work for any given household and the mix may vary considerably across households. Maki finds that his debt burden measure does not have strong predictive power for consumption growth, suggesting that, on average, debt is not a strong constraining force. In addition, growth in consumer credit tends to be positively correlated with future consumption growth. This relationship suggests that credit is an important tool for households in making their consumption choices. How households make those choices is the subject of the next section.



more long lasting, like a permanent decline in demand facing an industry in which a worker has accumulated a great deal of experience and skill.

Against these variations in income, a household uses financial services related to saving and borrowing to achieve the best lifetime pattern of consumption possible. What makes one pattern of consumption better than another? Well, for one thing, more is better than less, so a pattern that gives a household

more consumption of goods and services at every point in time is clearly better than one that gives less. But most comparisons of consumption patterns over one’s lifetime are not so straightforward. In particular, saving and borrowing decisions have to do with trading off consumption today for consumption in the future. So the important point to bear in mind is that household financial decisions are driven not so much by how people feel about having a bigger savings account or being more in debt as they are by how people feel about having more consumption today versus more consumption in the future.

■■■ HOW HOUSEHOLDS USE FINANCIAL INSTRUMENTS

It is important to view use of credit in the broader context of how a household chooses to consume and save or borrow over its lifetime. A household’s financial decisions are driven by the fact that its income varies over time. Broadly speaking, there are two types of variation in income. First, there is a typical, largely predictable, pattern by which an individual’s income first rises, say from young adulthood into middle age, then falls as the person or household moves into retirement. But there are also variations in income that are less predictable. Households face an array of shocks that affect their ability to participate and earn income in the labor market. Some of these shocks have only temporary effects, like an illness that keeps a worker out of the workforce but from which the worker fully recovers. Others can be

One principle for thinking about people’s preferences for consumption over time and how those preferences affect financial decisions is that people typically have a preference for *smooth* consumption—consumption that doesn’t vary too much over time. In other words, a household that gets a one-time windfall, like from winning a lottery for example, will probably not want to spend it all immediately on consumption of goods and services. Rather, the lucky household will want to save some of its temporarily higher income, so that it can spread the consumption benefits over a longer period of time. An important distinction here is between spending on durable versus nondurable goods. A lottery winner may in fact pour a large bulk of his or her winnings into the purchase of durable goods. But such expenditures bear a similarity to savings, because durable goods provide benefits to their

owner over an extended period of time, and the key thing about *consumption smoothing* is that the individual will want to use a temporary rise in income to generate consumption benefits that last over a long time period. This logic works on the other side as well, when a household faces a temporary income shortfall but expects to have higher income in the future. Such a household will want to keep its consumption up by drawing down savings or borrowing against those future increases in income.

The desire for smooth consumption over time can be explained by economists' usual assumption of diminishing marginal utility. This simply means that the less someone has consumed of a good or of goods and services in general, the more eager he or she is to increase consumption. So, if a household has a low income today but expects a higher income in the future, it faces the prospect of having less consumption today than in the future. According to diminishing marginal utility, the household would be eager to give up some of its consumption in the relatively abundant future for a little more in the present.

The same characteristic of people's preferences for consumption that makes them prefer smooth consumption over time also makes them dislike facing risk to their consumption opportunities. That is, diminishing marginal utility of consumption implies that people are *risk averse* and will be willing to take costly actions or purchase costly insurance to avoid risk.

So the usual assumptions about consumer preferences imply that households will typically desire a smooth consumption path even as their incomes vary over time. The two main sources of income variation are life-cycle effects and the effects of shocks to an individual's ability to earn income. To a large extent, the life-cycle pattern of income is predictable. Labor income rises from young adulthood to middle age, reaches a peak in the 45–54 age range, and then falls. Smoothing consumption over this pattern

of income would usually imply borrowing (or drawing down savings) when young, paying off debt and accumulating savings in the peak earning years, and using those savings for consumption in the later years.

Shocks to a household's income come in two forms. Some shocks are specific to an individual household. Prolonged illness

of a wage earner, for instance, can limit a household's earning ability. This sort of specific uncertainty in income is referred to as *idiosyncratic*. Other shocks affect larger groups of people. Swings in employment caused by decline of an industry or by the ups and downs of the business cycle affect the incomes of many households. That is, some income fluctuations are associated with aggregate risk. Financial markets are more effective at helping people smooth consumption against idiosyncratic shocks than against systematic or aggregate shocks. In fact, if financial markets worked perfectly, then people would be able to completely protect themselves against idiosyncratic shocks. Similarly, complete and well-functioning financial markets would allow people to smooth out their lifetime variation in income, since this is largely predictable. In this case, the only fluctuations in consumption would be those arising from aggregate income risk.

In perfect financial markets, in addition to cases where standard saving and borrowing instruments are used, households would have access to a wide array of contracts that would allow them to insure against any specific event that might cause a disruption to their incomes. But financial markets are not perfect, and there are limitations to households' abilities to smooth their consumption, even against idiosyncratic or life-cycle income fluctuations. Households and other market participants face an array of constraints on the types of financial contracts available for managing income risk. Some of these constraints have to do with information. Lenders typically cannot perfectly screen borrowers according to their likelihood or propensity to

“The key thing about **consumption smoothing** is that the individual will want to use a **temporary rise in income** to generate **consumption benefits** that last **over a long time period.**”



default. It is also difficult to monitor the behavior of borrowers once they have taken a loan. Other constraints have to do with the costs of enforcing contracts. Bankruptcy laws, for instance, limit the options available to a lender if a borrower defaults. These constraints have two kinds of effects. First, they limit the extent of specific insurance against income fluctuations that households can receive, making saving and borrowing the main means of consumption smoothing for many households. Second, the constraints tend to raise the costs of borrowing and place upper limits on the amount of debt any given household can accumulate. So while the bankruptcy option actually facilitates consumption smoothing for households that have fallen on hard enough times—by releasing them from some debt payment obligations—the more general effect of bankruptcy laws and other credit market constraints is to increase the cost of borrowing and to therefore limit opportunities to smooth consumption.

As Figure 1 clearly shows, the largest part of household debt is that used to finance housing. This specific use of credit is quite similar to the general use of credit for consumption smoothing purposes, since the purchase of a home—a very lumpy transaction—allows the household to consume a smooth stream of housing services. And while constraints associated with limited information and enforcement costs place limits on a household's unsecured borrowing capacity, such limitations are less stringent when borrowing is collateralized, as in the case of mortgage credit. Collateral reduces the risk of loss for the lender should a borrower become unable to repay a loan. Similarly, a portion of nonmortgage consumer credit is used to purchase cars and other durable goods. Much of this credit is tied directly to—that is, secured by—the items purchased. Still, the fastest growing part of nonmortgage credit, especially since the 1990s, has been unsecured borrowing.



THINKING ABOUT CHANGES IN CREDIT MARKETS—CAUSES

Figure 1 showed how consumers' use of credit has grown over time. This growth could be the result of a number of factors. One possibility is changes in the rate of income growth. Remember that in the most basic description of consumption behavior, a household will seek to perfectly smooth its consumption over time. This means that a household expecting a growing income will borrow against future income to even-out its consumption expenditures. The amount that a household will want to borrow will depend on how rapidly it expects its income to grow. So the total amount of borrowing done by households in an economy might be expected to depend on the anticipated growth in income. This logic—faster anticipated income growth makes people willing to take on more debt—carries over to the case where financial markets (and therefore consumption smoothing) are not perfect.

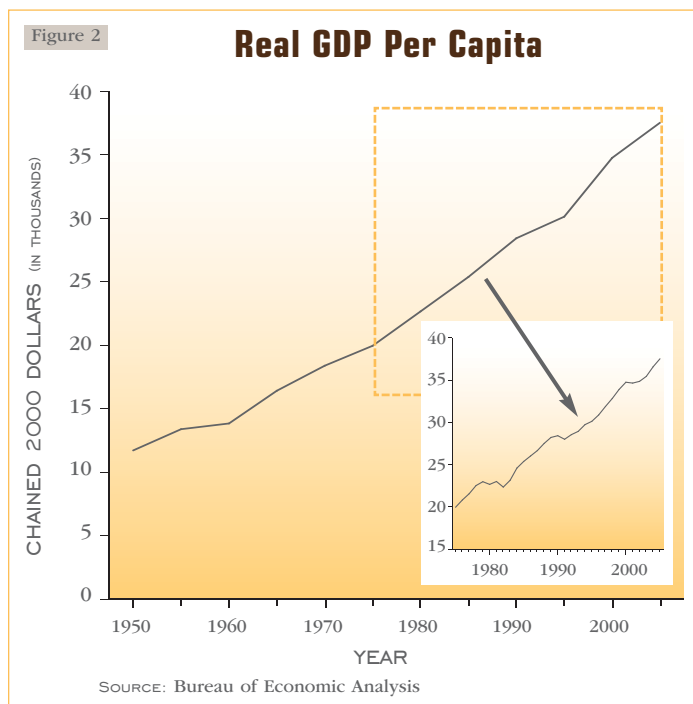
There have, in fact, been several swings in average income growth in the United States in the last fifty years. Figure 2, for instance, shows real GDP per capita. (See page 10.) Of particular note is an extended period of slow growth around 1980, with a pickup in growth beginning around 1984 and continuing to the present with two brief interruptions for the recessions of the early 1990s and the early 2000s. This latter period of faster income growth roughly coincides with the period of greatest growth in household debt-to-income ratios. And debt growth was basically flat during the extended period of stagnating income growth.

People's beliefs about their future income prospects are one determinant of the demand for credit. Demand could also be affected by the variability of income. Given the limitations to financial arrangements that result from information and enforcement constraints, saving and borrowing constitute the main tool used by households to

smooth consumption in the face of income risk. A household will feel well-prepared to deal with shocks to its income if it has a pool of savings to draw on or if it is confident that it will have ample access to credit. So, if a household faces an upper limit on how much credit it will receive from financial institutions, it will want to make sure it stays far enough away from that upper limit so that hitting the limit in the event of a reduction in income would be unlikely. If income risk increases—if income becomes more variable—the household will want to increase this cushion between its borrowings and its debt limit.

Evidence examined by Dirk Krueger and Fabrizio Perri suggests that income risk faced by households has increased since 1980, implying a rising possibility of running up against limits on debt capacity.⁵ This change could have been a force for lessening household demand for borrowing, perhaps partially offsetting the increase in demand that is likely to have come from faster income growth. On the other hand, Krueger and Perri argue that rising income risk could actually increase a household's borrowing capacity. Their argument follows from the assumption that, following default on a loan, a household's access to credit would be sharply reduced. Rising income risk makes losing access to credit more costly and therefore could make a borrower less likely to default. Knowing that a borrower is less likely to default makes a lender more willing to lend. So the effects of rising income risk on overall household borrowing are uncertain. But there are other factors affecting both demand and supply that could be at work in U.S. credit markets.

The make-up of household consumption among housing services, durable goods, and nondurable goods is one additional demand-side factor that could affect household borrowing. Since homes and durable goods are quite typically purchased with credit, an increase in consumers' relative demand for these goods could well be associated with an increase in borrowing. Some evidence in favor of this factor appeared earlier in this essay. As previously mentioned, rising homeownership and rising home values relative to income are at least suggestive of an increase in the relative demand for housing.



Also on the demand side, a household's willingness to borrow could be affected by its perceptions about the consequences of default. In the United States, defaulting borrowers can seek the protection of the bankruptcy law, which allows them to either re-schedule their payments to their creditors (under Chapter 13 of the bankruptcy code) or dismiss their debts in exchange for surrendering their assets, above a personal exemption (under Chapter 7, with exemptions determined at the state level). Some observers have argued that a greater propensity to file for bankruptcy is evidence of consumers seeing default as less costly than in the past and is one cause of rising consumer indebtedness. This is often discussed in terms of a sense of stigma that households may feel when filing for bankruptcy. The argument is that stigma, a psychic cost of default, has declined over time, perhaps for cultural reasons not directly related to credit market conditions. Such a decline of the perceived costs of default would make a household more willing to borrow at a given interest rate.

But the effect that a decline in stigma or in other costs of default has on borrowing amounts is at least muted because of the effect this change would have on lenders and the price of credit. Borrowers who increase their debt because they do not mind defaulting increase the risk faced by lenders, and lenders,



in turn, will have to raise their interest rates in order to compensate for this increase in risk. This rise in interest rates will tend to reduce borrowing, especially by those who consider themselves unlikely to default. In fact, Kartik Athreya has shown that the overall effect of declining stigma would likely be a decline in total borrowing.⁶

There could also be factors on the supply side of credit markets that contributed to a period of rising debt among U.S. households. In particular, technological improvements have reduced the costs to lenders of evaluating borrowers and managing exposures to default risks. This type of change would amount to a reduction of the overall cost of lending and would thereby lead to an increase in the supply of credit. This increase in supply would show up in a reduction in the financial intermediary's "spread" between the interest paid to retail savers and the rate charged on loans.

Of course, the financial intermediary that makes the loan is not the ultimate supply of funds to a borrower. Rather funds originate with the savings of other households or businesses. And the funds could come from within the same country or from abroad. In recent years, funds from other countries have indeed been a major source of supply for U.S. credit markets. Even though the bulk of this foreign investment is the purchase of government securities, these transactions do constitute an increase in the total amount of funds flowing into U.S. financial markets, which could translate into an easing of credit conditions for borrowing households.

Interpreting evidence on interest rates or spreads over time is made difficult by another trend in the pricing of loans. There is an increasing tendency of lenders to differentiate their lending terms based on borrower characteristics that are associated with default risk. In the 1980s, consumer lenders, especially for unsecured debt like credit card borrowings, usually set a single interest

rate at which they lent to all acceptable borrowers. Lenders then used relatively rough evaluations of borrower-default risk to determine who got credit.

Advances in credit scoring and other techniques allow lenders to estimate borrowers' default risk in a more precise way than was possible in the past, making it easier to offer different prices to borrowers, depending on their risk characteristics. This change has differing effects on the various types of borrowers. Very low-risk borrowers probably benefit, as they pay an interest rate that more closely reflects their risk level. On the other end of the spectrum, high-risk borrowers, who previously were screened out of access to credit, also benefit by finding their ability to borrow enhanced. Borrowers in the middle, on the other hand, could be hurt by a move from uniform to differential pricing of credit. These in-between borrowers may have benefited in the past from interest rates that averaged them in with lower-risk borrowers. The effects on different types of borrowers of increased use of differential pricing are detailed by Wendy Edelberg.⁷ Still, the technological change that makes differential pricing more practical is the same change that lowers the overall costs of lending, making it likely that many, if not most types of borrowers, have seen either a reduction in the cost of borrowing or an increase in access to credit.

Another change on the supply side of credit markets that would have effects similar to declining costs of lending is an increase in the degree of competition among lenders. If competition is weak, then lenders are able to set interest rate margins at levels that more than compensate for risk and the costs of lending. Many descriptions of the credit card lending market describe it as having relatively weak competition in the 1980s.⁸ The structure of the credit card market has changed considerably since then, with many observers concluding that increased competition has

“Falling average costs of borrowing, from a combination of improved technology and increased competition, appears to be a major contributing factor to the expansion of consumer credit.”

put downward pressure on interest rate spreads. Competition appears to have increased in the mortgage lending market as well, where consumers are increasingly able to search over a nationwide pool of potential lenders, rather than being restricted to a smaller set of local firms. Falling average costs of borrowing, from a combination of improved technology and increased competition, appears to be a major contributing factor to the expansion of consumer credit.⁹

■■■ THINKING ABOUT CHANGES IN CREDIT MARKETS—CONSEQUENCES

Changes in credit market conditions shift the demand or supply of credit, resulting in changes in the amount of borrowing done by households. The data show clearly that the net effect of these changes in recent decades has been to increase borrowing relative to income. But to evaluate these changes, we would like to have a sense of how they affected the overall economic well-being of the typical household. Some of the changes discussed in the previous section were supply changes that have the effect of reducing the cost of borrowing. These changes enhance households' ability to smooth their consumption and are therefore likely to make the average household better off.

When an increase in borrowing is driven by increases in demand for credit, the effect on a household's well-being depends on the reasons for the increase in demand. For instance, a temporary increase in borrowing could result from a disruption to a household's income. While the use of credit allows the household to respond efficiently to the disruption, the rise in borrowing in such an instance is occurring as the household is becoming worse-off. So, a short-lived surge in borrowing could be an indicator of households experiencing some financial stress. But the evidence reviewed in this essay deals more with a sustained rise in borrowing. As discussed previously, the demand-side factor most likely to be associated with such a sustained

increase is rising expectations of income growth. In this case, increased debt would be associated with improving economic well-being.

Given that a main motivation in households' use of credit is smoothing of consumption, one way to assess the impact of credit expansion is to ask whether this expansion has facilitated consumption smoothing. The previous section noted evidence studied by Krueger and Perri that points to rising income risk for U.S. households since the 1980s. These authors also examine the variability of consumption and find that, while consumption risk has risen over time as well, it has not risen nearly as much as income risk. They conclude that households' ability to smooth consumption has improved over time, consistent with a view that the expansion of credit has, on average, benefited households.

The fact that the typical household's welfare improves with a sustained expansion of credit does not mean that such a trend creates no problems or difficulties. Most importantly, the foregoing discussion assumes that household decision-making is well-informed by the relevant facts and based on sound analysis of the costs and benefits of credit. While this may be a reasonable assumption for enough households to make our conclusion about the "average" household valid, there may well be households whose decisions are imprudent, naive, or based on faulty analysis. This may be particularly true in a period when credit use is growing relatively rapidly. First, a period of credit expansion may be a period when the number of new and inexperienced borrowers is particularly high, and such borrowers may be more likely to make mistakes in their financial decisions. Second, if the growth of credit is associated with the introduction of new credit instruments or new ways of pricing credit, even some more experienced borrowers may not fully appreciate the implications of their decisions under the new arrangements.

“Ability to smooth consumption has improved over time, consistent with a view that the expansion of credit has, on average, benefited households.”



If credit market changes leave some consumers relatively uninformed about the choices they face, then these changes could also create opportunities for some providers of credit services to exploit consumers' lack of knowledge. It should therefore not be surprising to see periods of rapid credit growth coincide with increased instances and allegations of abusive practices. One particular area of change and growth in credit markets in the last fifteen years has been in subprime lending.



Products and practices in the subprime market have expanded the set of consumers with access to credit, meaning the average subprime borrower is even more likely to be an inexperienced borrower than the average borrower overall. So, in recent years we have seen rising public concern regarding potentially *predatory* lending, or abusive practices in the subprime lending market.

Of course, even for borrowers who are capable of evaluating their credit market opportunities and making well-informed decisions, outcomes are not always positive. A consumer may face unanticipated expenses or changes in income that limit the ability to service debt, leading to default, bankruptcy, or foreclosure on a mortgaged home. And it is often hard to know, after the fact, whether a distressed borrower made a sound financial decision at the time a loan was originally taken out. So distinguishing those who were victimized from those who were careless and from those who were just unlucky is not always possible.

The growth in bad outcomes from borrowing, a trend that follows from the general growth in the use of credit, can be a driving force for proponents of a public policy response to credit market phenomena. As more borrowers find themselves experiencing difficulties, sentiment emerges for policies that could keep consumers out of credit-induced financial trouble. With such policies tending to be aimed at protecting borrowers of low and moderate means, a look

at the relevant facts regarding credit use by households of different income levels may prove useful.

■■■ BORROWING TRENDS ACROSS THE INCOME DISTRIBUTION

The data presented in Figure 1 provide a picture of the borrowing behavior of the entire household sector. That is, these data might be thought of as reflective of the average household in the United States. These trends appear to be explained

by the supply and demand factors discussed in the previous section. But as was mentioned before, changes in credit market conditions do not affect all households in the same way. In particular, the uses and consequences of debt may differ among households at different income levels. Figure 3 presents information on household borrowing trends across the income distribution. (See page 14.) These data are drawn from the Federal Reserve Board's Survey of Consumer Finances, which is conducted every three years, with the most recent data coming from the 2001 survey.¹⁰ The data from this source do not stretch back as far as the aggregate data, but they do include the period of rapid credit growth in the 1990s.

The five graphs in the figure show the growth in median debt-to-income ratios for the second, third, and fourth income quintiles and for the top two income deciles. In broad terms, the trends for different income quintiles look similar to the aggregate, with debt-to-income ratios rising steadily through the 1990s. In percentage terms, this growth was the most pronounced for the group between the 20th and 39th percentiles, which registered a 290 percent increase, albeit from a very low base. By contrast, the median debt-to-income ratio among the wealthiest households—the top quintile—rose by 48 percent.

The poorest consumers—those in the lowest income quintile—are missing in Figure 3. This is because the figure shows median debt to income for each

quintile, and throughout this period, fewer than half of all households in the lowest quintile had any debt. If we were to plot, instead, the median ratio in each quintile for only those households with debt, the lowest quintile would look more similar to the others. Doing this leaves out growth in debt that comes from increased participation in credit markets and measures only the extent to which borrowing increased by people who were already borrowing. Among households having at least some debt, debt-to-income ratios grew fastest—78 percent growth from 1989 to 2001—for households in the lowest quintile. At the same time, the fraction of low- and moderate-income households with debt increased during this period. This rate of “participation” in taking on debt increased in all income groups below the median, with the fastest growth coming in the second lowest quintile.

The predominance of debt-to-income growth among households in the lower part of the income distribution raises questions about whether the causes or consequences of growing credit use among these households are different than for households at or above the median income level. As described in the third section, there are both demand and supply factors that have contributed to the growing use of credit among U.S. households. On the demand side,

a major determinant of borrowing is a household’s expectations of income growth. The growth of the aggregate use of credit in the 1990s lines up well with a pickup in income growth during that period. But income growth was uneven, with income inequality expanding. That is, the acceleration of income growth occurred more for higher-income households. So this demand-side factor might not have been as important for the growth of borrowing by low-income households.

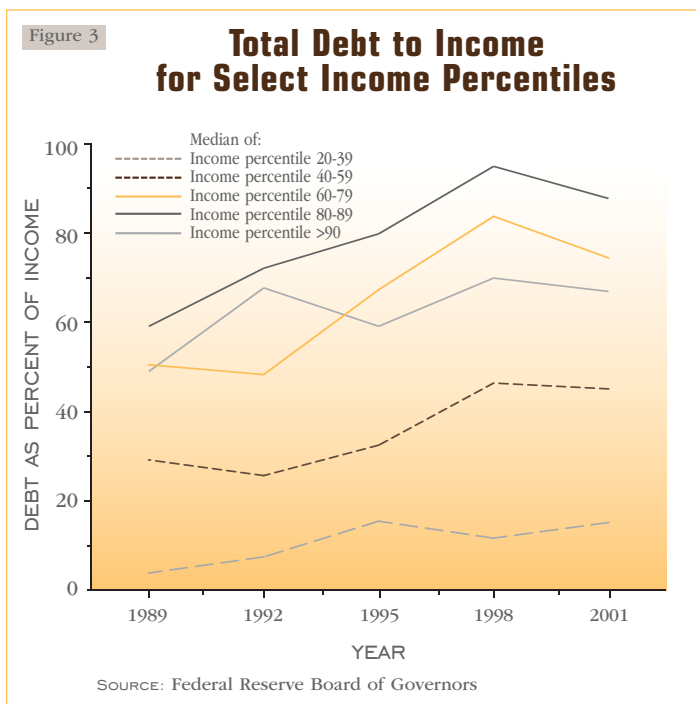
On the supply side, the main factors increasing debt have been improvements in technology that allow improved underwriting practices and a move to greater sensitivity of prices depending on borrowers’ risk characteristics. Both of these factors are likely to have improved financial markets’ and institutions’ ability to bear the risks associated with lending to lower-income households. The greater variability of pricing, in particular, is likely to have helped expand credit to households that previously would have been rationed out of the credit market. This effect may be reflected in the growth in the fraction of low-income households that hold credit.

To the extent that growing credit use among low-income households is being driven by growth in the number of borrowers, it is likely that this expansion has brought new, inexperienced borrowers into the market. This is consistent with the direction of much of the recent discussion about consumer credit policy.

■■■ POLICY RESPONSES TO CHANGES IN CREDIT MARKETS

There are three broad types of policy approaches to limiting financial difficulties for borrowers. First, one can imagine policies aimed at the problem of borrowers being uninformed about financial choices. Second, policies that seek to identify and punish instances of abuse by lenders could provide some protection to borrowers. Finally, regulators could try to place limits on the terms and prices that lenders can offer in the marketplace.

Efforts to raise consumers’ understanding of financial choices have gained considerable attention recently. There are two broad sets of tools that serve this goal. One can require disclosures by lenders with the aim





of ensuring that consumers can easily compare alternative credit options. This is the approach taken under the truth in lending laws. It is not always easy to summarize all of the relevant conditions in a credit contract with a few simple numbers, however. As the variety of terms and conditions available in the market continues to expand, there may be a limit to how much disclosures alone can enhance consumer knowledge.

The other avenue to creating better informed consumers is through the provision of financial literacy services. Credit counseling is one form of such services, and the 2005 bankruptcy legislation included counseling from an approved nonprofit provider as a precondition for bankruptcy filing. The act also provides for the development of postfiling educational materials. There has also been movement in some states to require financial literacy curricula in public primary and secondary schools. Some financial institutions and trade associations have become directly involved in the development of financial literacy programs, perhaps as an investment in their public image, but also perhaps because many banks see better informed customers as a legitimate business goal.

What exactly is it that consumers should learn from financial education? The goal, presumably, is for a household to be able to make informed, forward-looking choices with regard to the use of credit instruments. But being able to fully calculate the expected present value of different options may be beyond the reach of many consumers. Retail credit products are not simple financial contracts. They often involve provisions that amount to options for either the borrower or the lender. Such options might be explicit in the contract, like the option to prepay a mortgage, or implicit, like the option to file for bankruptcy. Accurately evaluating options is difficult, even for the financially sophisticated. Perhaps one realistic goal of financial education is for borrowers to appreciate that if one credit alternative has a lower initial monthly payment than another, then it is probably

more costly on another dimension. Borrowers who can understand such trade-offs are less likely to make choices that have a high chance of negative outcomes.

A by-product of raising the level of financial savvy among borrowers is that the potential gain to deceptive and abusive practices would be reduced. Still, there will always be instances of such behavior, and effective law enforcement is an important supplement to a well-informed population of borrowers. Prosecution of specific acts, however, is difficult and costly, leading some to advocate credit market regulations that prohibit certain practices

that are believed to be particularly susceptible to abuse. The prospect of prohibiting specific contractual terms presents a difficult trade-off. Such a prohibition may effectively prevent some instances of bad outcomes such as defaults, foreclosures, or bankruptcies. And some of those instances would undoubtedly represent cases where it was probably not in the borrower's best interest to take out a loan with the particular terms. Some would be the result of borrowers simply making mistakes, and some would arise from lenders being deceptive or manipulative. But some cases of bad outcomes would result even for borrowers making sound, well-informed choices. For those, the particular credit contract was the best option at the time they borrowed.

A prohibition of a particular practice limits some households' ability to manage their finances and consumption. So such a regulatory approach to credit market behavior necessarily protects some borrowers at the expense of others. Still, one could argue that such a policy is warranted if it were the case that the group that would be helped is much larger than the group that would be hurt, or if the amount by which some are helped significantly exceeds the amount by which others are hurt. But the type of data necessary to make this kind of determination is very hard to come by. To fully understand the overall impact on borrowers

“What exactly is it that consumers should learn from **financial education**? The goal, presumably, is for a household to be able to make **informed, forward-looking choices** with regard to the **use of credit instruments**.”

of a particular lending practice and to assess the likely effect of prohibiting it, one would want to take a look at a sample of households, some who used the product in question and some who did not. By tracking that sample for a considerable period, both before and after taking on the loan, one would reveal the average determinants of using the product together with its impact.

Without such detailed data, the regulatory prohibition of lending practices should be viewed very cautiously. The general description provided in this essay of the economics of and trends in household credit suggest that, on the whole, the growth of credit we have observed in recent decades has been beneficial for consumers, providing them with an expanded set of options for managing their lifetime consumption. And this observation points to an important principle for evaluating changes in credit markets, whether those changes are in the form of new products or new regulations. The decision to borrow is inherently a forward-looking decision. Households borrow to



align their consumption today, as well as their holdings of housing and durable goods, with their beliefs about their consumption possibilities in the future. Accordingly, the appropriate perspective in evaluating the addition or elimination of a credit product is from the point in time at which a household is making a borrowing choice. Is a household made better off or worse off by having access to this product? Adopting this perspective does not mean that one should ignore the bad

outcomes that result from use of the product. It means, instead, that one should think of those bad outcomes as part of a distribution of possible outcomes and ask whether this distribution presents the household, on average, with better consumption opportunities than would be available without the product. Without the data necessary to evaluate the distribution of outcomes, we are left simply knowing that the elimination of a particular credit product may help some but hurt others. Simply knowing that there is a trade-off is a first step, but a small step on the way to policy analysis. ■

Kartik Athreya, Ned Prescott, Aaron Steelman, and Alex Wolman contributed valuable comments to this article.

Endnotes

1. An example is "Night of the Living Debt" in the January 4, 2006, *Wall Street Journal*.
2. See Calder (1999).
3. Bostic (2002).
4. Maki (2002).
5. See Krueger and Perri (2005).
6. See Athreya (2004).
7. Edelberg (2003).
8. A notable example is Ausubel (1991).
9. Athreya (2004) examines alternative sources of rising credit and finds a strong case for technology and or competition as a primary factor.
10. At the time this Report was in production, the 2004 SCF results had not yet been released.

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Federal Reserve Bank of Richmond • Board of Directors

Our Richmond Board oversees the 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. The Board also has the responsibility of appointing the Bank's president and first vice president, with approval from the Federal Reserve Board of Governors. 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.

The Bank's board of directors annually appoints our District 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.

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Our Baltimore and Charlotte Offices have separate boards that oversee operations at their respective offices and, like our 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.

“The **Baltimore Office** focuses on the northern part of the Fifth District, **reaching out to the community** to more fully understand the economic concerns of business leaders and households and **seeking opportunities to provide educational seminars.**”

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“As Charlotte has emerged as the nation’s second largest financial center, the **Charlotte Office** has played a highly visible and important role in the **economic growth** of the entire region. Its impact has extended to many sectors in the **increasingly diversified regional economy.**”

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Established in 1985, the Small Business and Agriculture Advisory Council advises the Bank president and other senior officers on the impact that monetary, banking, and fiscal policies have on the District's small business and agricultural sectors. The Council's 12 members are appointed by the Bank president.

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Created in 1998 to enhance communication between the Bank and the public concerning community development issues, our Community Development Advisory Council advises the Bank president and other senior officers on community development concerns and related policy matters. The Council's eight members are appointed by the Bank president.

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Thank You

We express our gratitude to all members of our boards of directors for their guidance and support in 2005. Their insights are invaluable in the formulation of monetary policy and the oversight of Bank operations. Our appreciation also goes to members of our advisory groups for their dedicated service throughout the year. Thanks to our relationships with all of these individuals we learn a great deal about the communities and institutions that we serve and how we can work within the Federal Reserve System to better meet their needs.

We are especially grateful to those members of our boards of directors whose terms ended in 2005:

Barry J. Fitzpatrick and **W. Henry Harmon** • from our Richmond Board

Dyan Brasington • from our Baltimore Board

Michael A. Almond and **Lucy J. Rueben** • from our Charlotte Board

The economy of the Fifth Federal Reserve District is similar in many ways to the national economy. For instance, the distribution of employment and output across industry sectors in the District is similar to the United States as a whole. As a result, broad measures of economic conditions within the District often track national movements. Recently, the nation has experienced relatively strong growth in the services sector, while segments of the manufacturing sector have fared less well. The same is true in the Fifth District. This has led to differing levels of economic performance within the region. Notably, economic growth in the Fifth District tends to be centered in urban areas with weaker economic performance in rural areas.

In the region’s largest metropolitan center—Washington, D.C., along with its suburbs in Northern Virginia, southern and central Maryland, and the eastern panhandle of West Virginia—the government and services sectors play large roles in the economy. The strong government presence is not surprising given that the District of Columbia is the seat of the federal government and the neighboring states catch a lot of the spillover. In addition, high-wage service components such as professional services and health care boost the area’s income levels.

While North Carolina and South Carolina also have large services sectors, they have a bigger manufacturing presence than do other District states. Manufacturing is mainly located in the weaker-performing rural areas of the Carolinas, while the states’ faster growing urban areas—such as Raleigh, Charlotte, Columbia, and Charleston—have primarily services-based economies. The urban/rural distinction is important in much of West Virginia, Virginia, and Maryland as well. Beyond the sprawling suburbs of Washington, D.C, large parts of those states remain rural, though a number of moderate-to-large urban areas are scattered throughout. These urban pockets have typically seen somewhat stronger economic growth, while the rural regions exhibit economic characteristics similar to those found in the rural parts of North and South Carolina.

Reflecting on 2005, the overall Fifth District economy posted a solid performance during the year. The District’s unemployment rate remained below the national figure, job growth was strong, and personal income expanded briskly. Households shook off higher gasoline prices and prospects of softening housing prices, keeping consumer spending on track. Other measures were bright as well. Though business and household bankruptcy filings increased, the increases were below the national averages and likely boosted by impending changes in the law. Despite the overall positive tone, however, pockets of concern remained. In some industries and in some areas of the District, economic performance was less than robust.

Nonfarm Payroll Employment

	DECEMBER 2005 (thousands of persons)	% CHANGE FROM DECEMBER 2004
DISTRICT OF COLUMBIA	687	1.4
MARYLAND	2,568	1.3
NORTH CAROLINA	3,944	1.6
SOUTH CAROLINA	1,876	1.4
VIRGINIA	3,700	2.1
WEST VIRGINIA	752	1.6
FIFTH DISTRICT	13,526	1.6
UNITED STATES	134,376	1.5

SOURCE: Bureau of Labor Statistics/Haver Analytics
NOTE: All data are seasonally adjusted.

EMPLOYMENT

In labor markets, further tightening was the major trend in 2005. Districtwide, the unemployment rate edged down slightly, ending the year at 4.7 percent, 0.2 percentage points below the national rate. But there was significant variation among District jurisdictions. Virginia and Maryland posted the lowest rates, while West Virginia and North Carolina came in around the national average. In contrast, Washington, D.C., and South Carolina saw their unemployment rates on the high end, hovering well above both the District and national levels.

The District labor market entered 2005 somewhat tighter than even the taut national market, and a

number of businesses in our region reported some difficulty finding workers, especially in the latter part of 2005. This situation hampered the pace of job growth in some urban areas as a result. Overall, jobs in the Fifth District expanded at a 1.6 percent clip for the year, a bit above the national pace.

Total Personal Income

	FOURTH QTR. 2005 (chained 2000 dollars, in billions)	% CHANGE FROM FOURTH QTR. 2004
DISTRICT OF COLUMBIA	28	2.8
MARYLAND	212	1.8
NORTH CAROLINA	240	1.5
SOUTH CAROLINA	109	1.8
VIRGINIA	264	2.9
WEST VIRGINIA	45	1.9
FIFTH DISTRICT	898	2.1
UNITED STATES	9,318	1.7

SOURCE: Bureau of Economic Analysis/Haver Analytics

By sector, job growth was brisker in the goods-producing side of the economy than in the services side, a surprise perhaps given recent weakness in District factory employment. Manufacturing continued to shed quite a few jobs in 2005—about 2.0 percent of total employment in that sector—with the losses coming primarily in the Carolinas, where, despite these job cuts, the manufacturing presence remains pronounced. Nevertheless, strong growth in District construction jobs, combined with solid growth in natural resource and mining jobs, was more than enough to offset the factory losses, netting a solid gain in the Fifth District for the year. As for services, the pace of job growth was hampered by sluggish growth in the information, government, and trade/transportation/mining categories. In contrast, job growth was strong in the professional/business services and education/health services categories. Solid growth in these areas was welcome news, since many of the highest-paying services jobs are concentrated

in these sectors. To round out the job numbers, respectable gains were also registered in the financial activities and leisure/hospitality categories.

PERSONAL INCOME AND HOUSEHOLD FINANCIAL CONDITIONS

Reasonably strong growth in personal income accompanied strong growth in labor markets. For the year, total personal income in the District advanced 2.1 percent—several notches above the national pace. More impressive, perhaps, all District jurisdictions except North Carolina outpaced the nation. Virginia led the pack with the District of Columbia close behind.

With firm labor markets and solid growth in personal income, improvement in households' financial conditions would be expected. Although that was generally the case, not all measures strengthened. Personal bankruptcy filings, for example, increased sharply across the Fifth District. The increase, however, was significantly below the national rate and was likely driven by households' awareness of more stringent bankruptcy requirements that took effect October 31. The expectation of tougher requirements likely led many households to file in advance of the changes, leading to a bulge in third-quarter bankruptcies.

The story was more straightforward with past-due mortgages. At the end of the fourth quarter, only 3.1 percent of mortgages districtwide were past due 30 days or more. This figure represented a small decline from a year earlier and matched the national average. The improved performance likely reflected the firming of household income prospects but also may have been boosted by relatively low interest rates and widely available refinancing options. Overall, there was little evidence that the ability of Fifth District households to service their mortgage debt was much changed as 2005 drew to a close.

BUSINESS CONDITIONS

Broad measures of District business conditions also generally firmed in 2005, though not all gauges pointed higher. On balance, our monthly surveys of business conditions painted a fairly positive picture of services-producing firms in 2005. Over the year, revenues at these businesses generally expanded moderately, and managers remained optimistic about



their customer demand going forward. District retailers also generally reported good growth in sales, though strong incentives-driven automobile sales boosted summer activity, with some slowing noticed in the late fall. But as the holiday season got underway, retailers saw sales strengthen in December.

The firming of retail sales late in the year was comforting. Solid household financials should have bolstered spending as the year came to an end, but households faced several potential obstacles. First, of course, was the aftermath of the Gulf Coast hurricanes and the higher energy prices that followed. Second were the blaring headlines of a pending cooling or collapse in housing prices and the hit to household net worth that would ensue. Each of these factors could have derailed consumer confidence and dampened spending, but they didn't.

Manufacturers responding to our surveys reported that they struggled to gain traction on both revenues and new orders for the first half of the year. Both measures would register gains only to see the improvement fade in subsequent months—a pattern that repeated itself several times. Some momentum appeared to be building late in the year with several strong months of revenues and orders, but the December report showed retrenchment on both fronts, leaving prospects for early 2006 uncertain. Compounding the situation, factory job numbers slipped late in the year.

Another key indicator of District business conditions suggested a mixed message in 2005. Business bankruptcy filings increased significantly over the previous year, though, like household filings, the increase was probably driven in large part by pending stricter laws, which led businesses to take action sooner than they initially planned. At year's end, bankruptcy filings for the District were 37.1 percent ahead of a year before. While this increase was substantial, the increase was well below the national gain during the period. By jurisdiction, changes in the number of filings varied widely. To cite extreme changes, filings in Maryland were up nearly 160 percent, while they were down nearly 50 percent in neighboring Virginia.

■■■ HOUSING AND COMMERCIAL REAL ESTATE
Real estate remained in the headlines throughout most of the year. The year began with accelerating activity in housing, leading to multiple offers on homes in many areas and sharp rises in prices in the hotter markets. Compared to a year earlier, for example, house prices in the Washington, D.C., metro area posted a 24.7 percent increase, the fastest rate ever recorded. National headlines expressed increasing concern about the sustainability of home prices as the year progressed, leaving many analysts and homeowners uncertain about the future path of home values. At year's end, mounting evidence suggested a cooling in housing activity, as houses remained on the market longer and fourth-quarter home sales slipped 2.4 percent from year-earlier levels, but there were few signs of weakening prices. In commercial real estate, conditions were less frenzied. Steady progress was seen in 2005, with vacancy rates in office buildings gradually falling and some new construction taking hold late in the year. Vacancy rates also moved lower in industrial space and the construction of retail space progressed at a moderate pace.

■■■ LOOKING TO THE FUTURE
The District economy was generally solid in 2005. Gains in jobs and brisk growth in personal income left District households on firm footing as they entered 2006, suggesting bright prospects for the year ahead. Less clear, though, were prospects for District businesses. The strong performance of services firms and retailers in 2005 appeared to suggest momentum going forward, but conditions in manufacturing were spotty as the year drew to a close, creating uncertainty about near-term prospects. Nevertheless, a few bullets appeared to have been dodged during the year, in part because households remained resolute in their spending. Some of their optimism probably reflected housing markets that bent but didn't break. But the optimism may have had deeper roots. High gas prices and rising interest rates apparently didn't substantially change most households' opinions about their financial prospects. Overall, they remain optimistic. If District household spending holds up, it could boost the sputtering segments of the business sector and make for a bright 2006. But, of course, this outcome is not certain. Only time will tell. ■

Message • from Management

Over the past year, the Federal Reserve Bank of Richmond has been working to sharpen our identity and long-term goals. As we prepare for the future, we seek to build on the many things we are and the many things we do in service to the nation's economy.

The Richmond Fed is a research economist, bringing insights to the development of national monetary policy, and also studying our regional economy and the intricacies of consumer finance to educate the public by making complex topics understandable.

The Richmond Fed is a bank examiner, reviewing the financial condition of a commercial bank—from the smallest community bank to some of the largest banking organizations—to help preserve the safety and soundness of the nation's financial institutions. We are the person sorting checks in the middle of the night or distributing currency to depository institutions, who plays an important role in the payments system that makes the economy run.

The Richmond Fed is a community affairs specialist, reaching out to people and organizations in the Fifth District to spread information about economic development, strengthen relationships, and learn about the region and its issues so that we can better serve our communities and carry out the mission of the Bank. We are also the information technology, financial management, and human resources professionals who support all of our employees and critical activities.

People—as these and countless other examples demonstrate—are essential to the work and are vital to the success of the Federal Reserve Bank of Richmond. As the Bank's senior management, we recognize the critical value that all of our people bring to all that we do to carry out our vision of excellent performance and making important and unique contributions to the Federal Reserve System.

Our people influence the nation's economic policy. Research economists examine topics that are important to the country, and our publications seek to bring the voice of the Richmond Fed into national and regional policy discussions. We also endeavor to build upon our knowledge of our District and its economy,

from left to right

Robert E. Wetzel, Jr.

Claudia N. MacSwain

Walter A. Varvel



Jeffrey M. Lacker

John A. Weinberg

Marsha S. Shuler



looking for emerging issues to explore and for places where we can lead, even as we collaborate with researchers from other Reserve Banks and from research institutions around the world.

Our people perform valuable and critical functions for the banking and financial services industries. The diverse characteristics of commercial banking in our District have expanded the opportunities for our examiners to do challenging work and reinforced the responsibility to do complex and important work right. We have developed expertise that allows us to leverage our collective knowledge to benefit the Fifth District and the Federal Reserve System. Collaboration in our work and a focus on execution has improved performance in a variety of departments within the Bank and has resulted in recognition and additional responsibilities, such as the selection of our check adjustments operations for a greater role within the System.

Our people connect us to our District, helping us find ways to learn about our communities and to share what we know in a manner that will be meaningful to our constituencies. This is evident in our community affairs mission, the outreach we have through our

publications, and our efforts to improve financial literacy and economic education. But our links to the District are also much broader, from our varied relationships with the banking industry to our employees' involvement in the communities where they live and work. By developing a better understanding and having open communication, we broaden our presence in the region and help to make the Federal Reserve more relevant and more effective in meeting the needs of those we serve.

The Richmond Fed is all of these things and all of the people whose work is described here. But it is also the people working in other areas of the Bank who carry out a variety of tasks critical to our goals. To do what is necessary to fulfill our mission and achieve our vision, we have committed to building the strongest staff we can. We are pursuing a program to further strengthen the development, retention, and recruitment of talented staff for this important work, with the goal of matching up the right people for the right jobs. The right people to advocate ideas that lead to sound economic policy, the right people to know the industries we serve and perform the functions they rely on, the right people to understand our District.

from left to right

• The Management Team

Malcolm C. Alfrend

James McAfee

Jeffrey S. Kane



Janice E. Clatterback

Victor M. Brugh, II

David E. Beck

Officers • 2005

Jeffrey M. Lacker • President

Walter A. Varvel • First Vice President

Malcolm C. Alfriend • Senior Vice President

Victor M. Brugh, II • Medical Director

Janice E. Clatterbuck • Senior Vice President

Claudia N. MacSwain • Senior Vice President
and Chief Financial Officer

James McAfee • Senior Vice President
and General Counsel

Marsha S. Shuler • Senior Vice President

John A. Weinberg • Senior Vice President
and Director of Research

Robert E. Wetzel, Jr. • Senior Vice President
and General Auditor

James M. Barnes • Vice President

Roland Costa • Vice President

Alan H. Crooker • Vice President

A. Linwood Gill, III • Vice President

Howard S. Goldfine • Vice President

Mattison W. Harris • Vice President

Andreas L. Hornstein • Vice President

Eugene W. Johnson, Jr. • Vice President

Malissa M. Ladd • Vice President

Edgar A. Martindale, III • Vice President
and Controller

Raymond E. Owens, III • Vice President

Howard S. Whitehead • Vice President

Anthony Bardascino • Assistant Vice President

Hattie R. C. Barley • Assistant Vice President

Granville Burruss • Assistant Vice President

John B. Carter, Jr. • Assistant Vice President

Constance B. Frudden • Assistant Vice President

Joan T. Garton • Assistant Vice President

Anne C. Gossweiler • Assistant Vice President

Cathy I. Howdyshell • Assistant Vice President

Gregory A. Johnson • Assistant Vice President

Jeannette M. Johnson • Assistant Vice President

Steve V. Malone • Assistant Vice President

Page W. Marchetti • Assistant Vice President
and Secretary

Jonathan P. Martin • Assistant Vice President



Andrew S. McAllister • Assistant Vice President

William R. McCorvey, Jr. • Assistant General Counsel

Diane H. McDorman • Assistant Vice President

Robert J. Minter • Assistant Vice President

Susan Q. Moore • Assistant Vice President

Barbara J. Moss • Assistant Vice President

Edward B. Norfleet • Assistant Vice President

P. A. L. Nunley • Assistant General Counsel

Lisa T. Oliva • Assistant Vice President

Arlene S. Saunders • Assistant Vice President

Rebecca J. Snider • Assistant Vice President

Daniel D. Tatar • Assistant Vice President

Jeffrey K. Thomas • Assistant Vice President

Sandra L. Tormoen • Assistant Vice President

Mark D. Vaughan • Assistant Vice President

Lauren E. Ware • Assistant Vice President

William F. White • Assistant Vice President

Michael L. Wilder • Assistant Vice President

Karen J. Williams • Assistant Vice President

Julie Yoo • Assistant Vice President

David J. Zimmerman • Assistant Vice President

Baltimore Office

David E. Beck • Senior Vice President

Amy L. Eschman • Assistant Vice President

John I. Turnbull, II • Assistant Vice President

Charlotte Office

Jeffrey S. Kane • Senior Vice President

R. William Ahern • Vice President

Jennifer J. Burns • Vice President

Terry J. Wright • Vice President

Jennifer R. Zara • Vice President

T. Stuart Desch • Assistant Vice President

Ronald B. Holton • Assistant Vice President

Richard J. Kuhn • Assistant Vice President

Adam S. Pilsbury • Assistant Vice President

Lisa A. White • Assistant Vice President

Richard F. Westerkamp, Jr. • Examining Officer

Listing as of December 31, 2005

Financial Statements

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THE FIRM ENGAGED BY THE BOARD OF GOVERNORS FOR THE AUDITS OF THE INDIVIDUAL AND COMBINED FINANCIAL STATEMENTS OF THE RESERVE BANKS FOR 2005 WAS PRICEWATERHOUSECOOPERS LLP (PWC). FEES FOR THESE SERVICES TOTALED \$4.6 MILLION. TO ENSURE AUDITOR INDEPENDENCE, THE BOARD OF GOVERNORS REQUIRES THAT PWC BE INDEPENDENT IN ALL MATTERS RELATING TO THE AUDIT. SPECIFICALLY, PWC MAY NOT PERFORM SERVICES FOR THE RESERVE BANKS OR OTHERS THAT WOULD PLACE IT IN A POSITION OF AUDITING ITS OWN WORK, MAKING MANAGEMENT DECISIONS ON BEHALF OF THE RESERVE BANKS, OR IN ANY OTHER WAY IMPAIRING ITS AUDIT INDEPENDENCE. IN 2005, THE BANK DID NOT ENGAGE PWC FOR ANY MATERIAL ADVISORY SERVICES.

March 3, 2006

■■■ TO THE BOARD OF DIRECTORS:

The management of the Federal Reserve Bank of Richmond (“FRB Richmond”) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2005 (the “Financial Statements”). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks (“Manual”), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

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

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

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

FEDERAL RESERVE BANK OF RICHMOND



Jeffrey M. Lacker • President **Walter A. Varvel** • First Vice President **Claudia N. MacSwain** • Senior Vice President and Chief Financial Officer

■■■ TO THE BOARD OF DIRECTORS OF THE FEDERAL RESERVE BANK OF RICHMOND:

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

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

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

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

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

PRICEWATERHOUSECOOPERS LLP

March 8, 2006
McLean, Virginia

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

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

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

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

PRICEWATERHOUSECOOPERS LLP

March 8, 2006
McLean, Virginia

Statements of Condition • (in millions)

As of December 31,	2005	2004
Assets		
Gold certificates	\$ 836	\$ 819
Special drawing rights certificates	147	147
Coin	66	62
Items in process of collection	225	341
Loans to depository institutions	1	–
U.S. government securities, net	57,253	55,148
Investments denominated in foreign currencies	3,454	5,009
Accrued interest receivable	445	386
Interdistrict settlement account	8,521	–
Bank premises and equipment, net	252	252
Interest on Federal Reserve notes due from U.S. Treasury	35	–
Other assets	90	124
Total assets	\$ 71,325	\$ 62,288
Liabilities and Capital		
Liabilities:		
Federal Reserve notes outstanding, net	\$ 57,760	\$ 52,716
Securities sold under agreements to repurchase	2,328	2,340
Deposits:		
Depository institutions	3,182	1,645
Other deposits	153	71
Deferred credit items	509	544
Interest on Federal Reserve notes due U.S. Treasury	–	101
Interdistrict settlement account	–	420
Accrued benefit costs	107	91
Other liabilities	36	64
Total liabilities	64,075	57,992
Capital:		
Capital paid-in	3,942	2,148
Surplus	3,308	2,148
Total capital	7,250	4,296
Total liabilities and capital	\$ 71,325	\$ 62,288

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

Statements of Income • (in millions)

For the years ended December 31,	2005	2004
Interest Income		
Interest on U.S. government securities	\$ 2,143	\$ 1,677
Interest on investments denominated in foreign currencies	53	63
Total interest income	2,196	1,740
Interest Expense		
Interest expense on securities sold under agreements to repurchase	62	23
Net interest income	2,134	1,717
Other Operating Income (Loss)		
Income from services	–	66
Compensation received for check services provided	40	–
Reimbursable services to government agencies	28	32
Foreign currency gains (losses), net	(519)	289
Other income	8	5
Total other operating income (loss)	(443)	392
Operating Expenses		
Salaries and other benefits	241	215
Occupancy expense	33	32
Equipment expense	59	88
Assessments by the Board of Governors	99	102
Other credits	(99)	(121)
Total operating expenses	333	316
Net income prior to distribution	\$ 1,358	\$ 1,793
Distribution of Net Income		
Dividends paid to member banks	\$ 198	\$ 125
Transferred to surplus	1,160	74
Payments to U.S. Treasury as interest on Federal Reserve notes	–	1,594
Total distribution	\$ 1,358	\$ 1,793

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

Statements of Changes in Capital • (in millions)

For the years ended December 31, 2005 and December 31, 2004	Capital Paid-In	Surplus	Total Capital
Balance at January 1, 2004 (41.5 million shares)	\$ 2,074	\$ 2,074	\$ 4,148
Transferred to surplus	–	74	74
Net change in capital stock issued (1.5 million shares)	74	–	74
Balance at December 31, 2004 (43.0 million shares)	\$ 2,148	\$ 2,148	\$ 4,296
Transferred to surplus	–	1,160	1,160
Net change in capital stock issued (35.8 million shares)	1,794	–	1,794
Balance at December 31, 2005 (78.8 million shares)	\$ 3,942	\$ 3,308	\$ 7,250

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

■ ■ ■ 1. STRUCTURE

The Federal Reserve Bank of Richmond (“Bank”) is part of the Federal Reserve System (“System”) and one of the twelve Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Baltimore, Maryland, and Charlotte, North Carolina serve 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 are exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

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

■ ■ ■ 2. OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments system includ-

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

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

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

involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

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

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: Standard Cash Automation, Currency Technology Office, National Procurement Office, Daylight Overdraft Reporting and Pricing, and the Payroll Central Business Administration Function. 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 \$263 million and \$250 million for the years ended December 31, 2005 and 2004, respectively, and is included in "Other credits" on the Statements of Income.

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta ("FRBA") has the overall responsibility for managing the Reserve Banks' provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services. This compensation is reported as "Compensation received for check services provided" in the Statements of Income. If the management model had been in place in 2004, the Bank would have reported \$50 million as compensation received for check services provided and \$67 million in check revenue would have been reported by FRB Atlanta rather than the Bank.

■ ■ ■ 3. SIGNIFICANT ACCOUNTING POLICIES

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

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

In addition, the Bank has elected not to present a Statement of Cash Flows because the liquidity and cash position of the Bank are not a primary concern given the Bank's unique



powers and responsibilities. A Statement of Cash Flows, therefore, would not provide any additional meaningful information. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

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

a. Gold and Special Drawing Rights Certificates

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

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

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law

providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2005 or 2004.

b. Loans to Depository Institutions

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

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

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

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

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

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

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

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

e. Foreign Currency Swaps and Warehousing

F/X swap arrangements are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the

FOMC temporary access to the foreign currencies it may need to intervene to support the dollar and give the counterparty temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either FRBNY or the counterparty (the drawer) and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

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

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

f. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred. Capitalized assets including software, building, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significantly less than book value and is not recoverable.

Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct



services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

g. Interdistrict Settlement Account

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

h. Federal Reserve Notes

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

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

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is

insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of \$11,887 million, and \$12,275 million at December 31, 2005 and 2004, respectively.

i. Items in Process of Collection and Deferred Credit Items

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

j. Capital Paid-in

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

k. Surplus

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

additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

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

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

Due to the substantial increase in capital paid-in and the transfer of surplus, surplus was not equated to capital at December 31, 2005. The amount of additional surplus required due to these events exceeded the Bank's net income in 2005.

l. Income and Costs related to U.S. Treasury Services

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

m. Assessments by the Board of Governors

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

n. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were \$2 million for each of the years

ended December 31, 2005 and 2004, and are reported as a component of "Occupancy expense."

o. Restructuring Charges

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

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

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

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 7.632 percent and 7.600 percent at December 31, 2005 and 2004, respectively.

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

	2005	2004
Par value:		
U.S. government:		
Bills	\$ 20,703	\$ 19,987
Notes	29,009	27,425
Bonds	7,084	7,146
Total par value	56,796	54,558
Unamortized premiums	673	715
Unaccreted discounts	(216)	(125)
Total allocated to Bank	\$ 57,253	\$ 55,148



The total of the U.S. government securities, net held in the SOMA was \$750,202 million and \$725,584 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 and 2004, the total contract amount of securities sold under agreements to repurchase was \$30,505 million and \$30,783 million, respectively, of which \$2,328 million and \$2,340 million, were allocated to the Bank. The total par value of the SOMA securities pledged for securities sold under agreements to repurchase at December 31, 2005 and 2004 was \$30,559 million and \$30,808 million, respectively, of which \$2,332 million and \$2,342 million was allocated to the Bank.

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

Maturities of Securities Held	U.S Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 3,130	\$ 2,328
16 days to 90 days	13,147	–
91 days to 1 year	14,216	–
Over 1 year to 5 years	16,083	–
Over 5 years to 10 years	4,327	–
Over 10 years	5,893	–
Total	\$ 56,796	\$ 2,328

At December 31, 2005 and 2004, U.S. government securities with par values of \$3,776 million and \$6,609 million, respectively, were loaned from the SOMA, of which \$288 million and \$502 million, respectively, were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

The Bank's allocated share of investments denominated in foreign currencies was approximately 18.248 percent and 23.442 percent at December 31, 2005 and 2004, respectively.

The Bank's allocated share of investments denominated in foreign currencies, including accrued interest, valued at current foreign currency market exchange rates at December 31, was as follows (in millions):

	2005	2004
European Union Euro:		
Foreign currency deposits	\$ 990	\$ 1,425
Securities purchased under agreements to resell	352	502
Government debt instruments	650	925
Japanese Yen:		
Foreign currency deposits	477	361
Government debt instruments	985	1,796
Total	\$ 3,454	\$ 5,009

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

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

Maturities of Investments Denominated in Foreign Currencies	European Euro	Japanese Yen	Total
Within 15 days	\$ 616	\$ 478	\$ 1,094
16 days to 90 days	470	124	594
91 days to 1 year	381	184	565
Over 1 year to 5 years	521	677	1,198
Over 5 years to 10 years	3	–	3
Over 10 years	–	–	–
Total	\$ 1,991	\$ 1,463	\$ 3,454

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

At December 31, 2005 and 2004, the warehousing facility was \$5,000 million, with no balance outstanding.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	Useful Life Range (in Years)	2005	2004
Bank premises and equipment:			
Land	N/A	\$ 32	\$ 22
Buildings	6 - 48	142	138
Building machinery and equipment	2 - 20	51	50
Construction in progress	N/A	4	3
Furniture and equipment	1 - 10	288	312
Subtotal		\$ 517	\$ 525
Accumulated depreciation		(265)	(273)
Bank premises and equipment, net		\$ 252	\$ 252
Depreciation expense, for the years ended		\$ 43	\$ 44

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	2005	2004
Bank premises and equipment	\$ 9	\$ 10
Accumulated depreciation	(5)	(5)
Capitalized leases, net	\$ 4	\$ 5

The Bank leases space to outside tenants with lease terms ranging from one to eleven months. Rental income from such leases was \$1.5 million and \$1.4 million for the years ended December 31, 2005 and 2004, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2005, were (in millions):

2006	\$ 1.3
2007	–
2008	–
2009	–
2010	–
Thereafter	–
	\$ 1.3

The Bank has capitalized software assets, net of amortization, of \$41 million and \$59 million at December 31, 2005 and 2004, respectively. Amortization expense was \$19 million and \$27 million for the years ended December 31, 2005 and 2004, respectively. Capitalized software assets are reported as a component of “Other assets” and related amortization is reported as a component of “Other expenses.”

Assets impaired as a result of the Bank’s restructuring plan, as discussed in footnote 10, include furniture and equipment. There were no asset impairment losses in 2005 and 2004.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2005, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately seven months. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$16 million and \$38 million for the years ended December 31, 2005 and 2004, respectively. Certain of the Bank’s leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2005, were not material.

At December 31, 2005, the Bank, acting on behalf of the Reserve Banks, had contractual commitments extending through the year 2017 with a remaining amount of \$299 million. As of December 31, 2005, none of these commitments was recognized. Purchases of \$74 million and \$70 million were made against these commitments during 2005 and 2004, respectively. It is estimated that the Bank’s allocated share of these commitments will be \$28 million. These commitments represent maintenance of currency processing machines and have variable and fixed components. The variable portion of the commitment is



for incremental maintenance above the prepaid basis. The fixed payments for the next five years under these commitments are (in millions):

	Fixed Commitment
2006	\$ -
2007	25
2008	26
2009	26
2010	26

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

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

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of

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

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$8 million for each of the years ended December 31, 2005 and 2004, and are reported as a component of "Salaries and other benefits." The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits other than Pensions

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

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

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

	2005	2004
Accumulated post-retirement benefit obligation at January 1	\$ 93.7	\$ 107.8
Service cost-benefits earned during the period	14.0	2.0
Interest cost of accumulated benefit obligation	7.0	5.5
Actuarial (gain) loss	27.1	(8.0)
Contributions by plan participants	1.1	0.8
Benefits paid	(7.6)	(5.2)
Plan amendments	-	(9.2)
Accumulated postretirement benefit obligation at December 31	\$ 135.3	\$ 93.7

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

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

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

	2005	2004
Fair value of plan assets at January 1	\$ -	\$ -
Actual return on plan assets	-	-
Contributions by the employer	6.5	4.4
Contributions by plan participants	1.1	0.8
Benefits paid	(7.6)	(5.2)
Fair value of plan assets at December 31	\$ -	\$ -
Unfunded postretirement benefit obligation	\$ 135.3	\$ 93.7
Unrecognized prior service cost	7.7	10.8
Unrecognized net actuarial (loss)	(50.0)	(27.7)
Accrued postretirement benefit costs	\$ 93.0	\$ 76.8

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

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

	2005	2004
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	4.75%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2005 (in millions):

	1% Point Increase	1% Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 1.3	\$ (1.4)
Effect on accumulated post-retirement benefit obligation	17.3	(14.4)

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

	2005	2004
Service cost-benefits earned during the period	\$ 14.0	\$ 2.0
Interest cost of accumulated benefit obligation	7.0	5.5
Amortization of prior service cost	(1.4)	(1.1)
Recognized net actuarial loss	3.0	0.9
Total periodic expense	\$ 22.6	\$ 7.3
Curtailed (gain)	-	(7.2)
Net periodic postretirement benefit costs	\$ 22.6	\$ 0.1

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



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

The 2005 service cost contains an adjustment that resulted from a review of plan terms and assumptions.

A plan amendment that modified the credited service period eligibility requirements created curtailment gains in 2004.

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

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

Expected benefit payments:

	Without Subsidy	With Subsidy
2006	\$ 7.2	\$ 6.7
2007	7.5	7.0
2008	7.9	7.4
2009	8.4	7.7
2010	8.8	8.2
2011-2015	48.0	43.3
Total	\$ 87.8	\$ 80.3

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2005 and 2004, were \$13 million and \$14 million, respectively. This cost is included as a component of “Accrued benefit costs.” Net periodic postemployment benefit costs included in 2005

and 2004 operating expenses were \$1 million and (\$2) million, respectively and are recorded as a component of “Salaries and other benefits.”

10. BUSINESS RESTRUCTURING CHARGES

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

	Total Estimated Costs	Accrued Liability 12/31/04	Total Charges	Total Paid	Accrued Liability 12/31/05
Employee separation	\$ 4.1	\$ 3.9	\$ (1.7)	\$ 1.8	\$ 0.4
Contract termination	0.3	-	-	-	-
Total	\$ 4.4	\$ 3.9	\$ (1.7)	\$ 1.8	\$ 0.4

There were no charges in 2005. The negative total charges amount is due to unrecognized accrued liability adjustments.

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 177, including 62 staff reductions related to restructuring announced in 2004. These costs are reported as a component of “Salaries and other benefits.” Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of “Other expenses.”

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

The Bank substantially completed its announced plans by June 2005. ■

Summary of Operations • Unaudited

Year-to-Date December	Dollar Amount		Volume	
	2005	2004	2005	2004
Cash				
Currency received and counted	57.0 Billion	53.1 Billion	3.2 Billion	3.2 Billion
Currency destroyed	5.5 Billion	5.9 Billion	456.2 Million	496.1 Million
Coin bags received and counted	107.0 Million	36.8 Million	248 Thousand	107.0 Thousand
Noncash Payments				
Commercial checks processed	1.3 Trillion	1.3 Trillion	1.1 Billion	1.3 Billion
Commercial checks, packaged items handled	353.3 Billion	361.2 Billion	526.5 Million	587.4 Million
Loans to Depository Institutions				
Discount window loans made	364.2 Million	474.6 Million	64	47
Services to U.S. Treasury and Government Agencies				
Issues, redemptions, and exchanges of U.S. savings bonds ¹	425.7 Million	1.0 Billion	1.1 Million	4.5 Million

¹Fifth District Savings Bonds operations were discontinued June 2005 as a result of System consolidation efforts.

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