Financial Statements

Board of Governors Financial Statements

The financial statements of the Board for 2001 were audited by KPMG LLP, independent auditors.

KPMG

2001 M Street, N.W.
Washington, D.C. 20036

INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENTS

To the Board of Governors of the
Federal Reserve System

We have audited the accompanying balance sheet of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2001 and the related statements of revenues and expenses and changes in cumulative results of operations and cash flows for the year then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements as of and for the year ended December 31, 2000 were audited by other auditors who issued an unqualified opinion thereon dated February 21, 2001.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2001, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated March 22, 2002 on our consideration of the Board's internal control over financial reporting and its compliance with laws and regulations. Those reports are an integral part of an audit conducted in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

KPMG LLP

March 22, 2002

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BALANCE SHEETS

	As of December 31, 2001	As of December 31, 2000
ASSETS		
CURRENT ASSETS		
Cash	$ 40,788,564	$22,842,252
Accounts receivable	1,325,065	1,057,901
Prepaid expenses and other assets	866,407	1,108,766
Total current assets	42,980,036	25,008,919
PROPERTY AND EQUIPMENT, NET (Note 5)	138,895,601	68,521,774
Total assets	$181,875,637	$93,530,693
LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS		
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	$ 16,125,797	$10,702,740
Accrued payroll and related taxes	7,307,754	6,040,961
Accrued annual leave	10,732,356	8,492,728
Capital lease payable (current portion)	247,242	180,340
Unearned revenues and other liabilities	391,572	2,044,160
Total current liabilities	34,804,721	27,460,929
LONG-TERM LIABILITIES		
Capital lease payable (non-current portion)	80,276	280,683
Accumulated retirement benefit obligation (Note 2)	651,628	694,782
Accumulated postretirement benefit obligation (Note 3)	4,555,487	4,065,704
Accumulated postemployment benefit obligation (Note 4)	3,591,571	3,109,456
Total long-term liabilities	8,878,962	8,150,625
Total liabilities	43,683,683	35,611,554
CUMULATIVE RESULTS OF OPERATIONS		
Working capital	8,175,315	(2,452,010)
Unfunded long-term liabilities	(8,798,686)	(7,869,942)
Net investment in property and equipment	138,815,325	68,241,091
Total cumulative results of operations	138,191,954	57,919,139
Total liabilities and cumulative results of operations	$181,875,637	$93,530,693

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31,	
	2001	2000
BOARD OPERATING REVENUES		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures	$295,055,600	$ 188,067,200
Other revenues (Note 6)	8,747,799	10,099,585
Total operating revenues	303,803,399	198,166,785
BOARD OPERATING EXPENSES		
Salaries	132,647,612	118,632,019
Retirement and insurance contributions	22,277,244	19,945,692
Contractual services and professional fees	19,339,948	14,503,464
Depreciation and net losses on disposals	10,394,156	8,855,763
Postage and supplies	8,252,490	5,839,569
Utilities	5,880,777	6,249,503
Software	5,415,856	4,192,658
Travel	5,037,577	5,769,788
Repairs and maintenance	4,201,386	3,375,478
Equipment and facilities rental	3,830,557	5,075,502
Printing and binding	2,095,676	2,047,590
Other expenses (Note 6)	4,157,305	5,085,135
Total operating expenses	223,530,584	199,572,161
RESULTS OF OPERATIONS	80,272,815	(1,405,376)
ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES		
Assessments levied on Federal Reserve Banks for currency costs	338,537,426	435,837,762
Expenses for currency printing, issuance, retirement, and shipping	338,537,426	435,837,762
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES	0	0
TOTAL RESULTS OF OPERATIONS	80,272,815	(1,405,376)
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year	57,919,139	59,324,515
TRANSFERS TO THE U.S. TREASURY		
Transfers from surplus Federal Reserve Bank earnings (Note 1)	0	3,752,000,000
Transfers to the U.S. Treasury (Note 1)	0	(3,752,000,000)
CUMULATIVE RESULTS OF OPERATIONS, End of year	$138,191,954	$ 57,919,139

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF CASH FLOWS

	For the years ended December 31, 2001	2000
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS	$80,272,815	$(1,405,376)
Adjustments to reconcile change in results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals	10,394,156	8,855,763
(Increase) decrease in assets:		
Accounts receivable, prepaid expenses, and other assets	(24,805)	(499,519)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities	5,423,057	(1,657,349)
Accrued payroll and related taxes	1,266,793	(1,049,793)
Accrued annual leave	2,239,628	429,073
Unearned revenues and other liabilities	(1,652,588)	(303,143)
Accumulated retirement benefit obligation	(43,154)	(52,935)
Accumulated postretirement benefit obligation	489,783	450,876
Accumulated postemployment benefit obligation	482,115	528,377
Net cash provided by (used in) operating activities	98,847,800	5,295,974
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals	119,013	44,400
Capital expenditures	(80,886,996)	(13,609,871)
Net cash provided by (used in) investing activities	(80,767,983)	(13,565,471)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payable	(133,505)	(77,499)
Capital lease obligations incurred	0	116,340
Net cash provided by (used in) financing activities	(133,505)	38,841
NET INCREASE (DECREASE) IN CASH	17,946,312	(8,230,656)
CASH BALANCE, Beginning of year	22,842,252	31,072,908
CASH BALANCE, End of year	$40,788,564	$22,842,252

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2001 AND 2000

(1) Significant Accounting Policies

Organization—The Federal Reserve System was founded by Congress in 1913 and consists of the Board of Governors (Board) and twelve regional Reserve Banks. The Board was established as a federal government agency and is supported by Washington staff numbering about 1,700, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System. The accompanying financial statements include only the operations and activities for the Board.

Basis of Accounting—The financial statements have been prepared on the accrual basis of accounting.

Revenues—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow into ''Cumulative Results of Operations'' during the year.

Issuance and Redemption of Federal Reserve Notes—The Board incurs expenses and assesses the Federal Reserve Banks for the costs of printing, issuing, shipping, and retiring Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

Property and Equipment—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

Federal Reserve Bank Surplus Earnings—The Federal Reserve Act, as amended, required that $3,752,000,000 of surplus Federal Reserve Bank earnings be transferred from the Banks to the Board and then to the U.S. Treasury in 2000.

Estimates—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications—Certain 2000 amounts have been reclassified to conform with the 2001 presentation.

(2) Retirement Benefits

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office.

Employees of the Board who entered on duty prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who entered on duty after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2001 and 2000, and the Board was not assessed a contribution for these years. Excess Plan assets are expected to continue to fund future years' contributions. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefit plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled $308,000 and $266,000 in 2001 and 2000, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were $5,540,000 and $5,133,000 in 2001 and 2000, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Section 401(a) of the Code was amended to increase the contribution limitation base for highly paid employees to $170,000 from $160,000 effective in 2000. This increase resulted in a reduction in the benefit obligation of the BEP for 2000. Pension costs attributed to the BEP reduce the pension costs of the System Plan. Activity for the BEP for 2001 and 2000 is summarized in the following table:

	2001	2000
Change in benefit obligation		
Benefit obligation at beginning of year	$1,804	$631,264
Service cost	450	544
Interest cost	112	99
Plan participants' contributions	0	0
Plan amendments	0	(552,770)
Actuarial (gain)/loss	(241)	(69,229)
Benefits paid	0	(8,104)
Benefit obligation at end of year	$2,125	$ 1,804

	2001	2000
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	0	8,104
Plan participants' contributions	0	0
Benefits paid	0	(8,104)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$ (2,125)	$ (1,804)
Unrecognized net actuarial (gain)/ loss	(329,169)	(358,390)
Unrecognized prior service cost	(1,170,405)	(1,287,253)
Unrecognized net transition (asset)/ obligation	850,071	952,665
Prepaid/(accrued) postretirement benefit cost	$ (651,628)	$ (694,782)
Weighted-average assumptions as of December 31		
Discount rate	7.00%	7.50%
Expected asset return	N/A	N/A
Salary scale	4.50%	5.00%
Corridor	10.00%	10.00%
Components of net periodic expense for year		
Service cost	$ 450	$ 544
Interest cost	112	99
Expected return on plan assets	0	0
Amortization of prior service cost	(116,848)	(116,848)
Recognized net actuarial gain	(29,462)	(31,220)
Amortization of net (asset)/ obligation	102,594	102,594
Net periodic benefit expense	$ (43,154)	$ (44,831)

(3) POSTRETIREMENT BENEFITS

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2001 and 2000 is summarized in the following table:

	2001	2000
Change in benefit obligation		
Benefit obligation at beginning of year	$ 4,255,290	$ 4,096,411
Service cost	133,550	126,076
Interest cost	345,753	312,298
Plan participants' contributions	0	0
Plan amendments	95,993	0
Actuarial (gain)/loss	1,037,839	(278,501)
Benefits paid	0	(994)
Benefit obligation at end of year	$ 5,868,425	$ 4,255,290
Change in plan assets		
Fair value of plan assets at beginning of year	$ 0	$ 0
Actual return on plan assets	0	0
Employer contributions	0	994
Plan participants' contributions	0	0
Benefits paid	0	(994)
Fair value of plan assets at end of year	$ 0	$ 0
Reconciliation of funded status at end of year		
Funded status	$(5,868,425)	$(4,255,290)
Unrecognized net actuarial (gain)/loss	1,216,945	189,586
Unrecognized prior service cost	95,993	0
Unrecognized net transition obligation	0	0
Prepaid/(accrued) postretirement benefit cost	$(4,555,487)	$(4,065,704)
Components of net periodic expense for year		
Service cost	$ 133,550	$ 126,076
Interest cost	345,753	312,298
Amortization of prior service cost	0	0
Amortization of (gains)/losses	10,477	$ 13,497
Total net periodic expense	$ 489,780	$ 451,871

The liability and costs for the postretirement benefit plan were determined using discount rates of 7.00 percent and 7.50 percent as of December 31, 2001 and December 31, 2000 respectively. Unrecognized losses of $1,216,945 and $189,586 as of December 31, 2001 and 2000, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 5 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored programs upon retiring. Contributions for active employees participating in federally sponsored programs totaled $5,364,000 and $4,792,000 in 2001 and 2000, respectively.

(4) Postemployment Benefit Plan

The Board provides certain postemployment benefits to eligible employees after employment but before retirement. Effective January 1, 1994, the Board adopted Statement of Financial Accounting Standards No. 112, *Employers' Accounting for Postemployment Benefits*, which requires that employers providing postemployment benefits to their employees accrue the cost of such benefits. Prior to January 1994, postemployment benefit expenses were recognized on a pay-as-you-go basis.

	As of December 31,	
	2001	2000
Change in benefit obligation		
Benefit obligation at beginning of year	$3,109,456	$2,581,079
Service cost	755,135	721,293
Interest cost	115,142	159,808
Plan participants' contributions	0	0
Plan amendments	0	0
Actuarial (gain)/loss	(129,585)	(29,733)
Benefits paid	(258,577)	(322,991)
Benefit obligation at end of year	$3,591,571	$3,109,456

(5) Property and Equipment

The following is a summary of the components of the Board's property, buildings and equipment, at cost, net of accumulated depreciation.

	As of December 31,	
	2001	2000
Land and improvements	$ 18,640,314	$ 1,301,314
Buildings	104,403,830	45,233,537
Furniture and equipment	54,301,936	49,090,528
Software	9,215,280	7,883,210
Construction in process	6,901,864	9,725,857
	193,463,224	113,234,446
Less accumulated depreciation	(54,567,623)	(44,712,672)
Property and equipment, net	$138,895,601	$ 68,521,774

Furniture and equipment includes $864,000 for capitalized leases as of December 31, 2001 and 2000. Accumulated depreciation includes $510,000 and $366,000 for capitalized leases as of December 31, 2001 and 2000, respectively. The Board paid interest in the amount of $32,201 and $70,830 for 2001 and 2000, respectively.

The Board began the Eccles Building Infrastructure Enhancement Project in July 1999. This $12.5 million project, scheduled for nineteen phases over three and a half years, includes asbestos removal, lighting and plumbing improvements, cabling and other enhancements. Multiple phases will be in process at the same time.

In 2001, the Board purchased land and building located at 1709 New York Avenue, N.W., Washington, DC. This purchase increased land and improvements by $17,339,000 and buildings by $48,727,000 for 2001.

(6) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

	As of December 31,	
	2001	2000
Other revenues		
Data processing revenue	$4,427,360	$ 4,817,207
Subscription revenue	869,595	1,079,822
Reimbursable services to other agencies	568,753	607,716
National Information Center	25,591	2,606,998
Miscellaneous	2,856,500	987,842
Total Other Revenues	$8,747,799	$10,099,585
Other expenses		
Tuition, registration, and membership fees	$1,472,539	$ 1,429,231
Subsidies and contributions	851,225	837,071
Miscellaneous	1,833,541	2,818,833
Total Other Expenses	$4,157,305	$ 5,085,135

(7) Commitments

The Board has entered into several operating leases to secure office, training and warehouse space for periods ranging from one to ten years. Minimum future commitments under those leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2001, are as follows:

2002	$162,840
2003	151,038
2004	157,079
2005	163,363
2006	71,991
After 2006	0
	$706,311

Rental expenses under the operating leases were $171,000 and $155,000 in 2001 and 2000, respectively.

(8) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the ''Council''). During 2001 and 2000, the Board paid $293,000 and $256,000 respectively, in assessments for operating expenses of the Council. These amounts are included in other expenses for 2001 and 2000. ■

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2001 M Street, N.W.
Washington, D.C. 20036

Independent Auditors' Report on Internal Control over Financial Reporting

To the Board of Governors of the
Federal Reserve System

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the Board) as of and for the year ended December 31, 2001, and have issued our report thereon dated March 22, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

In planning and performing our audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. Material weaknesses are conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may occur and not be detected. However, we noted no matters involving internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the Board and management, the U.S. Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

March 22, 2002

KPMG

2001 M Street, N.W.
Washington, D.C. 20036

Independent Auditors' Report on Compliance with Laws and Regulations

To the Board of Governors of the
Federal Reserve System

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the Board) as of and for the year ended December 31, 2001, and have issued our report thereon dated March 22, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

The management of the Board is responsible for complying with laws and regulations applicable to the Board. As part of obtaining reasonable assurance about whether the Board's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

This report is intended solely for the information and use of the Board and management, the U.S. Office of Management and Budget, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

March 22, 2002

Federal Reserve Banks Combined Financial Statements

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent accountants, for the years ended December 31, 2001 and 2000.

PRICEWATERHOUSECOOPERS

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Governors of The Federal Reserve System
and the Board of Directors of each of The Federal Reserve Banks:

We have audited the accompanying combined statements of condition of The Federal Reserve Banks (the "Reserve Banks") as of December 31, 2001 and 2000, and the related combined statements of income and changes in capital for the years then ended. These financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on the 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 discussed in Note 3, the combined financial statements were prepared in conformity with 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 combined financial statements referred to above present fairly, in all material respects, the financial position of the Reserve Banks as of December 31, 2001 and 2000, and results of their operations for the years then ended, on the basis of accounting described in Note 3.

Washington, D.C.
March 4, 2002

PricewaterhouseCoopers LLP

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 2001 and 2000

(in millions)

Assets	2001	2000
Gold certificates	$ 11,045	$ 11,045
Special drawing rights certificates	2,200	2,200
Coin	1,047	949
Items in process of collection	3,188	7,152
Loans to depository institutions	34	110
Securities purchased under agreements to resell (tri-party)	50,250	43,375
U.S. government and federal agency securities, net	561,701	518,501
Investments denominated in foreign currencies	14,559	15,670
Accrued interest receivable	5,729	6,111
Bank premises and equipment, net	2,021	1,949
Other assets	3,175	2,815
Total assets	$654,949	$609,877

Liabilities and Capital	2001	2000
Liabilities		
Federal Reserve notes outstanding, net	$611,757	$563,450
Deposits		
Depository institutions	17,478	19,046
U.S. Treasury, general account	6,645	5,149
Other deposits	287	426
Deferred credit items	2,490	6,357
Interest on Federal Reserve notes due U.S. Treasury	498	560
Accrued benefit costs	882	848
Other liabilities	227	250
Total liabilities	640,264	596,086
Capital		
Capital paid-in	7,373	6,997
Surplus	7,312	6,794
Total capital	14,685	13,791
Total liabilities and capital	$654,949	$609,877

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

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 2001 and 2000

(in millions)

	2001	2000
Interest income		
Interest on U.S. government and federal agency securities	$30,523	$32,737
Interest on investments denominated in foreign currencies	331	269
Interest on loans to depository institutions	13	23
Total interest income	30,867	33,029
Other operating income (loss)		
Income from services	926	882
Reimbursable services to government agencies	286	302
Foreign currency losses, net	(1,435)	(1,410)
Government securities gains (losses), net	316	(82)
Other income	108	82
Total other operating income (loss)	201	(226)
Operating expenses		
Salaries and other benefits	1,616	1,507
Occupancy expense	204	196
Equipment expense	268	243
Assessments by Board of Governors	634	624
Other expenses	311	357
Cost of unreimbursed Treasury services	. . .	8
Total operating expenses	3,033	2,935
Net income prior to distribution	$28,035	$29,868
Distribution of net income		
Dividends paid to member banks	$ 428	$ 410
Transferred to surplus	518	4,115
Payments to U.S. Treasury as interest on Federal Reserve notes	27,089	25,343
Total distribution	$28,035	$29,868

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

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2001 and 2000

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2000 (128 million shares)	$6,431	$6,431	$12,862
Net income transferred to surplus	. . .	4,115	4,115
Surplus transfer to the U.S. Treasury	. . .	(3,752)	(3,752)
Net change in capital stock issued (11 million shares)	566	. . .	566
Balance at December 31, 2000 (139 million shares)	$6,997	$6,794	$13,791
Net income transferred to surplus	. . .	518	518
Net change in capital stock issued (8 million shares)	376	. . .	376
Balance at December 31, 2001 (147 million shares)	$7,373	$7,312	$14,685

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

Notes to the Combined Financial Statements of the Federal Reserve Banks

(1) Organization and Basis of Presentation

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act) which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Open Market Committee (FOMC) and the Federal Advisory Council. 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.

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared with adjustments to eliminate interdistrict accounts and transactions.

Structure

The Reserve Banks serve twelve Federal Reserve Districts nationwide. In accordance with the Federal Reserve Act, supervision and control of each Reserve Bank is exercised by a Board of Directors. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

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. Of the six elected by member banks, three represent the public and three represent member banks. 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.

(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 mechanism, including large-dollar transfers of funds, automated clearinghouse (ACH) operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of U.S. government and federal agency securities, matched sale–purchase transactions, the purchase of securities under agreements to resell, and the lending of U.S. government securities. FRBNY is also authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange (F/X) and securities contracts in nine foreign currencies, maintain reciprocal currency arrangements (F/X swaps) with various central banks, and ‘‘warehouse’’ foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks.

(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 Financial Accounting Standards Board. 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 to 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*.

These combined financial statements have been prepared in accordance with the *Financial Accounting Manual*. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States of America (GAAP). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale–purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is generally required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included as the liquidity and cash position of the Reserve Banks are not of primary concern to users of these combined financial statements. Other information regarding the Reserve Banks’ activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

The preparation of the combined 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 and disclosure of contingent assets and liabilities at the date of the combined 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 Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. 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 account is lowered. The value of gold for purposes of backing the gold certificates is set by law at $\$42\frac{2}{9}$ a fine troy ounce.

(B) *Special Drawing Rights Certificates*

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 account is increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations.

(C) *Loans to Depository Institutions*

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. 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 any loans were 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 Banks, subject to review by the Board of Governors. Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

(D) *U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies*

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account (SOMA). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

Matched sale–purchase transactions are accounted for as separate sale and purchase transactions. Matched sale–purchase transactions are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction.

In addition to the aforementioned matched sale–purchase transactions, the FRBNY engages in tri-party agreements. Tri-party agreements are conducted with two custodial banks that manage the clearing and settlement of collateral. Acceptable collateral under tri-party repurchase agreements primarily includes U.S. Government and agency securities, pass-through mortgage securities of GNMA, FHLMC, and FNMA, STRIP securities of the U.S. Government and ''stripped'' securities of other government agencies. The tri-party repurchase transactions are accounted for as financing transactions with the associated interest income accrued over the life of the agreement.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

Foreign exchange contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. 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 foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank 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 Treasury, U.S. dollars for foreign currencies held by the 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 Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which 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.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency 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 and is reported as ''Interest on U.S. government and federal agency securities'' or ''Interest on investments denominated in foreign currencies,'' as appropriate. Income earned on securities lending transactions is reported as a component of ''Other income.'' Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as ''Government securities gains (losses), net.'' Foreign-currency-denominated assets are revalued daily at current 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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

reported as "Foreign currency gains (losses), net." Foreign currencies held through F/X swaps, when initiated by the counterparty, and warehousing arrangements are revalued daily, with the unrealized gain or loss reported as a component of "Other assets" or "Other liabilities," as appropriate.

Statement of Financial Accounting Standards No. 133, as amended and interpreted, became effective on January 1, 2001. For the periods presented, the Reserve Banks had no derivative instruments required to be accounted for under the standard.

(E) *Bank Premises and Equipment*

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 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Internally developed software is capitalized based on the cost of direct materials and services and those indirect costs associated with developing, implementing, and testing software.

(F) *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents 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. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and federal agency securities, tri-party agreements, loans allowed under Section 13, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. 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. Tri-party agreements, however, are valued at the contract amount. 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 that certain assets of the Reserve Banks are 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 Federal Reserve notes reduced by currency held in the vaults of the Reserve Banks of $139,783 million and $188,264 million at December 31, 2001 and 2000, respectively.

At December 31, 2001 and 2000, all gold certificates, all special drawing rights certificates, and domestic securities with par values of $598,512 million and $550,205 million respectively, were pledged as collateral. At December 31, 2001 and 2000, no loans or investments denominated in foreign currencies were pledged as collateral.

(G) *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. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive 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.

(H) *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. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury 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.

The Consolidated Appropriations Act of 2000 (Public Law 106-113, Section 302) directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $3,752 million during the Federal Government's 2000 fiscal year. Reserve Banks were not permitted to replenish surplus for these amounts during fiscal year 2000, which ended September 30, 2000; however, the surplus was replenished by December 31, 2000, for eleven of the twelve Reserve Banks. Surplus was not equated to capital at December 31, 2001 and 2000, at one Reserve Bank where the amount of additional surplus required exceeded the Bank's net income.

In the event of losses, or a substantial increase in capital, a Reserve Bank will suspend its payments to the U.S. Treasury until such losses or increases in capital are recovered through subsequent earnings. Weekly payments to the U.S. Treasury may vary significantly.

(I) *Income and Costs Related to Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but will not be paid are reported as the "Cost of unreimbursed Treasury services."

(J) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

(4) U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31, 2001 and 2000, that were bought outright, were as follows (in millions):

	2001	2000
Par value		
Federal agency	$ 10	$ 130
U.S. government		
Bills	182,074	178,741
Notes	265,941	240,178
Bonds	103,660	92,784
Total par value	551,685	511,833
Unamortized premiums	11,302	9,735
Unaccreted discounts	(1,286)	(3,067)
Total	$561,701	$518,501

The maturity distribution of U.S. government and federal agency securities bought outright and securities purchased under agreements to resell, which were held in the SOMA at December 31, 2001, were as follows (in millions):

	Par value		
Maturities of securities held	U.S. government securities	Federal agency obligations	Total
Within 15 days	$ 10,685	$ . . .	$ 10,685
16 days to 90 days	124,547	. . .	124,547
91 days to 1 year	130,627	. . .	130,627
Over 1 year to 5 years	153,158	10	153,168
Over 5 years to 10 years	53,338	. . .	53,338
Over 10 years	79,320	. . .	79,320
Total	$551,675	$10	$551,685

Maturities of securities held	Repurchase agreement triparty (Contract amount)
Within 15 days	$35,250
16 days to 90 days	15,000
91 days to 1 year	. . .
Over 1 year to 5 years	. . .
Over 5 years to 10 years	. . .
Over 10 years	. . .
Total	$50,250

Total securities held under agreements to resell at December 31, 2001 were $50,250 million that consisted entirely of agreements through third party custodial arrangements and are reported as Securities purchased under agreements to resell (tri-party). In January 2001, the FOMC reduced the maximum permissible maturity for securities purchased under agreements to resell from 90 days to 65 days.

At December 31, 2001 and 2000, matched sale–purchase transactions involving U.S. government securities with par values of $23,188 million and $21,112 million, respectively, were outstanding. Matched sale–purchase transactions are generally overnight arrangements.

At December 31, 2001 and 2000, U.S. government securities with par values of $7,345 million and $2,086 million, respectively, were loaned.

(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 held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Total investments denominated in foreign currencies, valued at current exchange rates at December 31, were as follows (in millions):

	2001	2000
European Union euros		
Foreign currency deposits	$ 4,593	$ 4,633
Government debt instruments including agreements to resell	2,695	2,716
Japanese yen		
Foreign currency deposits	1,891	2,752
Government debt instruments including agreements to resell	5,315	5,497
Accrued interest	65	72
Total	$14,559	$15,670

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The maturity distribution of investments denominated in foreign currencies at December 31, 2001, were as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	
Within 1 year	$13,714
Over 1 year to 5 years	403
Over 5 years to 10 years	442
Over 10 years	. . .
Total	$14,559

At December 31, 2001 and 2000, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2001 and 2000, the warehousing facility was $5,000 million, with no balance outstanding.

(6) Bank Premises and Equipment

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

	2001	2000
Bank premises and equipment		
Land	$ 201	$ 192
Buildings	1,478	1,285
Building machinery and equipment	329	296
Construction in progress	32	163
Furniture and equipment	1,365	1,290
	3,405	3,226
Accumulated depreciation	(1,384)	(1,277)
Bank premises and equipment, net	$2,021	$1,949

Depreciation expense was $186 million and $182 million for the years ended December 31, 2001 and 2000, respectively.

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

	2001	2000
Bank premises and equipment	$21	$34
Accumulated depreciation	(14)	(22)
Capitalized leases, net	$ 7	$12

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 14 years. Rental income from such leases totaled $20 million and $18 million for the years ended December 31, 2001 and 2000, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2001, were (in millions):

2002	$17
2003	14
2004	11
2005	10
2006	7
Thereafter	16
Total	$75

(7) Commitments and Contingencies

At December 31, 2001, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 22 years. These leases provide for increased rentals 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 $69 million and $64 million for the years ended December 31, 2001 and 2000, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2001, were (in millions):

	Operating
2002	$ 15
2003	11
2004	11
2005	9
2006	8
Thereafter	$145
Total	$199

At December 31, 2001, the Reserve Banks had contractual commitments through the year 2007 totaling $100.5 million for the maintenance of currency machines and check-processing-related services, none of which has been recognized. Four Reserve Banks contract for these services on behalf of the System.

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

(8) Retirement and Thrift Plans

Retirement Plans

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks', Board of Governors', and the Plan Administrative Office's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Certain Board employees not covered by the Social Security Act also contribute to the plan. No separate accounting is maintained of assets contributed by the participating

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

employers. FRBNY acts as a sponsor of this Plan. The prepaid pension cost includes amounts related to employees participating in the plans from the 12 Reserve Banks, the Board of Governors, and the Plan Administrative Office.

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

	2001	2000
Estimated actuarial present value of projected benefit obligation at January 1	$2,810	$2,576
Service cost—benefits earned during the period	85	80
Interest cost on projected benefit obligation	207	191
Actuarial loss	125	90
Contributions by plan participants	3	3
Benefits paid	(139)	(132)
Plan amendments	...	2
Estimated actuarial present value of projected benefit obligation at December 31	$3,091	$2,810

Following is a reconciliation showing the beginning and ending balance of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	2001	2000
Estimated fair value of plan assets at January 1	$6,176	$6,156
Actual return on plan assets	(245)	149
Contributions by plan participants	3	3
Benefits paid	(139)	(132)
Estimated fair value of plan assets at December 31	$5,795	$6,176
Funded status	$2,703	$3,366
Unrecognized initial net transition (obligation)	...	(45)
Unrecognized prior service cost	107	122
Unrecognized net actuarial (gain)	(228)	(1,192)
Prepaid pension benefit cost	2,582	2,251

Prepaid pension benefit costs are reported as a component of "Other assets."

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan are as follows:

	2001	2000
Discount rate	7.00%	7.50%
Expected long-term rate of return on plan assets	9.00%	9.00%
Rate of compensation increase	4.50%	5.00%

The components of net periodic pension benefit credit for the System Plan as of December 31 are shown below (in millions):

	2001	2000
Service cost—benefits earned during the period	$ 85	$ 80
Interest cost on projected benefit obligation	207	190
Amortization of initial net transition obligation	(45)	(45)
Amortization of prior service cost	16	16
Recognized net (gain)	(44)	(85)
Expected return on plan assets	(550)	(549)
Net periodic pension benefit (credit)	$(331)	$(393)

Net periodic pension benefit (credit) is reported as a component of "Other expense."

The Reserve Banks' projected benefit obligation and net pension costs for the BEP at December 31, 2001 and 2000, and for the years then ended, are not material.

Thrift Plan

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled $50 million and $47 million for the years ended December 31, 2001 and 2000, respectively, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

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

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

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

	2001	2000
Accumulated postretirement benefit obligation at January 1	$644	$600
Service cost—benefits earned during the period	16	16
Interest cost of accumulated benefit obligation	47	44
Actuarial loss	54	14
Contributions by plan participants	4	3
Benefits paid	(31)	(28)
Plan amendments	(60)	(5)
Accumulated postretirement benefit obligation at December 31	$674	$644

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):

	2001	2000
Fair value of plan assets at January 1	$ . . .	$ . . .
Contributions by the employer	27	25
Contributions by plan participants	4	3
Benefits paid	(31)	(28)
Fair value of plan assets at December 31	$ . . .	$ . . .
Unfunded postretirement benefit obligation	$674	$644
Unrecognized prior service cost	146	95
Unrecognized net actuarial gain/(loss)	(48)	7
Accrued postretirement benefit costs	$772	$746

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

At December 31, 2001 and 2000, the weighted-average discount rate assumption used in developing the postretirement benefit obligation were 7.00 percent and 7.50 percent, respectively.

For measurement purposes, a 10.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2002. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2008, and remain at that level thereafter.

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, 2001 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 12	$ (9)
Effect on accumulated postretirement benefit obligation	86	(76)

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

	2001	2000
Service cost—benefits earned during the period	$16	$15
Interest cost of accumulated benefit obligation	47	44
Amortization of prior service cost	(9)	(9)
Recognized net actuarial loss	(1)	(1)
Net periodic postretirement benefit costs	$53	$49

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

Postemployment Benefits

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and those workers' compensation expenses self-insured by individual Reserve Banks. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2001 and 2000, were $110 million and $102 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2001 and 2000 operating expenses were $21 million.

(10) SUBSEQUENT EVENT

Subsequent to December 31, 2001 Federal Reserve System management determined that it would not proceed with an ongoing technology project. Accordingly, an asset impairment of $7 million will be recognized in 2002.