

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, 1998 and 1997.



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, 1998 and 1997, 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 generally accepted auditing standards. Those standards require that we plan and perform the audits 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 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 generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 1998 and 1997, and combined results of their operations for the years then ended, on the basis of accounting described in Note 3.

A handwritten signature in cursive script, likely representing a partner or manager at PricewaterhouseCoopers LLP.

Washington, D.C.
March 12, 1999

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CONDITION
December 31, 1998 and 1997

(in millions)

ASSETS	1998	1997
Gold certificates	\$ 11,046	\$ 11,047
Special drawing rights certificates	9,200	9,200
Coin	358	460
Items in process of collection	6,933	7,800
Loans to depository institutions	17	2,035
U.S. government and federal agency securities, net	488,911	458,555
Investments denominated in foreign currencies	19,768	17,046
Accrued interest receivable	4,680	4,386
Bank premises and equipment, net	1,787	1,781
Other assets	1,942	1,612
Total assets	\$544,642	\$513,922
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	\$491,657	\$457,469
Deposits		
Depository institutions	26,306	30,838
U.S. Treasury, general account	6,086	5,444
Other deposits	413	681
Deferred credit items	5,924	7,239
Surplus transfer due U.S. Treasury	1,373	653
Accrued benefit cost	780	747
Other liabilities	199	198
Total liabilities	532,738	503,269
CAPITAL		
Capital paid-in	5,952	5,433
Surplus	5,952	5,220
Total capital	11,904	10,653
Total liabilities and capital	\$544,642	\$513,922

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

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF INCOME
for the years ended December 31, 1998 and 1997

(in millions)

	<u>1998</u>	<u>1997</u>
Interest income		
Interest on U.S. government securities	\$26,842	\$25,699
Interest on foreign currencies	435	375
Interest on loans to depository institutions	9	15
Total interest income	<u>27,286</u>	<u>26,089</u>
Other operating income (loss)		
Income from services	816	789
Reimbursable services to government agencies	299	224
Foreign currency gains (losses), net	1,870	(2,593)
Government securities gains, net	44	13
Other income	72	61
Total other operating income (loss)	<u>3,101</u>	<u>(1,506)</u>
Operating expenses		
Salaries and other benefits	1,358	1,300
Occupancy expense	181	184
Equipment expense	244	261
Cost of unreimbursed Treasury services	8	35
Assessments by Board of Governors	587	539
Other expenses	374	474
Total operating expenses	<u>2,752</u>	<u>2,793</u>
Net income prior to distribution	<u>\$27,635</u>	<u>\$21,790</u>
Distribution of net income		
Dividends paid to member banks	\$ 343	\$ 300
Transferred to surplus	732	831
Payments to U.S. Treasury as interest on Federal Reserve notes	8,774	. . .
Payments to U.S. Treasury as required by statute	<u>17,786</u>	<u>20,659</u>
Total distribution	<u>\$27,635</u>	<u>\$21,790</u>

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

THE FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 1998 and 1997

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 1997			
(92 million shares)	\$4,602	\$4,496	\$9,098
Net income transferred to surplus .....	. . .	831	831
Statutory surplus transfer to the U.S. Treasury .....	. . .	(107)	(107)
Net change in capital stock issued			
(17 million shares)	831	. . .	831
Balance at December 31, 1997			
(109 million shares)	\$5,433	\$5,220	\$10,653
Net income transferred to surplus .....	. . .	732	732
Net change in capital stock issued			
(10 million shares)	519	. . .	519
Balance at December 31, 1998			
(119 million shares)	<u>\$5,952</u>	<u>\$5,952</u>	<u>\$11,904</u>

The accompanying notes are an integral part of these 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, adjusted 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 operations, and check processing; distribution of coin and currency; 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. Additionally, the FRBNY is authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange and securities contracts in fourteen 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*.

The 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 (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 required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to include a Statement of Cash Flows or a Statement of Comprehensive Income. 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 financial statements. The Statement of Comprehensive Income, which comprises net income plus or minus certain adjustments, such as the fair value adjustments for securities, has not been included because as stated above the securities are reported at amortized cost and there are no other adjustments in the determination of Comprehensive Income applicable to the Reserve Banks. 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 or a Statement of Comprehensive Income 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 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 financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

(A) Gold 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 $\frac{3}{4}$ 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 U.S. 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 recorded on the accrual basis and is charged at the applicable discount rate established at least every fourteen days by the boards of directors of the Reserve Banks, subject to review by the Board of

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

Governors. However, 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 other needs specified by the FOMC in carrying out the System's central bank responsibilities.

Purchases of securities under agreements to resell and matched sale-purchase transactions are accounted for as separate sale and purchase transactions. Purchases under agreements to resell are transactions in which the FRBNY purchases a security and sells it back at the rate specified at the commencement of the transaction. 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.

Reserve Banks are authorized 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 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 the lending Reserve Bank to take possession of the collateral in amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the lending Reserve Bank 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 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 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.

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

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

(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.

(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 agency securities, 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. 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 U.S. government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes reduced by cash held in the vaults of the Reserve Banks of \$120,030 million and \$92,131 million at December 31, 1998 and 1997, respectively.

At December 31, 1998 and 1997, all gold certificates, all special drawing rights certificates, and domestic securities with par values of \$471,411 million and \$437,222 million, respectively, were pledged as collateral. At December 31, 1998 and 1997, 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% 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% 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. Payments made after September 30, 1998, represent payment of interest on Federal Reserve notes outstanding.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which began on October 1, 1997 and 1996, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of \$107 million and \$106 million during fiscal years 1998 and 1997 respectively. These transfers were made on October 1, 1997 and 1996, respectively. Reserve Banks were not permitted to replenish surplus for these amounts during this time. The 1997 transfer is reported on the Statement of Changes in Capital as "Statutory surplus transfer to the U.S. Treasury."

In the event of losses, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury vary significantly.

(I) *Cost of Unreimbursed Treasury Services*

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

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

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

Securities bought outright and held under agreements to resell are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31, 1998 and 1997, that were bought outright were as follows (in millions):

	1998	1997
Par value		
Federal agency	\$ 337	\$ 685
U.S. government		
Bills	194,772	197,123
Notes	187,895	174,206
Bonds	69,474	59,407
Total par value	452,478	431,421
Unamortized premiums	7,387	6,197
Unaccreted discounts	(3,198)	(3,617)
Total	<u>\$456,667</u>	<u>\$434,001</u>

The maturities of U.S. government and federal agency securities bought outright, which were held in the SOMA at December 31, 1998, were as follows (in millions):

Maturities of securities held	Par value		
	U.S. government securities	Federal agency obligations	Total
Within 15 days ...	\$ 1,158	\$. . .	\$ 1,158
16 days to 90 days . . .	99,127	27	99,154
91 days to 1 year ..	143,635	75	143,710
Over 1 year to			
5 years	107,730	61	107,791
Over 5 years to			
10 years	44,822	174	44,996
Over 10 years	55,669	. . .	55,669
Total	<u>\$452,141</u>	<u>\$337</u>	<u>\$452,478</u>

Total securities held under agreements to resell at December 31 1998 and 1997, respectively were as follows (in millions):

	1998	1997
Par value		
Federal agency	\$10,702	\$ 2,652
U.S. government	19,674	21,188
Total par value	30,376	23,840
Unamortized premiums	2,133	996
Unaccreted discounts	(265)	(282)
Total	<u>\$32,244</u>	<u>\$24,554</u>

The resell date for securities purchased under agreements to resell does not exceed fifteen days after the purchase date.

At December 31, 1998 and 1997, matched sale-purchase transactions involving U.S. government securities with par values of \$20,927 million and \$17,027 million, respectively, were outstanding. Matched sale-purchase transactions are generally overnight arrangements.

At December 31, 1998 and 1997, U.S. government securities with par values of \$325 million and \$887 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):

	1998	1997
German marks		
Foreign currency deposits	\$10,451	\$ 8,271
Government debt instruments, including agreements to resell	2,373	3,215
Japanese yen		
Foreign currency deposits	666	575
Government debt instruments, including agreements to resell	6,196	4,902
Accrued interest	97	86
Total	<u>\$19,783</u>	<u>\$17,049</u>

In addition to the balances reported above, \$15 million and \$3 million in unearned interest collected on certain foreign currency holdings were also reported as "Investments denominated in foreign currencies" at December 31, 1998 and 1997, respectively.

The maturities of investments denominated in foreign currencies at December 31, 1998, were as follows (in millions):

<u>Maturities of Investments Denominated in Foreign Currencies</u>	
Within 1 year	\$18,826
Over 1 year to 5 years	496
Over 5 years to 10 years	461
Total	<u>\$19,783</u>

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

At December 31, 1998 and 1997, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 1998, the warehousing facility was \$5,000 million, with nothing outstanding.

(6) BANK PREMISES AND EQUIPMENT

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

	<u>1998</u>	<u>1997</u>
Bank premises and equipment		
Land	\$ 191	\$ 194
Buildings	1,177	1,100
Building machinery and equipment	271	255
Construction in progress	41	61
Furniture and equipment	<u>1,244</u>	<u>1,258</u>
	2,924	2,868
Accumulated depreciation	<u>(1,137)</u>	<u>(1,087)</u>
Bank premises and equipment, net	<u>\$1,787</u>	<u>\$1,781</u>

Depreciation expense was \$184 million and \$194 million for the years ended December 31, 1998 and 1997, respectively.

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

	<u>1998</u>	<u>1997</u>
Bank premises and equipment	\$89	\$95
Accumulated depreciation	<u>(78)</u>	<u>(81)</u>
Capitalized leases, net	<u>\$11</u>	<u>\$14</u>

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 16 years. Rental income from such leases totaled \$17 million for each of the years ended December 31, 1998 and 1997. Future minimum lease payments under agreements in existence at December 31, 1998, were (in millions):

1999	\$14
2000	14
2001	12
2002	11
2003	8
Thereafter	<u>23</u>
Total	<u>\$82</u>

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 1998, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 year to approximately 25 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 \$64 million and \$69 million for the years ended December 31, 1998 and 1997, 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, 1998, were (in millions):

	<u>Operating</u>
1999	\$ 14
2000	11
2001	9
2002	6
2003	6
Thereafter	<u>\$119</u>
Total	<u>\$165</u>

At December 31, 1998, the Reserve Banks had contractual commitments through the year 2007 totaling \$243 million for the maintenance of currency processing machines, none of which has been recognized. One Reserve Bank contracts for maintenance for these machines on behalf of the System and allocates the costs, annually, to each other Reserve Bank.

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' 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 (BEPs).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as the sponsor of this plan. The prepaid pension cost includes amounts related to the participation of employees of the twelve Reserve Banks, the Board of Governors, and the Plan Administrative Office in the plan.

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

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

	1998	1997
Estimated actuarial present value of projected benefit obligation at January 1	\$2,476	\$2,270
Service cost—benefits earned during the period	79	71
Interest cost of projected benefit obligation	169	160
Actuarial loss	140	80
Contributions by plan participants	4	4
Benefits paid	(125)	(117)
Special termination benefits	.	4
Plan amendments	31	4
Estimated actuarial present value of projected benefit obligation at December 31	<u>\$2,774</u>	<u>\$2,476</u>

During 1997, a special retirement program was offered by one of the employers to employees who were eligible to retire in 1998.

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

	1998	1997
Estimated fair value of plan assets at January 1	\$5,031	\$4,157
Actual return on plan assets	888	904
Contributions by employer	.	83
Contributions by plan participants	4	4
Benefits paid	(125)	(117)
Estimated fair value of plan assets at December 31	<u>\$5,798</u>	<u>\$5,031</u>
Funded status	\$3,024	\$2,555
Unrecognized initial net transition (obligation)	(136)	(181)
Unrecognized prior service cost	152	135
Unrecognized net actuarial (gain)	(1,549)	(1,307)
Prepaid pension benefit cost	<u>1,491</u>	<u>1,202</u>

Prepaid pension benefit cost is 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:

	1998	1997
Discount rate	6.25%	7.00%
Expected long-term rate of return on plan assets	9.00%	9.00%
Rate of compensation increase	4.25%	5.00%

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

	1998	1997
Service cost—benefits earned during the period	\$ 79	\$ 71
Interest cost on projected benefit obligation	169	160
Amortization of initial net transition obligation	(45)	(46)
Amortization of prior service cost	15	13
Recognized net (gain)	(59)	(34)
Expected return on plan assets	(448)	(369)
Cost of special termination benefits	.	4
Net periodic pension benefit (credit)	<u>\$(289)</u>	<u>\$(201)</u>

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, 1998 and 1997, 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 \$43 million and \$41 million for the years ended December 31, 1998 and 1997, 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 cost is 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):

	1998	1997
Accumulated postretirement benefit obligation at January 1	\$588	\$582
Service cost—benefits earned during the period	15	15
Interest cost of accumulated benefit obligation	39	39
Actuarial loss (gain)	41	(14)
Contributions by plan participants	3	3
Benefits paid	(24)	(22)
Plan amendments, acquisitions, foreign currency exchange rate changes, business combinations, diversitures, curtailments, settlements, special termination benefits	(17)	(15)
Accumulated postretirement benefit obligation at December 31	<u>\$645</u>	<u>\$588</u>

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

	1998	1997
Fair value of plan assets at January 1	\$. . .	\$. . .
Actual return on plan assets	. . .	. . .
Contributions by the employer	21	19
Contributions by plan participants	3	3
Benefits paid	(24)	(22)
Fair value of plan assets at December 31	<u>\$. . .</u>	<u>\$. . .</u>
Unfunded postretirement benefit obligation	\$645	\$588
Unrecognized initial net transition asset (obligation)	. . .	(1)
Unrecognized prior service cost	100	92
Unrecognized net actuarial (loss)	(50)	(7)
Accrued postretirement benefit cost	<u>\$695</u>	<u>\$672</u>

Accrued postretirement benefit cost is reported as a component of "Accrued benefit cost."

The weighted-average assumption used in developing the postretirement benefit obligation as of December 31 is as follows:

	1998	1997
Discount rate	6.25%	7.00%

For measurement purposes, an 8.5% annual rate of increase in the cost of covered health care benefits was assumed for 1999. Ultimately, the health care cost trend rate is expected to decrease gradually to 4.75% by 2006, 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 1 percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 1998 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit cost	\$ 10	\$ (10)
Effect on accumulated postretirement benefit obligation	106	(107)

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

	1998	1997
Service cost—benefits earned during the period	\$15	\$16
Interest cost of accumulated benefit obligation	39	40
Amortization of prior service cost	(8)	(6)
Recognized net actuarial loss	. . .	. . .
Net periodic postretirement benefit cost	<u>\$46</u>	<u>\$50</u>

Net periodic postretirement benefit cost is 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, 1998 and 1997, were \$84 million and \$76 million, respectively. This cost is included as a component of "Accrued benefit cost." Net periodic postemployment benefit costs included in 1998 and 1997 operating expenses were \$19 million and \$17 million, respectively.