# FEDERAL RESERVE BANK *of* NEW YORK

Puerto Rico and the U.S. Virgin Islands

SERVING THE SECOND DISTRICT AND THE NATION | **2012 ANNUAL REPORT**

# Federal Reserve Bank of New York

## Annual Report

*For the year ended December 31, 2012*

SECOND FEDERAL RESERVE DISTRICT

Federal Reserve Bank of New York
33 Liberty Street
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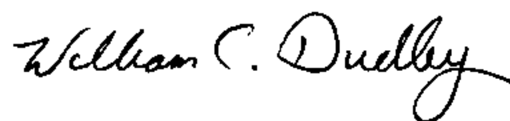
May 2013

To the Depository Institutions in
the Second Federal Reserve District:

It is my pleasure to send you the ninety-eighth annual report of the Federal Reserve Bank of New York, covering the year 2012.

Following the "Letter from the President," the *2012 Annual Report* presents detailed tables, with extensive notes, on the Bank's financial condition.

I hope you will find the information we present interesting and useful.



William C. Dudley
President

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# Letter from the President

# LETTER FROM THE PRESIDENT

## Financial Stability: Progress, but More Work to Be Done

Financial stability is central to the Federal Reserve's mission as a central bank. As the recent financial crisis demonstrated so painfully, we cannot achieve our dual mandate of full employment and price stability if financial instability disrupts the availability of credit and other financial services to households and businesses.

In the aftermath of the crisis, the New York Fed has been working with colleagues in the Federal Reserve System, as well as other agencies and regulators in the United States and around the world, to make our financial system more resilient. Our common aim is to strengthen the financial system and improve our capacity to identify, monitor, and mitigate emerging threats to financial stability.

Such threats to financial stability can either emerge from within the financial system itself or arise from external shocks. Both types of shocks can be amplified by vulnerabilities in the system. While it is impossible to predict the nature or timing of all risk events, we can make the financial system less prone to generate excesses and address structural weaknesses that magnify and propagate stress.

Because the United States—and, increasingly, countries around the globe—have a capital markets–based financial system, these efforts have to take place both at the level of the individual firms under our supervision and at the level of market infrastructures and practices.

In this letter, I will highlight some of the significant and wide-ranging contributions our staff has made to important financial sector reform initiatives over the past year. Since our work is ongoing, I will also highlight components of the overall architecture that are still in need of construction or repair.

A special problem still in the "in need of construction or repair" category is ending what is popularly known as the "too-big-to-fail" (TBTF) problem. The underlying problem is that the potential disorderly failure of a large, complex financial firm can generate significant negative externalities for society—externalities that the firm and its suppliers of capital have no incentive to internalize in advance, unless they are forced to do so by regulators.

By creating a perception that large, complex firms will not be allowed to fail, the TBTF phenomenon risks creating a funding subsidy for such institutions. This is bad not only because it creates an un-level playing field between larger and smaller institutions, but also because it may create incentives for financial institutions to become even larger and more complex, thereby increasing the degree of systemic risk in the financial system.

***Threats to financial stability can either emerge from within the financial system itself or arise from external shocks. . . . While it is impossible to predict the nature or timing of all risk events, we can make the financial system less prone to generate excesses and address structural weaknesses that magnify and propagate stress.***

*In 2012, the Federal Reserve worked with our sister agencies to strengthen . . . financial institutions. . . . As part of the Bank's ongoing supervisory activities at firms headquartered in our District, we focused on corporate governance, risk culture, and information systems in an effort to bolster the management of these firms and hence the financial system.*

TBTF cannot be ended simply by pledging in normal times never to intervene to prevent the failure of large, complex firms. Markets will view this as a "time-inconsistent" statement—one that will be reneged upon if a crisis situation emerges because the cost of a messy failure of a large, complex firm to workers, families, and businesses that had nothing to do with the firm's own risk taking would be intolerably high.

Ending TBTF requires more than this: it requires reducing the cost to society when large, complex firms fail and eliminating any perverse incentives for firms to become bigger or more systemically important. My view is that we should seek to do this in a way that preserves to the greatest extent possible such social benefits as come with scale and scope in finance.

The New York Fed is committed to doing all that we can within our authority to end TBTF in a way consistent with the public interest and the balancing of social cost and benefit. Aspects of this effort run through much of our execution of the Federal Reserve's financial stability agenda.

## Making Firms More Resilient and More Resolvable

The Bank plays an important role in the Federal Reserve System's efforts to make the firms under our supervision more resilient and resolvable. Large bank holding companies remain important building blocks of our financial system and are deeply integrated with our capital markets.

### Governance, business models, and risk

In 2012, the Federal Reserve worked with our sister agencies to strengthen these financial institutions, thereby reducing the risk of failure. As part of the Bank's ongoing supervisory activities at firms headquartered in our District, we focused on corporate governance, risk culture, and information systems in an effort to bolster the management of these firms and hence the financial system.

As we deepen the reorganization of our supervisory activities begun in 2010, we continue to focus on a better understanding of the business models and risks of these firms. This includes challenging senior management and boards of directors to ensure that their risk management practices are strong enough to promote sound decision making throughout the organization—from top to bottom and side to side.

### Capital

In the United States and internationally, regulators have focused on raising both the quantity and quality of capital held by major banks, with the aim of making them more resilient. One effort where the Bank has made substantial contributions is the design, modeling, and analysis of the Federal Reserve System's Comprehensive Capital Analysis and Review (CCAR).

In this year's CCAR exercise, a substantial number of Bank staff—more than 10 percent of the Bank—contributed to System efforts to promote the development and maintenance of robust, forward-looking capital planning at bank holding companies. The exercise is aimed at ensuring that firms have sufficient capital to continue operations during periods of severe economic and financial market stress. Since firm management—or we, as supervisors—will never be able to identify every emerging risk, it is important to ensure that firms have the capacity to withstand a wide range of negative events, and the CCAR has emerged as one of the Federal Reserve's most important tools for this resiliency.

### Liquidity

In addition to our work on capital assessment, the Bank has been a leader in developing and applying methods of evaluating the liquidity of large financial institutions. Liquidity, like capital, is a bulwark against unforeseen shocks; higher liquidity serves as a buffer so that firms do not have to sell illiquid assets at the first signs of stress.

Led by staff from the Office of Financial Stability and Regulatory Policy and the Financial Institution Supervision Group (FISG), the Bank has contributed to the development of the *liquidity coverage ratio*—a measure of the amount of liquid assets that banks should hold to cover short-term stress. The Bank offered insight on the Basel liquidity reforms through participation in the Basel Committee on Banking Supervision and the Bank for International Settlements' Committee on the Global Financial System. One of our senior leaders served as the co-chair of the Basel Committee's Working Group on Liquidity—which was instrumental in the Committee's establishment of global liquidity standards.

In addition, Bank staff helped direct System efforts on the design and execution of an innovative approach to horizontal liquidity analysis and review, including the evaluation of liquidity risk-management practices as well as liquidity adequacy.

### Recovery and resolution planning

No matter how much capital or liquidity a financial institution has, there is always some risk that it will fail. To end TBTF, our goal is to make it so that when a firm does get in distress, the costs to society of a failure are low enough that policymakers do not feel compelled to intervene.

On this front, New York Fed staff are working with our colleagues at the Federal Deposit Insurance Corporation and across the Federal Reserve to strengthen recovery and resolution planning as a discipline for the large financial firms under our supervision. The Bank has committed substantial supervisory and legal resources to the analysis of the "living wills" generated by the largest bank holding companies—statutorily mandated plans for the orderly wind-down of failing financial firms, designed to limit potential risks to financial stability.

This effort has generated significant insights into both the complex interconnections of the largest global banking organizations and the challenges such complexity poses for orderly resolution. While the efforts of our staff have been substantial, much more work remains before the costs of a TBTF institution's failure can be reduced to a tolerable level.

In this regard, the Bank is working with regulators around the world to determine how the official sector can manage the failure of a cross-border banking organization in a way that does not disrupt the global financial system. Our contributions have included substantial intellectual input on global financial stability work in support of the Financial Stability Board's Resolution Steering Group.

## Making Markets More Stable and Robust to Shocks

Financial stability cannot be achieved at the level of the individual firm alone. It requires stable and robust market infrastructures as well, so that the system as a whole will not generate excesses or amplify shocks and can absorb the failure of even the largest firms while continuing to supply credit to the economy.

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In 2012, the Bank contributed to multiple workstreams focused on improving financial stability through better market infrastructure. Key efforts included supporting reforms in the tri-party repo system, money market funds, over-the-counter (OTC) derivatives, and foreign exchange settlement. Significant work was also carried out to support the stability of financial market infrastructures.

### Tri-party repo system

The tri-party repo market is a large and important market where securities dealers fund a substantial portion of firm and client assets. The crisis revealed significant fragility in the tri-party repo system. To help support financial stability in this market in 2012, a cross-bank team including contributors from FISG and the Markets, Risk, and Research groups continued their work with market participants to effect changes in settlement infrastructure. The aim is to help reduce the extension of intraday credit within the tri-party repo market and to improve dealers' liquidity risk-management practices.

To this end, the Bank intensified its direct oversight of market participants to make the infrastructure changes necessary to reduce reliance on intraday credit and worked with broker-dealers affiliated with bank holding companies and foreign banking organizations to improve risk-management practices.

### Money market funds

In 2012, the Bank continued to support reform in the money market fund business. The crisis made clear that the monies provided to the money market mutual funds by their own investors are inherently unstable and susceptible to runs in times of panic. Investors in money market funds with a fixed net asset value can take money out on a daily basis at par value, with no redemption penalty. This can occur even if the money market fund does not have sufficient cash or liquid assets to meet all potential redemptions. This creates an incentive for investors to be the first to get out whenever there is any uncertainty about the underlying value of the assets in the fund. The size of the money market fund sector and its interconnectedness with the rest of the financial system make reform of these vulnerabilities crucial.

While the primary responsibility for implementing money market fund reform lies with the U.S. Securities and Exchange Commission, the Bank provided substantial analysis to policymakers on reform alternatives, with leadership from staff in the Research Group and the Office of Financial Stability and Regulatory Policy. In early 2013, I personally joined with the presidents of the other eleven Reserve Banks to offer our public support for reform in this market.

### OTC derivatives

The Bank continues its work in support of stability in the OTC derivatives markets. As the supervisor of the financial institutions most active in the OTC derivatives markets, the Bank understands that resilient and well-functioning OTC derivatives markets are an important component of the financial markets and the broader global economy. In 2012, Bank staff, led by FISG, contributed to efforts to ensure that the derivatives clearance and settlement activities at supervised firms (currently being transitioned to the new regulatory regime under the Dodd-Frank Wall Street Reform and Consumer Protection Act) are being conducted in a safe and sound manner.

Further, the Bank helped advance the Group of Twenty's OTC derivatives reform agenda and collaborated with domestic and international

authorities on a variety of initiatives to support implementation of OTC derivatives reform. Internationally, the Bank co-chaired the Financial Stability Board's OTC Derivatives Working Group, which monitors progress in implementing the Group of Twenty's commitments on central clearing, reporting to trade repositories, and trading on organized platforms. In addition, Bank staff, and particularly Risk and FISG staff, contributed to the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions, which will soon finalize a policy framework that establishes minimum standards for margin requirements for non-centrally cleared derivatives.

### Resiliency in the foreign exchange market

The Bank has special responsibilities for supporting stability and resiliency in the foreign exchange market. This market is the most liquid sector of global financial markets, and the one that generates the largest amount of daily cross-border payments. The Bank led a working group, sponsored by the Basel Committee on Banking Supervision and the Bank for International Settlements' Committee on Payment and Settlement Systems, that revised supervisory guidance on risks linked to the settlement of foreign exchange transactions. The updated guidance expands on and replaces a version published in 2000, covers a broader range of risks, and reflects the significant changes in the foreign exchange market during the past decade.[1] The guidance serves as a basis for the Bank to facilitate further discussions on sound practices with other regulators and the industry, and will be integrated with the Bank's supervisory program.

### Financial market infrastructure

Another area where the Bank provided leadership this year was the strengthening of the financial market utilities, multilateral systems that link financial institutions through the transfer, clearing, or settling of payments, securities, or other financial transactions. Regulators and supervisors are working together to ensure that the utilities have appropriate governance, risk-management practices, and resources. In addition, the Bank is collaborating with regulators to develop an enhanced ability to look at utilities across the Second District in a consistent way and aims to use this "lens" to identify and address sources of systemic risk.[2]

Again, this aspect of the Bank's work has international dimensions. For example, I served as chairman of the Committee on Payment and Settlement Systems of the Bank for International Settlements through the spring of last year and, together with other Bank staff, worked with central bankers and practitioners around the globe to finalize new principles for financial market infrastructures. These international principles for financial market infrastructures are aimed at substantially raising the bar for resiliency. This effort and other global engagements will help ensure that we are moving toward a more resilient financial system.

***We have made significant progress in increasing the stability of the world's financial system, but the task of reforming the system remains incomplete. . . . Much more must be done to ensure that the financial system is robust enough to absorb shocks and still provide the credit needed for economic growth and job creation.***

[1] *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions*, published by the Basel Committee and the Committee on Payment and Settlement Systems in February 2013 (available at https://www.bis.org/publ/bcbs241.htm).

[2] As outlined in *Risk Management Supervision of Designated Clearing Entities*, prepared by the Commodity Futures Trading Commission, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System (available at http://www.sec.gov/news/studies/2011/813study.pdf).

*Improved financial stability will also require more collaboration at home and internationally. After the crisis, it became evident that the regulatory and supervisory framework had not kept up with the changes in size, complexity, interconnectedness, and globalization that created growing systemic risk externalities.*

## Unfinished Business

We have made significant progress in increasing the stability of the world's financial system, but the task of reforming the system remains incomplete and uneven. Much more must be done to ensure that the financial system is robust enough to absorb shocks and still provide the credit needed for economic growth and job creation.

While we must be alert for unintended consequences and open to learning as we go, we must also recognize that changes to the scale and profitability of activities that were artificially inflated by flaws in the system pre-crisis are not unintended—they are necessary and intended consequences of reform.

### Living wills and resolution

We have much work still to do to reduce the cost to society of the failure of large, complex financial institutions. This is the key to resolving the TBTF problem. Changes to corporate organization and market practices, along with deep collaboration between regulators in different jurisdictions, will likely be needed to make the orderly resolution of internationally active firms truly credible.

### Wholesale funding, market structures, and OTC derivatives reform

While much has been done over the past few years to mitigate the structural flaws that make wholesale funding a point of weakness in the global financial system, some important issues and vulnerabilities remain. Tri-party repo reform still has considerable work to do, including completion of infrastructure reform and better contingency planning by market participants—particularly in the dimension of addressing the nexus of run risk, fire-sale risk, and resulting financial instability.

Going forward, we need to look at the larger issue of the appropriate role of wholesale funding in the financial system. We need to evaluate how comfortable we should be with a system in which critical financial activities continue to be financed with short-term wholesale funding beyond the scope of the type of lender-of-last-resort facility that reduces the risk of runs and asset fire sales that can threaten the stability of the entire financial system.

We also need to press ahead on OTC derivatives reform. The goal is fewer bespoke trades and more standardized trades. If regulators, financial market infrastructures, and market participants make the effort, the financial system will be safer, more resilient, and more transparent. The reforms under way, if properly executed, should over time significantly reduce the shortcomings in the OTC derivatives market that exacerbated the financial crisis.

### Collaboration at home and internationally

Improved financial stability will also require more collaboration at home and internationally. After the crisis, it became evident that the regulatory and supervisory framework had not kept up with the changes in size, complexity, interconnectedness, and globalization that created growing systemic risk externalities and widened the wedge between private and social costs in the event of stress.

In a globally integrated financial system, it is essential that we have effective coordination between regulators within and between countries. Such coordination allows us to better respond to crises and to avoid pernicious regulatory arbitrage that can foster excessive risk taking. We can do better through international cooperation and coordination, both

on macroeconomic policy and on regulation and supervision, than by trying to "go it alone."

In the United States, the creation of the Financial Stability Oversight Council and the implementation of the Dodd-Frank Act strengthen the mandate for coordination across the U.S. regulatory system on financial stability issues. My Bank colleagues and I are also involved in international efforts to secure financial stability. These global efforts align with our efforts at home to strengthen both market infrastructures and the largest financial institutions.

### The way forward

The task of securing financial stability will never be truly complete. A dynamic financial system, in intermediating between savers and borrowers and in allowing for efficient capital formation, will always have the potential to tip toward instability. As central bankers and regulators, we will need to continue the work of watching for symptoms of instability and intervening to correct when things threaten to go awry.

That said, the recent financial crisis carried stiff costs for society and hard lessons for the central banking community. We are on the path to learning from this episode and to addressing our shortcomings—in understanding the vulnerabilities of wholesale funding and in grappling with the complexities and costs of too-big-to-fail institutions. We are not where we need to be yet, but we are determined to get there.

William C. Dudley
July 2013

# Management's Report on Internal Control over Financial Reporting

**Management's Report on Internal Control over Financial Reporting**

To the Board of Directors of
the Federal Reserve Bank of New York:

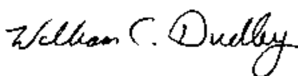
March 14, 2013

The management of the Federal Reserve Bank of New York (Bank) is responsible for the preparation and fair presentation of the Consolidated Statements of Condition as of December 31, 2012 and 2011, the Consolidated Statements of Income and Comprehensive Income, and the Consolidated Statements of Changes in Capital for the years then ended (the financial statements). The financial statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System as set forth in the *Financial Accounting Manual for Federal Reserve Banks (FAM)*, and, as such, include some amounts that are based on management judgments and estimates. To our knowledge, the financial statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the *FAM* and include all disclosures necessary for such fair presentation.

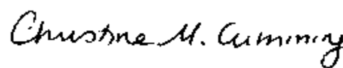
The management of the Bank is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the financial statements. The Bank's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial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

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

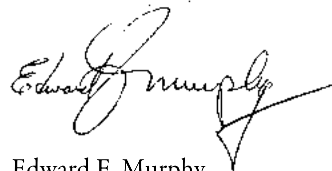
The management of the Bank assessed its internal control over financial reporting based upon the criteria established in the *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the Bank maintained effective internal control over financial reporting.



William C. Dudley
President



Christine M. Cumming
First Vice President



Edward F. Murphy
Principal Financial Officer

# External Auditor Independence

# EXTERNAL AUDITOR INDEPENDENCE

The Board of Governors engaged Deloitte & Touche LLP (D&T) to audit the 2012 combined and individual financial statements of the Reserve Banks and those of the consolidated LLC entities.[1] In 2012, D&T also conducted audits of internal controls over financial reporting for each of the Reserve Banks, Maiden Lane LLC, Maiden Lane III LLC, and TALF LLC. Fees for D&T's services totaled $7 million, of which $1 million was for the audits of the consolidated LLC entities. To ensure auditor independence, the Board requires that D&T be independent in all matters relating to the audits. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2012, the Bank did not engage D&T for any non-audit services.

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

# Consolidated Financial Statements

## Independent Auditors' Report

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

We have audited the accompanying consolidated financial statements of the Federal Reserve Bank of New York and its subsidiaries (collectively "FRB New York"), which are comprised of the consolidated statements of condition as of December 31, 2012 and 2011, and the related consolidated statements of income and comprehensive income, and of changes in capital for the years then ended, and the related notes to the consolidated financial statements. We also have audited the FRB New York's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

**Management's Responsibility**

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

**Auditors' Responsibility**

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

An audit of the consolidated financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments,

the auditor considers internal control relevant to the FRB New York's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of the consolidated financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. An audit of internal control over financial reporting involves obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

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

**Definition of Internal Control over Financial Reporting**

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

**Inherent Limitations of Internal Control over Financial Reporting**

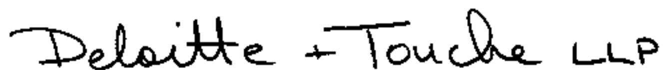
Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected and corrected on a timely basis. Also, projections of any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

**Opinions**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the FRB New York as of December 31, 2012 and 2011, and the results of its operations for the years then ended in accordance with the basis of accounting described in Note 3 to the consolidated financial statements. Also, in our opinion, the FRB New York maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

**Basis of Accounting**

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



March 14, 2013
New York, New York

## CONSOLIDATED STATEMENTS OF CONDITION

As of December 31, 2012, and December 31, 2011

(in millions)

| ASSETS | 2012 | 2011 |
|---|---|---|
| Gold certificates | $ 3,824 | $ 3,866 |
| Special drawing rights certificates | 1,818 | 1,818 |
| Coin | 90 | 80 |
| Loans: | | |
| Depository institutions | 18 | 9 |
| Term Asset-Backed Securities Loan Facility (measured at fair value) | 560 | 9,059 |
| System Open Market Account: | | |
| Treasury securities, net (of which $5,124 and $7,032 are lent as of December 31, 2012 and 2011, respectively) | 1,014,329 | 813,954 |
| Government-sponsored enterprise debt securities, net (of which $391 and $593 are lent as of December 31, 2012 and 2011, respectively) | 44,560 | 50,144 |
| Federal agency and government-sponsored enterprise mortgage-backed securities, net | 532,801 | 394,477 |
| Foreign-currency-denominated assets, net | 8,056 | 7,516 |
| Central bank liquidity swaps | 2,867 | 28,912 |
| Other investments | 13 | — |
| Investments held by consolidated variable interest entities (of which $2,266 and $35,593 are measured at fair value as of December 31, 2012 and 2011, respectively) | 2,750 | 35,693 |
| Accrued interest receivable | 10,612 | 9,160 |
| Bank premises and equipment, net | 471 | 310 |
| Deferred asset—interest on Federal Reserve notes | — | 378 |
| Interdistrict settlement account | — | 274,474 |
| Other assets | 199 | 248 |
| **Total assets** | **$1,622,968** | **$1,630,098** |



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

## CONSOLIDATED STATEMENTS OF CONDITION

As of December 31, 2012, and December 31, 2011
(in millions)

| LIABILITIES AND CAPITAL | 2012 | 2011 |
|---|---|---|
| Federal Reserve notes outstanding, net | $ 385,008 | $ 376,865 |
| System Open Market Account: | | |
| Securities sold under agreements to repurchase | 60,096 | 46,458 |
| Other liabilities | 1,781 | 636 |
| Consolidated variable interest entities: | | |
| Beneficial interest in consolidated variable interest entities (measured at fair value) | 803 | 9,845 |
| Other liabilities (of which $71 and $106 are measured at fair value as of December 31, 2012 and 2011, respectively) | 415 | 690 |
| Deposits: | | |
| Depository institutions | 917,383 | 1,024,868 |
| Treasury, general account | 92,720 | 85,737 |
| Other deposits | 33,744 | 64,850 |
| Interest payable to depository institutions | 124 | 121 |
| Accrued benefit costs | 2,395 | 2,577 |
| Accrued interest on Federal Reserve notes | 831 | — |
| Interdistrict settlement account | 110,116 | — |
| Other liabilities | 62 | 97 |
| **Total liabilities** | **1,605,478** | **1,612,744** |
| Capital paid-in | 8,745 | 8,677 |
| Surplus (including accumulated other comprehensive loss of $4,475 and $4,541 at December 31, 2012 and 2011, respectively) | 8,745 | 8,677 |
| **Total capital** | **17,490** | **17,354** |
| **Total liabilities and capital** | **$1,622,968** | **$1,630,098** |

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

## CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the years ended December 31, 2012, and December 31, 2011
(in millions)

| INTEREST INCOME | 2012 | 2011 |
|---|---|---|
| Loans: | | |
| Term Asset-Backed Securities Loan Facility | $ 80 | $ 265 |
| American International Group, Inc., net | — | 409 |
| System Open Market Account: | | |
| Treasury securities, net | 24,774 | 19,068 |
| Government-sponsored enterprise debt securities, net | 1,395 | 1,365 |
| Federal agency and government-sponsored enterprise mortgage-backed securities, net | 16,671 | 17,138 |
| Foreign-currency-denominated assets, net | 44 | 72 |
| Central bank liquidity swaps | 76 | 10 |
| Other investments | 5 | — |
| Investments held by consolidated variable interest entities | 1,110 | 3,429 |
| **Total interest income** | **44,155** | **41,756** |

| INTEREST EXPENSE | 2012 | 2011 |
|---|---|---|
| System Open Market Account: | | |
| Securities sold under agreements to repurchase | 77 | 19 |
| Beneficial interest in consolidated variable interest entities | 153 | 285 |
| Deposits: | | |
| Depository institutions | 2,575 | 2,492 |
| Term Deposit Facility | 2 | 3 |
| **Total interest expense** | **2,807** | **2,799** |
| **Net interest income** | **41,348** | **38,957** |



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

## CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the years ended December 31, 2012, and December 31, 2011

(in millions)

| | 2012 | 2011 |
|---|---|---|
| NONINTEREST INCOME (LOSS) | | |
| Term Asset-Backed Securities Loan Facility, unrealized losses | $ (34) | $ (84) |
| System Open Market Account: | | |
| Treasury securities gains, net | 7,151 | 1,050 |
| Federal agency and government-sponsored enterprise mortgage-backed securities gains, net | 124 | 5 |
| Foreign currency translation gains (losses), net | (364) | 44 |
| Consolidated variable interest entities: | | |
| Investments held by consolidated variable interest entities gains (losses), net | 7,451 | (3,920) |
| Beneficial interest in consolidated variable interest entities gains (losses), net | (2,345) | 491 |
| Dividends on preferred interests | — | 47 |
| Income from services | 82 | 75 |
| Compensation received for service costs provided | 3 | 3 |
| Reimbursable services to government agencies | 124 | 115 |
| Other | 14 | 73 |
| **Total noninterest income (loss)** | **12,206** | **(2,101)** |
| OPERATING EXPENSES | | |
| Salaries and benefits | 592 | 535 |
| Occupancy | 68 | 67 |
| Equipment | 22 | 25 |
| Compensation paid for service costs incurred | 32 | 33 |
| Assessments: | | |
| Board of Governors operating expenses and currency costs | 306 | 267 |
| Bureau of Consumer Financial Protection | 123 | 71 |
| Office of Financial Research | 1 | 12 |
| Net periodic pension expense | 637 | 513 |
| Professional fees related to consolidated variable interest entities | 25 | 71 |
| Other | 200 | 236 |
| **Total operating expenses** | **2,006** | **1,830** |
| Net income before interest on Federal Reserve notes expense remitted to Treasury | 51,548 | 35,026 |
| Interest on Federal Reserve notes expense remitted to Treasury | 51,023 | 32,432 |
| Net income | 525 | 2,594 |
| Change in prior service costs related to benefit plans | 180 | 32 |
| Change in actuarial losses related to benefit plans | (114) | (1,161) |
| **Total other comprehensive income (loss)** | **66** | **(1,129)** |
| **Comprehensive income** | **$ 591** | **$ 1,465** |

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

## CONSOLIDATED STATEMENTS OF CHANGES IN CAPITAL

For the years ended December 31, 2012, and December 31, 2011
(in millions, except share data)

| | Capital Paid-In | Surplus: Net Income Retained | Surplus: Accumulated Other Comprehensive Income (Loss) | Total Surplus | Total Capital |
|---|---|---|---|---|---|
| **Balance at December 31, 2010 (153,645,679 shares)** | **$7,682** | **$11,094** | **$ (3,412)** | **$7,682** | **$15,364** |
| Net change in capital stock issued (19,895,069 shares) | 995 | — | — | — | 995 |
| Comprehensive income: | | | | | |
| Net income | — | 2,594 | — | 2,594 | 2,594 |
| Other comprehensive loss | — | — | (1,129) | (1,129) | (1,129) |
| Dividends on capital stock | — | (470) | — | (470) | (470) |
| Net change in capital | 995 | 2,124 | (1,129) | 995 | 1,990 |
| **Balance at December 31, 2011 (173,540,748 shares)** | **$8,677** | **$13,218** | **$(4,541)** | **$8,677** | **$17,354** |
| Net change in capital stock issued (1,367,438 shares) | 68 | — | — | — | 68 |
| Comprehensive income: | | | | | |
| Net income | — | 525 | — | 525 | 525 |
| Other comprehensive income | — | — | 66 | 66 | 66 |
| Dividends on capital stock | — | (523) | — | (523) | (523) |
| Net change in capital | 68 | 2 | 66 | 68 | 136 |
| **Balance at December 31, 2012 (174,908,186 shares)** | **$8,745** | **$13,220** | **$(4,475)** | **$8,745** | **$17,490** |

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

# FEDERAL RESERVE BANK OF NEW YORK
## *Notes to Consolidated Financial Statements*

### 1. STRUCTURE

The Federal Reserve Bank of New York (Bank) is part of the Federal Reserve System (System) and is one of the twelve Federal Reserve Banks (Reserve Banks) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the Second Federal Reserve District, which includes the State of New York; the twelve northern counties of New Jersey; Fairfield County, Connecticut; the Commonwealth of Puerto Rico; and the U.S. Virgin Islands.

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

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

## 2. OPERATIONS AND SERVICES

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

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

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

Because of the global character of funding markets, the System has at times coordinated with other central banks to provide temporary liquidity. In May 2010, the FOMC authorized and directed the Bank to establish temporary U.S. dollar liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank through January 2011. Subsequently, the FOMC authorized and directed the Bank to extend these arrangements through February 1, 2013. In December 2012, the FOMC authorized and directed the Bank to extend these arrangements through February 1, 2014. In addition, in November 2011, as a contingency measure, the FOMC authorized the Bank to establish temporary bilateral foreign currency liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank so that liquidity can be provided to U.S. institutions in any of their currencies if necessary. In December 2012, the FOMC authorized the Bank to extend these temporary bilateral foreign currency liquidity swap arrangements through February 1, 2014.

Although the Reserve Banks are separate legal entities, they collaborate on the delivery of certain services to achieve greater efficiency and effectiveness. This collaboration takes the form of centralized operations and product or function offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are reimbursed for costs incurred in providing services to other Reserve Banks. Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include the management of SOMA, the Wholesale Product Office, the System Credit Risk Technology Support function, the Valuation Support team, centralized business administration functions for wholesale payments services, and three national information technology operations dealing with incident response, remote access, and enterprise search.

## 3. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

Preparing the consolidated financial statements in conformity with the *FAM* requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the consolidated 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. The presentation of "Dividends on capital stock" and "Interest on Federal Reserve notes expense remitted to Treasury" in the Consolidated Statements of Income and Comprehensive Income for the year ended December 31, 2011, has been revised to conform to the current year presentation format. In addition, the presentation of "Comprehensive income" and "Dividends on capital stock" in the Consolidated Statements of Changes in Capital for the year ended December 31, 2011, has been revised to conform to the current year presentation format. The revised presentation of "Dividends on capital stock" and "Interest on Federal Reserve notes expense remitted to Treasury" better reflects the nature of these items and results in a more consistent treatment of the amounts presented in the Consolidated Statements of Income and Comprehensive Income and the related balances presented in the Consolidated Statements of Condition. As a result of the change to report "Interest on Federal Reserve Notes expense remitted to Treasury" as an expense, the amount reported as "Comprehensive income" for the year ended December 31, 2011, has been revised. Significant accounts and accounting policies are explained below.

### a. Consolidation

The consolidated financial statements include the accounts and results of operations of the Bank as well as several variable interest entities (VIEs), which include Maiden Lane LLC (ML), Maiden Lane II LLC (ML II), Maiden Lane III LLC (ML III), and TALF LLC. The consolidation of the VIEs was assessed in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 810 (ASC 810) *Consolidation*, which requires a VIE to be consolidated by its controlling financial interest holder. Intercompany balances and transactions have been eliminated in consolidation. See Note 6 for additional information on the VIEs. The consolidated financial statements of the Bank also include accounts and results of operations of Maiden and Nassau LLC, a Delaware limited-liability company (LLC) wholly owned by the Bank, which was formed to own and operate the 33 Maiden Lane building, which was purchased on February 28, 2012. The Bank had been the primary occupant of the building since 1998, accounting for approximately 74 percent of the leased space.

The Bank consolidates a VIE if the Bank has a controlling financial interest, which is defined as the power to direct the significant economic activities of the entity and the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the VIE. To determine whether it is the controlling financial interest holder of a VIE, the Bank evaluates the VIE's design, capital structure, and relationships with the variable interest holders. The Bank reconsiders whether it has a controlling financial interest in a VIE, as required by ASC 810, at each reporting date or if there is an event that requires consideration.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the System that has supervisory authority over some institutions previously supervised by the Reserve Banks in connection with those institutions' compliance with consumer protection statutes. Section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board of Governors or the System. Section 152 of the Dodd-Frank Act established the Office of Financial Research (OFR) within the Treasury. The Board of Governors funds the Bureau and OFR through assessments on the Reserve Banks as required by the Dodd-Frank Act. The Reserve Banks reviewed the law and evaluated the design of and their relationships to the Bureau and the OFR and determined that neither should be consolidated in the Bank's consolidated financial statements.

### b. Gold and Special Drawing Rights Certificates

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

SDRs are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR certificate transactions occur, the Board of Governors allocates the SDR certificates among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding calendar year. SDR certificates are recorded by the Banks at original cost. There were no SDR certificate transactions during the years ended December 31, 2012 and 2011.

### c. Coin

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

### d. Loans

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

The Bank records the Term Asset-Backed Securities Loan Facility (TALF) loans at fair value in accordance with the fair value option provisions of FASB ASC Topic 825 (ASC 825) *Financial Instruments*. Unrealized gains (losses) on TALF loans that are recorded at fair value are reported as “Noninterest income (loss): Term Asset-Backed Securities Loan Facility, unrealized losses” in the Consolidated Statements of Income and Comprehensive Income. The interest income on TALF loans is recognized based on the contracted rate and is reported as a component of “Interest Income: Term Asset-Backed Securities Loan Facility” in the Consolidated Statements of Income and Comprehensive Income.

Interest income on the Bank’s loan to American International Group, Inc. (AIG), was recognized on an accrual basis. See Note 4 for additional information on AIG loan. Loan administrative and commitment fees were deferred and amortized on a straight-line basis, rather than using the interest method required by GAAP, over the term of the loan or commitment period. This method resulted in an interest amount that approximated the amount determined using the interest method.

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

Impaired loans include loans that have been modified in debt restructurings involving borrowers experiencing financial difficulties. The allowance for loan restructuring is determined by discounting the restructured cash flows using the original effective interest rate for the loan. Unless the borrower can demonstrate that it can meet the restructured terms, the Bank discontinues recognizing interest income. Performance prior to the restructuring, or significant events that coincide with the restructuring, is considered in assessing whether the borrower can meet the new terms.

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

The Bank may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are settled through a triparty arrangement. In a triparty arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the Bank and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the Bank for each class and maturity of acceptable collateral. Collateral designated by the Bank as acceptable under repurchase transactions primarily includes Treasury securities (including Treasury Inflation-Protected Securities and Separate Trading of Registered Interest and Principal of Securities [STRIPS] Treasury securities); direct obligations of several federal and GSE-related agencies, including Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and pass-through MBS of Fannie Mae, Freddie Mac, and Government National Mortgage Association. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction.

The Bank may engage in sales of securities under agreements to repurchase (reverse repurchase transactions) with primary dealers and selected money market funds. The list of eligible counterparties was expanded to include GSEs, effective in July 2011, and bank and savings institutions, effective in December 2011. These reverse repurchase transactions may be executed through a triparty arrangement as an open market operation, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international account holders as part of a service offering. Reverse repurchase agreements are collateralized by a pledge of an amount of Treasury securities, GSE debt securities, and federal agency and GSE MBS that are held in the SOMA. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest expense is recognized over t he life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities sold under agreements to repurchase" and the related accrued interest payable is reported as a component of "Other liabilities" in the Consolidated Statements of Condition.

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers to facilitate the effective functioning of the domestic securities markets. The amortized cost basis of securities lent continues to be reported as "Treasury securities, net" and "Government-sponsored enterprise debt securities, net," as appropriate, in the Consolidated Statements of Condition. Overnight securities lending transactions are fully collateralized by Treasury securities that have fair values in excess of the securities lent. The Bank charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Noninterest income (loss): Other" in the Consolidated Statements of Income and Comprehensive Income.

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

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

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

In addition to outright purchases of federal agency and GSE MBS that are held in the SOMA, the Bank enters into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell "to be announced" (TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. During the years ended December 31, 2012 and 2011, the Bank executed dollar rolls primarily to facilitate settlement of outstanding purchases of federal agency and GSE MBS. The Bank accounts for dollar roll transactions as purchases or sales on a settlement-date basis. In addition, TBA MBS transactions may be paired off or assigned prior to settlement. Net gains (losses) resulting from dollar roll transactions are reported as "Noninterest income (loss):

System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Consolidated Statements of Income and Comprehensive Income.

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

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

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

The Bank is authorized to hold foreign currency working balances and execute foreign exchange contracts to facilitate international payments and currency transactions it makes on behalf of foreign central bank and U.S. official institution customers. These foreign currency working balances and contracts are not related to the Bank's monetary policy operations. Foreign currency working balances are reported as a component of "Other assets" in the Consolidated Statements of Condition and the related foreign currency translation gains and losses that result from the daily revaluation of the foreign currency working balances and contracts are reported as a component of "Noninterest income (loss): Other" in the Consolidated Statements of Income and Comprehensive Income.

### g. Central Bank Liquidity Swaps

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

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

***U.S. Dollar Liquidity Swaps***

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

The foreign central bank compensates the Bank based on the foreign currency amounts it holds for the Bank. The Bank's allocated portion of the amount of compensation received during the term of the swap transaction is reported as "Interest income: System Open Market Account: Central bank liquidity swaps" in the Consolidated Statements of Income and Comprehensive Income.

***Foreign Currency Liquidity Swaps***

The structure of foreign currency liquidity swap transactions involves the transfer by the Bank, at the prevailing market exchange rate, of a specified amount of U.S. dollars to an account for the foreign central bank in exchange for its currency. The foreign currency amount received would be reported as a liability by the Bank.

### h. Investments Held by Consolidated Variable Interest Entities

The investments held by consolidated VIEs may include investments in federal agency and GSE MBS, nonagency residential mortgage-backed securities (RMBS), commercial and residential real estate mortgage loans, collateralized debt obligations (CDOs), short-term investments with maturities of greater than three months and less than one year, other investment securities, and swap contracts. Investments are reported as "Investments held by consolidated variable interest entities" in the Consolidated Statements of Condition. These investments are accounted for and classified as follows:

- ML's investments in debt securities are accounted for in accordance with FASB ASC Topic 320 (ASC 320) *Investments – Debt and Equity Securities* and ML elected the fair value option for all eligible assets and liabilities in accordance with ASC 825. Other financial instruments, including swap contracts in ML, are recorded at fair value in accordance with FASB ASC Topic 815 (ASC 815) *Derivatives and Hedging*.

- ML II and ML III qualify as nonregistered investment companies under the provisions of FASB ASC Topic 946 (ASC 946) *Financial Services – Investment Companies* and, therefore, all investments are recorded at fair value in accordance with ASC 946.

- TALF LLC follows the guidance in ASC 320 when accounting for any acquired ABS investments, and has elected the fair value option for all eligible assets in accordance with ASC 825.

### i. Preferred Interests

The Bank's preferred interests in American International Assurance Company Ltd. LLC (AIA) and American Life Insurance Company LLC (ALICO) were paid in full on January 14, 2011. The 5 percent cumulative dividends accrued by the Bank on the preferred interests are reported as "Noninterest Income (Loss): Dividends on preferred interests" in the Consolidated Statements of Income and Comprehensive Income.

### j. Bank Premises, Equipment, and Software

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

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

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

### k. Interdistrict Settlement Account

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

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

### l. Federal Reserve Notes

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

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

"Federal Reserve notes outstanding, net" in the Consolidated Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $93,101 million and $50,541 million at December 31, 2012 and 2011, respectively.

At December 31, 2012 and 2011, all Federal Reserve notes issued to the Reserve Banks were fully collateralized. At December 31, 2012, all gold certificates, all special drawing rights certificates, and $1,110 billion of domestic securities held in the SOMA were pledged as collateral. At December 31, 2012, no investments denominated in foreign currencies were pledged as collateral.

### m. Beneficial Interest in Consolidated Variable Interest Entities

ML, ML II, and ML III have outstanding senior and subordinated financial interests, and TALF LLC has an outstanding financial interest. The subordinated financial interests of ML II and ML III include the interest holder's allocated share of any residual net proceeds. Upon issuance of the financial interests, ML, ML II, ML III, and TALF LLC each elected to measure these obligations at fair value in accordance with ASC 825. Principal, interest, and changes in fair value on the senior financial interest, which were extended by the Bank, are eliminated in consolidation. The financial interests are recorded at fair value as "Beneficial interest in consolidated variable interest entities" in the Consolidated Statements of Condition. Interest expense and changes in fair value of the financial interest are recorded in "Interest expense: Beneficial interest in consolidated variable interest entities" and "Noninterest income (loss): Beneficial interest in consolidated variable interest entities gains (losses), net," respectively, in the Consolidated Statements of Income and Comprehensive Income.

### n. Deposits

***Depository Institutions***

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

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as a component of "Interest payable to depository institutions" in the Consolidated Statements of Condition. There were no deposits held by the Bank under the TDF at December 31, 2012 and 2011.

***Treasury***

The Treasury general account is the primary operational account of the Treasury and is held at the Bank.

***Other***

Other deposits include the Bank's allocated portion of foreign central bank and foreign government deposits held at the Bank and those in which the Bank has an undivided interest. Other deposits also include GSE deposits held by the Bank.

### o. Items in Process of Collection and Deferred Credit Items

Items in process of collection primarily represents amounts attributable to checks that have been deposited for collection and that, as of the balance sheet date, have not yet been presented to the paying bank. Deferred credit items is the counterpart liability to items in process of collection. The amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances of items in process of collection and deferred credit items were not material as of December 31, 2012 and 2011.

### p. Capital Paid-in

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

By law, each Reserve Bank is required to pay each member bank an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually.

### q. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in. On a daily basis, surplus is adjusted to equate the balance to capital paid-in. Accumulated other comprehensive income is reported as a component of "Surplus" in the Consolidated Statements of Condition and the Consolidated Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9, 10, and 11.

### r. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Interest on Federal Reserve notes expense remitted to Treasury" in the Consolidated Statements of Income and Comprehensive Income. See Note 13 for additional information on interest on Federal Reserve notes.

If earnings during the year are not sufficient to provide for the costs of operations, payment of dividends, and equating surplus and capital paid-in, remittances to the Treasury are suspended. A deferred asset is recorded that represents the amount of net earnings a Reserve Bank will need to realize before remittances to the Treasury resume. This deferred asset is periodically reviewed for impairment. The deferred asset is reported as "Deferred asset – interest on Federal Reserve notes" in the Consolidated Statements of Condition. As of December 31, 2011, no impairment existed.

### s. Income and Costs Related to Treasury Services

When directed by the Secretary of the Treasury, the Bank is required by the Federal Reserve Act to serve as fiscal agent and depositary of the United States government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2012 and 2011, the Bank was reimbursed for substantially all services provided to the Treasury as its fiscal agent.

### t. Income from Services and Compensation Received for Service Costs Provided

The Bank has overall responsibility for managing the Reserve Banks' provision of Fedwire funds and securities services and, as a result, reports total System revenue for these services as "Income from services" in its Consolidated Statements of Income and Comprehensive Income. The Bank compensates the applicable Reserve Banks for the costs incurred to provide these services and reports the resulting compensation paid as "Operating expenses: Compensation paid for service costs incurred" in its Consolidated Statements of Income and Comprehensive Income.

The Federal Reserve Bank of Atlanta (FRBA) has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions and the Federal Reserve Bank of Chicago (FRBC) has overall responsibility for managing the Reserve Banks' provision of electronic access services to depository institutions. The Reserve Bank that has overall responsibility for managing these services recognizes the related total System revenue in its Consolidated Statements of Income and Comprehensive Income. The Bank is compensated for costs incurred to provide these services and reports this compensation as "Noninterest income (loss): Compensation received for service costs provided" in its Consolidated Statements of Income and Comprehensive Income.

### u. Assessments

The Board of Governors assesses the Reserve Banks to fund its operations, the operations of the Bureau and, for a two-year period following the July 21, 2010, effective date of the Dodd-Frank Act, the OFR. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances. The Board of Governors also assesses each Reserve Bank for expenses related to producing, issuing, and retiring Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the prior year.

During the period before the Bureau transfer date of July 21, 2011, there was no limit on the funding provided to the Bureau and assessed to the Reserve Banks; the Board of Governors was required to provide the amount estimated by the Secretary of the Treasury needed to carry out the authorities granted to the Bureau under the Dodd-Frank Act and other federal law. The Dodd-Frank Act requires that, after the transfer date, the Board of Governors fund the Bureau in an amount not to exceed a fixed percentage of the total operating expenses of the System as reported in the Board of Governors' 2009 annual report, which totaled $4.98 billion. The fixed percentage of total 2009 operating expenses of the System is 10 percent ($498.0 million) for 2011, 11 percent ($547.8 million) for 2012, and 12 percent ($597.6 million) for 2013. After 2013, the amount will be adjusted in accordance with the provisions of the Dodd-Frank Act. The Bank's assessment for Bureau funding is reported as "Assessments: Bureau of Consumer Financial Protection" in the Consolidated Statements of Income and Comprehensive Income.

The Board of Governors assessed the Reserve Banks to fund the operations of the OFR for the two-year period ended July 21, 2012, following enactment of the Dodd-Frank Act; thereafter, the OFR is funded by fees assessed on bank holding companies and nonbank financial companies that meet the criteria specified in the Dodd-Frank Act.

### v. Fair Value

Certain assets and liabilities reported on the Bank's Consolidated Statements of Condition are measured at fair value in accordance with ASC 820, including TALF loans, investments and beneficial interests of the consolidated VIEs, and assets of the Retirement Plan for Employees of the System. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes a three-level fair value hierarchy that distinguishes between assumptions developed using market data obtained from independent sources (observable inputs) and the Bank's assumptions developed using the best information available in the circumstances (unobservable inputs). The three levels established by ASC 820 are described as follows:

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

The inputs or methodology used for valuing assets and liabilities are not necessarily an indication of the risk associated with those assets and liabilities.

### w. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $13 million and $8 million for the years ended December 31, 2012 and 2011, respectively, and are reported as a component of "Operating expenses: Occupancy" in the Consolidated Statements of Income and Comprehensive Income.

### x. Restructuring Charges

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

The Bank had no significant restructuring activities in 2012 and 2011.

### y. Recently Issued Accounting Standards

In April 2011, the FASB issued ASU 2011-02, *Receivables* (Topic 310): *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which clarifies accounting for troubled debt restructurings, specifically clarifying creditor concessions and financial difficulties experienced by borrowers. This update is effective for the Bank for the year ended December 31, 2012, and did not have a material effect on the Bank's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing* (Topic 860): *Reconsideration of Effective Control for Repurchase Agreements,* which reconsidered the effective control for repurchase agreements. This update prescribes when the Bank may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. This determination is based, in part, on whether the Bank has maintained effective control over the transferred financial assets. This update is effective for the Bank for the year ended December 31, 2012, and did not have a material effect on the Bank's consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement* (Topic 820): *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. This update requires additional disclosures for fair value measurements categorized as Level 3, including quantitative information about the unobservable inputs and assumptions used in the fair value measurement, a description of the valuation policies and procedures, and a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs. In addition, disclosure of the amounts and reasons for all transfers in and out of Level 1 and Level 2 is required. This update is effective for the Bank for the year ended December 31, 2012, and the required disclosures are included in Note 6.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet* (Topic 210): *Disclosures about Offsetting Assets and Liabilities*. This update will require a reporting entity to present enhanced disclosures for financial instruments and derivative instruments that are offset or subject to master netting agreements or similar such agreements. This update is effective for the Bank for the year ending December 31, 2013, and is not expected to have a material effect on the Bank's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income* (Topic 220): *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. This update indefinitely deferred the requirements of ASU 2011-05, which required an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective net income line items. Subsequently, in February 2013, the FASB issued ASU 2013-02, *Comprehensive Income* (Topic 220): *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, which established an effective date for the requirements of ASU 2011-05 related to reporting of significant reclassification adjustments from accumulated other comprehensive income. These presentation requirements of ASU 2011-05 are effective for the Bank for the year ending December 31, 2013, and will be reflected in the Bank's 2013 consolidated financial statements.

In January 2013, the FASB issued ASU 2013-01, *Balance Sheet* (Topic 210): *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. This update clarifies that the scope of ASU 2011-11 applies to derivatives accounted for in accordance with Topic 815. This update is effective for the Bank for the year ending December 31, 2013, and is not expected to have a material effect on the Bank's consolidated financial statements.

## 4. LOANS

***Loans to Depository Institutions***

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

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

Loans to depository institutions were $18 million and $9 million as of December 31, 2012 and 2011, respectively, with a remaining maturity within fifteen days.

At December 31, 2012 and 2011, the Bank did not have any loans that were impaired, past due, or on nonaccrual status, and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2012 and 2011.

***TALF***

The TALF assisted financial markets in accommodating the credit needs of consumers and businesses of all sizes by facilitating the issuance of ABS collateralized by a variety of consumer and business loans. Each TALF loan had an original maturity of three years, except loans secured by Small Business Administration (SBA) Pool Certificates, loans secured by SBA Development Company Participation Certificates, or ABS backed by student loans or commercial mortgage loans, which had an original maturity of five years if the borrower so elected. The loans are secured by eligible collateral, with the Bank having lent an amount equal to the value of the collateral, as determined by the Bank, less a margin. Loan proceeds were disbursed to the borrower contingent on receipt by the Bank's custodian of the eligible collateral, an administrative fee, and, if applicable, a margin.

The TALF loans were extended on a nonrecourse basis. If the borrower does not repay the loan, the Bank will enforce its rights in the collateral and may sell the collateral to TALF LLC, a Delaware limited-liability company, established on February 4, 2009, for the purpose of purchasing such assets. As of December 31, 2012, the Bank has not enforced its rights to the collateral because there have been no defaults.

Pursuant to a put agreement with the Bank, TALF LLC has committed to purchase assets that secure a TALF loan at a price equal to the principal amount outstanding plus accrued but unpaid interest, regardless of the fair value of the collateral. Funding for the TALF LLC's purchases of these securities is derived first through the fees received by TALF LLC from the Bank for this commitment and any interest earned on its investments. In the event that such funding proves insufficient for the asset purchases that TALF LLC has committed to make under the put agreement, the Treasury originally committed to lend up to $20 billion, and on March 25, 2009, the Treasury funded $100 million. In addition to the Treasury's commitment, the Bank originally committed, as a senior lender, to lend up to $180 billion to TALF LLC if it needed the funding to purchase assets pursuant to the put agreement. Subsequently, the Treasury and Bank commitments to lend to TALF LLC were reduced to $1.4 billion and $2.6 billion, respectively. The termination date of the funding commitments was originally July 31, 2015. Information regarding further reduction in commitments is presented in Note 14.

Any Treasury loan to TALF LLC bears interest at a rate of the one-month London interbank offered rate (Libor) plus 300 basis points. Any loan that the Bank makes to TALF LLC would be senior to any Treasury loan and would bear interest at a rate of the one-month Libor plus 100 basis points. To the extent that the Treasury and the Bank have extended credit to TALF LLC, their loans are secured by all of the assets of TALF LLC. The Bank is the managing member and the controlling party

of TALF LLC and will remain the controlling party as long as it retains an economic interest in TALF LLC. After TALF LLC has paid all operating expenses and principal due to the Bank, the remaining proceeds of the portfolio holdings will be distributed in the following order: principal due to the Treasury, interest due to the Bank, and interest due to the Treasury. Any residual cash flows will be shared between the Bank, which will receive 10 percent, and the Treasury, which will receive 90 percent.

The Bank has elected the fair value option for all TALF loans in accordance with ASC 825. Recording all TALF loans at fair value, rather than at the remaining principal amount outstanding, improves accounting consistency and provides the most appropriate presentation on the financial statements by matching the change in fair value of TALF loans, the related put agreement with TALF LLC, and the valuation of the beneficial interests in TALF LLC. Information regarding TALF LLC's assets and liabilities is presented in Note 6.

TALF loans are classified within Level 3 of the valuation hierarchy. External price information was not available, so market-based models were used to determine the fair value of the TALF loans. The fair value of the TALF loans was determined by valuing the future cash flows from loan interest income and the estimated fair value of the collateral that may be put to the Bank. The valuation model takes into account a range of outcomes on TALF loan repayments, market prices of the collateral, risk premiums estimated using market prices, and the volatilities of market-risk factors. Other methodologies employed or assumptions made in determining fair value could result in an amount that differs significantly from the amount reported.

The following table presents the TALF loans at fair value as of December 31 by ASC 820 hierarchy (in millions):

| | 2012 | 2011 |
|---|---|---|
| Level 3 fair value | $560 | $ 9,059 |

The following table presents a reconciliation of TALF loans measured at fair value using significant unobservable inputs (Level 3) during the years ended December 31, 2012 and 2011 (in millions):

| | TALF Loans |
|---|---|
| Fair value at December 31, 2010 | $ 24,853 |
| Loan repayments and prepayments | (15,710) |
| Total unrealized losses | (84) |
| **Fair value at December 31, 2011** | **$ 9,059** |
| Loan repayments and prepayments | (8,465) |
| Total unrealized losses | (34) |
| **Fair value at December 31, 2012** | **$ 560** |

The fair value of TALF loans reported in the Consolidated Statements of Condition as of December 31, 2012 and 2011, includes $3 million and $37 million in unrealized gains, respectively. The Bank attributes substantially all changes in fair value of loans to changes in instrument-specific credit spreads.

Eligible collateral includes U.S. dollar-denominated ABS that are backed by auto loans, student loans, credit card loans, equipment loans, floorplan loans, insurance premium financial loans, loans guaranteed by the SBA, residential mortgage servicing advances, or commercial mortgage loans. The following table presents the collateral concentration and remaining maturity distribution measured at fair value as of December 31, 2012 and 2011 (in millions):

| | Time to Maturity | | | |
|---|---|---|---|---|
| Collateral Type[1] | Within 90 Days | 91 Days to 1 Year | Over 1 Year to 5 Years | Total |
| December 31, 2012: | | | | |
| Student loan | $ — | $ — | $ 382 | $ 382 |
| Credit card | — | — | — | — |
| CMBS | 3 | — | 129 | 132 |
| Floorplan | — | — | — | — |
| Auto | — | — | — | — |
| SBAs | — | — | — | — |
| Other[2] | 46 | — | — | 46 |
| **Total** | **$ 49** | **$ —** | **$ 511** | **$ 560** |
| December 31, 2011: | | | | |
| Student loan | $ — | $ 23 | $ 1,937 | $1,960 |
| Credit card | — | 2,326 | 80 | 2,406 |
| CMBS | — | 578 | 1,454 | 2,032 |
| Floorplan | — | 533 | 430 | 963 |
| Auto | 1 | 374 | 36 | 411 |
| SBAs | — | 113 | 221 | 334 |
| Other[2] | — | 426 | 527 | 953 |
| **Total** | **$ 1** | **$4,373** | **$4,685** | **$9,059** |

[1] All credit ratings are AAA unless otherwise indicated.

[2] Includes equipment loans, insurance premium financial loans, and residential mortgage servicing advances.

The aggregate remaining principal amount outstanding on TALF loans as of December 31, 2012 and 2011, was $556 million and $9,013 million, respectively

At December 31, 2012 and 2011, no TALF loans were over ninety days past due or on nonaccrual status.

Earnings reported by the Bank related to the TALF include interest income and unrealized gains and losses on TALF loans as well as the Bank's allocated share of the TALF LLC's net income. Additional information regarding the income of the TALF LLC is presented in Note 6. The following table presents the components of TALF earnings recorded by the Bank for the years ended December 31 (in millions):

| | 2012 | 2011 |
|---|---|---|
| Interest income | $ 80 | $ 265 |
| Unrealized losses | (34) | (84) |
| **Subtotal–TALF loans** | **$ 46** | **$ 181** |
| Allocated share of TALF LLC | (7) | (48) |
| **Total TALF** | **$ 39** | **$ 133** |

***AIG Loan, Net***

In September 2008, the Board of Governors authorized the Bank to lend to AIG. Under the provisions of the original agreement, the Bank was authorized to lend up to $85 billion to AIG for two years at the three-month Libor, with a floor of 350 basis points, plus 850 basis points. In addition, the Bank assessed AIG a one-time commitment fee of 200 basis points on the full amount of the commitment and a fee of 850 basis points per annum on the undrawn credit line.

The Board and the Treasury announced a restructuring of the government's financial support to AIG in November 2008. As part of the restructuring, the Treasury purchased $40 billion of newly issued AIG preferred shares under the Troubled Asset Relief Program (TARP). The majority of the TARP funds was used to pay down AIG's debt to the Bank. In addition, the terms of the original credit agreement were modified to reduce the revolving line of credit to $60 billion; reduce the interest rate to the three-month Libor with a floor of 350 basis points, plus 300 basis points; reduce the fee on undrawn funds to 75 basis points; and extend the term of the agreement to five years. Concurrent with the November 2008 restructuring of its financial support to AIG, the Bank established two LLCs, ML II and ML III, which are discussed further in Note 6.

On April 17, 2009, the Bank, as part of the U.S. government's commitment to the orderly restructuring of AIG over time, in the face of continuing market dislocations, further restructured the AIG loan by eliminating the 350 basis-point floor on the Libor used to calculate the interest rate on the loan. After this restructuring, the interest rate on the modified loan was equal to the three-month Libor plus 300 basis points.

On December 1, 2009, the Bank's commitment to lend to AIG was reduced to $35 billion from $60 billion when the outstanding balance of the Bank's loan to AIG was reduced by $25 billion in exchange for a liquidation preference of nonvoting perpetual preferred interests in ALICO LLC and AIA LLC. AIG created these two LLCs to

hold, directly or indirectly, all of the outstanding common stock of ALICO and AIA, two life insurance holding company subsidiaries of AIG. The Bank was to be paid a 5 percent cumulative dividend on its nonvoting preferred interests through September 22, 2013, and a 9 percent cumulative dividend thereafter. Although the Bank had certain governance rights to protect its interests, AIG retained control of the two LLCs and the underlying operating companies.

On September 30, 2010, AIG announced an agreement with the Treasury, the Bank, and the trustees of the AIG Credit Facility Trust on a comprehensive recapitalization plan designed to repay all its obligations to American taxpayers. On January 14, 2011, upon closing of the recapitalization plan, the cash proceeds from certain asset dispositions, specifically the initial public offering of AIA and the sale of ALICO, were used first to repay in full the revolving line of credit extended to AIG by the Bank, including accrued interest and fees, and then to redeem a portion of the Bank's preferred interests in ALICO LLC taken earlier by the Bank in satisfaction of a portion of the revolving line of credit. The Bank's remaining preferred interests in ALICO LLC and AIA LLC, valued at approximately $20 billion, were purchased by AIG through a draw on the Treasury's Series F preferred stock commitment and then transferred by AIG to the Treasury as partial consideration for the transfer to AIG of all outstanding Series F shares. In addition, the Bank's commitment to lend any funds under the revolving line of credit was terminated.

## 5. SYSTEM OPEN MARKET ACCOUNT

### a. Domestic Securities Holdings

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

During the years ended December 31, 2012 and 2011, the Bank continued the purchase of Treasury securities and federal agency and GSE MBS under the large-scale asset purchase programs authorized by the FOMC. In August 2010, the FOMC announced that the Federal Reserve would maintain the level of domestic securities holdings in the SOMA portfolio by reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in longer-term Treasury securities. In November 2010, the FOMC announced its intention to expand the SOMA portfolio holdings of longer-term Treasury securities by an additional $600 billion and completed these purchases in June 2011. In September 2011, the FOMC announced that the Federal Reserve would reinvest principal payments from the SOMA portfolio holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS. In June 2012, the FOMC announced that it would continue the existing policy of reinvesting principal payments from the SOMA portfolio holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS, and suspended the policy of rolling over maturing Treasury securities into new issues at

auction. In September 2012, the FOMC announced that the Federal Reserve would purchase additional federal agency and GSE MBS at a pace of $40 billion per month and maintain its existing policy of reinvesting principal payments from its holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS. In December 2012, the FOMC announced that the Federal Reserve would purchase longer-term Treasury securities at a pace of $45 billion per month after its program to extend the average maturity of its holdings of Treasury securities is completed at the end of 2012.

During the years ended December 31, 2012 and 2011, the Bank also continued the purchase and sale of SOMA portfolio holdings under the maturity extension programs authorized by the FOMC. In September 2011, the FOMC announced that the Federal Reserve would extend the average maturity of the SOMA portfolio holdings of securities by purchasing $400 billion par value of Treasury securities with maturities of six to thirty years and selling or redeeming an equal par amount of Treasury securities with remaining maturities of three years or less by the end of June 2012. In June 2012, the FOMC announced that the Federal Reserve would continue through the end of 2012 its program to extend the average maturity of securities by purchasing $267 billion par value of Treasury securities with maturities of six to thirty years and selling or redeeming an equal par amount of Treasury securities with maturities of three-and-a-quarter years or less by the end of 2012. In September 2012, the FOMC announced it would continue its program to extend the average maturity of its holdings of securities as announced in June 2012.

The Bank's allocated share of activity related to domestic open market operations was 56.065 percent and 46.504 percent at December 31, 2012 and 2011, respectively.

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

| | 2012 | | | |
|---|---|---|---|---|
| | Par | Unamortized Premiums | Unaccreted Discounts | Total Amortized Cost |
| Bills | $ — | $ — | $ — | $ — |
| Notes | 622,549 | 18,240 | (399) | 640,390 |
| Bonds | 311,582 | 62,434 | (77) | 373,939 |
| **Total Treasury securities** | **$ 934,131** | **$80,674** | **$ (476)** | **$1,014,329** |
| GSE debt securities | $ 43,048 | $ 1,516 | $ (4) | $ 44,560 |
| Federal agency and GSE MBS | $519,536 | $ 13,662 | $ (397) | $ 532,801 |

| | 2011 | | | |
|---|---|---|---|---|
| | Par | Unamortized Premiums | Unaccreted Discounts | Total Amortized Cost |
| Bills | $ 8,567 | $ — | $ — | $ 8,567 |
| Notes | 598,206 | 12,466 | (574) | 610,098 |
| Bonds | 166,801 | 28,529 | (41) | 195,289 |
| **Total Treasury securities** | **$773,574** | **$40,995** | **$ (615)** | **$ 813,954** |
| GSE debt securities | $ 48,362 | $ 1,789 | $ (7) | $ 50,144 |
| Federal agency and GSE MBS | $ 389,559 | $ 5,403 | $ (485) | $ 394,477 |

The Bank executes transactions for the purchase of securities under agreements to resell primarily to temporarily add reserve balances to the banking system. Conversely, transactions to sell securities under agreements to repurchase are executed to temporarily drain reserve balances from the banking system and as part of a service offering to foreign official and international account holders.

There were no material transactions related to securities purchased under agreements to resell during the years ended December 31, 2012 and 2011. Financial information related to securities sold under agreements to repurchase for the years ended December 31 was as follows (in millions):

| | Allocated to the Bank | | Total SOMA | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Contract amount outstanding, end of year | $60,096 | $46,458 | $107,188 | $99,900 |
| Average daily amount outstanding, during the year | 49,057 | 32,647 | 91,898 | 72,227 |
| Maximum balance outstanding, during the year | 68,703 | 57,903 | 122,541 | 124,512 |
| Securities pledged (par value), end of year | 52,448 | 40,035 | 93,547 | 86,089 |
| Securities pledged (market value), end of year | 60,096 | 46,458 | 107,188 | 99,900 |

The remaining maturity distribution of Treasury securities, GSE debt securities, federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2012 and 2011 was as follows (in millions):

| | Within 15 Days | 16 Days to 90 Days | 91 Days to 1 Year | Over 1 Year to 5 Years | Over 5 Years to 10 Years | Over 10 Years | Total |
|---|---|---|---|---|---|---|---|
| December 31, 2012: | | | | | | | |
| Treasury securities (par value) | $ — | $ 3 | $ 9 | $212,194 | $483,514 | $238,411 | $934,131 |
| GSE debt securities (par value) | 877 | 1,567 | 8,523 | 29,619 | 1,146 | 1,316 | 43,048 |
| Federal agency and GSE MBS (par value)[1] | — | — | 1 | 1 | 1,326 | 518,208 | 519,536 |
| Securities sold under agreements to repurchase (contract amount) | 60,096 | — | — | — | — | — | 60,096 |
| December 31, 2011: | | | | | | | |
| Treasury securities (par value) | $ 7,555 | $12,605 | $41,807 | $302,138 | $302,238 | $107,231 | $773,574 |
| GSE debt securities (par value) | 1,161 | 2,335 | 9,159 | 28,183 | 6,433 | 1,091 | 48,362 |
| Federal agency and GSE MBS (par value)[1] | — | — | — | 6 | 16 | 389,537 | 389,559 |
| Securities sold under agreements to repurchase (contract amount) | 46,458 | — | — | — | — | — | 46,458 |

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

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities, which differs from the stated maturity primarily because it factors in scheduled payments and prepayment assumptions, was approximately 3.3 years and 2.4 years as of December 31, 2012 and 2011, respectively.

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

| | Allocated to the Bank | | Total SOMA | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Treasury securities (amortized cost) | $5,124 | $7,032 | $9,139 | $15,121 |
| Treasury securities (par value) | 4,743 | 6,500 | 8,460 | 13,978 |
| GSE debt securities (amortized cost) | 391 | 593 | 697 | 1,276 |
| GSE debt securities (par value) | 379 | 565 | 676 | 1,216 |

The Bank enters into commitments to buy and sell Treasury securities and records the related securities on a settlement-date basis. As of December 31, 2012, there were no outstanding commitments.

The Bank enters into commitments to buy and sell federal agency and GSE MBS and records the related securities on a settlement-date basis. As of December 31, 2012, the total purchase price of the federal agency and GSE MBS under outstanding purchase commitments was $118,215 million, of which $10,164 million was related to dollar roll transactions. The total purchase price of outstanding purchase commitments allocated to the Bank was $66,278 million, of which $5,699 million was related to dollar roll transactions. As of December 31, 2012, there were no outstanding sales commitments for federal agency and GSE MBS. These commitments, which had contractual settlement dates extending through February 2013, are for the purchase of TBA MBS for which the number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. These commitments are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The Bank requires the posting of cash collateral for commitments as part of the risk management practices used to mitigate the counterparty credit risk.

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

| | Allocated to the Bank | | Total SOMA | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Other investments | $ 13 | $ — | $ 23 | $ — |
| Other liabilities: | | | | |
| Cash margin | $1,733 | $591 | $3,092 | $1,271 |
| Obligations from MBS transaction fails | 48 | 45 | 85 | 97 |
| **Total other liabilities** | **$ 1,781** | **$636** | **$3,177** | **$1,368** |

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the years ended December 31, 2012 and 2011, is summarized as follows (in millions):

| | Allocated to the Bank | | | | | |
|---|---|---|---|---|---|---|
| | Bills | Notes | Bonds | Total Treasury Securities | GSE Debt Securities | Federal Agency and GSE MBS |
| Balance at December 31, 2010 | $ 7,517 | $ 320,965 | $106,891 | $ 435,373 | $ 62,421 | $ 409,969 |
| Purchases[1] | 107,531 | 320,871 | 72,472 | 500,874 | — | 19,600 |
| Sales[1] | — | (64,052) | — | (64,052) | — | — |
| Realized gains, net[2] | — | 1,050 | — | 1,050 | — | — |
| Principal payments and maturities | (107,534) | (30,362) | — | (137,896) | (19,269) | (87,742) |
| Amortization of premiums and accretion of discounts, net | 3 | (2,011) | (2,251) | (4,259) | (746) | (1,416) |
| Inflation adjustment on inflation-indexed securities | — | 578 | 493 | 1,071 | — | — |
| Annual reallocation adjustment[4] | 1,050 | 63,059 | 17,684 | 81,793 | 7,738 | 54,066 |
| **Balance at December 31, 2011** | **$ 8,567** | **$ 610,098** | **$195,289** | **$ 813,954** | **$ 50,144** | **$ 394,477** |
| Purchases[1] | 60,210 | 210,465 | 140,738 | 411,413 | — | 232,087 |
| Sales[1] | — | (270,524) | (6,310) | (276,834) | — | — |
| Realized gains, net[2] | — | 6,478 | 673 | 7,151 | — | — |
| Principal payments and maturities | (70,541) | (35,215) | — | (105,756) | (14,415) | (174,811) |
| Amortization of premiums and accretion of discounts, net | 3 | (2,909) | (4,038) | (6,944) | (603) | (2,845) |
| Inflation adjustment on inflation-indexed securities | — | 351 | 572 | 923 | — | — |
| Annual reallocation adjustment[4] | 1,761 | 121,646 | 47,015 | 170,422 | 9,434 | 83,893 |
| **Balance at December 31, 2012** | **$ —** | **$ 640,390** | **$373,939** | **$1,014,329** | **$ 44,560** | **$ 532,801** |
| Year ended December 31, 2011 | | | | | | |
| Supplemental information – par value of transactions: | | | | | | |
| Purchases[3] | $107,534 | $ 312,986 | $ 57,126 | $ 477,646 | $ — | $ 19,046 |
| Sales[3] | — | (62,701) | — | (62,701) | — | — |
| Year ended December 31, 2012 | | | | | | |
| Supplemental information – par value of transactions: | | | | | | |
| Purchases[3] | $ 60,212 | $ 202,776 | $109,286 | $ 372,274 | $ — | $ 222,141 |
| Sales[3] | — | (262,334) | (4,897) | (267,231) | — | — |

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

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

[3] Includes inflation compensation.

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

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the years ended December 31, 2012 and 2011, is summarized as follows (in millions):

| | Total SOMA | | | | | |
|---|---|---|---|---|---|---|
| | Bills | Notes | Bonds | Total Treasury Securities | GSE Debt Securities | Federal Agency and GSE MBS |
| Balance at December 31, 2010 | $ 18,422 | $ 786,575 | $261,955 | $1,066,952 | $152,972 | $1,004,695 |
| Purchases[1] | 239,487 | 731,252 | 161,876 | 1,132,615 | — | 42,145 |
| Sales[1] | — | (137,733) | — | (137,733) | — | — |
| Realized gains, net[2] | — | 2,258 | — | 2,258 | — | — |
| Principal payments and maturities | (239,494) | (67,273) | — | (306,767) | (43,466) | (195,413) |
| Amortization of premiums and accretion of discounts, net | 8 | (4,445) | (4,985) | (9,422) | (1,678) | (3,169) |
| Inflation adjustment on inflation-indexed securities | — | 1,283 | 1,091 | 2,374 | — | — |
| **Balance at December 31, 2011** | **$ 18,423** | **$1,311,917** | **$ 419,937** | **$1,750,277** | **$107,828** | **$ 848,258** |
| Purchases[1] | 118,886 | 397,999 | 263,991 | 780,876 | — | 431,487 |
| Sales[1] | — | (507,420) | (11,727) | (519,147) | — | — |
| Realized gains, net[2] | — | 12,003 | 1,252 | 13,255 | — | — |
| Principal payments and maturities | (137,314) | (67,462) | — | (204,776) | (27,211) | (324,181) |
| Amortization of premiums and accretion of discounts, net | 5 | (5,461) | (7,531) | (12,987) | (1,138) | (5,243) |
| Inflation adjustment on inflation-indexed securities | — | 643 | 1,047 | 1,690 | — | — |
| **Balance at December 31, 2012** | **$ —** | **$1,142,219** | **$666,969** | **$1,809,188** | **$ 79,479** | **$ 950,321** |
| Year ended December 31, 2011 | | | | | | |
| Supplemental information – par value of transactions: | | | | | | |
| Purchases[3] | $ 239,494 | $ 713,878 | $127,802 | $ 1,081,174 | $ — | $ 40,955 |
| Sales[3] | — | (134,829) | — | (134,829) | — | — |
| Year ended December 31, 2012 | | | | | | |
| Supplemental information – par value of transactions: | | | | | | |
| Purchases[3] | $118,892 | $ 383,106 | $205,115 | $ 707,113 | $ — | $ 413,160 |
| Sales[3] | — | (492,234) | (9,094) | (501,328) | — | — |

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

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

[3] Includes inflation compensation.

### b. Foreign-Currency-Denominated Assets

The Bank conducts foreign currency operations and, on behalf of the Reserve Banks, holds the resulting foreign-currency-denominated assets in the SOMA.

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

The Bank's allocated share of activity related to foreign currency operations was 32.258 percent and 28.963 percent at December 31, 2012 and 2011, respectively.

Information about foreign-currency-denominated assets, including accrued interest, valued at amortized cost and foreign currency market exchange rates at December 31 was as follows (in millions):

| | Allocated to the Bank | | Total SOMA | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Euro: | | | | |
| Foreign currency deposits | $2,879 | $2,713 | $ 8,925 | $ 9,367 |
| Securities purchased under agreements to resell | 213 | — | 659 | — |
| German government debt instruments | 703 | 546 | 2,178 | 1,885 |
| French government debt instruments | 797 | 763 | 2,470 | 2,635 |
| Japanese yen: | | | | |
| Foreign currency deposits | 1,146 | 1,154 | 3,553 | 3,985 |
| Japanese government debt instruments | 2,318 | 2,340 | 7,187 | 8,078 |
| **Total allocated to the Bank** | **$8,056** | **$7,516** | **$24,972** | **$25,950** |

The remaining maturity distribution of foreign-currency-denominated assets that were allocated to the Bank at December 31, 2012 and 2011, was as follows (in millions):

| | Within 15 Days | 16 Days to 90 Days | 91 Days to 1 Year | Over 1 Year to 5 Years | Total |
|---|---|---|---|---|---|
| December 31, 2012: | | | | | |
| Euro | $ 2,130 | $ 557 | $ 698 | $ 1,207 | $4,592 |
| Japanese yen | 1,226 | 158 | 690 | 1,390 | 3,464 |
| **Total** | **$ 3,356** | **$ 715** | **$1,388** | **$ 2,597** | **$8,056** |
| December 31, 2011: | | | | | |
| Euro | $ 1,550 | $ 849 | $ 613 | $ 1,010 | $4,022 |
| Japanese yen | 1,211 | 192 | 910 | 1,181 | 3,494 |
| **Total** | **$ 2,761** | **$ 1,041** | **$1,523** | **$ 2,191** | **$7,516** |

There were no foreign exchange contracts related to open market operations outstanding as of December 31, 2012.

The Bank enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2012, there were no outstanding commitments to purchase foreign government debt instruments. During 2012, there were purchases, sales, and maturities of foreign government debt instruments of $4,959 million, $0, and $4,840 million, respectively, of which $1,580 million, $0, and $1,542 million, respectively, were allocated to the Bank.

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

At December 31, 2012 and 2011, the authorized warehousing facility was $5 billion, with no balance outstanding.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2012 and 2011.

Foreign currency working balances held and foreign exchange contracts executed by the Bank to facilitate its international payments and currency transactions it made on behalf of foreign central banks and U.S. official institution customers were not material as of December 31, 2012 and 2011.

### c. Central Bank Liquidity Swaps

***U.S. Dollar Liquidity Swaps***

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 32.258 percent and 28.963 percent at December 31, 2012 and 2011, respectively.

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2012 and 2011, was $8,889 million and $99,823 million, respectively, of which $2,867 million and $28,912 million, respectively, were allocated to the Bank.

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

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Within 15 Days | 16 Days to 90 Days | Total | Within 15 Days | 16 Days to 90 Days | Total |
| Euro | $562 | $2,305 | $2,867 | $ 9,951 | $ 14,795 | $ 24,746 |
| Japanese yen | — | — | — | 2,617 | 1,435 | 4,052 |
| Swiss franc | — | — | — | 92 | 22 | 114 |
| **Total** | **$562** | **$2,305** | **$2,867** | **$12,660** | **$16,252** | **$28,912** |

***Foreign Currency Liquidity Swaps***

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2012 and 2011.

### d. Fair Value of SOMA Assets

The fair value amounts presented below are solely for informational purposes. Although the fair value of SOMA security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities.

The fair value of the fixed-rate Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign government debt instruments in the SOMA's holdings is subject to market risk, arising from movements in market variables such as interest rates and credit risk. The fair value of federal agency and GSE MBS is also affected by the expected rate of prepayments of mortgage loans underlying the securities. The fair value of foreign government debt instruments is affected by currency risk. Based on evaluations performed as of December 31, 2012, there are no credit impairments of SOMA securities holdings as of that date.

The following table presents the amortized cost and fair value of the Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign-currency-denominated assets, net, held in the SOMA at December 31 (in millions):

| | Allocated to the Bank | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | | 2011 | | |
| | Amortized Cost | Fair Value | Fair Value Greater than Amortized Cost | Amortized Cost | Fair Value | Fair Value Greater than Amortized Cost |
| Treasury securities: | | | | | | |
| Bills | $ — | $ — | $ — | $ 8,567 | $ 8,567 | $ — |
| Notes | 640,390 | 680,173 | 39,783 | 610,098 | 646,144 | 36,046 |
| Bonds | 373,939 | 426,735 | 52,796 | 195,289 | 236,565 | 41,276 |
| GSE debt securities | 44,560 | 47,658 | 3,098 | 50,144 | 53,125 | 2,981 |
| Federal agency and GSE MBS | 532,801 | 557,285 | 24,484 | 394,477 | 416,444 | 21,967 |
| Foreign-currency-denominated assets | 8,056 | 8,110 | 54 | 7,516 | 7,564 | 48 |
| **Total SOMA portfolio securities holdings** | **$1,599,746** | **$1,719,961** | **$120,215** | **$1,266,091** | **$1,368,409** | **$102,318** |
| Memorandum–commitments for: | | | | | | |
| Purchases of Treasury securities | $ — | $ — | $ — | $ 1,488 | $ 1,492 | $ 4 |
| Purchases of federal agency and GSE MBS | 66,278 | 66,380 | 102 | 19,301 | 19,473 | 172 |
| Sales of federal agency and GSE MBS | — | — | — | 2,060 | 2,080 | 20 |
| Purchases of foreign government debt instruments | — | — | — | 62 | 62 | — |

The following table presents the amortized cost and fair value of the Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign-currency-denominated assets, net, held in the SOMA at December 31 (in millions):

| | Total SOMA | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | | 2011 | | |
| | Amortized Cost | Fair Value | Fair Value Greater than Amortized Cost | Amortized Cost | Fair Value | Fair Value Greater than Amortized Cost |
| Treasury securities: | | | | | | |
| Bills | $ — | $ — | $ — | $ 18,423 | $ 18,423 | $ — |
| Notes | 1,142,219 | 1,213,177 | 70,958 | 1,311,917 | 1,389,429 | 77,512 |
| Bonds | 666,969 | 761,138 | 94,169 | 419,937 | 508,694 | 88,757 |
| GSE debt securities | 79,479 | 85,004 | 5,525 | 107,828 | 114,238 | 6,410 |
| Federal agency and GSE MBS | 950,321 | 993,990 | 43,669 | 848,258 | 895,495 | 47,237 |
| Foreign-currency-denominated assets | 24,972 | 25,141 | 169 | 25,950 | 26,116 | 166 |
| **Total SOMA portfolio securities holdings** | **$2,863,960** | **$3,078,450** | **$214,490** | **$2,732,313** | **$2,952,395** | **$220,082** |
| | | | | | | |
| Memorandum–commitments for: | | | | | | |
| Purchases of Treasury securities | $ — | $ — | $ — | $ 3,200 | $ 3,208 | $ 8 |
| Purchases of federal agency and GSE MBS | 118,215 | 118,397 | 182 | 41,503 | 41,873 | 370 |
| Sales of federal agency and GSE MBS | — | — | — | 4,430 | 4,473 | 43 |
| Purchases of foreign government debt instruments | — | — | — | 216 | 216 | — |

The fair value of Treasury securities, GSE debt securities, and foreign government debt instruments was determined using pricing services that provide market consensus prices based on indicative quotes from various market participants. The fair value of federal agency and GSE MBS was determined using a pricing service that utilizes a model-based approach that considers observable inputs for similar securities. The cost basis of foreign currency deposits adjusted for accrued interest approximates fair value. The contract amount for euro-denominated securities sold under agreements to repurchase approximates fair value.

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

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

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

| Distribution of MBS | 2012 | | 2011 | |
|---|---|---|---|---|
| Holdings by Coupon Rate | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Allocated to the Bank: | | | | |
| 2.0% | $ 474 | $ 475 | $ — | $ — |
| 2.5% | 21,060 | 21,174 | — | — |
| 3.0% | 90,048 | 90,690 | 610 | 621 |
| 3.5% | 100,686 | 103,582 | 9,029 | 9,143 |
| 4.0% | 77,235 | 81,830 | 75,096 | 78,947 |
| 4.5% | 147,162 | 158,206 | 189,024 | 200,513 |
| 5.0% | 70,142 | 74,126 | 84,869 | 89,597 |
| 5.5% | 22,409 | 23,446 | 31,063 | 32,583 |
| 6.0% | 3,163 | 3,301 | 4,256 | 4,472 |
| 6.5% | 422 | 455 | 530 | 568 |
| **Total** | **$532,801** | **$557,285** | **$394,477** | **$ 416,444** |
| Total SOMA: | | | | |
| 2.0% | $ 845 | $ 846 | $ — | $ — |
| 2.5% | 37,562 | 37,766 | — | — |
| 3.0% | 160,613 | 161,757 | 1,313 | 1,336 |
| 3.5% | 179,587 | 184,752 | 19,415 | 19,660 |
| 4.0% | 137,758 | 145,955 | 161,481 | 169,763 |
| 4.5% | 262,485 | 282,182 | 406,465 | 431,171 |
| 5.0% | 125,107 | 132,213 | 182,497 | 192,664 |
| 5.5% | 39,970 | 41,819 | 66,795 | 70,064 |
| 6.0% | 5,642 | 5,888 | 9,152 | 9,616 |
| 6.5% | 752 | 812 | 1,140 | 1,221 |
| **Total** | **$950,321** | **$993,990** | **$848,258** | **$ 895,495** |

The following tables present the realized gains and the change in the unrealized gain position of the domestic securities holdings during the year ended December 31, 2012 (in millions):

| | Allocated to the Bank | | Total SOMA | |
|---|---|---|---|---|
| | Portfolio Holdings Realized Gains[1] | Fair Value Changes in Unrealized Gains[2] | Portfolio Holdings Realized Gains[1] | Fair Value Changes in Unrealized Gains[2] |
| Treasury securities | $ 7,151 | $ 595 | $13,255 | $ (1,142) |
| GSE debt securities | — | (468) | — | (885) |
| Federal agency and GSE MBS | 124 | (2,142) | 241 | (3,568) |
| **Total** | **$ 7,275** | **$(2,015)** | **$13,496** | **$ (5,595)** |

[1] Total portfolio holdings realized gains are reported in "Noninterest income (loss): System Open Market Account" in the Consolidated Statements of Income and Comprehensive Income.

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

The amount of change in unrealized gains, net, related to foreign-currency-denominated assets was an increase of $3 million for the year ended December 31, 2012, of which $0.9 million was allocated to the Bank.

The following tables present the classification of SOMA financial assets at fair value as of December 31 by ASC 820 hierarchy (in millions):

| | Allocated to the Bank | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | | | | 2011 | | | |
| | Level 1 | Level 2 | Level 3 | Total Fair Value | Level 1 | Level 2 | Level 3 | Total Fair Value |
| Assets: | | | | | | | | |
| Treasury securities | $ — | $1,106,908 | $ — | $ 1,106,908 | $ — | $ 891,276 | $ — | $ 891,276 |
| GSE debt securities | — | 47,658 | — | 47,658 | — | 53,125 | — | 53,125 |
| Federal agency and GSE MBS | — | 557,285 | — | 557,285 | — | 416,444 | — | 416,444 |
| Foreign government debt instruments | — | 3,872 | — | 3,872 | — | 3,696 | — | 3,696 |
| **Total assets** | **$ —** | **$1,715,723** | **$ —** | **$1,715,723** | **$ —** | **$1,364,541** | **$ —** | **$1,364,541** |

| | Total SOMA | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | | | | 2011 | | | |
| | Level 1 | Level 2 | Level 3 | Total Fair Value | Level 1 | Level 2 | Level 3 | Total Fair Value |
| Assets: | | | | | | | | |
| Treasury securities | $ — | $1,974,315 | $ — | $ 1,974,315 | $ — | $ 1,916,545 | $ — | $ 1,916,545 |
| GSE debt securities | — | 85,004 | — | 85,004 | — | 114,238 | — | 114,238 |
| Federal agency and GSE MBS | — | 993,990 | — | 993,990 | — | 895,495 | — | 895,495 |
| Foreign government debt instruments | — | 12,003 | — | 12,003 | — | 12,762 | — | 12,762 |
| **Total assets** | **$ —** | **$3,065,312** | **$ —** | **$3,065,312** | **$ —** | **$2,939,040** | **$ —** | **$2,939,040** |

The SOMA financial assets are classified as Level 2 in the table above because the fair values are based on indicative quotes and other observable inputs obtained from independent pricing services that, in accordance with ASC 820, are consistent with the criteria for Level 2 inputs. Although information consistent with the criteria for Level 1 classification may exist for some portion of the SOMA assets, all securities in each asset class were valued using the inputs that are most applicable to the securities in the asset class. The inputs used for valuing the SOMA financial assets are not necessarily an indication of the risk associated with those assets.

## 6. INVESTMENTS HELD BY CONSOLIDATED VARIABLE INTEREST ENTITIES

### a. Summary Information for Consolidated Variable Interest Entities

The total assets of consolidated VIEs, including cash, cash equivalents, accrued interest, and other receivables at December 31, were as follows (in millions):

| | 2012 | 2011 |
|---|---|---|
| ML | $ 1,811 | $ 7,805 |
| ML II | 61 | 9,257 |
| ML III | 22 | 17,820 |
| TALF LLC | 856 | 811 |
| **Total** | **$2,750** | **$35,693** |

The Bank's approximate maximum exposure to loss at December 31, 2012 and 2011, was $829 million and $24,606 million, respectively. These estimates incorporate potential losses associated with assets recorded on the Bank's balance sheet, net of the fair value of subordinated interests (beneficial interest in consolidated VIEs).

The classification of significant assets and liabilities of the consolidated VIEs at December 31 was as follows (in millions):

| Assets: | 2012 | 2011 |
|---|---|---|
| CDOs | $ — | $17,854 |
| Nonagency RMBS | 2 | 10,903 |
| Federal agency and GSE MBS | 1 | 440 |
| Commercial mortgage loans | 466 | 2,861 |
| Swap contracts | 408 | 657 |
| Residential mortgage loans | — | 378 |
| Short-term investments | 690 | 1,076 |
| Other investments | 65 | 282 |
| **Subtotal** | **$1,632** | **$34,451** |
| Cash, cash equivalents, accrued interest receivable, and other receivables | 1,118 | 1,242 |
| **Total investments held by consolidated VIEs** | **$2,750** | **$35,693** |
| Liabilities: | | |
| Beneficial interest in consolidated VIEs | $ 803 | $ 9,845 |
| Other liabilities[1] | $ 415 | $ 690 |

[1] The amount reported as "Consolidated variable interest entities: Other liabilities" in the Consolidated Statements of Condition includes $341 million and $554 million related to cash collateral received on swap contracts at December 31, 2012 and 2011, respectively. The amount also includes accrued interest and accrued other expenses.

Total realized and unrealized gains (losses) for the year ended December 31, 2012, were as follows (in millions):

| | Total Portfolio Holdings Realized Gains (Losses) | Fair Value Changes Unrealized Gains (Losses) | Total Portfolio Holdings Realized/Unrealized Gains (Losses) |
|---|---|---|---|
| CDOs | $1,110 | $ 4,439 | $ 5,549 |
| Nonagency RMBS | (334) | 2,038 | 1,704 |
| Federal agency and GSE MBS | 12 | (13) | (1) |
| Commercial mortgage loans[1] | (101) | 394 | 293 |
| Swap contracts | 75 | (165) | (90) |
| Residential mortgage loans[1] | (326) | 322 | (4) |
| Short-term investments | — | 2 | 2 |
| Other investments | (1) | (1) | (2) |
| **Total** | **$ 435** | **$7,016** | **$7,451** |

[1] Substantially all unrealized gains (losses) on the commercial and residential mortgage loans are attributable to changes in instrument-specific credit risk.

Total realized and unrealized gains (losses) for the year ended December 31, 2011, were as follows (in millions):

| | Total Portfolio Holdings Realized Gains (Losses) | Fair Value Changes Unrealized Gains (Losses) | Total Portfolio Holdings Realized/Unrealized Gains (Losses) |
|---|---|---|---|
| CDOs | $ (60) | $ (3,278) | $ (3,338) |
| Nonagency RMBS | 227 | (1,084) | (857) |
| Federal agency and GSE MBS | 1,221 | (895) | 326 |
| Commercial mortgage loans[1] | (368) | 407 | 39 |
| Swap contracts | (258) | 225 | (33) |
| Residential mortgage loans[1] | (312) | 263 | (49) |
| Other investments | 29 | 3 | 32 |
| Other derivatives | (51) | 11 | (40) |
| **Total** | **$ 428** | **$(4,348)** | **$ (3,920)** |

[1] Substantially all unrealized gains (losses) on the commercial and residential mortgage loans are attributable to changes in instrument-specific credit risk.

The net income (loss) attributable to ML, ML II, ML III, and TALF LLC for the year ended December 31, 2012, was as follows (in millions):

| | ML | ML II | ML III | TALF LLC | Total |
|---|---|---|---|---|---|
| Interest income: | | | | | |
| Portfolio interest income | $ 34 | $ 52 | $1,023 | $ 1 | $ 1,110 |
| Less: Interest expense | 45 | 7 | 97 | 4 | 153 |
| **Net interest income (loss)** | **(11)** | **45** | **926** | **(3)** | **957** |
| Noninterest income: | | | | | |
| Portfolio holdings gains, net | 553 | 1,392 | 5,506 | — | 7,451 |
| Realized losses on beneficial interest in consolidated VIEs | — | (453) | (2,905) | — | (3,358) |
| Unrealized gains (losses) on beneficial interest in consolidated VIEs | — | 216 | 801 | (4)[1] | 1,013 |
| **Net noninterest income (loss)** | **553** | **1,155** | **3,402** | **(4)** | **5,106** |
| **Total net interest income and noninterest income (loss)** | **542** | **1,200** | **4,328** | **(7)** | **6,063** |
| Less: Professional fees | 13 | 1 | 11 | — | 25 |
| **Net income (loss) attributable to consolidated VIEs** | **$529** | **$1,199** | **$4,317** | **$(7)**[2] | **$6,038** |

[1] The TALF LLC's unrealized loss on beneficial interest represents the Treasury's financial interest in the net income of TALF LLC for the year ended December 31, 2012.

[2] Additional information regarding TALF-related income recorded by the Bank is presented in Note 4.

The net income (loss) attributable to ML, ML II, ML III, and TALF for the year ended December 31, 2011, was as follows (in millions):

| | ML | ML II | ML III | TALF LLC | Total |
|---|---|---|---|---|---|
| Interest income: | | | | | |
| Portfolio interest income | $ 808 | $ 609 | $2,012 | $ — | $3,429 |
| Less: Interest expense | 70 | 36 | 175 | 4 | 285 |
| **Net interest income (loss)** | **738** | **573** | **1,837** | **(4)** | **3,144** |
| Noninterest income: | | | | | |
| Portfolio holdings gains (losses), net | 434 | (991) | (3,363) | — | (3,920) |
| Unrealized gains (losses) on beneficial interest in consolidated VIEs | (114) | 91 | 558 | (44)[1] | 491 |
| **Net noninterest income (loss)** | **320** | **(900)** | **(2,805)** | **(44)** | **(3,429)** |
| **Total net interest income and noninterest income (loss)** | **1,058** | **(327)** | **(968)** | **(48)** | **(285)** |
| Less: Professional fees | 43 | 8 | 20 | — | 71 |
| **Net income (loss) attributable to consolidated VIEs** | **$1,015** | **$(335)** | **$ (988)** | **$ (48)**[2] | **$(356)** |

[1] The TALF LLC's unrealized loss on beneficial interest represents the Treasury's financial interest in the net income of TALF LLC for the year ended December 31, 2011.

[2] Additional information regarding TALF-related income recorded by the Bank is presented in Note 4.

Following is a summary of the consolidated VIEs' subordinated financial interest for the years ended December 31, 2012 and 2011 (in millions):

| | ML Subordinated Loan | ML II Deferred Purchase Price | ML III Equity Contribution | TALF Financial Interest | Total |
|---|---|---|---|---|---|
| Fair value, December 31, 2010 | $ 1,201 | $ 1,387 | $ 6,733 | $ 730 | $ 10,051 |
| Interest accrued and capitalized | 70 | 36 | 175 | 4 | 285 |
| Unrealized (gain)/loss | 114 | (91) | (558) | 44 | (491) |
| **Fair value, December 31, 2011** | **$ 1,385** | **$ 1,332** | **$ 6,350** | **$ 778** | **$ 9,845** |
| Interest accrued and capitalized | $ 45 | $ 7 | $ 97 | $ 4 | $ 153 |
| Realized (gain)/loss | — | 453 | 2,905 | — | 3,358 |
| Unrealized (gain)/loss | — | (216) | (801) | 4 | (1,013) |
| Repayments[1] | (1,430) | (1,566) | (8,544) | — | (11,540) |
| **Fair value, at December 31, 2012** | **$ —** | **$ 10** | **$ 7** | **$786** | **$ 803** |

[1] For ML, includes payments of $1,150 million of principal and $280 million of interest. For ML II, includes payments of $1,000 million of principal, $113 million of interest, and $453 million of variable deferred purchase price. For ML III, includes payments of $5,000 million of principal, $639 million of interest, and $2,905 million of excess amounts.

### b. Maiden Lane LLC

To facilitate the merger of The Bear Stearns Companies, Inc. (Bear Stearns), and JPMorgan Chase & Co. (JPMC), the Bank extended credit to ML in June 2008. ML is a Delaware limited-liability company formed by the Bank to acquire certain assets of Bear Stearns and to manage those assets over time, in order to maximize the potential for the repayment of the credit extended to ML and to minimize disruption to the financial markets. The assets acquired by ML were valued at $29.9 billion as of March 14, 2008, the date that the Bank committed to the transaction, and largely consisted of federal agency and GSE MBS, nonagency RMBS, commercial and residential mortgage loans, and derivatives and associated hedges.

The Bank extended a senior loan of approximately $28.8 billion and JPMC extended a subordinated loan of $1.15 billion to finance the acquisition of the assets. The two-year accumulation period that followed the closing date for ML ended on June 26, 2010. Consistent with the terms of the ML transaction, the distributions of

the proceeds realized on the asset portfolio held by ML, after payment of certain fees and expenses, now occur on a monthly basis unless otherwise directed by the Federal Reserve. On June 14, 2012, the remaining outstanding balance of the senior loan from the Bank to ML was repaid in full, with interest. On November 15, 2012, the remaining outstanding balance of the subordinated loan from JPMC was repaid in full, with interest. The interest rate on the JPMC subordinated loan was the primary credit rate plus 450 basis points. The Bank will continue to sell the remaining assets from the ML portfolio as market conditions warrant and if the sales represent good value for the public. In accordance with the ML agreements, proceeds from future asset sales will be distributed to the Bank as contingent interest after all derivative instruments in ML have been terminated and paid or sold from the portfolio.

As of December 31, 2012, ML's investments consisted primarily of commercial mortgage loans, credit default swaps (CDS), and short-term investments with maturities of greater than three months and less than one year when acquired (primarily consisting of U.S. Treasury bills). The following is a description of the significant holdings at December 31, 2012, and the associated risk for each holding:

***i. Debt Securities***

ML has investments in short-term instruments with maturities of greater than three months and less than one year when acquired. As of December 31, 2012, ML had approximately $251 million in U.S. Treasury bills. Other investments are primarily comprised of commercial mortgage-backed securities (CMBS) and various other structured debt instruments.

At December 31, 2012, the ratings breakdown of the $320 million of debt securities, which are recorded at fair value in the ML portfolio as a percentage of aggregate fair value of all securities in the portfolio, was as follows:

| | Ratings[1, 3] | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | AAA | AA+ to AA- | A+ to A- | BBB+ to BBB- | BB+ and Lower | Government /Agency | Not Rated[4] | Total |
| Security type:[2] | | | | | | | | |
| Short-term investments | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 78.4% | 0.0% | 78.4% |
| Nonagency RMBS | 0.0% | 0.0% | 0.0% | 0.0% | 0.5% | 0.0% | 0.0% | 0.5% |
| Federal agency and GSE MBS | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.2% | 0.0% | 0.2% |
| Other investments | 0.0% | 0.0% | 0.0% | 2.6% | 6.9% | 0.0% | 11.4% | 21.0% |
| **Total** | **0.0%** | **0.0%** | **0.0%** | **2.6%** | **7.4%** | **78.5%** | **11.4%** | **100.0%** |

[1] Lowest of all ratings is used for the purposes of this table if rated by two or more nationally recognized statistical rating organizations.

[2] This table does not include ML commercial mortgage loans and swap contracts.

[3] Rows and columns may not total due to rounding.

[4] Not rated by a nationally recognized statistical rating organization as of December 31, 2012.

### *ii. Commercial Mortgage Loans*

Commercial mortgage loans are subject to a high degree of credit risk because of exposure to financial loss resulting from failure by a counterparty to meet its contractual obligations. Default rates are subject to a wide variety of factors, including, but not limited to, property performance, property management, supply and demand, construction trends, consumer behavior, regional economic conditions, interest rates, and other factors.

The performance profile for the commercial mortgage loans at December 31, 2012, was as follows (in millions, except percentage data):

| | Unpaid Principal Balance | Fair Value | Fair Value as a Percentage of Unpaid Principal Balance |
|---|---|---|---|
| Commercial mortgage loans: | | | |
| Performing loans | $176 | $144 | 81.8% |
| Nonperforming/nonaccrual loans [1] | 519 | 322 | 62.0% |
| **Total** | **$695** | **$466** | 67.1% |

[1] Nonperforming/nonaccrual loans include loans with payments past due greater than ninety days.

The following table summarizes the property types of the commercial mortgage loans held in the ML portfolio at December 31, 2012 (in millions, except percentage data):

| Property Type | Unpaid Principal Balances | Concentration of Unpaid Principal Balances |
|---|---|---|
| Office[1] | $601 | 86.4% |
| Hospitality | 86 | 12.4% |
| Other[2] | 8 | 1.2% |
| **Total** | **$695** | **100.0%** |

[1] One sponsor represented in the office property type amount accounts for approximately 86 percent of total unpaid principal balance of the commercial mortgage loan portfolio.

[2] No other individual property type comprises more than 5 percent of the total.

Commercial mortgage loans held by ML are composed of different levels of subordination with respect to the underlying properties, and relative to each other. Senior mortgage loans are secured property loans evidenced by a first mortgage that is senior

to any subordinate or mezzanine financing. Subordinate mortgage interests, sometimes known as B Notes, are loans evidenced by a junior note or a junior participation in a mortgage loan. Mezzanine loans are loans made to the direct or indirect owner of the property-owning entity. Mezzanine loans are not secured by a mortgage on the property but rather by a pledge of the mezzanine borrower's direct or indirect ownership interest in the property-owning entity.

The following table summarizes commercial mortgage loans held by ML at December 31, 2012 (in millions, except percentage data):

| Loan Type | Unpaid Principal Balances | Concentration of Unpaid Principal Balances |
|---|---|---|
| Senior mortgage loans | $ 91 | 13.1% |
| Subordinate mortgage interests | 38 | 5.5% |
| Mezzanine loans | 566 | 81.4% |
| **Total** | **$695** | **100.0%** |

***iii. Derivative Instruments***

Derivative contracts are instruments, such as swap contracts, that derive their value from underlying assets, indexes, reference rates, or a combination of these factors. The ML portfolio is composed of derivative financial instruments included in a total return swap (TRS) agreement with JPMC. ML and JPMC entered into the TRS with reference obligations representing CDS primarily on RMBS and CMBS, with various market participants, including JPMC. ML, through its investment manager, currently manages the CDS contracts within the TRS as a runoff portfolio and may unwind, amend, or novate reference obligations on an ongoing basis.

On an ongoing basis, ML pledges collateral for credit- or liquidity-related shortfalls based on 20 percent of the notional amount of sold CDS protection and 10 percent of the present value of future premiums on purchased CDS protection. Failure to post this collateral constitutes a TRS event of default. Separately, ML and JPMC engage in bilateral posting of collateral to cover the net mark-to-market (MTM) variations in the swap portfolio. ML only nets the collateral received from JPMC from the bilateral MTM posting for the reference obligations for which JPMC is the counterparty.

The values of ML's cash equivalents, purchased by the rehypothecation of cash collateral associated with the TRS, were $0.5 billion and $0.8 billion, for the years ended December 31, 2012 and 2011, respectively. In addition, ML has pledged $0.2 billion and $0.6 billion of federal agency and GSE MBS and U.S. Treasury notes to JPMC as of December 31, 2012 and 2011, respectively.

The following risks are associated with the derivative instruments held by ML as part of the TRS agreement with JPMC:

*Market Risk*
CDS are agreements that provide protection for the buyer against the loss of principal and, in some cases, interest on a bond or loan in case of a default by the issuer. The nature of a credit event is established by the protection buyer and protection seller at the inception of a transaction, and such events include bankruptcy, insolvency, or failure to meet payment obligations when due. The buyer of the CDS pays a premium in return for payment protection upon the occurrence, if any, of a credit event. Upon the occurrence of a triggering credit event, the maximum potential amount of future payments the seller could be required to make under a CDS is equal to the notional amount of the contract. Such future payments could be reduced or offset by amounts recovered under recourse or by collateral provisions outlined in the contract, including seizure and liquidation of collateral pledged by the buyer. ML's derivatives portfolio consists of purchased and sold credit protection with differing underlying referenced names that do not necessarily offset.

*Credit Risk*
Credit risk is the risk of financial loss resulting from failure by a counterparty to meet its contractual obligations to ML. This can be caused by factors directly related to the counterparty, such as business or management. Taking collateral is the most common way to mitigate credit risk. ML takes financial collateral in the form of cash and marketable securities to cover JPMC counterparty risk as part of the TRS agreement with JPMC. ML remains exposed to credit risk for counterparties, other than JPMC, related to the swaps that underlie the TRS.

The following table summarizes the notional amounts of derivative contracts outstanding as of December 31 (in millions, except contract data):

| | Notional Amounts[1] | |
|---|---|---|
| | 2012 | 2011 |
| Credit derivatives: | | |
| CDS[2] | $1,755 | $3,940 |

[1] These amounts represent the sum of gross long and gross short notional derivative contracts. The change in notional amounts is representative of the volume of activity for the year ended December 31, 2012.

[2] There were 470 and 979 CDS contracts outstanding as of December 2012 and 2011, respectively.

The following table summarizes the fair value of derivative instruments by contract type on a gross basis as of December 31, 2012 and 2011, which is reported as a component of "Investments held by consolidated variable interest entities" in the Consolidated Statement of Condition (in millions):

| | 2012 | | 2011 | |
|---|---|---|---|---|
| | Gross Derivative Assets | Gross Derivative Liabilities | Gross Derivative Assets | Gross Derivative Liabilities |
| Credit derivatives: | | | | |
| CDS[1] | $ 816 | $(343) | $1,630 | $(791) |
| Counterparty netting | (272) | 272 | (685) | 685 |
| Cash collateral | (136) | — | (288) | — |
| **Total** | **$ 408** | **$ (71)** | **$ 657** | **$(106)** |

[1] CDS fair values as of December 31, 2012, for assets and liabilities include interest receivables of $15 million and payables of $9 million. CDS fair values as of December 31, 2011, for assets and liabilities include interest receivables of $22 million and payables of $13 million.

The table below summarizes certain information regarding protection sold through CDS as of December 31, 2012 and 2011 (in millions):

| | Maximum Potential Payout/Notional | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | | | | | | 2011 | |
| | Years to Maturity | | | | | Fair Value | | Fair Value |
| Credit Ratings of the Reference Obligation | 1 Year or Less | After 1 Year through 3 Years | After 3 Years through 5 Years | After 5 Years | Total | Liability | Total | Liability |
| Investment grade (AAA to BBB-) | $ — | $ — | $ — | $ 52 | $ 52 | $ (5) | $ 92 | $ (14) |
| Noninvestment grade (BB+ or lower) | — | — | — | 438 | 438 | (329) | 1,154 | (763) |
| **Total credit protection sold** | $ — | $ — | $ — | **$490** | **$490** | **$(334)** | **$1,246** | **$(777)** |

The table below summarizes certain information regarding protection bought through CDS as of December 31, 2012 and 2011 (in millions):

| | Maximum Potential Recovery/Notional | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | | | | | | 2011 | |
| | Years to Maturity | | | | | Fair Value | | Fair Value |
| Credit Ratings of the Reference Obligation | 1 Year or Less | After 1 Year through 3 Years | After 3 Years through 5 Years | After 5 Years | Total | Asset | Total | Asset |
| Investment grade (AAA to BBB-) | $ — | $ — | $ 25 | $ 125 | $ 150 | $ 27 | $ 170 | $ 46 |
| Noninvestment grade (BB+ or lower) | — | — | 9 | 1,106 | 1,115 | 774 | 2,525 | 1,562 |
| **Total credit protection bought** | **$ —** | **$ —** | **$34** | **$ 1,231** | **$1,265** | **$ 801** | **$2,695** | **$1,608** |

*Currency Risk*

Currency risk is the risk of financial loss resulting from exposure to changes in exchange rates between two currencies. Under the terms of the TRS, JPMC may post cash collateral in the form of either U.S. dollar or euro-denominated currencies to cover the net MTM variation in the swap portfolio. Starting in December 2012, JPMC began posting a portion of its collateral in euro currency. This risk is mitigated by daily variation margin updates that capture the movement in the value of the swap portfolio in addition to any movement in exchange rates on the swap collateral.

Swap collateral received that is denominated in a foreign currency is translated into U.S. dollar amounts using the prevailing exchange rate as of the date of the consolidated financial statements. There is no gain or loss associated with this foreign-denominated collateral, as the asset and liability positions associated with it are offsetting.

### c. Maiden Lane II LLC

Concurrent with the November 2008 restructuring of its financial support to AIG, the Bank extended credit to ML II, a Delaware limited-liability company formed to purchase nonagency RMBS from the reinvestment pool of the securities lending portfolios of several regulated U.S. insurance subsidiaries of AIG. ML II borrowed $19.5 billion from the Bank and used the proceeds to purchase nonagency RMBS that had an approximate fair value of $20.8 billion as of October 31, 2008, from AIG's domestic insurance subsidiaries. The Bank is the sole and managing member and the

controlling party of ML II and will remain as the controlling party as long as the Bank retains an economic interest in ML II. As part of the agreement, the AIG subsidiaries also received from ML II a fixed deferred purchase price of up to $1.0 billion, plus interest on any such fixed deferred purchase price outstanding. After repayment in full of the Bank's loan and the fixed deferred purchase price (each including accrued interest), any net proceeds will be distributed as contingent interest to the Bank, which is entitled to receive five-sixths, and as variable deferred purchase price to the AIG subsidiaries, which are entitled to receive one-sixth, in accordance with the agreement.

On March 30, 2011, the Federal Reserve announced that the Bank, through its investment manager, BlackRock Financial Management, Inc., would dispose of the securities in the ML II portfolio individually and in segments through a competitive sales process over time as market conditions warrant. During the year ended December 31, 2011, a total of nine bid list auctions were conducted and assets with a total current face amount of $9.96 billion were sold. On February 28, 2012, the Bank announced the sale of the remaining securities in the ML II portfolio. On March 1, 2012, the loan from the Bank to ML II was repaid in full with interest, in accordance with the terms of the facility. On March 15, 2012, the remaining portion of the fixed deferred purchase price plus interest owed to the AIG subsidiaries was repaid in full. Concurrently, distributions were made to the Bank and the AIG subsidiaries in the form of contingent interest and variable deferred purchase price for the amounts of $2.3 billion and $0.5 billion, respectively.

On March 19, 2012, ML II was dissolved, and the Bank began the wind-up process in accordance with and as required by Delaware law and the agreements governing ML II. Winding up requires ML II to pay or make reasonable provision to pay all claims and obligations of ML II before distributing its remaining assets. While its affairs are being wound up, ML II is retaining certain assets to meet trailing expenses and other obligations as required by law. Dissolution costs are not expected to be material.

### d. Maiden Lane III LLC

The Bank extended credit to ML III, a Delaware limited-liability company formed to purchase ABS CDOs from certain third-party counterparties of AIG Financial Products Corp. ML III borrowed approximately $24.3 billion from the Bank, and AIG provided an equity contribution of $5.0 billion to ML III. The proceeds were used to purchase ABS CDOs with a fair value of $29.6 billion. On April 3, 2012, the Bank revised ML III's investment objective to allow for asset sales, and began conducting such sales shortly thereafter. On June 14, 2012, the Bank announced that its loan to ML III had been repaid in full, with interest. On July 16, 2012, the Bank announced that net proceeds from additional sales of securities in ML III enabled the full repay-

ment of AIG's equity contribution plus accrued interest and provided residual profits to the Bank and AIG. Concurrently, distributions were made to the Bank and AIG in the form of contingent interest and excess amounts in the amounts of $5.9 billion and $2.9 billion, respectively. On August 23, 2012, the Bank announced that all remaining securities in ML III were sold. Any remaining proceeds will be divided between the Bank, which is entitled to receive two-thirds, and AIG (or its assignee), which is entitled to receive one-third, in accordance with the agreement.

On September 10, 2012, ML III was dissolved, and the Bank began the wind-up process in accordance with and as required by Delaware law and the agreements governing ML III. ML III expects the wind-up process to be concluded during 2013. Winding up requires ML III to pay or make reasonable provision to pay all claims and obligations of ML III before distributing its remaining assets. While its affairs are being wound up, ML III is retaining certain assets to meet trailing expenses and other obligations as required by law. Dissolution costs are not expected to be material.

### e. TALF LLC

Cash receipts resulting from the put option fees paid to TALF LLC and proceeds from the Treasury's loan are invested in the following types of U.S.-dollar-denominated short-term investments and cash equivalents eligible for purchase by TALF LLC: (1) U.S. Treasury securities, (2) federal agency securities that are senior, negotiable debt obligations of Fannie Mae, Freddie Mac, Federal Home Loan Banks, and Federal Farm Credit Banks, which have a fixed rate of interest, (3) repurchase agreements that are collateralized by Treasury and federal agency securities and fixed-rate agency mortgage-backed securities, and (4) money market mutual funds, registered with the Securities and Exchange Commission and regulated under Rule 2a-7 of the Investment Company Act, that invest exclusively in U.S. Treasury and federal agency securities. Cash may also be invested in a demand interest-bearing account held at the Bank of New York Mellon.

### f. Fair Value Measurement

The consolidated VIEs have adopted ASC 820 and ASC 825 and have elected the fair value option for all securities and commercial and residential mortgages held by ML and TALF LLC. ML II and ML III qualify as nonregistered investment companies under the provisions of ASC 946 and, therefore, all investments are recorded at fair value in accordance with ASC 820. In addition, the Bank has elected to record the beneficial interests in ML, ML II, ML III, and TALF LLC at fair value.

The accounting and classification of these investments appropriately reflect the VIEs' and the Bank's intent with respect to the purpose of the investments and most closely reflect the amount of the assets available to liquidate the entities' obligations.

***i. Determination of Fair Value***

The consolidated VIEs value their investments on the basis of the last available bid prices or current market quotations provided by dealers or pricing services selected by the Bank's designated investment managers. To determine the value of a particular investment, pricing services may use information on transactions in such investments; quotations from dealers; pricing metrics; market transactions in comparable investments; relationships observed in the market between investments; and calculated yield measures based on valuation methodologies commonly employed in the market for such investments.

Market quotations may not represent fair value in circumstances in which the investment manager believes that facts and circumstances applicable to an issuer, a seller, a purchaser, or the market for a particular security result in the current market quotations reflecting an inaccurate measure of fair value. In such cases or when market quotations are unavailable, the investment manager determines fair value by applying proprietary valuation models that use collateral performance scenarios and pricing metrics derived from the reported performance of the universe of investments with similar characteristics as well as the observable market.

Because of the uncertainty inherent in determining the fair value of investments that do not have a readily available fair value, the fair value of these investments may differ significantly from the values that would have been reported if a readily available fair value had existed for these investments and may differ materially from the values that may ultimately be realized.

The fair value of the liability for the beneficial interests of consolidated VIEs is estimated based upon the fair value of the underlying assets held by the VIEs. The holders of these beneficial interests do not have recourse to the general credit of the Bank.

***ii. Valuation Methodologies for Level 3 Assets and Liabilities***

In certain cases in which there is limited activity around inputs to the valuation, investments are classified within Level 3 of the valuation hierarchy. For example, in valuing CDOs, certain collateralized mortgage obligations, and commercial and residential mortgage loans, the determination of fair value is based on collateral performance scenarios. These valuations also incorporate pricing metrics derived from the reported performance of the universe of similar investments and from observations and estimates of market data. Because external price information is not available, market-based

models are used to value these securities. Key inputs to the model may include market spreads or yield estimates for comparable instruments, performance data (i.e., prepayment rates, default rates, and loss severity), valuation estimates for underlying property collateral, projected cash flows, and other relevant contractual features. Because there is a lack of observable pricing, securities and investment loans that are carried at fair value are classified within Level 3.

For the swap agreements, all of which are categorized as Level 3 assets and liabilities, there are various valuation methodologies. In each case, the fair value of the instrument underlying the swap is a significant input used to derive the fair value of the swap. When there are broker or dealer prices available for the underlying instruments, the fair value of the swap is derived based on those prices. When the instrument underlying the swap is a market index (i.e., CMBS index), the closing market index price, which can also be expressed as a credit spread, is used to determine the fair value of the swap. In the remaining cases, the fair value of the underlying instrument is principally based on inputs and assumptions not observable in the market (i.e., discount rates, prepayment rates, default rates, and recovery rates).

For ML II, the fair value of the senior loan and the deferred purchase price is determined based on the fair value of the underlying assets held by ML II and the allocation of ML II's net investment income or loss and realized gains or losses on investments. For ML III, the fair value of the senior loan and the equity contribution is determined based on the fair value of the underlying assets held by ML III and the allocation of ML III's net investment income or loss and realized gains or losses on investments. For TALF LLC, the fair values of the subordinated loan (including the Treasury contingent interest) and the Bank's contingent interest are determined based on the fair value of the underlying assets held by TALF LLC and the allocation of TALF LLC's gains and losses.

*ML Inputs for Level 3 Assets and Liabilities*

The following table presents the valuation techniques and ranges of significant unobservable inputs generally used to determine the fair values of ML's Level 3 assets and liabilities as of December 31, 2012 (in millions, except for input values):

| Instruments | Fair Value | Principal Valuation Technique | Unobservable Inputs | Range of Input Values |
|---|---|---|---|---|
| Commercial mortgage loans | $466 | Discounted cash flows | Discount rate | 6%-20% |
| | | | Property capitalization rate | 6%-10% |
| | | | Net operating income growth rate | 3%-7% |
| CDS[1] | $473 | Discounted cash flows | Credit spreads[2] | 100 bps-6,451 bps |
| | | | Discount rate | 0%-47% |
| | | | Constant prepayment rate | 0%-20% |
| | | | Constant default rate | 0%-34% |
| | | | Loss severity | 40%-80% |

[1] Swap assets and liabilities are presented net for the purposes of this table.

[2] Implied spread on closing market prices for index positions.

*Sensitivity of ML Level 3 Fair Value Measurements to Changes in Unobservable Inputs*

The following provides a general description of the impact of a change in an unobservable input on the fair value measurement and the interrelationship of unobservable inputs.

*I. Loans*

In general, an increase in isolation in either the discount rate or the property capitalization rate, which is the ratio between the net operating income produced by an asset and its current fair value, would result in a decrease in the fair value measurement, while an increase in the net operating income growth rate, in isolation, would result in an increase in the fair value measurement. For each of the relationships described above, the inverse would also generally apply.

*II. Derivatives*

For CDS with reference obligations on CMBS, an increase in credit spreads would generally result in a higher fair value measurement for protection buyers and a lower fair value measurement for protection sellers. The inverse would also generally apply to this relationship given a decrease in credit spreads.

For CDS with reference obligations on RMBS or other ABS assets, changes in the discount rate, constant prepayment rate, constant default rate, and loss severity would have an uncertain effect on the overall fair value measurement. This is because, in general, changes in these inputs could potentially affect other inputs used in determining the fair value measurement. For example, a change in the assumptions used for the constant default rate will generally be accompanied by a corresponding change in the assumption used for the loss severity and an inverse change in the assumption used for constant prepayment rates. Additionally, changes in the fair value measurement based on variations in the inputs used generally cannot be extrapolated because the relationship between each input is not perfectly correlated.

The following table presents the financial instruments recorded in VIEs at fair value as of December 31, 2012, by ASC 820 hierarchy (in millions):

| | 2012 | | | | |
|---|---|---|---|---|---|
| | Level 1[2] | Level 2[2] | Level 3 | Netting[1] | Total Fair Value |
| Assets: | | | | | |
| CDOs | $ — | $ — | $ — | $ — | $ — |
| Nonagency RMBS | — | 2 | — | — | 2 |
| Federal agency and GSE MBS | — | 1 | — | — | 1 |
| Commercial mortgage loans | — | — | 466 | — | 466 |
| Cash equivalents | 634 | — | — | — | 634 |
| Swap contracts | — | — | 816 | (408) | 408 |
| Residential mortgage loans | — | — | — | — | — |
| Short-term investments | 454 | 236 | — | — | 690 |
| Other investments | — | 10 | 55 | — | 65 |
| **Total assets** | **$1,088** | **$249** | **$1,337** | **$ (408)** | **$2,266** |
| Liabilities: | | | | | |
| Beneficial interest in consolidated VIEs | $ — | $803 | $ — | $ — | $ 803 |
| Swap contracts | — | — | 343 | (272) | 71 |
| **Total liabilities** | **$ —** | **$803** | **$ 343** | **$(272)** | **$ 874** |

[1] Derivative receivables and payables and the related cash collateral received and paid are shown net when a master netting agreement exists.

[2] There were no transfers between Level 1 and Level 2 during the year ended December 31, 2012.

The following table presents the financial instruments recorded in VIEs at fair value as of December 31, 2011, by ASC 820 hierarchy (in millions):

| | 2011 | | | | |
|---|---|---|---|---|---|
| | Level 1[3] | Level 2[3] | Level 3 | Netting[1] | Total Fair Value |
| Assets: | | | | | |
| CDOs | $ — | $ 167 | $ 17,687 | $ — | $ 17,854 |
| Nonagency RMBS | — | 5,493 | 5,410 | — | 10,903 |
| Federal agency and GSE MBS | — | 440 | — | — | 440 |
| Commercial mortgage loans | — | 1,464 | 1,397 | — | 2,861 |
| Cash equivalents | 1,171 | — | — | — | 1,171 |
| Swap contracts | — | — | 1,630 | (973) | 657 |
| Residential mortgage loans | — | — | 378 | — | 378 |
| Short-term investments[2] | 1,076 | — | — | — | 1,076 |
| Other investments[2] | 19 | 126 | 108 | — | 253 |
| **Total assets** | **$2,266** | **$7,690** | **$26,610** | **$(973)** | **$35,593** |
| Liabilities: | | | | | |
| Beneficial interest in consolidated VIEs | $ — | $ — | $ 9,845 | $ — | $ 9,845 |
| Swap contracts | — | — | 791 | (685) | 106 |
| **Total liabilities** | **$ —** | **$ —** | **$10,636** | **$(685)** | **$ 9,951** |

[1] Derivative receivables and payables and the related cash collateral received and paid are shown netted when a master netting agreement exists.

[2] Investments with a fair value of $1,076 million as of December 31, 2011, were recategorized from "Other investments" to a new line item labeled "Short-term investments" to conform to the current-year presentation.

[3] There were no significant transfers between Level 1 and Level 2 during the year ended December 31, 2011.

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2012 (in millions). Unrealized gains and losses related to those assets still held at December 31, 2012 are reported as a component of “Investments held by consolidated variable interest entities, net” in the Consolidated Statement of Condition.

| | 2012 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Fair Value, December 31, 2011 | Purchases, Sales, Issuances, and Settlements, Net | Net Realized/ Unrealized Gains (Losses) | Gross Transfers In[1, 2] | Gross Transfers Out[1, 2] | Fair Value, December 31, 2012 | Change in Unrealized Gains (Losses) Related to Financial Instruments Held at December 31, 2012 |
| Assets: | | | | | | | |
| CDOs | $17,687 | $ (23,196) | $5,509 | $ — | $ — | $ — | $ (2) |
| Nonagency RMBS | 5,410 | (6,347) | 937 | — | — | — | — |
| Commercial mortgage loans | 1,397 | (1,187) | 256 | — | — | 466 | 135 |
| Residential mortgage loans | 378 | (374) | (4) | — | — | — | (1) |
| Other investments | 108 | (65) | 2 | 10 | — | 55 | — |
| **Total assets** | **$24,980** | **$ (31,169)** | **$6,700** | **$ 10** | **$ —** | **$521** | **$ 132** |
| Net swap contracts[3] | $ 839 | $ (276) | $ (90) | $ — | $ — | $473 | $(93) |
| Liabilities: | | | | | | | |
| Beneficial interest in consolidated VIEs | $ 9,845 | $ (1,385) | $ — | $ — | $(8,460) | $ — | $ — |

[1] The amount of transfers is based on the fair values of the transferred assets at the beginning of the reporting period.

[2] Beneficial interest in consolidated VIEs, with a December 31, 2011, fair value of $8,460 million, was transferred from Level 3 to Level 2 because it is valued at December 31, 2012, based on model-based techniques for which all significant inputs are observable (Level 2). These investments were valued in the prior year on nonobservable model-based inputs (Level 3). There were also certain other investments for which valuation inputs became less observable during the year ended December 31, 2012, which resulted in $10 million in transfers from Level 2 to Level 3. There were no other transfers between Level 2 and Level 3 during the current year.

[3] Level 3 derivative assets and liabilities are presented net for purposes of this table.

The following table presents the gross components of purchases, sales, issuances, and settlements, net, shown for the year ended December 31, 2012 (in millions):

| | 2012 | | | | |
|---|---|---|---|---|---|
| | Purchases | Sales | Issuances | Settlements[3] | Purchases, Sales, Issuances, and Settlements, Net |
| Assets: | | | | | |
| CDOs | $ — | $ (22,206) | $— | $ (990) | $ (23,196) |
| Nonagency RMBS | — | (6,221) | — | (126) | (6,347) |
| Commercial mortgage loans | — | (1,119) | — | (68) | (1,187) |
| Residential mortgage loans | — | (370) | — | (4) | (374) |
| Other investments | — | (66) | — | 1 | (65) |
| **Total assets** | **$ —** | **$(29,982)** | **$—** | **$(1,187)** | **$(31,169)** |
| Net swap contracts[1] | $ — | $ (147) | $— | $ (129) | $ (276) |
| Liabilities: | | | | | |
| Beneficial interest in consolidated VIEs | $ 45[2] | $ — | $— | $ (1,430) | $ (1,385) |

[1] Level 3 swap assets and liabilities are presented net for the purposes of this table.

[2] Represents accrued and capitalized interest.

[3] Includes paydowns.

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2011 (in millions). Unrealized gains and losses related to those assets still held at December 31, 2011, are reported as a component of "Investments held by consolidated variable interest entities, net" in the Consolidated Statement of Condition.

| | 2011 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Fair Value, December 31, 2010 | Purchases, Sales, Issuances, and Settlements, Net | Net Realized/ Unrealized Gains (Losses) | Gross Transfers In[1, 2] | Gross Transfers Out[1, 2] | Fair Value, December 31, 2011 | Change in Unrealized Gains (Losses) Related to Financial Instruments Held at December 31, 2011 |
| Assets: | | | | | | | |
| CDOs | $ 22,811 | $(1,889) | $(3,351) | $ 116 | $ — | $17,687 | $(3,297) |
| Nonagency RMBS | 6,809 | (2,891) | (483) | 4,066 | (2,091) | 5,410 | (725) |
| Commercial mortgage loans | 1,931 | (626) | 92 | — | — | 1,397 | 65 |
| Residential mortgage loans | 603 | (175) | (50) | — | — | 378 | 263 |
| Federal agency and GSE MBS | 30 | (28) | (2) | — | — | — | — |
| Other investments | 79 | (29) | (2) | 94 | (34) | 108 | (9) |
| **Total assets** | **$32,263** | **$(5,638)** | **$(3,796)** | **$4,276** | **$(2,125)** | **$24,980** | **$(3,703)** |
| Net swap contracts[3] | $ 970 | $ (235) | $ 104 | $ — | $ — | $ 839 | $ 83 |
| Liabilities: | | | | | | | |
| Beneficial interest in consolidated VIEs | $ 10,051 | $ 285 | $ (491) | $ — | $ — | $ 9,845 | $ 491 |

[1] The amount of transfers is based on the fair values of the transferred assets at the beginning of the reporting period.

[2] Nonagency RMBS, with a December 31, 2010, fair value of $2,091 million, were transferred from Level 3 to Level 2 because they are valued at December 31, 2011, based on quoted prices in nonactive markets (Level 2). These investments were valued in the prior year on nonobservable model-based inputs (Level 3). There were also nonagency RMBS, CDOs, and other investments for which valuation inputs became less observable during the year ended December 31, 2011, which resulted in $4,066 million, $116 million, and $94 million, respectively, in transfers from Level 2 to Level 3. There were no other significant transfers between Level 2 and Level 3 during the current year.

[3] Level 3 derivative assets and liabilities are presented net for purposes of this table.

The following table presents the gross components of purchases, sales, issuances, and settlements, net, shown for the year ended December 31, 2011 (in millions):

| | 2011 | | | | |
|---|---|---|---|---|---|
| | Purchases | Sales | Issuances | Settlements[3] | Purchases, Sales, Issuances, and Settlements, Net |
| Assets: | | | | | |
| CDOs | $ — | $ (6) | $— | $ (1,883) | $ (1,889) |
| Nonagency RMBS | — | (1,978) | — | (913) | (2,891) |
| Commercial mortgage loans | — | (557) | — | (69) | (626) |
| Residential mortgage loans | — | (97) | — | (78) | (175) |
| Federal agency and GSE MBS | — | (17) | — | (11) | (28) |
| Other investments | 2 | (21) | — | (10) | (29) |
| **Total assets** | **$ 2** | **$ (2,676)** | **$—** | **$ (2,964)** | **$ (5,638)** |
| Net swap contracts[1] | $ — | $ (48) | $— | $ (187) | $ (235) |
| Liabilities: | | | | | |
| Beneficial interest in consolidated VIEs | $285[2] | $ — | $— | $ — | $ 285 |

[1] Level 3 swap assets and liabilities are presented net for the purposes of this table.

[2] Represents accrued and capitalized interest.

[3] Includes paydowns.

### g. Professional Fees

The consolidated VIEs have recorded costs for professional services provided, among others, by several nationally recognized institutions that serve as investment managers, administrators, and custodians for the VIEs' assets. The fees charged by the investment managers, custodians, administrators, auditors, attorneys, and other service providers are recorded in "Professional fees related to consolidated variable interest entities" in the Consolidated Statements of Income and Comprehensive Income.

## 7. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

| | 2012 | 2011 |
|---|---|---|
| Bank premises and equipment: | | |
| Land and land improvements | $ 68 | $ 21 |
| Buildings[1] | 500 | 349 |
| Building machinery and equipment | 88 | 79 |
| Construction in progress | 6 | 4 |
| Furniture and equipment | 113 | 128 |
| **Subtotal** | **775** | **581** |
| Accumulated depreciation | (304) | (271) |
| **Bank premises and equipment, net** | **$ 471** | **$ 310** |
| Depreciation expense, for the years ended December 31 | $ 37 | $ 30 |

[1] The Bank acquired the 33 Maiden Lane building on February 28, 2012. The Bank had been the primary occupant of the building since 1998, accounting for approximately 74 percent of the leased space.

The Bank leases space to outside tenants with remaining lease terms ranging from one to eleven years. Rental income from such leases was $5.8 million and $0 for the years ended December 31, 2012 and 2011, respectively, and is reported as a component of "Noninterest income: Other" in the Consolidated Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2012, are as follows (in millions):

| | |
|---|---|
| 2013 | $ 4 |
| 2014 | 2 |
| 2015 | 2 |
| 2016 | 2 |
| 2017 | 2 |
| Thereafter | 8 |
| **Total** | **$20** |

The Bank had capitalized software assets, net of amortization, of $57 million and $57 million at December 31, 2012 and 2011, respectively. Amortization expense was $24 million and $21 million for the years ended December 31, 2012 and 2011, respectively. Capitalized software assets are reported as a component of "Other assets" in the Consolidated Statements of Condition and the related amortization is reported as a component of "Operating expenses: Other" in the Consolidated Statements of Income and Comprehensive Income.

## 8. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2012, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately eight years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indexes.

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 $9 million and $22 million for the years ended December 31, 2012 and 2011, respectively.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2012, are as follows (in millions):

| | Operating Leases |
|---|---|
| 2013 | $ 2 |
| 2014 | 2 |
| 2015 | 2 |
| 2016 | 2 |
| 2017 | 2 |
| Thereafter | 7 |
| Future minimum rental payments | **$ 17** |

Under the Insurance Agreement of the Reserve Banks, each of the Reserve Banks has agreed to bear, on a per-incident basis, a share of certain losses in excess of 1 percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2012 and 2011.

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

***Other Commitments***

In support of financial market stability activities, the Bank entered into commitments to provide financial assistance to financial institutions. The contractual amounts shown below are the Bank's maximum exposures to loss in the event that the commitments are fully funded and there is a default by the borrower or total loss in value of pledged collateral. Total commitments at December 31 were as follows (in millions):

| | 2012 | | 2011 | |
|---|---|---|---|---|
| | Contractual Amount | Unfunded Amount | Contractual Amount | Unfunded Amount |
| Commercial loan commitments (ML) | $55 | $55 | $61 | $61 |
| Additional loan commitments (ML)[1] | — | — | 18 | 18 |
| **Total** | **$55** | **$55** | **$79** | **$79** |

[1] Represents additional restricted cash that may be required to be advanced by ML for property-level expenses or improvements.

The undrawn portion of the Bank's commercial loan commitments relates to commercial mortgage loan commitments acquired by ML.

## 9. RETIREMENT AND THRIFT PLANS

***Retirement Plans***

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

The System Plan provides retirement benefits to employees of the Reserve Banks, Board of Governors, OEB, and certain employees of the Bureau. The Bank, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its consolidated financial statements. During the years ended December 31, 2012 and 2011, certain costs associated with the System Plan were reimbursed by the Bureau.

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

| | 2012 | 2011 |
|---|---|---|
| Estimated actuarial present value of projected benefit obligation at January 1 | $10,198 | $ 8,258 |
| Service cost–benefits earned during the period | 349 | 258 |
| Interest cost on projected benefit obligation | 473 | 461 |
| Actuarial loss | 833 | 1,427 |
| Contributions by plan participants | 4 | 6 |
| Special termination benefits | 9 | 10 |
| Benefits paid | (334) | (315) |
| Plan amendments | (64) | 93 |
| **Estimated actuarial present value of projected benefit obligation at December 31** | **$11,468** | **$10,198** |

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

| | 2012 | 2011 |
|---|---|---|
| Estimated plan assets at January 1 (of which $7,977 and $6,998 are measured at fair value as of January 1, 2012 and 2011, respectively) | $ 8,048 | $ 7,273 |
| Actual return on plan assets | 1,066 | 649 |
| Contributions by the employer | 782 | 435 |
| Contributions by plan participants | 4 | 6 |
| Benefits paid | (334) | (315) |
| **Estimated plan assets at December 31 (of which $9,440 and $7,977 are measured at fair value as of December 31, 2012 and 2011, respectively)** | **$ 9,566** | **$ 8,048** |
| Funded status and accrued pension benefit costs | $(1,902) | $(2,150) |
| Amounts included in accumulated other comprehensive loss are shown below: | | |
| Prior service cost | $ (559) | $ (739) |
| Net actuarial loss | (3,784) | (3,710) |
| **Total accumulated other comprehensive loss** | **$(4,343)** | **$(4,449)** |

The Bank, on behalf of the System, funded $780.0 million and $420.1 million during the years ended December 31, 2012 and 2011, respectively. The Bureau is required by the Dodd-Frank Act to fund the System Plan for each Bureau employee based on an established formula. During the years ended December 31, 2012 and 2011, the Bureau funded contributions of $1.6 million and $14.4 million, respectively.

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

The accumulated benefit obligation for the System Plan, which differs from the estimated actuarial present value of projected benefit obligation because it is based on current rather than future compensation levels, was $10,035 million and $8,803 million at December 31, 2012 and 2011, respectively.

The weighted-average assumptions used in developing the accumulated pension benefit obligation for the System Plan as of December 31 were as follows:

| | 2012 | 2011 |
|---|---|---|
| Discount rate | 4.00% | 4.50% |
| Rate of compensation increase | 4.50% | 5.00% |

Net periodic benefit expenses for the years ended December 31, 2012 and 2011, were actuarially determined using a January 1 measurement date. The weighted-average assumptions used in developing net periodic benefit expenses for the System Plan for the years were as follows:

| | 2012 | 2011 |
|---|---|---|
| Discount rate | 4.50% | 5.50% |
| Expected asset return | 7.25% | 7.25% |
| Rate of compensation increase | 5.00% | 5.00% |

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows necessary to pay the System Plan's benefits when due. The expected long-term rate of return on assets is an estimate that is based on a combination of factors, including the System Plan's asset allocation strategy and historical returns; surveys of expected rates of return for other entities' plans; a projected return for equities and fixed-income investments based on real interest rates, inflation expectations, and equity risk premiums; and surveys of expected returns in equity and fixed-income markets.

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

| | 2012 | 2011 |
|---|---|---|
| Service cost–benefits earned during the period | $ 349 | $ 258 |
| Interest cost on projected benefit obligation | 473 | 461 |
| Amortization of prior service cost | 116 | 110 |
| Amortization of net loss | 292 | 187 |
| Expected return on plan assets | (599) | (531) |
| **Net periodic pension benefit expense** | **631** | **485** |
| Special termination benefits | 9 | 10 |
| Bureau of Consumer Financial Protection contributions | (2) | — |
| **Total periodic pension benefit expense** | **$ 638** | **$ 495** |

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic pension benefit expense in 2013 are shown below (in millions):

| | |
|---|---|
| Prior service cost | $103 |
| Net actuarial loss | 275 |
| **Total** | **$378** |

Following is a summary of expected benefit payments, excluding enhanced retirement benefits (in millions):

| | |
|---|---|
| 2013 | $ 379 |
| 2014 | 401 |
| 2015 | 425 |
| 2016 | 450 |
| 2017 | 476 |
| 2018-2022 | 2,777 |
| **Total** | **$4,908** |

The System's Committee on Investment Performance (CIP) is responsible for establishing investment policies, selecting investment managers, and monitoring the investment managers' compliance with its policies. The CIP is supported by staff in the OEB in carrying out these responsibilities. At December 31, 2012, the System Plan's assets were held in six investment vehicles: two actively managed long-duration fixed-income portfolios, an indexed U.S. equity fund, an indexed non-U.S. developed markets equity fund, an indexed long-duration fixed-income portfolio, and a money market fund.

The diversification of the Plan's investments is designed to limit concentration of risk and the risk of loss related to an individual asset class. The two long-duration fixed-income portfolios are separate accounts benchmarked to a custom benchmark of 55 percent Barclays Long Credit Index and 45 percent Citigroup 15+ years U.S. Treasury STRIPS Index, which was selected as a proxy for the liabilities of the Plan. These portfolios are actively managed and the guidelines are designed to limit portfolio deviations from the benchmark. The indexed long-duration fixed-income portfolio is invested in two commingled funds and is benchmarked to 55 percent Barclays Long Credit Index and 45 percent Barclays 20+ STRIPS Index. The indexed U.S. equity fund is intended to track the overall U.S. equity market across market capitalizations and is benchmarked to the Dow Jones U.S. Total Stock Market Index. The indexed non-U.S. developed markets equity fund is intended to track the Morgan Stanley Capital International (MSCI), Europe, Australia, Far East, plus Canada Index, which includes stocks from twenty-three markets deemed by MSCI to be "developed markets." Finally, the money market fund, which invests in high-quality money market securities, is the repository for cash balances and adheres to a constant-dollar methodology.

Permitted and prohibited investments, including the use of derivatives, are defined in either the trust agreement (for commingled index vehicles) or the investment guidelines (for the three separate accounts). The CIP reviews the trust agreement and approves all investment guidelines as part of the selection of each investment to ensure that the trust agreement is consistent with the CIP's investment objectives for the System Plan's assets.

The System Plan's policy weight and actual asset allocations at December 31, by asset category, were as follows:

| | | Actual Asset Allocations | |
|---|---|---|---|
| | Policy Weight | 2012 | 2011 |
| U.S. equities | 35.0% | 34.9% | 39.0% |
| International equities | 15.0% | 13.6% | 13.8% |
| Fixed-income | 50.0% | 50.4% | 46.6% |
| Cash | 0.0% | 1.1% | 0.6% |
| **Total** | **100.0%** | **100.0%** | **100.0%** |

Employer contributions to the System Plan may be determined using different assumptions than those required for financial reporting. The System Plan's anticipatory funding level for 2013 is $900 million. In 2013, the System plans to make monthly contributions of $75 million and will reevaluate the monthly contributions

upon completion of the 2013 actuarial valuation. The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2012 and 2011, and for the years then ended, were not material.

The System Plan's investments are reported at fair value as required by ASC 820. ASC 820 establishes a three-level fair value hierarchy that distinguishes between market participant assumptions developed using market data obtained from independent sources (observable inputs) and the Bank's assumptions about market participant assumptions developed using the best information available in the circumstances (unobservable inputs).

*Determination of Fair Value*

The System Plan's investments are valued on the basis of the last available bid prices or current market quotations provided by dealers, or pricing services. To determine the value of a particular investment, pricing services may use information on transactions in such investments; quotations from dealers; pricing metrics; market transactions in comparable investments; relationships observed in the market between investments; and calculated yield measures based on valuation methodologies commonly employed in the market for such investments.

Because of the uncertainty inherent in determining the fair value of investments that do not have a readily available fair value, the fair value of these investments may differ significantly from the values that would have been reported if a readily available fair value had existed for these investments and may differ materially from the values that may ultimately be realized.

The following table presents the financial instruments recorded at fair value as of December 31, 2012, by ASC 820 hierarchy (in millions):

| | 2012 | | | |
|---|---|---|---|---|
| Description | Level 1[1] | Level 2[1] | Level 3 | Total |
| Short-term investments | $ 23 | $ 25 | $ — | $ 48 |
| Treasury and federal agency securities | 141 | 1,746 | — | 1,887 |
| Corporate bonds | — | 1,947 | — | 1,947 |
| Other fixed-income securities | — | 352 | — | 352 |
| Commingled funds | — | 5,206 | — | 5,206 |
| **Total** | **$164** | **$9,276** | **$ —** | **$9,440** |

[1] U.S. Treasury STRIPs with a fair value of $1,737 million were transferred from Level 1 to Level 2 because they were valued based on quoted prices in nonactive markets (Level 2). There were no other transfers between Level 1 and Level 2 during the year.

The following table presents the financial instruments recorded at fair value as of December 31, 2011, by ASC 820 hierarchy (in millions):

| | 2011 | | | |
|---|---|---|---|---|
| Description | Level 1[1] | Level 2[1] | Level 3 | Total |
| Short-term investments | $ 31 | $ 29 | $ — | $ 60 |
| Treasury and federal agency securities | 1,685 | 14 | — | 1,699 |
| Corporate bonds[2] | — | 1,656 | — | 1,656 |
| Other fixed-income securities[2] | — | 306 | — | 306 |
| Commingled funds | — | 4,256 | — | 4,256 |
| **Total** | **$1,716** | **$ 6,261** | **$ —** | **$7,977** |

[1] There were no transfers between Level 1 and Level 2 during the year.

[2] Investments with a fair value of $1,656 million as of December 31, 2011, were recategorized from "Other fixed-income securities" to a new line item labeled "Corporate bonds" to conform to the current-year presentation.

The System Plan enters into futures contracts, traded on regulated exchanges, to manage certain risks and to maintain appropriate market exposure in meeting the investment objectives of the System Plan. The System Plan bears the market risk that arises from any unfavorable changes in the value of the securities or indexes underlying these futures contracts. The use of futures contracts involves, to varying degrees, elements of market risk in excess of the amount recorded in the Consolidated Statements of Condition. The guidelines established by the CIP further reduce risk by limiting the net futures positions, for most fund managers, to 15 percent of the market value of the advisor's portfolio.

At December 31, 2012 and 2011, a portion of short-term investments was available for futures trading. There were $7 million and $6 million of Treasury securities pledged as collateral for the years ended December 31, 2012 and 2011, respectively.

***Thrift Plan***

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Bank matches 100 percent of the first 6 percent of employee contributions from the date of hire and provides an automatic employer contribution of 1 percent of eligible pay. The Bank's Thrift Plan contributions totaled $25 million and $23 million for the years ended December 31, 2012 and 2011, respectively, and are reported as a component of "Operating expenses: Salaries and benefits" in the Consolidated Statements of Income and Comprehensive Income.

## 10. POSTRETIREMENT BENEFITS OTHER THAN RETIREMENT PLANS AND POSTEMPLOYMENT BENEFITS

***Postretirement Benefits Other Than Retirement Plans***

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

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

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

| | 2012 | 2011 |
|---|---|---|
| Accumulated postretirement benefit obligation at January 1 | $319 | $264 |
| Service cost benefits earned during the period | 13 | 9 |
| Interest cost on accumulated benefit obligation | 15 | 15 |
| Net actuarial loss | 49 | 45 |
| Contributions by plan participants | 2 | 2 |
| Benefits paid | (17) | (17) |
| Medicare Part D subsidies | 1 | 1 |
| **Accumulated postretirement benefit obligation at December 31** | **$382** | **$319** |

At December 31, 2012 and 2011, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 3.75 percent and 4.50 percent, respectively.

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

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

| | 2012 | 2011 |
|---|---|---|
| Fair value of plan assets at January 1 | $ — | $ — |
| Contributions by the employer | 14 | 14 |
| Contributions by plan participants | 2 | 2 |
| Benefits paid | (17) | (17) |
| Medicare Part D subsidies | 1 | 1 |
| **Fair value of plan assets at December 31** | **$ —** | **$ —** |
| Unfunded obligation and accrued postretirement benefit cost | $ 382 | $ 319 |
| Amounts included in accumulated other comprehensive loss are shown below: | | |
| Prior service cost | $ — | $ 1 |
| Net actuarial loss | (134) | (93) |
| **Total accumulated other comprehensive loss** | **$(134)** | **$(92)** |

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

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

| | 2012 | 2011 |
|---|---|---|
| Health-care cost trend rate assumed for next year | 7.00% | 7.50% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5.00% | 5.00% |
| Year that the rate reaches the ultimate trend rate | 2018 | 2017 |

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, 2012 (in millions):

| | One Percentage-Point Increase | One Percentage-Point Decrease |
|---|---|---|
| Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs | $ 5 | $ (4) |
| Effect on accumulated postretirement benefit obligation | 61 | (50) |

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

| | 2012 | 2011 |
|---|---|---|
| Service cost–benefits earned during the period | $13 | $ 9 |
| Interest cost on accumulated benefit obligation | 15 | 15 |
| Amortization of prior service cost | — | — |
| Amortization of net actuarial loss | 9 | 5 |
| **Net periodic postretirement benefit expense** | **$37** | **$ 29** |

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2013 are shown below (in millions):

| | |
|---|---|
| Prior service cost | $ — |
| Net actuarial loss | 12 |
| **Total** | **$ 12** |

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2012 and 2011, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 4.50 percent and 5.25 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of "Operating expenses: Salaries and benefits" in the Consolidated Statements of Income and Comprehensive Income.

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

Federal Medicare Part D subsidy receipts were $0.9 million and $0.8 million in the years ended December 31, 2012 and 2011, respectively. Expected receipts in 2013, related to benefits paid in the years ended December 31, 2012 and 2011, are $0.7 million.

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

| | Without Subsidy | With Subsidy |
|---|---|---|
| 2013 | $ 17 | $ 16 |
| 2014 | 18 | 17 |
| 2015 | 18 | 17 |
| 2016 | 19 | 18 |
| 2017 | 20 | 19 |
| 2018-2022 | 112 | 104 |
| **Total** | **$204** | **$191** |

***Postemployment Benefits***

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of providing disability, medical, dental, and vision insurance, and survivor income benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2012 and 2011, were $42 million and $39 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Consolidated Statements of Condition. Net periodic postemployment benefit expenses included in 2012 and 2011 operating expenses were $7 million and $8 million, respectively, and are recorded as a component of "Operating expenses: Salaries and benefits" in the Consolidated Statements of Income and Comprehensive Income.

## 11. ACCUMULATED OTHER COMPREHENSIVE INCOME AND OTHER COMPREHENSIVE INCOME

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

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Amount Related to Defined Benefit Retirement Plan | Amount Related to Postretirement Benefits Other Than Retirement Plans | Total Accumulated Other Comprehensive Income (Loss) | Amount Related to Defined Benefit Retirement Plan | Amount Related to Postretirement Benefits Other Than Retirement Plans | Total Accumulated Other Comprehensive Income (Loss) |
| Balance at January 1 | $(4,449) | $(92) | $ (4,541) | $(3,360) | $(52) | $(3,412) |
| Change in funded status of benefit plans: | | | | | | |
| Prior service costs arising during the year | 64 | — | 64 | (78) | — | (78) |
| Amortization of prior service cost | 116 | — | 116 | 110 | — | 110 |
| Change in prior service costs related to benefit plans | 180 | — | 180 | 32 | — | 32 |
| Net actuarial loss arising during the year | (366) | (49) | (415) | (1,308) | (45) | (1,353) |
| Amortization of net actuarial loss | 292 | 9 | 301 | 187 | 5 | 192 |
| Change in actuarial losses related to benefit plans | (74) | (40) | (114) | (1,121) | (40) | (1,161) |
| Change in funded status of benefit plans–other comprehensive income (loss) | 106 | (40) | 66 | (1,089) | (40) | (1,129) |
| **Balance at December 31** | **$(4,343)** | **$(132)** | **$ (4,475)** | **$(4,449)** | **$(92)** | **$(4,541)** |

Additional detail regarding the classification of accumulated other comprehensive loss is included in Notes 9 and 10.

## 12. BUSINESS RESTRUCTURING CHARGES

The Bank had no significant restructuring activities in 2012 and 2011.

## 13. DISTRIBUTION OF COMPREHENSIVE INCOME

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

| | 2012 | 2011 |
|---|---|---|
| Dividends on capital stock | $ 523 | $ 470 |
| Transfer to surplus–amount required to equate surplus with capital paid-in | 68 | 995 |
| Interest on Federal Reserve notes expense remitted to Treasury | 51,023 | 32,432 |
| **Total distribution** | **$51,614** | **$33,897** |

## 14. SUBSEQUENT EVENTS

On January 15, 2013, the Treasury, the Bank, and TALF LLC agreed to eliminate in their entirety the Treasury's subordinate funding commitment to TALF LLC and the Bank's senior funding commitment to TALF LLC. These commitments were no longer deemed necessary because the accumulated fees collected through the TALF program, and currently held in liquid assets in TALF LLC, exceed the amount of TALF loans outstanding. In addition, the agreement related to distribution of proceeds was amended to limit funding of the cash collateral account to an amount equal to the outstanding principal plus accrued interest of all TALF loans as of the payment determination date; all accumulated funding in excess of that amount would then be distributed according to the distribution priorities described in the agreements governing TALF LLC.

Pursuant to this agreement, TALF LLC repaid in full the outstanding principal and accrued interest on the subordinated loan to the Treasury, and additional distributions were made to the Treasury and the Bank as contingent interest in the amounts of $310 million and $35 million, respectively.

There were no other subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2012. Subsequent events were evaluated through March 14, 2013, which is the date the Bank issued the financial statements.

# Directors of the Federal Reserve Bank of New York

# CHANGES IN DIRECTORS *2013*

Member banks in this District have reelected GLENN H. HUTCHINS a class B director for a three-year term beginning January 2013. Mr. Hutchins, who is Co-Founder of Silver Lake, New York, N.Y., has been serving as a class B director since August 2011.

The Board of Governors has appointed SARA HOROWITZ, Executive Director, Freelancers Union, Brooklyn, N.Y., a class C director for a three-year term beginning January 2013. Ms. Horowitz succeeds Lee C. Bollinger, President, Columbia University, New York, N.Y., who served as a class C director since January 2007 and Chair and Federal Reserve Agent since January 2011.

The Board of Governors has designated EMILY K. RAFFERTY, President, The Metropolitan Museum of Art, New York, N.Y., as Chair of the Board and Federal Reserve Agent for the year 2013. Ms. Rafferty has been serving as a class C director since January 2011.

The Board of Governors has also redesignated KATHRYN S. WYLDE, President and Chief Executive Officer, Partnership for New York City, New York, N.Y., as Deputy Chair for the year 2013. Ms. Wylde has been serving as a class C director since July 2009 and Deputy Chair since January 2011.

# DIRECTORS OF THE FEDERAL RESERVE BANK OF NEW YORK

| DIRECTORS | TERM EXPIRES DEC. 31 | CLASS |
|---|---|---|
| JAMES DIMON<br>*Chairman and Chief Executive Officer*<br>JPMorgan Chase & Co., New York, N.Y. | 2012 | A |
| RICHARD L. CARRIÓN<br>*Chairman, President, and Chief Executive Officer*<br>Popular, Inc., San Juan, P.R. | 2013 | A |
| PAUL P. MELLO<br>*President and Chief Executive Officer*<br>Solvay Bank, Solvay, N.Y. | 2014 | A |
| GLENN H. HUTCHINS<br>*Co-Founder*<br>Silver Lake, New York, N.Y. | 2012 | B |
| ALPHONSO O'NEIL-WHITE<br>*President and Chief Executive Officer*<br>HealthNow New York Inc., Buffalo, N.Y. | 2013 | B |
| TERRY J. LUNDGREN<br>*Chairman, President, and Chief Executive Officer*<br>Macy's, Inc., New York, N.Y. | 2014 | B |
| LEE C. BOLLINGER, Chair and Federal Reserve Agent<br>*President*<br>Columbia University, New York, N.Y. | 2012 | C |
| KATHRYN S. WYLDE, Deputy Chair<br>*President and Chief Executive Officer*<br>Partnership for New York City, New York, N.Y. | 2013 | C |
| EMILY K. RAFFERTY<br>*President*<br>The Metropolitan Museum of Art, New York, N.Y. | 2014 | C |

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# Map of the Second Federal Reserve District

# THE SECOND FEDERAL RESERVE DISTRICT