Federal Reserve Bank of Boston • Annual Report 2003

Embracing Change . . .

In the midst of change our mission and core values remain the same.

Our Mission:

As part of the nation's central bank, the Federal Reserve Bank of Boston promotes sound growth and financial stability in New England and the nation. The Bank contributes to local communities, the region, and the nation through its high-quality research, regulatory oversight, and financial services, and through its commitment to leadership and innovation.

Integrity
Serving the Public
Respect
Leadership
Excellence
Continuous Improvement

FEDERAL RESERVE BANK OF BOSTON · 1914 ·

Dorothy Simpson Krause, Untitled (History Series - Charter 2003), mixed media; Bank Collection

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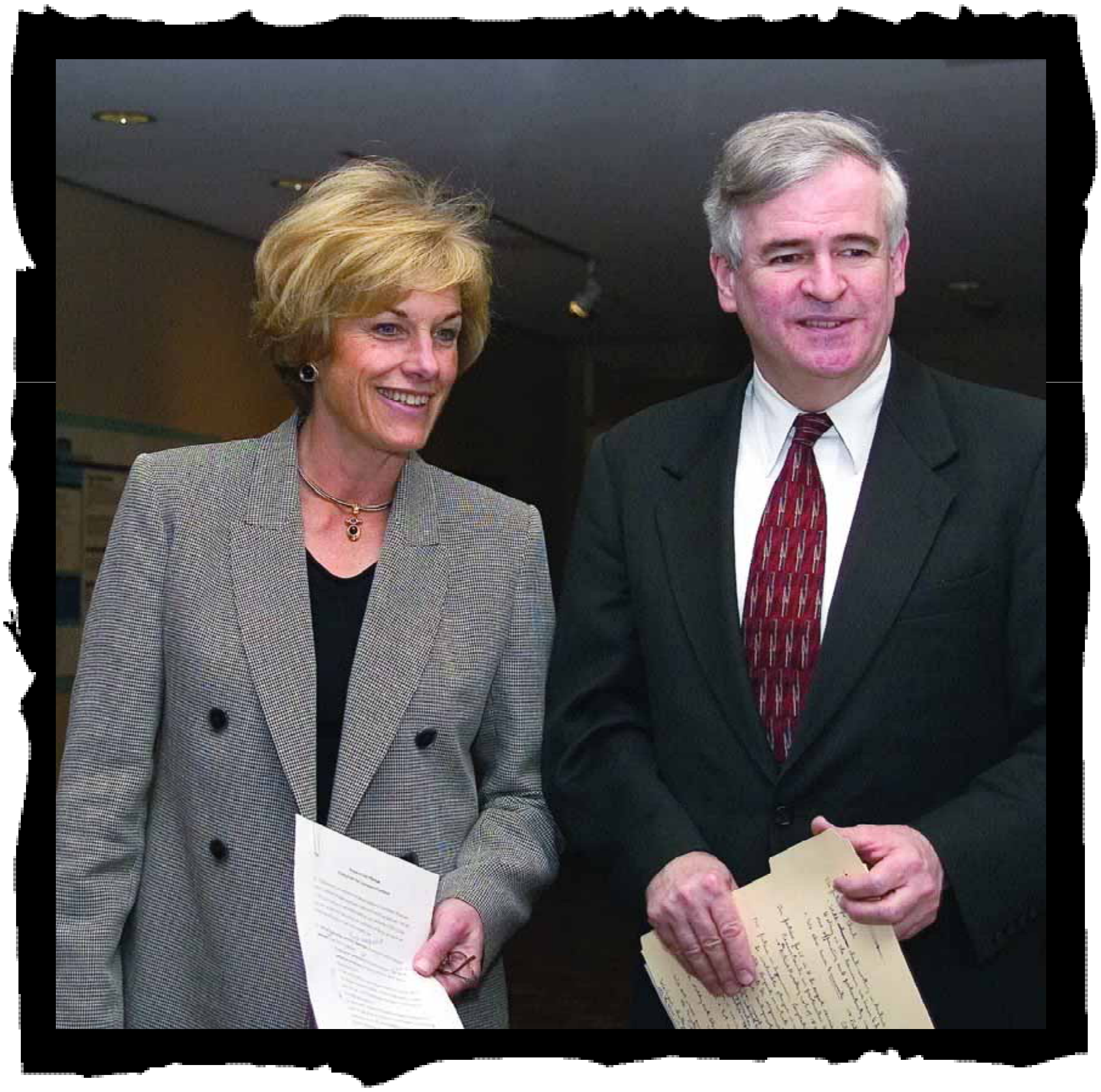


President Cathy E. Minehan and First Vice President Paul M. Connolly view storyboards from the Bank's Celebration of Excellence.

Letter from the President

As Paul Connolly and I celebrate ten years as the top management team of the Federal Reserve Bank of Boston, we are struck by the pace and intensity of change in the Bank's environment and its activities. These ten years haven't affected the Bank's outward face—we're about the same size, albeit housed in fewer locations—and our mission of supporting the monetary and financial stability of New England and the nation remains the guiding star for our activities. But the way in which we follow that star is changing. We are making a gradual transformation from an organization with a large base of clerical operations to one that is engaged more in technologically sophisticated and policy oriented activities. Over time, we will be smaller in size, but we will remain a vital part of both the region and the Federal Reserve System. This annual report highlights some of the changes we are seeing and how they affect the Bank.

Ten years ago, five major commercial banks had their headquarters in the First District, and hundreds of smaller institutions served the region. Today, banking assets are much more consolidated; nonbank providers of all types of financial services have proliferated; and, for all financial institutions, increased market complexity and competition have led to increasingly complex risk management. As we consider our responsibilities in an ever more competitive industry and society, the extent of change is striking. It is evident in how we supervise District banking institutions, how we provide financial services, and how we address our community and consumer protection responsibilities.

Ten years ago, the Bank operated its own data center and was a hub into the Federal Reserve's telecommunications system. Today, we, along with the other Reserve Banks, rely on centralized data centers that have proven to be both highly resilient in

We have a critical mission to fulfill, and . . .

times of crisis and much easier to update as automation needs change. We have transformed the Bank's information technology areas to focus on specialized competencies. Among other things, we provide support for the System's Internet firewalls; we design, maintain, and operate the accounting system that serves all Reserve Banks; we design new payment platforms for the U.S. Treasury; and we have responsibility for the national implementation and operation of a new digital imaging platform and archive for checks. Even in cash services, one of the time honored tasks of a Reserve Bank, high technology dominates. In Boston, we are pioneering new ways to make that technology more effective, and our operations—and those of other Reserve Banks—more efficient.

As recently as three years ago, we saw paper check processing growing by nine percent per year here in Boston; now it is declining nationwide at an annual pace of about five percent. Research conducted within the Federal Reserve System indicates that the nationwide use of checks as a retail payment instrument likely started to decline in the late 1990s. Electronic retail payments are overtaking paper as businesses and consumers use a variety of debit and credit card alternatives, the ACH, and other electronic systems. This is a good thing for the payment systems and for the efficiency of the U.S. economy, but, as with most major changes, it brings with it uncertainty and transitional concerns.

As we look ahead, we see an organization undergoing significant change as well. An early retirement program offered in 2003 will see us bidding farewell to 200 colleagues with over 5,000 years of Bank service by the end of 2004. It's hard to imagine the Bank without these respected staff. Looking ahead, by 2005, a third of our staff will have worked for the Bank for less than five years, and that staff will be less clerical and more technical and professional in nature. To keep pace, our organizational structure has evolved, and new areas have been added to increase our emphasis on new payment technologies, strategic risk management, and regional outreach and communications.

Our building, as always a vital resource for our operations, has faced challenges as well—from the Big Dig to higher security levels in the wake of September 11, 2001. After nearly ten years of upheaval on our door step, we have begun a project that will bring new luster to the Bank's outward face and repair and enhance the security of our 25- year-old infrastructure. And at the same time, we've opened our New England Economic Adventure to engage visitors of all ages in games, exhibits, and activities that demonstrate to them how economies grow.

The nation's economy is changing as well. After a short and not particularly severe recession, the ensuing recovery has taken some time to get on its feet. The second half of 2003 saw a remarkable pace of six percent GDP growth, but as this annual report goes to print, employment change has only begun to be positive. All the signs point to a strong 2004—renewed business spending, monetary and fiscal policy accommodation, and a renewal of growth around the globe even in the face of continued geopolitical uncertainty. And the spectacular increase in U.S. productivity augurs well for the long run. But for now, the slow pace of job growth surprises and puzzles us.

As we enter 2004, we say farewell to our chairman, James Norton, AFL-CIO vice president, who served six years as a director. His steady hand and common sense perspective were a mainstay as we encountered the many forces of change this annual report documents. We also recognize departing director Sherwin Greenblatt, past president of BOSE Corporation, for his contributions to our many discussions of high tech industries nationally and internationally; and departing directors Richard White, president and chief executive officer, Community National Bank in Derby, Vermont, and David Outhouse, president and chief executive officer, First and Ocean National Bank in Newburyport, Massachusetts, both of whom so ably represented the New England banking scene on our board.

As always, the measure of an institution lies not so much in the degree to which it is buffeted by change, but in the way in which it responds. Here, I have enormous confidence in the staff and management of the Bank. We have steered successfully through many changes during the 90 years since the Bank began to serve our region in 1914. We are and will remain an important cornerstone of financial life in New England and the nation and an important contributor to our communities as well.

Dorothy Simpson Krause, Untitled(History Series -Charter 2003), mixed media; Bank Collection

FRANK E. MORRIS, former President, and JAMES A. MCINTOSH, former First Vice President, are featured in a mural on the Bank's fourth floor.

we will remain an important cornerstone of financial life in New England.

Cathy E. Minehan

[Our Changing Environment

The Payments Evolution

New Approaches to Education

Managing Risk

An Economy Transformed]

Dorothy Simpson Krause, Untitled (History Series - Charter 2003), mixed media; Bank Collection

Over its entire history,

the Federal Reserve Bank of Boston has faced changes in the economy, in the financial services industry, and in its responsibilities. At times, we've reacted to change; at times, the Bank has served as a catalyst, as our staff have explored new ways to accomplish the tasks facing us. The Bank's mission has remained the same over the years—to support sound economic growth and financial stability in New England and the nation. But the ways in which we fulfill our mission and meet our changing responsibilities have evolved. Philosophers tell us that change is the only constant, but its pace is hardly constant. At present, it seems to be accelerating.

This essay features short segments on some aspects of change in the Bank in 2003 and beyond. It describes changes affecting the economy, our building and security measures, payments operations, educational efforts, and bank supervision. These are very different areas, but changes in each are driven by advances in technology, increasing complexity, and a continuing need to operate more efficiently and effectively.

[With appreciation to editor Kristin F. Kanders and graphic designer Fabienne Anselme Madsen]

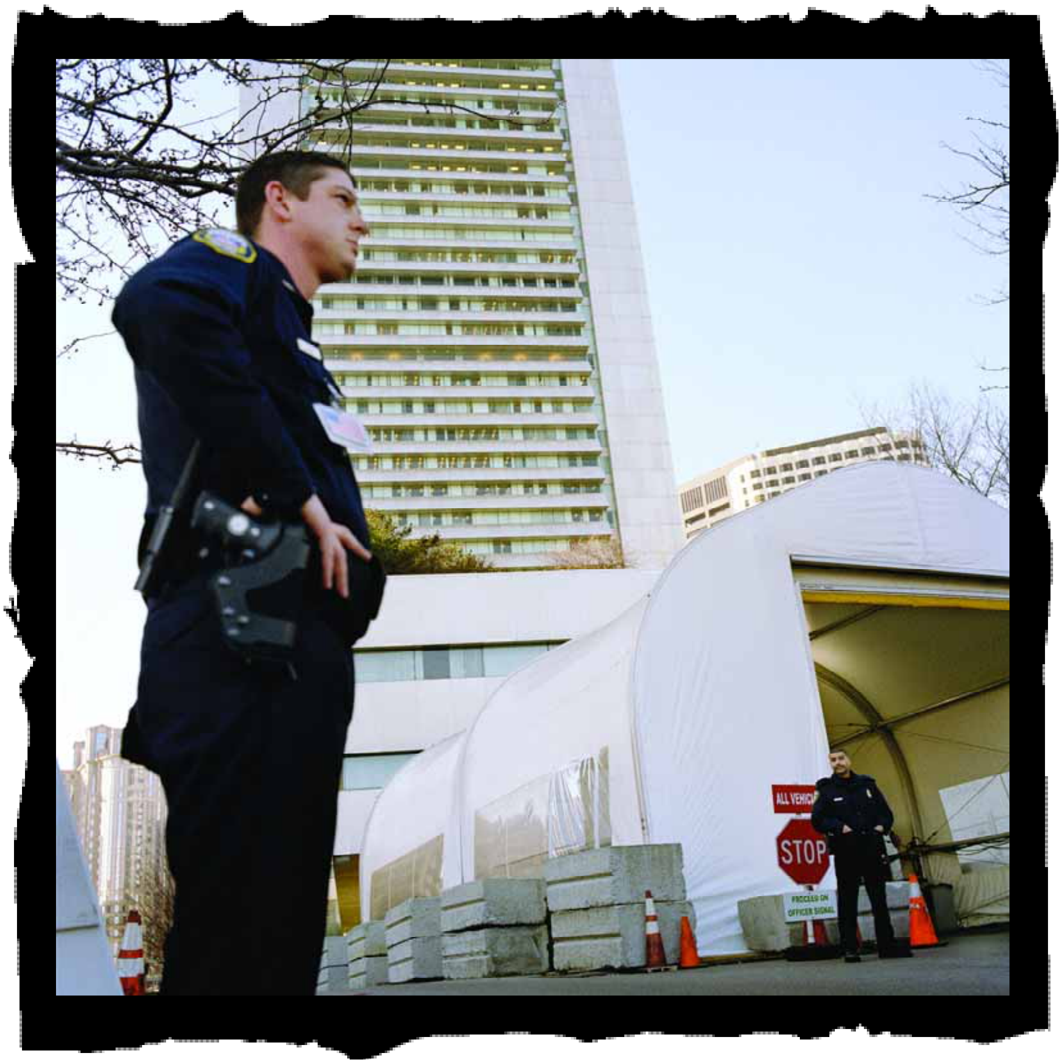
[A view from the Bank looking at the city under construction.]

Our Changing Environment

[The completion of the Big Dig and enhanced security prompt major building change.]

We in Boston have been experiencing the sights and sounds of the Central Artery/Tunnel Project for over a decade. The "Big Dig" was one of the largest and most complex and expensive highway projects in American history, and it is now in its final stages. Construction projects always cause some inconvenience, and this one certainly has. But the Big Dig is providing a once in a lifetime opportunity to improve the downtown Boston area.

At the Federal Reserve Bank of Boston, we have had a firsthand view of the construction. For a time, it was literally taking place in-house, as a part of our building underground was used for the slurry wall that enabled the tunnel to be built down

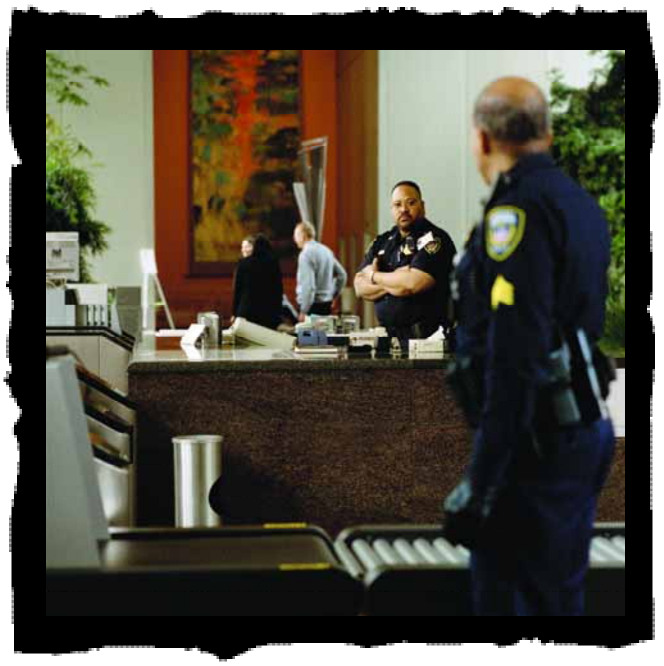


[Federal law enforcement officers, Monday, 8:13 a.m.]

Plans to renovate the plaza area have been in development since the late 1990s.

Atlantic Avenue. We are now taking advantage of the completion of this massive project to renovate our five and a half acre site to make it both more secure and more attractive. Plans for restoring the front plaza and other areas around the building have been in development since the late 1990s. After September 11, 2001, enhanced security elements became an additional consideration.

When our building was built in the 1970s, it was intended to be an open, welcoming facility with a public purpose and public space. We retain our desire to welcome visitors as well as our tenants and their visitors. But the times require new methods to improve security. Our Protection Officers are now fully trained federal law enforcement officers, and we use the best technology we can find to augment security—all in an effort to strike the right balance between security and accessibility.



Since 9/11, we have been increasing our protection presence, and our Protection Department personnel are now certified law enforcement officers.

[Entering our building, Monday, 9:43 a.m.]

[Checks on the high speed sorter, Tuesday, 5:39 a.m.]

The Payments Evolution

[The long awaited transition to electronic retail payments is finally here.]

The long awaited transition to electronic retail payments is finally here. Instead of pulling out checkbooks, people today swipe debit and credit cards at the corner store, initiate purchases online, and sign up for automatic payment plans. Businesses are finding new ways for electronics to reduce their payment transaction costs, and lawmakers have eased the way for check imaging. These changes are having a considerable effect on Federal Reserve Bank operations, both around the nation and in Boston.

The reasons for the paper check decline are understandable: consumers are attracted to the convenience of electronic payments, and businesses like the economics of converting checks to electronic transactions. For example, a credit card processor might convert the checks it receives to auto-

[The check team at work, Tuesday, 6:15 a.m.]

mated clearinghouse (ACH) transactions at its processing site and then, shortly thereafter, destroy the paper checks and store an electronic copy for recordkeeping purposes. This process is faster, cheaper, and safer than traditional paper processing.

Most knowledgeable observers thought about 70 billion checks were being written in the United States as recently as 2000. Research conducted by the Federal Reserve put the number closer to 40 billion; and that is declining, likely by as much as 5 percent a year. In addition, commercial bank mergers have reduced demand for the Federal Reserve's services as a check clearing intermediary, and competition among check processors has intensified. Reserve Banks will be challenged to reduce the Federal Reserve System's check processing infrastructure while at the same time positioning Bank services as viable alternatives should depository institutions outsource their check processing or need Reserve Banks to clear checks when problems occur.

This year, the Reserve Banks are responding to the current volume decline by discontinuing check processing at 13 of 45 sites, although check collection services will continue to be offered nationwide. Check adjustments, the error-resolution portion of the check business, will be handled in only one location per Reserve District. For Boston, this means we will do our error-resolution work at our office in Windsor Locks, Connecticut. Check processing will continue at both our Boston and our Windsor Locks sites, although as volumes continue to decline, we will have to consider all options facing us.

Technological change has made this consolidation and downsizing possible. In 2003, we in Boston converted our large processing offices to new, standard software that will enable the Banks' central technology operations to manage our check equipment. All Reserve Banks now provide consistent products and services across the country; check adjustments processing is integrated in ways that enable each Bank to help others as necessary; and digital imaging services for checks are standardized nationwide. Boston provides image services to commercial customers across the country and to the U.S. Treasury. These changes meet the needs of financial institutions that use services from multiple Reserve Banks. They also help the Banks increase efficiency and respond more quickly when launching new products.

Modernization of check processing is proving useful in other ways. The common

Even as electronic payments take hold, we still have to process billions of paper checks.

Cash being verified and processed, Tuesday, 10:18 a.m.]

Profiles:

A few minutes with Jim Cunha . . .

Emerging Payments

We are seeing tremendous change and growth in our work with the U.S. Treasury, especially as we provide stored value card services for the U.S. military. Stored value cards (a type of smart card) enable military personnel to be paid and make purchases easily and electronically. We entered the stored value card business in 2000, and today we are 20-people strong. We provide services to military training bases across the nation and in a handful of peacekeeping bases abroad. Earlier this year we deployed our system in Afghanistan and Qatar.

Because we own—rather than license—the software used on the smart cards, we have full responsibility for its future development, and this is really exciting. Both the technology and the business requirements of our operation are changing rapidly, so we are always being challenged and trying new things. I think of our business as a start-up technology services company, right here in the Fed.

Jim Cunha, Vice President,
Electronic Payment and Treasury Services

platform is making it easier for Reserve Banks to develop standards and services to implement the new "Check 21" legislation in October 2004. Check 21, short for the "Check Clearing in the 21st Century Act," removes the legal barriers to using digital images of checks as proof of payment. We expect Check 21 to increase efficiency in the payments system and encourage banks to provide innovative services to their customers.

At the same time that paper is declining, fully automated retail payment processes are gaining favor and using Reserve Bank services. The ACH is increasingly the way electronic payments are settled. In addition, other new electronic payment options seem to be developing at a rapid pace, pushed by consumer and business needs, and by the needs of the U.S. Treasury. The Reserve Banks are playing a leadership role both in the networks that support electronic payments and in serving the Treasury's needs. Retail payments are evolving. This is good for the payment system and good for the economy. All transitions bring challenges; we are ready to meet them.

Check 21 will increase check processing efficiency.

[Processing checks on the medium speed sorter, Wednesday, 6:15 a.m.]

[Cash bundles ready to go, Wednesday, 11:28 a.m.]

[Wholesale payment transactions being made, Wednesday, 3:14 p.m.]

[The Economic Adventure has hosted many school groups since opening in October 2003.]

www.economicadventure.org

New Approaches

to Economic and Financial Education

[This past fall, the Federal Reserve Bank of Boston opened the New England Economic Adventure to show how economies grow.]

When making decisions about how to save and spend, consumers face an ever-increasing array of financial products and services. Access to credit has grown tremendously, bringing new benefits but also posing new risks. In response, the Federal Reserve System has been intensifying its educational efforts. When consumers understand financial alternatives and make smart decisions, they help themselves and contribute to a stronger overall economy.

The Federal Reserve Bank of Boston has a long history of helping consumers understand economic and financial issues. We provide education about what the nation's central bank does and why, as well as insights into the workings of the economy more generally. In addition, our Community Affairs function has become increasingly

[The Adventure features objects from the 1810s, 1890s, and 1960s.]

The Adventure uses New England case histories to demonstrate the connection between productivity and living standards.

active in promoting financial literacy, the personal side of economics.

Boston's educational efforts in economics —both general and personal— were very much in evidence in 2003. In the fall, we opened the New England Economic Adventure, an educational program combining exhibits, video, and interactive games to show how increases in productivity have improved living standards. The Adventure celebrates the resilience of the New England economy by drawing upon the region's rich economic history to illustrate its theme. The experience engages visitors in exploring important economic concepts in an exciting way. It also includes an economic education laboratory and a web site with lesson plans and reference materials to help teachers use the Adventure to meet their evolving curriculum needs.

Community Affairs also supported a number of initiatives to educate consumers about such issues as the importance of saving, the wise use of credit, and the necessity of protecting personal financial information. The Community Affairs area dates from 1977 when the Federal Reserve was asked to implement the Community Reinvestment Act. This Act required supervised institutions to help meet the credit needs of low and moderate income communities, and over time they have proven they can do so. In Boston, commercial banks have stepped up their outreach to minority borrowers and neighborhoods. They have developed a variety of products to meet low and moderate income market needs. Communities report that they are becoming more comfortable with the financial

Profiles:

A few minutes with Lillian Seay . . .

Classrooms in the Workplace

It seems so incongruous—sending students to a workplace to study—but the Classroom in the Workplace program has been very successful. After the release in 1999 of the standardized test scores (Massachusetts Comprehensive Assessment System) for South Boston High School, the Boston Fed asked how it could work with its partner high school to improve student education and MCAS scores in particular. We decided to expand our summer jobs program, to make study part of the program. In 1999, the Boston Fed and two other participating companies each hired about a dozen interns. Every workday included 90 minutes as designated time to practice reading. By the end of the summer, the interns' reading ability tested 1.5 grade levels higher. We piloted a math program in 2001 to address MCAS graduation requirements. Five students in our program were required to take the MCAS that year, and all of them passed. Because of the success we were having, we made Classroom in the Workplace a year-round program in 2002. The results remain impressive, and we've been able to increase the number of participating students.

In addition to improving their English and math skills, the students become more self-confident through working with adults. The program gives students the structure to succeed and an understanding of what they need to do to move ahead in life. Now we're encouraging students to attend college while working at the Bank. This is why I like working for the Bank: We have a commitment to outreach.

Lillian Seay, Education and Partnership Specialist system, and minority households are increasingly becoming homeowners. Challenges remain, however, as financial products become more sophisticated, nonbank providers proliferate, and predatory lending becomes an increased focus of attention. In addition, increased immigration has expanded the number of potential users of financial services who have limited experience with the U.S. financial system.

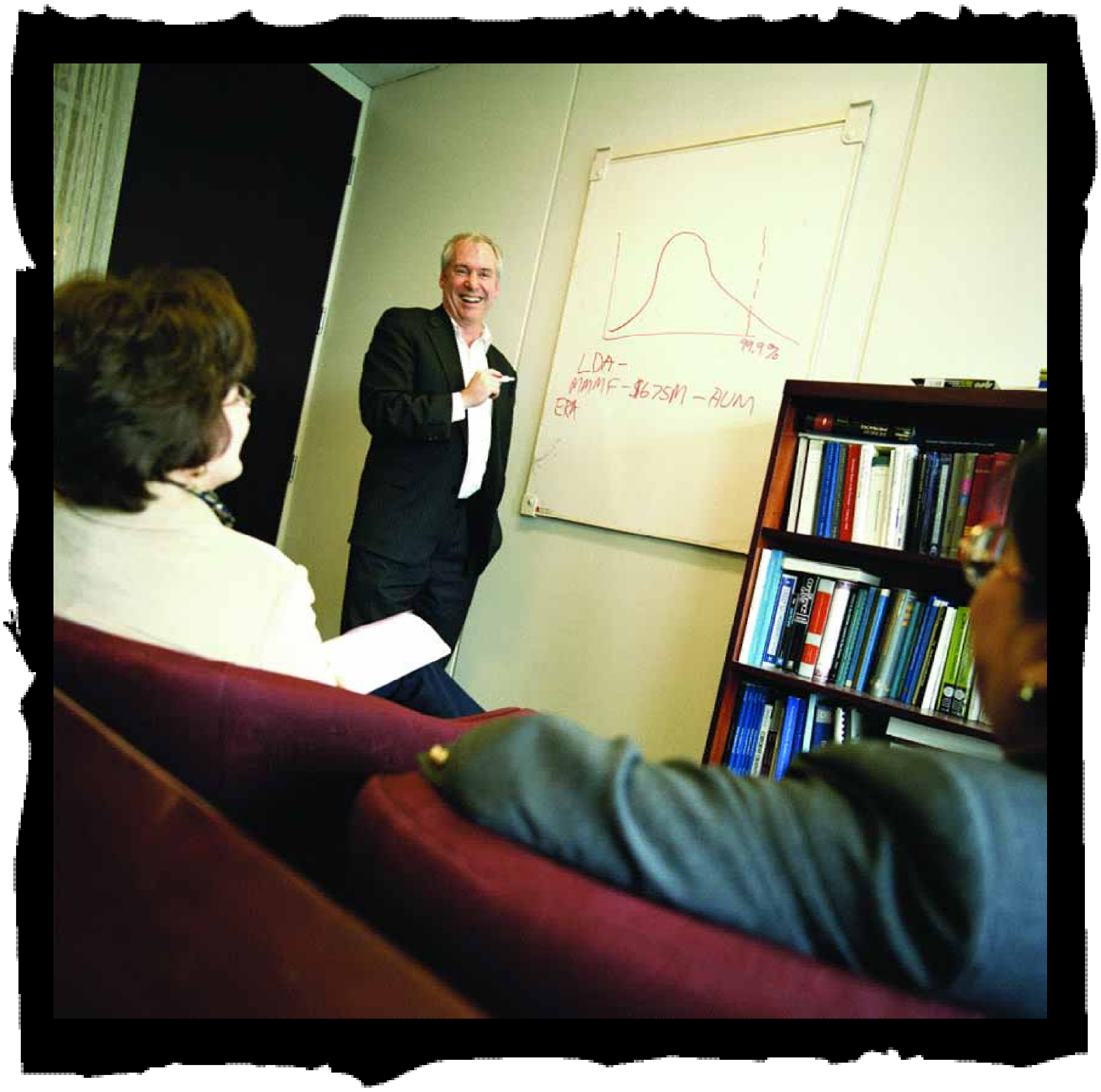
In response, Boston's Community Affairs area and its counterparts throughout the System have increased their emphasis on consumer-directed financial education.

Banks have stepped up outreach to minority borrowers and neighborhoods, developing products for low and moderate income needs.

[Editing **Communities & Banking**, Thursday, 11:25 a.m.]

Community affairs meeting at the Federal Reserve,
Thursday, 2:23 p.m.]

If borrowers and consumers of financial services are better informed about the financial products available to them, they will use these services and products more wisely. In delivering their message, both Community Affairs and our economic education staff work with nonprofit organizations, public schools, and other academic institutions to share expertise and enhance economic understanding with all our audiences.



[Discussing risk quantification, Tuesday, 10:48 a.m.]

Managing Risk

Changes in the World of Supervision and Regulation

[For bankers and bank supervisors the evaluation and management of risk have become critically important.]

The U.S. financial services sector generated about one-third of all U.S. corporate profits last year and had about one-fifth of the nation's market capitalization. Bank capital ratios were strong, even after the recession and the long, slow recovery. While not without its problems in the wake of a significant stock market correction and corporate governance problems, the banking industry emerged in remarkably strong shape. One reason for this was an increased focus on risk management.

Over the past decade, the nation's banks have been expanding across the country (and increasingly, the globe), diversifying income sources, hedging risks more effectively, and using technology to their advantage. These changes have come about

[Supervision and Regulation staff, Wednesday, 1:34 p.m.]

understand bank risks.

Modeling and measurement techniques for market risks, such as fluctuations in the stock market, are well established and integrated into risk management at most financial firms. Credit risk models that determine the likelihood and impact of loan defaults have existed for some time as well, though many have changed dramatically in recent years. The most recent risk to be analyzed quantitatively is operational risk. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems

in part because regulatory barriers to geographic and product expansion have been removed. The industry has also refined its methods for quantifying and managing risks to deal with the changing landscape.

To effectively evaluate risks in the current complex environment requires an increasing degree of sophistication on the part of both bankers and bank regulators. Supervision and Regulation staff at the Federal Reserve Bank of Boston and at other Reserve Banks are focused on using the best and most appropriate tools to harness information and

Operational risk has received more attention recently.

or from external events. Operational losses are often headline events: Employee fraud topples a respected bank; terrorist activity damages bank property; a bank settles a major lawsuit regarding its lending practices.

One of the key questions facing both bankers and regulators concerning operational risk is how much capital should be kept as a cushion against very large but unlikely losses. For most activities, the price charged for the service provided or effective controls and automation can limit the costs of operational risk to a financial institution. But some operational losses are sizable, and banks and regulators have been looking for ways to translate the costs of those unexpected losses into capital requirements. U.S. bank regulators had been studying this issue for some time; now it is being incorporated into the evolving discussion of a new international capital standard known as Basel II (Basel I is the existing standard).

During 2003, staff in Boston undertook several specialized studies to gain a greater understanding of banks' actual operational loss experience and capital allocations to address potential losses. Our analysis helped us conduct and support supervisory examinations within our District and at some of the country's largest and most complex banking organizations. We have disseminated our analytical findings by publishing research, and we will work with the industry going forward to take advantage of data and technology to provide effective supervision. This is a change for us, and our staff is strengthening its capacity to meet these new supervision needs. Change brings challenges, for sure, but meeting this challenge will help the Bank work toward ensuring that the U.S. financial system remains strong and stable.

Profiles:

A few minutes with Jackie Palladino . . .

Enterprise Risk

The financial services industry is ever more focused on risk management, and so are Reserve Banks. In Boston, we recently established an Enterprise Risk Management function to take a comprehensive look at the risks and opportunities that impact our strategic objectives. Our goals for this year include setting up an efficient framework to help us manage risks across the organization. We're also going to apply quantitative analysis in certain cases to enhance our risk management techniques. That is, we have a lot of controls, but do we have the right ones, and does our staff understand them?

I'm personally very excited about my new role because it will give me an opportunity to work with people in the business units and build upon existing risk management and control processes. A big part of my job will be to educate people about the role of risk management. As with anything new, I'm expecting some skepticism. But enterprise risk management can provide benefits, such as supporting informed decision-making and providing a view of risks that cross business lines. Ultimately, I think the best way to convince people will be to provide valuable and actionable information.

Jackie Palladino, Chief Analyst and Enterprise Risk Manager

[Our location in the financial district keeps us connected.]

An Economy Transformed

the "NEW" New Economy

[The nation's economy is reinventing itself in the face of technological change and intense global competition.]

One of the most remarkable features of the U.S. economy over the past year has been the continuing surge in productivity. Indeed, after rising at a pace of 2.5 percent per year through the late 1990s—after better than 20 years at a percentage point lower—productivity growth surged even higher in the new century. Over the four quarters of 2003, productivity growth averaged better than 5 percent per year—truly a staggering number for a mature, industrialized economy. It seems unlikely that such strong productivity growth is sustainable, but it seems equally unlikely that productivity will revert to its rate of growth in the early 1990s.

What does seem likely is that the nation's economy is reinventing itself in the face of newly emerging telecommunications technologies and intense global competition. The ongoing introduction of new technology and the ability of businesses to

[Fed economists discuss the economy, Monday, 11:15 a.m.]

use technology to improve efficiency augur well for the long run. In the short run, however, these changes have challenged everyone with the temerity to attempt economic forecasting—and that includes monetary policymakers.

In the first half of 2003, growth stalled and productivity surged, widening the gap between the current level of activity and the economy's full-employment capacity. At the same time, inflation fell to levels that raised concerns among some. But real growth rebounded in the second half of the year, and business investment revived after a three-year hiatus. Partly as a consequence, inflation appears to have stabilized in recent months.

Despite the resurgence in demand, however, new hiring remained weak. Boston Fed economists devoted significant research effort to making sense of this puzzling confluence of revitalized demand, stagnant employment, and high productivity growth. We were not alone in our puzzlement, as evidenced by the numerous newspaper and business magazine articles that flagged and then flogged potential explanations for labor market doldrums. Leading explanations in the press included export of jobs abroad ("outsourcing"); a severe mismatch between workers' skills and skills required for new jobs; rising labor costs, especially for health insurance and contributions to retirement funds; mis-measurement of employment trends; permanent substitution of capital for labor in key industries; a never-ending ability to find efficiency and process improvements that enabled companies to meet demand without hiring; and lingering uncertainty about geopolitical and economic prospects.

While all of these explanations have some basis in fact, and some are painfully real to businesses and employees in certain sectors, most fall short of the mark. At present, we are taking some comfort in the fact that our best explanations—some combination of uncertainties and the continued ability to achieve process improvements—are transitory and imply that labor market weakness is transitory as well. We are heartened by recent indications that hiring is improving. As a result, we expect that, as firms become more certain that solid economic growth is here to stay, hiring will resume, and productivity growth will recede from its very high levels.

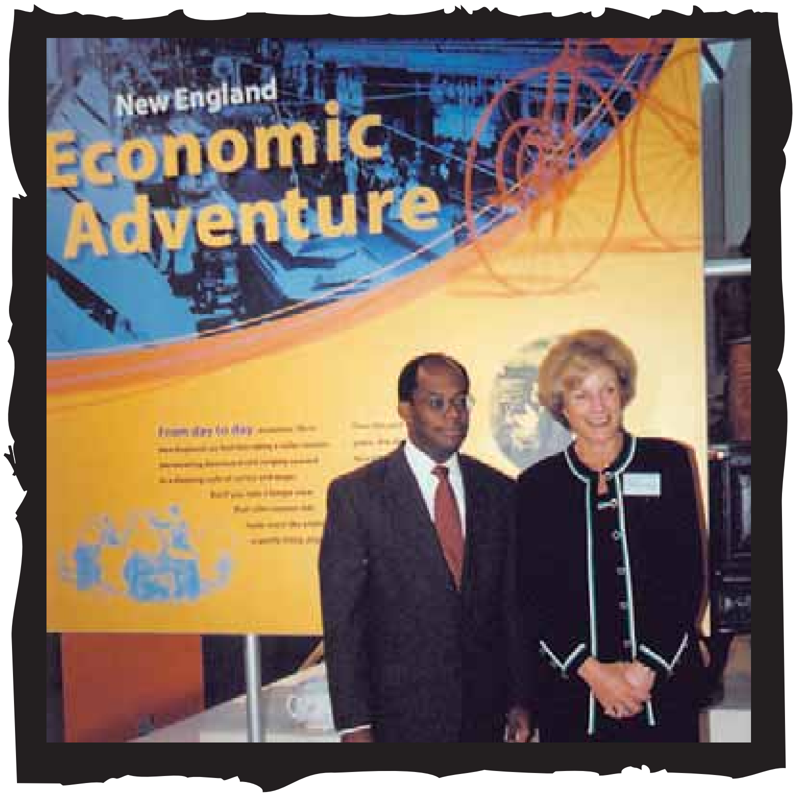
One thing of which we can be confident is that the dynamic U.S. economy will continue to change. In part, changes will be impelled by the underlying competitive drive that is a hallmark of our economy. As the economy transforms itself yet again, we will be confronted with new and challenging questions about how best to conduct monetary policy. In recognition of that likelihood, our 2003 annual economic conference focused on "behavioral economics." This strand of economics questions many of the underpinnings of standard economic theory, including how consumers and businesses respond to changes in the economic environment. It is probably a bit early to expect direct application of the insights from behavioral economics to monetary policymaking. But we believe that by expanding the set of viewpoints that we bring to analyzing the macroeconomy, we stand a better chance of detecting and making sense of new developments as they inevitably occur.

As we seek to better understand the evolving economy, we expect to benefit from listening to the public about their real-world experience of economic change, and we hope to share with them our insights about its consequences for policymaking. In so doing, we best position ourselves to push out the frontiers of research and to contribute creatively and effectively to the formation of monetary policy.

As the economy transforms itself yet again, we will be confronted with new and challenging questions about how best to conduct monetary policy.

[Bank volunteers on Community Care Day.]

[The Bank in the Community]



Working together to make a difference. . .

[Governor Roger Ferguson and President Cathy Minehan, Adventure Grand Opening, October 2003.]

[Federal Reserve Fenway outing: First Vice President Paul Connolly tosses out the ball.]

[First Vice President Paul Connolly presents a check to United Way.]

. . . and to support others

[Bank staff prepare lunch for a United Way shelter.]

[Material Life displays of the 1810s and 1890s, New England Economic Adventure.]

Board of Directors

Seated: James J. Norton (Chairman) and Cathy E. Minehan
Standing: Dr. Samuel O. Thier (Deputy Chairman) and Paul M. Connolly

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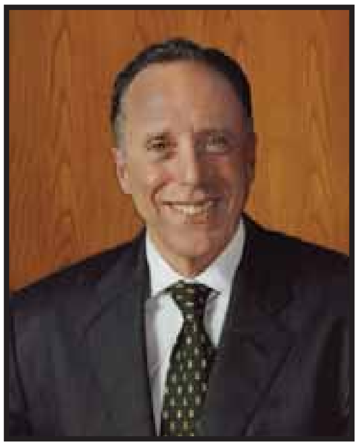

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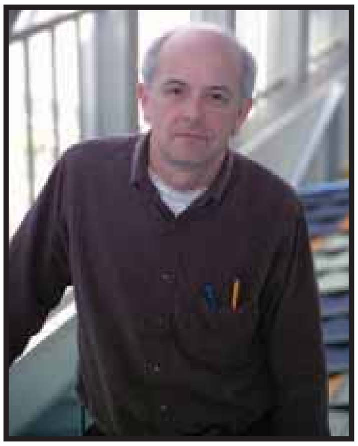

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Senior Vice President and Director of Research

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Richard W. Kopcke
Vice President and Economist

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Yolanda Kodrzycki
Assistant Vice President and Economist

Thomas L. Lavelle
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Scott D. Schuh
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Robert Tannenwald
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Robert K. Triest
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Left to right: Gregory Howey, Yolanda Kodrzycki, Craig Moore, Amar Kapur, Dwight Sargent, Joseph Boulos, John Morison, Cathy Minehan, Joyce Plotkin, Elisabeth Robert, George Shuster, Alan Wilson, Kathy Weare, Nancy Connolly, Paul Connolly, Peter Chase, Kirk Sykes, Les Kenney.

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President
Vermont Teddy Bear Company, Inc.

Joseph Boulos
Chief Executive Officer
CB Richard Ellis/The Boulos Company

James Brett (Advisor)
President and Chief Executive Officer
The New England Council

Craig D. Carlson
Director of Corporate Development
Viacom Boston

Peter Chase
President and Chief Executive Officer
Chase Corporation

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President and Chief Executive Officer
Lasertone Corporation

Roger Dickinson
President
Torrington Research Company

Gregory B. Howey
President
Okay Industries

Amar Kapur
President and Chief Executive Officer
Aimtek, Inc.

Leslie Kenney
Chief Executive Officer
Kenney Manufacturing Corporation

Yolanda Kodrzycki
Assistant Vice President and Economist
Federal Reserve Bank of Boston

Craig Moore
Chief Operating Officer
Marox Corporation

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Hitchiner Manufacturing Company, Inc.

Joyce Plotkin
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Massachusetts Software and Internet Council, Inc.

Dwight Sargent
President
Pompanoosuc Mills Corporation

George Shuster
President and Chief Executive Officer
Cranston Print Works Company

Kirk Sykes
Chief Executive Officer
The Primary Group, Inc.

Kathy Weare
Chief Executive Officer
Cliff House Resort and Spa

Alan Wilson
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Federal Reserve Bank of Boston

Marilyn Weekes
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New Hampshire Rural Development Council

Paul Douglas
Executive Director
Franklin County Regional Housing and
Redevelopment Authority

Dr. Marcia Feld
Executive Director
University of Rhode Island Urban Field Center

Heriberto Flores
Chair
Partners for Community

Elizabeth Humstone
Executive Director
Vermont Forum on Sprawl

Dennis P. Lagueux
Vice President and Director of
Community Development
BankNorth Group

Christopher R. Miller
Director, Management and Development
New Hampshire Housing Finance Authority

Charles Newton
Executive Director
Penquis Community Action Program, Inc.

William Rodriguez
Executive Director
La Alianza Hispana, Inc.

Cynthia Russell
President and Chief Executive Officer
Connecticut Housing Investment Fund, Inc.

Cheryl Senerchia
Vice President and CRA Officer
Citizens Financial Group

Marlon Shields
Founder and President
Greystone Financial Services, LLC

Seated, left to right: Marcia Feld, Heriberto Flores, Cathy Minehan, Cheryl Senerchia, Richard Walker. Standing, left to right: Charles Newton, Marilyn Weekes, Dennis Lagueux, Paul Douglas, Cynthia Russell, Christopher Miller, Elizabeth Humstone.

[Financial Statements]

Management Assertion

To the Board of Directors,

The management of the Federal Reserve Bank of Boston ("FRB Boston") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2003 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgements and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the Manual and include all disclosures necessary for such fair presentation.

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

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

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

March 1, 2004

Federal Reserve Bank of Boston

Cathy E. Minehan

Cathy E. Minehan, President

Paul M. Connolly

Paul M. Connolly, First Vice President

Sarah G. Green

Sarah Green, Principal Financial Officer

Report of Independent Accountants

PRICEWATERHOUSECOOPERS

To the Board of Directors of the
Federal Reserve Bank of Boston

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Boston ("FRB of Boston") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2003, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB of Boston's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management's assertion based on our examination.

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

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

In our opinion, management's assertion that the FRB of Boston maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2003 is fairly stated, in all material respects, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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

PricewaterhouseCoopers LLP

March 1, 2004

Report of Independent Auditors

PRICEWATERHOUSECOOPERS

To the Board of Governors of The Federal Reserve System
and the Board of Directors of The Federal Reserve Bank of Boston

We have audited the accompanying statements of condition of The Federal Reserve Bank of Boston (the "Bank") as of December 31, 2003 and 2002, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2003 and 2002, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 1, 2004

Statements of Condition As of December 31 (in millions)

	2003	2002
Assets		
Gold certificates	$495	$533
Special drawing rights certificates	115	115
Coin	23	45
Items in process of collection	531	1,002
U.S. government and federal agency securities, net	32,661	36,618
Investments denominated in foreign currencies	1,034	964
Accrued interest receivable	244	312
Interdistrict settlement account	3,079	-
Bank premises and equipment, net	113	111
Other assets	24	25
Total assets	$38,319	$39,725
Liabilities and Capital		
Liabilities:		
Federal Reserve notes outstanding, net	$33,877	$28,905
Securities sold under agreements to repurchase	1,240	1,208
Deposits:		
Depository institutions	1,633	1,212
Other deposits	3	3
Deferred credit items	576	832
Interest on Federal Reserve notes due U.S. Treasury	17	60
Interdistrict settlement account	-	6,558
Accrued benefit costs	66	64
Other liabilities	11	11
Total liabilities	37,423	38,853
Capital:		
Capital paid-in	448	436
Surplus	448	436
Total capital	896	872
Total liabilities and capital	$38,319	$39,725

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

Statements of Income For the years ended December 31 (in millions)

	2003	2002
Interest income:		
Interest on U.S. government and federal agency securities	$1,134	$1,459
Interest on investments denominated in foreign currencies	14	15
Total interest income	1,148	1,474
Interest expense:		
Interest expense on securities sold under agreements to repurchase	11	1
Net interest income	1,137	1,473
Other operating income:		
Income from services	39	54
Reimbursable services to government agencies	25	25
Foreign currency gains, net	141	120
U.S. government securities gains, net	-	5
Other income	10	13
Total other operating income	215	217
Operating expenses:		
Salaries and other benefits	103	100
Occupancy expense	13	14
Equipment expense	14	15
Assessments by Board of Governors	47	34
Other expenses	53	49
Total operating expenses	230	212
Net income prior to distribution	$1,122	$1,478
Distribution of net income:		
Dividends paid to member banks	$27	$26
Transferred to surplus	12	18
Payments to U.S. Treasury as interest on Federal Reserve notes	1,083	1,434
Total distribution	$1,122	$1,478

Statements of Changes in Capital For the years ended December 31, 2003 and December 31, 2002 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2002 (8.3 million shares)	$418	$418	$836
Net income transferred to surplus	-	18	18
Net change in capital stock issued (0.4 million shares)	18	-	18
Balance at December 31, 2002 (8.7 million shares)	$436	$436	$872
Net income transferred to surplus	-	12	12
Net change in capital stock issued (0.3 million shares)	12	-	12
Balance at December 31, 2003 (9.0 million shares)	$448	$448	$896

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

Notes to Financial Statements

1. Structure

The Federal Reserve Bank of Boston ("Bank") is part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act") which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). 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 First Federal Reserve District, which includes Maine, Massachusetts, New Hampshire, Rhode Island, Vermont and a portion of Connecticut. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Board of Directors

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

2. Operations and Services

The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

In performing fiscal agency functions for the U.S. Treasury, the Bank provides U.S. securities direct purchase and savings bond processing services. In December 2003, the U.S. Treasury announced plans to consolidate the provision of these services at FRB Cleveland and Minneapolis. An implementation plan is expected to be announced in March 2004. At this time, the Bank has not developed a detailed estimate of the financial effect of the consolidation.

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

3. Significant Accounting Policies

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

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

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: Internet and Directory Services, Government Image Archive, Image Services System, Integrated Accounting System, Account Management Information System, and System Purchasing Service.

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

a. Gold Certificates

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

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDRs certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2003 or 2002.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Boards of Directors of the Reserve Banks, subject to review by the Board of Governors. There were no outstanding loans to depository institutions at December 31, 2003, and 2002, respectively.

d. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

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

In December 2002, the FRBNY replaced matched sale-purchase ("MSP") transactions with securities sold under agreements to repurchase. MSP transactions, accounted for as separate sale and purchase transactions, are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction. Securities sold under agreements to repurchase are treated as secured borrowing transactions with the associated interest expense recognized over the life of the transaction.

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

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

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

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

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

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

Notes to Financial Statements

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on investments denominated in foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as U.S. government securities gains, net". Foreign- currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains, net." Foreign currencies held through F/X swaps, when initiated by the counter-party, and warehousing arrangements are revalued daily with the unrealized gain or loss reported by the FRBNY as a component of "Other assets" or "Other liabilities," as appropriate.

Balances of U.S. government and federal agency securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, interest income and expense, securities lending fee income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. Securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of $61 million representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual methods, of which $2.9 was allocated to the Bank. Interest accruals and the amortization of premiums and discounts are now recognized beginning the day that a security is purchased and ending the day before the security matures or is sold. Previously, accruals and amortization began the day after the security was purchased and ended on the day that the security matured or was sold. The effect of this change was not material; therefore, it was included in the 2003 interest income.

e. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs, and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

f. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and ACH operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In 2003, the Federal Reserve Act was amended to expand the assets eligible to be pledged as collateral security to include all Federal Reserve Bank assets. Prior to the amendment, only gold certificates, special drawing rights certificates, U.S. government and federal agency securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies could be pledged as collateral. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. The Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks in order to satisfy their obligation of providing sufficient collateral for outstanding Federal Reserve notes. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding reduced by its currency holdings of $4,750 million, and $4,065 million at December 31, 2003 and 2002, respectively.

h. Capital Paid-in

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

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

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

j. Income and Costs related to Treasury Services

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

K. 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 $4 million and $5 million for the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Occupancy expense."

Notes to Financial Statements

L. Recent Accounting Developments

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150, which will become applicable for the Bank in 2004, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and imposes certain additional disclosure requirements. When adopted, there may be situations in which the Bank has not yet processed a member bank's application to redeem its Reserve Bank stock. In those situations, this standard requires that the portion of the capital paid-in that is mandatorily redeemable be reclassified as debt.

M. 2003 Restructuring Charges

In 2003, the System restructured several operations, primarily in the check and cash services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations.

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8 and those associated with the Bank's enhanced postretirement benefits are disclosed in footnote 9.

4. U.S. Government and Federal Agency Securities

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts, and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 4.835 percent and 5.729 percent at December 31, 2003 and 2002, respectively.

The Bank's allocated share of securities held in the SOMA at December 31, that were bought outright, was as follows (in millions):

	2003	2002
Par value:		
Federal agency	$-	$1
U.S. government:		
Bills	11,837	12,988
Notes	15,633	17,067
Bonds	4,760	6,006
Total par value	32,230	36,062
Unamortized premiums	474	616
Unaccreted discounts	(43)	(60)
Total allocated to Bank	$32,661	$36,618

The total of SOMA securities bought outright was $675,569 million and $639,125 million at December 31, 2003 and 2002, respectively.

As noted in footnote 3, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase in December 2002. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a contract amount of $25,652 million and $21,091 million, respectively, were outstanding, of which $1,240 million and $1,208 million were allocated to the Bank. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a par value of $25,658 million and $23,188 million, respectively, were outstanding, of which $1,240 million and $1,329 million were allocated to the Bank.

Notes to Financial Statements

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2003, was as follows (in millions):

Maturities of Securities Held	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$2,308	$1,240
16 to 90 days	6,737	-
91 days to 1 year	7,932	-
Over 1 year to 5 years	9,043	-
Over 5 years to 10 years	2,481	-
Over 10 years	3,729	-
Total	$32,230	$1,240

At December 31, 2003 and 2002, U.S. government securities with par values of $4,426 million and $1,841 million, respectively, were loaned from the SOMA, of which $214 million and $105 million were allocated to the Bank.

5. Investments Denominated in Foreign Currencies

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 5.205 percent and 5.698 percent at December 31, 2003 and 2002, respectively.

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

	2003	2002
European Union Euro:		
Foreign currency deposits	$357	$318
Government debt instruments including agreements to resell	213	188
Japanese Yen:		
Foreign currency deposits	77	102
Government debt instruments including agreements to resell	382	351
Accrued interest	5	5
Total	$1,034	$964

Total investments denominated in foreign currencies were $19,868 million and $16,913 million at December 31, 2003 and 2002, respectively.

Notes to Financial Statements

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2003, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	
Within 1 year	$950
Over 1 year to 5 years	67
Over 5 years to 10 years	17
Over 10 years	-
Total	$1,034

At December 31, 2003 and 2002, there were no outstanding F/X swaps or material open foreign exchange contracts.

At December 31, 2003 and 2002, the warehousing facility was $5,000 million, with no balance outstanding.

6. Bank Premises, Equipment, and Software

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

	2003	2002
Bank premises and equipment:		
Land	$22	$22
Buildings	102	101
Building machinery and equipment	18	17
Construction in progress	5	2
Furniture and equipment	64	65
Subtotal	$211	$207
Accumulated depreciation	(98)	(96)
Bank premises and equipment, net	$113	$111
Depreciation expense, for the years ended	$9	$10

The Bank leases unused space to outside tenants. Those leases have terms ranging from one to thirteen years. Rental income from such leases was $9 million and $10 million for the years ended December 31, 2003 and 2002, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2003, were (in millions):

2004	$9
2005	7
2006	5
2007	5
2008	4
Thereafter	21
	$51

The Bank has capitalized software assets, net of amortization, of $4 million and $5 million at December 31, 2003 and 2002, respectively. Amortization expense was $2 million for each of the years ended December 31, 2003 and 2002.

7. Commitments and Contingencies

At December 31, 2003, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately nine years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $3 million and $2 million for the years ended December 31, 2003 and 2002, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2003, were (in thousands):

Operating	
2004	$502
2005	502
2006	502
2007	502
2008	502
Thereafter	1,883
	$4,393

At December 31, 2003, other commitments and long-term obligations in excess of one year were not material.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2003 or 2002.

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

8. Retirement and Thrift Plans

Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the Plan for the System and the costs associated with the Plan are not redistributed to the Bank. The Bank's projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2003 and 2002, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $4 million for each of the years ended December 31, 2003 and 2002, and are reported as a component of "Salaries and other benefits."

Notes to Financial Statements

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement Benefits other than Pensions

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

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

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

	2003	2002
Accumulated postretirement benefit obligation at January 1	$43.9	$40.4
Service cost-benefits earned during the period	0.8	1.0
Interest cost of accumulated benefit obligation	2.5	2.8
Actuarial loss	0.1	1.7
Curtailment loss	3.4	-
Special termination loss	0.5	-
Contributions by plan participants	0.5	0.3
Benefits paid	(2.0)	(1.9)
Plan amendments	-	(0.4)
Accumulated postretirement benefit obligation at December 31	$49.7	$43.9

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

	2003	2002
Fair value of plan assets at January 1	$-	$-
Actual return on plan assets	-	-
Contributions by the employer	1.5	1.6
Contributions by plan participants	0.5	0.3
Benefits paid	(2.0)	(1.9)
Fair value of plan assets at December 31	$-	$-
Unfunded postretirement benefit obligation	$49.7	$43.9
Unrecognized net curtailment gain	0.3	-
Unrecognized prior service cost	7.1	8.5
Unrecognized net actuarial gain	0.6	4.8
Accrued postretirement benefit costs	$57.7	$57.2

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

At December 31, 2003 and 2002, the weighted average discount rate assumptions used in developing the benefit obligation were 6.25 percent and 6.75 percent, respectively.

For measurement purposes, a 10.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2004. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2011 and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2003 (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	$0.6	$(0.5)
Effect on accumulated postretirement benefit obligation	7.7	(6.1)

Notes to Financial Statements

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

	2003	2002
Service cost-benefits earned during the period	$0.8	$1.0
Interest cost of accumulated benefit obligation	2.5	2.8
Amortization of prior service cost	(1.1)	(1.1)
Recognized net actuarial gain	(0.6)	(0.2)
Total periodic expense	$1.6	$2.5
Special termination loss	0.5	-
Net periodic postretirement benefit costs	$2.1	$2.5

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

The recognition of special termination and curtailment losses is the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10. The curtailment loss will be offset by the unrecognized actuarial gains and prior service costs. As a result, an unrecognized net curtailment gain will be recorded in 2004 when the affected employees terminate employment.

Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Medicare Prescription Drug Improvement and Modernization Act of 2003 until further guidance is issued. Neither the accumulated postretirement benefit obligation at December 31, 2003 nor the net periodic postretirement benefit cost for the year then ended reflect the effect of the Act on the plan.

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank were $7 million for each of the years ended December 31, 2003, and 2002. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2003 and 2002 operating expenses were $2 million for each year.

10. Restructuring Charges

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of Check operations and staff reductions in various functions of the Bank. These actions resulted in the following business restructuring charges:

Major categories of expense (in millions):

Accrued Liability 12/31/03	Total Estimated Costs	Accrued Liability 12/31/02	Total Charges	Total Paid	
Employee separation	$1.3	$-	$1.3	$0.4	$0.9
Contract termination	-	-	-	-	-
Other	-	-	-	-	-
Total	$1.3	$-	$1.3	$0.4	$0.9

Employee separation costs are primarily severance costs related to reductions of approximately 207 staff and are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

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

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2004.

The Bank anticipates substantially completing its announced plans by December 31, 2004.

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