

BANK HIGHLIGHTS

OUR ROLE IN NEW ENGLAND AND THE NATION

2005

The Federal Reserve Bank of Boston, as the New England arm of the nation's central bank, focuses its activities in four major areas:

- maintaining a safe, efficient, and cost-effective payments system,
- conducting economic research to support monetary policy and advance economic understanding,
- maintaining a safe and sound banking system, and
- sharing our expertise to benefit the public.

PAYMENTS SERVICES TODAY

The nation's payments system is changing rapidly. At the Federal Reserve Bank of Boston, this means we are constantly operating on two fronts—not only must we strive to see that the current payments system continues to operate flawlessly, but also we must lead efforts to develop newer payments approaches and bring them to reality.

It is clear that retail electronic transfers are coming to dominate paper checks in the U.S. payments system. Many paper checks are now being converted to some type of electronic transaction, eliminating the need to transport and process paper. For the Reserve Banks, this shift to electronic payments has meant that we need to reduce the scale of our check processing operations in order to keep them efficient and cost-effective. In 2005, we in Boston prepared for the consolidation of our Boston check processing operations into our facility in Windsor Locks, Connecticut—a consolidation successfully executed in February 2006. This was a major undertaking, involving renovations and new equipment at the Windsor Locks facility and extensive communication with First District banks about the change. We also provided as much assistance as we could to Boston staff in the form of access to retraining and other job opportunities within the Bank and elsewhere as that staff prepared for the transition. Our excellent operational data for the year are testimony to the dedication of that staff.

The year was the first full year of operation of “Check 21,” federal legislation that permits the payments system to clear an electronic image of a check, with the creation of a “substitute check” if that is necessary for clearing purposes. Not having to transport the physical paper check reduces costs and shortens the check clearing and settlement process. The Federal Reserve Bank of Boston was active in 2005 both in New England and nationally in promoting Check 21 services.



PAYMENTS SERVICES TOMORROW

The Boston Bank has long been a leader in the research and development of new payments services. We made notable progress in 2005 in two initiatives, both undertaken on behalf of the U.S. Treasury:

- The Internet Payment Platform project will provide federal agencies and their suppliers with a means to take the paperwork out of procurement transactions—by converting purchase orders, invoices, and payments to electronic form. In 2005, we researched, selected, and installed for testing a commercial software package that provides the basis for this new system. It is expected to be in production in late 2006, with the Bank providing continuing operational and software development support.
- An initiative that has been ongoing for several years is the Stored Value Card (SVC) program for U.S. military personnel, who can use these cards to pay for goods and services at overseas Army bases, eliminating the need for the military to keep stores of cash overseas. In 2005, we introduced a new self-service SVC kiosk. This kiosk allows overseas Army personnel to transfer money from their U.S.-based account to their stored value card. We arranged the installation of kiosks in Saudi Arabia, Honduras, Afghanistan, Bosnia, Kosovo, Qatar, and Germany. We expect to extend the SVC program to other countries in 2006.

The Bank also has key responsibilities for electronic transactions in U.S. Treasury securities and high-dollar-value Federal Reserve payments services. In 2005, the Bank's Internet and Directory Services Group (IDSG) led the design of a new Internet connectivity option that improves the flexibility and resiliency of Open Market operations. IDSG also played a leadership role in developing the security policy for large financial institutions executing high-dollar transactions through the System's new web-based payments technology.



A new initiative launched in 2005 is our Emerging Payments Research Group, a cross-departmental research center created to further the Federal Reserve System’s understanding of emerging payments trends, especially consumer behavior. The group helped shape a national survey of consumer payment behavior, contributed to System-sponsored studies, and organized a highly successful conference exploring why consumers choose the payment methods they do.

ECONOMIC RESEARCH AND MONETARY POLICY

In 2005, rising energy prices and diminishing excess capacity raised concerns, on the one side, about a possible acceleration in inflation. On the other side, the economic devastation caused by severe hurricanes and the increasing potential for a slowdown in the housing market raised concerns about a weakening economy. Balancing the risks posed on both sides, the Federal Open Market Committee (FOMC) voted to raise interest rates at each of its eight meetings, bringing the federal funds rate from 2.25 percent at the beginning of the year to 4.25 percent at the end. The resulting outcome—low and well-contained inflation accompanied by sustainable growth—was as favorable a result as policy makers could hope to see.



The Bank’s economists and visiting scholars produced a sizable volume of papers that spanned a wide array of topics. Many of the papers were, or will be, published in top-flight economic journals. Macro research examined the sources of inflation persistence in New Keynesian Phillips curves; the contribution to the evolution of inflation of gradual shifts in the Federal Reserve’s implicit inflation goal; the contribution to the decrease in economic volatility since the early 1980s of a decline in the covariance between sales and inventories; and the sources of, and uncertainty surrounding, longer-term trends in labor force participation. Finance-related research identified elusive supply effects on prices in asset markets; incorporated a more realistic borrowing environment to explain why more people do not invest in equities; and examined the link between properly measured cash flow and firm value.

The year 2005 was also the first full year of operation for the Bank’s new Center for Behavioral Economics and Decision-Making, established to gain a better understanding of how economic decisions are made with the ultimate aim of improving policy making. Behavioral economics seeks to understand economic decision-making through controlled experiments designed to observe behavior under specific conditions. A variety of papers were produced by the center in 2005, including one, “Tom Sawyer and the Construction of Value,” that examines the importance of context in how people perceive the value of compensation.



The Bank's 50th annual economic conference, held in June, addressed a topic widely recognized as critical to our nation—how to deliver, value, and pay for health care. “Wanting It All: The Challenge of Reforming the U.S. Health Care System” brought together economists, health practitioners, and policy makers to explore the best ways to measure, finance, and distribute the benefits of modern health care. A summary of the conference proceedings forms the essay featured in this Annual Report. The conference served to highlight areas of consensus and disagreement in this complex field.

A SAFE AND SOUND BANKING SYSTEM

New England banks recorded strong profits in 2005, as was also true for banks nationwide. Credit concerns were minimal, but interest margins narrowed as short-term rates rose by more than did long-term rates.

The Bank's Supervision, Regulation and Credit staff examined and supervised some 121 bank holding companies in 2005, as well as 11 state member banks. While fulfilling this basic responsibility, the Bank also took a leadership role in System work relating to the development of new regulatory policies and supervisory approaches. Our System contributions draw heavily on the expertise we have built up in how to assess, measure, and reserve for the operational risk that banks face. Operational risk is the risk of loss from inadequate or failed internal processes, people, and systems or from external events. In a new initiative, the Bank was chosen, along with three other Reserve Banks, to work on a program to achieve greater quality and consistency in the System's supervision of large financial institutions.

The Bank's Supervision group continued in 2005 to conduct research designed to address and clarify issues relating to international capital standards for large banks, standards commonly referred to as Basel II. Boston led two inter-agency work groups that examined aspects of the capital charges under the proposed new system, and we prepared a white paper on the competitive impact of the Basel II operational-risk charge that we presented to Congressional staff.

In May, the Bank hosted an international conference on the operational risk aspects of Basel II. With over 300 attendees, "Implementing an Advanced Management Approach for Operational Risk" called to attention a mix of research, policy, and implementation considerations.

REGIONAL OUTREACH

A particular focus of the Bank is serving New England. We do so by providing economic and consumer education, working with community organizations and financial institutions to foster community development and insure broad and equitable access to credit and financial services, and providing high-quality analysis of policy issues important to the region.

The Bank was pleased to see increased use in 2005 of virtually all of its economic education programs. Some 11,300 persons visited our New England Economic Adventure and our other in-Bank economic education programs, a 7 percent increase over 2004. In particular, we were pleased that these programs reached more groups from low and moderate income communities. The Economic Adventure, a combination of interactive games and exhibits, continues to be very effective in using New England as an example to teach about the process of economic growth.

The Bank successfully piloted a college version of Fed Challenge, our high school competition simulating the deliberations of Federal Reserve monetary policy makers. A variety of schools participated, and the quality of the competition was excellent. We look forward to offering this program on a larger scale in 2006.

A new consumer initiative of 2005 was the establishment of the New England Consumer Advisory Group (NECAG), consisting of regulators, industry professionals, attorneys, consumer advocates, and leaders of nonprofit groups. The goal of the Advisory Group is to identify and address emerging consumer issues, and a major activity was a conference on alternative mortgages (the pitfalls, as well as opportunities, they present for





borrowers). The Bank also provided information on how consumers may protect themselves against such fraudulent schemes as “phishing” and “pharming.” The Bank’s consumer pamphlet on identity theft, first produced in 2003, continued to be extremely popular and was the most frequently downloaded publication on the Bank’s public web site.

In the area of community development, a focus in 2005 was gaining a better understanding about New England’s immigrant population and its financial services needs. The Bank produced a discussion paper on international remittances—a funds-transfer mechanism important to the region’s immigrant population—that has attracted significant attention. The Bank’s *Communities & Banking* publication included an article on immigrant entrepreneurs; and the contributions of immigrants were also featured on our web site and in an exhibit displaying furniture and craftwork from the North Bennet Street School, which was founded over 100 years ago to serve Boston’s immigrant population.

A major new regional outreach initiative of the Bank came into being in 2005. The New

England Public Policy Center was formed to serve policy makers, policy analysts, and the public by conducting high-quality research on major policy issues that affect the region and by facilitating information sharing. While the Bank has a long history of research and analysis of regional economic issues, the Policy Center represents a new approach in its focus on topical issues and in responding to requests. The new research unit is leveraging its capabilities by reaching out to policy analysts throughout the region to develop a network of expertise in regional policy analysis. Among the topics addressed by working papers and conferences in 2005 were New England water supply issues, the pros and cons of mandating nurse-patient ratios, housing issues, and, in a major conference, New England’s energy situation.

