

# LETTER FROM THE PRESIDENT

As I think back on developments in 2005—at the national level, in New England, and in the Bank—I am struck by the importance of striking the right balance between coping with immediate challenges and looking ahead to address long-term issues. The Bank has been successful in addressing this balance in 2005. We are in the process of completing several major transitions, while at the same time proceeding with initiatives that will allow us to serve New England and the nation in new and exciting ways in the years to come.

At the national level, 2005 was marked by unexpected and daunting challenges. The Gulf Coast hurricanes caused enormous human tragedy, extensive property damage, and disruptions to energy supplies which contributed to sharp spikes in oil and natural gas prices. Nevertheless, the U.S. economy turned in a good performance in 2005, with real growth up 3.5 percent from the previous year, a rate of increase that speaks well for the resilience of our economy approaching its fifth year of expansion. About 2 million jobs were added, the unemployment rate declined, and despite the sharp increase in energy prices, core inflation remained moderate at just over 2 percent. A good definition of success, despite the challenges.

For the past several years, economic growth has been driven largely by consumer spending and strength in the housing sector. By the end of 2005, we began to see small signs of a flattening in housing and a few indications that consumer spending might be less vibrant than in the past, both as a result of slowing housing markets and increases in energy costs. Business spending, however, appears poised to pick up. Improved business confidence and stronger balance sheets are prompting businesses to boost capital spending and increase hiring, and the outlook for economic growth in 2006 is encouraging.

Here in New England, the economy continued to expand in 2005, but at a slower pace than nationally. While the region's unemployment rate remained below the national average, it did not improve over the course of the year, and New England has yet to regain its pre-recession job total. Nevertheless, prospects appear to be improving for a broad range of businesses in the region, and the pace of job growth should improve.

While the near-term outlook is positive, the U.S. economy faces risks in the longer term—risks that demand all of our attention. We have seen no improvement in the low rate of personal savings in the United States, and large current account and fiscal deficits pose threats to future standards of living. The rising cost of health care is another critical issue, not unrelated to our fiscal problems. While advances in health care technology have provided great benefits, paying for the associated increase in costs against the demographics of the aging “Baby Boomers” is a major challenge, potentially undermining the competitiveness of U.S. businesses and creating consumer concern and uncertainty. How to value and pay for health care was the subject of the Bank's 2005 economic conference—our fiftieth—which brought together national and international experts to both assess the problem and suggest solutions. The results of that conference are the subject of Jane Little's and Teresa Foy's essay in this annual report.

In the Bank, 2005 was a year of significant challenge and transition, but also one of progress toward goals of long-term, strategic importance. The year's key transition effort involved the extensive planning required for the consolidation of all First District check processing at our office in Windsor Locks, Connecticut, in early 2006. This consolidation is being undertaken in response to the nationwide shift from paper to electronic payment forms. Early in the new year, we bid farewell



Cathy E. Minehan, President, and Paul M. Connolly, First Vice President

to check staff in Boston, where we had check processing operations since 1915. But we also welcomed many new staff in Windsor Locks, where our office had undergone considerable renovation for the move. All our staff—in Boston and Windsor Locks—did an outstanding job in surpassing key operations targets in 2005 while at the same time preparing for the consolidation.

Another significant transition is also nearing completion: the renovation and restoration of the plaza and associated infrastructure surrounding the Bank. Completion of this project will provide improved security and a much more inviting approach to the Bank, which has been affected by construction activity in connection with Boston's "Big Dig" for at least the past decade.

While the volume of paper payments is declining, electronic forms of payments are expanding. The Bank has been chosen to play a leadership role in fostering the development of electronic payments in order to improve the long-term efficiency of the U.S. payments system and the economy. Together with the U.S. Treasury, we are working to advance electronic payment solutions through the development of an Internet Payment Platform that will provide federal agencies with a more efficient electronic approach to approving and tracking purchase orders, invoices, and payments. We also are expanding the Stored Value Card program that we operate for overseas U.S. military personnel. And in 2005, we launched an Emerging Payments Research Group, drawing from the Bank's research and financial services functions.

The Group is gaining a greater understanding of consumer behavior and payment choices and their implications for the economy.

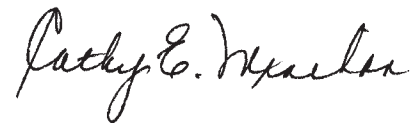
Our Research Department continued to conduct policy-oriented research in support of the Bank's role in the formulation of U.S. monetary policy—a task complicated in 2005 by the economic disruptions caused by the hurricane damage in the Gulf and rising energy costs. Looking to the future, Research has expanded on its traditional areas of focus with the establishment of a Center for Behavioral Economics and Decision-Making. This new center will take advantage of fresh thinking on consumer behavior so as to increase our understanding of economic decision-making, and ultimately improve policy-making. The Bank also formed the New England Public Policy Center to conduct research on major policy issues that affect our region—both immediate and long-term—and to facilitate information sharing among policy makers, policy analysts, and the public. Conferences and research sponsored by the center included such topics as energy policy in New England, Boston's economic vitality, and state and local tax issues.

Another significant achievement was the work of our Supervision and Regulation staff in the area of quantifying operational risk at large financial institutions, work which is helping to inform national and international regulatory policy. We also maintained an active program of outreach to regional and community banks, alerting them to emerging supervisory developments.

Attendance was up at the Bank's economic education programs and at the interactive New England Economic Adventure. Our community development initiatives focused on the financial needs of New England's immigrant populations, and we undertook an analysis of successful models of community development by universities. We developed a new newsletter focusing on the issues facing community development organizations around New England to further the efforts of our Community Development Advisory Council.

The Bank's accomplishments and contributions reflect the dedication of all associated with the Bank. We also benefit greatly from the insights and advice of others—the many people who serve on our various advisory boards and, of course, the Bank's board of directors. This year marked the completion of terms for two directors—Bain Consulting Chairman Orit Gadish and First National Bank of Suffield President James Wood. We very much appreciate their contributions—their interest in prudent management of day-to-day challenges and their counsel on long-term strategic matters. In addition, Dr. Samuel Thier stepped down this year as the Bank's chairman. We are extremely grateful to Sam for his leadership throughout his term as chair, and for his willingness to remain with us as a director. He will be succeeded as chair by Blenda Wilson, President and Chief Executive Officer of the Nellie Mae Education Foundation.

In closing, 2005 was a year of successful transition, accomplishment, and building for the future. All of our staff, past and present, in every area, in Boston and Windsor Locks, have made this success possible—their efforts are to be celebrated.



Cathy E. Minehan  
President and Chief Executive Officer