Federal Reserve Bank of Boston
Annual Report 2007

TURMOIL IN THE MORTGAGE MARKET

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Photographer: Leah Fasten (pages 16-25)

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Letter from the President

I am pleased to share this 2007 annual report with you and to provide some observations on the past year, my first as Bank president.

As you know, turmoil in U.S. and international financial markets emerged in late summer, making my first months as a Reserve Bank president very eventful.

Prior to July, the U.S. economy had appeared to be settling into a "sweet spot." Core inflation was edging down, and the U.S. unemployment rate remained near historic lows. To be sure, there were significant risks to this sweet spot, notably the weakening of the housing sector and rising energy prices.

Circumstances changed significantly in the middle of the year. Delinquency rates and foreclosures on subprime mortgages began to escalate, house prices in many parts of the country began to fall, and credit markets became turbulent and in some cases illiquid. As of mid-August, the combination of higher credit costs – and in some cases reduced availability of credit – threatened to weaken the U.S. economy.

I have spent the bulk of my career – first as a research economist and then a bank regulator – studying the ways that financial markets affect the real economy. Indeed, several of us who are current Federal Reserve monetary policy makers did extensive research on the credit crunch period of the early 1990s – work that has proven to be valuable preparation for dealing with today's financial problems.

To help ease the turmoil in financial markets and address the emerging risks to the real economy, the Federal Reserve has been proactive and decisive – mixing innovative new tactics with aggressive use of our traditional monetary tools. In the fall, the Federal Reserve opened a Term Auction Facility (TAF) for making collateralized loans to banks. The TAF allows banks to bid for reserves anonymously through an auction process and, thus, addresses banks' concerns that borrowing at the discount window may signal economic weakness. (Additional lending facilities were introduced in 2008.) These steps are designed to promote liquidity and smooth functioning in financial markets that have been under stress and to contain turmoil that could spread to many corners of the economy.

Here at the Federal Reserve Bank of Boston, we have been focusing intently on the problems stemming from subprime mortgages and on ways to mitigate the effects of rising delinquencies and foreclosures on borrowers and others. We have been actively sharing our research findings and participating in the national and regional policy debates. We also worked with five large New England banks to encourage their establishment of the Mortgage Relief Fund – designed to reach out to borrowers holding subprime loans and, where possible, to help them refinance into more affordable loans. A number of community banks will be joining this effort in 2008.

Other aspects of our work in 2007 are described in the Bank Highlights section of this annual report. Of particular note is our work helping the U.S. Treasury and federal agencies with a variety of financial applications. Also noteworthy is the work of our bank supervision staff in preparing for implementation of the new Basel II capital requirements; two Boston officers have taken on national Basel II leadership roles for the Federal Reserve System. Our economists made valuable contributions to economic research and policy making in 2007, and our three research centers – the New England Public Policy Center, the Behavioral Economics Center, and the Emerging Payments Research Group – continued to shed new light on topical economic policy issues. In payments and financial services, we made additional strides in our tradition of quality service and innovation.

In all of these activities – and the many others I do not have space to mention – we worked toward our vision of excellence in serving the public as the nation's central bank in New England. In our daily work, we are more than ever focused on the goal of making a difference.

I would like to thank the staff of the Bank, our directors, and the members of our advisory groups for their commitment and service. I also thank them, and many of you, for welcoming me to my new role as president and for offering support and counsel.

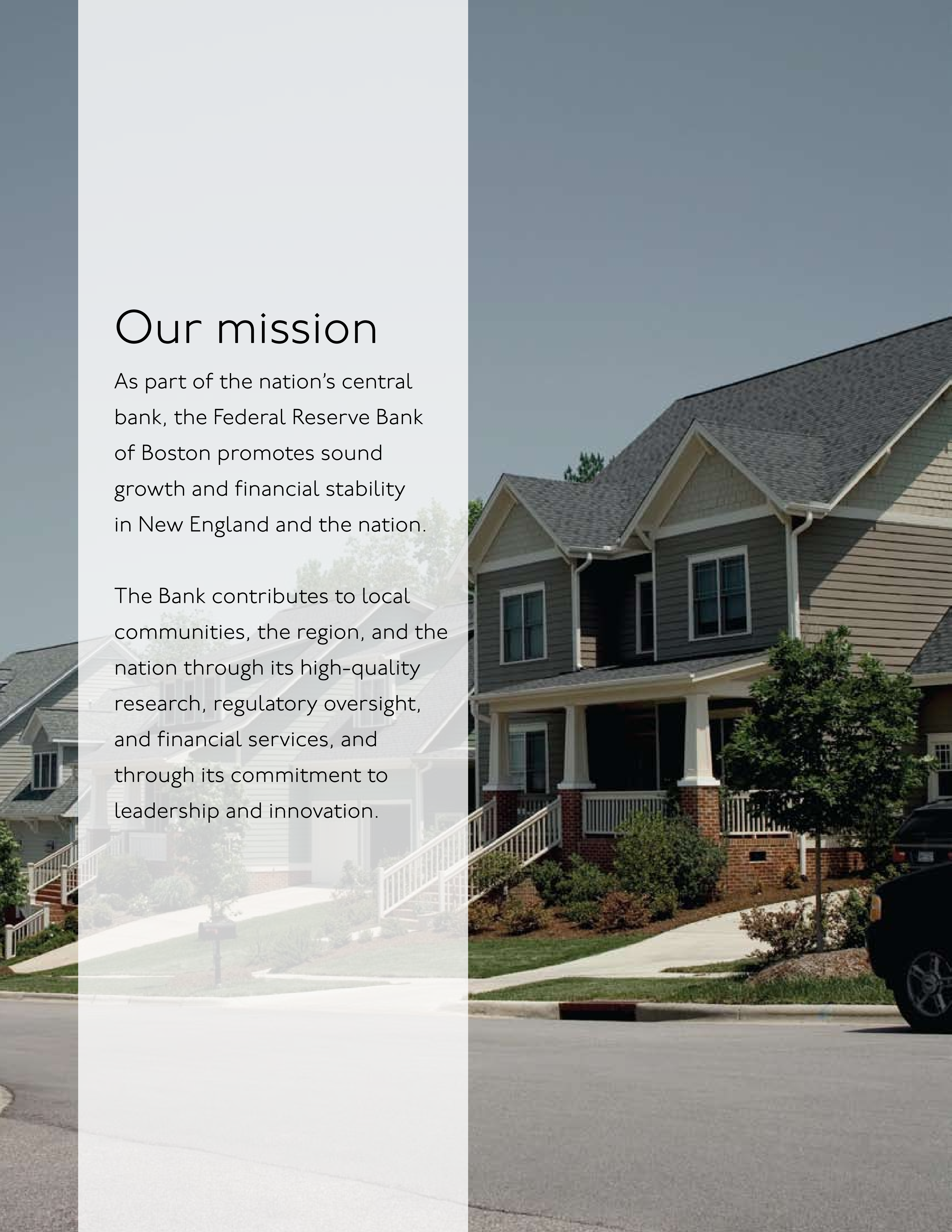
I want to conclude with words of appreciation for several individuals who completed their terms of service to the Bank in 2007. Two members of our Board of Directors, Ronald Logue, Chairman and CEO of State Street Corporation, and Dr. Samuel Thier, Professor of Medicine and Health Care Policy at Harvard Medical School and Massachusetts General Hospital, gave a wealth of wise counsel during their terms, and we thank them. We give special thanks to Dr. Thier for his service as chairman of the board in 2004 and 2005 and as deputy chair in 2003.

And on behalf of everyone here at the Bank, I want to thank my predecessor, Cathy Minehan, and congratulate her on nearly forty years of public service at the Federal Reserve, first in New York and then at our Bank, including her 13 years as President. Cathy instilled the highest standards of excellence in the Bank and in those of us who worked under her leadership. She worked tirelessly to advance the Bank's capabilities and public contributions in a distinguished term as President. We all wish Cathy the very best as she turns to new pursuits.

In 2007, the Bank's people worked together to make a difference and to advance the public interest. We look forward to continuing that work in 2008 and beyond.

Sincerely,

Eric S. Rosengren
President and Chief Executive Officer



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.

Cathy E. Minehan
Distinguished Service to the Federal Reserve System

After nearly four decades of distinguished public service to the Federal Reserve System, Cathy E. Minehan stepped down as president of the Bank in July 2007.

Cathy, who served as president and CEO of the Bank for 13 years, began her career in 1968 at the Federal Reserve Bank of New York. In 1991, she became first vice president and chief operating officer of the Federal Reserve Bank of Boston, and three years later she was named the Bank's president.

Cathy's tenure as Bank president included service as chair of the Financial Services Policy Committee for the entire Federal Reserve System and as chair of the System's Conference of Presidents. As a Reserve Bank president, Cathy was much admired for the breadth and depth of her knowledge of the Federal Reserve System's diverse functions, and especially for her expertise in the payments systems and financial services that underpin the U.S. economy. She made many contributions to financial services policy within the System, as well as to operational improvements in payments mechanisms. Cathy was also dedicated to advancing the economic well-being of New England – through thoughtful contributions to monetary policy, work on behalf of community and regional economic development, support for public education and workforce training, and championing innovation in economic and financial literacy

Cathy E. Minehan
Former President and Chief Executive Officer

During the months leading up to Cathy's retirement, business and civic leaders and Bank staff expressed their appreciation for Cathy's service to the region and the Bank. Federal Reserve Board Chairman Ben Bernanke paid her strong tribute, observing that Cathy "demonstrated exemplary leadership and keen insight across a broad range of the Fed's work, including monetary policymaking, banking supervision, and payments policy. We will miss her."

Cathy has continued her active engagement in the civic life of New England, sitting on the boards of numerous educational and charitable organizations and public companies.

The Bank's directors, officers, and staff salute Cathy on her distinguished career and her many contributions to the New England region.

Christopher L. Foote
Senior Economist and Policy Advisor

Ann Eggleston
Managing Editor

Subprime Outcomes: Turmoil in the Mortgage Market

Until 2007, few Americans had probably heard the word "subprime" – including many homeowners who would come to learn that their own mortgage was a subprime mortgage. Today, subprime mortgages are much discussed because they lie at the center of the turmoil that roiled credit markets in 2007 and 2008. Analysis conducted by economists at the Federal Reserve Bank of Boston provides insight into how subprime mortgages became as popular as they did, and why they have caused the problems that they have.[1] The analysis also suggests policy considerations for subprime lending in the future.

There is no standard definition of a "subprime" mortgage. In essence this term describes a loan that carries a relatively high interest rate because it is deemed to have a higher risk of default. If a borrower qualified for a mortgage on the basis of relaxed standards regard-

This essay is based on research conducted by a number of researchers in the Bank's Research Department, including Kristopher Gerardi, Lorenz Goette, and Paul Willen.

ing creditworthiness (such as borrower credit score, debt-to-income ratio, loan-to-value ratio, and/or loan documentation status), the mortgage is generally considered a subprime mortgage. As would be expected, such mortgages carry higher interest rates than prime mortgages, due to their higher probability of default.[2]

The most common type of subprime mortgage is a "hybrid" adjustable-rate mortgage. This type of loan is a 30-year mortgage with a fixed interest rate for the first two or three years. After this initial period, the interest rate "resets" to some fixed margin over a fluctuating benchmark market rate.[3] Hybrid subprime mortgages are commonly called "2/28s" or "3/27s," depending on the length of the initial fixed-rate period.

Subprime mortgages have been in use for many years, traditionally serving a small number of borrowers with blemished credit histories. As late as 1994, they constituted less than 5 percent of total mortgage originations. By 2005, however, they had climbed to 20 percent of originations. Soon after this peak market share was reached, foreclosures in many regional housing markets began to rise significantly. Given their greater risk, it is not surprising that subprime loans have accounted for a disproportionate share of these defaults. Some commentators have gone further and blamed current housing-market problems almost exclusively on subprime lending. But closer analysis of these claims shows that they often mischaracterize the role of subprime lending in current housing-market problems.

Interest Rate Reset

Much of the initial concern about subprime mortgages centered on the interest-rate resets of subprime hybrids. Because the interest rate on hybrids generally rises after the initial two- or three-year period, many people believed that subprime mortgages were defaulting *because* subprime borrowers were no longer able to afford their loans after they reset. A look at some data helps quantify the "reset shock" faced by subprime borrowers. For 2/28 subprime loans originated nationwide from 2004 to 2007, the initial interest rate ranged from 7.3 percent in 2004 to 8.6 percent in 2007. (See Table 1.) For a typical 2/28 originated in mid-2004, which reset in mid-2006, the interest rate rose from 7.3 percent to 11.5 percent, increasing the payments on a $200,000 loan by more than $600 per month. Clearly, a reset shock increase of this magnitude could place considerable strain on many subprime borrowers.

Yet the data show that reset shocks have played a minor role in subprime defaults so far. Subprime borrowers who defaulted on their mortgages tended to do

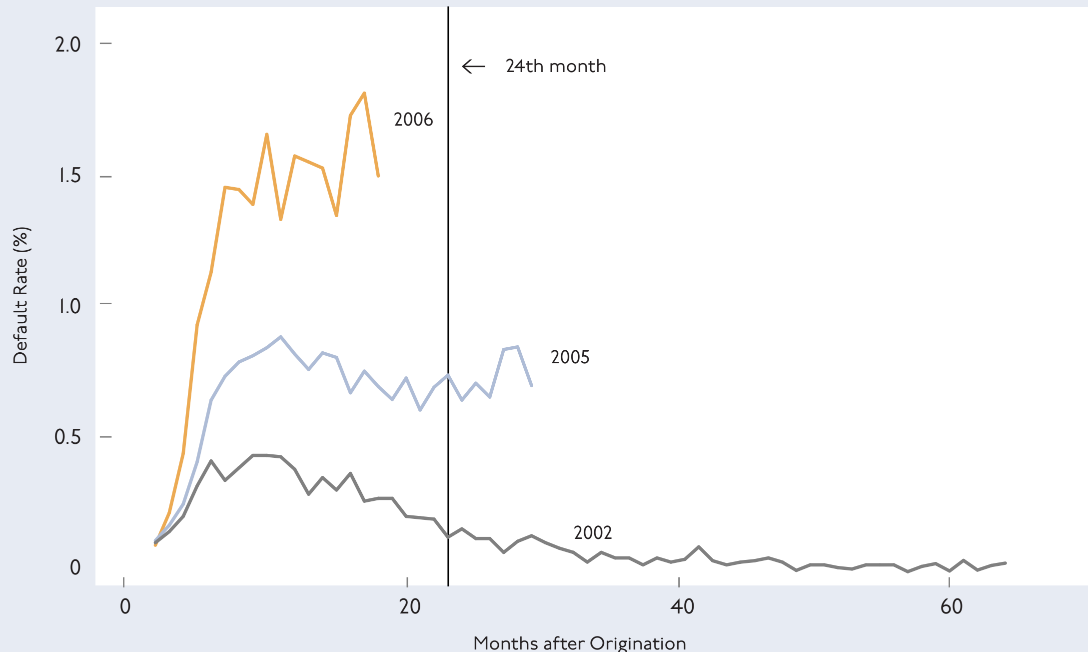
Table 1: Average Interest Rates on 2/28 Subprime Mortgages

(annual averages; all data in percentage points)

	Initial (pre-reset) interest rate	1-year prime ARM[1] rate	Margin of post-reset rate over LIBOR[2]	6-month LIBOR 2 years after origination	Adjusted (post-reset) interest rate
2004	7.3	3.9	6.1	5.4	11.5
2005	7.5	4.5	5.9	4.6	10.5
2006	8.5	5.5	6.1	3.0[3]	9.1
2007	8.6	5.7	6.1	3.0[3]	9.1

[1] Adjustable rate mortgage.
[2] London interbank offered rate.
[3] The 2006 and 2007 vintages of mortgages reset in 2008 and 2009. For these mortgages, the 6-month LIBOR two years after origination is assumed to be 3.0 percent (the April 2008 value) to allow comparison with other vintages.

Source: National LP dataset.



so *before* their resets occurred. This tendency emerges clearly in a dataset of subprime 2/28s originated in Connecticut, Massachusetts, and Rhode Island. From this pool, the default rate for mortgages originated in 2005 and 2006 is indeed much higher than the default rate for 2002 mortgages. But for the more recent loans, the big jump in likelihood of default comes before the reset occurs. (See Figure 1.) No significant increase in defaults is seen near the actual reset date of 24 months.

If resets are not the problem in the subprime market, then why are so many of these loans defaulting? When answering this question, the first thing to note is that interest rates on subprime hybrids are generally high even in the initial fixed-rate period. The initial rate is sometimes called a "teaser" rate because it is often lower than the fully indexed rate that the borrower pays after the reset occurs. But "teaser" or no, initial interest rates have been about three percentage points higher than rates on one-year *prime* adjustable-rate mortgages. Moreover, the interest burdens faced by many subprime borrowers are even greater than what is indicated by the initial and post-reset rates on subprime hybrids. Many subprime purchasers did not have enough savings to make sizeable downpayments when they bought their homes. To cover the gap between the price of the home and the value of the first-lien subprime mortgage, they often relied on second mortgages, sometimes called "piggyback" loans. These second mortgages were generally fixed-rate, ten-year loans with higher interest rates than even the initial interest rates on first-lien subprime mortgages. A subprime borrower with a high initial interest rate and a costly second mortgage faces a substantial interest burden even before his reset takes place.

The high interest rates paid by subprime borrowers allowed the subprime lending model to be profitable for lenders, even though most subprime borrowers never spent much time paying the post-reset rates. Instead, subprime borrowers generally refinanced their mortgages in advance of, or shortly after, the resets occurred. Of the 2/28 subprime loans originated in southern New England between 2001 and 2004, more than half had been prepaid by the reset date.[4] (See Figure 2.)

Declining Home Prices

High pre-reset interest rates explain why the subprime lending model was profitable during the housing boom. But they do not explain why default rates for subprime loans have risen, because subprime interest rates have always been high. To understand the reason for the rise in subprime defaults, we must first understand why homeowners default in the first place. Defaults typically occur when homeowners experience life events that prevent them from making timely mortgage payments. Such a life event can include the loss of a job, illness, or divorce. Each of these events can adversely affect the borrower's cash flow and disrupt his ability to keep current on a mortgage. Whether a bad life event leads to foreclosure depends on whether there is positive or negative equity in the home. With positive equity, foreclosure is unlikely. A homeowner is always better off selling the home and pocketing the difference between the proceeds of the sale and the outstanding balance of the mortgage. Similarly, if a life event causes only a temporary cash-flow problem (as would result, for example, from a temporary spell of unemployment), a homeowner with positive equity can often take out a cash-out refinance to tide him over the difficult period.

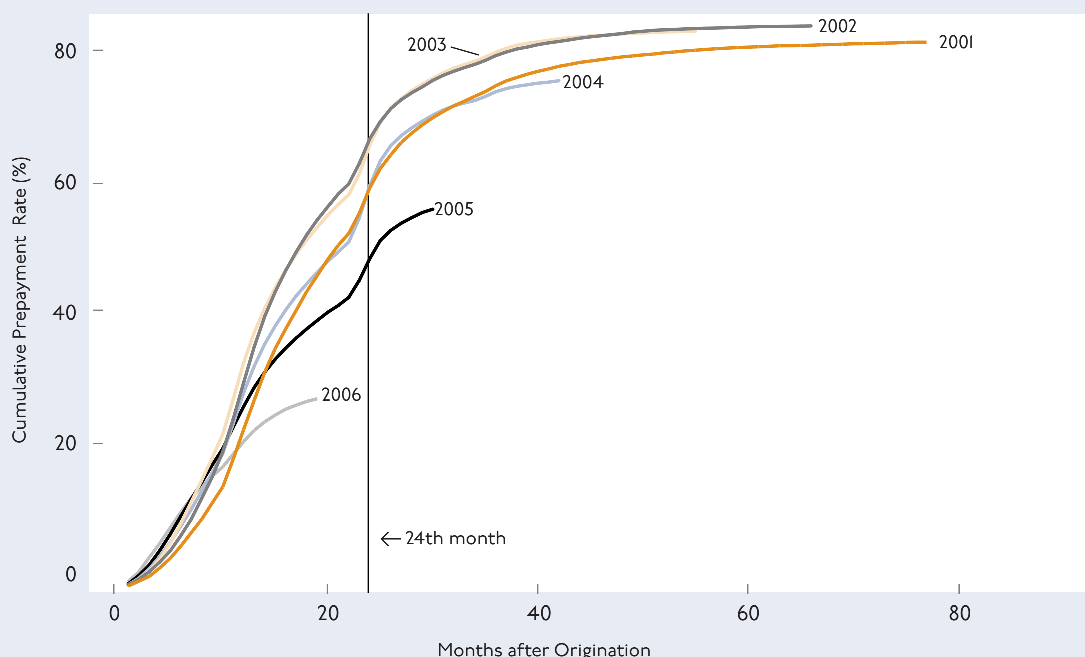
During the first half of the 2000s, house prices rose rapidly, so relatively few borrowers – subprime or prime – ever found themselves with negative equity. Therefore, few borrowers defaulted on their loans and foreclosures were rare, even among borrowers undergoing adverse life events. The picture changed when house prices began to level off and then decline. Owners who had purchased their homes when prices were at their peak often found themselves with negative equity as prices fell. If an adverse life event occurred to an owner with negative equity, foreclosure generally followed. For subprime borrowers, such a life event can occur before the interest rates on their loans reset. Thus, it is the recent decline in house prices that explains why so many recent subprime loans are defaulting even before reset occurs.

Risk Characteristics of Subprime Loans

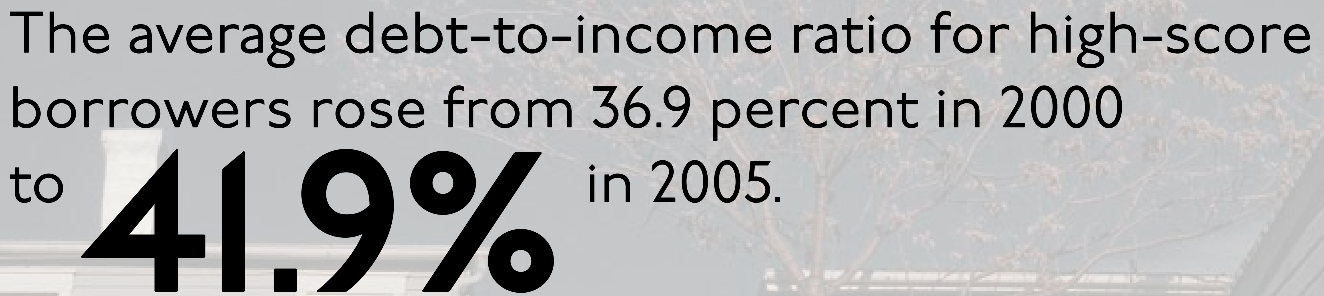
Default rates on all types of loans have risen as house prices have fallen, but subprime loans have proven par-

Figure 2: Cumulative Prepayment Rates for 2/28 Subprime Mortgages

by Year of Origination



Source: LP dataset for southern New England.



ticularly vulnerable to price declines. An analysis of the risk characteristics of subprime loans made during the housing boom shows why. One reason that borrowers take out subprime mortgages is that they do not have sizeable downpayments. Borrowers with low downpayments are more likely to find themselves with negative equity when house prices fall, so they are more likely to suffer a foreclosure in response to a bad life event. During the housing boom, the average loan-to-value ratio for subprime mortgages in southern New England rose rapidly, from 82.6 percent in 2000 to 92.8 percent by 2005. (See Table 2.) A second risk characteristic of subprime loans is documentation status. Borrowers who are unable or unwilling to supply documentation for their loan applications typically default more often than borrowers who do supply documentation. The fraction of fully documented subprime loans in the southern New England subprime pool fell from 69.6 percent in 2000 to 50.2 percent in 2005. A third factor affecting the risk of a mortgage is the borrower's debt-to-income ratio. The average for this ratio in the subprime pool rose from 37.1 percent in 2000 to 42.0 percent in 2005. All three of these factors moved in the direction that would make a subprime loan made in 2005 more sensitive to a house-price decline than one made in 2000.

One risk statistic that did improve in the southern New England subprime pool is the average credit score of subprime borrowers. Typically, a borrower with a FICO score of 620 or higher is considered a "prime borrower," because such a borrower would generally be able to obtain a prime loan.[5] As the housing boom progressed, more and more prime borrowers took out subprime loans. In 2000, only 44.5 percent of subprime loans were held by prime borrowers. By 2004, this fraction had risen to about 71.0 percent, an increase that is qualitatively similar to those found in nationally representative datasets.

Why is this particular risk characteristic suggesting less risk while the other three characteristics are flashing the opposite signal? While a credit score of 620 or above might qualify a borrower for *a* prime loan, it would not

qualify him for *any* prime loan. If a borrower wanted to take out a mortgage with a high loan-to-value ratio, or one that implied a high debt-to-income ratio, or if this borrower did not want to document his income, he would likely be turned down by a prime lender. A subprime lender, on the other hand, might be willing to make this loan – as long as this lender was compensated with a higher interest rate.

When we look deeper into the pool of Connecticut, Massachusetts, and Rhode Island subprime loans, we find that more and more prime borrowers were entering the subprime pool because they were taking out increasingly risky loans. For high-score subprime borrowers, the average loan-to-value ratio rose from 83.8 percent in 2000 to 93.8 percent in 2005, an increase that is similar to the increase for the subprime pool as a whole. Changes in documentation status are even more pronounced. The share of prime borrowers with full documentation fell from 67.0 percent in 2000 to only 40.8 percent in 2005. Finally, the average debt-to-income ratio for high-score borrowers rose from 36.9 percent in 2000 to 41.9 percent in 2005.

In short, the subprime market has evolved during the past several years. As noted above, this market started out by providing loans to risky *borrowers*. But as the housing boom gathered steam, this market began to provide risky *loans* to a variety of borrowers. The pool of subprime borrowers is often portrayed as a monolithic group of borrowers with low credit scores. But the reality is that subprime borrowers are a heterogeneous group with a wide range of FICO scores and a variety of reasons for using this market. What they have in common is a high vulnerability to the decline in home prices. By 2005, the share of subprime mortgages that had a risky level of at least one of the four risk characteristics (FICO score, loan-to-value ratio, debt-to-income ratio, and documentation status) had topped 95 percent.

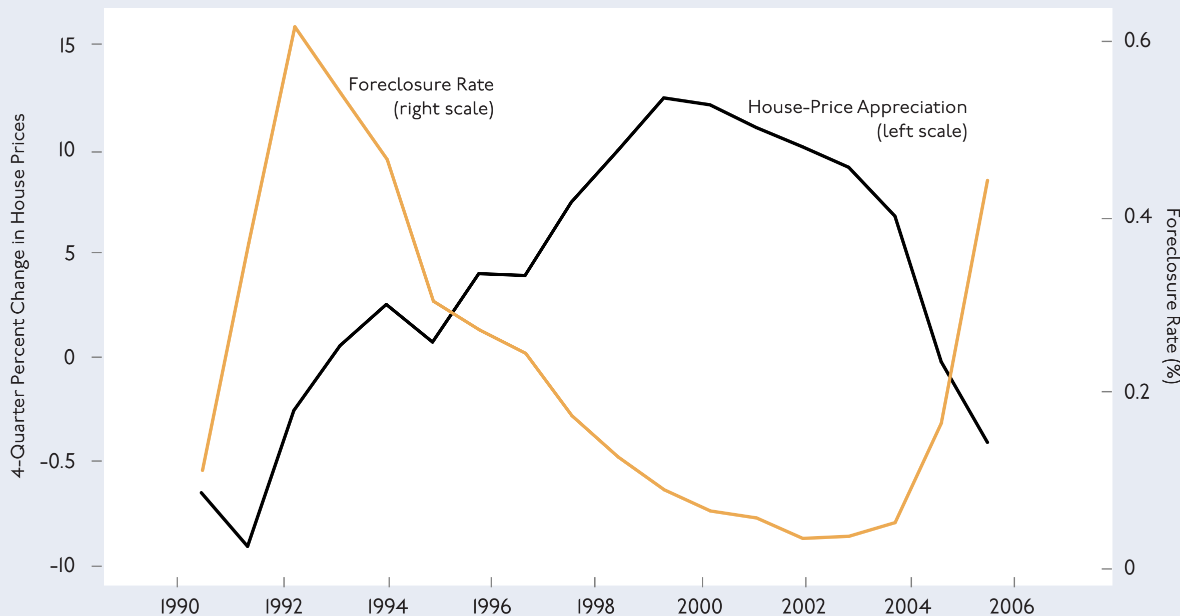
An important policy question is why this transformation took place. There are many reasons why prime borrowers may have found themselves holding risky subprime mortgages as the housing boom progressed. They may have been "steered" to the subprime mortgage market by real estate professionals who encouraged them to take out inappropriately risky loans. Alternatively, the high-score borrowers may have found their own way to the subprime market, because these borrowers wanted to buy houses that prime lenders were unwilling to finance. For whatever reason, these borrowers turned to the subprime mortgage market for loans that they could not have obtained in the prime mortgage market.

Table 2: Risk Characteristics of Subprime Loans in Southern New England

All borrowers	2000	2003	2005
Number of loans originated	3,171	13,486	30,219
Average loan-to-value ratio	82.6	88.6	92.8
Share of loans fully documented	69.6	55.5	50.2
Average debt-to-income ratio	37.1	38.9	42.0
Fraction of borrowers with FICO score of 620 or more	44.5	68.2	71.0
Borrowers with FICO score of 620 or more			
Number of loans originated	1,411	9,203	21,442
Average loan-to-value ratio	83.8	89.8	93.8
Share of loans fully documented	67.0	48.6	40.8
Average debt-to-income ratio	36.9	38.6	41.9

Source: LP dataset for southern New England.

Figure 3: Foreclosure Rate and House-Price Appreciation in Massachusetts



Source: Warren Group dataset. Federal Reserve Bank of Boston calculations.

Late 1980s and Early 1990s versus Now

Massachusetts has suffered from falling home prices and rising foreclosures before. The most notable example was the economic recession of the late 1980s and early 1990s. When the trough of this cycle was reached in 1992, house prices were down by more than 10 percent from their previous peak, while the foreclosure rate was more than 5 times its 1990 level. (See Figure 3.) While there are some parallels, there are also important differences between today's foreclosures and those of the earlier period. To begin with, borrowers losing their homes in the early 1990s tended to have lived in their homes longer and to have put down sizable downpayments. About 80 percent of the early group had lived in their home for more than three years; this contrasts with a little more than half of owners suffering foreclosure in the current period. (See Table 3.) The difference in downpayments at the time of purchase is also striking. More than 30 percent of foreclosees in the earlier period made a down payment of at least 20 percent at the time of purchase. But fewer than 10 percent of foreclosees in the current period did so, and more than one third of the current foreclosees made no down payment at all.

These differences stem from the different macroeconomic environments of the two foreclosure waves.

Table 3: Characteristics of Massachusetts Foreclosures, 1991–1992 and 2006–2007

	1991	1992	2006	2007
Share of foreclosees living in home...				
for 2 years or less	11.7	6.6	26.9	25.8
for more than 3 years	75.1	84.6	57.5	54.9
Share of foreclosees who put down...				
no downpayment	8.2	8.8	34.5	40.0
20% or more at purchase	35.9	30.4	8.6	8.0

Source: Warren Group dataset.

The early 1990s was a period of exceptionally high unemployment, with the state's unemployment rate peaking at 8.8 percent in 1991 and 1992. Additionally, the mid-1980s saw an explosion of residential construction in Massachusetts. High unemployment and a legacy of previous overbuilding put significant downward pressure on housing prices in the early 1990s, so that even people who moved into their homes with large equity cushions were in danger of having negative equity as prices fell. At the same time, the state's poor labor market caused many Massachusetts residents to lose their jobs, thereby supplying the negative life events needed to trigger foreclosures when negative equity is present. During the current foreclosure wave, the macroeconomic environment has not been nearly so bad.

Another difference between the earlier crisis and the current one involves the presence of the subprime market. Indeed, the current crisis is often described as a "subprime mortgage crisis," as if prime mortgages were not a significant factor. As we have seen, subprime mortgages are more sensitive to price declines for a number of reasons. Somewhat less than half (45.5 percent) of all defaulted mortgages in Massachusetts have been subprime loans, though this fraction varies across different types of houses (single-family, condominium, and multi-family). (See Table 4.) It is important to note, however, that many of these defaulted subprime loans were refinances on houses that were originally purchased with prime loans. About 30 percent of all foreclosures have come on houses originally purchased with subprime mortgages, though here again there is some variation

Table 4: Subprime Shares Among Defaulted Massachusetts Ownership Experiences and Mortgages in 2006-07

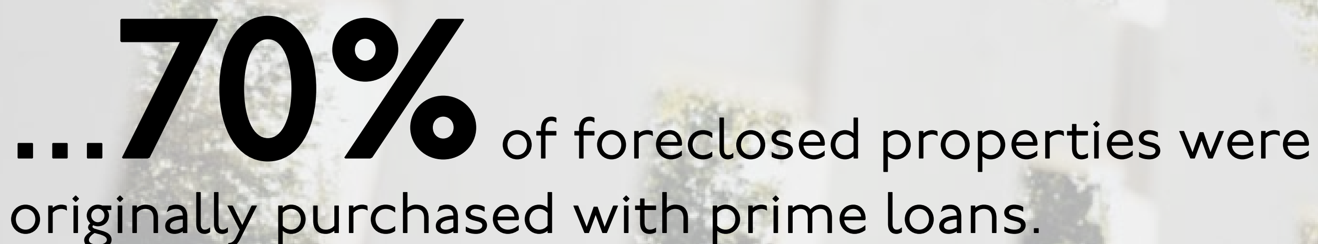
	Fraction of defaulted ownerships purchased with subprime mortgages	Subprime fraction of defaulted mortgages
Single-family residences	24.2	42.7
Condominiums	27.5	40.7
Multi-family residences	42.6	53.3
All Residences	30.0	45.5

Source: Warren Group dataset.

based on the type of house. These statistics point to the quantitative importance of subprime lending in the current foreclosure wave. But they also show that this crisis extends beyond the subprime market. The fact that 30 percent of all foreclosures have come on houses purchased with subprime mortgages suggests that the other 70 percent of foreclosed properties were originally purchased with prime loans.

Policy Considerations

Current problems in the subprime market have led many to ask what role this market should play in the future. Proponents of subprime lending argue that this market encourages homeownership by extending credit to people who may have blemished credit records but who are now capable of handling the financial obligations of homeownership. Other candidates for successful subprime lending include people who do not earn



enough to borrow a given amount from a prime lender, but who do have other, stable resources to call upon if conditions change. Finally, subprime lending can encourage homeownership by providing refinance loans to people undergoing adverse life events, such as the loss of a job. A prime lender may be nervous about extending credit to a borrower who has just lost a job, but a subprime lender may be willing to extend such a loan if he is compensated for the extra risk. Opponents of subprime lending counter that such lending causes more problems than it solves. To the extent that subprime borrowers are less financially sophisticated than other borrowers, they are more likely to fall victim to predatory lending schemes or be steered into loans that are inappropriate for them but profitable for their lenders.

The only thing we can say for certain about these claims is that to some extent, all of them are true. Subprime lending has helped many borrowers into homeownership; it is worth remembering that even with all of the problems in the subprime market, four out of five Massachusetts homeownerships that began with a subprime mortgage have avoided foreclosure. And, undoubtedly, some examples of inappropriate steering took place. Going forward, the challenge for policy makers will be to quantify the offsetting effects of subprime lending on the homeownership rate. How many people have been moved into homeownership with subprime lending, and what has been the impact of homeownership on other life outcomes, such as wealth accumulation? How much financial sophistication is needed to understand the typical subprime loan contract, and how much sophistication have previous subprime borrowers actually had in practice? Finally, how should financial markets be regulated to insure that credit is available to finance appropriate home purchases? Though subprime lending has only recently been on the policy agenda, it is likely to be at the center of housing policy research for some time to come.

Endnotes

[1] The research examines two types of datasets. The first consists of Registry of Deeds data for individual properties in the state of Massachusetts. The second is data on individual loans that have been packaged into non-agency mortgage-backed securities and sold to investors in the secondary market.

The Registry of Deeds dataset, which is available as far back as the late 1980s, permits the study of complete *ownership experiences*: For a single owner's time in a given house, all transactions can be traced, including the original purchase mortgage(s), refinance mortgages, home equity loans, and foreclosure deeds. This dataset was made available to the Federal Reserve Bank of Boston by the Warren Group, a private Boston firm that has been tracking real estate transactions in New England for more than a century. The Warren Group has published the data in its newspaper, *Banker and Tradesman*, since 1872. The Bank gratefully acknowledges the Warren Group's generosity in making this dataset available.

The second dataset – loans packaged and sold in the non-agency secondary market – provides interest rate information and the borrower's credit score, as well as other characteristics of the loan and the property. The Federal Reserve acquired this dataset from First American LoanPerformance, a subsidiary of First American CoreLogic, Inc., owned by First American Corporation.

[2] Certain lenders, typically mortgage banks, may specialize in subprime loans. Banks, especially smaller community banks, generally do not make subprime loans, although a few large banking organizations are active through mortgage banking subsidiaries. According to interagency regulatory guidance issued in 2001, "the term 'subprime' refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- bankruptcy in the last 5 years;
- relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers."

[3] Most often, the market rate used as an index for the post-reset rate is the six-month LIBOR. LIBOR is an acronym for London Interbank Offered Rate, an international interbank lending rate similar to the federal funds rate in the United States. The typical post-reset interest rate exceeded LIBOR by about six percentage points.

[4] Note that prepayment rates have fallen for subprime 2/28's originated in 2005 and 2006. This decline stems from the drop in housing prices over this period, a topic we return to below.

[5] FICO, an acronym for Fair Issac & Co., is a scoring system developed by Fair Isaac & Co. and widely used to evaluate the creditworthiness of borrowers. FICO scores range from 300 to 850, with about one-quarter of the U.S. population falling in the range of 750 to 799.

2007 Bank Highlights

Our role in New England and the Nation

This was an eventful year — along many dimensions. Within the Bank, we saw the retirement of Cathy E. Minehan as President and CEO, after 13 years of distinguished service in this position. Eric S. Rosengren was selected as the new President;

previously, Eric was the Bank's executive vice president in charge of Supervision, Regulation, and Credit. Meanwhile, rapidly deteriorating conditions in housing and credit markets challenged Federal Reserve System policy makers and all those who advise and assist them. The fallout from rising delinquencies in subprime mortgages became a major concern. Many borrowers could not meet mortgage payments, home prices declined, and foreclosures rose. The effect on financial markets was far-reaching, resulting in heightened uncertainty and volatility.

In response to the developments in housing and financial markets, a number of Bank departments – including Research; Public and Community Affairs; Corporate Affairs; and Supervision, Regulation and Credit – joined forces to understand better the subprime mortgage and credit crisis; to share our findings with policy makers, advocacy groups and the public; and to work toward possible solutions. These efforts, which are ongoing, are highlighted on pages 19 and 20 of this report. Particularly noteworthy was the research paper, "Subprime Outcomes: Risky Mortgages, Homeownership Experiences and Foreclosures," which dispelled misconceptions about the importance of interest rate "re-sets" in causing foreclosures and highlighted the important role of house price changes. Another important initiative was the Bank's support for the formation of the Mortgage Relief Fund, a collaboration of major New England banks to reach out to subprime borrowers who might be able to refinance into more affordable loans. A number of community banks will join the effort in 2008.

Other areas where the Bank made significant contributions include the following:

- Our research economists explored the role that behavioral economics can play in economic policy making and central banking. A conference we hosted on this topic enhanced our understanding and produced new avenues for research. Economists also added to our understanding of inflation dynamics through a number of new analyses. The Emerging Payments Research Group delved into contactless payments technology through research and a forum devoted to understanding the barriers, opportunities, and security risks presented by this relatively new payments method.

- The Bank's New England Public Policy Center provided timely analysis of key economic issues for the region's

public policy makers, with a particular focus on state aid to local governments, health insurance reform in the six New England states, and business taxation in Massachusetts. The center launched an online interactive resource that provides statistics on the New England economy.

- A highlight of the year was the successful implementation in November of the Internet Payment Platform. IPP is an application developed by the Federal Reserve Bank of Boston on behalf of the U.S. Treasury to enable federal agencies to handle in a single online system all of their purchase orders, invoices, workflow data, and payment information. We also managed substantial growth in our Stored Value Card program in 2007. This program now serves military personnel at more than 50 military bases in the United States and other countries.

- The Bank was selected to undertake a multi-year project to design, build, and operate a new cash management system for the U.S. Treasury to manage the inflow and outflow of government deposits. The new application will serve as the Treasury's means of concentrating cash from depository institutions and will improve the Treasury's ability to manage the public's money efficiently.

- Our check processing, cash, and wholesale payments staff achieved exceptional performance in 2007. Highlights included year-over-year gains of 17 percent in check processing productivity and 22 percent in cash paying and receiving productivity.

- Our bank supervision staff successfully conducted 18 extensive quantitative reviews at the largest, most sophisticated banks in the country as those banks prepared to implement systems that will help them qualify for the new Basel II capital requirements. Two members of our staff were chosen for national leadership roles as Basel II risk coordinators for the Federal Reserve System.

Subprime Mortgage and Credit Crisis: Research and Outreach

In 2007, Bank staff from several different departments collaborated to better understand and address the subprime mortgage crisis.

March	**"Understanding Foreclosures in Massachusetts"** We issued a discussion paper analyzing rising foreclosures in Massachusetts. The paper shows an association between communities with higher rates of foreclosure and concentrations of higher-cost lending.
March	**"Tackling Foreclosure" and "Foreclosure in Rhode Island"** Two articles in the Bank's magazine, *Communities & Banking*, describe programs that help families keep their homes and avoid foreclosure.
April	**Massachusetts legislative testimony** The Bank's community affairs officer testified on rising foreclosures at a Massachusetts state house hearing.
April	**Foreclosures in New England** A section of our public web site was devoted to information on foreclosures and the foreclosure process. The site provides information for both researchers and the general public. It includes quarterly updates of state foreclosure trends, research papers, and links to helpful resources for borrowers.
April	**"Infórmese antes de ir...a solicitar una hipoteca"** We published a Spanish-language version of our guide to alternative mortgage products and glossary of terms, "True or False? Know Before You Go To Get A Mortgage."
May and October	***New England Community Developments*** Articles in the spring and fall issues of our newsletter, *New England Community Developments*, are devoted to information on foreclosure intervention and prevention efforts in Massachusetts and across New England.
October 10	**"Recent Developments in Real Estate, Financial Markets, and the Economy"** In his first major speech as the Bank's new president, Eric Rosengren addressed a meeting of the Portland, Maine, Chamber of Commerce, talking about the subprime mortgage problem and foreclosures in New England. Subsequent speeches also addressed the problem and explored possible solutions.
October 15	**"Mortgage Lending Discrimination"** A senior Bank officer testified on foreclosures and the subprime mortgage situation at a hearing of the Committee on Financial Services, U.S. House of Representatives, held at Roxbury Community College, Boston.

November — **"You May Be Paying Too Much for Your Mortgage"**
We produced and began distributing a brochure explaining how mortgages are priced and encouraging consumers to shop for the best possible pricing. A Spanish-language version was produced in December.

November 13 — **"Foreclosure Crisis: Where Are We Now, How Did We Get Here, Where Are We Going?"**
The Bank's third annual New England Consumer Advisory Group conference gathered together consumer regulators, community advocates, economists, lenders, bankers, and loan intermediaries to discuss foreclosure problems and share information on foreclosure prevention programs.

November 14 — **Fair Housing Seminar Series**
A community affairs staff member provided an update on New England foreclosure trends to the Greater Boston Fair Housing Seminar Series.

December — **TheInformedHomeBuyer.org**
We launched a new consumer-oriented web site to assist mortgage borrowers in evaluating financing options. The site contains links to counseling services and other resources. A Spanish-language version of this web site was launched in April 2008.

December — **"Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures"**
The Research Department released a working paper on subprime mortgages that has received widespread attention. The paper points out that initial "teaser" rates on subprime mortgages were often not particularly low and that, historically, most borrowers refinanced before their rates re-set to higher levels. The paper highlights the importance of house price changes in determining foreclosures. Foreclosures are much more likely to occur if prices are declining.

December — **Mortgage Relief Fund**
We worked with five major New England banks to develop and publicize a program to reach out to borrowers with subprime loans to encourage them to see if lower-cost financing might be available. We also began discussions with community banks about their involvement in such an effort.

ongoing — **Public presentations**
Staff members made presentations on the foreclosure problem and assistance at forums throughout New England, including meetings sponsored by the Boston Foundation, U.S. Department of Housing and Urban Development (HUD), Massachusetts chapter of the American Society for Public Administration, Harvard Kennedy School of Government, state of Rhode Island, and Massachusetts state legislators.

ongoing — **Technical and analytical assistance**
We provided technical and analytical support to the City of Boston and other agencies in their work on foreclosure and delinquency prevention programs. For the City of Boston, we helped identify the impact of foreclosure on rental tenants.

The Bank in the Community

While many responsibilities of the Federal Reserve Bank of Boston are regional, national, and global in scope, the Bank also seeks to share its expertise with the communities throughout its District in a variety of outreach activities. In addition, Bank staff are engaged in the local community, working and volunteering on many projects and initiatives.

- We Care About Kids
- Community Care Day
- Homeless Children's Holiday Party
- Books and Kids Program
- FinTech Scholars Program
- Math and Kids Program
- United Way
- Citizen Schools
- Operation Hope
- School-to-Career Economics Club
- Boston Summer Jobs Program
- Boston Private Industry Council
- Asian American Civic Association, Inc.
- National Consumer League LifeSmarts Program
- Massachusetts School Bank Association
- Classroom at the Workplace
- Boston After School Jobs Program
- Job Shadow Day
- School-to-Career Project
- Workforce Development
- YMCA Training, Inc.
- WriteBoston
- Boys & Girls Reading Club
- Excel High School Partnership
- Mayor Menino's Boston Earned Income Tax Credit Campaign
- Timilty Middle School Promising Pals

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William L. Clayton Professor of International Economic Affairs
The Fletcher School of Law and Diplomacy
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Chairman and CEO
State Street Corporation

Kathleen C. Marcum
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Federal Advisory Council Member
James C. Smith
Chairman and CEO
Webster Bank, N.A.

Seated, left to right: Lisa Lynch, Stuart Reese, Michael Wedge

Standing, left to right: Paul Connolly, Eric Rosengren, Ronald Logue, David Lentini, Samuel Thier, Kathleen Marcum

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President
Chief Executive Officer

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First Vice President
Chief Operating Officer

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Senior Vice President

Ronald E. Mitchell, Jr.
Senior Vice President

James T. Nolan
Senior Vice President
Director of Supervision,
Regulation and Credit

Seated, left to right: James Nolan, Cynthia Conley, James Cunha
Standing, left to right: Lynn Browne, William McDonough, Jeffrey Fuhrer, Christopher Gale, Ronald Mitchell, Jr., Linda Mahon

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Meredith Reuben
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Kirk Sykes
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Urban Strategy America Fund

Kathy Weare
Chief Executive Officer
The Cliff House Resort & Spa

Daniel Wolf
President and CEO
Cape Air
Hyannis Air Services, Inc.

Advisor
James Brett
President and CEO
The New England Council

Seated, left to right: Dwight Sargent, Lynn Kraemer Goldfarb, James Brett, Kathy Weare, Leslie Kenney
Standing (middle row), left to right: Oz Griebel, Meredith Reuben, Joseph Nagle, Eric Rosengren, Amar Kapur, Daniel Wolf, Kirk Sykes, Craig Moore
Standing (back row), left to right: Michael Dubyak, Charles D'Amour, Ralph Crowley, Paul Connolly, Keith Hutchinson, Gregory Howey, William Gurley

Community Development Advisory Council

William Armitage II
Executive Director
Biddeford-Saco Area Economic
Development Corporation

Stuart Arnett
Managing Partner
Arnett Development Group LLC

Peter Gagliardi
Executive Director
Hamden Hampshire
Housing Partnership

Lori Lindfors
Senior Vice President
Citizens Bank of Connecticut

Frederick McKinney, Ph.D.
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Connecticut Minority
Supplier Development Council

Marc Reich
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Ironwood Capital
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Mayte Rivera
Director of
Community Development
Massachusetts Division of Banks

Bruce Seifer
Assistant Director for
Economic Development
Community and Economic
Development Office
Burlington, Vermont

Michael Swack
Dean
School of Community
Economic Development
Southern New Hampshire
University

Raymond Tung
Senior Vice President
United Commercial Bank

Eloise Vitelli
Director of Program
and Policy Development
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Peter Walsh
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Executive Director
West Elmwood Housing
Development Corporation

Darnell Williams
President and
Chief Executive Officer
Urban League of Eastern
Massachusetts

Richard Walker III
Vice President
Federal Reserve Bank of Boston

Seated, left to right: Sharon Conard Wells, Raymond Tung, Eloise Vitelli, Mayte Rivera, Richard Walker
Standing, left to right: Peter Walsh, Lori Lindfors, Michael Swack, Stuart Arnett, William Armitage II,
Eric Rosengren, Fredrick McKinney, Peter Gagliardi, Bruce Seifer

March 20, 2008
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, Statements of Income and Comprehensive Income, and Statement of Changes in Capital as of December 31, 2007 (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 management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRB Boston is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of the Financial Statements in accordance with the Manual. Internal control contains self monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal control are reported to management and appropriate corrective measures are implemented.

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

The management of the FRB Boston assessed its internal control over financial reporting 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. Based on this assessment, we believe that the FRB Boston maintained effective internal control over financial reporting as it relates to the Financial Statements.

Eric S. Rosengren, President

Paul M. Connolly, First Vice President

Jon Colvin, Chief Financial Officer

Deloitte.

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 statement of condition of the Federal Reserve Bank of Boston ("FRB Boston") as of December 31, 2007 and the related statements of income and comprehensive income and changes in capital for the year then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of FRB Boston as of December 31, 2007, based on criteria established in *Internal Control--Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Boston's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management Assertion*. Our responsibility is to express an opinion on these financial statements and an opinion on FRB Boston's internal control over financial reporting based on our audit. The financial statements of FRB Boston for the year ended December 31, 2006 were audited by other auditors whose report, dated March 12, 2007, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

FRB Boston's internal control over financial reporting is a process designed by, or under the supervision of, FRB Boston's principal executive and principal financial officers, or persons performing similar functions, and effected by FRB Boston's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. FRB Boston's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairy reflect the transactions and dispositions of the assets of FRB Boston; (2) provide reasonable assurance that transactions are

recorded as necessary to permit preparation of financial statements in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System, and that receipts and expenditures of FRB Boston are being made only in accordance with authorizations of management and directors of FRB Boston; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FRB Boston's assets that could have a material effect on the financial statements.

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

As described in Note 3 to the financial statements, FRB Boston has prepared these financial statements in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as set forth in the *Financial Accounting Manual for Federal Reserve Banks*, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 3.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FRB Boston as of December 31, 2007, and the results of its operations for the year then ended, on the basis of accounting described in Note 3. Also, in our opinion, FRB Boston maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control — Integrated Framework* issued by the Colnmittee of Sponsoring Organizations of the Treadway Commission.

Deloitte & Touche LLP

March 20, 2008
Boston, Massachusetts

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 statement of condition of the Federal Reserve Bank of Boston (the "Bank") as of December 31, 2006, and the related statements of income and changes in capital for the year 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 audit.

We conducted our audit in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides 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* which is 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, 2006, and the results of its operations for the year then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 12, 2007

STATEMENTS OF CONDITION

*(In millions)

	December 31, 2007	December 31, 2006
ASSETS		
Gold certificates	$ 449	$ 486
Special drawing rights certificates	115	115
Coin	36	27
Items in process of collection	82	96
Loans to depository institutions	178	9
Securities purchased under agreements to resell	2,143	-
U.S. government securities, net	34,363	37,393
Investments denominated in foreign currencies	1,222	491
Accrued interest receivable	293	321
Interdistrict settlement account	-	124
Bank premises and equipment, net	140	139
Interest on Federal Reserve notes due from U.S. Treasury	108	-
Other assets	26	24
Total assets	$ 39,155	$ 39,225
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	$ 32,946	$ 36,000
Securities sold under agreements to repurchase	2,027	1,413
Deposits:		
Depository institutions	532	549
Other deposits	25	4
Deferred credit items	92	352
Interest on Federal Reserve notes due to U.S. Treasury	-	39
Interdistrict settlement account	1,356	-
Accrued benefit costs	65	66
Other liabilities	14	10
Total liabilities	37,057	38,433
Capital:		
Capital paid-in	1,049	396
Surplus (including accumulated other comprehensive loss of $3 million and $7 million at December 31, 2007 and 2006, respectively)	1,049	396
Total capital	2,098	792
Total liabilities and capital	$ 39,155	$ 39,225

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

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

*(In millions)

	For the year ended December 31, 2007	For the year ended December 31, 2006
Interest income:		
Interest on U.S. government securities	$ 1,802	$ 1,712
Interest on securities purchased under agreements to resell	66	-
Interest on investments denominated in foreign currencies	15	13
Interest on loans to depository institutions	-	1
Total interest income	1,883	1,726
Interest expense:		
Interest expense on securities sold under agreements to repurchase	79	65
Net interest income	1,804	1,661
Other operating income		
Compensation received for services provided	47	47
Reimbursable services to government agencies	25	23
Foreign currency gains, net	49	32
Other income	18	15
Total other operating income	139	117
Operating expenses:		
Salaries and other benefits	104	96
Occupancy expense	19	17
Equipment expense	12	13
Assessments by the Board of Governors	39	38
Other expenses	54	53
Total operating expenses	228	217
Net income prior to distribution	1,715	1,561
Change in funded status of benefit plans	4	-
Comprehensive income prior to distribution	$ 1,719	$ 1,561
Distribution of comprehensive income:		
Dividends paid to member banks	$ 35	$ 22
Transferred to surplus and change in accumulated other comprehensive loss	653	86
Payments to U.S. Treasury as interest on Federal Reserve notes	1,031	1,453
Total distribution	$ 1,719	$ 1,561

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

STATEMENTS OF CHANGES IN CAPITAL

For the years ended December 31, 2007 and December 31, 2006
*(In millions)

		Surplus			
	Capital Paid-In	Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	Total Capital
Balance at January 1, 2006 (6.3 million shares)	$ 317	$ 317	$ -	$ 317	$ 634
Net change in capital stock issued (1.6 million shares)	79	-	-	-	79
Transferred to surplus	-	86	-	86	86
Adjustment to initially apply SFAS No. 158	-	-	(7)	(7)	(7)
Balance at December 31, 2006 (7.9 million shares)	$ 396	$ 403	$ (7)	$ 396	$ 792
Net change in capital stock issued (13.1 million shares)	653	-	-	-	653
Transferred to surplus and change in accumulated other comprehensive loss	-	649	4	653	653
Balance at December 31, 2007 (21.0 million shares)	$ 1,049	$ 1,052	$ (3)	$ 1,049	$ 2,098

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

1. STRUCTURE

The Federal Reserve Bank of Boston ("Bank") is part of the Federal Reserve System ("System") and one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the First Federal Reserve District, which includes Maine, Massachusetts, New Hampshire, Rhode Island, Vermont, and a portion of Connecticut.

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System ("Board of Governors") to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. 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.

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

2. OPERATIONS AND SERVICES

The Reserve Banks perform a variety of services and operations. Functions include participation in formulating and conducting monetary policy; participation in the payments system, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations, and check collection; distribution of coin and currency; performance of fiscal agency functions for the U.S. Treasury, certain federal agencies, and other entities; serving as the federal government's bank; provision of short-term loans to depository institutions; service to the consumer and the community by providing educational materials and information regarding consumer laws; and supervision of bank holding companies, state member banks, and U.S. offices of foreign banking organizations. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, 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 executes these open market transactions at the direction of the FOMC and holds the resulting securities and agreements 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. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("FX") and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements ("FX swaps") with four central banks and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although the Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized operations and product or function offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are billed for services provided to them by another Reserve Bank.

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, Financial Support Office, and Centralized Accounting Technology Services. Beginning in 2007, a portion of the Centralized Accounting Technology Services costs related to services provided to the System in support of the electronic access channel are redistributed to the Federal Reserve Bank of Chicago. The Bank's total reimbursement for these services was $3 million for the period ending December 31, 2007, and is included in "Other Income" on the Statements of Income and Comprehensive Income.

3. SIGNIFICANT ACCOUNTING POLICIES

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

Differences exist between the accounting principles and practices in the Financial Accounting Manual and generally accepted accounting principles in the United States ("GAAP"), primarily due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. U.S. government 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. Amortized cost more appropriately reflects the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings 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 Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding securities and foreign currency 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 securities and currencies are incidental to the open market operations and do not motivate decisions related to policy or open market activities.

In addition, the Bank has elected not to present a Statement of Cash Flows because the liquidity and cash position of the Bank are not a primary concern given the Reserve Banks' unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide additional meaningful information. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income and Comprehensive Income, and Changes in Capital. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the 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 and Special Drawing Rights Certificates

The Secretary of the U.S. Treasury is authorized to issue gold and special drawing rights ("SDR") certificates to the Reserve Banks.

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. The 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 reduced. 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 the average Federal Reserve notes outstanding in each Reserve Bank.

SDR certificates 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. SDR certificates 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. When SDR certificates are issued to the Reserve Banks, 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 SDR 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 each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2007 or 2006.

b. Loans to Depository Institutions

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain

lending agreements and deposit sufficient collateral before credit is extended. The Bank offers three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. Interest is accrued using the applicable discount rate established at least every fourteen days by the board of directors of the Reserve Bank, subject to review and determination by the Board of Governors.

In addition, depository institutions that are eligible to borrow under the Reserve Bank's primary credit program are also eligible to participate in the temporary Term Auction Facility ("TAF") program. Under the TAF program, the Reserve Banks conduct auctions for a fixed amount of funds, with the interest rate determined by the auction process, subject to a minimum bid rate. All advances under the TAF must be fully collateralized.

Outstanding loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established.

c. U.S. Government Securities and Investments Denominated in Foreign Currencies

Interest income on U.S. government securities and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. 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 (losses), net" in the Statements of Income and Comprehensive Income.

Activity related to U.S. government securities, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in April of each year. The settlement also equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

d. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending

The FRBNY may engage in tri-party purchases of securities under agreements to resell ("tri-party agreements"). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities, pass-through mortgage securities of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. Government, and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions, with the associated interest income accrued over the life of the agreement.

Securities sold under agreements to repurchase are accounted for as financing transactions and the associated interest expense is recognized over the life of the transaction. These transactions are reported in the Statements of Condition at their contractual amounts and the related accrued interest payable is reported as a component of "Other liabilities."

U.S. government securities held in the SOMA are lent to U.S. government securities dealers in order to facilitate the effective functioning of the domestic securities market. Securities-lending transactions are fully collateralized by other U.S. government securities and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer a fee

for borrowing securities and the fees are reported as a component of "Other income."

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account. On February 15, 2007 the FRBNY began allocating to the other Reserve Banks the activity related to securities purchased under agreements to resell.

e. FX Swap Arrangements and Warehousing Agreements

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, whereby the parties agree to exchange their currencies up to a prearranged 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 the foreign currencies it may need to support its international operations and give the authorized foreign central bank temporary access to dollars. Drawings under the FX swap arrangements can be initiated by either party and must be agreed to by the other party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. Foreign currencies received pursuant to these agreements are reported as a component of "Investments denominated in foreign currencies" in the Statements of Condition.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. 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 U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

FX swap arrangements and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are recorded by FRBNY and not allocated to the other Reserve Banks.

f. Bank Premises, Equipment, and Software

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

Costs incurred for software during the application development stage, either developed internally or acquired for internal use, 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. Maintenance costs related to software are charged to expense in the year incurred.

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

g. Interdistrict Settlement Account

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

h. 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 and their designees) to the Reserve Banks upon deposit with such agents of specified 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 at least equal to the sum of the notes applied for by such Reserve Bank.

Assets eligible to be pledged as collateral security include all of the Bank's assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities pledged for securities sold under agreements to repurchase is deducted.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States government. At December 31, 2007, all Federal Reserve notes issued to the Reserve Banks were fully collateralized.

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $5,886 million and $3,020 million at December 31, 2007 and 2006, respectively.

i. Items in Process of Collection and Deferred Credit Items

Items in process of collection in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection and that, as of the balance sheet date, have not yet been presented to the paying bank. Deferred credit items are the counterpart liability to items in process of collection, and the amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances in both accounts can vary significantly.

j. Capital Paid-in

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

By law, each Reserve Bank is required to pay each member bank an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. To reflect the Federal Reserve Act requirement that annual dividends are deducted from net earnings, dividends are presented as a distribution of comprehensive income in the Statements of Income and Comprehensive Income.

k. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. 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.

Accumulated other comprehensive income is reported as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to defined benefit pension plans and other postretirement benefit plans that, under accounting standards, are included in other comprehensive income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9 and 10.

The Bank initially applied the provisions of SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard required applying the provisions as of the end of the year of initial implementation, and the effect as of December 31, 2006 is recorded as "Adjustment to initially apply SFAS No. 158" in the Statements of Changes in Capital.

l. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the U.S. Treasury as interest on Federal Reserve notes, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Payments to U.S. Treasury as interest on Federal Reserve notes" in the Statements of Income and Comprehensive Income and is reported as a liability, or as an asset if overpaid during the year, in the Statements of Condition. Weekly payments to the U.S. Treasury may vary significantly.

In the event of losses or an increase in capital paid-in at a Reserve Bank, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to the U.S. Treasury in the following year.

m. Income and Costs Related to U.S. 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. During the years ended December 31, 2006 and 2007, the Bank was reimbursed for all services provided to the Department of the Treasury.

n. Compensation Received for Services Provided

The Federal Reserve Bank of Atlanta ("FRBA") has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions, and, as a result, recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. Similarly, the FRBNY manages the Reserve Banks' provision of Fedwire funds and securities transfer services, and recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. The FRBA and FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as "Compensation received for services provided" in the Statements of Income and Comprehensive Income.

o. Assessments by the Board of Governors

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank's capital and surplus balances as of December 31 of the prior year. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to prepare and retire Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the prior year.

p. 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 $5 million for each of the years ended December 31, 2007 and 2006, and are reported as a component of "Occupancy expense."

q. Restructuring Charges

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

Note 11 describes the Bank's restructuring initiatives and provides information about the costs and liabilities associated with employee separations. The costs associated with the impairment of certain of the Bank's assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY.

r. Recently Issued Accounting Standards

In September, 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and expands on required disclosures about fair value measurement. SFAS No. 157 is generally effective for the Bank on January 1, 2008, though the effective date of some provisions is January 1, 2009. The provisions of SFAS No. 157 will be applied prospectively and are not expected to have a material effect on the Bank's financial statements.

4. U.S. GOVERNMENT SECURITIES, SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 4.609 percent and 4.772 percent at December 31, 2007 and 2006, respectively.

The Bank's allocated share of U.S. Government securities, net, held in the SOMA at December 31, was as follows (in millions):

	2007	2006
Par value:		
U.S. government:		
Bills	$ 10,500	$ 13,219
Notes	18,516	19,200
Bonds	5,116	4,749
Total par value	34,132	37,168
Unamortized premiums	368	416
Unaccreted discounts	(137)	(191)
Total allocated to the Bank	$ 34,363	$ 37,393

At December 31, 2007 and 2006, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $35,815 million and $37,979 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was $745,629 million and $783,619 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was $777,141 million and $795,900 million, respectively, as determined by reference to quoted prices for identical securities.

Although the fair value of security holdings can be substantially greater or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as central bank, to meet their financial obligations and responsibilities, and should not be misunderstood as representing a risk to the Reserve Banks, their shareholders, or the public. The fair value is presented solely for informational purposes.

Financial information related to securities purchased under agreements to resell and securities sold under agreements to repurchase for the year ended December 31, 2007 was as follows (in millions):

	Securities purchased under agreements to resell	Securities sold under agreements to repurchase
Allocated to the Bank:		
Contract amount outstanding, end of year	$ 2,143	$ 2,027
Weighted average amount outstanding, during the year	1,616	1,606
Maximum month-end balance outstanding, during the year	2,373	2,027
Securities pledged, end of year		2,030
System total:		
Contract amount outstanding, end of year	$ 46,500	$ 43,985
Weighted average amount outstanding , during the year	35,073	34,846
Maximum month-end balance outstanding, during the year	51,500	43,985
Securities pledged, end of year		44,048

At December 31, 2006, the total contract amount of securities sold under agreements to repurchase was $29,615 million, of which $1,413 million was allocated to the Bank. The total par value of SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 was $29,676 million, of which $1,416 million was allocated to the Bank.

The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value.

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	U.S.Government Securities (Par Value)	Securities Purchased Under Agreements to Resell (Contract amount)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 1,258	$ 2,143	$ 2,027
16 days to 90 days	6,900		
91 days to 1 year	7,017		
Over 1 year to 5 years	11,087		
Over 5 years to 10 years	3,777		
Over 10 years	4,093		
Total allocated to the Bank	$ 34,132	$ 2,143	$ 2,027

At December 31, 2007 and 2006, U.S. government securities with par values of $16,649 million and $6,855 million, respectively, were loaned from the SOMA, of which $767 million and $327 million, respectively, 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 with 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 issuing foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 2.585 percent and 2.395 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
Euro:		
Foreign currency deposits	$ 710	$ 150
Securities purchased under agreements to resell	66	53
Government debt instruments	121	98
Japanese Yen:		
Foreign currency deposits	73	62
Government debt instruments	147	128
Swiss Franc:		
Foreign currency deposits	105	-
Total allocated to the Bank	$ 1,222	$ 491

At December 31, 2007, the total amount of foreign currency deposits held under FX contracts was $24,381 million, of which $630 million was allocated to the Bank. At December 31, 2006, there were no open foreign exchange contracts.

At December 31, 2007 and 2006, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $1,222 million and $490 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were $47,295 million and $20,482 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $47,274 million and $20,434 million, respectively.

The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	European Euro	Japanese Yen	Swiss Franc	Total
Within 15 days	$ 129	$ 77	$ -	$ 206
16 days to 90 days	597	10	105	712
91 days to 1 year	71	52	-	123
Over 1 year to 5 years	100	81	-	181
Total allocated to the Bank	$ 897	$ 220	$ 105	$ 1,222

At December 31, 2007 and 2006, the authorized warehousing facility was $5,000 million, with no balance outstanding.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2007	2006
Bank premises and equipment:		
Land	$ 27	$ 27
Buildings	133	123
Building machinery and equipment	29	28
Construction in progress	3	5
Furniture and equipment	60	65
Subtotal	252	248
Accumulated depreciation	(112)	(109)
Bank premises and equipment, net	$ 140	$ 139
Depreciation expense, for the year ended December 31	$ 11	$ 11

The Bank leases space to outside tenants with remaining lease terms ranging from 1 to 10 years. Rental income from such leases was $11 million and $10 million for the years ended December 31, 2007 and 2006, respectively, and is reported as a component of "Other income." Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2007, are as follows (in millions):

2008	$ 10
2009	11
2010	10
2011	9
2012	9
Thereafter	27
Total	$ 76

The Bank has capitalized software assets, net of amortization, of $7 million and $2 million at December 31, 2007 and 2006, respectively. Amortization expense was $1 million and $2 million for the years ended December 31, 2007 and 2006, respectively. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses."

Assets impaired as a result of the Bank's restructuring plan, as discussed in Note 11, include check equipment, software, and leasehold improvements. Asset impairment losses of $4 million for the period ending December 31, 2007 were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses." The Bank had no impairment losses in 2006.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2007, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms of approximately 5 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 $1 million and $2 million for the years ended December 31, 2007 and 2006, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2007 are as follows (in thousands):

	Operating
2008	$ 559
2009	559
2010	559
2011	559
2012	428
Thereafter	-
Future minimum rental payments	$ 2,664

At December 31, 2007, there were no material unrecorded unconditional purchase commitments or long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, 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 of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2007 or 2006.

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 three 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"). Employees at certain compensation levels participate in the Benefit Equalization Retirement Plan ("BEP") and certain Reserve Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan provides retirement benefits to employees of the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. The FRBNY, on behalf of the System, recognizes the net asset and costs associated with the System Plan in its financial statements. Costs associated with the System Plan are not redistributed to other participating employers.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2007 and 2006, and for the years then ended, were 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, 2007 and 2006 and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2007 and 2006, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

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.

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

	2007	2006
Accumulated postretirement benefit obligation at January 1	$ 58.6	$ 50.6
Service cost-benefits earned during the period	1.8	1.1
Interest cost on accumulated benefit obligation	3.4	2.8
Net actuarial (gain) loss	(3.0)	6.7
Curtailment gain	(0.9)	-
Contributions by plan participants	1.4	1.5
Benefits paid	(5.1)	(4.3)
Medicare Part D subsidies	0.2	0.2
Accumulated postretirement benefit obligation at December 31	$ 56.4	$ 58.6

At December 31, 2007 and 2006, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.25 percent and 5.75 percent, respectively.

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

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

	2007	2006
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	3.5	2.6
Contributions by plan participants	1.4	1.5
Benefits paid, net of Medicare Part D subsidies	(4.9)	(4.1)
Fair value of plan assets at December 31	$ -	$ -
Unfunded obligation and accrued postretirement benefit cost	$ 56.4	$ 58.6
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	$ 1.6	$ 2.8
Net actuarial loss	(5.4)	(9.9)
Deferred curtailment gain	0.3	-
Total accumulated other comprehensive loss	$ (3.5)	$ (7.1)

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

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

	2007	2006
Health care cost trend rate assumed for next year	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2013	2012

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, 2007 (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	$ 0.8	$ (0.7)
Effect on accumulated postretirement benefit obligation	6.8	(5.6)

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

	2007	2006
Service cost-benefits earned during the period	$ 1.8	$ 1.1
Interest cost on accumulated benefit obligation	3.4	2.8
Amortization of prior service cost	(0.9)	(0.9)
Amortization of net actuarial loss	0.6	-
Net periodic postretirement benefit expense	$ 4.9	$ 3.0

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit credit in 2008 are shown below:	
Prior service cost	$ (0.7)
Total	$ (0.7)

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2007 and 2006, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 5.50 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.

A deferred curtailment gain was recorded in 2007 as a component of accumulated other comprehensive loss; the gain will be recognized in net income in future years when the related employees terminate employment.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare (“Medicare Part D”) and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided under the Bank’s plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit expense.

There were no receipts of federal Medicare Part D subsidies in the year ended December 31, 2006. Receipts in the year ending December 31, 2007, related to benefits paid in the years ended December 31, 2006 and 2007 were $0.2 million and $0.1 million, respectively. Expected receipts in 2008, related to benefits paid in the year ended December 31, 2007 are $0.1 million.

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

	Without Subsidy	With Subsidy
2008	$ 3.7	$ 3.4
2009	3.9	3.7
2010	4.2	3.9
2011	4.5	4.1
2012	4.6	4.3
2013-2017	24.9	22.4
Total	$ 45.8	$ 41.8

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank for each of the years ended December 31, 2007 and 2006 were $6 million. This cost is included as a component of “Accrued benefit costs” in the Statements of Condition. Net periodic postemployment benefit expense included in 2007 and 2006 operating expenses was $269 thousand and $934 thousand, respectively, and is recorded as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME AND OTHER COMPREHENSIVE INCOME

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

	Amount Related to Postretirement Benefits other than Pensions
Balance at January 1, 2006	$ -
Adjustment to initially apply SFAS No. 158	$ (7)
Balance at December 31, 2006	$ (7)
Change in funded status of benefit plans:	
Net actuarial gain arising during the year	$ 4
Amortization of prior service cost	$ (1)
Amortization of net actuarial loss	$ 1
Change in funded status of benefit plan - other comprehensive income	$ 4
Balance at December 31, 2007	$ (3)

Additional detail regarding the classification of accumulated other comprehensive loss is included in Note 9.

11. BUSINESS RESTRUCTURING CHARGES

2007 Restructuring Plans

In 2007, the Reserve Banks announced a restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure will involve consolidation of operations into four regional Reserve Bank processing sites in Philadelphia, Cleveland, Atlanta, and Dallas.

2006 Restructuring Plans

In 2006, the Bank did not announce any new restructuring plans.

2005 and Prior Restructuring Costs

Prior to 2006, the Bank announced restructuring initiatives in Check, Treasury Direct, System Purchasing Services, and FedImage operations. The Bank completed these announced plans in April 2006.

Following is a summary of financial information related to the restructuring plans (in millions):

	2005 and Prior Restructuring Plans	2007 Restructuring Plans	Total
Information related to restructuring plans			
as of December 31, 2007:			
Total expected costs related to restructuring activity	$ 3.0	$ 2.4	$ 5.4
Estimated future costs related to restructuring activity	-	0.4	0.4
Expected completion date	2006	2009	
Reconciliation of liability balances:			
Balance at January 1, 2006	$ 1.7	$ -	$ 1.7
Adjustments	(0.4)	-	(0.4)
Payments	(1.3)	-	(1.3)
Balance at December 31, 2006	$ -	$ -	$ -
Employee separation costs	-	2.4	2.4
Balance at December 31, 2007	$ -	$ 2.4	$ 2.4

Employee separation costs are primarily severance costs for identified staff reductions associated with the announced restructuring plans. Separation costs that are provided under terms of ongoing benefit arrangements are recorded based on the accumulated benefit earned by the employee. Separation costs that are provided under the terms of one-time benefit arrangements are generally measured based on the expected benefit as of the termination date and recorded ratably over the period to termination. Restructuring costs related to employee separations are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income.

Restructuring costs associated with the impairment of certain Bank assets, including software, leasehold improvements, and equipment, are discussed in Note 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8.

12. SUBSEQUENT EVENTS

In March 2008, the Board of Governors announced several initiatives to address liquidity pressures in funding markets and promote financial stability, including increasing the Term Auction Facility (see Note 3b) to $100 billion and initiating a series of term repurchase transactions (see Notes 3d and 4) that may cumulate to $100 billion. In addition, the Reserve Banks' securities lending program (see Notes 3d and 4) was expanded to lend up to $200 billion of Treasury securities to primary dealers for a term of 28 days, secured by federal agency debt, federal agency residential mortgage-backed securities, agency collateralized mortgage obligations, non-agency AAA/Aaa-rated private-label residential mortgage-backed securities, and AAA/Aaa-rated commercial mortgage-backed securities. The FOMC also authorized increases in its existing temporary reciprocal currency arrangements (see Notes 3e and 5) with specific foreign central banks. These initiatives will affect 2008 activity related to loans to depository institutions, securities purchased under agreements to resell, U.S. government securities, net, and investments denominated in foreign currencies, as well as income and expenses. The effects of the initiatives do not require adjustment to the amounts recorded as of December 31, 2007.

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2007 was Deloitte & Touche LLP (D&T). Fees for these services totaled $ 4.7 million. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2007, the Bank did not engage D&T for any material advisory services.

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