Federal Reserve Operations

Banking Supervision and Regulation

The Federal Reserve has supervisory and regulatory authority over a variety of financial institutions and activities. It plays an important role as umbrella supervisor of bank holding companies, including financial holding companies. And it is the primary federal supervisor of state banks that are members of the Federal Reserve System.

U.S. bank holding companies and state member banks continued to face substantial challenges in 2008, exacerbated by problems in funding and capital markets as well as the ongoing economic slowdown. Bank holding company asset quality and earnings continued their deterioration over the course of the year, in part due to ongoing problems linked to the residential housing market. The effects of the substantial challenges facing the banking industry were revealed in bank holding companies' reported net losses of $27 billion for the full year. Nonperforming assets increased notably as the quality of various types of assets declined, and overall loan delinquencies increased. As in 2007, several institutions recognized significant valuation write-downs on assets affected by market conditions. Liquidity and capital continued to be strained. Some institutions received federal government assistance in the form of capital injections via the Treasury's Troubled Asset Relief Program, and many others drew on Federal Reserve liquidity facilities to a considerable degree. While regulatory capital ratios suffered some erosion over 2008, bank holding companies in general continued to maintain ratios in excess of minimum regulatory requirements.

State member banks faced challenges similar to those faced by bank holding companies in 2008. As a group, they suffered net losses of $3.2 billion, reflecting asset write-downs and higher loan-loss provisions. Credit quality indicators worsened further during the year, with additional increases in nonperforming loans and delinquencies. Charge-off ratios reached their highest level in over a decade. Risk-based capital ratios increased somewhat over the year; at year-end more than 98 percent of all state member banks continued to report capital ratios consistent with a "well capitalized" designation under prompt corrective action standards. One state member bank, with assets of $237.5 million, failed.

During 2008, the Federal Reserve undertook a range of activities to identify and correct some of the risk-management weaknesses revealed by the financial crisis that began in mid-2007. These supervisory activities covered a number of areas, including firm-wide risk identification and senior management oversight. Liquidity risk management and capital adequacy were given special attention. Where institutions did not make appropriate progress, supervisors downgraded supervisory ratings and used enforcement tools to bring about corrective action. In addition, the Federal Reserve undertook a Systemwide effort to identify lessons learned for supervisors and to begin developing recommendations for potential improvements to supervisory practices. The objective of the lessons-learned process is to improve all aspects of the supervisory process, including oversight of individual institutions and promotion of overall financial stability. The lessons-learned process, which will continue into 2009, has drawn on staff from around the Federal Reserve System, including presidents and members of the boards of directors of the Reserve Banks.

In 2008, banking supervisors continued to focus on the adequacy of banks' credit-risk management practices and the important role banks play in credit intermediation. The Federal Reserve issued two statements emphasizing the critical role that banking organizations have in U.S. credit markets and encouraging those organizations to pursue responsible lending activities as they meet the credit needs of households and businesses. Also, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) jointly issued revisions to the *Guide to the Interagency Country Exposure Review Committee Process* to reflect improvements in regulated institutions' analyses of cross-border-exposure and country-risk management programs and the increased availability of information on country and transfer risk. In addition, the Federal Reserve, FDIC, OCC, Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA) jointly issued for comment proposed Interagency Appraisal and Evaluation Guidelines to reaffirm supervisory expectations for sound practices in appraising and evaluating real estate.

Federal Reserve staff continued to work with the other federal banking agencies to implement the advanced approaches of the Basel II Capital Accord in the United States, with the final rule taking effect on April 1, 2008.[1] Institutions may begin transitioning to the new rules after they adopt an implementation plan and have in place systems that comply with the final rule's qualification requirements. In January 2008, the agencies published final reporting requirements and reporting templates for institutions that will be adopting the Basel II advanced approaches. In light of identified supervisory lessons learned, the Federal Reserve plans to augment its processes for conducting examinations and inspections as needed, as well as its processes for ensuring that there is appropriate follow-up with institutions about issues identified during examinations and inspections.

Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies, including financial holding companies formed under the authority of the 1999 Gramm-Leach-Bliley Act, and state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve seeks primarily to promote their safe and sound operation, including their compliance with laws and regulations.

The Federal Reserve also has responsibility for supervising the operations of all Edge Act and agreement corporations, the international operations of

1. The Basel II Capital Accord, an international agreement formally titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," was developed by the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of 19 countries. The original document was issued in 2004; the original version and an updated version issued in November 2005 are available on the website of the Bank for International Settlements (www.bis.org).

state member banks and U.S. bank holding companies, and the U.S. operations of foreign banking organizations.

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system, and the structure of the system, through its administration of the Bank Holding Company Act, the Bank Merger Act (with regard to state member banks), the Change in Bank Control Act (with regard to bank holding companies and state member banks), and the International Banking Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with the other federal banking agencies, state agencies, functional regulators (that is, regulators for insurance, securities, and commodities firms), and the bank regulatory agencies of other nations.

Supervision for Safety and Soundness

To promote the safety and soundness of banking organizations, the Federal Reserve conducts on-site examinations and inspections and off-site surveillance and monitoring. It also takes enforcement and other supervisory actions as necessary.

Examinations and Inspections

The Federal Reserve conducts examinations of state member banks, the U.S. branches and agencies of foreign banks, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of bank holding companies and their nonbank subsidiaries. Whether an examination or an inspection is being conducted, the review of operations entails (1) an evaluation of the adequacy of governance provided by the board and senior management, including an assessment of internal policies, procedures, controls, and operations; (2) an assessment of the quality of the risk-management and internal control processes in place to identify, measure, monitor, and control risks; (3) an assessment of the key financial factors of capital, asset quality, earnings, and liquidity; and (4) a review for compliance with applicable laws and regulations. The table provides information on examinations and inspections conducted by the Federal Reserve during the past five years.

Inspections of bank holding companies, including financial holding companies, are built around a rating system introduced in 2005 that reflects the shift in supervisory practices away from a historical analysis of financial condition toward a more dynamic, forward looking assessment of risk-management practices and financial factors. Under the system, known as RFI but more fully termed RFI/C(D), holding companies are assigned a composite rating (C) that is based on assessments of three components: Risk Management (R), Financial Condition (F), and the potential Impact (I) of the parent company and its nondepository subsidiaries on the subsidiary depository institution.[2] The fourth component, Depository Institution (D), is intended to mirror the primary supervisor's rating of the subsidiary depository institution.

The Federal Reserve uses a risk-focused approach to supervision, with activities focused on identifying the areas of greatest risk to banking organi-

2. Each of the first two components has four subcomponents: Risk Management—Board and Senior Management Oversight; Policies, Procedures, and Limits; Risk Monitoring and Management Information Systems; and Internal Controls. Financial Condition—Capital; Asset Quality; Earnings; and Liquidity.

State Member Banks and Bank Holding Companies, 2004–2008

Entity/Item	2008	2007	2006	2005	2004
State member banks					
Total number	862	878	901	907	919
Total assets (billions of dollars)	1,854	1,519	1,405	1,318	1,275
Number of examinations	717	694	761	783	809
By Federal Reserve System	486	479	500	563	581
By state banking agency	231	215	261	220	228
Top-tier bank holding companies					
Large (assets of more than $1 billion)					
Total number	485	459	448	394	355
Total assets (billions of dollars)	14,138	13,281	12,179	10,261	8,429
Number of inspections	519	492	566	501	500
By Federal Reserve System[1]	500	476	557	496	491
On site	445	438	500	457	440
Off site	55	38	57	39	51
By state banking agency	19	16	9	5	9
Small (assets of $1 billion or less)					
Total number	4,545	4,611	4,654	4,760	4,796
Total assets (billions of dollars)	1,008	974	947	890	852
Number of inspections	3,192	3,186	3,449	3,420	3,703
By Federal Reserve System	3,048	3,007	3,257	3,233	3,526
On site	107	120	112	170	186
Off site	2,941	2,887	3,145	3,063	3,340
By state banking agency	144	179	192	187	177
Financial holding companies					
Domestic	557	597	599	591	600
Foreign	45	43	44	38	36

1. For large bank holding companies subject to continuous risk-focused supervision, includes multiple targeted reviews.

zations and assessing the ability of the organizations' management processes for identifying, measuring, monitoring, and controlling those risks. Key aspects of the risk-focused approach to consolidated supervision of large complex banking organizations (LCBOs) include (1) developing an understanding of each LCBO's legal and operating structure, and its primary strategies, business lines, and risk-management and internal control functions; (2) developing and executing a tailored supervisory plan outlining the work required to maintain a comprehensive understanding and assessment of each LCBO, incorporating reliance to the fullest extent possible on assessments and information developed by other relevant domestic and foreign supervisors and functional regulators; (3) maintaining continual supervision of these organizations—including through meetings with banking organization management and analysis of internal and external information—so that the Federal Reserve's understanding and assessment of each organization's condition remains current; (4) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the Federal Reserve System's central point of contact for the organization, has responsibility for only one LCBO, and is supported by specialists capable of evaluating the risks of LCBO business activities and functions and assessing the LCBO's consolidated financial condition); and (5) promoting Systemwide and interagency information-sharing through automated systems and other mechanisms (see box "Enhanced Guidance for the Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations).

For other banking organizations, the risk-focused consolidated supervision program provides that examination and inspection procedures are tailored to each banking organization's size, complexity, risk profile, and condition. As with the LCBOs, these supervisory programs entail both off-site and on-site work, including planning, pre-examination visits, detailed documentation, and examination reports tailored to the scope and findings of the examination.

State Member Banks

At the end of 2008, 862 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 15 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year, although certain well-capitalized, well-managed organizations having total assets of less than $500 million may be examined once every 18 months.[3] The Federal Reserve conducted 486 exams of state member banks in 2008.

Bank Holding Companies

At year-end 2008, a total of 5,757 U.S. bank holding companies were in operation, of which 5,030 were top-tier bank holding companies. These organizations controlled 5,893 insured commercial banks and held approximately 97 percent of all insured commercial bank assets in the United States.

Federal Reserve guidelines call for annual inspections of large bank holding companies and complex smaller companies. In judging the financial condition of the subsidiary banks owned by holding companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the supervisory burden on banking organizations. Noncomplex bank holding companies with consolidated assets of $1 billion or less are subject to a special supervisory program that permits a more flexible approach.[4] In 2008, the Federal Reserve conducted 500 inspections of large bank holding companies and 3,048 inspections of small, noncomplex bank holding companies.

3. The Financial Services Regulatory Relief Act of 2006, which became effective in October 2006, authorized the federal banking agencies to raise the threshold from $250 million to $500 million, and final rules incorporating the change into existing regulations were issued on September 21, 2007.

4. The special supervisory program was implemented in 1997 and modified in 2002. See SR letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex (www.federalreserve.gov/boarddocs/srletters/).

Enhanced Guidance for the Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations

> *This guidance should not only provide greater clarity regarding our long-standing responsibilities as a consolidated supervisor, but is also responsive to ongoing developments in the financial sector. The objectives of fostering financial stability and deterring or managing financial crises will be furthered by the Federal Reserve having a more complete view of firmwide risks and controls.*
>
> Randall S. Kroszner, *Member*, Board of Governors
> October 2008

The continuing growth and increased complexity of many banking organizations exposes these firms to a wide array of potential risks, and financial trouble in one part of an organization can spread rapidly to other parts of the organization. Moreover, because large banking organizations increasingly operate with multiple domestic and foreign banking and nonbanking entities, but operate and manage their businesses on an integrated basis, a single supervisor of a particular legal entity is unlikely to have a complete view of firmwide risks and controls.

In response to these trends, and to better fulfill both its supervisory responsibilities and its other central bank objectives such as fostering financial stability and deterring or managing financial crises, the Federal Reserve on October 16, 2008, issued guidance refining and clarifying its programs for the consolidated supervision of bank holding companies (including financial holding companies) and the combined U.S. operations of foreign banking organizations.[1]

The Federal Reserve has a longstanding responsibility for the consolidated supervision of U.S. bank holding companies (including financial holding companies). Consolidated supervision, which encompasses the parent holding company and its subsidiaries, enables the Federal Reserve to understand the organization's structure, activities, resources, and risks and to address any deficiencies before they pose a danger to the holding company's subsidiary depository institutions. In addition to its role as consolidated supervisor, the Federal Reserve is responsible for the overall supervision of the U.S. operations of foreign banking organizations. Fundamental to the effectiveness of the Federal Reserve as consolidated supervisor is coordination with, and reliance on, the work of other relevant domestic and foreign bank supervisors and functional regulators (that is, a federal or state regulator of a functionally regulated nondepository subsidiary of a bank holding company or foreign banking organization, such as the Securities and Exchange Commission).

While the effort to enhance and clarify the Federal Reserve's approach to consolidated supervision began well before the recent period of considerable strain in financial markets, the enhanced approach set forth in the guidance emphasizes several elements that should support a more resilient financial system. These include, among other things, greater focus on corporate governance, capital adequacy, funding and liquidity management, and the supervision of nonbank subsidiaries.

The guidance specifies principal areas of focus for consolidated supervision activities and provides for more-consistent Federal Reserve supervisory practices and assessments across institutions having similar activities and risks. It sets forth specific expectations for supervisors to use when assessing primary

1. See SR letter 08-9/CA letter 08-12, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations."

governance functions, risk controls, and business lines; nonbank operations; and other key activities and risks, with added emphasis on risk-management systems and internal controls used by bank holding companies and foreign banking organizations that provide core clearing and settlement services or have a significant presence in critical financial markets. In addition, the guidance discusses unique aspects of supervising the combined U.S. operations of foreign banking organizations.

For each bank holding company and foreign banking organization, the Federal Reserve (1) maintains an understanding of key elements of the organization's strategy, structure, business lines, framework for governance and internal control, presence in the financial markets, and primary sources of revenue and risk, and (2) assesses the effectiveness of the organization's risk-management systems and controls in accounting for the main risks inherent in the organization's activities, its financial condition, and the potential negative impact of nonbank operations on affiliated depository institutions. The Federal Reserve takes a systematic approach to developing these assessments, as reflected in the RFI (Risk management, Financial condition, and Impact) rating assigned to bank holding companies and the combined U.S. operations rating assigned to foreign banking organizations having multiple U.S. operations.

While the Federal Reserve's supervisory objectives are the same for all bank holding companies and foreign banking organizations, the amount and nature of the supervisory and examination work necessary to understand, supervise, and develop an assessment of an individual organization varies. Supervisory activities are tailored for each organization on the basis of a variety of factors, including the nature and degree of involvement by other supervisors and regulators; the risks posed by the organization's specific activities and systems; and the potential effect of weaknesses in control functions on the organization, its subsidiary depository institutions, or key financial markets. For example, additional supervisory activities may be conducted if there are gaps in information relating to significant risks or activities, indications of weaknesses in risk-management systems or internal controls, or indications of violations of consumer protection or other laws, or if a consolidated organization or subsidiary depository institution is in less-than-satisfactory condition.

An important aspect of the Federal Reserve's consolidated supervision programs for bank holding companies and foreign banking organizations is the assessment and evaluation of practices across groups of organizations having similar characteristics and risk profiles. This "portfolio approach" facilitates consistency of supervisory practices and assessments across comparable organizations and improves the Federal Reserve's ability to identify outlier organizations among established peer groups. Because the Federal Reserve's supervisory activities are tailored to specific institutions and portfolios, separate guidance documents were issued for different supervisory portfolios to promote appropriate and consistent supervision of organizations.

The nature and scope of the independent Federal Reserve supervisory work required to develop and maintain this understanding and assessment depends largely on the extent to which the Federal Reserve can draw on information or assessments from other bank supervisors or functional regulators. Understanding and assessing some areas—such as the risk management and financial condition of significant nonbank subsidiaries that are not functionally regulated—will, by their nature, typically require more independent Federal Reserve supervisory work. Understanding and assessing other areas—such as firmwide risk-management and control functions—typically will require a greater degree of coordination with other bank supervisors or functional regulators.

Financial Holding Companies

Under the Gramm-Leach-Bliley Act, bank holding companies that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in a wider range of financial activities, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales. The statute streamlines the Federal Reserve's supervision of all bank holding companies, including financial holding companies, and sets forth parameters for the supervisory relationship between the Federal Reserve and other regulators. The statute also differentiates between the Federal Reserve's relations with regulators of depository institutions and its relations with functional regulators.

As of year-end 2008, 557 domestic bank holding companies and 45 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 33 had consolidated assets of $15 billion or more; 128, between $1 billion and $15 billion; 87, between $500 million and $1 billion; and 309, less than $500 million.

International Activities

The Federal Reserve supervises the foreign branches and overseas investments of member banks, Edge Act and agreement corporations, and bank holding companies and also the investments by bank holding companies in export trading companies. In addition, it supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

Foreign Operations of U.S. Banking Organizations

In supervising the international operations of state member banks, Edge Act and agreement corporations, and bank holding companies, the Federal Reserve generally conducts its examinations or inspections at the U.S. head offices of these organizations, where the ultimate responsibility for the foreign offices lies. Examiners also visit the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate the organizations' efforts to implement corrective measures or to test their adherence to safe and sound banking practices. Examinations abroad are conducted with the cooperation of the supervisory authorities of the countries in which they take place; for national banks, the examinations are coordinated with the OCC.

At the end of 2008, 53 member banks were operating 545 branches in foreign countries and overseas areas of the United States; 32 national banks were operating 495 of these branches, and 21 state member banks were operating the remaining 50. In addition, 20 nonmember banks were operating 26 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international business, especially exports. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into an agreement with the Board to refrain from exercising any power that is not permissible for an Edge Act corporation.

Sections 25 and 25A of the Federal Reserve Act grant Edge Act and agreement corporations permission to engage in international banking and foreign financial transactions. These corporations, most of which are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions, and (2) make foreign investments that are broader than those permissible for member banks.

At year-end 2008, 60 banking organizations, operating 11 branches, were chartered as Edge Act or agreement corporations. These corporations are examined annually.

U.S. Activities of Foreign Banks

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, commercial banks, bank holding companies, and certain nonbanking companies. Foreign banks continue to be significant participants in the U.S. banking system.

As of year-end 2008, 175 foreign banks from 53 countries were operating 208 state-licensed branches and agencies, of which 6 were insured by the FDIC, and 45 OCC-licensed branches and agencies, of which 4 were insured by the FDIC. These foreign banks also owned 12 Edge Act and agreement corporations and 2 commercial lending companies; in addition, they held a controlling interest in 61 U.S. commercial banks. Altogether, the U.S. offices of these foreign banks at the end of 2008 controlled approximately 18 percent of U.S. commercial banking assets. These 175 foreign banks also operated 95 representative offices; an additional 54 foreign banks operated in the United States through a representative office.

State-licensed and federally licensed branches and agencies of foreign banks are examined on-site at least once every 18 months, either by the Federal Reserve or by a state or other federal regulator. In most cases, on-site examinations are conducted at least once every 12 months, but the period may be extended to 18 months if the branch or agency meets certain criteria.

In cooperation with the other federal and state banking agencies, the Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations. The program has two main parts. One part involves examination of those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 487 examinations in 2008.

Compliance with Regulatory Requirements

The Federal Reserve examines supervised institutions for compliance with a broad range of legal requirements, including anti-money-laundering and consumer protection laws and regulations, and other laws pertaining to certain banking and financial activities. Most compliance supervision is conducted under the oversight of the Board's Division of Banking Supervision and Regulation, but consumer compliance supervision is conducted under the oversight of the Division of Community and Consumer Affairs. The two divisions coordinate their efforts with each other and also with the Board's Legal Division to ensure consistent and comprehensive Federal Reserve supervision for compliance with legal requirements.

Anti-Money-Laundering Examinations

U.S. Department of the Treasury regulations implementing the Bank Secrecy Act (BSA) generally require banks and other types of financial institutions to file certain reports and maintain certain records that are useful in criminal or regulatory proceedings. The BSA and separate Board regulations require banking organizations supervised by the Board to file reports on suspicious activity related to possible violations of federal law, including money laundering, terrorism financing, and other financial crimes. In addition, BSA and Board regulations require that banks develop written BSA compliance programs and that the programs be formally approved by bank boards of directors. The Federal Reserve is responsible for examining its supervised institutions for compliance with applicable anti-money-laundering laws and regulations and conducts such examinations in accordance with the Federal Financial Institutions Examination Council (FFIEC) *Bank Secrecy Act/ Anti–Money Laundering Examination Manual.*[5]

Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology, fiduciary activities, transfer agent activities, and government and municipal securities dealing and brokering. The Federal Reserve also conducts specialized examinations of certain entities, other than banks, brokers, or dealers, that extend credit subject to the Board's margin regulations.

Information Technology Activities

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised banking organizations as well as certain independent data centers that provide information technology services to these organizations. All safety and soundness examinations include a risk-focused review of information technology risk-management activities. During 2008, the Federal Reserve continued as the lead agency in two interagency examinations of large, multiregional data processing servicers and assumed leadership in two additional such examinations.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for state member commercial banks and depository trust companies that together reported, at the end

5. The FFIEC is an interagency body of financial regulatory agencies established to prescribe uniform principles, standards, and report forms and to promote uniformity in the supervision of financial institutions. The Council has six voting members: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the chair of the State Liaison Committee.

of 2008, $39 trillion of assets in various fiduciary or custodial capacities. Additionally, state member nondepository trust companies supervised by the Federal Reserve reported $28 trillion of assets held in a fiduciary or custodial capacity. During on-site examinations of fiduciary activities, an organization's compliance with laws, regulations, and general fiduciary principles and its potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2008, Federal Reserve examiners conducted 116 on-site fiduciary examinations.

Transfer Agents

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of an organization's operations and its compliance with relevant securities regulations. During 2008, the Federal Reserve conducted on-site examinations at 14 of the 62 state member banks and bank holding companies that were registered as transfer agents.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Treasury regulations governing dealing and brokering in government securities. Twelve state member banks and 5 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2008, the Federal Reserve conducted 2 examinations of broker-dealer activities in government securities at these organizations. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring that state member banks and bank holding companies that act as municipal securities dealers comply with the Securities Act Amendments of 1975. Municipal securities dealers are examined pursuant to the Municipal Securities Rulemaking Board's rule G-16 at least once every two calendar years. Of the 12 entities that dealt in municipal securities during 2008, 5 were examined during the year.

Securities Credit Lenders

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. As part of its general examination program, the Federal Reserve examines the banks under its jurisdiction for compliance with the Board's Regulation U (Credit by Banks and Persons other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock). In addition, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to Regulation U. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration (FCA) or the NCUA.

At the end of 2008, 580 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 191 of these lenders, and the remaining 389 were subject to limited Federal Reserve supervision. The Federal Reserve exempted 180 lenders from its on-site inspection program on the basis of their regulatory status and annual reports. Nonexempt lenders are subject to either biennial or triennial inspection. Sixty-four inspections were conducted during the year.

Business Continuity

In 2008, the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions. The Federal Reserve, together with other federal and state financial regulators, are members of the Financial Banking Information Infrastructure Committee (FBIIC), which was formed to improve coordination and communication among financial regulators, enhance the resilience of the U.S. financial sector, and promote the public/private partnership. The FBIIC has established emergency communication protocols to maintain effective communication among members in the event of an emergency. The FBIIC protocols were activated in 2008 at the time of the flooding in the Midwest, each time a significant hurricane made landfall in the United States, and at the time of the white powder HazMat incident.[6]

6. In October 2008, the FBI, U.S. Postal Inspectors, and state and local authorities began investigating more than 30 threatening letters that were received at financial institutions in New York, New Jersey, Washington, D.C., Ohio, Illinois, Colorado, Oklahoma, Georgia, California, and Texas. Most of the letters contained a powder substance with a threatening communication.

The Federal Reserve and the other FFIEC agencies continued in 2008 to coordinate their efforts to ensure a consistent supervisory approach in the area of business continuity practices. In March, the agencies published an update to the FFIEC *Business Continuity Planning Booklet*, which provides guidance to both examiners and the industry. The revised booklet expands discussions of business impact analysis and testing; discusses lessons learned in recent years, for example, lessons from Hurricanes Katrina and Rita; and provides a framework for financial institutions to develop or update their pandemic plans to address the unique business continuity challenges associated with a pandemic influenza outbreak. The booklet also stresses the responsibilities of each institution's board and management to address business continuity planning with an enterprise-wide perspective by considering technology, business operations, communications, and testing strategies for the entire institution.

Enforcement Actions

The Federal Reserve has enforcement authority over the banking organizations it supervises and their affiliated parties. Enforcement actions may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. In 2008, the Federal Reserve completed 54 formal enforcement actions. Civil money penalties totaling $32,790 were assessed, and an order of restitution totaling $203,923 was issued. As directed by statute, all civil money penalties are remitted to either the Treasury or the Federal Emergency Management

Agency. Enforcement orders, which are issued by the Board, and written agreements, which are executed by the Reserve Banks, are made public and are posted on the Board's website (www.federalreserve.gov/boarddocs/enforcement/).

In addition to taking these formal enforcement actions, the Reserve Banks completed 216 informal enforcement actions in 2008. Informal enforcement actions include memoranda of understanding and board of directors resolutions. Information about these actions is not available to the public.

Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. Such monitoring and analysis helps direct examination resources to institutions that have higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

The primary off-site monitoring tool used by the Federal Reserve is the Supervision and Regulation Statistical Assessment of Bank Risk model (SR-SABR). Drawing mainly on the financial data that banks report on their Reports of Condition and Income (Call Reports), SR-SABR uses econometric techniques to identify banks that report financial characteristics weaker than those of other banks assigned similar supervisory ratings. To supplement the SR-SABR screening, the Federal Reserve also monitors various market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations. In addition, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised banking organizations. The BHCPRs, which are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP), contain, for individual companies, financial statistics and comparisons with peer companies. BHCPRs are made available to the public on the National Information Center (NIC) website, which can be accessed at www.ffiec.gov.

During 2008, four major upgrades to the web-based Performance Report Information and Surveillance Monitoring (PRISM) application were completed. PRISM is a querying tool used by Federal Reserve analysts to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial information drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, BHCPRs, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of surveillance screening for banks and bank holding companies. The upgrades made more regulatory data available for querying, gave users the ability to display more data on commercial real estate concentration ratios, and provided a way to access SEC Focus Report (Part II) data.

The Federal Reserve works through the FFIEC Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.

International Training and Technical Assistance

In 2008, the Federal Reserve continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by Federal Reserve staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2008 was concentrated in Latin America, Asia, and former Soviet bloc countries. The Federal Reserve, along with the OCC, the FDIC, and the Treasury, was also an active participant in the Middle East and North Africa (MENA) Financial Regulators' Training Initiative, which is part of the U.S. government's Middle East Partnership Initiative. The Federal Reserve also contributes to the regional training provision under the Asia Pacific Economic Cooperation (APEC) Financial Regulators' Training Initiative.

During the year, the Federal Reserve offered a number of training courses exclusively for foreign supervisory authorities, both in the United States and in a number of foreign jurisdictions. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Asian Development Bank, the Basel Committee on Banking Supervision (Basel Committee), and the Financial Stability Institute.

The Federal Reserve is also an associate member of the Association of Supervisors of Banks of the Americas (ASBA), an umbrella group of bank supervisors from countries in the Western Hemisphere. The group, headquartered in Mexico, promotes communication and cooperation among bank supervisors in the region; coordinates training programs throughout the region, with the help of national banking supervisors and international agencies; and aims to help members develop banking laws, regulations, and supervisory practices that conform to international best practices. The Federal Reserve contributes significantly to ASBA's organizational management and to its training and technical assistance activities.

Initiatives for Minority-Owned and De Novo Depository Institutions

The Federal Reserve is committed to fostering the strength and vitality of the nation's minority and de novo depository institutions. In furtherance of this objective, during 2008 the Federal Reserve launched Partnership for Progress, a training and technical assistance program designed specifically for these institutions. The program seeks to help these institutions compete effectively in today's marketplace by offering them a combination of one-on-one guidance and targeted workshops on topics of particular relevance to starting and growing a bank in a safe and sound manner. In addition, training and information on resources are provided via an extensive web-based program center (www.fedpartnership.gov). Designated Partnership for Progress contacts in each of the twelve Reserve Bank Districts and at the Board answer questions and coordinate assistance for institutions requesting guidance. These contacts also host regional conferences and conduct other outreach activities within their Districts in support of minority and de novo institutions. The Reserve Banks hosted 14 such regional training sessions and conferences during the year.

The Federal Reserve has coordinated its efforts with those of the other agencies through participation in an annual interagency conference for minority depository institutions. For the federal bank regulatory agencies, the conference provides an opportunity to meet with senior managers from minority-owned institutions and gain a better understanding of the institutions' unique challenges and opportunities. In addition, the agencies offer training classes and breakout sessions on emerging banking issues.

Supervisory Policy

Capital Adequacy Standards

Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

During the year, the Federal Reserve, OCC, FDIC, and OTS issued a final rule, effective April 1, 2008, implementing the advanced approaches of Basel II. The advanced approaches framework is broadly consistent with the advanced approaches of the Basel II Capital Accord. It also includes a number of prudential safeguards—such as the requirement that banking organizations satisfactorily complete a four-quarter parallel run before operating under the advanced approaches framework—and transitional capital floors that limit maximum cumulative reductions of a banking organization's risk-based capital requirements over three transitional periods. It retains the long-standing minimum risk-based capital requirement of 4 percent tier 1 capital and 8 percent total qualifying capital relative to risk-weighted assets.[7] Banking organizations subject to the framework are required to meet certain public disclosure requirements designed to foster transparency and market discipline.

Institutions may begin transitioning to the new advanced approaches after they adopt an implementation plan and have in place systems that comply with the rule's qualification requirements. Final reporting requirements and reporting templates for institutions that will be adopting the Basel II advanced approaches were also published in 2008. In June, the agencies issued a notice of proposed rulemaking to adopt the standardized approaches of the Basel II Capital Accord. The agencies are currently reviewing and considering the comments received. In addition, in July the U.S. banking agencies issued supervisory guidance relating to an aspect of the Basel II framework, known as Pillar 2, that requires banks to have a robust internal capital adequacy assessment process (ICAAP) that prescribes capital levels commensurate with their full risk profiles—levels above those prescribed by minimum regulatory measures.

The recent market turmoil has highlighted areas in which the Basel II Capital Accord must be strengthened, and efforts are under way to address those areas. Among the changes under consideration are higher capital requirements for re-securitizations, such as collateralized debt obligations backed by asset-backed securities. The capital treatment of liquidity facilities that support asset-backed commercial paper conduits is also under review. In addition, the current market risk capital framework for trading activities is being reexamined to better reflect potential exposures arising from the complex, less-liquid credit products that institutions hold in their trading portfolios. These changes, which are being devel-

7. Tier 1 capital comprises common stockholders' equity and qualifying forms of preferred stock, less required deductions such as goodwill and certain intangible assets.

oped by the Basel Committee, will be considered for implementation in the United States through the agencies' notice and comment process.

Also during the year, the federal banking and thrift regulatory agencies issued a final rule that permits a banking organization to reduce the amount of goodwill it must deduct from tier 1 capital by any associated deferred tax liability. Under the rule, the regulatory capital deduction for goodwill is equal to the maximum capital reduction that could occur as a result of a complete write-off of the goodwill under generally accepted accounting principles (GAAP).

In response to the recent market turmoil, the Federal Reserve, in some instances together with the other banking agencies, issued several rulemakings and guidance.

- The agencies issued an interagency statement allowing banking organizations to recognize the effect of the tax change enacted in the Economic Emergency Stabilization Act of 2008 in their third quarter 2008 regulatory capital calculations. The change provided relief to banking organizations in recognizing their losses on certain holdings of Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) preferred stock by changing the character of the losses from capital to ordinary for federal income tax purposes.

- The agencies published a Notice of Proposed Rulemaking that proposed amending the agencies' risk-based capital rules to change the risk weight on Fannie Mae and Freddie Mac debt and guaranteed securities from 20 percent to 10 percent.

- The Board approved an interim final rule to provide state member banks and bank holding companies participating in the Board's newly established Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility with an exemption from the Board's leverage and risk-based capital guidelines for asset-backed commercial paper held as a result of participation in the facility. The exemption is subject to safety and soundness conditions.

- The Board approved an interim final rule to allow bank holding companies to include in their tier 1 capital, without restriction, the senior perpetual preferred stock issued to the Department of the Treasury under its newly established Capital Purchase Program.

Other Capital Issues

In 2008, Board staff conducted supervisory analyses of innovative capital instruments and novel transactions to determine whether the instruments qualify for inclusion in regulatory capital. Much of the work involved evaluating enhanced forms of trust preferred securities, mandatory convertible securities, perpetual preferred stock, and convertible perpetual preferred stock (mandatory and optionally convertible). Also, later in 2008 significant staff effort was devoted to working with Treasury staff to develop the Capital Purchase Program as part of the Troubled Asset Restructuring Program.

Staff members also identified and addressed supervisory concerns related to banking organizations' capital issuances and worked with the Reserve Banks to evaluate the overall composition of banking organizations' capital. As part of this process, the staff often must review the funding strategies proposed in applications for acquisitions and other transactions submitted to the Federal Reserve by banking organizations.

Other Policy Issues

Equity Investments in Banks and Bank Holding Companies

Also in 2008, the Board approved a policy statement that explains some of the most significant factors and principles considered when determining whether minority equity investments in a banking organization are "controlling" for purposes of the BHC Act. In assessing whether a minority equity investor has a controlling influence over the management or policies of the banking organization, all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization will be considered, as well as the percentage of total equity owned.

Accounting Policy

The Federal Reserve strongly endorses sound corporate governance and effective accounting and auditing practices for all regulated financial institutions. Accordingly, the supervisory policy function is responsible for monitoring major domestic and international proposals, standards, and other developments affecting the banking industry in the areas of accounting, auditing, internal controls over financial reporting, financial disclosure, and supervisory financial reporting.

Federal Reserve staff members interact with key constituents in the accounting and auditing professions, including standard-setters, accounting firms, other financial sector regulators, accounting and banking industry trade groups, and the banking industry. These efforts help in understanding current practice and proposed standards and in formulating appropriate policy responses based on the potential impact of changes in standards or guidance, or other events, on financial institutions. As a consequence, Federal Reserve staff routinely provide informal input to standard-setters, as well as formal input through public comment letters on proposals, to ensure appropriate and transparent financial statement reporting. Supervisory guidance is also issued to financial institutions and supervisory staff by the Federal Reserve as appropriate. In addition, Federal Reserve policy staff support the efforts of the System and Reserve Banks in financial institution supervisory activities related to financial accounting, auditing, reporting, and disclosure.

Domestic Accounting

During 2008, economic conditions resulted in accounting and reporting challenges for financial institutions. Addressing these challenges was a priority for Federal Reserve staff members. Significant issues arising from stressed market conditions included accounting for financial instruments at fair value, accounting for impairment in securities and other financial instruments, and analyzing proposals for modifying accounting for off-balance-sheet structures. Staff members participated in a number of discussions with accounting and auditing standard-setters and provided commentary on a number of proposals relevant to the banking industry. For example, they provided comment letters to the Financial Accounting Standards Board (FASB) on proposals related to accounting for transfers of financial assets, reducing complexity in reporting financial instruments, accounting for hedging activities, and impairment of certain beneficial interests.

Federal Reserve staff also participated in FASB and Securities and Exchange Commission (SEC) efforts to improve financial reporting and to consider accounting issues that have arisen during the global crisis, such as public roundtable discussions. A senior Federal Reserve representative was an official observer on the SEC Advisory Committee on Improvements to Financial Reporting, which was established to examine the U.S. financial reporting system with the goals of reducing unnecessary complexity and making information more useful and understandable for investors. In this role, senior staff participated in efforts that led to the issuance of the *Final Report of the Advisory Committee on Improvements to Financial Reporting* provided to the SEC in August 2008. In addition, the SEC consulted with Federal Reserve staff, as required under section 133 of the Emergency Economic Stabilization Act, when preparing its *Report on Mark-to-Market Accounting.*

Compliance Risk Management

Bank Secrecy Act and Anti-Money-Laundering Compliance

In 2008, the Federal Reserve provided training for staff on risk-focusing and the use of the FFIEC minimum Bank Secrecy Act/Anti–Money Laundering (BSA/AML) examination procedures in conjunction with broader efforts to increase consistency and address industry concerns about regulatory burden. The Federal Reserve participates in the FFIEC BSA/AML working group, which is a forum for the discussion of all pending BSA policy and regulatory matters, as well as the Treasury-led Bank Secrecy Act Advisory Group, which includes representatives of regulatory agencies, law enforcement, and the financial services industry and covers all aspects of the BSA.

The Federal Reserve and other federal banking agencies continued during 2008 to regularly share examination findings and enforcement proceedings with the Financial Crimes Enforcement Network (FinCEN) under the interagency memorandum of understanding (MOU) that was finalized in 2004, and with the Treasury's Office of Foreign Assets Control (OFAC) under the interagency MOU that was finalized in 2006.

International Coordination on Sanctions, Anti–Money Laundering, and Counter-Terrorism Financing

The Federal Reserve participates in a number of international coordination initiatives related to sanctions, money laundering, and terrorism financing. For example, the Federal Reserve has a long-standing role in the U.S. delegation to the intergovernmental Financial Action Task Force and its working groups, contributing a banking supervisory perspective to formulation of international standards on these matters.

The Federal Reserve also continues to contribute to international efforts to promote transparency and address risks faced by financial institutions involved in international funds transfers. The Federal Reserve participates in a subcommittee of the Basel Committee that focuses on AML/counter-terrorism financing issues. In 2008, the Basel Committee released for public comment a consultative document titled *Due Diligence and Transparency regarding Cover Payment Messages Related to Cross-Border Wire Transfers* and assisted in the review of comments in preparation for finalizing the paper.

Corporate Compliance

In October 2008, the Federal Reserve issued guidance clarifying supervisory expectations with respect to compliance risk management. The guidance endorses principles applicable to all banking organizations set forth by the Basel Committee in its April 2005 paper titled *Compliance and the Compliance Function in Banks.* It also clarifies the Federal Reserve's supervisory views relating to firmwide compliance-risk management programs and oversight at large banking organizations having complex compliance profiles.

International Guidance on Supervisory Policies

As a member of the Basel Committee, the Federal Reserve participates in efforts to advance sound supervisory policies for internationally active banking organizations and to improve the stability of the international banking system. In 2008, the Federal Reserve participated in ongoing cooperative work on strategic responses to the financial markets crisis, initiatives to enhance Basel II, implementation of Basel II, and development of international supervisory risk-management guidance, particularly in the areas of funding liquidity risk management, counterparty credit risk, and stress-testing practices.

Risk Management

The Federal Reserve contributed to supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2008 that were generally aimed at improving the supervision of banking organizations' risk-management practices.[8] Three of these were

- *Principles for Sound Liquidity Risk Management and Supervision,* published in September
- *Proposed Revisions to the Basel II Market Risk Framework and Guidelines for Computing Capital for Incremental Risk in the Trading Book,* published in July
- *Liquidity Risk: Management and Supervisory Challenges,* published in February

Joint Forum

In 2008, the Federal Reserve continued to participate in the Joint Forum—a group established under the aegis of the Basel Committee to address issues related to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is made up of representatives of the Basel Committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Federal Reserve contributed to the development of supervisory policy papers, reports, and recommendations issued by the Joint Forum during 2008.[9] The Federal Reserve also participated in Joint Forum–sponsored information-sharing on pandemic planning and other business continuity initiatives. In 2008, work of the Joint Forum published by the Basel Committee included

8. Papers issued by the Basel Committee can be accessed via the Bank for International Settlements website (www.bis.org).

9. Papers issued by the Joint Forum can be accessed via the Bank for International Settlements website (www.bis.org).

- *Credit Risk Transfer Developments* from 2005 to 2007, published in July
- *Cross-Sectoral Review of Group-wide Identification and Management of Risk Concentrations,* published in April
- *Customer Suitability in the Retail Sale of Financial Products and Services,* published in April

International Accounting

The Federal Reserve participates in the Basel Committee's Accounting Task Force (ATF), which represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. During 2008, Federal Reserve staff participated in activities arising from global market conditions and in support of efforts related to financial stability. In particular, staff members contributed to the development of numerous Basel Committee comment letters related to accounting and auditing matters that were submitted to the International Accounting Standards Board and the International Auditing and Assurance Standards Board (IAASB).

The Basel Committee in November 2008 issued for public comment a consultative paper titled *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices.* The paper describes supervisory expectations regarding bank practices and the supervisory assessment of valuation practices. It evolved from work related to the development of the paper *Fair Value Measurement and Modeling: An Assessment of Challenges and Lessons Learned from the Market Stress,* which was issued in June 2008. The two papers were prepared as a result of initial findings and lessons learned from the current financial crisis and were incorporated in *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,* issued in April.

Credit Risk Management

The Federal Reserve works with the other federal banking agencies to develop guidance on the management of credit risk, to coordinate the assessment of regulated institutions' credit risk, and to ensure that institutions properly identify, measure, and manage credit risk.

Working with Mortgage Borrowers

The ongoing financial and economic stress has highlighted the crucial role that prudent bank lending practices play in promoting the nation's economic welfare. In 2008, the Federal Reserve issued two statements to emphasize the important role of banking organizations in U.S. credit markets and to encourage these organizations to pursue responsible lending activities as they meet the credit needs of American households and businesses. In March, the Federal Reserve issued a statement emphasizing the need for regulated institutions to be transparent in their residential mortgage modification activities and to support industry efforts to improve the collection of data on the type and volume of mortgage modifications. In November, the Federal Reserve, FDIC, OCC, and OTS issued a statement emphasizing the need for banking organizations and their regulators to work together in meeting the credit needs of consumers and businesses. In this statement, the agencies encouraged banking organizations to pursue economically viable and appropriate lending opportunities and stressed the importance of prudent lending practices, a strong capital position, prudent dividend policies, and appropriate employee compensation practices.

Shared National Credit Program

In October, the Federal Reserve, FDIC, OCC, and OTS released summary results of the 2008 annual review of the Shared National Credit Program. The agencies established the program in 1977 to promote an efficient and consistent review and classification of shared national credits. A shared national credit (SNC) is any loan or formal loan commitment—and any asset, such as other real estate, stocks, notes, bonds, and debentures taken as debts previously contracted—extended to borrowers by a supervised institution, its subsidiaries and affiliates. A SNC must have an original loan amount that aggregates to $20 million or more and either (1) is shared by three or more unaffiliated supervised institutions under a formal lending agreement or (2) a portion of which is sold to two or more unaffiliated supervised institutions, with the purchasing institutions assuming their pro rata share of the credit risk.

The 2008 SNC review was based on analyses of credit data as of December 31, 2007, provided by federally supervised institutions. The 2008 review found that the volume of shared national credits rose 22.6 percent over the 2007 review, to $2.8 trillion. The record growth in credit volume was concentrated in large syndicated loans underwritten in late 2006 and the first half of 2007, led by the media and telecom, utilities, finance and insurance, and oil and gas sectors. "Criticized" credits rose $259.3 billion, to $373.4 billion, accounting for 13.4 percent of the SNC portfolio compared with 5.0 percent in the 2007 review. Within the "criticized" category, "special mention" (potentially weak) credits increased $167.9 billion, accounting for 7.5 percent of the SNC portfolio compared with 1.9 percent in the 2007 review, and "classified" credits (credits having well-defined weaknesses) increased $91.5 billion, accounting for 5.8 percent of the SNC portfolio compared with 3.1 percent in the 2007 review. The criticized credits and related ratios do not include the effects of hedging or other techniques that organizations often use to mitigate risk.

The 2008 SNC review also included a supervisory assessment of underwriting standards. Examiners found an inordinate volume of syndicated loans having structurally weak underwriting characteristics, particularly in non-investment-grade or leveraged transactions. The most commonly cited weaknesses were liberal repayment terms, repayment dependent on refinancing or recapitalization, and nonexistent or weak loan covenants. Examiners also found that an excessive number of loan agreements did not provide adequate warnings or allow for proactive control over the credit.

Revisions to the Guide to the Interagency Country Exposure Review Committee Process

In November, the Federal Reserve, FDIC, and OCC jointly issued revisions to the *Guide to the Interagency Country Exposure Review Committee (ICERC) Process* to reflect improvements in regulated institutions' cross-border exposure analyses and country risk management programs, as well as increased availability of information on country and transfer risk (see SR letter 08-12). The agencies will now assign an ICERC rating to only those countries in default and, accordingly, have eliminated the rating categories Other Transfer Risk Problems (OTRP), Weak, Moderately Strong, and Strong. They will continue to closely monitor regulated institutions' cross-border exposures. The revised guide sets forth supervisory expectations for an institution's country risk assessment process and rating systems. It also emphasizes that an institution is expected to have appropriate limits on exposure to each sovereign entity, to perform financial analyses of its exposures, and to apply robust risk management to all country exposures, not just to the countries rated by the agencies.

Proposed Interagency Appraisal and Evaluation Guidelines

In November, the Federal Reserve, FDIC, NCUA, OCC, and OTS jointly issued for comment proposed Interagency Appraisal and Evaluation Guidelines to reaffirm supervisory expectations for sound real estate appraisal and evaluation practices. The proposed guidance would replace the 1994 Interagency Appraisal and Evaluation Guidelines to reflect changes in industry practice, uniform appraisal standards, and technology. It incorporates supervisory guidance issued by the agencies since 1994 and clarifies their expectations for a regulated institution's risk-management principles and internal controls for its real estate collateral valuation function. The proposed guidance also includes a discussion of the use of automated valuation models in the development of an evaluation of real estate collateral for real estate transactions below the appraisal threshold set forth in the agencies' appraisal regulation. The comment period for the proposal closed on January 20, 2009.

Pandemic Planning

In January, the FBIIC and the Financial Services Sector Coordinating Council (FSSCC), an organization made up of financial services trade associations and individual firms, published an after-action report on a pandemic flu exercise held in September and October 2007 for the financial services sector in the United States. A total of 2,775 organizations participated in the exercise, of which approximately 62 percent were banks, thrifts, and credit unions. The exercise revealed several key themes that are important to pandemic planning: communications plans, infrastructure-dependency plans, cross-trained employees, telecommuting, human resources issues, and plans for a second wave of the pandemic.

Throughout 2008, the Federal Reserve and the other FFIEC agencies were engaged in several projects designed to help the agencies prepare for a pandemic event. The agencies sponsored a Roundtable on Pandemic Planning attended by approximately 170 industry representatives, including some international participants. The FFIEC's *Business Continuity Planning Booklet* was updated in March to include guidance on identifying the continuity planning that should be in place to minimize adverse effects of a pandemic event. The agencies also discussed with industry representatives the potential industry need for regulatory relief in the event of a pandemic. A meeting of FFIEC members and industry trade group representatives focusing on emergency preparedness, response, and recovery was held in March, and a second meeting was held in September.

In January, the Federal Reserve Bank of New York began a series of reviews to assess the progress made by the top 15 banking organizations in the country with respect to pandemic preparedness. A white paper was published that highlights the practices of firms as well as conclusions and themes as they relate to the current state of pandemic preparedness planning at systemic banking organizations.[10]

Banks' Securities Activities

In August, the Federal Reserve released the *Small Entity Compliance Guide for Regulation R.* Regulation R, adopted jointly by the Board and the Securities and Exchange Commission in September 2007, implemented certain key exceptions for banks from the definition of the term "broker" under section 3(a)(4) of the Securities Exchange Act of 1934, as amended by the Gramm-Leach-Bliley Act. The guide provides a general description of the regulation and contact information for small entities having questions regarding compliance.

Regulatory Reports

The Federal Reserve's supervisory policy function is responsible for developing, coordinating, and implementing regulatory reporting requirements for various financial reporting forms filed by domestic and foreign financial institutions subject to Federal Reserve supervision. Federal Reserve staff members interact with relevant federal and state supervisors, including foreign bank supervisors as needed, to recommend and implement appropriate and timely revisions to the reporting forms and the attendant instructions.

10. The population under review included core clearing and settlement organizations and firms that play a critical role in financial markets and are subject to resiliency guidelines issued in April 2003, also called the "Sound Practices Paper."

Bank Holding Company Regulatory Reports

The Federal Reserve requires that U.S. bank holding companies periodically submit reports providing financial and structure information. The information is essential in supervising the companies and in formulating regulations and supervisory policies. It is also used in responding to requests from Congress and the public for information about bank holding companies and their nonbank subsidiaries. Foreign banking organizations also are required to periodically submit reports to the Federal Reserve.

Reports in the FR Y-9 series—FR Y-9C, FR Y-9LP, and FR Y-9SP—provide standardized financial statements for bank holding companies on both a consolidated and a parent-only basis. The reports are used to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze a holding company's overall financial condition. Nonbank subsidiary reports—FR Y-11, FR 2314, and FR Y-7N—help the Federal Reserve determine the condition of bank holding companies that are engaged in nonbank activities and also aid in monitoring the number, nature, and condition of the companies' nonbank subsidiaries. The FR Y-8 report provides information on transactions between an insured depository institution and its affiliates that are subject to section 23A of the Federal Reserve Act; it is used to monitor bank exposures to affiliates and to ensure banks' compliance with section 23A of the Federal Reserve Act. The FR Y-10 report provides data on changes in organization structure at domestic and foreign banking organizations (FBOs). The FR Y-6 and FR Y-7 reports gather additional information on organization structure and shareholders from domestic banking organizations and FBOs, respectively; the information is used to monitor structure so as to determine compliance with provisions of the Bank Holding Company Act and Regulation Y and to assess the ability of an FBO to continue as a source of strength to its U.S. operations.

In February, a number of revisions to the FR Y-9C report were approved for implementation during 2008: (1) reporting of interest and fee income on one- to four-family residential mortgages and all other real estate loans separately from income on all other loans; (2) reporting of the quarterly average for one- to four-family residential mortgages and all other real estate loans separately from the quarterly average for all other loans; (3) addition of data items for restructured troubled mortgages and mortgage loans in the process of foreclosure; (4) expansion of the schedule for closed-end one- to four-family residential mortgage banking activity to include originations, purchases, and sales of open-end mortgages as well as closed-end and open-end mortgage loan repurchases and indemnifications during the quarter; (5) modification of the definition of "trading account" and collection of additional information about instruments accounted for under the fair value option on the loan schedule and the fair value measurements schedule; (6) revision of the schedule on trading assets and liabilities; (7) clarification of the instructions for reporting credit derivative data in the risk-based capital schedule, and corresponding change to the report; (8) modification of the threshold for reporting sub-categories of other non-interest income and expense in the income statement; and (9) revision of the instructions for reporting fully insured brokered deposits in the deposit liabilities schedule to conform to the instructions for reporting time deposits in the schedule.

Effective March 2008, the requirement that subsidiaries created for the purpose of issuing trust preferred securities (trust preferred securities subsidiaries) file the FR Y-11, FR 2314, and FR Y-7N was dropped. In addition, new items were added to the reports to collect (1) certain data from all institutions that choose, under generally accepted accounting principles, to apply a fair value option to one or more financial instruments and one or more classes of servicing assets and liabilities and (2) data on income from annuity sales. Also added on the FR Y-7N were a new item for reporting the amount of partnership interests and a new section, Notes to the Financial Statements. Effective December, a question was added to the FR Y-11S, FR 2314S, and FR Y-7NS to determine whether the subsidiary has adopted a fair value option.

Also effective December 2008, the FR Y-10 report was updated to include collection of the tax ID number for all reportable banking and nonbanking entities located in the United States. In addition, cover pages and instructions for the FR Y-6 and FR Y-7 were modified to highlight, for reporting entities, issues surrounding the submission of information on individuals.

In November, the Federal Reserve proposed a number of revisions to the FR Y-9C for implementation in 2009 comparable to those proposed for the bank Call Report, as described in the next section. In addition, the Federal Reserve proposed to revise the FR Y-9C to (1) add new data items and revise existing data items on trading assets and liabilities; (2) collect information associated with the Treasury's Capital Purchase Program; and (3) add new data items and revise existing data items on regulatory capital requirements. Also in November, the Federal Reserve proposed to revise the FR Y-11, FR 2314, and FR Y-7N in March 2009 to collect new information on assets held in trading accounts and to require that respondents submit all FR Y-8 reports electronically, effective with the June 30, 2009, report date.

Commercial Bank Regulatory Financial Reports

As the federal supervisor of state member banks, the Federal Reserve, along with the other banking agencies through the FFIEC, requires banks to submit quarterly Call Reports. Call Reports are the primary source of data for the supervision and regulation of banks and the ongoing assessment of the overall soundness of the nation's banking system. Call Report data, which also serve as benchmarks for the financial information required by many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community.

During 2008, the FFIEC implemented revisions to the Call Report to address new safety and soundness considerations and to facilitate supervision. Among these revisions were collection of additional information related to one- to four-family residential mortgage loans; modification of the definition of "trading account" in response to the creation of a fair value option under generally accepted accounting principles; revision of certain schedules to collect additional information about instruments accounted for under the fair value option; revision of the instructions for reporting daily average deposit data by newly insured institutions to conform with the FDIC's assessment regulations; clarification of the instructions for reporting credit derivatives data on the risk-based capital schedule; and collection of information necessary to calculate assessments for participants in the FDIC's Transaction Account Guarantee Program.

In September, the FFIEC proposed a number of revisions to the Call Report for implementation in 2009. The proposed revisions include new items on (1) held-for-investment loans and leases acquired in business combinations; (2) the date on which the bank's fiscal year ends; (3) real estate construction and development loans on which interest is capitalized; (4) holdings of commercial mortgage–backed securities and structured financial products, such as collateralized debt obligations; (5) fair value measurements for assets and liabilities reported at fair value on a recurring basis; (6) pledged loans and pledged trading assets; (7) collateral and counterparties associated with over-the-counter derivatives exposures; (8) credit derivatives; (9) remaining maturities of unsecured other borrowings and subordinated notes and debentures; (10) unused short-term commitments to asset-backed commercial paper conduits; (11) past due and nonaccrual trading assets; (12) investments in real estate ventures; and (13) held-to-maturity and available-for-sale securities in domestic offices. In addition, revisions were proposed to (1) modify several data items relating to noncontrolling (minority) interests in consolidated subsidiaries; (2) provide for exemptions from reporting certain existing items by banks having less than $1 billion in total assets; (3) clarify the definition of the term "loan secured by real estate"; (4) provide guidance in the reporting instructions on quantifying misstatements in the Call Report; (5) eliminate the confidential treatment of data collected from trust institutions on fiduciary income, expenses, and losses; and (6) expand information collected on trust department activities.

Supervisory Information Technology

Information technology supporting Federal Reserve supervisory activities is managed within the System supervisory information technology (SSIT) function in the Board's Division of Banking Supervision and Regulation. SSIT works through assigned staff at the Board and the Reserve Banks, as well as through System committees, to ensure that key staff members throughout the System participate in identifying requirements and setting priorities for information technology initiatives.

In 2008, the SSIT function worked on several strategic projects and initiatives: (1) alignment of technology investments with business needs; (2) identification and implementation of improvements to make technology and data more accessible to staff working in the field; (3) strengthening of compliance with data-privacy regulations; (4) implementation of new software to improve the processing of bank applications; and (5) implementation of collaboration and analysis technologies (such as communities of practice and business intelligence tools) to integrate supervisory and management information systems that support both office-based and field staff. With the other federal regulatory agencies, the SSIT also implemented the first phase of the modernization of the Shared National Credit system. And it began a project to develop a comprehensive tool for tracking exam findings Systemwide.

National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking-structure data. It is also the main repository for many supervisory documents. NIC includes (1) data on banking structure throughout the United States as well as foreign banking concerns; (2) the National Examination Database (NED), which enables supervisory personnel as well as federal and state banking authorities to access NIC data; (3) the Banking Organization National Desktop (BOND), an application that facilitates secure, real-time electronic information-sharing and collaboration among federal and state banking regulators for the supervision of banking organizations; and (4) the Central Document and Text Repository, which contains documents supporting the supervisory processes.

Within the NIC, the supporting systems have been modified over time to extend their useful lives and improve business workflow efficiency. During 2008, work continued on upgrading the entire NIC infrastructure to provide easier access to information, a consistent Federal Reserve enterprise information data repository, a comprehensive metadata repository, and uniform security across the Federal Reserve System. An initial model was provided to a representative group of Federal Reserve users and stakeholders. Significant design changes resulted from the feedback of that group. Implementation is expected to be phased in beginning mid-year 2009 and to be completed by year-end 2010. Also during the year, several programming changes were made to NIC applications in support of business needs, primarily for the credit risk and discount window functions to monitor new Federal Reserve programs

Training for Banking Supervision and Regulation, 2008

Course sponsor or type	Number of participants		Instructional time (training days unless otherwise noted)	Number of course offerings
	Federal Reserve personnel	State personnel		
Federal Reserve System	3,217	359	11,998	128
FFIEC	508	275	2,006	55
The Options Institute[1]	6	4	18	1
Rapid response	1,745	0	10 one-hour conference calls	10

1. The Options Institute, an educational arm of the Chicago Board Options Exchange, provides a three-day seminar on the use of options in risk management.

created to assist the financial and banking markets.

The Federal Reserve continued in 2008 to work with other federal regulatory agencies to modernize the collection of SNC information by creating a common collection facility. Implementation of the initial phase was effective year-end 2008, for fourth-quarter data. SNC data will begin being reported on a quarterly basis.

Finally, the Federal Reserve participated in a number of technology-related initiatives supporting the supervision function as part of FFIEC task forces and subgroups.

Staff Development

Training and staff development focuses on recruiting, deploying, developing, and retaining staff having the skills necessary to meet supervisory responsibilities today and in the future. The staff development program is responsible for the ongoing development of nearly 2,300 professional supervisory staff. Training for banking supervision and regulation in 2008 is summarized in the table.

Examiner Commissioning Program

The Examiner Commissioning Program (ECP) involves approximately 22 weeks of instruction. Individuals move through a combination of classroom offerings, self-paced assignments, and on-the-job training over a period of two to five years. Achievement is measured by two professionally validated proficiency examinations: the first proficiency exam is required of all ECP participants; the second proficiency exam is offered in two specialty areas—safety and soundness, and consumer affairs. A third specialty, in information technology, requires that individuals earn the Certified Information Systems Auditor certification offered by the Information Systems Audit Control Association. In 2008, 147 examiners passed the first proficiency exam and 93 passed the second proficiency exam (63 in safety and soundness, and 30 in consumer affairs).

Continuing Professional Development

Other formal and informal learning opportunities are available to examiners, including other schools and programs offered within the System and FFIEC-sponsored schools. System programs are also available to state agencies. In 2008, “rapid response” sessions were instituted in response to emerging or urgent training needs associated with implementation or issuance of new laws, regulations, or guidance.

Regulation of the U.S. Banking Structure

The Federal Reserve administers five federal statutes that apply to bank holding companies, financial holding companies, member banks, and foreign banking organizations—the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, the Federal Reserve Act, and the International Banking Act. In administering these statutes, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of the U.S. banking system at the local, regional, and national levels; the international operations of domestic banking organizations; or the U.S. banking operations of foreign banks. The proposals concern bank holding company formations and acquisitions, bank mergers, and other transactions involving bank or nonbank firms. In 2008, the Federal Reserve acted on 1,057 proposals representing 1,910 individual applications filed under the five statutes.

Bank Holding Company Act

Under the Bank Holding Company Act, a corporation or similar legal entity must obtain the Federal Reserve's approval before forming a bank holding company through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. Also, bank holding companies generally may engage in only those nonbanking activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the Bank Holding Company Act. Depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.[11]

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve may consider the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. In 2008, the Federal Reserve acted on 495 applications and notices filed by bank holding companies to acquire a bank or a nonbank firm, or to otherwise expand their activities.

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2008,

11. Since 1996, the act has provided an expedited prior notice procedure for certain permissible nonbank activities and for acquisitions of small banks and nonbank entities. Since that time the act has also permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

the Federal Reserve reviewed 7 stock repurchase proposals by bank holding companies.

The Federal Reserve also reviews elections submitted by bank holding companies seeking financial holding company status under the authority granted by the Gramm-Leach-Bliley Act. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve. In 2008, 29 domestic financial holding company declarations and 5 foreign bank declarations were approved.

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the relevant federal banking agency. The Federal Reserve has primary jurisdiction if the institution surviving the merger is a state member bank. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined organizations, the convenience and needs of the community(ies) to be served, and the competitive effects of the proposed merger. The Federal Reserve also must consider the views of the U.S. Department of Justice regarding the competitive aspects of any proposed bank merger involving unaffiliated insured depository institutions. In 2008, the Federal Reserve approved 71 merger applications under the act.

Change in Bank Control Act

The Change in Bank Control Act requires individuals and certain other parties that seek control of a U.S. bank or bank holding company to obtain approval from the relevant federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and bank holding companies. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank or bank holding company being acquired; the future prospects of the institution to be acquired; the effect of the proposed change on competition in any relevant market; the completeness of the information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the Deposit Insurance Fund. A proposed transaction should not jeopardize the stability of the institution or the interests of depositors. During its review of a proposed transaction, the Federal Reserve may contact other regulatory or law enforcement agencies for information about relevant individuals. In 2008, the Federal Reserve approved 124 changes in control of state member banks and bank holding companies.

Federal Reserve Act

Under the Federal Reserve Act, a member bank may be required to seek Federal Reserve approval before expanding its operations domestically or internationally. State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers, among other things, the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2008, the Federal Reserve acted on new and merger-related branch proposals for 890 domestic branches and granted prior approval for the establishment of 6 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities-related and insurance agency–related activities. In 2008, 4 financial subsidiary applications were approved.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Federal Reserve, large and other significant investments require prior approval. In 2008, the Federal Reserve approved 67 proposals for overseas investments by U.S. banking organizations, many of which represented investments through an Edge Act or agreement corporation.

International Banking Act

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires foreign banks to obtain Federal Reserve approval before establishing branches, agencies, commercial lending company subsidiaries, or representative offices in the United States.

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. It also considers whether the home-country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home-country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Federal Reserve, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law. In 2008, the Federal Reserve approved 19 applications by foreign banks to establish branches, agencies, or representative offices in the United States.

Public Notice of Federal Reserve Decisions

Certain decisions by the Federal Reserve that involve an acquisition by a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank are made known to the public by an order or an announcement.

Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release. The H.2 release also contains announcements of applications and notices received by the Federal Reserve upon which action has not yet been taken. For each pending application and notice, the related H.2 gives the deadline for comments. The Board's website (www.federalreserve.gov) provides information on orders and announcements as well as a guide for U.S. and foreign banking organizations that wish to submit applications or notices to the Federal Reserve.

Enforcement of Other Laws and Regulations

The Federal Reserve's enforcement responsibilities also extend to the disclosure of financial information by state member banks and the use of credit to purchase and carry securities.

Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 2008, 12 state member banks were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to purchase debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Several regulatory agencies enforce the Board's securities credit regulations. The SEC, the Financial Industry Regulatory Authority (formed through the combination of the National Association of Securities Dealers and the regulation, enforcement, and arbitration functions of the New York Stock Exchange), and the Chicago Board Options Exchange examine brokers and dealers for compliance with Regulation T. With respect to compliance with Regulation U, the federal banking agencies examine banks under their respective jurisdictions; the Farm Credit Administration and the National Credit Union Administration examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Federal Reserve Membership

At the end of 2008, 2,378 banks were members of the Federal Reserve System and were operating 55,892 branches. These banks accounted for 34 percent of all commercial banks in the United States and for 70 percent of all commercial banking offices. ■

Consumer and Community Affairs

Among the Federal Reserve's responsibilities in the areas of consumer and community affairs are

- writing and interpreting regulations to implement federal laws that protect and inform consumers,
- supervising state member banks to ensure compliance with the regulations,
- investigating complaints from the public about state member banks' compliance with regulations,
- promoting community development in historically underserved markets, and
- conducting research and promoting consumer education.

These responsibilities are carried out by the members of the Board of Governors, the Board's Division of Consumer and Community Affairs (DCCA), and the consumer and community affairs staffs at Federal Reserve Banks.

The Federal Reserve System's various consumer protection and community development roles continued to be areas of interest in 2008. Amid the consequences of a deteriorating financial marketplace, consumer protection was among the issues of concern, particularly in the mortgage and credit card markets. Throughout the year, lawmakers, regulators, the media, and consumers scrutinized various practices used in the financial services marketplace, expressing concern at the complexity of products and characterizing some practices as unfair or deceptive. In 2008, the Federal Reserve Board advanced consumer protection in financial services by finalizing regulations that set new rules for fairness and transparency in the high-cost mortgage and credit card markets. In addition, the Board continued to commit significant resources in the areas of supervision, research, community development, and consumer education to increase understanding of the issues and impacts of the credit crisis on consumers and communities.

Mortgage Credit

Throughout 2008, concerns over consumer protection and access to credit in the mortgage market continued to escalate, prompting the Federal Reserve to continue to pursue a range of efforts to support both consumers and industry through its regulatory and supervisory activities.

Regulatory Actions

Expansion of Consumer Protections under Regulation Z

Concerns about the mortgage credit markets continued into 2008 as many lenders and borrowers suffered significant losses and as property values declined in much of the country. Analyses of these developments revealed a range of lender practices that contributed to the crises, including lax underwriting standards and inadequate analyses of borrowers' ability to repay their mortgages. Many of these practices were common among nonbank, subprime mortgage creditors offering higher-priced mortgage loans. These lenders were not subject to the same level of supervision as insured depository institutions.

The Board had taken action to address some of these concerns in late 2007, when it issued proposed amendments to Regulation Z to strengthen consumer protection and underwriting standards. The proposed rules addressed, in particular, certain creditor practices as they relate to higher-priced mortgage loans, under authority granted by the Home Ownership and Equity Protection Act (HOEPA). The proposal received more than 4,500 comment letters from the mortgage industry, consumer and community organizations, individual consumers, and policymakers.

In July 2008, the Board approved and published the final rules for mortgage loans under Regulation Z to improve consumer protections and facilitate responsible lending. The new rules apply to all mortgage lenders, not just insured depository institutions, to provide broader protection to consumers and a uniform set of rules for the mortgage industry. The regulation prohibits unfair, abusive, or deceptive home mortgage lending practices, and restricts certain other mortgage practices. The final rules also establish advertising standards, and require lenders to provide certain mortgage disclosures to consumers earlier in the lending process.[1]

The regulation was approved at a public meeting held by the Board, where Federal Reserve Chairman Ben S. Bernanke stated, "The proposed final rules are intended to protect consumers from unfair or deceptive acts and practices in mortgage lending, while keeping credit available to qualified borrowers and supporting sustainable homeownership." The new rules apply to "higher-priced mortgage loans"—defined to capture virtually all loans originated in the subprime market—but generally exclude loans in the prime market. In addition, the rules also establish new consumer protections that apply to all mortgage loans secured by a borrower's principal dwelling.

For higher-priced mortgage loans secured by a consumer's principal dwelling, the final regulation adds four key protections:

- It prohibits a lender from making a loan without regard to a borrower's ability to repay the loan from income and assets other than the home's value.
- It requires creditors to verify the income and assets they rely upon to determine a borrower's ability to repay a loan.
- It bans any prepayment penalty if the payment can change in the initial four years. For other higher-priced loans, a prepayment penalty period cannot last for more than two years. This restriction on prepayment penalties is substantially more limiting than originally proposed.
- It requires creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

For all mortgage loans secured by a borrower's principal dwelling, the final rules establish several requirements:

- Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value.
- Companies that service mortgage loans are prohibited from engaging in

1. See press release, "Board Issues Final Rule Amending Home Mortgage Provisions of Regulation Z" (July 14, 2008), www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm.

certain practices, such as pyramiding late fees. In addition, servicers are required to credit consumers' loan payments as of the date of receipt and to provide a payoff statement within a reasonable time following a request.

- Creditors must provide a good-faith estimate of a loan's costs, including a schedule of payments, within three days after a consumer applies for any mortgage loan secured by the consumer's principal dwelling, such as a home improvement or a straight refinance loan.

The final rules also set additional standards that apply to all mortgage advertising, requiring additional information about rates, monthly payments, and other loan features. In addition, the final rules ban seven deceptive or misleading advertising practices, including representing that a rate or payment is "fixed" when it can change. The new rules take effect on October 1, 2009, except for the escrow requirement, which will be phased in during 2010 to allow lenders to establish new systems as needed.

After extensive consumer testing, the Board withdrew one element of the original proposal relating to "yield-spread premiums"—a common compensation method used by lenders originating loans through mortgage brokers. The testing, conducted to ascertain the effectiveness of a variety of strategies to disclose this practice and its impact on the cost of the loan to borrowers, revealed that the proposed disclosures were inadequate in conveying this information to consumers.[2] As a result, the Board committed to considering alternative approaches as part of its ongoing review of mortgage rules under Regulation Z.

Illustrations to Improve Consumers' Understanding of Adjustable-Rate Mortgage Products

With the expansion of mortgage credit markets over the last several years, the range and complexity of loan types also increased, particularly in the subprime market. Here, various adjustable-rate mortgage (ARM) loan products became more prevalent as a means to make homeownership more affordable through lower rates and payments in the early years of a loan.

While beneficial to some borrowers, ARMs also can be very complex and can present repayment challenges to borrowers whose circumstances prove unsuitable for loans with significant payment increases. Because of concerns that consumers were not fully aware of the implications presented by these products, the Federal Reserve and other federal financial regulatory agencies in May 2008 issued guidance containing illustrations that mortgage lenders can use to help consumers understand certain hybrid ARMs.[3] These illustrations are designed to assist institutions in complying with recommendations set forth in the agencies' 2007 "Statement on Subprime Mortgage Lending," which called on institutions to provide clear, balanced, and timely information to consumers about the relative benefits, costs, and risks of

2. See *Summary of Findings, Consumer Testing of Mortgage Broker Disclosures* (July 10, 2008), www.federalreserve.gov/newsevents/press/bcreg/20080714regzconstest.pdf.

3. See press release, "Federal Financial Regulators Issue Final Illustrations of Consumer Information for Hybrid Adjustable-Rate Mortgage Products" (May 22, 2008), www.federalreserve.gov/newsevents/press/bcreg/20080522a.htm.

Foreclosures: Responding to Consumers and Communities in Crisis through the Federal Reserve's Home Mortgage Initiative

With continued deterioration of the subprime mortgage market and the overall economy, 2008 was marked by an increase in the rate of foreclosure throughout the country. As foreclosures mounted and projections worsened throughout the year, nonprofit organizations, governments, lenders, and servicers mobilized to respond to the needs of borrowers and communities confronting defaulting mortgages and foreclosures. The Federal Reserve System actively engaged in national and regional partnerships to help inform policy and practices around foreclosure prevention and neighborhood stabilization in communities hard hit by foreclosures.

The Federal Reserve System has a significant presence throughout the country through its 12 regional banks and their branch offices and the Board of Governors in Washington, D.C. Each of these locations offers important research, supervision, and community development expertise and insights that help inform local and regional responses to economic conditions. As the mortgage market continued to deteriorate in 2008, the System worked to coordinate its resources through the Homeownership and Mortgage Initiative (HMI), a comprehensive strategy to provide information and outreach to stem unnecessary foreclosures, to stabilize communities, and to prevent negative spillovers at the neighborhood level. The HMI coordinated the activities of the various functional areas of the System, including research, public affairs, and community affairs, to improve access to data and information and to develop policies relating to foreclosure. This strategy capitalized on the following areas of expertise:

- *outreach* to strengthen existing collaborations with other regulators, community groups, policy organizations, financial institutions, and public officials to identify solutions to prevent unnecessary foreclosures and their negative effects
- *regulation* to foster an environment that supports the homeownership goals of creditworthy borrowers with appropriate consumer protection and responsible lending practices
- *research and analysis* to provide community groups, counseling agencies, regulators, financial institutions, and others with detailed analysis to support efforts to help troubled borrowers and communities
- *financial education* to help consumers make informed personal financial decisions, including those about home ownership

hybrid ARM products.[4] The illustrations were developed in response to requests by some industry groups, in commenting on the proposed Subprime Statement, that the agencies either provide uniform disclosures for these products or publish illustrations of the consumer information.

Although the illustrations are not mandatory, institutions may use them, provide information based on them, or provide consumers with information described in the guidance in an alternate format. The illustrations provide

- an explanation of some of the key features of certain ARM loans that are identified in the Subprime State-

4. See press release, "Federal Financial Regulatory Agencies Issue Final Statement on Subprime Mortgage Lending" (June 29, 2007), www.federalreserve.gov/newsevents/press/bcreg/20070629a.htm.

With respect to outreach, the Federal Reserve provided community coalitions, counseling agencies, fellow regulators, financial institutions, and others with detailed analyses identifying neighborhoods at high risk of foreclosures. By understanding those areas with high concentrations of subprime mortgages, delinquencies, and foreclosures, community leaders can better target their scarce resources to borrowers in need of counseling and other interventions that may help forestall foreclosure.

To explore the impact of the foreclosure crisis on different real estate markets, the Federal Reserve hosted a series of conferences entitled, "Recovery, Renewal, Rebuilding: A Federal Reserve Foreclosure Series,"[1] in five cities. These conferences, held in Atlanta, Los Angeles, Columbus (Ohio), St. Louis, and Washington, D.C., looked at strategies to address the negative impact of foreclosures in high-cost markets, as well as the difficulty of dealing with foreclosures in neighborhoods in weak-market communities. The series also highlighted research on foreclosure and the resulting problems of vacancy and abandonment. Through this series, conference attendees worked to clarify the issues and identify the strategies and best practices for moving toward solutions by examining best practices, creative solutions, and innovative ways to prepare for the future.

1. See additional information on the conferences at stlouisfed.org/RRRseries/ and www.clevelandfed.org/Our_Region/Community_Development/Events/Seminars/2008/20080827/Overview_4Forums.pdf.

The Federal Reserve also forged a partnership with NeighborWorks America, a national nonprofit organization, to address issues related to neighborhood stabilization and, in particular, the disposition of real estate owned (REO) properties. As part of the collaboration, a website, www.stablecommunities.org, was developed to provide a one-stop source of information for homeowners, community development organizations, and local governments dealing with foreclosure-related vacant and abandoned properties.

In addition, the Community Affairs offices at each of the 12 Reserve Banks launched online Foreclosure Resource Centers that provide information for homeowners, prospective homebuyers, and community groups to prevent foreclosures and lessen their negative influence on neighborhoods. A Community Foreclosure Mitigation Toolkit was also developed.[2] The Board also developed information for consumers on how to protect their homes from foreclosure and updated other mortgage publications, including *A Consumer's Guide to Mortgage Settlement Costs* and *What You Should Know about Home Equity Lines of Credit.*

2. See Foreclosure Resources at www.federalreserve.gov/consumerinfo/foreclosure.htm.

ment, including payment shock, responsibility for taxes and insurance, prepayment penalties, balloon payments, and increased costs associated with stated-income or reduced-documentation loans, and

- a chart, with numerical examples, that depicts in a concrete, readily understandable manner the potential payment shock for a loan structured with a discounted interest rate good for the first two years and then subject to increase.

Supervisory Actions

The Board applied its supervisory authority in an effort to address the aggressive credit tightening that gave cause for concern in 2008 and to urge mortgage lenders to work with troubled mortgage borrowers. Joining with other financial regulatory agencies, the Board

Staff also revised *A Consumer's Guide to Mortgage Refinancings,* providing a link to a mortgage refinancing calculator.[3] For consumers with questions about banking procedures and rules, or who feel they may have been treated unfairly by their banks, the Federal Reserve Consumer Help Center feeds queries directly to the various regulatory agencies so that consumers have only one stop to make to ask questions or file complaints.[4]

In the regulatory realm, the Federal Reserve issued new rules to improve consumer protections and disclosures relating to loans secured by a borrower's home (see the "Mortgage Credit" discussion earlier in this chapter).

To support needed research and analysis, the Federal Reserve System launched several initiatives to provide studies, data, and other foreclosure-related resources to communities grappling with foreclosures. The System provided, on the website of the Federal Reserve Bank of New York, data concerning subprime lending patterns and performance.[5] These dynamic maps and data illustrate subprime and alt-A mortgage loan conditions that may assist community groups, policymakers, and local governments as they prioritize the use of their resources for these foreclosure-related efforts. In addition, a System workgroup, consisting of some of the Federal Reserve System's top economists and community development experts, prepared overviews that summarize the current state of knowledge about housing and mortgage markets, as well as about foreclosures. The System continues to conduct research on a wide range of topics to fill analytical gaps and better understand the effects of foreclosure on neighborhoods, the economy, and the housing and mortgage markets.

In the interest of supporting borrowers experiencing difficulty in meeting their mortgage obligations, the Board has provided outlets for mortgage-related consumer financial education materials. In addition, through the HMI, the Federal Reserve has posted internal and external resources on each of the System's 13 websites to help improve staff and consumers' access to information that can assist them as they work to address challenges in the mortgage market.[6] As the mortgage and foreclosure issues and their implications evolve, the Federal Reserve will continue to coordinate its resources and expertise to assist consumers and communities during the crisis.

3. See "5 Tips for Protecting your Home from Foreclosure, www.federalreserve.gov/pubs/foreclosuretips/default.htm and www.federalreserve.gov/consumerinfo/mortgages.htm."

4. See www.federalreserveconsumerhelp.gov.

5. See "Dynamic Maps of Nonprime Mortgage Conditions in the United States," www.newyorkfed.org/mortgagemaps/.

6. See Resources for Consumers, www.federalreserve.gov/consumerinfo/foreclosure_consumers.htm.

issued an interagency statement on both topics in November 2008.[5]

With respect to the credit tightening, the supervisory statement noted the agencies' expectation that all banking organizations should fulfill their fundamental role in the economy as intermediaries that provide credit to businesses, consumers, and other creditworthy borrowers. The statement emphasizes the essential nature of providing credit in a manner consistent with prudent lending practices and continuing to ensure the pursuit of new lending opportunities on the basis of realistic asset valuations and balanced assessments of borrowers' repayment capacities.

In light of the escalating rate of mortgage foreclosures in 2008, the supervisory statement also articulated the agen-

5. See press release, "Interagency Statement on Meeting the Needs of Creditworthy Borrowers" (November 12, 2008), www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

cies' expectation that financial institutions work with existing borrowers to avoid preventable foreclosures, which can prove costly to both the institutions and to the communities they serve, and to help mitigate other potential mortgage-related losses. The agencies' statement urges all lenders and servicers to adopt systematic, proactive, and streamlined mortgage loan modification protocols and to review troubled loans using these protocols. The goal of such efforts is to help achieve modifications that result in mortgages that borrowers can better manage.

Credit Cards

Credit cards are the most common consumer financial services credit product, and represent an important tool for facilitating transactions for both consumers and businesses. Advances in technology (such as credit scoring) and the expansion of the financial services marketplace have contributed to a significant increase in competition in the credit card market over the last decade. During this time, lenders have employed aggressive marketing and product development strategies and have applied billing practices to generate more fee-based income. (Previously, lenders had relied almost solely on interest from their customers' account balances for revenue.) These industry developments have elevated concerns about consumer protection, the transparency of credit card pricing, and the adequacy of consumer disclosures in credit card marketing materials, contracts, and periodic statements.

With the significant presence and increased consumer use of credit cards in the marketplace, concerns about certain practices have been the topic of public discussion and debate. In response, the Board issued proposed amendments to Regulation Z (Truth in Lending) in May 2007 that were intended to increase consumer protections and improve disclosures for credit cards.[6] Throughout 2008, Board staff conducted consumer testing and collected input from consumer advocates, lenders, and policymakers to gain insight into the effect the proposed rules would have on consumers' access to credit and their understanding of information they need to make informed decisions about the myriad credit card options in the market (see the "Advice from the Consumer Advisory Council" discussion later in this chapter). Based on this information, the Board issued additional proposed amendments to Regulation Z as well as proposed amendments to Regulation AA (Unfair or Deceptive Acts or Practices) in May 2008.[7] The public response to these proposals was unprecedented, with Board staff carefully considering information obtained through extensive consumer testing and review of more than 60,000 comment letters received during the comment period.[8]

Final rules regarding credit cards were issued in December 2008, with an

6. See press release (May 23, 2007), www.federalreserve.gov/newsevents/press/bcreg/20070523a.htm.

7. See press release (May 2, 2008), www.federalreserve.gov/newsevents/press/bcreg/20080502a.htm.

8. See Design and Testing of Effective Truth in Lending Disclosures: Findings from Qualitative Consumer Testing Research, submitted to the Federal Reserve Board of Governors by Macro International, Inc. (December 15, 2008), www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a7.pdf, and Design and Testing of Effective Truth in Lending Disclosures: Findings from Experimental Study, submitted to the Federal Reserve Board by Macro International, Inc. (December 15, 2008), www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a8.pdf.

effective date of July 1, 2010.[9] These rules were designed to address areas of concern by prohibiting certain unfair acts or practices and by improving the disclosures consumers receive in connection with credit card accounts and other revolving credit plans.

The final rules prohibit certain credit card practices that the Board found most concerning. At the Board meeting where the rules were approved, Chairman Bernanke remarked, "The revised rules represent the most comprehensive and sweeping reforms ever adopted by the Board for credit card accounts. These protections will allow consumers to access credit on terms that are fair and more easily understood."[10] The rules seek to promote the responsible use of credit cards through greater transparency in credit card pricing, including the abolition of unfair practices. Greater transparency will enhance competition in the marketplace and improve consumers' ability to find products that meet their needs. In addition, reduced reliance on penalty rate increases should spur industry efforts to improve upfront underwriting.

The final rule amending Regulation AA prohibits specific unfair acts or practices by banks in connection with credit card accounts. Specifically, the final rule will

- protect consumers from unexpected interest charges, including increases in the interest rate during the first year after account opening and increases in the rate charged on preexisting credit card balances;
- forbid banks from imposing interest charges using the "two-cycle" billing method;
- require that consumers receive a reasonable amount of time to make their credit card payments;
- prohibit the use of payment allocation methods that unfairly maximize interest charges; and
- address subprime credit cards by limiting the fees that reduce the amount of available credit.

The final rule amending Regulation Z improves the effectiveness of the disclosures consumers receive in connection with credit card accounts and certain other revolving credit plans. These revisions are designed to ensure that information is provided to consumers in a timely manner and in a readily understandable form. Specifically, the final rule will

- increase the amount of advance notice consumers receive from 15 to 45 days before an increased rate or a new contract term can be imposed (in order to better allow consumers to obtain alternative financing or change their account usage);
- apply the advance notice requirement when the lender increases a rate due to the consumer's delinquency or default;
- prohibit advertisements that refer to a rate as "fixed" unless the rate (1) will not increase for any reason while the plan is open or a period is specified and (2) will not increase for any reason during that period; and
- require changes to the format, timing, and content requirements for credit

9. See press release (December 18, 2008), www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm.

10. See statement by Chairman Ben S. Bernanke (December 18, 2008), www.federalreserve.gov/newsevents/press/bcreg/bernanke20081218a.htm.

card applications and solicitations and for the disclosures that consumers receive throughout the life of an open-end account.

As Governor Randall Kroszner noted when the rules were approved, "Our intent is to increase transparency and fairness in how credit card and deposit accounts operate, thereby enhancing competition and empowering consumers to better manage their accounts and avoid unnecessary costs. The rules represent a significant step forward in consumer protection."[11]

Overdraft Services

Overdraft services are sometimes offered by depository institutions as an alternative to traditional ways of covering transactions that overdraw a deposit account (for example, overdraft lines of credit or linked accounts). Coverage is generally provided "automatically" to consumers who meet a depository institution's criteria (for example, the account has been open a certain number of days or deposits are made regularly). If an overdraft is paid, the consumer is charged a flat fee for each item. A daily fee also may apply for each day the account remains overdrawn.

In the past, institutions generally provided overdraft coverage only for check transactions. In recent years, however, the service has been extended to cover overdrafts resulting from other types of transactions, including automated teller machine (ATM) withdrawals and debit card transactions at the point of sale. For debit card transactions in particular, the fee may far exceed the amount of the transaction. Thus, concerns have been raised regarding the potentially substantial costs associated with a service that consumers may not be aware of or did not request.

In December 2008, the Board addressed concerns regarding overdraft services by adopting a final rule amending Regulation DD (Truth in Savings) and a proposed rule amending Regulation E (Electronic Fund Transfers).[12] The final rule amending Regulation DD (effective January 1, 2010) addresses depository institutions' disclosure practices related to overdrafts. This rule is intended to ensure that consumers receive accurate information regarding the available funds in their deposit accounts so that they can make informed decisions about the costs of engaging in transactions that overdraw those accounts. Specifically, the final rule will

- require all institutions to disclose on periodic statements the aggregate dollar amounts charged for overdraft fees and for returned-item fees (for the statement period and the year-to-date); and
- require institutions that provide account balance information through an automated system to provide a balance that does not include additional funds that may be made available to cover overdrafts.

In addition, the proposed rule amending Regulation E would, if adopted, provide consumers with certain protections relating to the assessment of overdraft fees. The proposed rule would

- generally prohibit institutions from imposing an overdraft fee when the

11. See statement by Governor Randall S. Kroszner (December 18, 2008), www.federalreserve.gov/newsevents/press/bcreg/kroszner20081218a.htm.

12. See press release (December 18, 2008), www.federalreserve.gov/newsevents/press/bcreg/20081218a.htm.

account is overdrawn because of a hold placed on funds in the consumer's account that exceeds the actual transaction amount; and

- provide consumers with a choice regarding their institutions' overdraft coverage for ATM and one-time debit card transactions, but solicits comment on two different approaches:
    - — under one approach, an institution would be prohibited from imposing an overdraft fee unless (1) the consumer is given an initial notice and a reasonable opportunity to opt out of the institution's overdraft service and (2) the consumer does not opt out; or
    - — under an alternative approach, an institution would be prohibited from imposing an overdraft fee for paying such overdrafts unless the consumer affirmatively consents (or opts in) to the institution's overdraft service.

Other Regulatory Actions: Proposed Rules on Risk-Based Pricing Notices

Consumer reports are a primary tool used by creditors to evaluate consumer creditworthiness and establish appropriate credit terms, including pricing, based on the risk level a loan applicant represents. Risk-based pricing refers to the practice of using consumer reports (which reflect a consumer's risk of nonpayment) in setting or adjusting the price and other terms of credit offered or extended to an individual. Many creditors offer more favorable terms to consumers with better credit histories. In recent years, concerns have been raised that consumers may not be provided with adequate information regarding risk-based pricing and the role that negative information in consumer reports can play in determining the cost of credit.

To help address this issue, Congress enacted the Fair and Accurate Credit Transactions Act (FACT Act), which directed the Federal Reserve Board and the Federal Trade Commission (FTC) to issue joint regulations requiring creditors to provide consumers with risk-based pricing notices when, based in whole or in part on information in consumer reports, a creditor offers or provides credit to a consumer on terms less favorable than it offers or provides to other consumers.[13]

The Board and the FTC issued proposed regulations in May 2008.[14] The proposed regulations would apply, with certain exceptions, to all creditors that engage in risk-based pricing. Under these regulations, a risk-based pricing notice would generally be provided to the consumer after the terms of credit have been set, but before the consumer becomes contractually obligated with regard to the credit transaction. The proposed regulations reflect the agencies' judgments as to the best approaches identified through extensive outreach efforts to consumer groups, financial institutions, mortgage bankers, and consumer reporting agencies. Based on this outreach, the proposal provides creditors with a number of acceptable approaches to use in identifying consumers to whom they must provide risk-based pricing notices. The notices

13. In general, the FACT Act amended the Fair Credit Reporting Act (FCRA) to enhance the ability of consumers to combat identity theft, increase the accuracy of consumer reports, and allow consumers to exercise greater control regarding the type and amount of solicitations they receive.

14. See press release, "Agencies Issue Proposed Rules on Risk-Based Pricing Notices" (May 8, 2008), www.federalreserve.gov/newsevents/press/bcreg/20080508a.htm.

serve to alert consumers to the existence of negative information on their consumer reports so that they may check their reports for accuracy and correct any inaccurate information.

In addition, the proposed regulations include certain exceptions to the notice requirement. The most significant of the exceptions permits creditors, in lieu of providing a risk-based pricing notice to those consumers who receive less favorable terms, to provide all of their consumers with their credit scores and explanatory information about their scores. The proposed regulations include model notices to facilitate compliance.

Other Supervisory Activities Related to Compliance with Consumer Protection and Community Reinvestment Laws

DCCA supports and oversees the supervisory efforts of the Federal Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Division staff members provide guidance and expertise to the Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. Routinely, staff members develop and update examination policies, procedures, and guidelines; review Reserve Bank supervisory reports and work products; and participate in interagency activities that promote uniformity in examination principles and standards.

Examinations are the Federal Reserve System's primary means for enforcing compliance with consumer protection laws. During the 2008 reporting period,[15] Reserve Banks conducted 268 consumer compliance examinations: 263 of state member banks and five of foreign banking organizations.[16]

Fair Lending

The Federal Reserve is committed to ensuring that the institutions it supervises comply fully with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. The Federal Reserve enforces ECOA and the provisions of the Fair Housing Act that apply to its supervised lending institutions. The Federal Reserve conducts fair lending reviews regularly within the supervisory cycle. Additionally, examiners may conduct fair lending reviews outside of the usual supervisory cycle, if warranted by fair lending risk. When examiners find evidence of potential discrimination, they work closely with the division's Fair Lending Enforcement Section, which brings additional legal and statistical expertise to the examination and ensures that fair lending laws are enforced rigorously and consistently throughout the Federal Reserve System.

ECOA prohibits creditors from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in

15. The 2008 reporting period for examination data was July 1, 2007, through June 30, 2008.

16. The foreign banking organizations examined by the Federal Reserve are organizations that operate under section 25 or 25A of the Federal Reserve Act (Edge Act and agreement corporations) and state-chartered commercial lending companies owned or controlled by foreign banks. These institutions are not subject to the Community Reinvestment Act and typically engage in relatively few activities covered by consumer protection laws.

good faith, any right under the Consumer Credit Protection Act. The Fair Housing Act prohibits discrimination in residential real estate-related transactions, including the making and purchasing of mortgage loans, on the basis of race, color, religion, national origin, handicap, familial status, or sex.

Pursuant to ECOA, if the Board has reason to believe that a creditor has engaged in a pattern or practice of discrimination in violation of ECOA, the matter will be referred to the Department of Justice (DOJ). The DOJ reviews the referral and decides if further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. The DOJ may decide instead to return the matter to the Federal Reserve for administrative enforcement. When a matter is returned to the Federal Reserve, staff ensures that the institution takes all appropriate corrective action.

During 2008, the Board referred the following three matters to the DOJ:

- One referral involved an institution's policy of automatically discounting child support income, in violation of Regulation B, ECOA's implementing regulation. As this policy primarily affected female applicants, the policy also constituted discrimination on the basis of gender in violation of Regulation B and ECOA.
- Two referrals involved improper spousal guarantees. One referral involved a bank's policy and practice of obtaining spousal signatures on all automobile loans secured by jointly held collateral, in violation of Regulation B. In another matter, an institution obtained spousal guarantees for all of its agricultural and commercial loans, in violation of Regulation B.

If a fair lending violation does not constitute a pattern or practice, the Federal Reserve takes action to ensure that it is remedied by the bank. Most lenders readily agree to correct fair lending violations. In fact, lenders often take corrective steps as soon as they become aware of a problem. Thus, the Federal Reserve generally uses informal supervisory tools (such as memoranda of understanding between the bank's board of directors and the Reserve Bank) or board resolutions to ensure that violations are corrected. If necessary to protect consumers, however, the Board can and does bring public enforcement actions.

Evaluating Pricing Discrimination Risk with HMDA Data and Other Information

When Home Mortgage Disclosure Act (HMDA) pricing data first became available in 2005, Board staff developed—and presently continues to refine—HMDA screens that identify institutions warranting further review based on an analysis of HMDA pricing data. Because HMDA data lack many factors that lenders routinely use to make credit decisions and set loan prices, such as information about a borrower's creditworthiness and loan-to-value ratios, HMDA data alone cannot be used to determine whether a lender discriminates. Thus, the Federal Reserve staff analyzes HMDA data in conjunction with other available supervisory information to evaluate a lender's risk for engaging in discrimination.

For the 2007 HMDA pricing data—the most recent year for which the data are publicly available—Federal Reserve examiners performed a pricing discrimination risk assessment for each institution that was identified through the HMDA screening process. These risk assessments considered not just the institution's HMDA data, but also the strength of the institution's fair lending compliance program; past supervisory experience with the institution; consumer complaints against the institution; and the presence of fair lending risk factors, such as discretionary pricing. On the basis of these comprehensive assessments, Federal Reserve staff determined which institutions would receive a targeted pricing review. Depending on the examination schedule, the targeted pricing review could occur as part of the institution's next examination or outside the usual supervisory cycle.

Even if an institution is not identified through HMDA screening, examiners may still conclude that it is at risk for engaging in pricing discrimination and may elect to perform a pricing review. The Federal Reserve supervises many institutions that are not required to report data under HMDA. Also, many of the HMDA-reporting institutions supervised by the Federal Reserve originate few higher-priced loans and, therefore, report very little pricing data. For these institutions, examiners analyze other available information to assess pricing-discrimination risk and, when appropriate, perform a pricing review.

During a targeted pricing review, staff analyze additional information, including potential pricing factors not available in the HMDA data, to determine whether any pricing disparity by race or ethnicity is fully attributable to legitimate factors, or whether any portion of the pricing disparity may be attributable to illegal discrimination. To perform these reviews, staff use analytical techniques that account for the increasing complexity of the mortgage market. Two industry changes in particular—the proliferation of product offerings and the increased use of risk-based pricing—have increased the complexity of fair lending reviews. To effectively detect discrimination by lenders offering an expanding range of products and credit-risk categories, the Federal Reserve increasingly uses statistical techniques. When performing a pricing review, staff typically obtain extensive proprietary loan-level data on all mortgage loans originated by the lender, including prime loans (that is, not just the higher-priced loans reported under HMDA). To determine how to analyze these data, the Federal Reserve studies the lender's specific business model, its pricing policies, and its product offerings. On the basis of the review of the lender's policies, staff determine which factors from the lender's data should be considered. A statistical model is then developed that takes those factors into account and is then tailored to that specific lender. Typically, a test for discrimination in particular geographic markets, such as metropolitan statistical areas (MSAs), is performed. Analyzing specific markets is important, as relatively small unexplained pricing disparities at the national level can mask much larger disparities in individual markets.

Monitoring Emerging Fair Lending Issues

During this period of financial turbulence in credit markets, many institutions have been reevaluating and tightening credit standards. Some consumer advocates have voiced concern that certain policies implemented by lenders to tighten credit standards may fall disproportionately on minorities. For example, some lenders have implemented tighter credit standards in specific geographic markets.

The Federal Reserve evaluates lenders' policies to ensure that lenders comply with the federal fair lending laws as they adjust their lending practices. It conducts reviews to evaluate whether lender policies may violate the fair lending laws by having an illegal disparate impact on minorities, and to identify steering, redlining, reverse redlining, and other fair lending violations.

Reporting on HMDA Data

HMDA, enacted by Congress in 1975, requires most mortgage lenders located in metropolitan areas to collect data about their housing-related lending activity, report the data annually to the federal government, and make the data publicly available. In 1989, Congress expanded the data required by HMDA to include information about loan applications that did not result in a loan origination, as well as information about the race, sex, and income of applicants and borrowers.

In response to the growth of the subprime loan market, the Federal Reserve updated Regulation C (HMDA's implementing regulation) in 2002. The revisions, which became effective in 2004, require lenders to collect price information for loans they originated in the higher-priced loan segment of the home mortgage market. When applicable, lenders report the number of percentage points by which a loan's annual percentage rate exceeds the threshold that defines "higher-priced loans." The threshold is 3 percentage points or more above the yield on comparable Treasury securities for first-lien loans, and 5 percentage points or more above that yield for junior-lien loans. The HMDA data, collected in 2004 and released to the public in 2005, provided the first publicly available loan-level data about loan prices. The Federal Financial Institutions Examination Council (FFIEC) released the 2007 HMDA data to the public in September 2008.

Analysis of the HMDA data for 2004 through 2007 found that the approach used to identify higher-priced loans could be improved in a way that could make the identification of higher-priced loans less sensitive to changes in the term-structure of interest rates and more consistent with the way mortgage prices are established. Consequently, Regulation C was modified in 2008 (effective for loan applications taken as of October 1, 2009) to define higher-priced loans as closed-end mortgages where the spread between the loan's APR and a survey-based estimate of rates currently offered on prime mortgage loans of a comparable type meets or exceeds 1.5 percentage points for a first-lien loan (or 3.5 percentage points for a subordinate-lien loan). The revised definition of higher-priced loans under Regulation C is the same as the definition of "higher-priced mortgage loan" adopted by the Federal Reserve Board under Regulation Z (Truth in Lending) in July 2008, when it modified this regulation to address unfair and deceptive practices in the closed-end segment of the mortgage market.

An article published in December 2008 by Federal Reserve staff in the *Federal Reserve Bulletin* uses the 2007 HMDA data to describe the market for higher-priced loans and patterns of lending across loan products, geographic markets, and borrowers and neighborhoods of different races and incomes.[17] The article focuses attention

17. Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2007 HMDA Data," *Federal Reserve Bulletin* vol. 94 (December 2008) www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf.

on the effects of the mortgage market turmoil on the 2007 HMDA data, including a detailed assessment of the effects on the data of the unusually large number of institutions that discontinued operations in 2008.

As with the 2004–2006 HMDA data, the 2007 HMDA data show that most reporting institutions originated few if any higher-priced loans in 2007: 56 percent of the lenders originated less than 10 higher-priced loans that year, and 33 percent originated no higher-priced loans. The data also indicate that relatively few lenders accounted for most of the higher-priced loan originations in 2007. Of the 8,610 mortgage lenders reporting HMDA data, 987 made 100 or more higher-priced loans. The 10 mortgage lenders with the largest volume of higher-priced loans accounted for about 31 percent of all such loans in 2007.

As in earlier years, the HMDA data show that the majority of all loan originations were not higher priced; in fact, owing in large part to the mortgage market turmoil in 2007, the incidence of higher-priced lending fell from 28.7 percent in 2006 to 18.3 percent in 2007. Some of the decrease reflects the fact that (1) 169 lenders reporting HMDA data for 2006 data closed operations in 2007 and (2) although these lenders extended higher-priced loans in 2007, they did not report this lending activity. The effect of these 169 institutions on the 2007 data is explored in-depth in the *Federal Reserve Bulletin* article. The analysis shows that these lenders were heavily involved in the higher-priced segment of the mortgage market, but they did not account for most of the decline in the share of loans that were higher-priced. The 169 lenders that closed operations also tended to extend larger loans than did other lenders, and these lenders were more likely to lend in the western region of the United States and in U.S. metropolitan areas that experienced greater recent declines in home values and greater increases in mortgage delinquencies.

Loan pricing is a complex process that may reflect a wide variety of factors about the level of risk a particular loan or borrower presents to the lender. As a result, the prevalence of higher-priced lending varies widely.

First, the incidence of higher-priced lending varies by product type. For example, manufactured-home loans show the greatest incidence of higher-priced lending (more than half of these loans are higher priced), because these loans are considered higher risk. In addition, first-lien mortgages are generally less risky than comparable junior-lien loans: 14.0 percent of first-lien conventional home purchase loans were reported as higher-priced in 2007, compared with 21.6 percent of comparable junior-lien loans.

Second, higher-priced lending varies widely by U.S. geographic region, reflecting among other things differences in regional housing and economic conditions and differences in the credit-risk profiles of borrowers by region. As in 2004, 2005, and 2006, many of the metropolitan areas reporting the greatest incidence of higher-priced lending in 2007 were in the southern region of the country, including a number of areas in Texas. Several West Coast metropolitan areas also reported elevated incidences of higher-priced lending in 2007. Overall, in many metropolitan areas in the South, Southwest, and West, 25 percent to 40 percent of the homebuyers who obtained conventional loans in 2007 received higher-priced loans.

Third, the incidence of higher-priced lending varies greatly among borrowers of different races and ethnicities. In 2007—as in 2004, 2005, and 2006—

African-Americans and Hispanics were much more likely than non-Hispanic whites and Asians to receive higher-priced loans. For example, in the second half of 2007, 29.5 percent of African-American borrowers and 24.3 percent of Hispanic borrowers received higher-priced, first-lien conventional home purchase loans, compared with 9.2 percent of non-Hispanic white and 5.6 percent of Asian borrowers.[18] Because HMDA data lack information about credit risk and other legitimate pricing factors, it is not possible to determine from HMDA data alone whether the observed pricing disparities and market segmentation reflect discrimination. When analyzed in conjunction with other fair lending risk factors and supervisory information, however, the HMDA data can facilitate fair lending supervision and enforcement (see the "Fair Lending" discussion earlier in this chapter).

Examinations and Activities Related to the Community Reinvestment Act

The Community Reinvestment Act (CRA) requires that the Federal Reserve and other banking agencies encourage financial institutions to help meet the credit needs of the local communities in which they do business, consistent with safe and sound operations. To carry out this mandate, the Federal Reserve

- examines state member banks to assess their compliance with CRA,[19]
- analyzes applications for mergers and acquisitions by state member banks and bank holding companies in relation to performance under CRA, and
- disseminates information on community development techniques to bankers and the public through community affairs offices at the Reserve Banks.

The Federal Reserve assesses and rates the performance of state member banks under CRA in the course of examinations conducted by staff at the 12 Reserve Banks. During the 2008 reporting period, the Reserve Banks conducted 243 CRA examinations: 35 of the banks were rated Outstanding, 204 were rated Satisfactory, 4 were rated Needs to Improve, and none was rated Substantial Noncompliance.[20]

Annual Release of CRA Distressed or Underserved List

In May 2008, the Federal Reserve and other federal bank and thrift regulatory agencies[21] released the 2008 list of "distressed" or "underserved" nonmetropolitan, middle-income geographies where bank revitalization or stabilization activities will receive consideration as "community development" under CRA. "Distressed" or "underserved" geographies are designated by the agencies in accordance with their CRA regulations. In accordance with 2005 CRA regulatory changes, the agencies annually designate "distressed" and "underserved" geographies, and post the list

18. Because the 169 lenders that discontinued operations in 2008 extended an unknown quantity of loans in the first part of 2007 but were all out of business by the second half of 2007, focusing on data for the second half of 2007 provides the most reliable assessment of lending patterns.

19. See testimony by Sandra F. Braunstein, director, Division of Consumer and Community Affairs (February 13, 2008), www.federalreserve.gov/newsevents/testimony/braunstein20080213a.htm.

20. The 2008 reporting period for examination data was July 1, 2007, through June 30, 2008.

21. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

of these geographies on the FFIEC website.

Supervisory Practices regarding Banking Organizations Affected by Hurricanes

In September 2008, the Federal Reserve released a joint supervision and regulation (SR) and consumer affairs (CA) letter reaffirming a longstanding policy to use available regulatory flexibility to facilitate the recovery efforts of banking organizations affected by hurricanes. Banking organizations supervised by the Federal Reserve were encouraged to work with Reserve Bank supervisory and operations staff to resolve any operational issues resulting from Hurricane Gustav or any subsequent storms. The letter encouraged banking organizations to work with borrowers and other customers in affected areas, and recognized that banking organizations may have to take prudent steps to modify, extend, or restructure existing loans in areas affected by 2008 hurricanes.

A separate CA letter, issued in October 2008, extended for an additional 36 months the period for examiners to recognize community development activities related to revitalization or stabilization activities in the Gulf Coast areas affected by Hurricanes Rita and Katrina. The extension was based on the continued need for long-term recovery efforts in those communities affected by these hurricanes.

Analysis of Applications for Mergers and Acquisitions in relation to CRA

Throughout 2008, the Board considered applications for several significant banking mergers. In June, the Board approved the application by Bank of America Corporation, Charlotte, North Carolina, one of the nation's largest depository institutions, to acquire Countrywide Financial Corporation, Calabasas, California. Public meetings were held in Chicago, Illinois, and Los Angeles, California, to allow interested persons the opportunity to present oral testimony on the factors the Board must review under the Bank Holding Company Act.

Several other significant applications were

- an application by PNC Financial Services Group, Inc., Pittsburgh, Pennsylvania, to acquire Sterling Financial Corporation, Lancaster, Pennsylvania, which was approved in January;
- an application by Toronto-Dominion Bank, Toronto, Canada, to acquire Commerce Bancorp, Inc., Cherry Hill, New Jersey, which was approved in March;
- an application by Fifth Third Bancorp, Cincinnati, Ohio, to acquire First Charter Corporation, Charlotte, North Carolina, which was approved in April;
- an application by Wells Fargo & Company, San Francisco, California, to acquire Wachovia Corporation, Charlotte, North Carolina, which was approved in October;
- an application by Bank of America Corporation to acquire Merrill Lynch & Co., New York, New York, and its subsidiaries, Merrill Lynch Bank & Trust Co., FSB, New York, New York, and Merrill Lynch Bank USA, Salt Lake City, Utah, and Merrill Lynch Yatirim Bank A.S., Istanbul, Turkey, which was approved in November; and
- an application by PNC Financial Services Group, Inc., Pittsburgh, Penn-

sylvania, to acquire National City Corporation, Cincinnati, Ohio, which was approved in December.

The public submitted comments related to concerns about consumer compliance or CRA issues on nine applications. Many of the commenters referenced pricing information on residential mortgage loans and concerns that minority applicants were more likely than nonminority applicants to receive higher-priced mortgages. These concerns were largely based on observations of lenders' 2006 and 2007 HMDA pricing data. Other issues raised by commenters included incidents where minority applicants were allegedly denied mortgage loans more frequently than nonminority applicants, where potentially predatory lending was practiced by subprime and payday lenders, where branch closings created potentially adverse effects, and where lenders allegedly failed to effectively address the needs of low- and moderate-income communities. In addition, the Board also received comments about the adverse effects of increased foreclosures, especially in low- and moderate-income communities.

The Board considered an additional 59 expansionary applications by bank holding companies or state member banks with outstanding issues involving compliance with consumer protection statutes and regulations, including several related to CRA or fair lending laws. Of those applications, 55 were approved, three were withdrawn (including one with an adverse CRA rating), and one was returned due to an adverse consumer compliance rating.

The Board also considered several-nontraditional bank holding company applications from commercial entities with banking affiliates, including GMAC, LLC, in Detroit, Michigan, and CIT Group, Inc., in New York, New York. These entities were required to become bank holding companies in order to participate in the TARP program administered by the Department of the Treasury. CRA and consumer compliance performance records of those banking affiliates were factors considered by the Board in approving the applications.

Bank Examiner Training and Guidance

Ensuring that financial institutions comply with the laws that protect consumers and encourage community reinvestment is an important part of the Federal Reserve's bank examination and supervision process. As the number and complexity of consumer financial transactions have grown, training for examiners of the organizations under the Federal Reserve's supervisory responsibility has become even more crucial. The Board's consumer compliance examiner training curriculum consists of six courses, focused on various consumer protection laws, regulations, and examination concepts. In 2008, these courses were offered in 12 sessions where nearly 200 consumer compliance examiners and System staff members participated.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2008, staff conducted a curriculum review of the Consumer Compliance Examinations II (CA II) course in order to incorporate recent technical changes in policy and laws, along with changes in instructional delivery techniques. This course, renamed Real Estate Lending Examination Techniques, enables assistant examiners to focus on the fundamental skills necessary to determine a bank's compliance with consumer laws and regulations as they apply to real estate products. Examiners also learn about the Federal Reserve System policies and regulatory requirements associated with the residential real estate lending examination, including annual percentage rate calculations. In addition, Board and Reserve Bank staff conducted an interim curriculum review of the Consumer Affairs Risk-focused Examination Techniques course to update and realign technical content with the risk-focused examination procedures.

The consumer compliance examiner training curriculum was included in the System's content mapping initiative. These content maps provide stakeholders—staff development experts throughout the Federal Reserve—a "bird's eye view" of individual instructional learning objectives and topics for all of the courses included in the Federal Reserve's examiner commissioning program. The goal of the mapping initiative is to facilitate modularization of course content for "just-in-time training" and periodic sourcing of course content for core proficiency examinations.

When appropriate, courses are delivered by methods alternative to classroom training, such as via the Internet or other distance-learning technologies. Several courses use a combination of instructional methods: (1) classroom instruction focused on case studies, and (2) specially developed computer-based instruction that includes interactive self-check exercises.

In addition to providing core training, the examiner curriculum emphasizes the importance of continuing professional development. In 2008, the System initiated a powerful training delivery method, entitled Rapid Response, to better meet this need. In contrast to a much longer and more traditional training development and delivery model, technical and instructional content on time-sensitive or emerging topics are being designed, developed, and presented to System staff within days or weeks of any perceived need.

Statement to Financial Institutions Servicing Residential Mortgages on Reporting Loss Mitigation of Subprime Mortgages

In March 2008, DCCA and the Division of Banking Supervision and Regulation jointly released a statement that encourages financial institutions that service subprime mortgage loans to report their loss-mitigation activities consistent with uniform standards.[22] The statement encourages financial institutions to consider utilizing loan modification reporting standards provided by the HOPE NOW alliance, and emphasizes that standard reporting will help investors in securitized mortgages, including financial institutions, monitor foreclosure prevention efforts.[23] It also notes that consistent loan modification reporting will foster transparency in the securitization market and provide standardized data across the mortgage industry. The latest statement follows previous statements, issued by the Federal Reserve and the other federal banking agencies, that encourage financial institutions to

22. For purposes of this statement, the term "financial institutions" refers to state-chartered banks and their subsidiaries and bank holding companies and their nonbank subsidiaries.

23. HOPE NOW is an alliance between mortgage counselors, market participants, and servicers to create a unified, coordinated plan to reach and help as many homeowners in distress as possible. The Department of the Treasury and the Department of Housing and Urban Development encouraged the formation of this alliance. For more information, visit www.hopenow.com.

work constructively with residential borrowers who are financially unable to make contractual payment obligations on their home loans.[24]

Interagency Examination Procedures for the Department of Defense's Final Rule on Limitations on Consumer Credit Extended to Service Members and Dependents (Talent Amendment)

In July 2008, DCCA issued interagency examination procedures associated with establishing compliance with a Department of Defense (DoD) rule limiting the extension of consumer credit to service members and their dependents (the Talent Amendment). The examination procedures are intended to help determine a service provider's compliance with regulations issued by the DoD regarding limitations on the amount of consumer credit that may be extended to service members and dependents for payday loans, motor vehicle title loans, and tax refund anticipation loans. The rule applies to all persons engaged in the business of extending such credit and their assignees, and limits the amount that a creditor can charge service members and their dependents in connection with these transactions. Total charges must be expressed as a total dollar amount and as an annualized rate referred to as the "Military Annual Percentage Rate" or "MAPR," and which may not exceed 36 percent.

24. See SR 07-16/CA 07-4, Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages (September 4, 2007), www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm, and SR 07-6/CA 07-1, Working with Mortgage Borrowers (April 17, 2007), www.federalreserve.gov/boarddocs/srletters/2007/SR0706.htm.

Interagency Examinations Concerning Affiliate Marketing Standards

In August 2008, DCCA issued interagency examination procedures associated with establishing compliance with a regulation implementing Section 624 of the Fair Credit Reporting Act (FCRA), as amended by the FACT Act. This "affiliate marketing regulation" generally prohibits a financial institution from using certain information received from an affiliate to make a solicitation to a consumer unless the consumer is given notice and a reasonable opportunity to opt out of such solicitations, and the consumer does not opt out. The final rule applies to information obtained from the consumer's transactions or account relationships with an institution's affiliate, from any application the consumer submitted to an affiliate, and from third-party sources, such as credit reports, if the information will be used to send marketing solicitations.

Interagency Examinations concerning Identity-Theft Red Flags and Other Regulations under the Fair Credit Reporting Act

In October 2008, DCCA and the Board's Division of Banking Supervision and Regulation jointly released interagency[25] examination procedures associated with establishing compliance with regulations implementing several sections of the FCRA, as amended by the FACT Act. The procedures estab-

25. The Board of Governors of the Federal Reserve System, the Conference of State Bank Supervisors, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

lished the agencies' expectations for financial institutions and examination staff with respect to the final rules and guidelines regarding identity-theft red flags as well as for other regulations under FCRA. The regulatory provisions focused on the duties of users of consumer reports regarding address discrepancies; the duties of financial institutions and creditors in detecting, preventing, and mitigating identity theft; the duties of card issuers regarding changes of address; and the duties of financial institutions regarding affiliate marketing practices.

A new identity-theft red-flags rule requires a financial institution to periodically determine whether it offers or maintains consumer accounts susceptible to identity theft. For accounts covered under the new rule, an institution must develop and implement a written identity-theft prevention program that detects, prevents, and mitigates identity theft involving new or existing covered accounts. The program must be appropriate to the size and complexity of the financial institution and the nature and scope of its activities. A new card-issuer rule requires credit and debit card issuers to develop reasonable policies and procedures to assess the validity of requests for changes of address followed closely by requests for additional or replacement cards. In such situations, the card issuer must not issue an additional or replacement card until it assesses the validity of the change of address in accordance with its policies and procedures.

Examinations Concerning Truth in Savings Disclosures

In July 2008, DCCA issued updated interagency examination procedures associated with establishing compliance with Regulation DD (Truth in Savings). The updated procedures incorporate recommendations made by the Government Accountability Office (GAO) in a report issued in March 2008 entitled *Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts* (GAO-08-281). The study suggests that, despite regulatory disclosure requirements, consumers may find it difficult to obtain information about checking and savings account fees. As a result of the study, the GAO recommended that federal banking regulators assess the extent to which customers receive disclosures on fees, terms, and conditions prior to opening an account. It also recommended that the agencies incorporate appropriate steps into their oversight programs to ensure that disclosures continue to be made available.

The Board's updated Regulation DD examination procedures emphasize the existing requirement to provide full account disclosure (e.g., fees, terms, and conditions) to a consumer, upon request, whether or not the consumer is an existing or a prospective customer. The revisions also highlight that the disclosures should be provided at the time of the request if the consumer makes the request in person, or within 10 days if the consumer is not present when making the request. The revisions to the procedures also remind examiners that institutions must maintain evidence of compliance with Regulation DD, including the requirement to provide consumer disclosures upon request.

Interagency Examinations Concerning Electronic Fund Transfers

In August 2008, DCCA issued approved interagency examination procedures associated with establishing compliance with Regulation E (Electronic Fund Transfers). The updated procedures incorporate all amendments to Regulation E (and the Federal Reserve's Official Staff Commentary) since a prior version was released in 1998. Among other changes, the procedures clarify the responsibilities of parties involved in electronic check conversion transactions, include a requirement that consumers receive written notification in advance of these transactions, and revise the Official Staff Commentary to provide guidance on preauthorized transfers from consumers' accounts, error resolution, and disclosures at automated teller machines.

Interagency Statement on Lending to Creditworthy Borrowers

In November 2008, the agencies issued an Interagency Statement on Meeting the Needs of Creditworthy Borrowers. In implementing this statement, institutions were encouraged to lend prudently and responsibly to creditworthy borrowers, work with borrowers to preserve homeownership and avoid preventable foreclosures, adjust dividend policies to preserve capital and lending capacity, and employ compensation structures that encourage prudent lending. The statement emphasized that the agencies expect banking organizations to work with existing borrowers to avoid preventable foreclosures, which can be costly to both the organizations and to the communities they serve, and to mitigate other potential mortgage-related losses. The agencies urged that all lenders and servicers seek modifications that result in mortgages that borrowers will be able to sustain over the remaining maturity of their loans. The statement also emphasized that the agencies will fully support banking organizations as they work to implement effective and sound loan modification programs.

Flood Insurance

The National Flood Insurance Act imposes certain requirements on loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood hazards. Under Regulation H, which implements the act, state member banks are generally prohibited from making, extending, increasing, or renewing any such loan unless the building or mobile home—and any personal property securing the loan—are covered by flood insurance for the term of the loan. Moreover, the act requires the Board and other federal financial institution regulatory agencies to impose civil money penalties when it finds a pattern or practice of violations of the regulation. The civil money penalties are payable to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

In March 2008, the agencies, along with the National Credit Union Administration (NCUA) and Farm Credit System, requested public comment on new and revised interagency questions and answers regarding flood insurance. The agencies proposed substantive as well as technical revisions to existing guidance to help financial institutions meet their responsibilities under federal flood insurance legislation and increase public understanding of the flood insurance regulations. Final action on these proposed revisions is expected in 2009.

During 2008, the Board imposed civil money penalties against four state member banks that violated the act. The penalties, which were assessed via consent orders, totaled $17,790.

Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This discussion summarizes data collected from the 12 Federal Reserve Banks and the FFIEC member agencies (collectively, the FFIEC agencies), as well as other federal enforcement agencies.[26]

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 85 percent of institutions examined during the 2008 reporting period were in compliance with Regulation B, which equals the level of compliance for the 2007 reporting period. The most frequently cited violations involved

- the failure to properly collect information for government monitoring purposes, including data on race, ethnicity, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence;
- the improper collection of information on applicant race, color, religion, national origin, or sex when not permitted by regulation;
- the improper requirement of the signature of an applicant's spouse or other person, other than a joint applicant, when the applicant qualified under the creditor's standards of creditworthiness for the amount and terms of the credit requested; and
- the failure to provide a credit applicant with a written notice of denial or other adverse action that contains the specific reason for the adverse action, along with other required information.

The FFIEC agencies did not issue any public enforcement actions specific to Regulation B during the reporting period.

The Farm Credit Administration, the Department of Transportation, the Securities and Exchange Commission, the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the United States Department of Agriculture reported substantial compliance among the entities they supervise.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 94 percent of the institutions examined during the 2008 reporting period complied with Regulation E, which equals the level of compliance for the 2007 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- determining whether an error occurred within 10 business days of receiving a notice of error from a consumer;
- giving a consumer provisional credit for the amount of an alleged error when an investigation into the alleged error could not be completed within 10 business days;
- providing initial disclosures that contain required information, including limitations on the types of transfers

26. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2008 reporting period was July 1, 2007, through June 30, 2008.

permitted and error-resolution procedures, at the time a consumer contracted for an electronic fund transfer service; and

- providing a written explanation noting the consumer's right to request documentation that supports the institution's findings when a determination is made that no error has occurred.

The FFIEC agencies did not issue any formal enforcement actions specific to Regulation E during the period.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of institutions examined during the 2008 reporting period complied with Regulation M, which equals the level of compliance for the 2007 reporting period. The FFIEC agencies did not issue any formal enforcement actions relating to Regulation M during the period.

Regulation P (Privacy of Consumer Financial Information)

The FFIEC agencies reported that 97 percent of the institutions examined during the 2008 reporting period complied with Regulation P, which equals the level of compliance for the 2007 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- providing a clear and conspicuous annual privacy notice to customers;
- disclosing the institution's information-sharing practices in initial, annual, and revised privacy notices; and
- providing customers with a clear and conspicuous initial privacy notice that accurately reflects the institution's privacy policies and practices, not later than when the customer relationship is established.

The FFIEC agencies did not issue any formal enforcement actions relating to Regulation P during the reporting period.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 81 percent of the institutions examined during the 2008 reporting period were in compliance with Regulation Z, compared with 82 percent in 2007. The most frequently cited violations involved the failure to accurately disclose one or more of the following:

- the finance charge in closed-end credit transactions;
- the amount financed by subtracting any prepaid finance charges;
- the payment schedule, including the number, amounts, and timing of payments scheduled to repay the obligations; and
- the annual percentage rate in closed-end credit transactions.

In addition, 146 banks supervised by the Federal Reserve, FDIC, OCC, and OTS were required, under the Interagency Enforcement Policy in Regulation Z, to reimburse a total of approximately $2.77 million to consumers for understating annual percentage rates or finance charges in their consumer loan disclosures.

The FFIEC agencies did not issue any public enforcement actions specific to Regulation Z during the reporting period. The Department of Transportation continued to prosecute one air carrier for its improper handling of credit card refund requests and other Federal Aviation Act violations.

Regulation AA (Unfair or Deceptive Acts or Practices)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2008 reporting period were in compliance with Regulation AA, which equals the level of compliance for the 2007 reporting period. No formal enforcement actions relating to Regulation AA were issued during the reporting period.

Regulation CC (Availability of Funds and Collection of Checks)

The FFIEC agencies reported that 89 percent of institutions examined during the 2008 reporting period were in compliance with Regulation CC, compared with 90 percent for the 2007 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- making available on the next business day the lesser of $100 or the aggregate amount of checks deposited that are not subject to next-day availability;
- following procedures when invoking the exception for large-dollar deposits;
- providing required information when placing exception holds on accounts; and
- making funds from local and certain other checks available for withdrawals within the times prescribed by regulation.

The FFIEC agencies did not issue any public enforcement actions specific to Regulation CC during the reporting period.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 86 percent of institutions examined during the 2008 reporting period were in compliance with Regulation DD, compared with 88 percent for the 2007 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- providing additional required language in advertisements that contain the term "annual percentage yield";
- using the term "annual percentage yield" if advertisements state rates of return;
- providing initial account disclosures containing all required information; and
- providing account disclosures in writing and in a form consumers may keep.

The FFIEC agencies did not issue any public enforcement actions specific to Regulation DD during the reporting period.

Consumer Complaints and Inquiries

The Federal Reserve investigates complaints against state member banks, and forwards complaints against other creditors and businesses to the appropriate enforcement agency. Each Reserve Bank investigates complaints against state member banks in its District. The Federal Reserve also responds to consumer inquiries on a broad range of banking topics, including consumer protection questions.

The Federal Reserve centralized processing of consumer complaints and inquiries in late 2007, with the establishment of Federal Reserve Consumer Help (FRCH). In 2008, its first full year of operation, FRCH processed 36,996 cases. Of these cases, 19,515 (53 percent) were inquiries and 17,481 (47 percent) were complaints, with most cases received directly from consumers. Approximately six percent were referred from other agencies.

While consumers can contact FRCH by phone, fax, mail, e-mail, or online (www.federalreserveconsumerhelp.gov/), most FRCH consumer contacts occurred by telephone. Nevertheless, online complaints submissions totaled 5,147 (29 percent) of all complaints received in 2008, and the online form received over 300,000 visits during the year.

Consumer Complaints

Complaints against state member banks totaled 5,520 in 2008. Most of these complaints, 2,411 (44 percent) were closed without investigation pending the receipt of additional information from consumers. Of the remaining 3,109 complaints, 2,173 (70 percent) involved unregulated practices and 936 (30 percent) involved regulated practices.

The Federal Reserve forwarded 11,966 complaints against other banks and creditors to the appropriate regulatory agencies for investigation. To minimize the time required to re-route complaints to these agencies, referrals were transmitted electronically.

Complaints against State Member Banks about Regulated Practices

The majority of regulated-practice complaints concerned checking account (28 percent) and credit card (26 percent) activity. The most common checking account complaints related to insufficient funds or overdraft charges and procedures (33 percent), funds availability (13 percent), and disputed withdrawals of funds (15 percent). The most common credit card complaints concerned billing error resolutions (14 percent), "other rates, terms and fees" (12 percent) and debt-collection practices (9 percent).

Complaints against State Member Banks That Involve Regulated Practices, by Classification, 2008

Classification	Number
Regulation AA (Unfair or Deceptive Acts or Practices)	117
Regulation B (Equal Credit Opportunity)	30
Regulation C (Home Mortgage Disclosure Act)	8
Regulation E (Electronic Funds Transfers)	116
Regulation M (Consumer Leasing)	3
Regulation P (Privacy of Consumer Financial Information)	41
Regulation Q (Payment of Interest)	0
Regulation Z (Truth in Lending)	247
Regulation BB (Community Reinvestment)	0
Regulation CC (Expedited Funds Availability)	122
Regulation DD (Truth in Savings)	71
Regulation V (Fair and Accurate Credit Transactions)	9
Fair Credit Reporting Act	72
Fair Debt Collection Practices Act	62
Fair Housing Act	3
National Flood Insurance Act/ Insurance Sales	6
Home Ownership Counseling	1
HOPA (Homeowners Protection Act)	0
Real Estate Settlement Procedures Act	18
Right to Financial Privacy Act	10
Total	**936**

Real estate-related complaints[27] made up 18 percent of total complaints. Of those, 48 percent related to home-purchase loans, 32 percent to home equity credit lines, and only one percent (or two complaints) concerned adjustable rate mortgages. The most common complaints related to real estate-related payment errors and delays (14 percent), "other rates, terms, and fees" (10 percent), and escrow account problems (9 percent).

27. Includes adjustable-rate mortgages; residential construction loans; open-end home equity lines of credit; home improvement loans; home purchase loans; home refinance/closed-end loans; and reverse mortgages.

Complaints against State Member Banks That Involve Regulated Practices, 2008

Subject of complaint	All complaints		Complaints involving violations	
	Number	Percent	Number	Percent
Total	**936**	**100**	**44**	**5**
Discrimination alleged				
Real estate loans	10	1	1	0.1
Credit cards	1	0.1	0	0
Other loans	6	1	0	0
Nondiscrimination complaints[1]				
Credit cards	245	26	6	1
Checking accounts	264	28	16	2
Real estate loans	156	18	7	1

1. Only the top three product categories of nondiscrimination complaints are listed here.

Seventeen complaints (2 percent) alleged discrimination on the basis of prohibited borrower traits or rights (race, color, religion, national origin, sex, marital status, handicap, age, applicant income deriving from public assistance programs, or applicant reliance on Consumer Credit Protection Act provisions). Sixty-five percent of discrimination complaints were related to the race or national origin of the applicant or borrower.

In the substantial majority (80 percent) of investigated complaints against state member banks, gathered evidence revealed that banks correctly handled the situation. Of the remaining 20 percent, 5 percent were deemed law violations, 3 percent were general errors, and the remainder mainly involved factual disputes or litigated matters. The most common violations involved checking accounts and credit cards.

Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board continued to monitor complaints about banking practices not subject to existing regulations, with a focus on instances of potential unfair or deceptive practices. In 2008, the Board received 2,119 complaints against state member banks that involved these unregulated practices. Most complaints concerned credit card and checking account activity. More specifically, consumers most frequently complained about issues involving insufficient funds or overdraft charges and procedures (386), deposit forgery, fraud, embezzlement or theft (91), concerns about credit card interest rates, terms, and fees (87), and concerns about opening and closing deposit accounts (80).

Complaint Referrals to HUD

In 2008, the Federal Reserve forwarded three complaints to the Department of Housing and Urban Development that alleged violations of the Fair Housing Act.[28] The Federal Reserve's investigation of these complaints revealed no evidence of illegal credit discrimination.

Consumer Inquiries

In 2008, the Federal Reserve received 19,515 inquiries from consumers re-

28. In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies requiring that complaints alleging a violation of the Fair Housing Act be forwarded to HUD.

lated to a wide range of topics. Of these, 4,488 (23 percent) fell into the "other" category, with several inquiries related to personal and national economic conditions and several inquiries related to regulatory changes or proposals under consideration. The top three consumer protection issues documented with specific codes were the following: adverse action notices received pursuant to the Equal Credit Opportunity Act (13 percent), consumer protection regulations (7 percent), and preapproved credit solicitations (7 percent). Consumers were typically directed to other resources, including other federal agencies or written materials, to address their inquiries.

Outreach and Response to Community Development Needs in Historically Underserved Communities and Markets

The mission of the community affairs function within the Federal Reserve System is to promote community economic development and fair access to credit for low- and moderate-income communities and populations. A decentralized function, the Community Affairs Offices (CAOs) are maintained at each of the 12 Reserve Banks, where CAO staffs design activities in response to the needs of communities in the Districts they serve, with oversight of operations provided by Board staff. The CAOs focus on providing information and promoting awareness of investment opportunities to financial institutions, government agencies, and organizations that serve low- and moderate-income people and communities. Similarly, the Board's CAO promotes and coordinates Systemwide community development efforts; in particular, Board community affairs staff focus on issues that have public policy implications.

In 2008, the Board's regulatory and supervisory actions were augmented by the System's Community Affairs staff activities to address the negative impact of foreclosures on individuals and communities. Community Affairs staff developed online Foreclosure Resource Centers on the websites of each Reserve Bank and the Board. These centers provide up-to-date information regarding resources available to distressed borrowers, local governments, and lenders. Community Affairs analysts and outreach specialists continued to use their longstanding networks of industry and community relationships to convene meetings and provide information to local community and business leaders, government officials, consumer and community groups, and others engaged in addressing the foreclosure issue locally. To complement these efforts, System research staff collected and analyzed data on real estate and subprime mortgage conditions, and provided regional foreclosure projections and in-depth analysis of the incidence of defaults within particular areas to support state and local government efforts to develop action plans under the Neighborhood Stabilization Program (NSP). In addition, visiting scholar Alan Mallach, of the Federal Reserve Bank of Philadelphia, published a discussion paper, *How to Spend $3.92 Billion: Stabilizing Neighborhoods by Addressing Foreclosed and Abandoned Properties.* The paper serves to assist states, counties, and cities in determining the best use of funds distributed under the Housing and Economic Recovery Act of 2008 (HERA).

Federal Reserve Community Affairs staff also hosted a number of events, conferences, and meetings on the topic of foreclosure in 2008. The System developed a conference series, *Renewal, Recovery, Rebuilding: A Federal*

Reserve System Foreclosure Series, to highlight issues and best practices in weak as well as strong housing markets (see *Foreclosures: Responding to Consumers and Communities in Crisis through the Federal Reserve's Home Mortgage Initiative* in the "Mortgage Credit" discussion earlier in this chapter). The culmination of the series, held at the Board's offices in Washington, D.C., were presentations on the challenges of valuing foreclosed properties, on the NSP program, and on the issuance of best practices for dealing with large numbers of foreclosures developed in communities such as Flint, Michigan and Youngstown, Ohio.

The System also continued to work with the HOPE NOW alliance, a collaboration of counselors, servicers, investors, and other mortgage market participants. Many Reserve Banks co-sponsored "foreclosure mitigation" events, bringing distressed borrowers together with counselors and mortgage servicers to discuss and, where possible, to implement loan compromises between borrowers and lenders. The largest such event drew more than 2,000 borrowers to Gillette Stadium in Foxboro, Massachusetts. The Federal Reserve Bank of Boston is working to track the success of the loan modifications that were arranged at that event and to better understand any limitations of the current modification structure. Similar events have either been held or are planned in other Reserve Bank districts.

The Board and System worked with NeighborWorks America on a unique partnership to (1) address the impact of foreclosures on neighborhoods by jointly developing the tools and training necessary to help local governments and nonprofit organizations, and (2) evaluate approaches and tailor responses to address the increase in foreclosures and real-estate-owned (REO) properties. The partnership, begun in May 2008, not only builds on an existing relationship with NeighborWorks (Federal Reserve staff serve on its Board of Directors), but also leverages the System's ability to conduct data analysis, research, and outreach to address issues related to neighborhood stabilization. As part of the partnership, the Board supported the development of a new website,[29] and new courses for the NeighborWorks Training Institute, which helps ensure effective management of REO properties. In addition to being offered as part of the Training Institute, these courses are designed to be portable so that they can be brought directly to communities in 2009.

Finally, the Community Affairs programs at all 12 Reserve Banks and the Board of Governors collaborated to publish *The Enduring Challenge of Concentrated Poverty: Case Studies from Communities Across the U.S.,* a project undertaken by Community Affairs in partnership with the Brookings Institution. The report was undertaken to develop a deeper understanding of the relationship between "poverty, people, and place." The Board hosted a policy forum to highlight issues raised in the case studies and to discuss place-based and people-based policy solutions, such as workforce development and education, to address problems prevalent in communities experiencing concentrated poverty.

Advice from the Consumer Advisory Council

The Board's Consumer Advisory Council—whose members represent consumer and community organiza-

29. See www.stablecommunities.org.

tions, the financial services industry, academic institutions, and state agencies—advises the Board of Governors on matters of Board-administered laws and regulations as well as other consumer-related financial services issues. Council meetings, open to the public, were held in March, June, and October. For a list of members of the Council, see the "Federal Reserve System Organization" section in this report; also, visit the Board's website for transcripts of Council meetings.[30]

Three significant topics of discussion for the Council in 2008 were

- the Board's proposal to establish new protections for consumers in the residential mortgage market through amendments to Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act;
- the Board's proposal, under the Federal Trade Commission Act (FTC Act), to prohibit unfair or deceptive acts or practices by banks in connection with credit card accounts and overdraft services for deposit accounts; and
- issues related to home foreclosures, including loss-mitigation strategies, counseling initiatives, and community stabilization efforts.

Proposed Rules for Home Mortgage Loans

In its March meeting, the Council addressed various issues related to consumer protections proposed under Regulation Z (see the "Mortgage Credit" discussion earlier in this chapter).

Some industry representatives endorsed the Board's approach to define subprime loans based on the annual percentage rate (APR) charged rather than on other loan features, but they expressed the view that the proposed definition would be too broad and would cover many prime loans. One member recommended using a mortgage-rate (instead of Treasury-securities) index to set the threshold and apply a different spread for first-lien loans. Another member commented that any APR threshold or other definitional trigger for higher-priced loans would be, at times, under-inclusive or over-inclusive, and expressed a preference for erring on the side of over-inclusion.

Several consumer representatives expressed support for the Board's proposal under which a creditor would be prohibited from engaging in a "pattern or practice" of lending based on the collateral without regard to the consumer's ability to make scheduled payments. They emphasized the importance of establishing rules for prudent underwriting. Offering the perspective of community banks, an industry representative commented that such institutions generally follow rigorous underwriting standards, but noted that they sometimes need flexibility to adjust their practices to meet the needs of particular customers. Regarding the proposal's "pattern or practice" provision, members expressed concern about the difficulty of establishing proof of a pattern or practice in litigation, and urged the Board to clarify what constitutes a pattern or practice. Some members noted that the "pattern or practice" provision sets up significant hurdles for individual consumers to bring cases against lenders. Members presented a variety of views about the idea of designating a bright-line presumption of a violation, or a safe harbor, for repayment ability at

30. See the Federal Reserve Board's Consumer Advisory Council webpage, www.federalreserve.gov/aboutthefed/cac.htm.

a 50 percent debt-to-income (DTI) ratio. Several members cautioned against using the 50 percent DTI ratio or another specific number in the regulation.

Several members endorsed the use of third-party documentation to verify income and assets, noting that such flexibility would help address the needs of different borrowers. A consumer representative urged the Board to clarify whether nontraditional forms of documentation from small- or micro-business owners would be acceptable under the regulation.

Various members endorsed a complete ban on prepayment penalties for higher-priced loans. They expressed concern that prepayment penalties are not balanced by lower interest rates for subprime borrowers, who are often the least financially sophisticated consumers and for whom there is no well-known interest-rate benchmark for negotiating better loan terms. Several industry representatives expressed the view that, although there have been problems with prepayment penalties in the subprime market, they can be useful tools and yield lower interest rates for consumers. Industry representatives suggested that prepayment penalties can be effectively regulated, such as through better disclosure and limits on duration or amount. Both consumer and industry representatives agreed that the five-year duration permitted in the proposal for penalties would be too long, and considered it not reflective of current best practices in the industry.

There was general support among Council members for proposed mandatory escrow accounts as a way to help ensure the successful performance of higher-priced loans. In considering the option to cancel escrow accounts 12 months after consummation, one member expressed the view that 12 months would be too short, especially for more financially vulnerable borrowers or first-time homeowners. Several industry representatives noted the potential impacts of mandatory escrow accounts on financial institutions' business processes.

In the discussion of yield-spread premiums, some members expressed support for requiring the same compensation disclosures for all loan originators in order to facilitate better comparisons among products and services as well as to better ensure fair lending. Other members supported applying the proposed disclosure rules only to brokers. Some members spoke against the idea of establishing an agreement characterized by a specific compensation figure before the loan application is received. In the absence of key information about the borrower or the loan product, the broker would have to disclose the highest possible fee, which would not be useful to the particular borrower. One member noted that, in the subprime market, loan applications and fees are often taken at closing, and recommended that the Board consider another trigger for the written agreement that would more likely occur earlier.

Consumer representatives generally supported the proposal's advertising restrictions. They specifically endorsed a "bright-line" rule for use of the word "fixed" in advertisements, permitting it only if the rate or payment would not change for the entire length of the loan.

Members expressed support for the proposed rules regarding servicing practices. An industry member noted that most of the rules, such as crediting payments as of the date of receipt and not pyramiding late fees, are consistent with current best practices in the industry. Other members expressed concern about the difficulty of accurately disclosing third-party fees, which may change without notice, and potential compliance challenges if a re-disclosure is required whenever a third-party fee changes.

There was general consensus regarding the provisions prohibiting coercion of appraisers, with one member noting that the rule should highlight the more subtle ways of unduly influencing the appraisal process.

Under the proposal, creditors would be required to provide transaction-specific cost disclosures earlier. Some members cautioned that providing disclosures earlier would not clarify loan terms for consumers, who could end up with several sets of disclosures as various details changed during the loan process. One member expressed concern about the proposed rule regarding what fees can be collected before early disclosures are provided. Another member stated that providing the cost disclosures early in the application process would not address a key issue, which is that estimates generally change by the time loans close.

Proposed Rules for Credit Cards and Overdraft Services

In its June and October meetings, the Council's discussions focused on various aspects of the Board's proposed rules to prohibit unfair or deceptive acts or practices in connection with credit card accounts and overdraft services for deposit accounts (see the "Credit Cards" discussion earlier in this chapter).

Credit Card Accounts

Some industry representatives expressed concern about labeling certain practices that are used widely among financial institutions as unfair or deceptive, and urged the Board to consider issuing many of the credit card rules under TILA. Other members supported issuing the rules under the FTC Act rather than TILA. They expressed the view that institutions would face little new litigation risk from the proposal, especially if the regulations have clear safe harbors.

In the discussion of payment allocation, consumer representatives encouraged the Board to require that payments be allocated first to balances with the highest APR. Several members commented that a single allocation method would make credit pricing more transparent to consumers and would provide a level playing field for creditors. Some consumer representatives emphasized the benefit to less sophisticated consumers of allocating payments first to the highest APR balance.

Industry representatives supported the current industry practice of allocating payments to the lowest APR balance first, expressing the view that the proposed pro rata and equal portion allocation methods would be confusing to consumers. They also cautioned that switching to the proposed allocation methods likely would lead to higher credit costs and reduced access to credit as institutions seek to offset losses in revenue. Some members urged the Board, in applying the approved payment-allocation methods, to treat promotional rate balances and deferred interest balances in the same way as other balances.

Several members supported the proposal to restrict creditors' ability to increase rates on existing balances, emphasizing that it would provide safeguards for both consumers and lenders. They noted that consumers may not be able to prevent risk-based repricing solely through their behavior because often they lack information about how credit scores are determined and can change. Industry representatives opposed the proposal, saying it would eliminate a key risk-management tool for creditors. They stated that, due to lost revenues, overall pricing for credit may increase and credit availability may decline if creditors cannot apply risk-based pricing to their riskiest customers. Industry representatives also urged the Board to consider expanding the circumstances where existing balances can be repriced to include other consumer behavior that raises concerns about a borrower's risk.

There was general support among the Council members for restricting the practice of financing security deposits and initial fees that use up most of a borrower's credit limit. Several members expressed concern that the percentages in the proposed rule would be too high, and they cautioned that those thresholds could become the standard. One member recommended that the financing of security deposits and fees should be spread out beyond the proposed 12 months.

Members disagreed about the appropriateness of the proposed safe harbor for mailing periodic statements 21 days before a payment's due date, particularly given the trend toward electronic payments. There was general agreement among the members about the proposed provisions regarding cut-off times and due dates for mailed payments. Several members recommended that the rule apply to all types of payments. Consumer representatives endorsed the ban on two-cycle billing, and expressed support for the proposed provision regarding firm offers of credit.

Overdraft Services

The Board's overdraft services proposal would prohibit banks from imposing a fee for paying an overdraft unless the bank provides the consumer with an opportunity to opt out of the overdraft payment and the consumer has not done so. Industry representatives recommended issuing the rules under Regulation E (Electronic Fund Transfer Act) rather than the FTC Act, expressing the view that overdraft services do not constitute an unfair or deceptive practice because they provide important benefits to consumers. Industry representatives supported the proposed right to opt out of the payment of overdrafts and described potential operational difficulties with an opt-in. They also suggested additional exceptions under which overdrafts should be paid and a fee charged even if the consumer has opted out.

Several other members urged the Board to require institutions to gain consumers' affirmative consent for overdraft payments with an opt-in, commenting that banks would be more likely to provide clear information about overdraft services to their customers. They expressed concern that consumers are currently enrolled in overdraft programs automatically, which they described as an expensive form of credit that often poses more harm than benefits for low- and moderate-income consumers, especially college-age students and the elderly. Some members supported the proposed rule requiring institutions to allow consumers to opt out of overdrafts for ATM and point-of-sale transactions without opting out of overdraft services for checks. Industry representatives opposed the partial opt-out, and urged the Board to treat all transactions in the same way. There was general support for requiring notice of the opt-out at least once for each periodic statement cycle in which an overdraft fee or charge occurs.

Industry representatives commented on the operational challenges and the potential impact on consumers of a provision that would prohibit banks from imposing a fee when an account is overdrawn solely because a hold was placed on funds in the consumer's deposit account. Consumer representatives supported the provision, expressing the view that institutions should be able to readily address any operational issues. There was general consensus on the importance of faster settlement of authorized transactions so that debit holds can be released more quickly. Several members also expressed the view that consumers should receive better notice of debit holds from merchants at the point of sale so they can choose whether and how to proceed with the transaction.

In a discussion of disclosures related to overdraft services, several members emphasized the importance of disclosing, on the opt-out notice, any alternatives for the payment of overdrafts that the institution offers. Consumer representatives expressed support for disclosing on periodic statements the aggregate dollar amounts charged for overdraft fees and returned-item fees. Some members also stated that institutions, when they provide account-balance information, should not be permitted to include funds that would be available through overdrafts.

Foreclosure Issues

In its March and October meetings, the Council also addressed various issues related to the surge in foreclosures, including loss-mitigation strategies, counseling initiatives, and community stabilization efforts. The October discussion focused on two initiatives in HERA: the HOPE for Homeowners Program and the NSP.

In March, consumer representatives expressed concern about the capacity of servicers to engage in loss mitigation on a large scale. They stated that, despite some recent improvements, servicers generally are overwhelmed. Members pointed to other areas of concern regarding servicers, such as the lack of coordination between servicers' foreclosure and loss-mitigation departments as well as pressure for repayment workouts rather than modifications of loan rates or principal amounts. The efforts of the HOPE NOW alliance—coordinating servicer and lender work with borrowers and collecting and sharing data—were also highlighted.

In October, there was general agreement that the results of loss-mitigation efforts by servicers have been mixed, with some improvement in responsiveness but also continued backlogs and capacity issues. Several members also expressed concern about the voluntary nature of the HOPE for Homeowners Program for lenders, though industry representatives noted that the program is only one tool among various loss-mitigation strategies.

Several members expressed support for a more comprehensive plan to stem the increasing wave of foreclosures, including a moratorium on foreclosures and more systematic loan modifications. They urged the Board to use its influence with lenders and servicers to encourage them to pursue sustainable loan modifications. One member expressed support for court-ordered modifications of mortgages for principal residences. Several consumer representatives suggested that institutions participating in the Troubled Assets Relief Program (TARP) should be required to modify loans.

Industry representatives expressed the view that servicers and lenders increasingly recognize the importance of doing loan modifications that are sustainable for the long term, but a consumer advocate stated that many modifications still have too short-term a time frame. Several consumer representatives endorsed a focus on principal write-downs as a key way to achieve sustainable modifications. Industry representatives pointed to the difficulties in doing principal write-downs, and noted that focusing on affordability in loss mitigation can preserve homeownership even if the loss of equity is not addressed.

There was a consensus that timely, accurate, comprehensive, and accessible information about the scope of delinquencies and defaults and the outcomes of loss-mitigation efforts are critical to an effective analysis of foreclosure issues and proposed policies or solutions. Noting that some key data on these issues are privately held, several members supported the idea of a survey conducted by the Federal Reserve to ensure the credibility and comprehensiveness of the data collected.

Several members expressed concerns about the proliferation of firms that offer loan-modification or foreclosure-rescue services at high upfront fees, and consumer representatives described the need for greater support for counseling agencies.

Various members described the negative impact of the rising number of foreclosures in their communities, and expressed concern about the effects of foreclosure concentrations in low- and moderate-income neighborhoods. They also described various local efforts to respond to foreclosures, such as programs to provide counseling to struggling borrowers and initiatives to reclaim and rehabilitate foreclosed properties. Some consumer representatives recommended giving favorable Community Reinvestment Act (CRA) credit to institutions to address foreclosure-related issues, which could prompt banks to go beyond their usual work in low-income areas and take on initiatives related to foreclosures. Another member suggested that banks could get favorable CRA credit for foreclosure efforts that fall outside their assessment area, similar to what was permitted after Hurricane Katrina.

There was general support for the wide array of activities permitted under the NSP, which will give communities various strategies to address their specific challenges. One member emphasized the need to pay attention to fair-housing issues amid the NSP implementation. Another member commended the intent of the NSP but cautioned that its goals cannot be met if financial institutions do not resume lending for community development projects. He expressed the view that such lending could be tied to the receipt of TARP funds or could be accomplished through the network of the Community Development Financial Institutions Fund. The members generally agreed on the need for comprehensive and accurate data on real-estate-owned properties, so that communities can more effectively develop and evaluate their stabilization strategies.

Other Discussion Topics

At the Council's June meeting, members provided feedback on proposed regulations from the Board and the Federal Trade Commission to implement a provision of the Fair and Accurate Credit Transactions Act of 2003 (which amends the Fair Credit Reporting Act) that addresses risk-based pricing. An industry representative commended the Board for its attention to the goal of operational feasibility in implementing the proposal. Some members expressed support for defining "material terms" primarily with reference to the annual percentage rate because the bright-line test would make it easier for creditors to identify consumers who must receive risk-based pricing notices. In considering the proposed tests for identifying which consumers should receive notices, one member urged the Board to set forth a test to identify those consumers receiving less-favorable terms across the spectrum of creditors. Several members expressed concern about the vagueness of the proposed definition of "materially less favorable."

One member commented that while the risk-based pricing notices would aid consumers by encouraging them to check their consumer reports, they would benefit further if the notices advised that other factors also can affect the credit terms and if the notices gave examples of those factors. Members expressed divergent views about the Board's interpretation that the statute gives a consumer the right to request a free consumer report upon receipt of a risk-based pricing notice. An industry representative commended the Board for providing alternative approaches by which creditors could determine which consumers must receive risk-based pricing notices. Several members expressed support for the proposal's exceptions for prescreened credit solicitations and credit-score disclosures. One member urged the Board to require a notice for consumers who lack credit files, so that they might become aware of their lack of credit records and receive information on how to establish traditional credit files.

At the Council's October meeting, members discussed recent financial developments, including the challenges faced by banks and nonbank financial institutions, disruptions in credit markets, and the recently launched TARP. In the discussion of the challenges and opportunities presented by the current financial crisis, several members cited the need to encourage the flow of credit to communities, especially to low-income communities. They also highlighted the opportunity for Community Development Fund Institutions, community development banks, minority banks, and credit unions to continue their responsible lending activities, particularly in distressed communities. Members also commented on the importance of maintaining access to credit for small businesses. Both consumer and industry representatives emphasized the need for greater accountability from institutions that receive TARP funds to ensure that there are benefits for low- and moderate-income areas.

Another October discussion topic was the Board's analysis of the 2007 Home Mortgage Disclosure Act (HMDA) data (see the "Evaluating Pricing Discrimination Risk with HMDA Data and Other Information" discussion earlier in this chapter). Several consumer representatives pointed to the HMDA statistics (about higher-priced loan originations by independent mortgage companies and the percentage of higher-priced loans made to CRA-eligible customers) as evidence that CRA did not cause the subprime mortgage crisis. Various members urged the Board to use its data and analysis to rebut misperceptions about CRA, especially in connection with the subprime crisis, and to highlight the positive outcomes of CRA for low- and moderate-income individuals and communities. ■

Federal Reserve Banks

The Federal Reserve Banks provide payment services to depository and certain other institutions, distribute the nation's currency and coin, and serve as fiscal agents and depositories for the United States. The Reserve Banks also contribute to setting national monetary policy and supervision and regulation of banks and other financial entities (discussed in the preceding chapters of this report).

Developments in Federal Reserve Priced Services

Federal Reserve Banks provide a range of payment and related services to depository institutions, including collecting checks, operating an automated clearinghouse (ACH) service, transferring funds and securities, and providing a multilateral settlement service. The Reserve Banks charge fees for providing these "priced services."

The Monetary Control Act of 1980 requires that the Federal Reserve establish fees for priced services provided to depository institutions so as to recover, over the long run, all direct and indirect costs actually incurred as well as the imputed costs that would have been incurred, including financing costs, taxes, and certain other expenses, and the return on equity (profit) that would have been earned if a private business firm had provided the services.[1] The imputed costs and imputed profit are collectively referred to as the *private-sector adjustment factor* (PSAF).[2] Over the past 10 years, Reserve Banks have recovered 98.7 percent of their priced services costs, including the PSAF (see table, next page).[3]

In 2008, Reserve Banks recovered 98.5 percent of total priced services costs of $886.9 million, including the PSAF.[4] Revenue from priced services amounted to $773.4 million, other income was $100.4 million, and costs were $820.4 million, resulting in net income from priced services of $53.4 million.[5]

1. Financial data reported throughout this chapter—including revenue, other income, costs, income before taxes, and net income—can be linked to the pro forma financial statements at the end of this chapter.

2. In addition to income taxes and the return on equity, the PSAF includes three other imputed costs: interest on debt, sales taxes, and an assessment for deposit insurance by the Federal Deposit Insurance Corporation (FDIC). Board of Governors assets and costs that are related to priced services are also allocated to priced services; in the pro forma financial statements at the end of this chapter, Board assets are part of long-term assets, and Board expenses are included in operating expenses.

3. Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* which has resulted in the recognition of a $690.6 million reduction in equity related to the priced services' benefit plans through 2008. Including this reduction in equity, which represents a decline in economic value, results in cost recovery of 92.0 percent for the 10-year period. For details on how implementing SFAS No. 158 affected the pro forma financial statements, refer to notes 3 and 5 at the end of this chapter.

4. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the FDIC assessment), imputed income taxes, and the targeted return on equity.

5. *Other income* is revenue from investment of clearing balances net of earnings credits, an amount termed net income on clearing balances.

Priced Services Cost Recovery, 1999–2008

Millions of dollars except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity	Total costs	Cost recovery (percent)[3, 4]
1999	867.6	775.7	57.2	832.9	104.2
2000	922.8	818.2	98.4	916.6	100.7
2001	960.4	901.9	109.2	1,011.1	95.0
2002	918.3	891.7	92.5	984.3	93.3
2003	881.7	931.3	104.7	1,036.1	85.1
2004	914.6	842.6	112.4	955.0	95.8
2005	994.7	834.7	103.0	937.7	106.1
2006	1,031.2	875.5	72.0	947.5	108.8
2007	1,012.3	913.3	80.4	993.7	101.9
2008	873.8	820.4	66.5	886.9	98.5
1999–2008	9,377.4	8,605.3	896.3	9,501.7	98.7

NOTE: Here and elsewhere in this chapter, components may not sum to totals or yield percentages shown because of rounding.

1. For the 10-year period, includes revenue from services of $8,774.1 million and other income and expense (net) of $603.3 million.

2. For the 10-year period, includes operating expenses of $8,092.7 million, imputed costs of $171.3 million, and imputed income taxes of $341.3 million.

3. Revenue from services divided by total costs.

4. For the 10-year period, cost recovery is 92.0 percent, including the net reduction in equity related to FAS 158 reported by the priced services in 2008.

Commercial Check-Collection Service

In 2008, Reserve Banks recovered 97.8 percent of the total costs of their commercial check-collection service, including the PSAF. Reserve Banks' operating expenses and imputed costs totaled $647.1 million, of which $14.1 million was attributable to the transportation of commercial checks between Reserve Bank check-processing offices. Revenue amounted to $605.2 million, of which $11.0 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing offices, and other income was $78.4 million. The resulting net income was $36.5 million. Check-service fee revenue in 2008 decreased $99.8 million from 2007.

Reserve Banks handled 9.5 billion checks in 2008, a decrease of 4.6 percent from 2007 (see table, opposite page). The decline in Reserve Bank check volume is consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.[6] Of all the checks presented by Reserve Banks to paying banks in 2008, 75.9 percent were deposited and 53.9 percent were presented using Check 21 products, compared with 42.2 percent and 24.6 percent, respectively, in 2007.[7] By year-end 2008, this growth resulted in 91.1 percent of Reserve Bank check deposits and 70.5 percent of Reserve

6. The Federal Reserve System's retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. For details, see Federal Reserve System, "The 2007 Federal Reserve Payments Study: Noncash Payment Trends in the United States, 2003-2006" (December 2007), www.frbservices.org/files/communications/pdf/research/2007_payments_study.pdf.

7. The Reserve Banks also offer non-Check 21 electronic-presentment products. In 2008, 8.4 percent of Reserve Banks' deposit volume was presented to paying banks using these products.

Activity in Federal Reserve Priced Services, 2006–2008
Thousands of items

Service	2008	2007	2006	Percent change	
				2007 to 2008	2006 to 2007
Commercial check	9,545,424	10,001,289	11,083,122	–4.6	–9.8
Commercial ACH	10,040,388	9,363,429	8,230,782	7.2	13.8
Fedwire funds transfer	134,220	137,555	135,227	–2.4	0.9
National settlement	469	505	470	7.2	7.4
Fedwire securities transfer	11,717	10,110	9,053	15.9	11.7

NOTE: Activity in *commercial check* is the total number of commercial checks collected, including processed and fine-sort items; in *commercial ACH,* the total number of commercial items processed; in *Fedwire funds transfer* and *securities transfer,* the number of transactions originated online and offline; and in *national settlement,* the number of settlement entries processed.

Bank check presentments being made through Check 21 products.

In November 2008, the Federal Reserve Banks announced that the System would consolidate to a sole site for paper-check-processing and check-adjustments operations. These announcements are part of the Reserve Banks' multiyear initiative, begun in 2003, to reduce the number of offices at which Banks process checks and in order to meet their long-run cost-recovery requirement under the Monetary Control Act of 1980. Because of the rapid adoption of electronic check processing, the Reserve Banks were able to reduce their check-processing infrastructure more quickly than originally expected. The consolidations made it possible for Reserve Banks, in December 2008, to discontinue their dedicated check-transportation routes between Reserve Bank offices. Remaining paper checks that must be shipped between Reserve Banks are transported by the U.S. Postal Service or air freight services.

Commercial Automated Clearinghouse Services

In 2008, the Reserve Banks recovered 101.5 percent of the total costs of their commercial ACH services, including the PSAF. Reserve Bank operating expenses and imputed costs totaled $88.8 million. Revenue from ACH operations totaled $86.6 million and other income totaled $11.3 million, resulting in net income of $9.0 million. The Banks processed 10.0 billion commercial ACH transactions, an increase of 7.2 percent from 2007.

In 2008, nationwide ACH volumes continued to grow, but at a slower rate, as volume increases associated with electronic check-conversion applications—including checks converted at lockbox locations or at the point of purchase—decelerated.

Fedwire Funds and National Settlement Services

In 2008, Reserve Banks recovered 100.4 percent of the costs of their Fedwire Funds and National Settlement Services, including the PSAF. Reserve Bank operating expenses and imputed costs totaled $62.3 million in 2008. Revenue from these operations totaled $59.9 million, and other income amounted to $7.9 million, resulting in net income of $5.5 million.

Fedwire Funds Service

The Fedwire Funds Service allows participants to use their balances at Reserve Banks to transfer funds to other participants. In 2008, the number of Fedwire funds transfers originated by depository institutions decreased 2.4 percent from 2007, to approximately 134.2 million. The average daily value of Fedwire funds transfers in 2008 was $3.0 trillion.

In 2008, the Reserve Banks announced plans to implement enhanced Fedwire Funds Service message formats for cover payments and for payments containing remittance information by November 2009 and late 2010, respectively. These changes are intended to improve payment transparency and efficiency, and provide additional value-added services to Fedwire Funds Service participants.

National Settlement Service

The National Settlement Service is a multilateral settlement system that allows participants in private-sector clearing arrangements to settle transactions using Federal Reserve balances. In 2008, the service processed settlement files for 47 local and national private-sector arrangements, primarily check clearinghouse associations. The Reserve Banks processed slightly more than 15,000 files that contained almost 469,000 settlement entries for these arrangements in 2008.

Fedwire Securities Service

In 2008, the Reserve Banks recovered 102.5 percent of the total costs of their Fedwire Securities Service, including the PSAF. The Reserve Banks' operating expenses and imputed costs for providing this service totaled $22.2 million in 2008. Revenue from the service totaled $21.6 million, and other income totaled $2.9 million, resulting in net income of $2.3 million.

The Fedwire Securities Service allows participants to transfer electronically to other participants in the service certain securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations.[8] In 2008, the number of non-Treasury securities transfers processed via the service increased 15.9 percent from 2007, to approximately 11.7 million.

Float

The Federal Reserve had daily average credit float of $1,193.4 million in 2008, compared with credit float of $604.9 million in 2007.[9]

Developments in Currency and Coin

The Federal Reserve Banks issue the nation's currency (in the form of Federal Reserve notes) and distribute coin through depository institutions. The Reserve Banks also receive currency and coin from circulation through these institutions. The Reserve Banks received 36.7 billion Federal Reserve notes from circulation in 2008, a

8. The expenses, revenues, volumes, and fees reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and certain international organizations. Reserve Banks provide Treasury securities services in their role as the U.S. Treasury's fiscal agent. These services are not considered priced services. For details, see the section "Debt Services" later in this chapter.

9. Credit float occurs when the Reserve Banks present items for collection to the paying bank prior to providing credit to the depositing bank, and debit float occurs when the Reserve Banks credit the depositing bank prior to presenting items for collection to the paying bank.

3.4 percent decrease from 2007, and made payments of 37.7 billion notes into circulation in 2008, a 2.1 percent decrease from 2007. They received 64.4 billion coins from circulation in 2008, a 1.9 percent increase from 2007, and made payments of 72.3 billion coins into circulation, a 4.5 percent decrease from 2007.

Since mid-September, the crisis in financial markets has heightened demand for $100 notes among both international and domestic users.[10] In 2008, payments exceeded receipts by 1.0 billion notes, most of which were of the $100 denomination. For this reason, the value of currency in circulation, as of December 31, increased 7.8 percent from December 31, 2007, to $853.2 billion.[11]

Board staff worked with the Treasury Department, the U.S. Secret Service, and the Reserve Banks' Currency Technology Office to develop more-secure designs for the $5 and $100 Federal Reserve notes. Reserve Banks issued the redesigned $5 note in March 2008. The Treasury is continuing to develop a new design for the $100 note.

Consistent with the requirements of the Presidential $1 Coin Act, the Federal Reserve and the Mint conducted additional outreach to depository institutions and coin users to gauge demand for the coins and to anticipate and eliminate obstacles to the efficient circulation of $1 coins. Board staff worked with the Reserve Banks' Cash Product Office to address other coin distribution and management issues, including increased coin inventories, resulting partially from the United States Mint's commemorative circulating coin programs.

Reserve Banks continued implementing a program to extend the useful life of the System's BPS 3000 high-speed currency-processing machines. The program will replace the operating systems of the current equipment, which will help improve processing efficiency. Reserve Banks are in the early stages of adopting a new cash automation platform, known as the currency and coin handling environment, or CACHE. The new system will facilitate control and improve efficiency in cash operations, provide an expansive and responsive management information reporting system with superior and flexible report tools, facilitate business continuity and contingency planning, and enhance the support provided to customers and business partners.

Developments in Fiscal Agency and Government Depository Services

As fiscal agents and depositories for the federal government, the Federal Reserve Banks provide services related to the federal debt, help the Treasury collect funds owed to the federal government, process electronic and check payments for the Treasury, maintain the Treasury's bank account, and invest Treasury balances. Reserve Banks also provide certain fiscal agency and depository services to other entities.

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2008 amounted to $461.1 million, compared with $458.2 million in 2007 (see table, next page). Treasury-related costs

10. The Federal Reserve measures demand for U.S. currency in terms of growth in net payments (payments to circulation minus receipts from circulation). International demand for U.S. currency is influenced primarily by political and economic uncertainties associated with certain foreign currencies, which contrast with the U.S. dollar's relatively high degree of stability.

11. This increase is double the 3.9 percent average annual increase over the last five years.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2006–2008

Thousands of dollars

Agency and service	2008	2007	2006
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Treasury retail securities	72,373.7	74,149.2	73,931.4
Treasury securities safekeeping and transfer	9,304.7	8,687.7	7,535.2
Treasury auction	37,071.6	41,372.0	23,594.9
Computer infrastructure development and support	4,463.7	3,558.7	3,853.1
Other services	909.9	724.5	1,578.7
Total	124,123.7	128,492.1	110,493.2
Financial Management Service			
Payment services			
Government check processing	16,366.9	17,522.7	20,918.6
Automated clearinghouse	6,530.5	6,050.3	5,823.1
Fedwire funds transfers	108.3	116.8	123.1
Other payment programs	85,212.8	81,636.9	69,696.8
Collection services			
Tax and other revenue collections	37,412.1	38,254.5	37,095.5
Other collection programs	11,767.6	12,483.6	14,122.6
Cash-management services	51,620.6	46,093.6	48,320.2
Computer infrastructure development and support	65,058.6	70,999.9	67,046.4
Other services	7,577.4	**7,245.7**	7,414.8
Total	281,654.8	**280,404.2**	270,561.2
Other Treasury			
Total	24,073.1	**18,258.6**	16,786.3
Total, Treasury	429,851.5	427,154.9	397,840.7
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	2,676.3	2,706.0	2,929.8
United States Postal Service			
Postal money orders	8,257.7	8,913.2	9,334.4
Other agencies			
Other services	20,358.4	19,412.0	15,977.1
Total, other agencies	31,292.3	31,031.1	28,241.4
Total reimbursable expenses	461,143.9	458,186.0	426,082.1

NOTE: Numbers in bold reflect restatements due to recategorization.

were $429.9 million in 2008, compared with $427.2 million in 2007, an increase of 0.6 percent. The cost of providing services to other entities was $31.3 million, compared with $31.0 million in 2007. In 2008, as in 2007, the Treasury and other entities reimbursed Reserve Banks for the costs of providing these services.

Debt Services

The Reserve Banks support Treasury's wholesale securities services by auctioning, providing book-entry safekeeping for, and transferring Treasury securities. Reserve Bank operating expenses for these activities totaled $46.4 million in 2008, compared with $50.1 million in 2007. To improve support of Treasury-securities auction activities, the Reserve Banks implemented a new Treasury-securities auction application and infrastructure in April 2008. The Banks conducted 263 Treasury securities auctions in 2008, compared with 220 in 2007. In addition, the Banks processed 12.8 million transfers of Treasury securities in 2008 through the Fedwire Securities Service, compared with 13.7 million transfers in 2007.

Reserve Banks also support the Treasury's retail securities program that primarily serves individual investors. Reserve Bank operating expenses for these activities were $72.4 million in 2008, compared with $74.1 million in 2007. Reserve Banks operate the Legacy Treasury Direct system, which allows investors to purchase and hold marketable Treasury securities directly with the Treasury instead of through a financial institution. The Legacy Treasury Direct system held $63.4 billion (par value) of Treasury securities as of December 31. The Banks also issue, service, and redeem nonmarketable savings bonds. The Banks printed and mailed more than 22.6 million savings bonds in 2008, a 9.7 percent decrease from 2007. Overall, the volume of retail securities transactions processed by the Reserve Banks has declined for several years and, consequently, the Banks have reduced expenses and staffing levels.

Payments Services

Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments and for payments-related programs totaled $108.2 million in 2008, compared with $105.3 million in 2007. In 2008, the Banks processed 1,132 million ACH payments for the Treasury, an increase of 10.2 percent from 2007. They also processed 269.4 million government checks, an increase of 26.1 percent from 2007. The increase in ACH and check payments is largely attributable to economic stimulus payments issued in 2008.

The proportion of government checks processed in paper form continues to decline, as an increasing number of depository institutions present checks in image form. Of all the government checks processed by the Reserve Banks in 2008, 23 percent were presented in paper form and 77 percent in image form, compared with 54 percent and 46 percent, respectively, in 2007.

Reserve Banks also support the Treasury's initiative to convert check benefit payments to direct deposit. In 2008, more than 577,000 check payments were converted to direct deposit.

Collection Services

Reserve Banks support several Treasury programs that serve to collect funds owed the federal government. Reserve Bank operating expenses related to these programs totaled $49.2 million in 2008, compared with $50.7 million in 2007. For example, the Banks operate the Federal Reserve Electronic Tax Application (FR-ETA), which provides taxpayers a same-day electronic federal tax payment alternative. FR-ETA collected $505.0 billion for the Treasury in 2008, compared with $519.8 billion in 2007.

In addition, the Reserve Banks operate Pay.gov, a Treasury program that allows the public to use the Internet to initiate and authorize payment for federal government goods and services. They also operated the Treasury's Paper Check Conversion and Electronic Check Processing programs, whereby checks written to government agencies are converted into ACH transactions at the point of sale or at lockbox locations. In 2008, Reserve Banks originated 35.6 million ACH transactions through these three programs, compared with 15.3 million in 2007. At the Treasury's direction, Reserve Banks worked to ensure a smooth transition of the Paper Check Conversion and Electronic Check Processing programs to a commercial bank effective in early 2009.

Treasury Cash-Management Services

The Treasury maintains an operating cash account at the Reserve Banks, and invests the funds it does not need for a given day's payments with qualified depository institutions through several investment programs supported by the Reserve Banks. Reserve Bank operating expenses related to these programs and other cash management initiatives totaled $51.6 million in 2008, compared with $46.1 million in 2007. In the Treasury Tax and Loan (TT&L) program, qualified depository institutions collect tax payments and may retain these funds as investments for the Treasury. The Treasury also invests funds at certain TT&L depositories through direct deposits. These fully collateralized investments are either callable on demand or set for a term. In 2008, Reserve Banks placed a total of $783.1 billion in immediately callable investments—including funds invested through retained tax deposits and direct investments—and $1,217.8 billion in term investments. In addition, the Treasury may invest a portion of its operating funds directly with TT&L depositories through its repurchase agreements program. In 2008, the Reserve Banks placed a total of $225.8 billion of investments through this program.

In 2008, the Reserve Banks and Treasury continued work on the Collections and Cash Management Modernization (CCMM) initiative, which is a multiyear effort to streamline, modernize, and improve the services, systems, and processes supporting the Treasury's collections and cash management programs. Several Reserve Banks have been selected to work on aspects of the CCMM initiative.

Services Provided to Other Entities

When permitted by federal statute or when required by the Secretary of the Treasury, Reserve Banks provide fiscal agency and depository services to other domestic and international entities. The majority of the work performed for these entities is securities-related.

Electronic Access to Reserve Bank Services

In 2008, the Federal Reserve Banks substantially completed the migration of computer interface customers to FedLine Direct and FedLine Command.[12] This migration, typically for high-volume depository institutions, and the FedLine Advantage migration, typically for low- to moderate-volume depository institutions, complete the Reserve Banks' initiative to migrate electronic access to Reserve Bank services to internet-protocol-based electronic access.[13]

Information Technology

In 2008, the Federal Reserve continued to develop and implement the Reserve Banks' IT strategy, further strengthened IT governance, managed information security risk, and analyzed and coordinated the System's IT investments.

In 2008, Federal Reserve Information Technology (FRIT) continued to lead Reserve Bank efforts to transition to

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12. FedLine Direct is a computer-to-computer electronic access channel used to access critical payment services, such as Fedwire Funds, Fedwire Securities, National Settlement, and FedACH Services. FedLine Command is a lower-cost internet-protocol-based computer-to-computer electronic access channel for file delivery services, including the FedACH Service.

13. FedLine Advantage is a web-based electronic access channel used to access critical payment services. The Reserve Banks completed the FedLine Advantage migration in 2006.

a more-robust information security model. The Information Security Architecture Framework (ISAF), a three-year program, was successfully completed. ISAF was developed to respond to the continuing and increasingly sophisticated security threats facing information technology systems and to improve information security at all points in the Federal Reserve. Through ISAF, the System was able to implement projects that enhanced user authentication, separated sensitive applications and infrastructure from low- and moderate-risk systems, and strengthened compliance and patch management. FRIT will continue working to address residual information security risks.

To enable certain functionalities and, secondly, to help address the business implications of reduced demand for mainframe services, Reserve Banks are engaged in a multiyear effort to move major business applications off the mainframe and to a distributed environment. In 2008, the new Treasury automated auction processing system became one of the first major business applications to be migrated.

Examinations of the Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board performs its own reviews and engages a public accounting firm. The public accounting firm performs an annual audit of the combined financial statements of the Reserve Banks (see the "Federal Reserve Banks Combined Financial Statements" section of this report) as well as the annual financial statements of each of the 12 Banks and the consolidated limited liability company (LLC) entities. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to assess their internal controls over financial reporting, including the safeguarding of assets. The Reserve Banks have further enhanced their assessments under the COSO framework to strengthen the key control assertion process and, in 2008, again met the requirements of the Sarbanes-Oxley Act of 2002. Within this framework, the management of each Reserve Bank provides an assertion letter to its board of directors annually that confirms adherence to COSO standards, and a public accounting firm issues an attestation report to each Bank's board of directors and to the Board of Governors.

In 2008, the Board engaged Deloitte & Touche LLP (D&T) for the audits of the individual and combined financial statements of the Reserve Banks and those of the consolidated LLC entities. Fees for D&T's services totaled \$9.5 million. Of the total fees, \$2.3 million were for the audits of the consolidated LLC entities that are associated with recent Federal Reserve actions to address the financial crisis, and are consolidated in the financial statements of the Federal Reserve Bank of New York (the New York Reserve Bank).[14] To ensure auditor independence, the Board 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

14. Each LLC will reimburse the Board of Governors for the fees related to the audit of its financial statements from the entity's available net assets.

its audit independence. In 2008, one Reserve Bank engaged D&T for nonaudit consulting services for which the fees were immaterial.

The Board's annual examination of the Reserve Banks and the consolidated LLC entities includes a wide range of off-site and on-site oversight activities, conducted primarily by the Division of Reserve Bank Operations and Payment Systems. Division personnel monitor the activities of each Reserve Bank on an ongoing basis and conduct a comprehensive on-site review of each Reserve Bank at least once every three years. The reviews also include an assessment of the internal audit function's conformance to *International Standards for the Professional Practice of Internal Auditing,* conformance to applicable policies and procedures, and the audit department's efficiency.

To assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division also reviews the accounts and holdings of the System Open Market Account (SOMA) at the New York Reserve Bank and the foreign currency operations conducted by that Bank. In addition, D&T audits the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. The FOMC receives the external audit reports and the report on the division's examination.

Income and Expenses

The table opposite summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 2008 and 2007. Income in 2008 was $41,046 million, compared with $42,576 million in 2007.

Expenses totaled $5,723 million ($3,232 million in operating expenses, $901 million in interest paid to depository institutions on reserve balances and earnings credits granted to depository institutions, $737 million in interest expense on securities sold under agreements to repurchase, $352 million in assessments for Board of Governors expenditures, and $500 million for currency costs).[15] Net additions to and deductions from current net income showed a net profit of $3,341 million, which consists of $3,769 million in realized gains on sales of U.S. government securities and $1,266 million in unrealized gains on investments denominated in foreign currencies revalued to reflect current market exchange rates, reduced by $1,693 million in net losses associated with consolidated variable interest entities (VIEs). Dividends paid to member banks, set at 6 percent of paid-in capital by section 7(1) of the Federal Reserve Act, totaled $1,190 million, $198 million more than in 2007; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled $31,689 million in 2008, down from $34,598 million in 2007; the payments equal net income after the deduction of dividends paid and of the amount necessary to equate the Reserve Banks' surplus to paid-in capital.

In the "Statistical Tables" section of this report, table 10 details the income and expenses of each Reserve Bank for

15. Effective October 9, 2008, the Reserve Banks began paying explicit interest on reserve balances held by depository institutions at the Reserve Banks as authorized by the Emergency Economic Stabilization Act of 2008.

Income, Expenses, and Distribution of Net Earnings of the Federal Reserve Banks, 2008 and 2007

Millions of dollars

Item	2008	2007
Current income	41,046	42,576
Current expenses	4,870	**5,198**
Operating expenses[1]	3,232	3,270
Interest paid to depository institutions and earnings credits granted[2]	901	240
Interest expense on securities sold under agreements to repurchase	737	**1,688**
Current net income	36,175	**37,378**
Net additions to (deductions from, –) current net income	3,341	**1,886**
Profits on sales of U.S. government securities	3,769	. . .
Profits on foreign exchange transactions	1,266	1,886
Net loss from consolidated VIEs[3]	–1,693	. . .
Assessments by the Board of Governors	853	872
For Board expenditures	352	296
For currency costs	500	576
Change in funded status of benefit plans[4]	–3,159	324
Comprehensive income before payments to Treasury	35,504	38,716
Dividends paid	1,190	992
Transferred to surplus and change in accumulated other comprehensive income	2,626	3,126
Payments to U.S. Treasury[5]	31,689	34,598

NOTE: Numbers in bold reflect reclassification of amounts to maintain comparability for the years presented.

1. Includes a net periodic pension expense of $160 million in 2008 and $110 million in 2007.
2. In October 2008, the Reserve Banks began to pay interest to depository institutions on qualifying balances.
3. Includes $961 million of interest earnings on loans extended by the New York Reserve Bank in 2008.
4. Subsequent to the adoption of SFAS 158 in 2006, the Reserve Banks began to recognize the change in funded status of benefit plans as an element of other comprehensive income in their Statements of Income and Comprehensive Income.
5. Interest on Federal Reserve notes.

. . . Not applicable.

2008, and table 11 shows a condensed statement for each Bank for the years 1914 through 2008; table 9 is a statement of condition for each Bank, and table 13 gives the number and annual salaries of officers and employees for each Bank. A detailed account of the assessments and expenditures of the Board of Governors appears in the section "Board of Governors Financial Statements."

SOMA Holdings and Loans

The Federal Reserve Banks' average net daily holdings of securities and loans during 2008 amounted to $1,035,700 million, an increase of $233,072 million from 2007 (see table, next page).

SOMA Securities Holdings

The average daily holdings of U.S. government, federal agency, and government-sponsored enterprise (GSE) securities decreased by $235,014 million, to an average daily level of $547,165 million. The decrease is due to the sale of securities during 2008 and maturing securities that were not replaced, offset by the purchase of federal agency and GSE securities beginning in 2008. Average daily holdings of securities purchased under agreements to resell in 2008 were $86,130 million, an increase of $54,447 million from 2007, while the average daily balance of securities sold under agreements to repurchase was $55,034 million, an increase of $20,486 million from 2007. Average daily holdings of investments denominated in for-

SOMA Holdings and Loans of the Federal Reserve Banks, 2008 and 2007[1]

Millions of dollars except as noted

Item	Average daily assets (+)/ liabilities(−)[2]		Current income (+)/ expense (−)		Average interest rate (percent)	
	2008	2007	2008	2007	2008	2007
U.S. government securities[3]	547,165	**782,179**	25,631	**38,707**	4.68	**4.95**
Securities purchased under agreements to resell	86,130	**31,683**	1,891	**1,591**	2.20	**5.02**
Securities sold under agreeements to repurchase	−55,034	−34,548	−737	−1,688	1.34	4.89
Investments denominated in foreign currencies[4]	24,212	21,325	623	546	2.57	2.56
Central bank liquidity swaps[5]	160,331	532	3,606	28	2.25	5.34
Primary, secondary, and seasonal credit[6]	32,022	**636**	512	33	1.60	**5.20**
Term auction credit	172,905	822	3,305	38	1.91	4.66
Other loans						
Primary dealer and other broker-dealer credit[7]	28,298	. . .	511	. . .	1.81	. . .
AMLF	21,036	. . .	470	. . .	2.24	. . .
Credit extended to AIG[8]	18,636	. . .	2,367	. . .	12.70	. . .
Total	1,035,700	802,628	38,179	39,256	3.69	4.89

NOTE: Amounts in bold reflect restatements due to changes in previously reported data and recategorization.

1. Does not include loans to consolidated VIEs.
2. Based on holdings at opening of business.
3. Includes federal agency and GSE obligations beginning in 2008.
4. Excludes accrued interest. Investments denominated in foreign currencies are revalued daily at market exchange rates.
5. Dollar value of foreign currency held under these agreements valued at the exchange rate to be used when the foreign currency is returned to the foreign central bank. This exchange rate equals the market exchange rate used when the foreign currency was acquired from the foreign central bank.
6. Excludes indebtedness assumed by the Federal Deposit Insurance Corporation.
7. Includes credit extended through the PDCF and credit extended to certain other broker-dealers.
8. Excludes credit extended to consolidated LLCs and undrawn amounts.

. . . Not applicable.

eign securities in 2008 were $24,212 million, compared with $21,325 million in 2007. During 2008, the Federal Reserve authorized increases in the amount of central bank liquidity swaps and in the number of eligible foreign central banks. The average daily balance of central bank liquidity swap drawings was $160,331 million in 2008 and $532 million in 2007.

The average rate of interest earned on the Reserve Banks' holdings of government securities decreased to 4.68 percent, from 4.95 percent in 2007. The average interest rates for securities purchased under agreements to resell and securities sold under agreements to repurchase were 2.20 percent and 1.34 percent, respectively, in 2008. Investments denominated in foreign currencies and central bank liquidity swaps earned interest at average rates of 2.57 percent and 2.25 percent, respectively, in 2008.

Lending

In 2008, average daily primary, secondary, and seasonal credit extended increased $31,386 million to $32,022 million and term auction credit extended under the Term Auction Facility increased $172,083 million to $172,905 million. The average rate of interest earned on primary, secondary, and seasonal credit decreased to 1.60 percent in 2008, from 5.20 percent in 2007, while the average interest rate on term auction credit decreased to 1.91 percent in 2008, from 4.66 percent in 2007.

During 2008, the Federal Reserve established several lending facilities under authority of section 13(3) of the Federal Reserve Act. These included the Primary Dealer Credit Facility

(PDCF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), and the American International Group, Inc. (AIG) credit line. Amounts funded by the Reserve Banks under these programs are recorded as loans by the Reserve Banks. During 2008, the average daily holdings under the PDCF and AMLF were $28,298 million and $21,036 million, respectively, with average rates of interest earned of 1.81 percent and 2.24 percent, respectively. The average daily balance of credit extended to AIG in 2008 was $18,636 million, which earned interest at an average rate of 12.70 percent.

Investments of Consolidated Variable Interest Entities

Additional lending facilities established during 2008 under authority of section 13(3) of the Federal Reserve Act involved creating and lending to special purpose vehicles (SPVs).[16] The SPVs were funded by the New York Reserve Bank and acquired financial assets and financial liabilities pursuant to the policy objectives. The SPVs were determined to be VIEs, and the New York Reserve Bank is considered to be the primary beneficiary of each.[17] Consistent with generally accepted accounting principles, the assets and liabilities of these VIEs have been consolidated with the assets and liabilities of the New York Reserve Bank in the preparation of the statements of condition included in this report.[18] The proceeds at the maturity or the liquidation of the VIEs' assets will be used to repay the loans extended by the New York Reserve Bank. Information regarding the Reserve Banks' lending to the VIEs and the asset portfolios of each VIE is as described in the table, next page.

Reserve Bank Branch Closure

The Board approved the discontinuation of the New York Reserve Bank's Buffalo Branch effective October 31.[19] At the time of the discontinuation, the Branch consisted of a small research and community outreach staff and the Branch board of directors, which provided economic and financial intelligence to the Bank. The Branch had not performed financial services since 2004. The Branch board of directors was replaced by an upstate New York regional advisory board, which provides economic and financial intelligence.

Federal Reserve Bank Premises

A number of Reserve Banks took action in 2008 to upgrade and refurbish their

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16. For further information on the establishment and policy objectives of these SPVs, see the "Monetary Policy Report" section of this report.

17. A VIE is an entity for which the value of the beneficiaries' financial interests in the entity changes with changes in the fair value of its net assets. A VIE is consolidated by the financial interest holder that is determined to be the primary beneficiary of the VIE because the primary beneficiary will absorb a majority of the VIE's expected losses, receive a majority of the VIE's expected residual gains, or both. To determine whether it is the primary beneficiary of a VIE, the Reserve Bank evaluates the VIE's design, capital structure, and the relationships among the variable interest holders.

18. As a consequence of the consolidation, the extensions of credit from the New York Reserve Bank to the VIEs are eliminated, the net assets of the VIEs appear as assets in table 9 in the "Statistical Tables" section of this report, and the liabilities of the VIEs to entities other than the New York Reserve Bank, including those with recourse only to the portfolio holdings of the VIEs, are included in other liabilities in statistical table 9.

19. Before the Buffalo Branch closure, the only discontinued Branch in the history of the System was the Federal Reserve Bank of San Francisco's Spokane Branch, which was discontinued in 1938.

Key Financial Data for Consolidated Variable Interest Entities as of December 31, 2008

Millions of dollars

Item	Commercial Paper Funding Facility LLC (CPFF)	Maiden Lane LLC[1]	Maiden Lane II LLC[1]	Maiden Lane III LLC[1]	Total
Net portfolio assets[2]	334,910	30,635	19,195	27,256	411,996
Liabilities of consolidated VIEs	−812	−4,951	−2	−48	−5,813
Net portfolio assets available[3]	334,098	25,684	19,193	27,208	406,183
Loans extended by the New York Reserve Bank[4]	333,020	29,087	19,522	24,384	406,013
Other beneficial interests[4,5]	. . .	1,188	1,003	5,022	7,213
Total loans and other beneficial interests	333,020	30,275	20,525	29,406	413,226
Allocation of excess/(deficiency) of net portfolio assets available over loans and other beneficial interests[6]					
Loans extended by the New York Reserve Bank	1,078	−3,403	−329	0	−2,654
Other beneficial interests	. . .	−1,188	−1,003	−2,198	−4,389
Total	1,078	−4,591	−1,332	−2,198	−7,043

1. Maiden Lane LLC was formed to acquire certain assets of Bear Stearns; Maiden Lane II LLC and Maiden Lane III LLC were formed to acquire certain assets of AIG and its subsidiaries.

2. Maiden Lane, Maiden Lane II, and Maiden Lane III holdings are recorded at fair value. Fair value reflects an estimate of the price that would be received upon selling an asset if the transaction were to be conducted in an orderly market on the measurement date. CPFF holdings are recorded at book value, which includes amortized cost and related fees.

3. Represents the net assets available for repayment of loans extended by the New York Reserve Bank and other beneficiaries of the consolidated VIEs as of December 31, 2008.

4. Book value. Includes accrued interest.

5. The "other beneficiary" for Maiden Lane is JPMorgan Chase & Co., and AIG is the "other beneficiary" for Maiden Lane II and Maiden Lane III.

6. Represents the allocation of the change in net assets and liabilities of the consolidated VIEs available for repayment of the loans extended by the New York Reserve Bank and other beneficiaries of the consolidated VIEs. The differences between the fair value of the net assets available and the face value of the loans (including accrued interest) are indicative of gains or losses that would be incurred by the beneficiaries if the assets had been fully liquidated at prices equal to the fair value as of December 31, 2008.

. . . Not applicable.

facilities and streamline operations. The Kansas City Bank moved into its new building, and the Seattle Branch of the San Francisco Bank dedicated its new building. The multiyear renovation program at the New York Bank's headquarters building also continued, while the St. Louis Bank continued a long-term facility redevelopment program that includes the construction of an addition to the Bank's headquarters building. The New York Bank made progress on a program to enhance the business resiliency of its information technology systems and to upgrade facility support for the Bank's open market operations, central bank services, and data center operations.

Security-enhancement programs continued at several facilities, including construction of security improvements to the Richmond Bank's headquarters building and the development of remote vehicle-screening facility designs for the Philadelphia and Dallas Banks.

Additionally, the St. Louis Bank sold its Little Rock Branch building, and the San Francisco Bank continued its efforts to sell the former Seattle Branch building.

For more information, see Table 14 in the "Statistical Tables" section of this report, which details the acquisition costs and net book value of the Federal Reserve Banks and Branches.

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Federal Reserve Priced Services, December 31, 2008 and 2007

Millions of dollars

Item	2008		2007	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	418.8		755.7	
Imputed investments	4,292.7		6,465.7	
Receivables	60.0		66.7	
Materials and supplies	2.1		1.8	
Prepaid expenses	29.2		28.5	
Items in process of collection	983.1		1,769.6	
Total short-term assets		5,786.0		9,088.0
Long-term assets (Note 2)				
Premises	441.1		453.5	
Furniture and equipment	113.0		130.2	
Leases, leasehold improvements, and long-term prepayments	76.7		64.2	
Prepaid pension costs	0.0		484.6	
Deferred tax asset	313.2		109.4	
Total long-term assets		944.0		1,242.0
Total assets		6,729.9		10,330.0
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	2,391.8		7,641.1	
Deferred-availability items	2,779.8		1,685.1	
Short-term debt	0.0		0.0	
Short-term payables	573.5		102.4	
Total short-term liabilities		5,745.1		9,428.5
Long-term liabilities				
Long-term debt	0.0		0.0	
Accrued benefit costs	605.6		385.0	
Total long-term liabilities		605.6		385.0
Total liabilities		6,350.7		9,813.5
Equity (including accumulated other comprehensive loss of $690.6 million and $237.9 million at December 31, 2008 and 2007, respectively)		379.2		516.5
Total liabilities and equity (Note 3)		6,729.9		10,330.0

NOTE: Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

Pro Forma Income Statement for Federal Reserve Priced Services, 2008 and 2007

Millions of dollars

Item	2008		2007	
Revenue from services provided to depository institutions (Note 4)		773.4		878.4
Operating expenses (Note 5)		808.7		888.2
Income from operations		–35.3		–9.8
Imputed costs (Note 6)				
Interest on float	–22.4		–32.0	
Interest on debt	0.0		0.0	
Sales taxes	9.4		11.6	
FDIC Insurance	0.5	–12.5	0.0	–20.4
Income from operations after imputed costs		–22.8		10.6
Other income and expenses (Note 7)				
Investment income	181.2		362.3	
Earnings credits	–80.7	100.4	–228.5	133.8
Income before income taxes		77.6		144.5
Imputed income taxes (Note 6)		24.2		45.5
Net income		53.4		98.9
MEMO: Targeted return on equity (Note 6)		66.5		80.4

NOTE: Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2008

Millions of dollars

Item	Total	Commercial check collection	Commercial ACH	Fedwire funds	Fedwire securities
Revenue from services (Note 4)	773.4	605.2	86.6	59.9	21.6
Operating expenses (Note 5)	808.7	644.4	84.4	59.0	20.9
Income from operations	–35.3	–39.2	2.2	0.9	0.7
Imputed costs (Note 6)	–12.5	–13.8	0.3	0.8	0.3
Income from operations after imputed costs	–22.8	–25.3	1.9	0.2	0.5
Other income and expenses, net (Note 7)	100.4	78.4	11.3	7.9	2.9
Income before income taxes	77.6	53.0	13.1	8.1	3.3
Imputed income taxes (Note 6)	24.2	16.5	4.1	2.5	1.0
Net income	53.4	36.5	9.0	5.5	2.3
MEMO: Targeted return on equity (Note 6)	66.5	51.9	7.6	5.3	1.7
MEMO: Cost recovery (percent) (Note 8)	98.5	97.8	101.5	100.4	102.5

NOTE: Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

FEDERAL RESERVE BANKS

Notes to Pro Forma Financial Statements for Priced Services

(1) Short-Term Assets

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in a portfolio of investments, shown as imputed investments.

Receivables are comprised of fees due the Reserve Banks for providing priced services and the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection are gross Federal Reserve cash items in process of collection (CIPC), stated on a basis comparable to that of a commercial bank. They reflect adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with nonpriced items (such as those collected for government agencies); and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) Long-Term Assets

Long-term assets consist of long-term assets used solely in priced services, the priced-service portion of long-term assets shared with nonpriced services, an estimate of the assets of the Board of Governors used in the development of priced services, and a deferred tax asset related to the priced services pension and postretirement benefits obligation (see Note 3).

(3) Liabilities and Equity

Under the matched-book capital structure for assets, short-term assets are financed with short-term payables and clearing balances. Long-term assets are financed with long-term liabilities and core clearing balances. As a result, no short- or long-term debt is imputed. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment, postretirement, and qualified and nonqualified pension benefits costs and obligations on capital leases.

Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standard Board's Statement of Financial Accounting Standards (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* which requires an employer to record the funded status of its benefit plans on its balance sheet. In order to reflect the funded status of its benefit plans, the Reserve Banks recognized the deferred items related to these plans, which include prior service costs and actuarial gains or losses, on the balance sheet. This resulted in an adjustment to the pension and benefit plans related to priced services and the recognition of an associated deferred tax asset with an offsetting adjustment, net of tax, to accumulated other comprehensive income (AOCI), which is included in equity. The Reserve Bank priced services recognized a net pension liability in 2008 and a net pension asset in 2007. The reduction in the System Retirement Plan's funded status in 2008 was due to reduced asset values and an increase in the projected benefit obligation. This reduction in the funded status resulted in a corresponding change in AOCI of $452.7 million in 2008.

To satisfy the FDIC requirements for a well-capitalized institution, equity is imputed at 10 percent of total risk-weighted assets.

(4) Revenue

Revenue represents fees charged to depository institutions for priced services, and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits (see Note 7).

(5) Operating Expenses

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses of the Board of Governors related to the development of priced services. Board expenses were $7.2 million in 2008 and $6.7 million in 2007.

Effective January 1, 1987, the Reserve Banks implemented SFAS No. 87, *Employers' Accounting for Pensions.* Accordingly, the Reserve Bank priced services recognized qualified pension-plan operating expenses of $28.8 million in 2008 and $21.3 million in 2007. Operating expenses also include the nonqualified pension expense of $5.4 million in 2008 and $3.1 million in 2007. The implementation of SFAS No. 158 does not change the systematic approach required by generally accepted accounting principles to recognize the expenses associated with the Reserve Banks' benefit plans in the income statement. As a result, these expenses do not include amounts related to changes in the funded status of the Reserve Banks' benefit plans, which are reflected in AOCI (see Note 3).

The income statement by service reflects revenue, operating expenses, imputed costs, other income and expenses, and cost recovery. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services based on an expense-ratio method. Corporate overhead was allocated among the priced services during 2008 and 2007 as follows (in millions of dollars):

	2008	2007
Check	31.0	34.7
ACH	4.6	4.3
Fedwire Funds	3.5	3.0
Fedwire Securities	1.9	1.7
Total	41.2	43.7

(6) Imputed Costs

Imputed costs consist of income taxes, return on equity, interest on debt, sales taxes, an FDIC assessment, and interest on float. Many imputed costs are derived from the private-sector adjustment factor (PSAF) model. The cost of debt and the effective tax rate are derived from bank holding company data, which serves as the proxy for the financial data of a representative private-sector firm, and are used to impute debt and income taxes in the PSAF model. The after-tax rate of return on equity is based on the returns of the equity market as a whole, and is used to impute the profit that would have been earned had the services been provided by a private-sector firm.

Interest is imputed on the debt assumed necessary to finance priced-service assets; however, no debt was imputed in 2008 or 2007.

Effective in 2007, the Reserve Bank priced services imputed a one-time FDIC assessment credit. In 2008, the credit offset $4.6 million of the imputed $5.1 million assessment, resulting in a remaining credit of $8.0 million. The remaining credit can be used to offset up to 90 percent of the assessment in the future.

Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for the Check, Fedwire Funds, National Settlement Service, ACH, and Fedwire Securities services.

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses, less shipping expenses, for each service to the total expenses, less the total shipping expenses, for all services.

The following shows the daily average recovery of actual float by the Reserve Banks for 2008 in millions of dollars:

Total float	–1,191.8
Unrecovered float	–42.1
Float subject to recovery	–1,149.7
Sources of recovery of float	
Income on clearing balances	–89.3
As-of adjustments	1.6
Direct charges	111.8
Per-item fees	–1,173.8

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for CIPC, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2008.

(7) Other Income and Expenses

Other income and expenses consist of investment and interest income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2008 and 2007 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. Before October 9, 2008, the return was applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. On October 9, 2008, the Federal Reserve began paying interest on required reserve and excess balances held by depository institutions at Reserve Banks as authorized by the Emergency Economic Stabilization Act of 2008. As a result of this change, the investment return is applied only to the *required* portion of the clearing balance. Other income also includes imputed interest on the portion of clearing balances set aside as required reserves. Expenses for earnings credits granted to depository institutions on their clearing balances are based on a discounted average coupon-equivalent yield on three-month Treasury bills.

(8) Cost Recovery

Annual cost recovery is the ratio of revenue, including other income, to the sum of operating expenses, imputed costs, imputed income taxes, and targeted return on equity.

The Board of Governors and the Government Performance and Results Act

The Government Performance and Results Act (GPRA) of 1993 requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. Although the Federal Reserve is not covered by the GPRA, the Board of Governors voluntarily complies with the spirit of the act.

Strategic Plan, Performance Plan, and Performance Report

The Board's strategic plan articulates the Board's mission, sets forth major goals, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses the evaluation of performance. The most recent strategic plan covers the period 2008–2011.

Both the performance plan and the performance report are prepared every two years. The performance plan includes specific targets for some of the performance measures identified in the strategic plan and describes the operational processes and resources needed to meet those targets. It also discusses validation of data and verification of results. The most recent performance plan covers the period 2008–09.

The performance report discusses the Board's performance in relation to its goals. The most recent performance report covers the period 2006–07.

The strategic plan, performance plan, and performance report are available on the Board's website, at www.federalreserve.gov/boarddocs/rptcongress. The Board's mission statement and a summary of the Federal Reserve's goals and objectives, as set forth in the most recently released strategic and performance plans, are listed below. Updated documents will be posted on the website as they are completed.

Mission

The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems to promote optimal macroeconomic performance.

Goals and Objectives

The Federal Reserve has six primary goals with interrelated and mutually reinforcing elements.

Goal

Conduct monetary policy that promotes the achievement of the statutory objectives of maximum employment and stable prices

Objectives

- Stay abreast of recent developments in and prospects for the U.S. economy and financial markets, and in those

abroad, so that monetary policy decisions will be well informed.
- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities.
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure.
- Contribute to the development of U.S. international policies and procedures, in cooperation with the U.S. Department of the Treasury and other agencies, with respect to global financial markets and international institutions.
- Promote understanding of Federal Reserve policy among other government policy officials and the general public.

Goal

Promote a safe, sound, competitive, and accessible banking system and stable financial markets

Objectives

- Promote overall financial stability, manage and contain systemic risk, and identify emerging financial problems early so that crises can be averted.
- Provide a safe, sound, competitive, and accessible banking system through comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations, and related entities. At the same time, remain sensitive to the burden on supervised institutions.
- Enhance efficiency and effectiveness, while remaining sensitive to the burden on supervised institutions, by addressing the supervision function's procedures, technology, resource allocation, and staffing issues.
- Promote compliance by domestic and foreign banking organizations supervised by the Federal Reserve with applicable laws, rules, regulations, policies, and guidelines through a comprehensive and effective supervision program.

Goal

Develop regulations, policies, and programs designed to inform and protect consumers, to enforce federal consumer protection laws, to strengthen market competition, and to promote access to banking services in historically underserved markets

Objectives

- Be a leader in, and help shape the national dialogue on, consumer protection in financial services.
- Promote, develop, and strengthen effective communications and collaborations within the Board, the Federal Reserve Banks, and other agencies and organizations.

Goal

Provide high-quality professional oversight of Reserve Banks

Objective

- Produce high-quality assessments and oversight of Federal Reserve System strategies, projects, and operations, including adoption of technology to meet the business and operational needs of the Federal Reserve. The oversight process and outputs should help Federal Reserve management foster and strengthen sound internal control systems, efficient and reliable operations, effective performance, and sound project management and should assist the Board in the effective discharge of its oversight responsibilities.

Goal

Foster the integrity, efficiency, and accessibility of U.S. payment and settlement systems

Objectives

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility. Support and assist the Board in overseeing U.S. dollar payment and securities settlement systems by assessing their risks and risk management approaches against relevant policy objectives and standards.
- Conduct research and analysis that contributes to policy development and increases the Board's and others' understanding of payment system dynamics and risk.

Goal

Foster the integrity, efficiency, and effectiveness of Board programs

Objectives

- Develop appropriate policies, oversight mechanisms, and measurement criteria to ensure that the recruiting, training, and retention of staff meet Board needs.
- Establish, encourage, and enforce a climate of fair and equitable treatment for all employees regardless of race, creed, color, national origin, age, or sex.
- Provide strategic planning and financial management support needed for sound business decisions.
- Provide cost-effective and secure information resource management services to Board divisions, support divisional distributed-processing requirements, and provide analysis on information technology issues to the Board, Reserve Banks, other financial regulatory institutions, and central banks.
- Efficiently provide safe, modern, secure facilities and necessary support for activities conducive to efficient and effective Board operations. ■

Federal Legislative Developments

The Federal Reserve played an important role in the public debates leading up to enactment of the Housing and Economic Recovery Act of 2008 (HERA) and the Emergency Economic Stabilization Act of 2008 (EESA). Each of these laws provided the U.S. government with important new tools—utilized during 2008—to help address the causes and consequences of the recent and ongoing turmoil in the financial markets.

Although the following summaries are not comprehensive reviews of these laws, they highlight some of the key provisions, including those that affect Federal Reserve System functions.

This report also describes the Higher Education Opportunity Act of 2008 (HEOA), legislation that modified the disclosure requirements for private educational loans under the Truth in Lending Act, which is administered by the Board.

Housing and Economic Recovery Act of 2008

On July 30, 2008, President Bush signed into law the Housing and Economic Recovery Act of 2008 (HERA) (Pub. L. No. 110-289), which substantially revises the supervisory and regulatory framework for housing-related government-sponsored enterprises (GSEs), specifically, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLBs). Among other things, HERA establishes a new, independent agency, the Federal Housing Finance Agency (FHFA) to succeed to (i) the supervisory and regulatory responsibilities of the Office of Federal Housing Enterprise Oversight (OFHEO) with respect to Fannie Mae and Freddie Mac (collectively, the enterprises) and of the Federal Housing Finance Board with respect to the FHLBs, and (ii) the authority of the Secretary of the Department of Housing and Urban Development (HUD) with respect to housing goals and new program approval requirements for the enterprises.

To help stabilize and maintain confidence in the enterprises, the Act also provides the Department of Treasury with temporary authority to acquire obligations of the GSEs, as well as other securities of the enterprises. In addition, HERA includes provisions to

- modernize the mortgage insurance programs of the Federal Housing Administration (FHA);
- create a new HOPE for Homeowners program within FHA to assist distressed homeowners attempting to refinance into more sustainable mortgages;
- establish a nationwide mortgage originator licensing and registration system; and
- improve the disclosures provided consumers in connection with mortgage transactions.

Treasury Authorization to Provide Financial Support to GSEs

As strains in financial markets intensified in 2008, investors became increasingly worried that the capital of Fannie

Mae and Freddie Mac would be insufficient to absorb current and expected losses on their mortgage portfolios. In light of the important role that the GSEs play in the housing finance markets and the financial system, Treasury requested and Congress passed changes as part of HERA that granted temporary authority to Treasury to purchase obligations of the GSEs and other securities (including equity capital) issued by Fannie Mae and Freddie Mac, on such terms and in such amounts as the Treasury determines. The statute requires that the Treasury secretary determine that any such purchases are necessary to provide stability to the financial markets, prevent disruptions in the availability of mortgage finance, and protect the taxpayer. The Treasury's authority to purchase such obligations or securities expires on December 31, 2009; however, the statute expressly permits the Treasury, after December 31, 2009, to retain (and exercise any rights associated with) any obligations or securities acquired by such date.

On September 7, 2008, FHFA, after consulting with Treasury Secretary Henry M. Paulson and Federal Reserve Board Chairman Ben S. Bernanke, appointed itself conservator for Fannie Mae and Freddie Mac in accordance with the conservatorship and consultation provisions of HERA (described in "Prompt Corrective Action and Conservatorship and Receivership" and "Required Consultations" later in this section). In conjunction with this action, the Treasury, utilizing the new purchase authority granted under HERA, entered into stock purchase agreements with Fannie Mae and Freddie Mac pursuant to which Treasury acquired preferred shares of each enterprise. Pursuant to these stock purchase agreements, Treasury agreed to provide up to $100 billion to each enterprise to ensure that the enterprise maintains a positive net worth. In connection with these actions, Treasury also established a temporary secured lending credit facility for Fannie Mae, Freddie Mac, and the FHLBs, and initiated a temporary program to purchase mortgage-backed securities guaranteed as to principal and interest by Fannie Mae and Freddie Mac. The actions taken by FHFA and Treasury helped to stabilize the GSEs, as investors became more confident of the government's support for the GSEs.

GSE Regulation and Supervision

Title I of HERA significantly reforms the supervisory and regulatory framework for the GSEs, representing the culmination of almost a decade of work by Congress and other relevant parties. For several years prior to the enactment of HERA, the Board had supported legislative changes to improve the supervisory and regulatory framework of the GSEs and to address the systemic risks posed by the retained mortgage portfolios of Fannie Mae and Freddie Mac. For example, the Board had urged the Congress to

- provide the supervisor of Fannie Mae and Freddie Mac with the authority to set and adjust the capital requirements for the enterprises in a manner comparable to the capital authority available to the federal banking agencies with respect to insured banks;
- establish a clear and credible receivership process for the enterprises; and
- limit the size of the retained portfolios of the enterprises by anchoring them to a well-understood public purpose.

The supervisory and regulatory changes enacted under HERA include provisions that address each of these elements. As a general matter, HERA allows the FHFA director to oversee the prudential operations of the GSEs and to ensure that each GSE operates in a safe and sound manner by, among other means, maintaining adequate capital and establishing adequate internal controls.

Capital

Importantly, HERA grants the FHFA director broad new authority to set and adjust the capital requirements for the GSEs. For example, HERA provides the director a free hand to establish, by regulation, risk-based capital requirements for the enterprises to ensure that the enterprises operate in a safe and sound manner and maintain sufficient capital and reserves to support the risks that arise in the operations and management of the enterprises. Previously, federal law specified, in many respects, the type of risk-based capital standards that had to be applied to the enterprises, thus greatly constraining the ability of the supervisor of the enterprises to alter or modify these standards to improve their risk sensitivity or take account of financial developments or improvements in methodologies for assessing regulatory capital adequacy.

HERA also authorizes the FHFA director to raise, by regulation, the minimum capital level for Fannie Mae and Freddie Mac under statute (generally, core capital equal to at least 2.5 percent of on-balance-sheet assets plus 0.45 percent of mortgage-backed securities guaranteed by the enterprise and other off-balance-sheet obligations) or by the FHLBs (generally, total capital equal to at least 5 percent of total assets). Specifically, the director is permitted to raise a GSE's minimum capital level to the extent needed to ensure its safe and sound operation. The director also must periodically review GSE capital levels, and may increase, by order, the minimum capital levels for the enterprises or FHLBs on a temporary basis, if necessary, and consistent with the prudential regulation and the safe and sound operation of the GSE.

Portfolio Limits

HERA requires that the FHFA director establish, by regulation, criteria governing the portfolio holdings of Fannie Mae and Freddie Mac to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises. In establishing such criteria, the director must consider (i) the ability of the enterprises to provide a liquid secondary market through securitization activities, (ii) the portfolio holdings of the enterprises in relation to the overall mortgage market, and (iii) the enterprise's adherence to the prudential management and operation standards established by the director under HERA and described below (see "Prudential Management and Operation Standards"). Additionally, the director is authorized, by order, to make temporary adjustments to these portfolio criteria, such as during times of economic distress or market disruption, and to make an enterprise dispose of or acquire any asset if the director determines that such action is consistent with the purposes of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended, or consistent with the authorizing statutes for the enterprises.

Prompt Corrective Action and Conservatorship and Receivership

HERA significantly alters the statutory provisions governing the supervisory actions that may or must be taken against a GSE as its regulatory capital levels decline, and addresses the manner in which a troubled or failing GSE's condition may be resolved. As a general matter, HERA modifies the prompt corrective action framework applicable to a troubled GSE in a manner more closely tracking a similar regime used with a troubled insured depository institution under the Federal Deposit Insurance Act (FDIA). In addition, HERA establishes a process for placing a troubled GSE into conservatorship or receivership and for managing such a conservatorship or receivership broadly similar in nature to those used with insured depository institutions under the FDIA. However, because GSEs, unlike insured depository institutions, do not offer federally insured deposits, the provisions under FDIA related to insured deposits (e.g., depositor preferences) and the FDIC's deposit insurance fund (e.g., least-cost resolution and related requirements) do not apply in the case of the resolution of a GSE.

For example, HERA modifies the existing prompt corrective action regime for Fannie Mae and Freddie Mac to

- require the FHFA director to closely monitor the condition of an undercapitalized enterprise and its compliance with the mandatory capital restoration plan and other restrictions applicable to an undercapitalized entity;
- restrict the ability of an undercapitalized enterprise to grow in asset size, acquire additional companies, or engage in new activities;
- allow the FHFA director to order a new election for the board of directors of a significantly undercapitalized enterprise, require a significantly undercapitalized enterprise to employ qualified executive officers, or require the dismissal of any director or officer who held office for more than 180 days before the enterprise became significantly undercapitalized; and
- allow the FHFA director to appoint the FHFA as receiver for a critically undercapitalized enterprise.

HERA also applied the prompt corrective action regime governing the enterprises (as modified) to FHLBs.

HERA also allows, or requires, the FHFA director to place a GSE into conservatorship or receivership for reasons other than critical undercapitalization. Specifically, HERA authorizes the director to establish a conservatorship or a receivership for a GSE if the director finds that any of 11 other separate conditions are met. These conditions include, among others, that

- the GSE's obligations exceed its assets;
- the GSE is in an unsafe or unsound condition to transact business;
- the GSE is likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business;
- the GSE has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect that the firm will become adequately capitalized; and
- the board of directors, shareholders, or members of the GSE have consented to the appointment.

HERA also requires that the FHFA director place a GSE (even one then operating in a conservatorship) into a receivership if the director determines in writing that

- the assets of the GSE are, and during the preceding 60 calendar days have been, less than the obligations of the GSE to its creditors or others; or

- the GSE is not, and during the preceding 60 calendar days has not been, generally paying its debts as they become due (other than debts subject to a bona fide dispute).

If a GSE is placed into either conservatorship or receivership, HERA authorizes the FHFA to take over the business and operations of the troubled GSE and change management of the GSE. In the case of a conservatorship, the FHFA is directed to seek to rehabilitate the troubled entity for the benefit of its shareholders and creditors by preserving the entity's assets and improving its business operations in order to restore the entity to a sound and solvent condition. In contrast, in the case of a receivership, the FHFA must place the GSE into liquidation, and it has the ability to determine claims of creditors against the GSE.

HERA allows FHFA, as receiver, to establish a "bridge" entity to assume the assets and liabilities of an FHLB in receivership. HERA also requires the FHFA director to organize a bridge entity (referred to in HERA as a limited-life regulated entity) if Fannie Mae or Freddie Mac are placed into a receivership. HERA provides that a bridge entity established for Fannie Mae or Freddie Mac would immediately, and by operation of law, succeed to the charter of Fannie Mae or Freddie Mac, as relevant. Moreover, HERA specifically provides that the amount of assets transferred from a failed enterprise to the bridge entity must exceed the amount of liabilities transferred to the bridge entity. Together, these provisions help ensure that, if an enterprise were to be placed into a receivership, a new, solvent entity would be established that could continue to fulfill the enterprises' important mission in accordance with the enterprises' governing charter.

Required Consultations

Title I of HERA requires the FHFA director to consult with, and consider the views of, the Chairman of the Board of Governors of the Federal Reserve System with respect to the risks posed by the GSEs to the financial system prior to issuing any proposed or final regulations, orders, or guidelines regarding prudential management and operations standards, safe and sound operations of, and capital requirements and portfolio standards applicable to, the GSEs. The Act also requires the director to consult with the chairman regarding any decision to place a GSE into conservatorship or receivership. These consultation requirements expire on December 31, 2009. As noted above, FHFA Director James Lockhart consulted with Federal Reserve Board Chairman Bernanke prior to placing Fannie Mae and Freddie Mac into separate conservatorships on September 7, 2008.

Prudential Management and Operation Standards

HERA also requires that the FHFA director establish standards for the GSEs related to, among other things, the management of interest rate risk exposure; management of market risk; adequacy and maintenance of liquidity and reserves; management of asset and investment portfolio growth; investments and acquisitions of assets; overall risk-management processes; and such other operational and management standards as the director deems appropriate.

Increase in Conforming-Loan Limits

HERA also permanently increases the Fannie Mae and Freddie Mac conforming-loan limits, which are the maximum dollar size of a mortgage that may be purchased by the enterprises. Earlier in 2008, the Economic Stimulus Act of 2008 increased, until December 31, 2008, the conforming-loan limit for mortgages on single-family residences to the greater of $417,000, or 125 percent of the relevant area median home price (not to exceed $729,500). Effective January 1, 2009, HERA allows Fannie Mae and Freddie Mac to purchase single-family mortgages with a maximum origination balance of up to the greater of $417,000, or the lesser of 115 percent of the area median price or $625,500. Adjustments also were made to the conforming-loan limits for two-to-four-family residences.

New Products and Activities

Under HERA, Fannie Mae and Freddie Mac must obtain the FHFA director's prior approval before offering any new product. In considering a request, the director must determine that the product is consistent with the enterprise's statutory authority, is consistent with the safety and soundness of the enterprise or the mortgage finance system, and is in the public interest. The director also must request public comment on any new product approval request for 30 days. The statute includes certain exclusions from the definition of a new product to avoid unduly interfering with the development of loan underwriting systems and mortgage products offered by the enterprises.

FHA Modernization

HERA also includes the FHA Modernization Act of 2008, which makes several modifications to the National Housing Act to improve the mortgage insurance programs of the FHA. Similar to the conforming-loan limits of Fannie Mae and Freddie Mac, FHA conforming-loan limits were increased by the Economic Stimulus Act of 2008 and HERA. Effective January 1, 2009, the maximum size of a single-family mortgage eligible for FHA insurance is the greater of $417,000, or the lesser of 115 percent of the area median price or $625,500. In addition, HERA

- increases from 3 percent to 3.5 percent the down payment that a borrower must make in cash or cash equivalents on a home in order for the mortgage to be eligible for FHA insurance;
- prohibits borrowers from receiving any part of the required down payment from the seller of the property, any other person who financially benefits from the transaction, or any third party or entity that is reimbursed by such a person or entity for providing the down payment assistance to the borrower;
- increases, from 2.25 percent to 3.0 percent, the maximum annual mortgage insurance premium that the FHA may collect; and
- prohibits the secretary of HUD from taking any action, prior to October 1, 2009, to implement the risk-based premium pricing program that the secretary had published in the *Federal Register* on May 13, 2008, or any other risk-based premium pricing program based on the borrower's "decision credit score" described in such *Federal Register* notice.

HOPE for Homeowners

As noted above, HERA also establishes the HOPE for Homeowners Program

(H4H Program), which is a voluntary program designed to allow qualified, at-risk mortgage borrowers to refinance their existing mortgages into new mortgage loans guaranteed by the FHA, subject to certain conditions and restrictions. FHA may insure eligible mortgages under the H4H Program commencing no earlier than October 1, 2008, and the authority to insure new mortgages expires on September 30, 2011. The Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008, modified the H4H Program in several respects. The following outlines the key elements of the H4H Program as amended.

Borrower Eligibility Requirements

To be eligible for the H4H Program, a borrower must have a debt-to-income ratio of at least 31 percent before applying for a H4H Program mortgage. The borrower must occupy the property as his or her primary residence, and the borrower may not have an ownership interest in another residential property. Accordingly, investors and investor properties are not eligible for the program. Additionally, to be eligible for the H4H Program, a borrower must certify that he or she did not intentionally default on the existing mortgage or any other debt, and has not knowingly or willfully furnished material information known to be false for the purpose of obtaining the existing mortgage. Mortgagors that have been convicted under federal or state law for fraud in the past 10 years also are not eligible for this program.

H4H Mortgage Requirements

Loan-to-value and maximum loan amount. The new FHA-insured mortgage refinances an eligible borrower's existing mortgage at a potentially significant write-down from its current principal balance and, thus, may significantly benefit borrowers who are "underwater"—that is, owe more on their current mortgage than the value of their home. HERA prohibits the new FHA-insured mortgage loan from exceeding 90 percent (or such higher percentage as the oversight board for the program determines to be appropriate) of the appraised value of the property serving as security for the mortgage. The new FHA-insured refinancing loan also may not exceed 132 percent of the conforming-loan limit for Fannie Mae that was in effect for 2007 for a property of applicable size.

Premiums. HERA requires that HUD collect an amount equal to 3 percent of the principal balance of the new H4H mortgage as an upfront insurance premium. This amount is paid by the existing lender through a reduction in the amount paid to the lender upon refinancing. The Act also requires borrowers that refinance into an H4H Program mortgage to pay to HUD an annual premium equal to 1.5 percent of the amount of the outstanding mortgage balance.

Release of previous mortgage liens. Participation in the H4H Program by borrowers, mortgagees, servicers, and investors is voluntary. However, all holders of outstanding mortgage liens on a property to be refinanced under the H4H Program must agree to accept the proceeds of the new FHA-insured refinancing loan as payment in full for their existing mortgages on the property and release all liens on the property. In addition, all prepayment penalties and fees associated with default or delinquency must be waived in order for an existing mortgage to be refinanced into a new

H4H Program mortgage. HERA also limits the ability of a person with a H4H Program mortgage to take a second lien on the mortgaged property during the first five years of the new H4H mortgage term.

Loan term. HERA mandates that an H4H Program mortgage may have a term of not less than 30 years and must bear a single rate of interest that is fixed for the entire term of the mortgage, thereby eliminating the potential for future payment shocks on the mortgage.

First payment default. HERA prohibits HUD from paying insurance benefits on any mortgage where the borrower fails to make the first payment on the new H4H Program mortgage.

Requirement to Share Equity and Appreciation

HERA also requires borrowers that refinance into an H4H Program mortgage to share any newly created equity and future appreciation in the property with HUD. Specifically, under HERA, borrowers are required to share with HUD a portion of any new equity in the home created as a result of the H4H Program. Mortgagors also are required to share with HUD 50 percent of any future property appreciation upon sale or disposition of the property. HUD is authorized to offer subordinate mortgage lien holders on the property, in exchange for releasing their lien, either (1) a share of HUD's 50 percent interest in future appreciation of the mortgaged property *or* (2) an upfront payment in lieu of the right to receive a portion of HUD's interest in the property's future appreciation, if any.

Oversight Board

HERA also establishes a Board of Directors (Oversight Board) to oversee the H4H Program. The Oversight Board is composed of the secretary of Housing and Urban Development, the Treasury secretary, the Federal Reserve Board chairman, and the chairperson of the Board of Directors of the Federal Deposit Insurance Corporation, or the respective designee of each such person. HERA further requires the Board to, among other things, establish requirements and standards for the H4H Program and prescribe regulations and guidelines as may be necessary or appropriate to implement such requirements and standards. The Oversight Board published rules to implement the H4H Program in the *Federal Register* on October 6, 2008, and January 7, 2009.

Study of Auction or Bulk-Refinance Program

HERA also requires the Oversight Board to conduct a study of the need for, and efficacy of, an auction or bulk-refinancing mechanism to facilitate the refinancing of existing residential mortgages that are at risk for foreclosure into mortgages insured under the H4H Program. The study must identify and examine various options for mechanisms under which lenders and servicers of such mortgages may make bids for forward commitments for such insurance in an expedited manner. As required by HERA, the Oversight Board submitted the study of auction or bulk-refinancing mechanisms to Congress on September 29, 2008.

S.A.F.E. Mortgage Licensing Act

Another part of HERA—the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act)—provides for the establishment of a nationwide mortgage licensing system and registry for the residential mortgage industry. The registry is intended to improve the flow of information between regulators, increase industry accountability, enhance consumer protections and information, and establish a means by which residential mortgage loan originators would be required, to the extent possible, to act in the best interests of consumers.

The statute requires all states to develop and maintain a system for licensing and registering individuals engaged in mortgage loan originations. Pursuant to the S.A.F.E. Act, these state licensing and registering systems must interact with the Nationwide Mortgage Licensing System and Registry (NMLSR), which is to be developed and maintained by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. In addition, the S.A.F.E. Act requires the federal banking agencies, along with the Federal Financial Institutions Examination Council and the Farm Credit Administration, to jointly develop and maintain a system for registering employees of depository institutions, or regulated subsidiaries of depository institutions, as loan originators with the NMLSR. Such a system must be implemented within one year after the date of enactment of the S.A.F.E. Act, and is to take into consideration, as may be appropriate, the same exceptions and requirements set forth below for state-licensed loan originators. If by the end of a one-year period (or in limited cases a two-year period) the secretary of HUD determines a state does not have an adequate system of licensing and registration, the S.A.F.E. Act requires the secretary to establish and maintain a system for that state.

The S.A.F.E. Act also requires that individuals obtain a license from a state, and that they register with either the state or federal registration system, before they may engage in loan originations. In connection with an application for licensing and registration, an individual must, at a minimum, provide information concerning the applicant's identity, including fingerprints and personal history and experience. An individual may not receive a license or registration if the individual fails to satisfy certain criteria outlined in the statute. The S.A.F.E. Act also outlines the minimum competence requirements for the pre-licensing education and testing requirements for loan originators, as well as for renewal of state-licensed loan originators, which includes a continuing education requirement.

In addition to provisions relating to registration and licensing, the S.A.F.E. Act requires the HUD secretary to recommend reforms to the Real Estate Settlement Procedures Act of 1974, and submit a preliminary report on the root causes of defaults and foreclosures of home loans to Congress not later than six months after the date of statute enactment.

Mortgage Disclosure Improvement Act

Title X of HERA enacts the Mortgage Disclosure Improvement Act (MDIA), which amends, in turn, portions of the Truth in Lending Act (TILA) to help ensure that a consumer is provided with timely and meaningful disclosures in connection with certain extensions of credit secured by the consumer's dwelling. EESA, enacted on October 3, 2008, also includes several amendments to the MDIA.

The MDIA, as amended, includes mortgage refinancings among the types of extensions of credit subject to early disclosures under TILA. The amendments to MDIA also modify the early disclosure requirement of TILA so that creditors must provide certain disclosures to borrowers no later than three days after receiving an application and at least seven days prior to closing. Additional disclosures are required in cases of extensions of credit secured by the dwellings of consumers where the annual rates of interest or schedules of payments are variable. Moreover the MDIA requires that any disclosure statement that no longer accurately reflects the annual percentage rate of interest should be replaced by an accurate statement within three business days before the date of transaction. The statute also provides that consumers must receive the disclosures before paying any fee related to the extension of credit. However, the statute allows a consumer to waive the timing requirement, in case of a bona fide personal financial emergency, by providing a lender with a signed written request outlining such emergency and specifically requesting waiver of the timing requirement.

Some of the disclosure modifications codified in the MDIA were previously required by regulations issued by the Board in July 2008. The Board issued a notice of proposed rulemaking on December 10, 2008, to implement the additional requirements included in the MDIA.

Emergency Economic Stabilization Act of 2008

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (EESA) (Pub. L. No. 110-343), which provides the Treasury secretary with important new tools to help restore liquidity and stability to the financial system, and establishes several mechanisms to oversee the implementation of this authority. The central feature of EESA is the establishment of the Troubled Assets Relief Program (TARP), through which the secretary is authorized to purchase troubled assets from qualifying financial institutions to help maintain and promote financial stability.

The EESA also includes several important limitations and conditions designed to protect the interests of taxpayers. For example, EESA generally requires that the secretary obtain warrants or comparable debt instruments from any financial institution from which the TARP acquires troubled assets. In addition, and as described below, section 111 of EESA requires that the secretary develop and impose certain executive compensation restrictions on financial institutions from which the TARP purchases troubled assets. Related provisions of EESA limit the ability of certain financial institutions that participate in TARP to deduct executive compensation expenses for federal tax purposes.

EESA also includes several other provisions affecting financial institutions or the Federal Reserve, including a temporary increase in federal deposit insurance coverage and an acceleration of the effective date of a previously adopted legislative amendment that permits the Federal Reserve to pay interest on balances held at Federal Reserve Banks by depository institutions.

Troubled Assets Relief Program

In light of the extraordinary events occurring in the financial markets and the substantial risks such events posed to financial stability and the U.S. economy, Congress passed EESA to immediately provide the Treasury secretary with the authority and facilities to restore liquidity and stability to the U.S.

financial system. EESA also provides that the secretary should seek to use such authorities and facilities to

- protect home values, college funds, retirement and other savings accounts;
- preserve homeownership;
- promote jobs and economic growth;
- maximize overall returns to taxpayers; and
- provide public accountability for the exercise of such authority.

In exercising this authority under EESA, the Treasury secretary must consult with the Federal Reserve Board, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Administration Board, and the HUD secretary.

To assist in accomplishing these goals, EESA authorizes the Treasury secretary to establish the TARP and purchase troubled assets from financial institutions on such terms and subject to such conditions as the secretary may establish in accordance with EESA. As a general matter, the term "troubled assets" is defined to include residential and commercial mortgages, and any securities, obligations, or other instruments based on or related to such mortgages, so long as they were issued or originated on or before March 14, 2008. However, EESA also provides that the term "troubled assets" shall also apply to any other financial instrument (including, for example, equity instruments) that the secretary, after consultation with the Federal Reserve Board Chairman and notification to Congress, determines the purchase of which is necessary to promote financial market stability. EESA also generally defines a "financial institution" to mean any institution having significant operations in the United States—including but not limited to banks and other depository institutions—which is established and regulated under U.S. laws, or those of any of its states, territories, or possessions. EESA also provides that, if Treasury purchases troubled assets under the TARP, the secretary must establish a program to guarantee troubled assets originated or issued prior to March 14, 2008. The secretary must collect premiums for any guarantee issued under the program in an amount that the secretary deems necessary to meet the purposes outlined in EESA and provide sufficient reserves, based on an actuarial analysis, to ensure taxpayers are fully protected.

The purchase authority granted to the secretary by EESA terminates on December 31, 2009, although the secretary may extend this date until October 3, 2010 upon submission of a written certification to Congress. However, the authority of the secretary to hold any troubled assets purchased prior to the termination of authority, or to purchase or fund the purchase of troubled assets under a commitment already entered into before the termination date, is not subject to such termination.

EESA authorizes the secretary to purchase or insure up to a maximum of $700 billion in troubled assets. Of this amount, $250 billion was made immediately available for use when EESA was enacted, and the remaining amount was made available in two separate tranches of $100 billion and $350 billion.

Executive Compensation and Compensation-Related Tax Provisions

As noted above, EESA establishes certain executive compensation restrictions on financial institutions that sell troubled assets to the Treasury under the TARP. Specifically, EESA requires that the secretary impose executive compensation restrictions on a financial institution if the secretary directly (and not through an auction process) purchases troubled assets from the institution, if market prices for the assets are not available, and if the secretary receives a meaningful equity or debt position in the institution as a result of the transaction. These restrictions must

- be designed to ensure that the compensation paid to senior executive officers of the institution does not provide incentives to take unnecessary and excessive risks;
- require the financial institution to recover any bonus or incentive compensation paid to a senior executive officer based on criteria that are later proven to be materially inaccurate; and
- prohibit any "golden parachute" payment to a senior executive officer during the period that the secretary holds an equity or debt position in the financial institution.

For these purposes, the term "senior executive officer" refers, in the case of a publicly held financial institution, to an individual who is one of the five highest paid executives of the institution as disclosed under regulations issued under the Securities Exchange Act of 1934 and, in the case of a nonpublic company, the counterparts of such individuals.

If assets are purchased through an auction and the total amount of assets acquired from the institution exceeds certain quantitative levels, the secretary must prohibit any new employment contract with a senior executive officer from providing for a golden parachute in the event of the individual's involuntary termination or the institution's bankruptcy filing, insolvency, or receivership.

Title III of EESA modifies the Internal Revenue Code to provide special rules for the tax treatment of compensation (including so-called "golden parachute" payments) paid by TARP recipients to covered executives (as defined in the EESA). Among other things, financial institutions participating in the TARP and selling troubled assets to the TARP (on an aggregate basis) in excess of $300 million are prohibited, for a limited period, from deducting for federal tax purposes any remuneration in excess of $500,000 to any covered executive. In addition, such financial institutions will be subject to a 20 percent tax on certain "golden parachute" payments provided to covered executives.

Foreclosure Mitigation Efforts and Assistance to Homeowners

EESA provides that, if Treasury acquires mortgages, mortgage-backed securities, and other assets backed by residential real estate under the TARP, the Treasury secretary must implement a plan that seeks to maximize assistance to homeowners and, considering net present value to the taxpayers, encourage the servicers of underlying mortgages to take advantage of the HOPE for Homeowners Program as well as other programs available to minimize foreclosures. In dealing with loan modification requests under existing investment contracts, the secretary, where appropriate and after consideration of net present value to the taxpayer, is directed to consent to reasonable loss-mitigation measures, including rate reductions or principal write-downs. Furthermore, the secretary must coordinate with the FDIC, Board, FHFA, HUD, and other agencies that hold troubled assets to identify opportunities for acquiring different classes of troubled assets, such as mortgage-backed securities, in order to improve the loan modification and restructuring processes and provide protections to bona fide tenants who are current on their rent.

Additionally, EESA requires that designated "federal property managers" develop foreclosure prevention plans for residential mortgages and residential mortgage-backed securities that the managers hold, own, or control. Such plans must seek to maximize assistance for homeowners and, considering net present value to the taxpayers, encourage the servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program. Generally speaking, a "federal property manager" is defined to include the FHFA, the FDIC, and the Board, assuming that certain specific circumstances are present. The FHFA is deemed to be a federal property manager only in its capacity as conservator for Fannie Mae and Freddie Mac, and the FDIC is considered a federal property manager in cases where residential mortgage loans and mortgage-backed securities are held by a bridge depository institution established by the FDIC in connection with the resolution of a failed insured depository institution. The Board is considered a federal property manager only with respect to any mortgage or mortgage-backed securities held, owned, or controlled by or on behalf of a Reserve Bank, other than when such assets are held, owned, or controlled in connection with open-market operations under section 14 of the Federal Reserve Act or as collateral for an advance or discount that is not in default.

Oversight and Transparency Provisions

Continuing Oversight, Auditing, and Reporting Requirements

The EESA imposes several continuing reporting obligations on the Treasury Department with respect to its investments under the TARP. Section 114 of the EESA requires Treasury, within two business days after an investment, to make available to the public, in electronic form, pricing and other information about the investment. In addition, section 105(a) of EESA requires Treasury to issue a tranche report approximately every 30 days, which must provide information on, among other things, its actions taken during the covered period under the TARP and the administrative expenses of the TARP. Finally, for each additional aggregate Treasury investment of $50 billion under the TARP, section 105(b) of the EESA requires the Department to issue a report that describes, among other things, the transactions related to its additional incremental exposure, the pricing mechanism for each relevant transaction, a description of the challenges that remain in the financial system, and an estimate of the additional actions that may be necessary to address such challenges.

EESA also requires that the secretary provide to Congress no later than April 30, 2009, a report that analyzes both the current state of the regulatory system and its effectiveness in overseeing financial market participants. This report must include recommendations for improving the regulatory system.

Special Inspector General for the TARP

As an additional measure to increase transparency of TARP-related actions, EESA provides for the establishment of an Office of the Special Inspector General (Special IG) for the TARP, which must, among other things, conduct, supervise, and coordinate audits and investigations of the purchase, guarantee, management, and sale of troubled assets under the TARP. The Special IG must provide certain designated committees of Congress with periodic reports summarizing the activities of the Special IG during the reporting period. The Special IG, appointed by the President by and with the advice and consent of the Senate, also assumes inspector general duties and responsibilities as outlined under the Inspector General Act of 1978.

Government Accountability Office

EESA provides authority to the Comptroller General of the United States to commence ongoing oversight of TARP activities and performance, including examining TARP's efficacy in meeting the purposes of EESA. The comptroller must furnish Congress, as well as the Special IG, with reports at least every 60 days. These reports are required to analyze, among other things

- the performance of the TARP in meeting the purposes of the EESA,
- the financial condition of the TARP,
- characteristics of transactions and commitments entered into by the TARP,
- the efficiency of the TARP, and
- the compliance of TARP, its agents, and representatives with applicable laws and regulations.

The comptroller must also undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions served as a factor in the current financial crisis. This study must be provided to Congress no later than June 1, 2009.

Financial Stability Oversight Board

EESA also establishes the Financial Stability Oversight Board (FINSOB), a body comprising the Federal Reserve Board chairman; the Treasury secretary; the FHFA director; the Securities and Exchange Commission chairman; and the HUD secretary. The FINSOB is authorized to review the policies implemented by Treasury under TARP and make recommendations, as appropriate, to the Treasury secretary regarding use of EESA authority. Additionally, the FINSOB must report suspected TARP-related fraud, misrepresentations, or malfeasance to the Special IG or the U.S. attorney general.

Furthermore, the FINSOB is authorized to ensure, through appropriate means, that the policies implemented by the Treasury secretary are in accordance with the purposes of EESA, are in the economic interests of the United States, and are consistent with protecting taxpayers. The FINSOB must meet at least monthly and file a quarterly report with certain designated Congressional committees.

Congressional Oversight Panel

EESA also establishes a Congressional Oversight Panel to monitor the TARP and review the current state of the financial markets and the regulatory system. The Oversight Panel consists of five members appointed by members of Congress in the manner specified in section 125 of EESA. The Oversight Panel must submit reports to Congress every 30 days that discuss, among other things, the use by the Treasury secretary of EESA authority, the impact of purchases made by the TARP on the financial markets and financial institutions, the extent to which the information made available on transactions under the program has contributed to market transparency, the effectiveness of foreclosure mitigation efforts, and the effectiveness of the program in minimizing long-term costs and maximizing the benefits to taxpayers. Additionally, EESA requires the Oversight Panel to submit a separate report analyzing the current state of the regulatory system and its effectiveness in providing oversight of financial market participants, including analysis of existing gaps in consumer protections and recommendations for improvement. This separate report was submitted to Congress on January 20, 2009.

Other Provisions of Interest

Interest on Reserves

Section 128 of EESA accelerated to October 1, 2008, the effective date of an amendment, previously adopted as part of the Financial Services Regulatory Relief Act of 2006, that authorizes the Reserve Banks, in accordance with Board regulations, to pay interest on balances held by or on behalf of depository institutions at a Reserve Bank. EESA also authorized the Board to lower the level of reserve requirements on transaction accounts below the ranges established by the Monetary Control Act of 1980. On October 9, 2008, the Board issued an interim final rule implementing this new authority.

Section 13(3) Reporting Requirement

Section 129 of EESA requires that the Board submit a report to designated Congressional committees within seven days of authorizing any loan to an individual, partnership, or corporation under the emergency lending authority of section 13(3) of the Federal Reserve Act. This section of the Federal Reserve Act permits the Federal Reserve to make secured loans to such persons in unusual and exigent circumstances and subject to certain additional conditions. The newly required reports must include the justification for exercising such authority, and discuss the specific terms of the action, as well as any expected cost to taxpayers. In addition, while a loan under section 13(3) is outstanding, the Board must submit periodic updates to designated congressional committees not less than every 60 days. These periodic reports must address the status of the loan, the value of collateral held by the Reserve Bank which initiated the loan, and the projected cost to taxpayers.

Margin Study Requirement

Not later than June 1, 2009, the comptroller must complete and submit to designated congressional committees a study regarding the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the financial crisis. The study must include an analysis of the roles and responsibilities of the Board, the SEC, the Treasury secretary, and other federal banking agencies with respect to monitoring these issues, analysis of the authority of the Board to regulate leverage, including to what extent such authority has been used, and an analysis of usage of margin authority by the Board, and any related recommendations.

Temporary Increase in Deposit Insurance and FDIC Borrowing Authority

As noted above, EESA provides for a temporary increase from $100,000 to $250,000 in FDIC deposit insurance coverage for insured depository institutions and NCUA share insurance coverage for insured credit unions. This temporary increase ends on December 31, 2009.

Additionally, EESA allows the FDIC to borrow from the Treasury amounts in excess of that authorized under sections 14(a) and 15(c) of the Federal Deposit Insurance Act and as necessary to carry out this increase in deposit insurance coverage.

Mark-To-Market Accounting

EESA authorizes the SEC to suspend application of the mark-to-market provisions embodied in Statement Number 157 of the Financial Accounting Standards Board, if it determines that doing so is necessary or appropriate in the public interest and consistent with the protection of investors. Additionally, the SEC, in consultation with the Federal Reserve Board and the Treasury secretary, must conduct a study to consider (1) the effects of these mark-to-market standards on the balance sheets of a financial institution, (2) the impact of such accounting on bank failures in 2008, (3) the extent to which such standards affect the quality of information available to investors, (4) the process used by FASB in developing such standards, and (5) whether alternative accounting standards would better suit the industry. This study, including legislative and administrative recommendations, was submitted to Congress on December 30, 2008.

Higher Education Opportunity Act of 2008

On August 14, 2008, President Bush signed the Higher Education Opportunity Act of 2008 (HEOA) (Pub. L. No. 11-315), which includes amendments to the disclosure requirements for private educational loans under TILA. The Federal Reserve Board must adopt regulations implementing HEOA's disclosure provisions, which require creditors to provide a number of new disclosures about the terms and features of private educational loans. Creditors will also have to disclose information about federal student loan programs, which may offer less costly alternatives.

The new disclosures required by the HEOA would be incorporated into the segregated cost disclosures that creditors must provide under TILA. Currently, creditors integrate much of this information in credit agreements, along with other contract terms. HEOA seeks to highlight key information by including it on the TILA disclosure and requiring that the information be disclosed multiple times during the lending process. As a result, the TILA disclosures for private educational loans will become longer and more detailed. HEOA also requires the Board to develop and test model disclosure forms, which the Board would publish to encourage lenders to standardize disclosure format.

HEOA defines "private educational loans" as loans made expressly for postsecondary educational expenses, excluding loans made, insured, or guaranteed by the federal government. Generally, creditors must furnish TILA cost disclosures before credit is extended. Under HEOA, however, creditors will be required to furnish three sets of disclosures for private educational loans. First, creditors must disclose the available loan rates and terms in an application or solicitation for a private educational loan. Creditors must also furnish a second set of disclosures after the borrower has been approved for a loan, and afford the applicant at least 30 days in which to accept the loan. During this period, the creditor may not change the rate or terms (except for changes to a variable interest rate based on an index). If the consumer accepts the loan, the creditor must then furnish a third set of disclosures, after which the consumer has three days in which to cancel the loan. The creditor may not disburse the loan funds until the three-day cancellation period expires.

HEOA also contains restrictions for the marketing of private student loans. It prohibits private creditors from using the name, emblem, or mascot of an educational institution in a way that implies that the institution endorses the creditor's loans. Some schools, however, enter into "preferred lender" arrangements and explicitly agree to endorse that creditor's student loan product. HOEA restricts but does not prohibit this practice.

The Board issued a notice of proposed rulemaking to implement these provisions on March 11, 2009. ■