*Federal Reserve Operations*

# *Consumer and Community Affairs*

The consumer and community affairs function of the Board of Governors focused on activities in two key areas in 1999—providing information to a variety of audiences, including consumers, community groups, financial institutions, and the small business community; and improving the process for supervising state member banks for compliance with federal consumer banking and civil rights laws. The Board also reviewed several large bank holding company applications; strengthened regulatory guidance on disclosures and other matters; referred two cases reflecting possible patterns or practices of discrimination to the U.S. Department of Justice; and investigated and responded to issues raised in consumer complaints.

## Community Development

The Federal Reserve promotes the economic viability of underserved populations and markets through its community affairs program, which provides technical assistance and conducts outreach to advise lenders, community developers, and government officials on innovative approaches for funding community-based economic development activities. Capitalizing on their access to information on financial intermediaries, the Community Affairs Officers at the twelve Reserve Banks design programs tailored to the information and development needs of their Districts. The Board's Division of Consumer and Community Affairs offers a national perspective and provides oversight and guidance, engaging in projects that have broad implications for public policy or that present issues industrywide in scope. This organizational structure supports a program that is both cohesive and diverse.

During 1999, the Board adopted a strategic plan and a revised mission statement for the community affairs function to take account of the significant changes occurring in the banking and community development industries. With an updated focus, the Federal Reserve System is positioned to apply its resources and expertise to projects promoting community-based economic development efforts throughout the country. In working toward this objective, the Reserve Banks hosted 284 conferences, conducted 1,689 outreach meetings, provided technical assistance on 878 occasions, delivered 280 speeches, and distributed 170,000 copies of newsletters during 1999. These activities are featured in *Capital Connections*, a newsletter begun in 1999 by the Board that highlights innovative and important projects undertaken by the Reserve Banks.

Many of the Division's community affairs efforts during 1999 were undertaken in cooperation with the Reserve Banks. For example, the Board and the Reserve Banks cosponsored a major research conference on small-business financing and development (see box). The Federal Reserve assisted the U.S. Small Business Administration (SBA) in its effort to increase awareness of the venture capital available to entrepreneurs through its small-business investment company (SBIC) program, a funding resource that leverages private investment with SBA guarantees. The Board coordinated the sponsorship of six seminars on SBICs by the Reserve

## The Business of Small Business Access to Capital and Credit

*The availability of business capital and credit is an essential component of healthy communities. Research on the relationship between small business and credit providers can provide information that is critical for dynamic markets.*

Alan Greenspan, *Chairman*, Board of Governors

Small business is often referred to as the ‘‘engine of our economy.’’ Accordingly, the Federal Reserve System has a keen interest in its significance in financial markets. In 1999, the System’s community affairs officers demonstrated this interest by partnering with their research colleagues to sponsor an academic conference on the availability of funding resources for small businesses.

The two-day conference, ‘‘Business Access to Capital and Credit,’’ was the first national research conference of its kind for the Federal Reserve System. It provided a forum for economists, scholars, and advocates to present research findings, and it served as a foundation for continued research and discussion. Topics addressed included lending relationships, access to credit for minority-owned businesses, microenterprise lending, and credit scoring. The conference drew nearly 400 lenders, community developers, researchers, and government officials.

### Small Business as an Economic Force

Small businesses provide jobs to more than half the private-sector workforce and generate more than half the nation’s sales and private gross domestic product. More agile than their ‘‘big business’’ counterparts, small firms can react quickly to customer demands and market changes. It is frequently because of their size, rather than in spite of it, that these small businesses are successful and often lead their industries in innovation. However, these entrepreneurial firms typically lack sufficient business experience and capital—factors that represent credit risk to lenders. This risk, whether perceived or real, has been cited as the reason small businesses, particularly those owned by minorities or located in low-income neighborhoods, have historically found it difficult to obtain the funding vital to their operation and growth.

### Small Business and Community Development

In the course of their outreach and technical assistance activities, the System’s community affairs officers have over the years gathered anecdotal evidence of the credit gap that small enterprises continually struggle with. The lack of access to capital is viewed as particularly detrimental to the

Banks of New York, Atlanta, Chicago, Kansas City, Dallas, and San Francisco for a target audience of bankers, investors, and small-business developers.

The Board also played a role in the BusinessLINC Initiative, an interagency project headed by the SBA and the U.S. Department of the Treasury that seeks to stimulate business-to-business relationships, with larger companies mentoring small firms. Among other things, the Board assisted in the development of a national conference promoting BusinessLINC.

revitalization of low-income areas, given that these communities rely heavily on small firms for the economic stability and services that are critical to initiating and sustaining redevelopment. Without sufficient funding, these firms have difficulty remaining in business.

> *Small-business owners must contend with lenders with varying underwriting standards, varying appetites for risk, and varying expected rates or return for loans they may approve. The vagaries of local economies may also influence the likelihood that a small firm gets approved for credit.*
>
> Edward M. Gramlich, *Member*
> Board of Governors

In 1998, Board and Reserve Bank community affairs and research officers concluded that a research conference would foster better understanding of small business lending and credit issues and would encourage ongoing research and discussion. Scholars, practitioners, and policymakers nationwide responded to the call for papers. Seventeen studies identified as the most germane to the conference's objectives provided the framework for the conference, which was held in Arlington, Virginia, on March 8–9, 1999. Remarks by Federal Reserve Board Chairman Alan Greenspan and Governor Edward Gramlich reinforced the importance of understanding the challenges and opportunities involved in funding small businesses.

**The Research**

The conference focused on six topics:

- *CRA data on small-business lending*—The flow of credit to small businesses in low- and moderate-income communities, and ways to finance the operation of small farms
- *Access to credit for minority-owned businesses*—Differences in credit extensions to businesses owned by African Americans
- *The small business–small lender relationship*—The effect of banking consolidation and bank size on the relationship between business owners and lenders
- *Microenterprise lending*—Increasing the probability of repayment of micro-loans, and the efficacy of such programs in promoting self-sufficiency, providing training, and predicting success
- *Credit scoring and securitization of small-business loans*—The effect of credit scoring and securitization of small business loans on the availability of credit to small businesses in general and in low- and moderate-income communities.

Conference proceedings are available at www.federalreserve.gov/community.htm.

The success of the conference gave evidence of a desire for continued research on community economic development issues. System community affairs officers and their research colleagues are now collaborating on a second conference, to be held in spring 2001. This one will focus on the effect of changing financial markets on community development.

To support a presidential initiative on microenterprise development, the Board helped compile and disseminate information on existing federal programs that provide funding and technical support to very small firms. It also helped design and develop content for a centralized, Internet-based database of resources available to these businesses.

In 1999 the Federal Reserve System dedicated resources to several national home ownership initiatives. One was an interagency effort to increase home ownership in rural America; the community affairs function supported the Rural Home Loan Partnership by promoting the availability of a new financing vehicle offered by the U.S. Department of Agriculture, the Federal Home Loan Bank System, and the Rural Local Initiatives Support Corporation. The Reserve Banks of Boston, Richmond, St. Louis, and San Francisco convened bankers and community developers in their Districts to discuss the program and the availability of mortgage guarantees. The community affairs function also provided leadership and technical expertise in connection with the One-Stop Mortgage Initiative, a project initiated by the White House to create home ownership opportunities among Native Americans residing in Indian country. A work group for this initiative—made up of representatives of numerous other government agencies and the Minneapolis, Kansas City, and San Francisco Reserve Banks—identified specific actions needed to improve financial literacy and homebuyer preparation among the target market, critical elements in ensuring the success of any affordable housing program.

The Board and the Federal Reserve Bank of Richmond worked to promote economic development in the District of Columbia through a partnership among community groups, government agencies, financial institutions, and corporate businesses. Key representatives of these groups addressed issues that hamper growth, and proposed remedial actions at meetings convened by the Federal Reserve. Expertise in structuring and facilitating this partnership was provided by the Cleveland Reserve Bank, which offered recommendations on the basis of its experiences with a similar initiative.

In addition to participating directly in such collaborative efforts, the Federal Reserve's Community Affairs Offices sponsored conferences on new community development funding strategies and resources. The Federal Reserve Bank of New York sponsored a three-part series on innovative financing mechanisms for preserving low- and moderate-income communities. The series, which targeted community developers and investors, included seminars on real estate investment trusts, venture capital, and the securitization of community development loans. The San Francisco Reserve Bank also hosted a conference on the securitization of small-business and community development loans. Securitization could lead to the creation of a secondary market for these loans, which would, in turn, expand creditors' lending capacity.

The Community Affairs Offices also stressed the mutual benefits that can be achieved through creative partnerships among community stakeholders. The Federal Reserve Bank of Boston sponsored a conference highlighting the special resources that local universities can provide and the leadership and funding roles they can play in community development collaborations. The New York Reserve Bank spearheaded efforts to promote school-to-work programs and other work-training initiatives for low-income youth as qualified community reinvestment activities for financial institutions.

To give the public ready access to community development information, the Federal Reserve launched two web-based databases in 1999. The Federal Reserve Bank of Kansas City unveiled 1st Source, an interactive database of government funding and other community development support programs available through federal agencies. The Chicago Reserve Bank posted the Consumer and Economic Development Research and Information Center, a one-stop site for research and information on upcoming events related to community development.

## Consumer Advisory Council

The Board's Consumer Advisory Council convened in March, June, and October 1999 to advise the Board on matters concerning laws that the Board administers and on other issues related to consumer financial services. The council's thirty members come from consumer and community organizations, the financial services industry, academic institutions, and state agencies. Council meetings are open to the public.

During the year, the council focused on numerous issues, including the Community Reinvestment Act (CRA), financial privacy, electronic disclosures, and subprime lending. Council members' diverse views provided valuable insight on consumer issues. Highlights of a few of the discussion topics follow.

The CRA was a major topic at the March and June meetings. Issues discussed included the banking agencies' collection and use of data related to small-business lending, the limitations of these data, and the feasibility of conducting a comprehensive study of small-business lending. Also discussed were lending agreements between financial institutions and community groups and the ways these agreements facilitate successful partnerships.

Privacy issues were another topic at the March and June meetings. In March, council members provided views on appropriate privacy protections for consumers and discussed the use of either mandatory directives or voluntary principles to address privacy concerns. Although they held differing views on whether mandatory or voluntary privacy protections would work best, council members agreed on the need for consumer privacy protections. In June, the group reviewed the growing number of privacy initiatives and expressed general support for a uniform approach to privacy to avoid proliferation of rules by state courts and regulators.

Electronic disclosures were a key topic at the June and October meetings. Council members discussed proposed rules for providing electronic disclosures under five of the Board's consumer protection regulations: B (Equal Credit Opportunity), E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings). Although members had differing views on suggested changes to the content and format of the proposed disclosure forms, they supported adding more consumer protections to the proposals, at least initially.

In October, the council discussed proposed changes to Regulation B concerning the removal of the general prohibition against noting information about an applicant's race, color, religion, national origin, and sex in transactions for nonmortgage credit. Members generally favored the removal of the prohibition, but opinions differed on whether data collection should be voluntary (as proposed) or mandatory.

In October, the council also addressed subprime lending—the extension of "nonconforming" loans to borrowers who may not qualify for conventional rates. Although subprime lending in many instances meets the credit needs of individuals who have impaired credit histories, some borrowers are subject to predatory, or abusive, practices by lenders. Council members emphasized the need to strengthen education, particularly for the most vulnerable population of borrowers, so that they do not become victims of abusive lending practices.

## Fair Lending

In 1999 the Board implemented new, risk-based procedures for examinations to ensure compliance with the federal fair lending laws and regulations. These procedures were also adopted by other member agencies of the Federal Financial Institutions Examination Council. The new examination procedures are intended to facilitate more sophisticated analysis than was previously reflected in agency procedures and to give examiners the flexibility to tailor the fair lending focus of an examination to the institution being reviewed.

To educate examiners about the new procedures, the Federal Reserve carried out an extensive training program. In 1999, a comprehensive two-week course for less-experienced examiners was conducted on four occasions and an intensive one-week course for experienced examiners was conducted on six occasions. The two-week course will be offered on each ongoing basis three times a year.

Training in the fair lending examination procedures was also offered outside the Federal Reserve System. The Reserve Banks developed and presented outreach programs to bankers during the first half of 1999. And at the request of bank trade associations, federal and state banking and law enforcement agencies, and other interested parties, the Board gave fifteen presentations on the new procedures in ten cities during the year.

Since 1994, the Federal Reserve has used a two-stage statistical regression program in its assessment of fair lending compliance by large-volume mortgage lenders. The program identifies—on the basis of an initial analysis of reported HMDA (Home Mortgage Disclosure Act) data—banks that show significant disparities in rates of loan denial for minority and nonminority applicants; it then subjects the banks' records to a supplemental analysis that is based on additional information from a sample of the banks' loan files. In 1999, the Board issued updated guidance to examiners on the use of the regression program in conjunction with the new fair lending examination procedures. The Board also hosted a conference at which Reserve Banks discussed their program-related experiences. A number of program improvements were adopted, including several that will help in the identification of banks that merit more intensive review.

In accordance with the Equal Credit Opportunity Act, the Board refers violations of Regulation B that it has reason to believe constitute a "pattern or practice" of discrimination to the U.S. Department of Justice. During 1999 the Board reviewed nineteen potential referrals, including four carried over from 1998. All had been detected during Reserve Bank compliance examinations. Of the nineteen cases, fourteen involved possible discrimination in underwriting and the remaining five involved potential discrimination in pricing, including three instances of possible violations in setting prices of "indirect," or brokered, loans.

The Board referred two of the nineteen cases to the Justice Department, and three matters were still under review at year's end. One of the two referred cases involved discrimination on the prohibited basis of marital status; the bank combined the incomes of married joint applicants for purposes of evaluating the applications, but did not do so for unmarried joint applicants. The second referral involved allegations that female and minority applicants had been charged higher rates on direct and indirect loans than had white and male applicants and that bank personnel had full knowledge of the discriminatory pricing.

During 1999, certain lending practices described as abusive, or ‘‘predatory,’’ came under increasing criticism by private and government organizations and by the media. Predatory lending generally targets—for high-cost mortgage loans—financially unsophisticated elderly, minority, and lower-income homeowners who have substantial equity in their property and possibly have experienced some credit imperfections. The practices may involve fair lending violations as well as violations of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and state and federal laws prohibiting fraud and deceptive practices. In October 1999 the Federal Reserve and representatives of nine federal agencies established a working group to define practices that constitute predatory lending and to propose steps that the agencies could take to address the practices.

## Risk-Focused Compliance Examinations

In January 1999 the Board implemented a risk-focused supervision program that represents a fundamental change in the way the Federal Reserve System conducts examinations for compliance with the consumer banking laws and regulations. The program tailors the examination to the individual bank under review. To focus examination resources on the areas of greatest risk to banks and their customers, the program requires an in-depth preliminary review of such things as the bank's compliance history, new products, and management changes. Using the results of this review, the examining Reserve Bank identifies the areas of highest risk and develops an examination plan that covers all consumer compliance areas, with special emphasis on those reflecting the highest risk. The program also has outreach and monitoring components.

Both the risk-focused compliance examination procedures and the fair lending examination procedures, described in the preceding section, rely heavily on examiner judgment about the appropriate level of review and supervision for a particular bank. To determine the extent of implementation of these procedures Systemwide, and to identify best practices for implementing the risk-focused program, teams of Reserve Bank and Board staff members in 1999 conducted a review of each Reserve Bank. The findings helped in refining the examination procedures and the overall risk-focused supervision process.

## The Gramm–Leach–Bliley Act

On November 12, 1999, President Clinton signed the Gramm–Leach–Bliley Act into law. Two areas covered by the act—CRA examinations and the creation of ‘‘financial holding companies’’—have implications for both the Board's compliance examination function and its applications processing function. Among other things, the act extends the length of time between CRA examinations for financial institutions that have assets of not more than $250 million and a CRA rating of ‘‘satisfactory’’ or ‘‘outstanding.’’ With few exceptions, banks rated satisfactory for CRA performance are to be examined no more than once every forty-eight months and banks rated outstanding, no more than once every sixty months. Previously, state member banks rated satisfactory or outstanding for CRA and with satisfactory compliance ratings were examined once every twenty-four or thirty-six months.

The act also repeals those provisions of the Glass–Steagall Act of 1933 and the Bank Holding Company Act of 1956 that restricted the affiliation of bank holding companies with securities firms and insurance companies. The legislation creates ‘‘financial holding companies,’’ which may conduct a broad range of financial activities, including insurance and securities underwriting, and merchant banking. It also bars a bank holding company from becoming a financial holding company if any of its depository subsidiaries received a rating lower than satisfactory at its most recent CRA examination, and bars an existing financial holding company from taking on additional powers or making acquisitions if the CRA rating of one of its depository subsidiaries falls below satisfactory.

In addition, the act requires the federal banking agencies to issue customer-protection regulations governing the sale and marketing of insurance products by depository institutions. These regulations are to prohibit depository institutions from engaging in coercive sales practices, such as conditioning the extension of credit on the purchase of an insurance product from the institution or one of its affiliates. They are also to ensure that consumers are given disclosures clarifying that insurance products sold by a depository institution involve an investment risk and are not insured by the Federal Deposit Insurance Corporation. In addition, the act requires the federal banking agencies to establish a mechanism for addressing consumer complaints that allege violations of the regulations.

Privacy issues are also part of the act’s provisions. For example, the act requires the federal regulatory agencies to establish standards for the security, confidentiality, and integrity of customer records and information, including protection against unauthorized access. Financial institutions must notify consumers about the institution’s privacy policies and must give consumers a means of ‘‘opting out’’ of disclosures to nonaffiliated third parties. The Board is working with the other agencies to develop substantially similar regulations implementing these privacy requirements. The agencies are also working together to develop regulations implementing the act’s ‘‘sunshine’’ provisions applicable to CRA-related agreements between insured depository institutions or their affiliates and nongovernmental entities or persons. The act requires that the agencies draft rules for disclosing the agreements and rules requiring the parties to the agreements to report on them annually.

## Consumer Policies

Through its consumer policies program, the Board conducts research and explores ways other than by regulation to protect consumers in the area of retail financial services. In 1999 the Board worked with other agencies, as well as with public- and private-sector organizations, to develop consumer-related educational materials.

Two significant interagency education efforts involved electronic bank accounts and mortgage shopping. New fact sheets for low- and moderate-income households on managing electronic bank accounts (scheduled for publication in March 2000) were developed to complement the U.S. Department of the Treasury’s initiatives to provide government payments electronically. Also, the consumer brochure *Looking for the Best Mortgage: Shop, Compare, Negotiate*, developd by an interagency fair lending task force, was released. By the end of 1999, more than 380,000 copies of the brochure, which identifies key considerations for persons shopping for a mortgage, had been distributed; information from the brochure is also available on the Board's public web site.

Working with a broad-based coalition of agencies and organizations from the private and public sectors, the Board also continued its initiative on vehicle leasing education. Materials developed by the leasing education team include a comprehensive computer-based program entitled *Keys to Vehicle Leasing—A Consumer Resource*, which is scheduled for release in early 2000, and a Spanish-language version of the brochure *Keys to Vehicle Leasing—A Consumer Guide*. During 1999, the Federal Reserve distributed more than 800,000 copies of the brochure and received approximately 190,000 visits to the Board's public web site.

Electronic banking and leasing were also the topics of research projects. Using data from the University of Michigan Survey Research Center's monthly Surveys of Consumers, for example, the Board analyzed consumers' credit shopping practices, leasing experiences, and attitudes toward the use of electronic banking services. Results of the research were shared with other agencies and the public through meetings, conferences, and journal articles.

## Civil Money Penalty for Flood Insurance Violations

In June 1999 the Board assessed a civil money penalty against a state member bank for flood insurance violations. Without admitting to any of the allegations, the bank consented to the Board's order in connection with an alleged pattern or practice of violations of the Board's regulations implementing the National Flood Insurance Act. The order required the bank to pay a civil money penalty of $10,000. This was the first time the Board has imposed a monetary penalty for flood insurance violations.

## Regulatory Matters

The Board has responsibility for implementing a wide range of federal laws concerning consumer financial services and fair lending. In August 1999, the Board took the following actions:

- Published proposed rules and official staff commentary as part of a comprehensive review of Regulation B (Equal Credit Opportunity). The Board proposed removing the general prohibition against creditors' noting characteristics such as the race, sex, and national origin of applicants for nonmortgage credit; requiring creditors to retain certain records in connection with preapproved credit solicitations; and expanding the record-retention period for most business credit applications from twelve to twenty-five months. The Board is reviewing more than 700 letters from members of Congress, local governments, community organizations, businesses, and consumers in response to the proposal.
- Issued revised proposals to permit the electronic delivery of federally mandated disclosures under five consumer protection regulations: Regulations B, E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings). The Board had received and considered more than 200 letters responding to earlier proposals issued in 1998. The revised proposals generally allow delivery of disclosures by electronic mail or other means, such as posting them on a web site, if the consumer consents. They also specify what information must be given to consumers before they consent; this

information would be provided on a standardized form. The Board has received letters from more than 100 commenters and also obtained the views of individual consumers by conducting focus group interviews.

- Issued an interim rule for deposit accounts that allows institutions to deliver Regulation DD disclosures for periodic statements electronically if the consumer agrees. The Regulation DD rule is consistent with an interim rule issued in 1998 under Regulation E, and makes it possible for institutions to deliver deposit account statements electronically under a single set of procedures.

In addition, the Board took the following regulatory actions during the year:

- Revised the official staff commentary to Regulation Z to give guidance on the rules prohibiting the issuance of unsolicited credit cards; calculating payment schedules for loans involving mortgage insurance; and disclosing credit sale transactions for which the down payment includes cash and property used as a trade-in
- Adopted revisions to the official staff commentary to Regulation M to provide guidance on disclosures for lease renegotiations and extensions, official fees and taxes, multiple-item leases, and advertisements
- Proposed revisions to the official staff commentary to Regulation Z to clarify that those cash advances commonly called "payday loans" are credit transactions covered by the regulation
- Adjusted the dollar amount that triggers additional disclosure requirements for certain mortgage loans under the Home Ownership and Equity Protection Act of 1994
- Increased to $30 million the exemption threshold for depository institutions required to report data under the Home Mortgage Disclosure Act.

## Testimony and Legislative Recommendations

In March 1999 the Board testified before the Senate Committee on Banking, Housing, and Urban Affairs on consumer protection issues raised by the conference report on H.R. 3150, the Bankruptcy Reform Act of 1998. The Board's testimony centered on proposed legislation in two areas—amendments to the Truth in Lending Act and requirements that the Board conduct three consumer-related studies. In general, the proposed TILA amendments involved new disclosures describing the effect of making only minimum payments on open-end credit plans. The proposed studies concerned the adequacy of existing disclosures and protections for debit cards that can be used without personal identification numbers; certain home-secured loans for which the total amount of the credit extended exceeds the fair market value of the dwelling; and specific consumer borrowing practices.

In July the Board testified on consumer financial privacy before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services. The Board's testimony focused on proposed legislation to place additional limitations on financial institutions' disclosure of customer information and stressed the need for Congress to balance personal privacy concerns with economic efficiency. In addition, the testimony emphasized the need for consistency across markets to ensure that any limitations imposed on one industry, such as financial services, do not place that industry at a competitive disadvantage.

## Economic Effects of the Electronic Fund Transfer Act

As required by statute, the Board monitors the effects of the Electronic Fund Transfer Act (EFTA) on the compliance costs and consumer benefits related to electronic fund transfer (EFT) services. The economic effects of the EFTA likely continued to increase in 1999 because of the continued growth of EFT services.

Results of consumer surveys indicate that during this decade the proportion of U.S. households using EFT services grew at an annual rate of about 2 percent. Approximately 85 percent of households have one or more EFT features on their accounts at financial institutions. Automated teller machines (ATMs) remain the most widely used EFT service. During 1999, the number of ATM transactions decreased somewhat, to about 907 million a month from 930 million a month in 1998, probably in part because of higher average ATM fees. Over the same period, the number of installed ATMs rose more than 20 percent, to 227,000. Direct deposit is another widely used EFT service: More than half of U.S. households have funds deposited directly into their accounts. Use of the service is particularly common in the public sector, accounting for 76 percent of social security payments and 91 percent of federal salary and retirement payments. About one-third of U.S. households have debit cards, which consumers use at merchant terminals to debit their transaction accounts. Although these point-of-sale (POS) systems still account for a fairly small share of electronic transactions, their use continued to grow rapidly in 1999. The number of POS transactions rose a third, from about 150 million a month in 1998 to 202.3 million a month in 1999, and the number of POS terminals rose 38 percent, to 2.35 million.

The incremental costs associated with the EFTA are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure, as they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with EFT at present. (See ‘‘Agency Reports on Compliance with Consumer Regulations.’’)

## Compliance Activities

The Federal Reserve System’s compliance activities in 1999 included conducting and overseeing examinations of state member banks, training System compliance examiners, and participating in the compliance activities of the Federal Financial Institutions Examination Council (FFIEC). As noted in earlier sections, the System also worked to develop and implement new risk-focused examination procedures.

### Compliance Examinations

Since 1977 the Federal Reserve System’s compliance examination program has ensured that state member banks and foreign banking organizations subject to Federal Reserve examination comply with federal laws protecting consumers in the provision of financial services. During the 1999 reporting period (July 1, 1998, through June 30, 1999), the Federal Reserve conducted 487 examinations for compliance with consumer protection laws: 344 examinations of state member banks and 143 of foreign banking organizations.[1]

### Examiner Training

Examiners well versed in the consumer protection laws, fair lending laws, and the Community Reinvestment Act (CRA) are essential to the Board's compliance program. Therefore, the type and timeliness of training opportunities are important. New Reserve Bank examiners attend a two-week basic compliance course; and examiners with six to twelve months of field experience attend a two-week advanced course, a two-week course in techniques for fair lending examinations, and a one-week course in CRA examination techniques. During the 1999 reporting period, eleven sessions attended by a total of 197 individuals were held—two sessions of the basic compliance course, two of the advanced compliance course, four in fair lending examination techniques, and three in CRA examination techniques.

### Participation in FFIEC Activities

Through the cooperation of its five member agencies—the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA)—the Federal Financial Institutions Examination Council develops uniform examination principles, standards, and report forms. In 1999 the member agencies continued working to improve coordination of consumer compliance and CRA examination activities. Actions to promote uniformity among the federal supervisors of financial institutions included issuing new interagency fair lending examination procedures; amending Interagency Questions and Answers for the CRA; revising the Interagency Questions and Answers on the Policy Guide on Administrative Enforcement of the Truth in Lending Act; and approving interagency examination procedures for the Fair Credit Reporting Act. The FFIEC is currently developing interagency examination procedures for the Homeowners Protection Act of 1998, which requires that lenders or servicers provide information on private mortgage insurance on loans secured by the consumer's primary residence.

## Agency Reports on Compliance with Consumer Regulations

The Board is required to report annually on compliance with Regulation B (which implements the Equal Credit Opportunity Act, ECOA); Regulation E (Electronic Fund Transfer Act, EFTA); Regulation M (Consumer Leasing Act, CLA); Regulation Z (Truth in Lending Act, TILA); Regulation CC (Expedited Funds Availability Act, EFTA); Regulation DD (Truth in Savings Act, TISA); and Regulation AA (Unfair or Deceptive Acts or Practices Act). The Board assembles compliance data from the Reserve Banks and also collects data from the FFIEC agencies and from other federal supervisory agencies.[2]

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1. The foreign banking organizations examined by the Federal Reserve are organizations operating under section 25 or 25(a) 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, compared with state member banks, they engage in relatively few activities that are covered by consumer protection laws.

2. The agencies use different methods to compile compliance data. Accordingly, the data—which are presented here in terms of percentages of financial institutions supervised or examined—support only general conclusions.

A summary of the reported compliance data for the 1999 reporting period (July 1, 1998, through June 30, 1999) follows. In general, the overall level of compliance in 1999 was similar to that in 1998. As in past years, the level of compliance varied considerably from regulation to regulation.

## Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 78 percent of the institutions examined during the 1999 reporting period were in compliance with Regulation B, compared with 79 percent for the 1998 reporting period. Of the institutions not in compliance, 68 percent had one to five violations. The most frequent violations involved the failure to take one or more of the following actions:

- Provide a written notice of credit denial or other adverse action containing a statement of the action taken, the name and address of the creditor, a notice of rights under Regulation B, and the name and address of the federal agency that enforces compliance
- Collect information for monitoring purposes about the race or national origin, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- Notify the credit applicant of the action taken within the time frames specified in the regulation
- Provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the credit denial or other adverse action
- Take a written credit application for the purchase or refinancing of a principal residence
- Refrain from requesting the race, color, religion, national origin, or sex of an applicant in transactions not covered by the data collection requirements.

The OTS issued three formal enforcement actions that contained provisions relating to Regulation B.

The Federal Trade Commission (FTC) obtained consent decrees against two vehicle finance companies for violations of the ECOA. The violations included, among others, providing inadequate notices of adverse action to loan applicants and discriminating against applicants on the basis of sex, marital status, or the fact that an applicant's income derived from public assistance sources. Under the consent decrees, the defendants agreed to civil money penalties and to the entry of a permanent injunction.

The FTC also continued litigation against a mortgage lender for violations of the ECOA. The allegations included, among others, failing to take written applications for mortgage loans, failing to collect monitoring information on mortgage loan applicants, and providing inadequate notices of adverse action to loan applicants. The FTC is seeking civil money penalties and injunctive relief in connection with the case.

The FTC is continuing its work with other government agencies and with creditor and consumer organizations to increase awareness of and compliance with the ECOA.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation (DOT), the Securities and Exchange Commission (SEC), the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA's examination and enforcement activities revealed certain violations of the ECOA, most of them due to creditors' failure to collect information for monitoring purposes and to comply with rules regarding adverse action notices; however, no formal actions were initiated.

## Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 1999 reporting period were in compliance with Regulation E, compared with 96 percent for the 1998 reporting period. Financial institutions most frequently failed to comply with the following requirements:

- Investigate an alleged error promptly after receiving a notice of error
- Determine whether an error was actually made, and transmit the results of the investigation and determination to the consumer within ten business days
- Provide customers with a periodic statement of all required information at least quarterly (or monthly, if an electronic funds transfer occurred).

The OTS issued two formal enforcement actions that contained provisions relating to Regulation E.

The FTC issued a brochure, "Guide to Online Payments," that gives consumers information about different types of online payment systems and security features. The SEC reported that no violations of Regulation E were detected in examinations of registered broker–dealers conducted by self-regulatory organizations.

## Regulation M (Consumer Leasing)

The FFIEC agencies reported substantial compliance with Regulation M for the 1999 reporting period. As in 1998, more than 99 percent of the institutions examined were in compliance. The few violations noted involved failure to adhere to specific disclosure requirements.

The FTC issued one consent decree against a vehicle manufacturer and one consent decree against two related vehicle dealerships and their owner. These decrees, which provided for civil penalties and other relief for allegedly deceptive lease or credit advertising, involved the failure to disclose important lease or credit terms clearly and conspicuously, in violation of the CLA or the TILA. The FCA reported that it identified no violations of the CLA during its examinations.

## Regulation Z (Truth in Lending)

The FFIEC agencies reported that 74 percent of the institutions examined during the 1999 reporting period were in compliance with Regulation Z, the same percentage as in 1998. The Board and the FDIC reported an increase in compliance, the OTS and the NCUA reported a decrease, and the OCC reported an unchanged level of compliance. The FFIEC agencies indicated that of the institutions not in compliance, 63 percent were in the lowest-frequency category (one to five violations), compared with 62 percent in 1998. The violations of Regulation Z most often observed were failure to take these actions:

- Accurately disclose the finance charge, payment schedule, annual per-

centage rate, security interest in collateral, and amount financed
- Accurately itemize the amount financed upon request
- Provide disclosures within three business days of application for RESPA-related residential mortgage applications
- Redisclose the annual percentage rate when a change occurred before consummation or settlement
- Withhold loan funds until the end of the rescission period
- Ensure that disclosures reflect the terms of the legal obligation between the parties.

The OTS issued three formal enforcement actions subject to provisions of Regulation Z. Altogether, a total of 342 institutions supervised by the Federal Reserve, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund $2.1 million to consumers in 1999 because of improper disclosures.

The FTC obtained consent judgments against seven subprime lenders and their owners for alleged violations of the Home Ownership and Equity Protection Act and the TILA. That agency also issued a final decision and order against a nationwide mortgage company for violating the TILA. This judgment involved allegedly deceptive cost information and practices. In addition, the FTC continued to litigate a complaint it had filed in federal district court in 1998. The complaint charged a mortgage lender in the Washington, D.C., area and its owner with violating the TILA in connection with alleged deceptive and unfair practices in home mortgage lending. As previously discussed under Regulation M, the FTC also issued a consent decree against two vehicle dealerships and their owner for violation of the CLA and the TILA.

In response to concerns about home equity fraud, the FTC issued ‘‘Need a Loan? Think Twice about Using Your Home as Collateral,’’ a consumer publication that provides information to consumers considering home equity loans. In addition, the FTC continued to participate in interagency efforts to educate consumers.

The DOT continued to prosecute a cease-and-desist consent order issued in 1993 against a travel agency and a charter operator. The complaint alleged that the two organizations violated Regulation Z by routinely failing to send credit statements for refund requests to credit card issuers within seven days of receiving fully documented credit refund requests from customers. The DOT is currently in negotiations to settle this litigation.

## Regulation AA (Unfair or Deceptive Acts or Practices)

The three bank regulators with responsibility for enforcing Regulation AA’s Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—reported that 98 percent of the institutions examined during the 1999 reporting period were in compliance. The most frequent violation was failure to provide a clear, conspicuous disclosure regarding a cosigner’s liability for a debt. No formal enforcement actions for violations of the regulation were issued during the period.

## Regulation CC (Availability of Funds and Collection of Checks)

The FFIEC agencies reported that 91 percent of institutions examined during the 1999 reporting period were in compliance with Regulation CC, compared with 89 percent for the 1998 reporting period. Of the institutions not in compliance, 66 percent had one to five violations. Institutions most frequently failed to comply with the following requirements:

- Follow special procedures for large-dollar deposits
- Provide immediate availability of amounts up to $100, for deposits not subject to next-day availability
- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- Provide exception notices about funds availability, including all required information.

The OTS issued two formal enforcement actions that contained provisions relating to Regulation CC.

### Regulation DD (Truth in Savings)

The FFIEC agencies reported that 87 percent of institutions examined during the 1999 reporting period were in full compliance with Regulation DD. Institutions most frequently failed to comply with the following requirements:

- State the rate of return as an annual percentage yield in an advertisement
- Provide appropriate maturity notices for certificates of deposit maturing in more than one year
- State required additional information in advertisements containing the annual percentage yield
- Provide all applicable information on account disclosures. Community Reinvestment Act

## Community Reinvestment Act

The Federal Reserve assesses the Community Reinvestment Act (CRA) performance of state member banks during regular compliance examinations. In addition, the Board considers CRA ratings (as well as other factors) when acting on applications from state member banks and bank holding companies for mergers, acquisitions, and certain other actions. The Federal Reserve has a three-faceted program for fostering better bank performance under the CRA. The program includes the following:

- Examining institutions to assess compliance with the CRA
- Disseminating information on community development techniques to bankers and the public through Community Affairs Offices at the Reserve Banks
- Performing CRA analyses in connection with applications from banks and bank holding companies.

During the 1999 reporting period, the Federal Reserve conducted 338 CRA examinations. Of the banks examined, 63 were rated outstanding in meeting community credit needs, 269 were rated satisfactory, 4 were rated needs to improve, and 2 were rated as being in substantial noncompliance.

## Applications

During 1999, the number of megamergers declined considerably from the previous year. Still, the Board of Governors considered applications for several very large banking mergers.

- In May the Board approved the application by Deutsche Bank, Frankfurt, Germany, to acquire Bankers Trust Corporation, New York, New York, a transaction creating the largest commercial banking organization in the world.

- In September the Board approved the application by Fleet Financial Group, Inc., to acquire BankBoston Corporation, both of Boston, Massachusetts. Because of the considerable public interest in the proposal, the Board held a public meeting to give interested persons a chance to present oral testimony.
- In December the Board approved the application by HSBC Holdings plc, London, England, to acquire Republic New York Corporation, New York, New York. HSBC was the eighth largest banking organization in the world and Republic was the nineteenth largest commercial banking organization in the United States at the time of the application.
- Also in December the Board approved the application by First Security Corporation to acquire Zions Bancorporation, both of Salt Lake City, Utah. Had the transaction been consummated, it would have created the twenty-fourth largest commercial banking organization in the nation.

In each of these applications, the Board found that the CRA records of the organizations involved were consistent with approval. In two of the three cases involving anticipated branch closures (Fleet and First Security), the Board required that the merged organizations report, for a two-year period, all branch closings and consolidations occurring as a result of the mergers.

In addition to these large transactions, the Federal Reserve System in 1999 acted on ten bank and bank holding company applications that involved protests by members of the public concerning insured depository institutions' performance under the CRA and acted on two applications that involved depository institutions having less than satisfactory CRA ratings. The Federal Reserve reviewed another twenty-nine applications involving fair lending and other issues related to compliance with consumer protection laws.[3]

## HMDA Data and Mortgage Lending Patterns

The Home Mortgage Disclosure Act requires mortgage lenders covered by the act to collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. Depository institutions generally are covered if they were located in metropolitan areas and met the asset threshold at the end of the preceding year; the asset threshold for the data reported in 1999 was $29 million. Mortgage companies are covered if they were located in or made loans in metropolitan areas and had assets of more than $10 million (when combined with the assets of any parent company) at the end of the preceding year. These entities are also covered, regardless of asset size, if they originated 100 or more home purchase loans in the preceding year.

In 1999, 6,707 depository institutions and affiliated mortgage companies and 1,130 independent mortgage companies reported to their supervisory agencies HMDA data for calendar year 1998. These lenders submitted information about the geographic location of the properties related to their loans and applications, the disposition of loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The Federal Financial Institutions Examination Council processed the data and pro-

3. In addition, one application (involving a CRA protest) was withdrawn in 1999.

duced disclosure statements on behalf of the U.S. Department of Housing and Urban Development and the FFIEC member agencies.

Individual disclosure statements are prepared for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity; in 1999 the FFIEC prepared 57,294 statements based on the 1998 data. In July, each institution made its disclosure statement public, and reports containing aggregate data for all lenders in a given metropolitan area were made available at central depositories in the nation's approximately 330 metropolitan areas. These data are used not only by the FFIEC member agencies, the reporting institutions, and the public, but also by HUD in its oversight of Fannie Mae and Freddie Mac and by HUD and the Department of Justice as one component of fair lending reviews. The data also assist HUD, the Department of Justice, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.[4]

The data reported in 1999 for the preceding year covered 24.7 million loans and applications, an increase of about 51 percent over 1998 that was due primarily to increased refinancing activity. The number of home purchase loans extended in 1998 compared with 1997 increased 13 percent for Asians and whites, 9 percent for blacks, 16 percent for Hispanics, and 21 percent for Native Americans. Over the six years 1993 through 1998, the number of home purchase loans extended increased 46 percent for Asians, 72 percent for blacks, 87 percent for Hispanics, 52 percent for Native Americans, and 31 percent for whites.

The number of home purchase loans extended to applicants in all income categories increased in 1998 compared with the preceding year. The number of such loans extended to lower-income applicants increased 19 percent, and the number extended to upper-income applicants increased 14 percent. Over the six years 1993 through 1998, the number of home purchase loans extended to lower-income and upper-income applicants increased 64 percent and 45 percent respectively.

In 1998, 31 percent of Hispanic applicants and 23 percent of black applicants for home purchase loans sought government-backed mortgages; the comparable figures for white, Asian, and Native American applicants were 14 percent, 10 percent, and 12 percent respectively. Twenty-four percent of lower-income applicants for home purchase loans, compared with 10 percent of upper-income applicants, applied for government-backed loans in 1998.

Denial rates for conventional (non-government-backed) home purchase loans in 1998 were 12 percent for Asian applicants, 54 percent for black applicants, 39 percent for Hispanic applicants, 53 percent for Native American applicants, and 26 percent for white applicants. Except for Asian applicants, each of these rates exceeded, by a small measure, the comparable rate for 1997.

Overall, the denial rate for conventional loans was 29 percent in 1998. This rate has increased in each of the past several years, reflecting in part the increasing share of applications for conventional loans filed by lower-income applicants. The increase in denial rates also reflects the growing share of applications reported under HMDA that are filed with lenders that specialize in

4. On behalf of the nation's eight active private mortgage insurance (PMI) companies, the FFIEC also compiles information on applications for PMI similar to the information on home mortgage lending collected under HMDA. Lenders typically require PMI for conventional mortgages that involve small down payments.

manufactured home and subprime lending.[5] In 1998, these 260 lenders denied 55 percent of all applications for conventional home purchase loans they received, compared with 16 percent for other lenders. If the activities of these specialty lenders are excluded from the calculations, denial rates for the remaining institutions show little change since 1993.

## Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agencies complaints that involve other creditors and businesses (see table). The Federal Reserve also monitors and analyzes complaints about unregulated practices.

In 1999 the Board implemented a new PC-based database system, CAESAR (Complaint Analysis Evaluation System and Reports). For both the Board and the Reserve Banks, CAESAR facilitates access to information on the status and resolution of complaints and inquiries as well as any supervisory actions taken as a result of complaint investigations. It also facilitates analysis of the type of discrimination complaints received, and produces reports used to identify patterns and trends in complaints and inquiries.

During 1999, the Board also revised its *Consumer Complaint Manual*. The revised manual includes updated policies and procedures for the Systemwide consumer complaint program, a new chapter on Board evaluation of Reserve Bank complaint program performance, a checklist for Reserve Banks to use when investigating complaints alleging illegal credit discrimination, and information about CAESAR.

5. See Glenn B. Canner and Wayne Passmore, ‘‘The Role of Specialized Lenders in Extending Mortgages to Lower-Income and Minority Homebuyers,’’ *Federal Reserve Bulletin*, vol. 85 (November 1999), pp. 709–23.

### Complaints against State Member Banks

In 1999 the Federal Reserve received a total of 4,697 complaints—3,782 by mail, 885 by telephone, and 30 in

Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System, 1999

| Subject | State member banks | Other institutions[1] | Total |
|---|---|---|---|
| Regulation B (Equal Credit Opportunity) | 70 | 43 | 113 |
| Regulation E (Electronic Fund Transfers) | 34 | 69 | 103 |
| Regulation M (Consumer Leasing) | 23 | 22 | 45 |
| Regulation Q (Payment of Interest) | 1 | 0 | 1 |
| Regulation Z (Truth in Lending) | 375 | 531 | 906 |
| Regulation BB (Community Reinvestment) | 3 | 3 | 6 |
| Regulation CC (Expedited Funds Availability) | 19 | 47 | 66 |
| Regulation DD (Truth in Savings) | 48 | 54 | 102 |
| Fair Credit Reporting Act | 110 | 314 | 424 |
| Fair Debt Collection Practices Act | 10 | 21 | 31 |
| Fair Housing Act | 0 | 0 | 0 |
| Flood insurance | 2 | 3 | 5 |
| Regulations T, U, and X | 0 | 1 | 1 |
| Real Estate Settlement Procedures Act | 6 | 45 | 51 |
| Unregulated practices | 1,278 | 1,565 | 2,843 |
| **Total** | **1,979** | **2,718** | **4,697** |

1. Complaints against these institutions were referred to the appropriate regulatory agencies.

Consumer Complaints Received by the Federal Reserve System, by Subject of Complaint, 1999

| Subject of complaint | Complaints against state member banks | | | | | |
|---|---|---|---|---|---|---|
| | Total | | Not investigated | | Investigated | |
| | | | | | Bank legally correct | |
| | Number | Percent | Unable to obtain sufficient information from consumer | Explanation of law provided to consumer | No reimbursement or other accommodation | Goodwill reimbursement or other accommodation |
| Loans | | | | | | |
| Discrimination alleged | | | | | | |
| Real estate loans | 18 | 1 | 0 | 1 | 8 | 0 |
| Credit cards | 31 | 1 | 3 | 2 | 8 | 4 |
| Other loans | 21 | 1 | 1 | 3 | 8 | 1 |
| Other type of complaint | | | | | | |
| Real estate loans | 153 | 8 | 4 | 26 | 39 | 25 |
| Credit cards | 996 | 50 | 27 | 81 | 173 | 475 |
| Other loans | 214 | 11 | 7 | 57 | 69 | 25 |
| Deposits | 394 | 20 | 11 | 101 | 94 | 65 |
| Electronic fund transfers | 34 | 2 | 0 | 6 | 8 | 2 |
| Trust services | 22 | 1 | 3 | 6 | 7 | 1 |
| Other | 96 | 5 | 15 | 10 | 11 | 15 |
| **Total** | **1,979** | **100** | **71** | **293** | **425** | **613** |

person. Of the complaints, 1,979 were against state member banks (see tables). Of the complaints against state member banks, about 75 percent involved loan functions: 3 percent alleged discrimination on a prohibited basis, and 69 percent addressed a variety of other practices, such as credit denial on a basis not prohibited by law (credit history or length of residence, for example) and miscellaneous other practices (release or use of credit information, for example). Another 20 percent of the complaints involved disputes about interest on deposits and general deposit account practices; the remaining 8 percent concerned disputes about electronic fund transfers, trust services, or other practices.

During 1999, investigations were also completed in connection with 159 state member bank complaints pending at year-end 1998. Investigations revealed that in the vast majority of the cases, the banks were legally correct. Notwithstanding, in nearly half of these cases the banks chose to reimburse or otherwise accommodate the consumer. Only two of these complaints concerned violations of regulations.

The Federal Reserve also received more than 2,000 inquiries about consumer credit and banking policies and practices. In responding to these inquiries, the Board and the Federal Reserve Banks gave specific explanations of laws, regulations, and banking practices and provided relevant printed materials on consumer issues.

## Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board continued to monitor complaints about banking practices that are not subject

Consumer Complaints Received—Continued

| Complaints against state member banks | | | | | | Referred to other agencies | Total complaints |
|---|---|---|---|---|---|---|---|
| Investigated | | | | | Pending, December 31 | | |
| Customer error | Bank error | Factual or contractual dispute—resolvable only by courts | Possible bank violation—bank took corrective action | Matter in litigation | | | |
| 0 | 0 | 0 | 0 | 0 | 9 | 28 | 46 |
| 0 | 1 | 1 | 0 | 1 | 11 | 9 | 40 |
| 0 | 0 | 1 | 0 | 0 | 7 | 6 | 27 |
| 4 | 36 | 10 | 1 | 0 | 8 | 383 | 536 |
| 3 | 121 | 16 | 1 | 0 | 99 | 953 | 1,949 |
| 0 | 36 | 2 | 1 | 3 | 14 | 283 | 497 |
| 3 | 64 | 13 | 0 | 13 | 30 | 621 | 1,015 |
| 0 | 6 | 3 | 1 | 1 | 7 | 69 | 103 |
| 0 | 1 | 1 | 0 | 0 | 3 | 30 | 52 |
| 1 | 21 | 4 | 0 | 1 | 18 | 336 | 432 |
| **11** | **286** | **51** | **4** | **19** | **206** | **2,718** | **4,697** |

to existing regulations and to focus on those that concern possibly unfair or deceptive practices. Of the 2,843 complaints about unregulated practices received in 1999, four of the five categories that received the most complaints involved credit cards: miscellaneous problems involving credit cards (216 complaints); penalty charges on accounts (159); customer service problems (115); and interest rates and terms (113). Among the issues raised by the customer service complaints were the failure to close accounts as requested; the failure to provide account information; and the imposition of an annual fee after an account was closed. The remaining category, miscellaneous unregulated practices (167 complaints), covered a wide range of issues, including check-cashing problems and release of liens. Each of these five complaint categories accounted for a small portion (5 percent or less) of all consumer complaints received.

## Complaint Referrals to HUD

The Federal Reserve in 1999 continued to refer to the Department of Housing and Urban Development complaints alleging violations of the Fair Housing Act, in accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies. Nine such complaints about state member banks were referred during the year. Investigations of seven of the nine revealed no evidence of illegal discrimination; the remaining complaints were pending at year-end. ■

# Banking Supervision and Regulation

The U.S. banking system reported strong performance in 1999, as earnings continued to set new records, capital ratios rose, and problem assets increased only moderately from below-average levels. That performance was achieved as the U.S. economy continued to expand at a strong pace and emerging-market economies that had experienced considerable turmoil in the preceding year stabilized. Fee and other noninterest revenues grew at a faster pace than bank balance sheets, with banks relying to a greater extent on revenues from trust, securitization, loan servicing, asset management, trading, venture capital, and other activities. Growth of noninterest revenues made up for flat, and in some cases narrowing, interest margins that reflected the industry's growing reliance on wholesale sources of funds as well as the gradual decline of lower-cost, retail deposits. At the same time, provisioning for credit losses declined and noninterest expenses moderated, resulting in stronger operating earnings.

The rapid pace of industry consolidation among the largest firms subsided somewhat during 1999 as many firms prepared for the century date change and worked to digest the significant mergers already undertaken. Competition among banking firms remained intense, amid signs that loan terms and conditions were continuing to weaken and that banking organizations were extending credit to some borrowers largely on the expectation that the borrower's current strong financial performance would continue indefinitely. Federal Reserve supervisory staff identified several instances in which meaningful stress-testing had not been performed. These trends prompted the issuance of guidance to Federal Reserve examiners and the industry regarding the potential consequences of banks departing from accepted sound lending standards. The rise in adverse examiner classifications over the year provided some evidence that such weakening standards were affecting credit-quality conditions and raised questions about the greater vulnerability of weakly underwritten credits if economic conditions were to deteriorate.

The final year of the 1990s witnessed two significant legislative and regulatory events: (1) modernization of the U.S. financial system through the Gramm–Leach–Bliley Act, which repealed depression-era banking laws and provides for the affiliation of banks with securities and insurance firms within financial holding companies, and (2) the first steps toward a comprehensive revision of the 1988 Basel Capital Accord. Under the financial modernization act, the Federal Reserve will play an important role as umbrella supervisor of financial holding companies. To a great extent, the Federal Reserve will rely on information and analysis provided by functional regulators of the bank and securities or insurance firms. The focus of the Federal Reserve's review will be the holding company's risk profile and managerial strength on a fully consolidated basis, with emphasis on whether any weaknesses might adversely affect the insured depository institution.

While U.S. lawmakers were modernizing banking laws, the Basel Committee on Banking Supervision announced that it would modernize international capital standards by undertaking the

## The Implications of Financial Modernization Legislation for Bank Supervision

> *Now the financial services industry faces the challenge of how best to take advantage of the new opportunities provided by the financial modernization law, and their regulators face the challenge of implementing the framework for regulating and supervising the more diversified financial holding companies allowed under the new legislation.*
>
> Laurence H. Meyer, *Member*, Board of Governors

The Gramm–Leach–Bliley Act, signed by the President in November 1999, provides long-needed reform of the U.S. financial regulatory system. It permits traditional bank holding companies and foreign banks to expand into new insurance and securities activities, and insurance and securities firms to enter commercial banking. Moreover, it does so in a relatively expeditious way, avoiding many regulatory procedures that would have been required in the past. (For a description of the act's provisions, see the section on the Bank Holding Company Act in this chapter and also the chapter ''Federal Legislative Developments.'')

The Gramm–Leach–Bliley Act, along with the implementing regulations and associated supervisory policies, promises to transform the U.S. financial system. By validating affiliations between banks and diversified financial services firms, through ''financial holding companies,'' the legislation should improve the competitiveness and efficiency of financial markets and provide a broader array of financial products to consumers. With the flexibility it introduces—together with the workings of time, technology, and innovation—world financial markets and institutions undoubtedly will look much different a decade from now than they do today. Whether the new landscape will be fruitful for institutions and consumers depends a great deal on how well government develops regula-

first wholesale review of the Basel Capital Accord. The committee's consultative document called for comment on a revised capital framework that would rely on three pillars: (1) capital standards that better align minimum requirements with the actual level of bank risk-taking, (2) supervisory review of a banking organization's positions and risk management capabilities as well as their effect on capital adequacy, and (3) improved market discipline of bank risk-taking activities through greater disclosure of risk positions and capital.

Federal Reserve staff members are involved in this review. In particular, they are exploring the use of bank internal risk grades in setting minimum requirements for credit risk. Staff are also exploring techniques for applying capital charges for operating risk and for interest rate risk when institutions take on significantly high levels of interest rate risk, so called ''outliers.'' Work is also under way in connection with the supervisory component of the framework (the second pillar) as well as the disclosure elements of the third pillar. Development and implementation of tions and industry defines new strategies for competing effectively in the years ahead.

The Federal Reserve's challenge will be to avoid extending the federal safety net to more institutions as it constructs supervisory and regulatory policies under financial reform. The federal safety net gives banks the special benefits of access to federal deposit insurance and to the Federal Reserve's clearing process and discount window. Extending that access could result in relaxed market discipline and could thereby expose U.S. taxpayers to the kind of dangers experienced more than a decade ago during the savings and loan crisis.

The Federal Reserve has sought to address the risks associated with any extension of the safety net by separating the conduct of new activities as much as reasonably possible from insured depositories and by providing a framework for adequate supervision of financial holding companies. Such efforts will contribute to the market discipline necessary to make supervision most effective.

Determining the right mix of active government oversight and market discipline has become more difficult as financial markets and institutions have grown larger and more complex. In fulfilling its role as umbrella supervisor, the Federal Reserve must look across the entire financial holding company to adequately assess its risk-management process and its financial condition. Fortunately, the diversification that comes with the greater size and range of activities of today's large financial institutions has improved these firms' ability to withstand shocks and has probably reduced the likelihood that one or more of them will fail. At the same time, the larger size of these institutions means greater damage to the entire financial system should just one of them fail.

Financial institutions and their regulators must remain flexible and innovative in dealing with rapidly changing markets and financial products. Large banking organizations and financial holding companies, in particular, must be willing to meet high standards of soundness and disclosure and improve their ability to assess risk in step with the burgeoning complexity of the marketplace. The potential benefits from financial reform should be substantial, but they will be so only if both government and industry work together to keep the system sound.

this challenging initiative is expected to take a considerable amount of time.

To ensure that its supervisory program adequately takes account of the risks assumed by more complex organizations that undertake innovative activities, the Federal Reserve has increasingly relied on information and analysis provided by banks' own risk-management systems for evaluating capital adequacy. After identifying areas in which the organizations' practices could be improved, the Federal Reserve has issued guidance on sound practices for evaluating capital adequacy. The guidance to larger institutions with complex risk profiles enumerated the fundamental elements of a sound internal capital-adequacy analysis and encouraged the institutions to strengthen their risk-measurement capabilities as well as to integrate these capabilities more fully into evaluations of their own capital adequacy.

The Federal Reserve's approach to assessing capital adequacy is an important aspect of a program for large, complex banking organizations (LCBOs) that was formalized during 1999. That program involves more continuous, risk-focused supervisory oversight of these institutions as well as greater use of horizontal comparative analysis of these companies' business lines and other activities. This approach to supervision is intended not only to improve the Federal Reserve's hands-on knowledge of these organizations but also to improve its ability to identify sound practices. The program will be supported by improved information technology that will provide supervisory staff and examiners with more up-to-date information on and analysis of banking organizations and will facilitate the sharing and coordination of information among the banking agencies and other authorities. The Federal Reserve's approach to LCBOs and the supporting technology will be a solid foundation for efforts to supervise financial holding companies, which require more continuous information and greater collaboration among authorities.

Another area of note during 1999 was the culmination of the Federal Reserve's multiyear effort to ensure that U.S. banks recognized their responsibility to be prepared for the century date change. During the rollover period, only minor problems were reported domestically and abroad. Potentially large costs to the financial system and the public were avoided because of these efforts and the work of domestic and international banking regulators, and the banks themselves, to ensure a smooth transition to the year 2000.

## 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 Gramm–Leach–Bliley Act) and of 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 and their compliance with laws and regulations, including the Bank Secrecy Act, certain securities law provisions applicable to banks, and consumer and civil rights laws.[1] In examining these activities it relies to the greatest extent possible on reports and information provided by the functional regulator of the activities, if other than the Federal Reserve.

The Federal Reserve also has responsibility for the supervision of all Edge Act and agreement corporations; the international operations of state member banks and U.S. bank holding companies; and the operations of foreign banking organizations in the United States.

The Federal Reserve exercises important regulatory influence over the entry into, and the structure of, the U.S. banking system through its administration of the Bank Holding Company Act; the Bank Merger Act, for state member banks; the Change in Bank Control Act, for 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 other federal and state regulatory agencies and with the bank regulatory agencies of other nations.

1. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with consumer and civil rights laws. To carry out this responsibility, the Federal Reserve trains a number of its bank examiners to evaluate institutions with regard to such compliance. The chapter of this REPORT covering consumer and community affairs describes these regulatory responsibilities.

## Supervision for Safety and Soundness

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

### Examinations and Inspections

The Federal Reserve conducts *examinations* of state member banks, branches and agencies of foreign banks, Edge Act corporations, and agreement corporations; it conducts *inspections* of holding companies and their nonbank subsidiaries, as many aspects of the reviews at bank holding companies and their nonbank subsidiaries differ from bank examinations. Pre-examination planning and on-site review of operations are integral parts of ensuring the safety and soundness of financial institutions. In both examinations and inspections, the review entails (1) an assessment of the quality of the processes in place to identify, measure, monitor, and control risks, (2) an appraisal of the quality of the institution's assets, (3) an evaluation of management, including an assessment of internal policies, procedures, controls, and operations, (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk, and (5) a review for compliance with applicable laws and regulations.

#### *State Member Banks*

At the end of 1999, 1,010 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented about 11.8 percent of all insured U.S. commercial banks and held about 23.5 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. For most of these banks, a full-scope, on-site examination is required at least once a year; certain well-capitalized, well-managed institutions having assets of less than $250 million may be examined every eighteen months.

During 1999, the Federal Reserve Banks conducted 517 examinations of state member banks (some of them jointly with the state agencies), and state banking departments conducted 248 independent examinations of state member banks.

#### *Bank Holding Companies*

At year-end 1999, the number of U.S. bank holding companies totaled 5,941. These organizations controlled 6,774 insured commercial banks and held approximately 95 percent of all insured commercial bank assets.

Federal Reserve guidelines call for annual inspection of large bank holding companies as well as smaller companies that have significant nonbank assets. In judging the financial condition of subsidiary banks, Federal Reserve examiners consult the examination reports of the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. In 1999, Federal Reserve examiners conducted 1,427 bank holding company inspections, of which 980 were on site and 447 were off site, and state examiners conducted 70 independent inspections. These inspections were conducted at 1,218 bank holding companies.

Small, noncomplex bank holding companies—those that have less than $1 billion in consolidated assets, do not have debt outstanding to the public, and do not engage in significant nonbank activities—are subject to a special supervisory program that became effective in 1997. The program permits a more flexible approach to supervising those entities in a risk-focused environment and is designed to improve the overall effectiveness and efficiency of the Federal Reserve's bank supervisory efforts. Each such holding company is subject to off-site review once during each supervisory cycle, which corresponds to the mandated examination cycle for the company's lead bank. In 1999, the Federal Reserve conducted 2,058 reviews of these companies.

## Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology; fiduciary activities; transfer agent activities; government and municipal securities broker and dealer activities; and securities underwriting and dealing through so-called section 20 subsidiaries of bank holding companies. As part of the technology review, examiners in 1999 also conducted targeted reviews of preparedness for the century date change.

### *Information Technology*

The Federal Reserve examines the information technology activities of state member banks, U.S. branches and agencies of foreign banks, Edge Act and agreement corporations, and independent data centers that provide electronic data processing services to these institutions. These examinations are conducted in recognition of the importance of information technology to the financial services industry and help ensure that banking organizations conduct their operations in a safe and sound manner. During 1999, the Federal Reserve conducted 178 examinations that focused on the safety and soundness of information technology and electronic data processing systems. The Federal Reserve was also the lead agency in four examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

### *Year 2000 Compliance*

The Federal Reserve conducted reviews of the Year 2000 readiness of supervised institutions. These focused on the successful completion of testing and implementation of mission-critical systems by June 30, 1999, and the progress being made by those that were unable to meet that target. In much of the second half of the year, the focus was on the completion of contingency plans for business resumption and event management at the century rollover.

When necessary, supervisors initiated enforcement actions against individual institutions. The severity of the actions was scaled to the severity of the Year 2000 problems faced by the institution. In the most serious cases, the actions were made public so that affected consumers and counterparties could evaluate their own actions relative to the institution's problems.

### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for institutions that together hold more than $12 trillion of assets in various fiduciary capacities. During on-site examination of an institution's fiduciary activities, examiners evaluate the institution's management and operations, including its asset and account management, risk management, and audit and control procedures, and review its compliance with laws, regulations, general fiduciary principles, and potential conflicts of interest. In 1999, Federal Reserve examiners conducted 191 on-site examinations of fiduciary activities.

### *Transfer Agents and Securities Clearing Agencies*

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 transfer agent operations and compliance with relevant securities regulations. During 1999 Federal Reserve examiners conducted on-site examinations at 44 of the 127 state member banks and bank holding companies that were registered as transfer agents.

Also during the year the Federal Reserve examined one state-member limited-purpose trust company that acted as a national securities depository to ensure the safety and soundness of its operations and its compliance with applicable laws and regulations.

### *Government and Municipal Securities Dealers and Brokers*

The Federal Reserve is responsible for examining the government securities dealer and broker activities of state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations. Thirty-eight state member banks and eight state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 1999 the Federal Reserve conducted twelve examinations of broker–dealer activities in government securities at these institutions.

Under the Securities Act Amendments of 1975, the Federal Reserve is also responsible for the supervision of state member banks and bank holding companies that act as municipal securities dealers. The Federal Reserve supervises thirty-two banks that act as municipal securities dealers. In 1999, ten of these institutions were examined.

### *Securities Subsidiaries of Bank Holding Companies*

Before enactment of the Gramm–Leach–Bliley Act, all subsidiaries of bank holding companies established pursuant to section 20 of the Banking Act of 1933 (so-called section 20 firms or subsidiaries) were required to conduct business subject to uniform operating standards, consistent with safe and sound operations. To ensure that section 20 firms were not engaged principally in underwriting and dealing in securities, the Board limited revenues derived from such activities to less than 25 percent of the total revenues of the section 20 subsidiary.

At year-end 1999, forty-five bank holding companies and foreign banking organizations owned a total of fifty-two section 20 subsidiaries authorized to underwrite and deal in ineligible securities; largely because of mergers and acquisitions, seven of these institutions owned more than one section 20 subsidiary. Of the fifty-two authorized section 20 subsidiaries, forty-four were permitted to underwrite any debt or equity security, three were permitted to underwrite any debt security, and five were permitted to underwrite only the limited types of debt securities first approved by the Board in 1987. The Federal Reserve follows specialized inspection procedures to review the operations of these securities subsidiaries; it conducted fifty such inspections in 1999.

The section 20 inspection program is currently being revised in light of the provisions of the Gramm–Leach–Bliley Act.

## Enforcement Actions, Civil Money Penalties, and Suspicious Activity Reporting

In 1999 the Federal Reserve Banks recommended, and members of the Board's staff initiated and worked on, twenty-seven enforcement cases involving fifty-one separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties.

In other significant matters, the Board of Governors assessed civil money penalties totaling more than $595,000. The Board also terminated all outstanding enforcement actions related to Year 2000 deficiencies because the affected organizations had taken appropriate actions to address the deficiencies.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 1999 are available to the public and can be accessed from the Board's public web site.

In addition to formal enforcement actions, the Federal Reserve Banks in 1999 completed 107 informal enforcement actions, such as memorandums of understanding and board resolutions.

## Risk-Focused Supervision

Over the past several years the Federal Reserve has initiated a number of programs aimed at enhancing the effectiveness of the supervisory process. The main objective of these initiatives has been to sharpen the focus on (1) those business activities posing the greatest risk to banking organizations and (2) the organizations' management processes for identifying, measuring, monitoring, and controlling their risks.

### *Risk-Focused Supervision of Community Banks*

The risk-focused supervision program for community banks emphasizes that certain elements are key to the risk-focused supervision process. These elements include adequate planning time, completion of a pre-examination visit, preparation of a detailed scope-of-examination memorandum, thorough documentation of the work done, and preparation of an examination report tailored to the scope of the examination.

### *Risk-Focused Supervision of Large, Complex Banking Organizations*

Large, complex banking organizations are supervised under the Federal Reserve's Framework for Risk-Focused Supervision of Large, Complex Financial Institutions. In 1999, more-specific guidance on the applicability of this program to the larger and more complex banking organizations was developed. The key features of the LCBO supervision program are (1) identifying those LCBOs that, based on their shared risk characteristics, present the highest level of supervisory risk to the Federal Reserve System, (2) maintaining continual supervision of these institutions to keep current the Federal Reserve's assessment of each organization's condition, (3) instituting a defined, stable team to supervise each LCBO, a team composed of Reserve Bank staff who have skills appropriate for the organization's unique risk profile, led by a Reserve Bank central point of contact who has responsibility for only one LCBO, and supported by specialists skilled in evaluating the risks of highly complex LCBO business activities and functions, and (4) promoting Systemwide and interagency information-sharing through an automated system.

An important element of the program is the sharing of resources across the System. Several initiatives are under way to better utilize supervisory resources Systemwide in order to facilitate comprehensive reviews of institutions and to assist in horizontal risk assessments across groups of institutions to identify emerging trends.

### *Risk-Focused Supervision of Small Shell Bank Holding Companies*

The Federal Reserve uses automated screening systems for small shell bank holding companies to identify trends that may adversely affect individual companies. These screens support the risk-focused supervision program for these companies, which tailors supervisory activities to an assessment of each company's reported condition and activities and the condition of its subsidiary banks. Under the program, Reserve Banks are expected to perform a risk assessment of each small shell bank holding company at least once during each supervisory cycle, which depends on the examination frequency for the holding company's lead bank. If a preliminary assessment identifies no unusual supervisory issues or concerns, no special follow-up with the company is necessary. However, if it supports the assignment of a supervisory rating (that is, a BOPEC rating) of 3 or worse or a management rating of less than satisfactory, a full-scope, on-site inspection is expected to be performed. New companies are subject to a full-scope, on-site inspection within the first twelve to eighteen months of operation.

### *Technology Initiatives for the Risk-Focused Supervision Program*

Work continued during 1999 toward the implementation of phase I of the Banking Organization National Desktop (BOND) application, which is scheduled for release in 2000. This information technology initiative is designed to facilitate the high degree of information-sharing and collaboration necessary to support risk-focused supervision of the largest, most complex U.S and foreign banking organizations by providing immediate, user-friendly access to a full range of internal and third-party information. It will also facilitate the analysis of trends across similar organizations and improve the Federal Reserve's ability to identify and manage the risks posed by these diversified banking organizations.

## Surveillance and Risk Assessment

To supplement on-site examinations, the Federal Reserve routinely monitors the financial condition and performance of banking organizations using automated screening systems. In these surveillance systems, data from regulatory financial reports are analyzed to identify companies that appear to be deteriorating or to be weaker than current supervisory ratings suggest. The analysis helps to direct examination resources to potentially troubled institutions. Surveillance systems also identify companies that are engaging in new or complex activities to assist in planning examinations. Currently, separate surveillance programs are run quarterly for state member banks; large, complex bank holding companies; and small shell bank holding companies. The Federal Reserve also produces and distributes the quarterly Bank Holding Company Performance Report (BHCPR) to assist supervisory staff in evaluating individual bank holding companies.

During 1999 the Federal Reserve initiated development of surveillance programs for U.S. branches and agencies of foreign banking organizations and for changes in cross-border exposures of banking holding companies. Staff members also adapted a number of surveillance screens to be used in the BOND application.

To facilitate access to data from regulatory reports and to surveillance program results, the Federal Reserve maintains a PC-based application that accesses data housed in the National Information Center (NIC) and electronically distributes surveillance screen results. During the year, staff members expanded the capabilities of this application—the Performance Report Information and Surveillance Monitoring application (PRISM)—to include financial information on U.S. nonbank subsidiaries and data on institution structure.

The Federal Reserve works with the other federal banking agencies to enhance and coordinate surveillance activities through representation on the Federal Financial Institutions Examination Council's Task Force on Surveillance Systems.

## International Activities

The Federal Reserve plays a critical role in the supervision of the international activities of U.S. banking organizations and the U.S. activities of foreign banking organizations. It supervises foreign branches of member banks; overseas investments by member banks, Edge Act corporations and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. It also supervises the U.S. activities of foreign banking organizations, including U.S. branches, agencies, and representative offices, U.S. bank subsidiaries, and commercial lending company subsidiaries and nonbanking subsidiaries.

### *Foreign Office Operations of U.S. Banking Organizations*

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank holding companies, principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. In 1999 the Federal Reserve conducted examinations of five foreign branches of state member banks and twenty foreign subsidiaries of Edge Act corporations and bank holding companies. The examinations abroad were conducted with the cooperation of the supervisory authorities of the countries in which they took place; when appropriate, the examinations were coordinated with the Office of the Comptroller of the Currency. Also, examiners made three visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their compliance with corrective measures or to test their adherence to safe and sound banking practices.

### *Foreign Branches of Member Banks*

At the end of 1999, eighty-two member banks were operating 921 branches in foreign countries and overseas areas of the United States; fifty-one national banks were operating 717 of these branches, and thirty-one state member banks were operating the remaining 204 branches. In addition, twenty nonmember banks were operating 45 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. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into agreements with the Board not to exercise any power that is not permissible for an Edge Act corporation.

Under sections 25 and 25(A) of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, which in most cases 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 in companies such as finance and leasing companies, as well as in foreign banks.

At year-end 1999, there were eighty-three Edge Act and agreement corporations with twenty-nine branches. During the year, the Federal Reserve examined all of these corporations.

### *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, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system. As of year-end 1999, 230 foreign banks from 58 countries operated 317 state-licensed branches and agencies (of which 15 were insured by the Federal Deposit Insurance Corporation) as well as 57 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 17 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 82 U.S. commercial banks. Altogether, these U.S. offices of foreign banks at the end of 1999 controlled approximately 19 percent of U.S. commercial banking assets. These foreign banks also operated 115 representative offices; an additional 84 foreign banks operated in the United States solely through a representative office.

The Federal Reserve has acted to ensure that all state-licensed and federally licensed branches and agencies are examined on site at least once every eighteen 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 twelve months, but the period may be extended to eighteen months if the branch or agency meets certain criteria. The Federal Reserve conducted or participated with state and federal regulatory authorities in 274 examinations during 1999.

### *Joint Program for Supervising the U.S. Operations of Foreign Banking Organizations*

In 1995 the Federal Reserve, in cooperation with the other federal and state banking supervisory agencies, formally adopted a joint program for supervising the U.S. operations of foreign banking organizations (FBOs). The program has two main parts. One part focuses on the examination process for those FBOs that have multiple U.S. operations and is intended to improve coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each FBO to assess its general ability to support its U.S. operations and to determine what risks, if any, the FBO poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. During 1999 the Federal Reserve continued to implement program goals through coordination with other supervisory agencies and the development of financial and risk assessments of foreign banking organizations and their U.S. operations.

*Technical Assistance*

In 1999 the Federal Reserve System continued to provide staff for technical assistance missions covering bank supervisory matters to an increasing number of central banks and supervisory authorities around the world. Technical assistance takes a variety of forms ranging from official visits by foreign supervisors to the Board and Reserve Banks for the purpose of learning about U.S. supervisory practices and procedures to secondments of Federal Reserve System staff to overseas supervisory authorities for the purpose of advising on strengthening the bank supervisory process in a foreign country. In 1999, technical assistance was concentrated in Latin America, the Far East, and former Soviet bloc countries. During the year, the Federal Reserve offered supervision training courses in Washington, D.C., and on site in a number of foreign jurisdictions exclusively for the staff of foreign supervisory authorities. System staff members also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, and the Basel Committee on Banking Supervision.

## Supervisory Policy

Within the supervisory policy function, the Federal Reserve develops guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Staff members also participate in international supervisory forums and provide support for the work of the FFIEC.

### Capital Adequacy Standards

During 1999 the Federal Reserve, together with the other federal banking agencies, issued two final rules that amended their capital standards for market risk and implemented technical modifications.

*Market Risk/Specific Risk*

On April 19 the Federal Reserve, together with the FDIC and the OCC, issued a final rule amending their respective risk-based capital standards for market risk applicable to certain institutions having significant trading activities. The final rule permits institutions to use qualifying internal models to determine their capital requirements in relation to specific risk (an element of market risk) without comparing the requirements generated by their internal models with the so-called standardized specific-risk capital requirement.

*Technical Modifications*

On March 2 the federal banking agencies issued a final rule amending their capital adequacy standards to eliminate differences among the agencies. The final rule revises and makes consistent among the agencies the risk-based capital treatment of construction loans for presold one- to four-family residential properties, junior liens on one- to four-family residential properties, and investments in mutual funds and simplifies the agencies' leverage capital rules for banks and thrift institutions.

The final rule permits a 50 percent risk weight for all qualifying construction loans on presold one- to four-family residential properties. It also requires that a lending institution holding the first and junior liens on a one- to four-family residential property, with no other intervening liens, treat the loans on a combined basis as a single extension of credit for loan-to-value and risk-weighting purposes. The institution's combined loan amount is then assigned in its entirety to either the 50 percent or 100 percent risk category, depending on underwriting and performance criteria. In addition, the final rule gives institutions the option of assigning a mutual fund investment on a pro rata basis among the risk categories according to the investment limits in the mutual fund prospectus. Finally, with regard to the leverage capital standards, the final rule clarifies that certain institutions having the highest supervisory rating must have a minimum leverage ratio of 3.0 percent; all other banks and thrift institutions must have a minimum leverage ratio of 4.0 percent.

## Trading and Capital Markets Activities

In 1999 the Board's Division of Banking Supervision and Regulation updated its *Trading and Capital Markets Activities Manual*, which provides examiners with guidance for reviewing capital markets and trading activities at financial institutions of all types and sizes. The manual discusses the risks involved in various activities, risk-management and risk-measurement techniques, appropriate internal controls, and examination objectives and procedures. It takes a functional approach to activities, as opposed to a legal-entity approach. In the 1999 update, chapters on counterparty credit risk, capital adequacy, and accounting were revised to reflect new regulatory guidance and best practices.

## Recourse

During 1999 the Federal Financial Institution Examination Council recommended that the Federal Reserve, together with the OCC, FDIC, and OTS (Office of Thrift Supervision), adopt the interagency proposal that would amend the risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrift institutions to credit risk. The proposed revisions would use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations. It is expected that the proposal will be issued for public comment in the first quarter of 2000.

## Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations

In July the Federal Reserve issued supervisory guidance that emphasizes the growing need for banking organizations to ensure that their capital not only is adequate to meet formal regulatory standards but also is sufficient to support their underlying risk positions. The guidance suggests that internal capital management processes at several large, complex banking organizations could be improved and better integrated with internal risk measurement and analysis. In coming months, the Federal Reserve will evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of an institution's capital needs.

## Loan Write-Up Standards

The Federal Reserve amended its loan write-up standards for criticized assets in 1999 to bring them into conformity with the risk-focused examination approach. In the case of a majority of adversely classified assets, the new standards allow the examiner to omit details that are of little benefit to the banking organization and supervision staff. The new approach, which uses asset-classification write-ups to illustrate loan administration weaknesses, encourages a cooperative effort between examiners and bank management. Full loan write-ups are still required for certain criticized assets in situations in which bank management disagrees with the disposition accorded by the examiner and when the institution is viewed as a problem bank. Abbreviated write-ups are appropriate to formalize certain decisions and to clarify actions by management.

## Real Estate Lending Standards

In October the Federal Reserve, together with the other federal banking agencies, issued guidance on high loan-to-value (LTV) residential real estate loans as a clarification of the agencies' real estate lending regulations. The guidance describes some of the risks inherent in high LTV lending and the controls that institutions should have in place to manage these risks. It also reminds institutions about the 100 percent capital limitations on this type of lending.

## Synthetic Securitizations

On November 17 the Federal Reserve, together with the OCC, issued guidance on the way synthetic securitizations should be treated under the current leverage and risk-based capital guidelines. The guidance permits a banking organization sponsoring a leveraged synthetic securitization to reduce its capital requirement against certain retained exposures if the institution has eliminated virtually all of its credit risk exposure to the specified portfolio being synthetically securitized. The guidance specifies minimum requirements that the sponsoring institution must meet to ensure that it has eliminated virtually all of its credit exposure; it also specifies disclosure requirements regarding the transaction.

## Retained Interests

On December 13 the Federal Reserve, together with the OCC, FDIC and the OTS, issued guidance emphasizing the importance of fundamental risk-management practices in connection with securitization activities. The guidance stresses the specific expectation that any securitization-related retained interest claimed and booked by a financial institution should be supported by documentation of the interest's fair value, determined by using reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet the supervisory standards set forth in the guidance are to be classified as a loss and disallowed as assets of the institution for regulatory capital purposes.

## Examination-Frequency Guidelines

In October the Federal Reserve and the other federal banking agencies issued a final rule revising their examination-frequency guidelines to address provisions in the Riegle Community Development and Regulatory Improvement Act of 1994 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996. As a result of the revision, certain U.S. branches and agencies of foreign banking organizations may qualify for an eighteen-month examination cycle rather than a twelve-month cycle.

To qualify for consideration for less-frequent examination, a U.S. branch or agency must have total assets of $250 million or less, must have received a composite supervisory rating of 1 or 2 at its most recent examination, and must not be subject to a formal enforcement action. In addition, the U.S. branch or agency must have satisfied the requirements that either (1) the foreign bank's most recently reported capital adequacy position consists of, or is equivalent to, tier 1 and total risk-based capital ratios of at least 6 percent and 10 percent respectively, on a consolidated basis, or (2) the office has maintained, on a daily basis over the past three quarters, eligible assets (determined in accordance with applicable federal and state laws) in an amount not less than 108 percent of the preceding quarter's average third-party liabilities and sufficient liquidity is currently available to meet its obligations to third parties. Finally, the foreign bank must not have experienced a change in control during the preceding twelve months.

## Guide to the Interagency Country Exposure Review Committee (ICERC) Process

In November the Federal Reserve, together with the OCC and the FDIC, issued a document, "Guide to the Interagency Country Exposure Review Committee Process," that clarifies and makes more transparent for financial institutions and examiners the ICERC's functions and operating procedures. The ICERC is responsible for assessing the degree of transfer risk (that is, the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor) inherent in the cross-border and cross-currency exposures of U.S. banks.

## Interagency Guidance on Subprime Lending

In March the Federal Reserve, together with the other federal banking agencies, issued interagency guidance on subprime lending. The guidance was developed to bring greater attention to the supervisory issues related to banks' and thrifts' involvement in subprime lending and to how these institutions should manage the unique risks associated with this activity. The guidance notes that the agencies consider subprime lending to be a high-risk activity that is unsafe and unsound if the risks associated with subprime loans are not properly controlled. It advances sound practices for managing the risks involved in subprime lending. Institutions are expected to have policies and procedures in place to measure, monitor, and control the additional risks associated with this activity.

## Joint Policy Statement Regarding Branch Closings by Insured Depository Institutions

On June 29 the federal banking agencies issued a revised joint policy statement regarding branch closings by insured depository institutions. The statement incorporates changes in the underlying statute made by section 106 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 and section 2213 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. It clarifies the steps that interstate banks should take regarding notice and consultation for proposed branch closings in low- or moderate-income areas. It also clarifies the status of automated teller machines, relocations and consolidations, and branch closings in connection with emergency acquisitions or assistance by the FDIC.

## Interagency Guidance on the Allowance for Loan Losses

During 1999 the Federal Reserve, the Securities and Exchange Commission, and the other federal banking agencies continued to develop guidance regarding the allowance for loan losses. In March the agencies issued a joint statement outlining initiatives the agencies and the accounting profession are undertaking to develop enhanced guidance on appropriate methodologies, disclosures, and supporting documentation for loan loss allowances and other issues. In May the Federal Reserve issued guidance addressing the need for banking organizations to maintain conservative allowances for loan losses in the context of existing accounting standards; the guidance is now a part of generally accepted accounting principles (GAAP). In July the agencies issued a joint statement emphasizing a number of factors that should be considered when establishing appropriate allowance levels, consistent with the May Federal Reserve guidance. As part of an interagency statement also issued in July, the SEC agreed to consult with the banking regulators when determining whether to take a significant action against financial institutions with respect to their loan loss allowance.

## Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations

In September the Federal Reserve and the other federal banking agencies issued a joint policy statement regarding the external auditing programs of banks and savings associations. The statement encourages banks and savings associations with less than $500 million in total assets to adopt an external auditing program as a part of their overall risk-management process. It reflects the agencies' view that higher-risk areas of an institution's business should be subjected to regular independent testing and evaluation to ensure that the institution's financial statements and regulatory reports are accurately and reliably prepared. The statement also encourages the board of directors of each institution to establish an audit committee made up entirely of outside directors. The statement is effective for fiscal years beginning on or after January 1, 2000.

## International Guidance on Internal Control, Accounting, and Disclosure

As a member of the Basel Committee on Banking Supervision, the Federal Reserve plays a key role in the development of supervisory guidance on internal control, accounting, and reporting practices among banking organizations.

The objectives of this guidance are to promote market discipline through greater transparency in financial statements, to encourage sound risk management, and to improve disclosures of qualitative and quantitative information on bank risk exposures and risk-management policies and practices. During 1999 the Federal Reserve contributed to several papers and reports that were issued by the Basel Committee, including the following:

- "Sound Practices for Loan Accounting and Disclosure" (July) provides guidance to banks, banking supervisors, and those who set accounting standards on recognition and measurement of loans, establishment of loan loss allowances, disclosure of credit risk, and related matters. The paper sets out banking supervisors' views on sound loan accounting and loan-disclosure practices for banks. It also serves as a framework for supervisory evaluation of banks' policies and practices in these areas.
- "Best Practices for Credit Risk Disclosure" (July) provides guidance on best practices in public disclosure of credit risk by banking institutions. Banks are encouraged to provide market participants and the public with the information they need to make meaningful assessments of their credit risk profile. The paper is part of the Basel Committee's ongoing efforts to promote transparency and effective market discipline.
- "Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms" (October) presents recommendations for public disclosure of the trading and derivatives activities of banks and securities firms. The recommendations complement the annual survey of trading and derivatives disclosures by large, internationally active banks and securities firms.
- "Trading and Derivatives Disclosures of Banks and Securities Firms: Results of the Survey of Public Disclosures in 1998 Annual Reports" (December) is a report of the fifth annual joint survey by the Basel Committee and the IOSCO on the public disclosure of trading and derivatives activities of banks and securities firms worldwide. The report provides an overview and analysis of the disclosures about trading and derivatives activities presented in the 1998 annual reports of a sample of the largest internationally active banks and securities firms in the G–10 countries and notes improvements since 1993.
- "Working Paper on Capital Requirements and Bank Behavior: The Impact of the Basel Accord" (April) reviews the empirical evidence on the effect of the 1988 Basel Accord on banks. The paper addresses whether the adoption of fixed minimum capital requirements led some banks to maintain higher capital ratios than they would have otherwise and whether these requirements have been successful in limiting risk-taking by banks.
- "Working Paper on Supervisory Lessons to be Drawn from the Asian Crisis" (June) makes recommendations for G–10 creditor banks and their supervisors in the wake of the 1997–98 Asian financial crisis. Recommendations address revisions to the Basel Accord and the use of rating-agency ratings, large-exposure guidance, country-risk assessments, and country-risk-management practices.
- "Banks' Interactions with Highly Leveraged Institutions and Sound Practices for Banks' Interactions with Highly Leveraged Institutions" (January) evaluates the potential risks resulting from banks' interactions

with highly leveraged institutions, assesses the deficiencies in banks' risk-management practices, and evaluates alternative policy responses, including encouraging the use of sound practices by banks. It sets forth sound practices standards for the management of counterparty credit risk in banks' trading and derivatives activities with highly leveraged institutions.
- "Performance of Models-Based Capital Charges for Market Risk: 1 July–31 December 1998" (September) reports on a survey of more than forty banks in nine countries subject to the market-risk amendment to the Basel Accord during the third and fourth quarters of 1998, a period of high market volatility. The survey found that the capital charge for market risk under the internal-models approach provided an adequate buffer against trading losses at the surveyed institutions over the period reviewed. The survey encouraged banks to continue to reassess the performance of internal models and to complement those models with robust stress-testing.

In addition to serving on the Basel Committee on Banking Supervision, Federal Reserve staff members participate in meetings of the Financial Accounting Standards Board's (FASB) Financial Instruments Task Force. The task force was created to help the FASB address issues related to the accounting and disclosure standards for financial instruments. Staff members also participate in meetings of the International Accounting Standards Committee (IASC) on behalf of the Basel Committee's Task Force on Accounting Issues. The IASC's objectives are to formulate and publish international accounting standards and to promote their worldwide acceptance and observance.

## Bank Holding Company Reports

As the federal supervisor and regulator of U.S. bank holding companies, the Federal Reserve requires periodic regulatory reports from these organizations. These reports, which are revised periodically, provide essential information to assist the Federal Reserve in the supervision of these banking organizations and in the formulation of regulations and supervisory policies. The reports are also used by the Federal Reserve to respond to requests from the Congress and the public for information on bank holding companies and their nonbank subsidiaries. The FR Y–9 series of reports (FR Y–9C, FR Y–9LP, and FR Y–9SP) provides standardized financial statements for the consolidated bank holding company and its parent. The Federal Reserve uses these reports 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 bank holding company's overall financial condition to ensure safe and sound operations. The FR Y–11 series of reports aids the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries.

Most of the revisions made to the FR Y–9C during 1999 paralleled revisions made to the FFIEC 031 Call Report. They included the elimination of detailed items for "high-risk mortgage securities;" implementation of the disclosure requirements of Statement of Financial Accounting Standard No. 133 (FAS 133), Accounting for Derivative Instruments and Hedging Activities, for cash-flow hedges; and implementation of items for monitoring risk-based capital. The revisions to the other FR Y–9 reports and to the FR Y–11 series consisted primarily of implementation of the FAS 133 disclosure requirements for cash-flow hedges. A section for ‘‘Notes to the Financial Statements’’ was also added to the FR Y–11 reports, but otherwise there were no substantive revisions to the FR Y–11 series.

## Federal Financial Institutions Examination Council

### *Uniform Retail Credit Classification and Account Management Policy*

On February 10, the FFIEC issued the Uniform Retail Credit Classification and Account Management Policy, which updates and expands the guidelines for classifying consumer loans that were first issued in 1980. The policy, among other things, adds guidance on the treatment of loans to bankrupt borrowers, fraudulent loans, loans to deceased borrowers, and delinquent residential real estate and home equity loans and on the treatment of partial payments. It also sets forth the criteria that must be satisfied before a depository institution may consider a delinquent account current. The policy statement becomes effective on December 31, 2000.

### *Revisions to the Call Report*

The FFIEC implemented a few changes to the bank Reports of Condition and Income (Call Reports), effective with the March 1999 report, to improve the banking agencies’ ability to monitor the safety and soundness of financial institutions. The changes included new items to conform with GAAP, specifically, items necessary to implement FAS 133. Certain detailed items on bank investment portfolios were eliminated, and instructions for reporting securities activities, risk-based capital, and intangible assets were clarified. The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the March 1999 report, to maintain consistency with the bank Call Reports. In September, the FFIEC announced that no new items would be added to the Call Report for the March 31, 2000 report.

### *Year 2000 Supervision Program*

Throughout 1999 the FFIEC agencies continued their efforts to ensure the readiness of supervised financial institutions’ automated information systems, and those of their customers, for the century date change. The final phase of the supervisory program undertaken by the agencies was extensive and included the issuance of additional policy guidance, the conduct of on-site examinations and intensive monitoring of financial institutions and markets, contingency planning to respond to disruptions that could occur, and event management for the year-end rollover period. The program focused on promoting industry and consumer awareness; establishing targets for completion of testing; developing implementation and contingency plans; and providing feedback, in part through examinations, to institutions in their attempts to assess their progress and to identify outstanding issues.

The FFIEC worked rigorously to ensure broad awareness of the importance and scope of the problem, both domestically and internationally, and joined with the private sector in a coordinated effort to successfully address the Year 2000. The agencies made significant contributions to the financial industry’s successful transition into the new millennium without serious disruption to the financial services provided to the industry and the public.

## Supervisory Information Technology

The Supervisory Information Technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates management of the diverse information technology requirements of the Federal Reserve's supervision function. Its goals are to ensure that

- IT initiatives support a broad range of supervisory activities without duplication or overlap
- The underlying IT architecture fully supports those initiatives
- The supervision function's use of technology takes advantage of the systems and expertise available more broadly within the Federal Reserve System.

The SIT function works through assigned staff at the Board of Governors and the Reserve Banks and through a committee structure that ensures that key staff members actively participate in identifying requirements and setting priorities for IT initiatives.

### Large Bank Supervision

During 1999 significant progress was made in developing a new information system to support the supervision of large, complex banking organizations. Known as BOND (Banking Organization National Desktop), the system, which is scheduled for implementation in 2000, will provide collaboration, messaging, and document-management capabilities as well as access to regulatory and market data.

### Community Bank Supervision

For several years the Federal Reserve has worked closely with the FDIC, the Conference of State Bank Supervisors, and several state banking authorities to automate the examination process for community banks. The agencies now have a common set of automated examination tools that support the risk-focused supervision process (ED), loan analysis (ALERT), and report preparation (GENESYS). These tools are continually evaluated and enhanced. A major rewrite of the GENESYS application that will enable broader implementation among the agencies is scheduled for completion in June 2000.

### National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data. Also included under the NIC management structure is the National Examination Database (NED), a major application that gives supervisory personnel throughout the Federal Reserve System, as well as state banking authorities and the other federal regulators, access to NIC data. Several enhancements to the NIC and NED are under way.

The NED system was enhanced in February to capture large banking organization risk-assessment information. A web-enabled user access interface is being developed, and the application will be enhanced to reflect further changes in the supervision business model to address a continuous supervisory program and financial modernization.

In June the final phase of the NIC banking structure updating system was implemented. Completion of the final phase brings all structure-updating functions to the client/server platform. This new architecture for processing and analyzing NIC data ensures easier access to banking structure data as well as a more cost-effective approach to applying system modifications. Work is also continuing on a project for the electronic submission of data on changes in investments and activities of bank holding companies. The web-based application will offer respondents the same level of state-of-the-art tools used by NIC's structure-updating functions in order to enhance the respondent's ability to submit data more quickly and with greater accuracy.

In conjunction with the BOND project, the NIC is being enhanced to include a repository for supervisory documents. Called the Central Document and Text Repository (CDTR), the repository will initially house those supervisory products that are associated with the framework for risk-focused supervision of large, complex banking organizations. Broad categories of documents to be housed in the CDTR are examination and inspection documents, enforcement-event documents, and other products associated with a region of the United States or a Federal Reserve District (for domestic bank holding companies), a country (for foreign banking organizations), or risk profiles. In addition, staff members are exploring the expansion of the CDTR to serve broader document-management needs within the supervision function and with other regulatory agencies.

The NIC public web site was also enhanced during the year. The site (http://www.ffiec.gov/nic/) makes available bank holding company performance ratios, NIC banking structure and financial data, and, since December 1999, all consolidated and large parent financial statement schedules for bank holding companies.

### Strategic Planning

With Board and Reserve Bank participation, SIT is developing a vision statement and a multiyear strategic plan to guide the information technology direction and investments of the supervision and regulation function. A work group is developing a current-period operating plan that emphasizes national projects, supporting budgets, and appropriate documentation for senior level review. Each of these endeavors will use a "repeatable process" to outline the approach for future efforts. The work group is also evaluating alternatives to track national IT development and projects costs for the supervision and regulation function.

### S&R Enterprise Information Architecture (EIA)

SIT established a work group of Reserve Bank and Board staff to begin the process of documenting the Systemwide enterprise information architecture (EIA) for the supervision and regulation function. Using a business-centered, top-down approach, the work group is defining the business processes, information, data, applications/information systems, and systems infrastructure that make up the EIA. It will prepare a technical reference manual that documents the EIA and describes maintenance procedures. Documentation will enhance the effectiveness of the supervision and regulation function, help guide IT development and acquisition efforts, and increase return on information technology investments by improving interoperability between systems.

### IT Project Management

To draw on the best practices for managing IT projects in private industry and

Number of Sessions of Training Programs for Banking Supervision and Regulation, 1999

| Program | Total | Regional |
|---|---|---|
| *Schools or seminars conducted by the Federal Reserve* | | |
| Core schools | | |
| Banking and supervision elements | 10 | 8 |
| Operations and analysis | 6 | 3 |
| Bank management | 4 | 1 |
| Report writing | 17 | 17 |
| Management skills | 11 | 9 |
| Conducting meetings with management | 15 | 15 |
| Other schools | | |
| Loan analysis | 5 | 5 |
| Examination management | 1 | ... |
| Real estate lending seminar | 4 | 4 |
| Specialized lending seminar | 3 | 2 |
| Senior forum for current banking and regulatory issues | 2 | 2 |
| Banking applications | 1 | ... |
| Basic entry-level trust | 2 | ... |
| Advanced trust | 1 | ... |
| Consumer compliance examinations I | 2 | ... |
| Consumer compliance examinations II | 2 | 1 |
| CRA examination techniques | 3 | 3 |
| Fair lending examination techniques | 4 | 2 |
| Foreign banking organizations | 3 | 3 |
| Information systems and emerging technology risk management | 5 | 5 |
| Information systems continuing education | 2 | ... |
| Intermediate information systems examination | 1 | 1 |
| Capital markets seminars | 18 | 12 |
| Section 20 securities seminar | 3 | 1 |
| Internal controls | 1 | ... |
| Leadership dynamics | 7 | 6 |
| Seminar for senior supervisors of foreign central banks [1] | 1 | ... |
| *Other agencies conducting courses* [2] | | |
| Federal Financial Institutions Examination Council | 45 | 5 |
| The Options Institute | 2 | 2 |

1. Conducted jointly with the World Bank.
2. Open to Federal Reserve employees.

... Not applicable.

the government, SIT is studying those practices and developing a project manager's handbook. The handbook will be included in the EIA technical reference manual and will be available to project managers, team members, and stakeholders. In addition to producing the handbook, SIT is working to identify project management training opportunities for Reserve Bank and Board staff and will propose a project management training curriculum and certification program.

## Staff Training

The Supervisory Education Program trains staff members that have supervisory or regulatory responsibilities at the Reserve Banks, at the Board of Governors, and at state banking departments. Students from supervisory counterparts in foreign countries attend the training sessions on a space-available basis. The program provides training at the basic, intermediate, and advanced levels for the four disciplines of bank supervision: bank examinations, bank holding company inspections, surveillance and monitoring, and applications analysis. Classes are conducted in Washington, D.C., or at regional locations and may be held jointly with regulators of other financial institutions. The program is designed to increase a student's knowledge of the entire supervisory and regu-

Status of Students Registered for the Core Proficiency Examination, 1999

| Student status | Core examination | Specialty area[1] | | | |
|---|---|---|---|---|---|
| | | Safety and soundness | Consumer affairs | Trust | Information technology |
| In queue, year-end 1998 | 33 | 22 | 10 | 1 | 0 |
| Test taken, 1999 | 108 | 63 | 38 | 1 | 0 |
| Passed | 94 | 55 | 24 | 1 | 0 |
| Failed | 14 | 8 | 14 | 0 | 0 |
| In queue, year-end 1999 | 15 | 9 | 6 | 0 | 0 |

1. Students are examined in one specialty area of their choice.

latory process and thereby provide a higher degree of cross-training among staff members.

The Federal Reserve System also participates in training offered by the Federal Financial Institutions Examination Council and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in various emerging issues as well as in such specialized areas as trust activities, international banking, information technology, municipal securities dealer activities, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

In 1999 the Federal Reserve conducted numerous schools and seminars, and staff members participated in several courses offered by or cosponsored with other agencies, as shown in the accompanying table. Over the year the Federal Reserve trained 2,719 students in System schools, 856 in schools sponsored by the FFIEC, and 42 in other schools, for a total of 3,617 students, including 290 representatives from foreign central banks. The number of training days in 1999 totaled 18,729.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 451 state examiners were trained—247 in Federal Reserve courses, 196 in FFIEC programs, and 8 in other courses.

The Federal Reserve System continued in 1999 to make revisions initiated in 1997 to the core training program that leads to the commissioning of assistant examiners. The project was undertaken to give assistant examiners a greater understanding of risk-focused examination concepts, the components of sound internal controls, the importance of management information systems, the concept of risk as it applies to banking, and the key supervisory issues related to integrated supervision. These changes, which resulted in a new curriculum, will be completed by the end of 2000.

Depending on their hire date, staff members seeking an examiner's commission follow one of two training tracks. One track is for examiners hired before February 28, 1998, who must take the "core proficiency examination" as well as an examination in a specialty area of the student's choice—safety and soundness, consumer affairs, trust, or information technology. Examiners on this track should complete their commissioning requirements by the end of 2001. In 1999, 108 examiners completed the core proficiency examination (see table).

Status of Students Registered for the First Proficiency Examination, 1999

| Student status | First examination | Specialty area[1] |
|---|---|---|
| Test taken | 205 | 1 |
| Passed | 204 | 1 |
| Failed | 1 | 0 |
| In queue, year-end 1999 | 9 | 0 |

1. As is the case for the core proficiency examination, students will be examined in one of four specialty areas of their choice. In 1999, the only specialty examination available was for the consumer affairs area.

The other track is for examiners hired after February 28, 1998, who must take the ‘‘first proficiency examination’’ as well as a ‘‘specialty proficiency examination’’ in one of the four specialty areas. By the end of 1999, 205 examiners had completed the first proficiency examination. The only specialty examination available in 1999 was for consumer affairs (see table); the other specialty examinations will be developed in the first quarter of 2000.

## Regulation of the U.S. Banking Structure

The Board of Governors administers the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, and the International Banking Act in relation to bank holding companies, member banks, and foreign banking organizations. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of U.S. banking at the local, regional, and national levels; the international operations of domestic banking organizations; and the U.S. banking operations of foreign banks.

### Bank Holding Company Act

Under the Bank Holding Company Act, a company must obtain the Federal Reserve’s approval before forming a bank holding company by acquiring control 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. The act also identifies other activities permissible for a bank holding company, which depending on the circumstances may or may not be commenced without prior Federal Reserve approval.

The Bank Holding Company Act and various related statutes were significantly amended in November 1999 by passage of the Gramm–Leach–Bliley Act. Title I of the latter act, which becomes effective in March 2000, authorizes those bank holding companies that meet applicable statutory requirements to become financial holding companies and to engage without prior Federal Reserve approval in a broad array of financially related activities, including securities underwriting and dealing, insurance agency and insurance underwriting, and merchant banking. All bank holding companies will continue to need prior Federal Reserve approval to acquire or establish additional banks.

Bank holding companies that do not become financial holding companies will be more restricted in the types of nonbank activities in which they may engage, and they may need prior Federal Reserve approval to conduct those activities. However, various streamlined application processes remain available to these companies. Since 1996, the act has permitted well-run bank holding companies that satisfy certain criteria to commence certain nonbank activities on a de novo basis without prior Federal Reserve approval and has provided an expedited prior-notice procedure for other nonbank activities and for small bank and nonbank acquisitions.

When reviewing an application or notice that requires prior approval, the Federal Reserve must consider several factors, including 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 Board 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 1999 the Federal Reserve approved 302 proposals by foreign or domestic companies to become bank holding companies, 98 proposals by existing bank holding companies to merge with other bank holding companies, 231 proposals by existing bank holding companies to acquire or retain banks, 450 requests by existing bank holding companies to acquire or establish nonbank firms engaged in activities closely related to banking, and 173 other bank holding company-related applications or notices. Data on these and all other decisions are shown in the accompanying table.

## Bank Merger Act

The Bank Merger Act requires that all proposed mergers of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has

Decisions by the Federal Reserve on Domestic and International Applications, 1999

| Proposal | Direct action by the Board of Governors | | | Action under authority delegated by the Board of Governors | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Director of the Division of Banking Supervision and Regulation | | Office of the Secretary | Federal Reserve Banks | | |
| | Approved | Denied | Permitted | Approved | Denied | Approved | Approved | Permitted | |
| Formation of bank holding company | 15 | 0 | 0 | 0 | 0 | 1 | 218 | 68 | 302 |
| Merger of bank holding company | 11 | 0 | 0 | 0 | 0 | 8 | 47 | 32 | 98 |
| Acquisition or retention of bank | 21 | 0 | 0 | 0 | 0 | 6 | 134 | 70 | 231 |
| Acquisition of nonbank | 0 | 0 | 146 | 0 | 0 | 26 | 0 | 278 | 450 |
| Merger of bank | 34 | 0 | 0 | 0 | 0 | 16 | 122 | 0 | 172 |
| Change in control | 0 | 1 | 2 | 0 | 0 | 0 | 0 | 138 | 141 |
| Establishment of a branch, agency, or representative office by a foreign bank | 17 | 0 | 0 | 0 | 0 | 0 | 9 | 0 | 26 |
| Other | 508 | 0 | 41 | 29 | 0 | 600 | 1,123 | 153 | 2,454 |
| **Total** | **606** | **1** | **189** | **29** | **0** | **657** | **1,653** | **739** | **3,874** |

primary jurisdiction. Before acting on a proposed merger, the Federal Reserve considers factors relating to the financial and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposal. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction.

During 1999 the Federal Reserve approved 172 merger applications. As required by law, each merger is described in this REPORT (in table 15 of the "Statistical Tables" section).

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors to ensure comparable enforcement of the antitrust provisions of the Bank Merger Act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to ensure consistency in administering the act. The Federal Reserve submitted 635 reports on competitive factors to the other federal banking agencies in 1999.

## Change in Bank Control Act

The Change in Bank Control Act requires persons seeking control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and of bank holding companies. In doing so, the Federal Reserve reviews the financial position, competence, experience, and integrity of the acquiring person; considers the effect of the proposal on the financial condition of the bank or bank holding company to be acquired; determines the effect of the proposal on competition in any relevant market; assesses the completeness of information submitted by the acquiring person; and considers whether the proposal would have an adverse effect on the federal deposit insurance funds. As part of this process, the Federal Reserve may conduct name checks on each acquiring person.

The appropriate federal banking agencies are required to publish notice of each proposed change in control and to invite public comment, particularly from persons located in the markets served by the institution to be acquired.

In 1999 the Federal Reserve approved 140 proposed changes in control of state member banks and bank holding companies and denied 1.

## International Banking Act

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

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. The System may also take into account 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 Board, if deemed necessary to determine and enforce compliance with applicable law; and the record of the foreign bank with respect to compliance with U.S. law.

In 1999 the Federal Reserve approved applications by nineteen foreign banks from thirteen foreign countries to establish branches, agencies, and representative offices in the United States.

## Overseas Investments by U.S. Banking Organizations

U.S. banking organizations, with the authorization of the Federal Reserve, may engage in a broad range of activities overseas. Most foreign investments may be made under general consent procedures that involve only an after-the-fact notification to the Board; significant investments must be reviewed in advance by the Board. In 1999 the Board approved fifty-eight proposals (excluding those relating to recent large domestic mergers) by U.S. banking organizations to make significant investments overseas.

The Federal Reserve also has authority to act on proposals involving Edge Act and agreement corporations, which are established by banking organizations to provide a means of engaging in international business. In 1999 the Federal Reserve approved two applications to establish new Edge corporations (one of which proposed to engage in foreign exchange settlement activities) and one application by a member bank to increase its total investment in its Edge corporation subsidiaries to more than 10 percent, but less than 20 percent, of the bank's capital and surplus. In addition, the Federal Reserve approved one application to establish a new agreement corporation.

## Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals for domestic branches, the Federal Reserve considers the scope and character of the proposed 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. Once a member bank has received authority to open a branch in a particular foreign country, the member bank may open additional branches in that country without prior Federal Reserve approval. In 1999 the Federal Reserve acted on new and merger-related branch proposals for 2,042 domestic branches and granted prior approval for the establishment of 12 foreign branches (excluding those relating to recent large domestic mergers).

## Stock Repurchases by Bank Holding Companies

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases its debt and decreases its equity. Relatively larger repurchases may undermine the financial condition of a bank holding company and its bank subsidiaries. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital guidelines. In 1999 the Federal Reserve reviewed eighteen proposed stock repurchases by bank holding companies, all of which were approved, under delegated authority, by either a Reserve Bank or the Secretary of the Board.

## Public Notice of Federal Reserve Decisions

Most decisions by the Federal Reserve that involve 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 effected 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 and in the monthly *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve but not yet acted on. For each pending application and notice, the related H.2A contains the deadline for comments. In 1999 the Board's public web site was expanded to include more information relevant to the applications process.

## Timely Processing of Applications

The Federal Reserve maintains internal target dates and procedures for the processing of applications. The setting of target dates promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. The time frame for final action ranges from twelve to sixty days, depending on the type of application or notice. In 1999, 82 percent of decisions met this standard.[2]

## Delegation of Applications

Historically, the Board of Governors has delegated certain regulatory functions, including the authority to approve, but not to deny, certain types of applications, to the Reserve Banks, to the Director of the Board's Division of Banking Supervision and Regulation, and to the Secretary of the Board. In 1999, 79 percent of the applications processed were acted on under delegated authority.

## Banking and Nonbanking Proposals

Some of the largest U.S. banking organizations were party to significant banking proposals in 1999. The Board approved two proposals by foreign banking organizations to acquire large U.S. banking organizations. It also approved one merger proposal by two bank holding companies operating in the same markets that required the largest level of branch divestitures ever considered by the Board. As with other large banking proposals, the Board received many comments, particularly with respect to Community Reinvestment Act, fair lending, and competitive issues. The Federal Reserve also continued to act on proposals involving mutual bank holding companies.

The Board approved two proposals involving new nonbank activities during the year. One proposal was by two institutions to own and operate an electronic securities exchange. The other was by a group of foreign and domestic bank

2. If the data were adjusted for multiple related applications filed in connection with several larger merger proposals, the percentage would be 94 percent.

holding companies that sought to engage in digital certification activities. The Federal Reserve also approved various other securities-related proposals involving section 20 companies.

## Enforcement of Other Laws and Regulations

### Financial Disclosure 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 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 1999, twenty state member banks, most of them small or medium size, were registered with the Board under the Securities Exchange Act.

### Securities Credit

Under the Securities Exchange Act of 1934, 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 trade 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 compliance with the Board's securities credit regulations. The Securities and Exchange Commission, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. The federal banking agencies examine banks under their respective jurisdictions for compliance with Regulation U. The Farm Credit Administration, the National Credit Union Administration, and the Office of Thrift Supervision examine lenders under their respective jurisdictions for compliance with Regulation U; the Federal Reserve examines other Regulation U lenders.

Since 1990 the Board has published a list of foreign stocks that are eligible for margin treatment at broker–dealers on the same basis as domestic margin securities. In 1999, the foreign list was revised in March and September.

At the end of 1999, 839 lenders other than banks, brokers, or dealers were registered with the Federal Reserve; of these, 577 were under the Federal Reserve's supervision. The Federal Reserve regularly inspects 262 of these lenders either biennially or triennially, according to the type of credit they extend; 70 of the 262 were inspected in 1999 for compliance with Regulation U. The remaining 315 lenders were exempt from periodic on-site inspections by the Federal Reserve but were monitored through the filing of periodic regulatory reports.

### Bank Secrecy Act/ Anti–Money Laundering

The regulation (31 CFR Part 103) implementing the Currency and Foreign Transactions Reporting Act, also known as the Bank Secrecy Act, requires banks and other types of financial institutions to file certain reports and maintain certain records. These reports and records include information concerning persons involved in large currency transactions as well as suspicious activity related to possible violations of federal law, including money laundering and other financial crimes. The act is regarded as a primary tool in the fight against money laundering, and its requirements deter money laundering by creating a paper trail of financial transactions that helps law enforcement and regulators identify and trace the proceeds of illegal activity.

In addition, pursuant to Regulation H, section 208.63, each banking organization supervised by the Federal Reserve must develop a written Bank Secrecy Act compliance program that is formally approved by the institution's board of directors. The compliance program must (1) establish a system of internal controls to ensure compliance with the act, (2) provide for independent compliance testing, (3) identify individuals responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for appropriate personnel. Through its examination process, training, and other off-site measures, the Federal Reserve monitors compliance with the Bank Secrecy Act and Regulation H by the banking organizations under its supervision.

In 1999 the Federal Reserve continued to provide expertise and guidance to the Bank Secrecy Act Advisory Group, a committee established at the Department of the Treasury by congressional mandate to seek measures to reduce unnecessary Bank Secrecy Act burdens and to increase the utility of data gathered under the act to regulators and law enforcement. In addition, the Federal Reserve is continuing to participate in the governmentwide effort to deter money laundering as announced by the Department of the Treasury in the National Money Laundering Strategy for 1999. The Federal Reserve also led an interagency group that revised the Suspicious Activity Report to make it less burdensome for filers, more useful to law enforcement, and Year 2000 compliant. An interim form that is Year 2000 compliant was released midyear, and a new form incorporating all the enhancements will be released in the first quarter of 2000.

In December 1998 the Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued proposed rules that would have required domestic and foreign banking organizations to develop and maintain Know Your Customer programs. The proposed rules were intended to provide guidance to banks to facilitate and ensure their compliance with existing federal reporting and recordkeeping requirements, such as those found in the Bank Secrecy Act. It was intended to help protect the integrity and reputation of the financial services industry and assist the government in its efforts to combat money laundering and other illegal activities that might be occurring through financial institutions. After receiving more than 15,000 comments from community, regional and multinational banks, members of Congress, trade and industry groups, and the public that viewed the proposed regulations as an invasion of personal privacy, among other issues, the Federal Reserve, along with the other agencies, withdrew the proposal.

Through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve has assisted in the investigation of money laundering activities, including Operation Casablanca, which

Loans by State Member Banks to their Executive Officers, 1998 and 1999

| Period | Number | Amount (dollars) | Range of interest rates charged (percent) |
|---|---|---|---|
| *1998* | | | |
| October 1–December 31 | 753 | 45,385,000 | 4.0–19.8 |
| *1999* | | | |
| January 1–March 31 | 764 | 51,396,000 | 4.0–18.0 |
| April 1–June 30 | 752 | 63,852,000 | 4.9–19.8 |
| July 1–September 30 | 722 | 157,568,000 | 2.0–18.0 |

SOURCE. Call Reports.

involved a number of foreign banking organizations. The section has also provided anti-money-laundering training to designated staff members at each Reserve Bank, to the domestic banking sector through trade association conferences and seminars, and to representatives of law enforcement agencies.

Internationally, the section has assisted the State Department by providing anti-money-laundering training and technical assistance to countries in Asia, eastern Europe and the newly independent states, South and Central America, and the Caribbean. Federal Reserve staff members have also participated in numerous multilateral international anti-money-laundering initiatives sponsored by such groups as the G–7, the Financial Action Task Force, and the Asia Pacific Working Group on Money Laundering.

### Loans to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information.

## Federal Reserve Membership

At the end of 1999, 3,478 banks were members of the Federal Reserve System. At that time, member banks were operating 47,673 branches and accounted for 41 percent of all commercial banks in the United States and for 74 percent of all commercial banking offices. ■

# *Federal Reserve Banks*

The Federal Reserve Banks devoted significant attention in 1999 to preparing for the century date change. Efforts in that area as well as other activities affecting the Reserve Banks are described in this chapter.

## Century Date Change

The Federal Reserve was fully prepared for the year 2000 rollover and on the days before, during, and after the event experienced only minor problems related to the date change. The extensive work of testing and preparing the critical components and operational entities that took place prior to the rollover prevented major disruptions in Federal Reserve services to the nation's banking and financial markets. All mission-critical components were tested for year 2000 compliance and put into production during 1999. The Reserve Banks continued to support extensive year 2000 testing by depository institutions throughout the year. The Federal Reserve also took steps to ensure an adequate supply of currency for the century rollover.

By year-end 1999, more than 9,000 financial institutions had tested the services they use with the Federal Reserve. These institutions included all of the System's major customers in terms of volume and dollar amount of the transactions processed through the Federal Reserve. The Federal Reserve also tested the automated payment services it provides to federal agencies, such as the Social Security Administration, to ensure that banks could receive government payments. In 1999, the Joint Year 2000 Council, sponsored by the Bank for International Settlements, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions and chaired by Federal Reserve Vice Chairman Roger Ferguson, served as the key forum for Y2K communications among financial market authorities around the globe. Representatives from more than 100 countries participated in the council's activities, including developing guidance papers to assist regulators, issuing bulletins to share information, and attending regional meetings throughout the world.

In 1999, the Federal Reserve focused on event management and contingency planning for the Y2K rollover. System Communication Centers were established at the Federal Reserve Bank of Boston and the Board of Governors, with supporting Local Communication Centers in each Reserve Bank to manage information concerning the status of Federal Reserve systems during the rollover event. The Federal Reserve tested contingency scenarios to exercise all lines of communication and tested responses to the scenarios to prepare for the event. As the year came to an end, the Federal Reserve met increased demands for currency.

As in 1998, the Federal Reserve continued to inform the public about plans for addressing the year 2000 problem and continued to advise depository institutions of the Federal Reserve's plans and schedules. The Federal Reserve provided extensive information concerning its year 2000 activities to government oversight organizations, including the U.S. General Accounting Office, the House and Senate Banking Committees,

## The Benefits of the Federal Reserve's Year 2000 Preparations

> *As a result of Y2K preparations, we have vividly seen how complex and interdependent our economic affairs have become, and this new awareness is already beginning to pay off in higher levels of efficiency and effectiveness.*
>
> Edward W. Kelley, Jr., *Member*, Board of Governors

In the three years leading to the rollover to the new century, U.S. banking organizations devoted considerable time, talent, and money to protecting their computer systems from date-related glitches. They also measured and managed potential customer and counterparty risk and planned their responses to possible internal and external disruptions or other unexpected events.

Was the enormous effort worth it? U.S. Representative James Leach, chairman of the House Committee on Banking and Financial Services, answered that question with a definite "yes." In a letter to Board Chairman Alan Greenspan, Leach expressed Congress's gratitude to the Federal Reserve for its leadership, both domestically and internationally, in preparing the banking industry and financial system for the century date change. Now, having come smoothly through the date change, both the Federal Reserve and private-sector banking organizations are finding that their preparations are yielding benefits that extend far beyond the absence of disruption on New Year's Day.

### Greater Efficiency and Better Management

For the Federal Reserve System, Y2K preparations have yielded greater productivity, better management of information technology, and enhanced communication with and services to customers. Productivity improvements include the elimination of redundant applications, the standardization of operating environments, and the adoption of better security procedures and better processes for implementing system upgrades. Improved processes for adopting changes ensure that changes are well tested and that controls provide assurance that the compiled application and source code are the same. Applications are running with fewer bugs and fewer end-of-year or other operating problems.

Senior managers involved in the development of year 2000 programs for information systems now better understand the critical roles automated systems play in the success of business lines. And line managers, because they had to become more involved in meeting the technology needs of their operations, now more fully appreciate the use of information technology as a business opportunity rather than a cost. This knowledge will be used to further improve services.

For example, century change preparations improved risk-management structures that can be used to monitor and control operational risk in the future. Similarly, experience in monitoring risks to customers and counterparties and in assessing

and the Office of Management and Budget. The Federal Reserve provided leadership to the financial community, domestically and internationally, and participated in the President's Y2K Council activities.

The Federal Reserve undertook three major initiatives to prepare for cash interdependencies with service providers will yield incremental efficiencies and improved reliability. Finally, review and extensive testing of business-resumption contingency plans resulted in contingency procedures that are more comprehensive, more up-to-date, and more effective.

**Other Long-Term Benefits**

Federal Reserve customers, counterparties, and the public also benefited from year 2000 preparations. Communication efforts to ease the public's concern about potential problems contributed to responsible public behavior during the century rollover. And close collaboration with banking organizations ensured that cash supplies were adequate to meet customer demand and that liquidity needs could be met quickly through discount window operations. As a result, the public and the financial community retained a high level of confidence in the banking system, and there was neither an abnormal demand for cash nor volatility in payment systems. A spirit of cooperation and the ability to develop an effective communication strategy will be crucial tools for future initiatives.

Because of the close coordination with suppliers and service providers during year 2000 preparations, technology vendors and telecommunications, electric utility, and city services providers have a better understanding of their critical role in maintaining the continuity of central bank operations. The stronger relationships with these firms should ensure that coordination of disaster recovery plans will continue and that recovery of services to the central bank will remain a high priority for suppliers.

**Plans for Technology**

The improvements that resulted from year 2000 preparations—improved risk assessment and contingency procedures, better management of information technology for efficiencies and customer service, and enhanced communication—will also prove useful as the Federal Reserve broadens its use of information technology across business lines in order to identify opportunities and control activities more closely. Internet and e-commerce activities will expand significantly in the future; emphasis will shift away from the simple on-line delivery of existing services and toward redefining business lines to take full advantage of technology. Strengthening lines of communication internally and with the banking community, with a special focus on enhancing customer service, will be an important part of the Federal Reserve's business strategy.

Overall, preparations for the century date change enhanced the Federal Reserve's ability to respond to the needs of the banking community and the public and to deliver new services. The greater public trust in the banking system and in the federal Reserve's ability to manage the century rollover and continue operations suggests confidence that future challenges will be met with a similar level of expertise.

demand associated with the year 2000 rollover. First, the fiscal year 1999 new-currency print order was larger and more concentrated in the higher denominations than usual, so that there would be ample cash if the public chose to withdraw more currency in anticipation of Y2K problems. Second, in an effort to address the possibility that remote locations might need extra currency quickly, the Federal Reserve established strategic inventory locations. The Federal Reserve contracted with depository institutions and armored carriers in locations far from Reserve Bank offices to hold Federal Reserve notes for potential emergency cash orders. Finally, the Federal Reserve increased its communication with several industries on the Y2K problem. Meetings, conference calls, surveys, and general exchanges of information were common between the Federal Reserve and depository institutions, foreign central banks, armored carriers, retail industries, and the public.

## Developments in Federal Reserve Priced Services

The Monetary Control Act of 1980 requires that the Federal Reserve set fees for providing ‘‘priced services’’ to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the pretax return on equity that would have been earned had the services been provided by a private firm. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).[1]

Overall, fees charged in 1999 for priced services were lowered approximately 1.2 percent from 1998.[2] Revenue from priced services was $835.9 million, other income related to priced services was $31.7 million, and costs related to priced services were $775.7 million, including costs other than profit imputed in the PSAF, resulting in net income of $92.0 million. Priced services recovered 104.2 percent of total costs, including $57.2 million of targeted return on equity associated with the PSAF. Over the past ten years, the Reserve Banks have recovered 101.1 percent of their priced services costs, including the PSAF (table).[3]

### Check Collection

Federal Reserve Bank operating expenses and imputed costs for commercial check services in 1999 totaled $649.8 million. Revenue from check operations totaled $681.0 million, and other income amounted to $26.3 million, resulting in net income of $57.5 million.

The Reserve Banks handled 17.1 billion checks in 1999, an increase of 3.0 percent from 1998 (see table). The volume of fine-sort checks, which are presorted by the depositing banks according to paying bank, declined 6.8 percent, compared with a 3.6 percent decrease in 1998. The volume of checks deposited that required processing by the Reserve Banks increased 4.4 percent.

The Reserve Banks continued to encourage electronic innovations that make the collection system more effi-

1. In addition to income taxes and targeted return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance from the Federal Deposit Insurance Corporation. Also allocated to priced services are assets and personnel costs of the Board of Governors that are related to priced services; in the pro forma statements at the end of this chapter, Board expenses are included in operating expenses and Board assets are part of long-term assets.

2. Based on a chained Fisher ideal price index not adjusted for quality changes.

3. Financial data reported throughout this chapter—revenue, other income, cost, net income, and targeted return on equity—can be linked to the pro forma statements at the end of this chapter. *Other income* is revenue from investment of clearing balances, net of earnings credits, an amount termed net income on clearing balances. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the Federal Deposit Insurance Corporation assessment), imputed income taxes, and the targeted return on equity. *Net income* is revenue plus net income on clearing balances minus total cost.

Priced Services Cost Recovery, 1990–99

Millions of dollars, except as noted

| Year | Revenue from services[1] | Operating expenses and imputed costs[2] | Targeted return on equity | Total expenses | Cost recovery (percent) |
|---|---|---|---|---|---|
| 1990 | 746.5 | 684.3 | 33.6 | 717.9 | 104.0 |
| 1991 | 750.2 | 692.0 | 32.5 | 724.5 | 103.5 |
| 1992 | 760.8 | 710.7 | 24.9 | 735.6 | 103.4 |
| 1993 | 774.5 | 820.4 | 17.5 | 837.9 | 92.4 |
| 1994 | 767.2 | 760.2 | 21.0 | 781.2 | 98.2 |
| 1995 | 765.2 | 752.7 | 31.5 | 784.2 | 97.6 |
| 1996 | 815.9 | 746.4 | 42.9 | 789.3 | 103.4 |
| 1997 | 818.8 | 752.8 | 54.3 | 807.1 | 101.5 |
| 1998 | 839.8 | 743.2 | 66.8 | 809.9 | 103.7 |
| 1999 | 867.6 | 775.7 | 57.2 | 832.9 | 104.2 |
| **1990–99** | **7,906.5** | **7,438.2** | **382.2** | **7,820.4** | **101.1** |

1. Includes revenue from services of $7,684.8 million and other income and expense (net) of $221.7 million for the ten-year period.

2. Includes operating expenses of $6,539.0 million, imputed costs of $556.4 million, and imputed income taxes of $249.3 million for the ten-year period. Also, the effect of one-time accounting changes of $74.1 million and $19.4 million is included for 1993 and 1995 respectively.

cient. In 1999, 26.9 percent of all checks presented by the Reserve Banks to paying banks were presented electronically (approximately 3.2 billion), an increase of 13.4 percent from 1998. Images of 5.2 percent of checks presented by Reserve Banks were captured, compared with 3.9 percent in 1998. Check-imaging pilot programs at the Utica, New York, and Helena, Montana, offices began evaluating the efficiency of the environments for image-enhanced check processing.

In 1999, the Reserve Banks decided to standardize their check-processing platforms across all forty-five check-processing offices. The Reserve Banks believe that, over the long run, standardized platforms will enable them to increase operating efficiency, reduce

Activity in Federal Reserve Priced Services, 1999, 1998, and 1997

Thousands of items

| Service | 1999 | 1998 | 1997 | Percent change 1998 to 1999 | Percent change 1997 to 1998 |
|---|---|---|---|---|---|
| Commercial checks | 17,075,008 | 16,573,463 | 15,949,152 | 3.0 | 3.9 |
| Funds transfers | 105,408 | 100,609 | 91,800 | 4.8 | 9.6 |
| Securities transfers | 5,147 | 5,115 | 4,136 | .6 | 23.7 |
| Commercial ACH | 3,343,615 | 2,965,739 | 2,602,892 | 12.7 | 13.9 |
| Noncash collection | 613 | 755 | 887 | –18.8 | –14.8 |
| Cash transportation | 18 | 18 | 27[1] | 1.0 | –32.6 |

Note. Components may not yield percentages shown because of rounding. Activity in *commercial checks* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfers* and *securities transfers*, the number of transactions originated on line and off line; in *commercial ACH*, the total number of commercial items processed; in *noncash collection*, the number of items on which fees are assessed; and in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

1. Restatement resulting from a change in definition or to correct a previously reported error.

costs, and improve the quality of service provided to depository institutions. The Reserve Banks' Retail Payments Product Office will continue to manage this long-term initiative.

## Fedwire Funds Transfer and Net Settlement

Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and net settlement services totaled $61.3 million in 1999. Revenue from these operations totaled $66.8 million, and other income amounted to $2.3 million, resulting in net income of $7.8 million.

### *Funds Transfer*

The number of Fedwire funds transfers originated by depository institutions increased 4.8 percent in 1999, to 105.4 million.

Fees for Fedwire funds transfers have declined nearly 50 percent since 1996. In January 1999, the Reserve Banks reduced the basic transfer fee from $0.40 to $0.34. In February, the Banks introduced a volume-based pricing structure for the funds transfer service that takes into account the scale economies achieved by centralized processing and recognizes differences in demand for large-value transfers. The pricing structure is similar to those used by other domestic and international large-value transfer systems. In 1999, the basic per-transfer fee of $0.34 was charged for the first 2,500 funds transfers originated and received by a depository institution each month; a per-transfer fee of $0.27 was charged for additional transactions up to 80,000 transfers each month; and a per-transfer fee of $0.21 was assessed for every transaction after 80,000 transfers each month.

Depository institutions that do not have an electronic connection to the Fedwire funds transfer system can originate transfers via ''off-line'' telephone instructions. The volume of off-line Fedwire funds transfers has been declining substantially in recent years. Because of the decline and the small percentage of transfers that are originated off line (0.03 percent in 1999), the Federal Reserve began in 1998 to consolidate its Fedwire off-line funds transfer operations at the Federal Reserve Banks of Boston and Kansas City. The consolidation, completed in March 1999, has made it possible to streamline service and ensures uniform service nationwide. To reflect more fully the costs of processing off-line transfers and to encourage off-line customers having higher transfer volume to install electronic connections, the off-line transaction surcharge was increased in February from $12.00 to $13.00.

### *Net Settlement*

The Reserve Banks provide settlement services to approximately 100 local and national private-sector clearing and settlement arrangements. In 1999, the Reserve Banks processed about 361,000 settlement entries for these arrangements.

The Federal Reserve offers three types of settlement services. In the ''settlement sheet'' service, the settlement agent for a clearinghouse provides a settlement sheet to a Reserve Bank. The Reserve Bank posts net debit and credit entries to the accounts of the settling participants. The entries are provisional until the banking day after settlement. In the Fedwire-based settlement service, the clearinghouse uses a zero-balance settlement account to receive and send Fedwire funds transfers to settle participants' obligations. Fedwire funds transfers are final and irrevocable when processed. In March 1999, the Reserve Banks implemented an enhanced settlement service that offers finality characteristics similar to those of the Fedwire funds transfer service and provides settlement arrangements that include an automated mechanism for submitting settlement files to the Reserve Banks. This enhanced settlement service improves operational efficiency and reduces settlement risk to participants by granting settlement finality on the settlement day. It also enables the Reserve Banks to manage and limit risk by incorporating risk controls that are as robust as those used in the Fedwire funds transfer service. The Reserve Banks will continue to offer the Fedwire-based settlement service. The settlement sheet service, however, will be phased out gradually, and all participating arrangements will need to move to the enhanced service by year-end 2001.

In 1999, the fees and fee structure for the settlement sheet and the enhanced settlement services were revised by lowering the per-entry fee from $1.00 to $0.95, introducing a settlement file fee of $12.00, increasing both the off-line surcharge and the telephone notification surcharge from $10.00 to $13.00, and introducing a minimum monthly fee of $60. Fees for the Fedwire-based settlement service were not changed.

## Fedwire Book-Entry Securities

Reserve Bank operating expenses and imputed costs for the Fedwire book-entry securities service totaled $13.9 million in 1999. Revenue from these operations totaled $16.7 million, and other income amounted to $0.6 million, resulting in net income of $3.4 million.

The Reserve Banks processed 5.1 million transfers of government agency securities on the Fedwire book-entry securities transfer system during the year, an increase of 1.2 percent from 1998.[4]

In February, the Reserve Banks implemented a fee structure for the book-entry service that splits the basic transfer fee equally between the originator and the receiver of a securities transfer (rather than charge the entire transfer fee to the originator). The fee for an on-line Fedwire book-entry securities transfer was reduced to $0.85, a 24 percent reduction from 1998. Changing the on-line transfer fee to a fee assessed on both senders and receivers more accurately aligns the costs and benefits to participants in a transfer. In July, the Reserve Banks began applying an account-maintenance fee of $15 to each joint-custody securities account held by a customer, rather than to just the customer's master account.[5]

4. The revenues, expenses, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions such as the World Bank. The Fedwire book-entry securities service also provides custody, transfer, and settlement services for U.S Treasury securities. The Reserve Banks act as fiscal agents of the United States when they provide transfer and safekeeping of U.S. Treasury securities, and the Treasury Department assesses fees on depository institutions for some of these services. For more details, see the section ''Fiscal Agency Services'' later in this chapter.

5. Before the conversion of all Reserve Banks to the National Book-Entry System (NBES), account maintenance fees for joint custody securities accounts were different across the Reserve Banks. During the transition to NBES, the interim pricing practice for these accounts was standardized to charge one account-maintenance fee per customer regardless of the number of pledgees. This interim practice achieved consistency and minimized the effect on customers converting to the new system but resulted in reduced revenue and incomplete recovery of processing costs.

Depository institutions that do not have an electronic connection to the Fedwire securities transfer system can originate transfers via ''off-line'' telephone instructions. The volume of off-line Fedwire securities transfers has been declining substantially in recent years. Because of the decline and the small percentage of transfers that are originated off line (0.19 percent in 1999), the Federal Reserve began in 1998 to consolidate its Fedwire off-line securities transfer operations at the Federal Reserve Banks of Boston and Kansas City. The consolidation, completed in March 1999, has made it possible to streamline service and ensures uniform service nationwide. In 1999, the $10 off-line securities transfer fee was converted to an off-line surcharge and was increased to $13 to be consistent with the off-line surcharge in the Fedwire funds transfer and net settlement services.

## Automated Clearinghouse

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled $55.9 million in 1999. Revenue from ACH operations totaled $65.5 million, and other income amounted to $2.3 million, resulting in net income of $11.9 million. The Reserve Banks processed 3.3 billion ACH transactions, an increase of 12.7 percent from 1998.

Fees for originating ACH transactions were reduced $0.0005 per transaction in August. The reduction amounted to a decrease of 8.5 percent for originating a large file and 7.1 percent for originating a small file.

The Reserve Banks continued to encourage the growth of electronic payments by participating during 1999 in an ACH cross-border pilot program between the United States and Canada.

In May, the Board requested comments on the effect of modifying the Reserve Banks' pricing practices and deposit deadlines for ACH transactions they exchange with private-sector operators. Board staff members met with commenters in December to further discuss private-sector-operator issues.

In November, the Board approved modifications to the settlement finality for ACH credit transactions processed by the Reserve Banks. This approval, which will become effective in early 2001, makes settlement final when posted to depository institutions' accounts. To lower settlement risk, prefunding will be required for those ACH credit transactions that are settled through a Federal Reserve account that is monitored in real time.

## Noncash Collection

Reserve Bank operating expenses and imputed costs for noncash collection services totaled $2.0 million in 1999. Revenue from noncash operations totaled $2.9 million, and other income amounted to $0.1 million, resulting in net income of $1.0 million. The Jacksonville Branch of the Federal Reserve Bank of Atlanta, which is the Reserve Banks' centralized processing site for this service, processed 613,000 noncash collection items (coupons and bonds), a decrease of 18.8 percent from 1998.

## Cash Services

Because providing high-quality currency and coin is a basic responsibility of the Federal Reserve, the Reserve Banks charge fees only for special cash services and nonstandard access.[6] Special cash services represent a very small

6. Nonstandard access is not treated as a priced service; instead, fees for nonstandard access are treated as a recovery of expenses.

portion (less than 1 percent) of the cost of overall cash services provided by the Reserve Banks to depository institutions; these services include the provision of wrapped coin, packaging of nonstandard currency orders and deposits as well as coin deposits, and shipping of currency and coin by registered mail.

The Cleveland District and the Helena Branch of the Minneapolis Reserve Bank provide wrapped coin as a priced service. The Chicago District provides currency in nonstandard packages, the Helena Branch provides coin in nonstandard packages, and the El Paso Branch provides nonstandard packaging of same-day express cash orders. In addition, five Districts provide cash transportation by registered mail. Reserve Bank operating expenses and imputed costs for special cash services totaled $2.8 million in 1999. Revenue from cash operations totaled $2.9 million, and other income amounted to $0.1 million, resulting in net income of $0.2 million.

## Float

Federal Reserve float decreased in 1999 to a daily average of $584.4 million, from a daily average of $632.7 million in 1998.[7] The Federal Reserve recovers the cost of float associated with priced services as part of the fees for those services.

7. The measure of Federal Reserve float used here is different from that used in previous years; it has been changed to make the figures more comparable to those reported in the Board's weekly statistical releases. In previous years, daily average float was shown net of float recovered through deposit adjustments; if the data here were calculated as in previous years, the figures for float in 1999 and 1998 would be $199.1 million and $323.6 million respectively. See footnote 6 of the pro forma financial statements at the end of this chapter for detailed information on Federal Reserve float.

## Developments in Currency and Coin

The Federal Reserve experienced unprecedented demand for coin in 1999, when the Mint and the Federal Reserve paid out more than $5.8 billion in coin, an 8.1 percent increase from 1998 and a 20.0 percent increase from 1997. The Federal Reserve worked closely with the Mint to move coin inventories around the System, replenishing low stocks at certain Reserve Bank offices. Rather than have each office maintain its own coin inventories, the Reserve Banks' Cash Fiscal Product Office, located at the Federal Reserve Bank of Philadelphia, began the centralized management of coin. This effort will ensure an equitable supply of coin among the twelve Reserve Banks.

Contributing to the greater demand for coin in 1999 was the beginning of the Mint's 50 State Quarters program. The Mint produced five different quarters in 1999, and the quarters were very popular with the public. Historically, the Mint produces about 1.5 billion quarters every year. The original forecast of need in 1999 was 3.5 billion, but the Mint had to increase production to 5 billion because of the extraordinarily high demand.

Strong economic growth and robust retail sales in 1999 were probably also factors in the increase in demand for all denominations of coin. Because of continued prosperity, consumers may not feel the need to spend the extra coin they hold, thus reducing the amount of coin in circulation.

In fiscal year 1999, the Federal Reserve directed the Bureau of Engraving and Printing to print 11.4 billion notes, an increase of nearly 24 percent from its fiscal 1998 order. As part of the Federal Reserve's preparations for the century date change, each Reserve Bank office increased its volume of currency available for potential increased payments to depository institutions.

## Developments in Fiscal Agency and Government Depository Services

The Federal Reserve Act provides that when required by the Secretary of the Treasury, Reserve Banks will act as fiscal agents and depositories of the United States. As fiscal agents, Reserve Banks provide the Department of the Treasury with services related to the federal debt. For example, they issue, transfer, reissue, exchange, and redeem marketable Treasury securities and savings bonds; they also process secondary market transfers initiated by depository institutions. As depositories, Reserve Banks collect and disburse funds on behalf of the federal government. They also provide fiscal agency services on behalf of several domestic and international government agencies.

The Reserve Banks spent much of 1999 preparing for a smooth transition into the year 2000. They worked with the Treasury and other government agencies, including the Department of Defense, the Social Security Administration, and the Department of Veterans Affairs, to ensure the payment of government benefits into the new year and to support the Treasury's debt-management program. These efforts were part of the extensive planning process that contributed to the successful transition into the new century.

The total cost of providing fiscal agency and depository services to the Treasury in 1999 amounted to $255.6 million, compared with $250.9 million in 1998 (table). The cost of providing services to other government agencies was $39.3 million, compared with $46.6 million in 1998.

The Reserve Banks establish uniform and consistent practices for accounting for, reporting of, and billing for the full costs of providing fiscal agency and depository services to the U.S. government. In 1999, the Reserve Banks requested reimbursement by the Treasury and other government agencies of $294.8 million in fiscal agency and depository expenses, a decrease of $2.7 million from 1998.

The Reserve Banks also worked with federal agencies to restructure certain Federal Reserve services. The objective was to assess services that are conducted at more than one location, such as the redemption of Treasury and agency interest coupons, and to centralize these operations to reduce expenses. Some of these projects will be implemented in 2000.

### Fiscal Agency Services

The Reserve Banks handle marketable Treasury securities and savings bonds and monitor the collateral pledged by depository institutions to the federal government.

#### *Marketable Treasury Securities*

Reserve Bank 1999 operating expenses for activities related to marketable Treasury securities totaled $74.8 million, a 2.5 percent increase from 1998. The Banks processed nearly 253,000 commercial tenders for government securities in Treasury auctions, a 20.1 percent decline from 1998. Commercial tenders are processed at the New York, Chicago, and San Francisco Reserve Banks using a common automated application known as the Treasury Automated Auction Processing System.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire book-entry secu-

Expenses of Federal Reserve Banks for Fiscal Agency and Depository Services, 1999, 1998, and 1997

Thousands of dollars

| Agency and service | 1999 | 1998 | 1997 |
|---|---|---|---|
| DEPARTMENT OF THE TREASURY | | | |
| *Bureau of the Public Debt* | | | |
| Savings bonds | 70,285.8 | 71,401.8 | 70,340.4 |
| Treasury Direct | 40,446.2 | 35,859.1 | 35,440.4 |
| Commercial book entry | 15,744.2 | 17,880.4 | 26,809.4 |
| Marketable Treasury issues | 13,715.1 | 15,530.5 | 14,855.4 |
| Definitive securities and Treasury coupons | 4,886.7 | 3,734.2 | 3,618.9 |
| Other services | 100.4 | 83.7 | n.a. |
| Total | 145,178.4 | 144,489.7 | 151,064.5 |
| *Financial Management Service* | | | |
| Treasury tax and loan and Treasury general account | 34,971.0 | 35,428.2 | 35,265.9 |
| Government check processing | 33,365.4 | 34,096.4 | 26,548.0 |
| Automated clearinghouse | 11,263.4 | 11,716.0 | 14,477.3 |
| Government agency check deposits | 2,422.7 | 2,731.0 | 2,795.3 |
| Fedwire funds transfers | 187.7 | 186.3 | 422.0 |
| Other services | 20,423.5 | 16,045.2 | 20,994.2 |
| Total | 102,633.7 | 100,203.1 | 100,502.7 |
| *Other Treasury* | | | |
| Total | 7,786.8 | 6,237.6 | 3,840.0 |
| Total, Treasury | 255,598.9 | 250,930.4 | 255,407.2 |
| OTHER FEDERAL AGENCIES | | | |
| Department of Agriculture | | | |
| Food coupons | 18,643.9 | 24,452.4 | 25,495.7 |
| U.S. Postal Service | | | |
| Postal money orders | 6,623.3 | 5,275.3 | 6,108.7 |
| Miscellaneous agencies | | | |
| Other services | 13,983.0 | 16,850.6 | 17,042.1 |
| Total, other agencies | 39,250.2 | 46,578.3 | 48,646.5 |
| **Total reimbursable expenses** | **294,849.1** | **297,508.7** | **304,053.7** |

n.a. Not available.

rities system, which provides custody and transfer, and Treasury Direct, which provides custody services only.[8] Almost all book-entry Treasury securities, 97.4 percent of the total par value outstanding at year-end 1999, were maintained on Fedwire; the remainder were maintained on Treasury Direct.

The Reserve Banks in 1999 processed 8.1 million Fedwire transfers of Treasury securities, a 9.0 percent decline from 1998. They also processed 26.6 million interest and principal payments for Treasury and government agency securities, a decrease of 0.2 percent from 1998.

Treasury Direct, operated by the Philadelphia Reserve Bank, is a system of book-entry securities accounts for institutions and individuals planning to hold their Treasury securities to maturity. The Treasury Direct system holds more than 721,000 accounts. During 1999, the Reserve Banks processed nearly 239,000 tenders for Treasury Direct customers seeking to purchase Treasury securities at Treasury auctions and handled 0.6 million reinvestment requests; the number of tenders was

8. The Fedwire book-entry securities mechanism is also used for safekeeping and transfer of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. For more details, see the section "Fedwire Book-Entry Securities" earlier in this chapter.

22.7 percent lower than in 1998, and the number of reinvestment requests was 45.5 percent lower. The Philadelphia Reserve Bank issued 6.4 million payments for discounts, interest, and redemption proceeds; the Treasury Direct facility was also used to originate 2.8 million payments for savings bonds and more than 41,000 interest payments for definitive (paper) Treasury issues.

In May, the Reserve Banks started working with Treasury to reduce the number of sites that provide Treasury Direct customer service from thirty-seven to three—Boston, Minneapolis, and Dallas—and to enhance customer service for Treasury Direct investors. A few Treasury Direct offices moved their investors' accounts to new servicing locations in 1999, but the majority will move sometime in 2000. By 2001, all applications to purchase, reinvest, and redeem Treasury securities will go to one of the three consolidated sites, where they will receive the same quality and type of service as before. The Philadelphia Reserve Bank will continue to operate the Treasury Direct application.

As part of the Treasury Direct consolidation, the Reserve Banks began to design automation support for a toll-free customer contact center for Treasury Direct customers. The center will route calls to a variety of electronic services available from the Treasury or connect the investor to the next available agent at one of the three Reserve Banks, regardless of the caller's location.

At the Treasury's direction, the Reserve Banks eliminated walk-in services for Treasury securities and savings bond investors in September. Only a few customers were using this costly service, and the number of Federal Reserve offices that processed these transactions was declining as a result of consolidation. In 1998, the Treasury started to expand the services offered to investors electronically; for example, individuals can purchase Treasury securities and savings bonds on the Treasury's web site, and investors can use a touch-tone telephone to reinvest their maturing Treasury securities or to request statements of account. Throughout the summer, the Reserve Banks conducted an extensive information program to reduce the effect on walk-in customers.

As a service to Treasury Direct investors, the Chicago Reserve Bank, through the Sell Direct program, continued to sell investors' Treasury securities on the secondary market for a fee. In Sell Direct's second full year, the Bank sold nearly 16,000 securities worth $581.2 million, compared with more than 16,000 securities worth $510.6 million in 1998. The Bank collected almost $535,000 in fees on behalf of the Treasury, a decrease of 2.7 percent from the $550,000 in fees collected in 1998.

### *Savings Bonds*

Reserve Bank operating expenses for savings bond activities totaled $70.3 million in 1999, a decrease of 1.5 percent from 1998. The Banks printed and mailed 40.5 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 10.3 percent decline from 1998. In the first full year that the inflation-indexed Series I savings bond was offered, the Reserve Banks processed nearly 160,000 original-issue transactions for the Series I savings bond and 7.0 million original-issue transactions for the Series EE savings bond. They also processed approximately 550,000 redemption, reissue, and exchange transactions, a 9.0 percent decrease from 1998. The Reserve Banks responded to 1.6 million service calls from owners of savings bonds, approximately the same number as in 1998.

The Reserve Banks continued to enhance the automation aspects of savings bond processing. Following a successful pilot program in 1998, all savings bond processing sites implemented digital scanning software, which converts paper applications submitted by banks across the country into an electronic medium. Work also continued on a distributed processing automation platform for savings bonds to replace several current mainframe applications.

Savings bond operations are conducted at five Reserve Bank offices: Buffalo, Pittsburgh, Richmond, Minneapolis, and Kansas City. All five offices process transactions, but only the Pittsburgh and Kansas City offices print and mail savings bonds.

## Depository Services

The Reserve Banks maintain the Treasury's funds account, accept deposits of federal taxes and fees, pay checks drawn on the Treasury's account, and make electronic payments on behalf of the Treasury.

### *Federal Tax Payments*

Reserve Bank operating expenses related to federal tax payment activities in 1999 totaled $35.0 million. The Banks processed approximately 44,000 paper and 4.8 million electronic advices of credit from depository institutions handling tax payments for businesses and individuals. Advices of credit are notices from depository institutions to the Federal Reserve and the Treasury that summarize taxes collected on a given day. The volume of paper advices of credit declined 80.9 percent from 1998 to 1999, and the volume of tax payments submitted electronically decreased 4.0 percent. The Reserve Banks also received a small number of tax payments directly.

Depository institutions that receive tax payments may either place the funds in a Treasury tax and loan (TT&L) account or remit the funds to a Reserve Bank. The Federal Reserve controls the collateral pledged to secure federal tax payment deposits held by depository institutions. The Minneapolis Reserve Bank operates an automated system through which businesses pay taxes that are due on the same day the tax liability is determined. These electronic tax payments, a part of the Treasury's Electronic Federal Tax Payment System (EFTPS), are invested in depository institutions' TT&L balances via the Federal Reserve's TT&L mechanism. In 1999, this electronic tax application processed approximately 164,000 tax payments from 7.8 million taxpayers totaling $201.0 billion. Approximately 93.6 percent of business taxes are collected electronically. Most EFTPS payments are made via ACH to accounts maintained by two commercial banks as Treasury's financial agents.

In 1999, work continued on a new automated program to be implemented in mid-2000, the Treasury Investment Program (TIP), which will replace the twelve existing TT&L applications with a single application and database. Besides centralizing this function, TIP also provides the Treasury with investment capabilities. The new program will process only electronic tax payments, which constitute most business tax payments today. A separate application, called Patax (paper tax processing system), will automate the handling of paper tax payments. The St. Louis Reserve Bank, acting on behalf of all the Reserve Banks, will truncate paper tax coupons when the TIP application is implemented.

*Payments Processed for the Treasury*

Reserve Bank operating expenses related to government payment operations in 1999 amounted to $47.2 million. The Treasury continued to encourage electronic payments: ACH transactions processed for the Treasury amounted to 823.6 million, an increase of 9.4 percent from 1998. Most government payments made via the ACH are social security, pension, and salary payments; some are payments to vendors. All recurring Treasury Direct payments and many definitive securities interest payments are made via the ACH.

In support of the Treasury's effort to make payments electronically, the Federal Reserve Bank of Dallas implemented Electronic Transfer Accounts in 1999. The accounts give beneficiaries of federal payments who do not have bank accounts access to low-cost transaction accounts at federally insured depository institutions. The Dallas Bank will manage enrollment of depository institutions that want to provide these accounts and will help payment recipients and others locate institutions that are authorized to offer the accounts.

The Treasury continues to reduce the number of payments it makes by paper check. The Reserve Banks processed 288.2 million paper government checks in 1999, a decrease of 10.3 percent from 1998. The Banks also issued nearly 609,000 paper fiscal agency checks, a decrease of 22.5 percent from 1998. Fiscal agency checks were used primarily to pay semiannual interest on registered, definitive Treasury notes and bonds and on Series H and HH savings bonds; some were used to pay the principal of matured securities and coupons and to make discount payments to first-time purchasers of government securities through Treasury Direct.

In 1999, the Reserve Banks continued to operate the check-imaging system, implemented in 1998, that captures and stores digital images of all U.S. government checks for the Treasury's Financial Management Service. This service improves processing efficiency for the U.S. Treasury and lowers its operating costs. In 1999, the Reserve Banks imaged 80.1 percent of all the U.S. government checks they processed, compared with 42.3 percent in 1998.

## Services Provided to Other Entities

The Reserve Banks provide fiscal agency and depository services to other domestic and international agencies when they are required to do so by the Secretary of the Treasury or when they are required or permitted to do so by federal statute. Depending on the authority under which the services are provided, the Reserve Banks may (1) maintain book-entry accounts of government agency securities and handle their transfer,[9] (2) provide custody for the stock of unissued definitive securities, (3) maintain and update balances of outstanding book-entry and definitive securities for issuers, (4) perform various other securities-servicing activities, (5) maintain funds accounts for some government agencies, and (6) provide various payments services.

One such service is the provision of food coupon services for the U.S. Department of Agriculture. Reserve Bank operating expenses for food coupon services in 1999 totaled $18.6 million, 24.1 percent lower than in 1998.

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9. The Federal Reserve tracks the transfer and account maintenance of agency securities as a priced service to depository institutions. No expenses of providing these services to depository institutions are charged to the agencies.

The Banks redeemed 1.2 billion food coupons, a decrease of 33.3 percent from 1998. As a result of the Department of Agriculture's program to provide benefits electronically, the volume of paper food coupons redeemed by the Reserve Banks is expected to continue to decline. In 1999, the Richmond Reserve Bank helped facilitate the elimination of paper food coupons through its Account Management Agent software, which monitors funding requests for electronic benefit transfer and reports payment activity.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. The Reserve Banks processed 225.9 million postal money orders in 1999, 6.2 percent more than in 1998. Much of this work is centralized at the St. Louis Reserve Bank. In 1999, that Bank worked with the U.S. Postal Service to design an image-capture service for postal money orders, similar to the service provided for Treasury checks. When the Bank implements this service in 2000, the digital files of paid money orders will facilitate the Postal Service's accounting, reconcilement, and claims processes.

## Information Technology

Although year 2000 preparations dominated Federal Reserve information technology activities in 1999, a number of strategic initiatives were undertaken to improve the IT infrastructure over the next several years. In 1999, the Federal Reserve initiated a plan to modernize the current telecommunications network, Fednet, that supports both external electronic connections between the Federal Reserve and depository institutions and internal communications among Reserve Banks: Fednet will be upgraded with frame relay technology. The new network will improve the speed, reliability, and performance of depository institutions' electronic connections during contingencies and will provide the capacity and flexibility to support new electronic services that will use web-based technologies. The new network will also enable the Federal Reserve to introduce efficiencies into its internal IT operations by facilitating further standardization and consolidation of processing resources.

In 1999, the Federal Reserve completed installation of Triple DES, an advanced application of the Data Encryption Standard (DES), on its internal network and deployed Triple DES to approximately 12,000 Fedline connections, which give depository institutions access to a variety of Federal Reserve services. The Federal Reserve adopted Triple DES as its encryption method in 1998 to strengthen protection of information transmitted electronically among Reserve Banks and to depository institutions. As part of the frame relay network conversion, those depository institutions that connect to the Federal Reserve via computer interface will be converted to Triple DES.

During 1999, several depository institutions participated in a successful pilot program of Fedline for Windows (FLW). Concurrent with application testing, a significant effort was undertaken to improve the security of the new FLW platform. The security enhancements are directed at authenticating FLW operators, encrypting information, and interconnecting FLW with the administrative systems of depository institutions. Conversion of dial customers from the Federal Reserve's current DOS Fedline platform to the new FLW platform is expected to begin in late 2000. Deployment of FLW will also enable the Federal Reserve to complete its Triple DES initiative.

Reserve Banks continue to make significant progress in using the World Wide Web as a service-delivery channel. The Federal Reserve is developing an overall strategy for providing access to services through web browser interfaces. In 1999, the Federal Reserve planned the implementation of a public key infrastructure strategy to secure external access to its services. Depository institutions are currently conducting pilot programs of check-imaging, cash services, Treasury auction, and statistical-reporting web-based applications.

## Financial Examinations of 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 assigns this responsibility to its Division of Reserve Bank Operations and Payment Systems. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section ''Federal Reserve Banks Combined Financial Statements''). The public accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. Within this framework, each Reserve Bank annually provides an assertion letter to its board of directors confirming adherence to the COSO standards, and a public accounting firm certifies management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

In 1999, the division's attentions at the Reserve Banks focused on rendering an opinion, using a format consistent with the integrated COSO framework, on each District's internal control system. The scope of these examinations included comprehensive reviews of each Bank's internal control system in terms of the five COSO control components: control environment, risk assessment, control activities, information and communication, and monitoring.

Each year, to assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division examines the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, a public accounting firm certifies the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. Division personnel follow up on the results of these audits. The FOMC receives the external audit reports and the report on the division's follow-up.

## Income and Expenses

The accompanying table summarizes the income, expenses, and distribution of net earnings of the Federal Reserve Banks for 1998 and 1999.

Total income in 1999 was $29,347 million, compared with $28,149 million in 1998. In 1999, total income included revenue from fees for the provision of priced services of $836 million. Total expenses were $2,552 million ($1,532 million in operating expenses, $321 million in earnings credits granted to depository institutions, $485 million in assessments for the cost of new currency, and $214 million in assessments for other expenditures by

Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks, 1999 and 1998

Millions of dollars

| Item | 1999 | 1998 |
|---|---|---|
| Current income | 29,347 | 28,149 |
| Current expenses | 1,852 | 1,833 |
| Operating expenses[1] | 1,532 | 1,487 |
| Earnings credits granted | 321 | 346 |
| Current net income | 27,495 | 26,316 |
| Net additions to (deductions from, – ) current net income | –526 | 1,914 |
| Cost of unreimbursed services to Treasury | 8 | 8 |
| Assessments by the Board of Governors | 699 | 587 |
| For expenditures of Board | 214 | 178 |
| For cost of currency | 485 | 409 |
| Net income before payments to Treasury | 26,262 | 27,636 |
| Dividends paid | 374 | 343 |
| Transferred to surplus | 479 | 732 |
| Payments to Treasury[2] | 25,410 | 26,561 |

NOTE. In this and the following table, components may not sum to totals because of rounding.

1. Includes a net periodic credit for pension costs of $367 million in 1999 and $288 million in 1998.

2. Interest on Federal Reserve notes.

the Board of Governors). Unreimbursed expenses for services provided to the Treasury and other government entities amounted to $8 million.[10]

The profit and loss account showed a net loss of $526 million. The loss was due primarily to unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled $374 million, $31 million more than in 1998; 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 Treasury in the form of interest on Federal Reserve notes totaled $25,410 million in 1999, down from $26,561 million in 1998; the payments equal net income after the deduction of dividends paid and of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid in.

In the ‘‘Statistical Tables’’ section of this REPORT, table 5 details the income and expenses of each Reserve Bank for 1999, and table 6 shows a condensed statement for each Bank for 1914–99. A detailed account of the assessments and expenditures of the Board of Governors appears in the section ‘‘Board of Governors Financial Statements.’’

## Holdings of Securities and Loans

The Reserve Banks average daily holdings of securities and loans during 1999 amounted to $495,606 million, an increase of $48,511 million from 1998 (see table). Holdings of U.S. government securities increased $48,451 million, and holdings of loans increased $60 million.

10. The Reserve Banks bill the Treasury and other government entities for the cost of certain services, and the portions of the bills that are not paid are reported as unreimbursed expenses.

Securities and Loans of Federal Reserve Banks, 1997–99

Millions of dollars, except as noted

| Item and year | Total | U.S. government securities[1] | Loans[2] |
|---|---|---|---|
| *Average daily holdings*[3] | | | |
| 1997 | 417,805 | 417,529 | 277 |
| 1998 | 447,095 | 446,933 | 161 |
| 1999 | 495,606 | 495,384 | 221 |
| *Earnings* | | | |
| 1997 | 25,714 | 25,699 | 15 |
| 1998 | 26,851 | 26,842 | 9 |
| 1999 | 28,227 | 28,216 | 11 |
| *Average interest rate (percent)* | | | |
| 1997 | 6.15 | 6.16 | 5.27 |
| 1998 | 6.01 | 6.01 | 5.44 |
| 1999 | 5.70 | 5.70 | 5.02 |

1. Includes federal agency obligations.
2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.
3. Based on holdings at opening of business.

The average rate of interest earned on the Reserve Banks' holdings of government securities declined to 5.70 percent from 6.01 percent in 1998, and the average rate of interest earned on loans declined to 5.02 percent from 5.44 percent.

## Volume of Operations

Table 8 in the "Statistical Tables" section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1995 through 1999.

## Federal Reserve Bank Premises

In 1999, the design of the Atlanta Reserve Bank's new headquarters building was completed and construction began, and construction of the Bank's new Birmingham Branch building continued. Multiyear renovation programs were completed at the Kansas City Bank's Oklahoma City Branch and at the San Francisco Bank's Portland and Salt Lake City Branches. Other multiyear renovation programs continued at the New York Bank's headquarters building and the San Francisco Bank's Seattle Branch.

The multiyear leasehold improvements program continued for the New York Reserve Bank's new leased office facility in New York City, and some staff members have moved into the new offices. The Kansas City Bank continued to analyze options for expanding its headquarters parking facility.

The Board of Governors approved the installation of exterior security enhancements for the Richmond Reserve Bank's headquarters building. It also approved the selection of the site for the San Francisco Bank's new currency-processing facility in Phoenix; the facility's design was completed, and construction is planned to begin in 2000. Finally, the Board approved the Dallas Bank's request to begin a new building program for its Houston Branch and approved the selection of a site. Analysis of options for developing the site is continuing. ■

# Pro Forma Financial Statements for Federal Reserve Priced Services

## Pro Forma Balance Sheet for Priced Services, December 31, 1999 and 1998

Millions of dollars

| Item | 1999 | | 1998 | |
|---|---|---|---|---|
| *Short-term assets* (Note 1) | | | | |
| Imputed reserve requirements on clearing balances | 777.2 | | 725.3 | |
| Investment in marketable securities | 6,994.8 | | 6,527.7 | |
| Receivables | 78.2 | | 76.8 | |
| Materials and supplies | 4.2 | | 4.4 | |
| Prepaid expenses | 24.4 | | 20.4 | |
| Items in process of collection | 3,747.8 | | 4,272.5 | |
| Total short-term assets | | 11,626.5 | | 11,626.9 |
| *Long-term assets* (Note 2) | | | | |
| Premises | 431.7 | | 398.6 | |
| Furniture and equipment | 146.5 | | 127.6 | |
| Leases and leasehold improvements | 59.5 | | 26.8 | |
| Prepaid pension costs | 542.8 | | 437.3 | |
| Total long-term assets | | 1,180.5 | | 990.4 |
| **Total assets** | | **12,807.0** | | **12,617.3** |
| *Short-term liabilities* | | | | |
| Clearing balances and balances arising from early credit of uncollected items | 7,996.3 | | 8,011.8 | |
| Deferred-availability items | 3,523.5 | | 3,513.7 | |
| Short-term debt | 106.7 | | 101.5 | |
| Total short-term liabilities | | 11,626.5 | | 11,626.9 |
| *Long-term liabilities* | | | | |
| Obligations under capital leases | .0 | | .0 | |
| Long-term debt | 237.2 | | 193.6 | |
| Postretirement/postemployment benefits obligation | 231.2 | | 217.4 | |
| Total long-term liabilities | | 468.5 | | 411.0 |
| **Total liabilities** | | **12,095.0** | | **12,037.9** |
| Equity | | 712.0 | | 579.4 |
| **Total liabilities and equity** (Note 3) | | **12,807.0** | | **12,617.3** |

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, 1999 and 1998

Millions of dollars

| Item | 1999 | | 1998 | |
|---|---|---|---|---|
| Revenue from services provided to depository institutions (Note 4) | | 835.9 | | 816.0 |
| Operating expenses (Note 5) | | 692.7 | | 654.1 |
| Income from operations | | 143.2 | | 161.9 |
| Imputed costs (Note 6) | | | | |
| Interest on float | 8.7 | | 16.2 | |
| Interest on debt | 18.5 | | 17.0 | |
| Sales taxes | 9.8 | | 8.7 | |
| FDIC insurance | 2.7 | 39.7 | 1.4 | 43.4 |
| Income from operations after imputed costs | | 103.5 | | 118.5 |
| Other income and expenses (Note 7) | | | | |
| Investment income | 337.3 | | 352.0 | |
| Earnings credits | –305.5 | 31.7 | –328.2 | 23.7 |
| Income before income taxes | | 135.3 | | 142.3 |
| Imputed income taxes (Note 8) | | 43.3 | | 45.7 |
| **Net income** (Note 9) | | **92.0** | | **96.6** |
| MEMO: Targeted return on equity (Note 10) | | 57.2 | | 66.8 |

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, 1999

Millions of dollars

| Item | Total | Commercial check collection | Funds transfer and net settlement | Book-entry securities | Commercial ACH | Noncash collection | Cash services |
|---|---|---|---|---|---|---|---|
| Revenue from services (Note 4) | 835.9 | 681.0 | 66.8 | 16.7 | 65.5 | 2.9 | 2.9 |
| Operating expenses (Note 5) | 692.7 | 589.2 | 54.8 | 11.8 | 47.8 | 1.4 | 2.7 |
| Income from operations | 143.2 | 91.7 | 12.1 | 5.0 | 17.7 | 1.5 | .2 |
| Imputed costs (Note 6) | 39.7 | 33.5 | 2.9 | .6 | 2.5 | .1 | .0 |
| Income from operations after imputed costs | 103.5 | 58.2 | 9.2 | 4.4 | 15.2 | 1.4 | .1 |
| Other income and expenses, net (Note 7) | 31.7 | 26.3 | 2.3 | .6 | 2.3 | .1 | .1 |
| Income before income taxes | 135.3 | 84.6 | 11.5 | 5.0 | 17.4 | 1.5 | .2 |
| Imputed income taxes (Note 8) | 43.3 | 27.1 | 3.7 | 1.6 | 5.6 | .5 | .1 |
| **Net income** (Note 9) | **92.0** | **57.5** | **7.8** | **3.4** | **11.9** | **1.0** | **.2** |
| MEMO: Targeted return on equity (Note 10) | 57.2 | 46.1 | 5.3 | 1.0 | 4.6 | .1 | .1 |

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 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 non-earning 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. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) 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 is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced 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

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized credits to expenses of $105.5 million in 1999 and $87.1 million in 1998 and corresponding increases in this asset account.

### (3) Liabilities and Equity

Under the matched-book capital structure for assets that are not "self-financing," short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt to equity for the fifty largest bank holding companies, which are used in the model for the private-sector adjustment factor (PSAF). The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been furnished by a private-sector firm. 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 and postretirement benefits costs and obligations on capital leases.

### (4) Revenue

Revenue represents charges 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.

### (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 for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $3.4 million in 1999 and $2.8 million in 1998. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense-ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 1999 and 1998 as follows (in millions):

| | 1999 | 1998 |
|---|---|---|
| Check | .0 | 27.1 |
| ACH | .0 | .0 |
| Funds transfer | 1.7 | 19.6 |
| Book entry | .0 | .0 |
| Noncash collection | .0 | .1 |
| Special cash services | .0 | .1 |
| **Total** | **1.7** | **46.9** |

Total operating expense on the income statement by service does not equal the sum of operating expenses for each service because of the effect of SFAS 87. Although the portion of the SFAS 87 credit related to the current year is allocated to individual services, the amortization of the initial effect of implementation is reflected only at the System level.

### (6) Imputed Costs

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. 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 checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).

Float costs are 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 for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of actual float by the Reserve Banks for 1999 in millions of dollars:

| | |
|---|---|
| Total float | 584.4 |
| Unrecovered float | 21.3 |
| Float subject to recovery | 563.1 |
| Sources of recovery of float | |
| Income on clearing balances | 56.2 |
| As-of adjustments | 385.3 |
| Direct charges | 209.5 |
| Per-item fees | (87.9) |

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 cash items in process of collection, 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; float recovered through per-item fees has been added to the cost base subject to recovery in 1999.

### (7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are allocated to each service based on each service's ratio of income to total income.

### (8) Income Taxes

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3).

### (9) Adjustments to Net Income for Price Setting

In setting fees, certain costs are excluded in accordance with the System's overage and shortfalls policy and its automation consolidation policy. Accordingly, to compare the financial results reported in this table with the projections used to set prices, adjust net income as follows (amounts shown are net of tax):

| | 1999 | 1998 |
|---|---|---|
| Net income | 91.8 | 96.6 |
| Amortization of the initial effect of implementing SFAS 87 | −10.2 | −10.2 |
| Deferred costs of automation consolidation | −1.2 | −14.5 |
| Adjusted net income | 80.4 | 71.9 |

### (10) Return on Equity

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3). This amount is adjusted to reflect the recovery of $1.2 million of automation consolidation costs for 1999 and $14.5 million for 1998. The Reserve Banks recovered these amounts, along with a finance charge, by the end of 1999.

# *The Board of Governors and the Government Performance and Results Act*

Under the Government Performance and Results Act of 1993, federal agencies are required, in consultation with the Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not required to do so, the Board of Governors is voluntarily complying with the act's requirements.

## Strategic and Performance Plans

The Board sent its strategic plan for the period 1997–2002 to the Congress in October 1997. The document states the Board's mission, articulates major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cut across agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation. The strategic plan for the period 2000–05 is being prepared; the mission, goals, and other elements of the plan will remain essentially unchanged.

In September 1998, the Board sent to the Congress a performance plan for its 1998–99 budget.[1] Except for the monetary policy function, the plan set forth specific targets for some of the performance measures identified in the strategic plan. It also described the operational processes and resources needed to meet those targets and discussed validation and verification of results.

The strategic and performance plans are available on the Board's public web site (www.federalreserve.gov/boarddocs/rptcongress). A summary of the goals and objectives set forth in those plans is given in the next section.

## Goals and Objectives

The Federal Reserve has three interrelated and mutually reinforcing goals, with supporting objectives:

### Goal

To conduct monetary policy toward the achievement of maximum sustainable long-term growth and stable prices

### Objectives

- Stay abreast of recent developments and prospects in 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

1. The act requires that a performance plan be submitted for each fiscal year beginning with fiscal 1999. The Board budgets over a calendar year, and its budget covers a two-year period. The budget for 2000–01 was approved in September 1999. The performance plan for the 2000–01 budget is being prepared for publication in the second half of 2000. A report on the results of the performance plan for the 1998–99 budget is being prepared for release at about the same time.

- 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 Department of the Treasury and other agencies
- Promote understanding of Federal Reserve policy among other government policy officials and the general public.

## Goal

To promote a safe, sound, competitive, and accessible banking system and stable financial markets through supervision and regulation of the nation's banking and financial systems, through its function as the lender of last resort, and through effective implementation of statutes designed to inform and protect the consumer

## Objectives

- Maintain ability and capacity as a bank supervisor and central bank to ensure that emerging financial threats can be identified early and successfully resolved
- Provide comprehensive and effective supervision of U.S. banks, bank holding companies, U.S. operations of foreign banking organizations, and related entities by focusing supervisory efforts and resources on areas of highest risk to individual organizations and the financial system as a whole, and by developing effective regulations to promote a safe and sound banking environment
- Promote sound practices for managing risk at banking organizations in order to provide for strong internal controls, active boards of directors, and senior management oversight and accountability
- Promote sound banking and effective supervisory practices among developed and emerging countries through ongoing coordination with international supervisory bodies and through training programs for international supervisors and bankers
- Heighten the positive effect of market discipline on banking organizations by encouraging improved disclosures, accounting standards, risk measurement, and overall market transparency
- Harness benefits of technology in carrying out responsibilities to improve supervisory efficiency and to reduce burden on banking organizations
- Maintain an understanding of the effect of financial innovation and technology (for example, new powers and products, new risk management and measurement methodologies, and electronic banking) on the operations and risk profile of banking organizations and the payment system; ensure that supervisory programs accommodate prudent advances that benefit consumers and businesses or improve risk management
- Remove unnecessary banking restrictions, consistent with safety and soundness. Refine or eliminate unnecessary or ineffective policies, procedures, regulations, or restrictions to ensure that reforms are effectively implemented, consistent with safety and soundness of banking organizations
- Assure fair access to financial services for all Americans through vigorous enforcement of the Equal Credit Opportunity, Fair Housing, Community Reinvestment, and Home Mortgage Disclosure Acts and by encouraging state member bank involvement in community development activities
- Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (such as the Truth in Lending,

Truth in Savings, Consumer Leasing, and Electronic Fund Transfer Acts) to carry out congressional intent, striking the proper balance between protection of consumers and regulatory burden to the industry.
- Implement appropriate rules, regulations, and policies to comply with the Gramm–Leach–Bliley Act, which was enacted in November 1999.

### Goal

To foster the integrity, efficiency, and accessibility of U.S. dollar payment and settlement systems, issue currency, and act as the fiscal agent and depository of the U.S. government

### Objectives

- Provide Federal Reserve Bank priced payment services that maintain and improve the efficiency and integrity of the U.S. dollar payment mechanism
- Meet public demand for U.S. currency in the United States and abroad, work with Treasury to implement effective counterfeit-deterrence and detection features in U.S. currency, and provide for the smooth introduction of new-design currency
- Provide efficient and effective fiscal agency and depository services on behalf of Treasury and other government agencies
- Study and monitor U.S. dollar payment, clearing, and settlement systems and the risk issues pertaining to these systems to facilitate sound policy decisions that foster the integrity of the nation's payment systems.

## Interagency Coordination

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As required by the Government Performance and Results Act and in conformance with past practice, the Board has worked closely with other federal agencies to consider plans and strategies for programs, such as bank supervision, that cross jurisdictional lines. In particular, coordination with the Department of the Treasury and other agencies is evident throughout both the strategic and performance plans.

Much of the Board's formal effort to plan jointly has been made through the Federal Financial Institutions Examination Council (FFIEC), a group made up of the five federal agencies that regulate depository institutions.[2] In addition, a coordinating committee of the chief financial officers of the five agencies has been created to address and report on strategic planning issues of mutual concern. This working group has been meeting since June 1997 and has established four subgroups to focus on examinations, outreach, performance planning, and planning/budget linkage. These and similar planning efforts can significantly lower data processing and other costs for the government and the costs for depository institutions of compliance with federal regulations. ■

2. The FFIEC member agencies are the Board of Governors, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. It was established in 1979 pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions. The FFIEC also provides uniform examiner training and has taken a lead in developing standardized software needed for major data collection programs to support the requirements of the Home Mortgage Disclosure Act and the Community Reinvestment Act.

# Federal Legislative Developments

The following federal legislation enacted during 1999 significantly affects the Federal Reserve System and the institutions it supervises: the Gramm–Leach–Bliley Act; the Federal Reserve Retirement Portability Act; the consolidated appropriation for fiscal year 2000; and an amendment to the Federal Reserve Act to broaden the range of discount window loans.

## Gramm–Leach–Bliley Act

The Gramm–Leach–Bliley Act (GLB Act), Public Law 106-102, enacted on November 12, 1999, amends the Bank Holding Company Act of 1956 (BHC Act), the Federal Reserve Act, and other federal banking laws. It allows banks to affiliate with securities broker–dealers, insurance companies and agents, and other entities engaged in a wide range of financial activities and establishes a prudential framework for the supervision of holding companies engaged in banking and other financial activities. The following sections summarize the GLB Act's seven titles and describe the portions that bear significantly on the Federal Reserve System and the institutions it supervises.

### Title I

Title I revises the BHC Act to expand the ability of qualifying bank holding companies to engage in, or affiliate with companies engaged in, financial activities; establishes a prudential framework for the Board's supervision of bank holding companies and their subsidiaries; and establishes the conditions under which an insured bank may control a subsidiary engaged in activities that the parent bank is not allowed to conduct directly. It also makes other revisions to the BHC Act and other federal banking laws.

#### *Expanded Activities for Financial Holding Companies*

Title I repeals the provisions of the Glass–Steagall Act and the BHC Act that restricted the affiliation of bank holding companies with securities firms and insurance companies and agents. It also authorizes bank holding companies that qualify as financial holding companies (FHCs) to engage in, or affiliate with companies engaged in, a wide array of financial activities, including securities underwriting and dealing; insurance agency and underwriting activities; merchant banking activities; and any other activity that the Federal Reserve Board, in conjunction with the Secretary of the Treasury, determines to be financial in nature or incidental to financial activities. FHCs may also engage in nonfinancial activities that the Board determines are complementary to a financial activity and do not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

To become an FHC, a bank holding company must file a declaration with the Board certifying that all of its depository institution subsidiaries are well managed and well capitalized. Title I provides that a bank holding company's certification is not effective if any of the company's insured depository institution subsidiaries received less than a "satisfactory" rating at its most recent examination under the Community Reinvestment Act of 1977. It also requires that the Board establish comparable capital and managerial standards for foreign banks that seek to become an FHC.

*Umbrella Supervision and Functional Regulation*

Title I preserves the Board's role as the umbrella supervisor for all bank holding companies, including FHCs, and the Board's ability to establish consolidated capital requirements for bank holding companies and to obtain reports from and examine any bank holding company or subsidiary. In exercising its supervisory authority, the Board must rely, to the fullest extent possible, on publicly available information, externally audited financial statements, and reports that a bank holding company or subsidiary is required to provide to other supervisory authorities. In addition, the Board must focus its examination efforts, to the maximum extent possible, on bank holding companies and on those of the companies' subsidiaries that may have a materially adverse effect on an affiliated depository institution.

To reduce unnecessary regulatory burden and enhance functional regulation, Title I places certain additional limits on the Board's ability to obtain reports from, examine, establish capital requirements for, require a capital transfer from, or take enforcement action against a ‘‘functionally regulated subsidiary'' of a bank holding company. The GLB Act places similar limits on the supervisory authority of the other federal banking agencies with respect to a functionally regulated subsidiary of an insured depository institution.

Title I authorizes the Board to adopt rules governing relationships and transactions between state member banks and their subsidiaries, between depository institutions and their holding company affiliates, and between the U.S. branches, agencies, and commercial lending subsidiaries of foreign banks and their U.S. affiliates.

*Financial Subsidiaries of Banks*

Title I establishes the criteria under which a national bank may own or control a subsidiary engaged in activities that national banks are not allowed to conduct directly (a ‘‘financial subsidiary'') and establishes prudential requirements for national banks that have financial subsidiaries. A financial subsidiary does not include a subsidiary that national banks are expressly authorized by federal law (other than the GLB Act) to own or control, such as an Edge or agreement subsidiary controlled pursuant to sections 25 or 25A of the Federal Reserve Act.

Title I provides that financial subsidiaries of national banks may engage only in those activities that are determined to be financial in nature (or incidental to such activities) and other activities permissible for national banks to conduct directly. They are prohibited from engaging as principal in underwriting insurance (other than credit-related insurance); providing or issuing annuities; real estate investment or development activities (unless expressly authorized by law); and merchant banking activities. The Board and the Secretary of the Treasury may jointly remove the restrictions on the conduct of merchant banking activities by financial subsidiaries, but no earlier than five years after the date of enactment of the GLB Act.

Insured state banks may own or control a subsidiary that engages as principal in activities that national banks may conduct only through a financial subsidiary (for example, securities underwriting and dealing) only if the state bank complies with many of the same requirements applicable to national banks that have a financial subsidiary.

### *Derivatives Transactions and Intra-Day Credit under Section 23A*

Title I amends section 23A of the Federal Reserve Act to require that the Board promulgate rules to address as "covered transactions" (1) the credit exposure arising from derivatives transactions between banks and their affiliates and (2) intra-day extensions of credit by banks to their affiliates.

## Title II

Title II addresses the regulation of the securities, investment advisory, and investment company activities of banks and requires the Securities and Exchange Commission (SEC) to consult with the appropriate federal banking agency before taking any action with respect to the loan loss reserves of an insured depository institution or the holding company of an insured depository institution. It also permits companies that control a registered broker–dealer (but do not control an insured depository institution other than limited-purpose institutions) to voluntarily elect to be supervised by the SEC on a consolidated basis and establishes the framework for SEC supervision.

### *Bank Securities Activities*

Title II amends the Securities Exchange Act of 1934, effective in May 2001, to repeal the blanket exemption for banks from the definitions of "broker" and "dealer." It replaces those exemptions with a set of specific exemptions for banks engaged in traditional bank securities activities. Under Title II, a bank may avoid registering as a broker or dealer with the SEC only if it limits its securities activities to those specifically exempted by the GLB Act.

The specific exemptions would, among other things, allow banks to do the following subject to restrictions specified in the GLB Act: effect securities transactions in connection with their trust, custody, and safekeeping operations; privately place securities; purchase and sell traditional banking products, such as certificates of deposit, loan participations, and interest rate, currency, credit and equity swaps; and broker securities in up to 500 transactions per year that are not otherwise exempt.

Title II also allows banks to offer and sell, without registering as a broker or dealer, any financial product developed in the future unless the SEC determines, through a formal rulemaking process, that the new product is a security and that the registration of banks selling such products is in the public interest and necessary or appropriate to protect investors. In making this determination, the SEC is required to consider the views of the Board and the regulation of the product under the federal banking laws. The Board may challenge a determination by the SEC on a newly developed product area in federal court.

### *Consultation Concerning Loan Loss Reserves*

Title II requires the SEC to consult with the appropriate federal banking agency before taking any action or rendering an opinion on the manner in which an insured depository institution or a depository institution holding company reports its loan loss reserves in its financial statements.

## Title III

Title III addresses insurance-related issues, including the ability of national banks (and their subsidiaries) to provide insurance as principal and the regulation of the retail sale of insurance products by, or on the premises of, insured depository institutions. It also addresses the circumstances under which a mutual insurance company may change its state of incorporation for the purpose of reorganizing into a stock insurer controlled by a mutual holding company. In addition, Title III authorizes the creation of a new self-regulatory organization—the National Association of Registered Agents and Brokers—to establish uniform criteria for the qualification, training, and continuing education of insurance agents and brokers.

### *Insurance Underwriting Activities of National Banks*

Title III generally prohibits national banks and their subsidiaries from underwriting insurance and providing or issuing annuities. National banks and their subsidiaries may continue to underwrite only those types of insurance that national banks were permitted to underwrite as of January 1, 1999. Title III establishes a procedure for determining whether financial products first offered after January 1, 1999, are banking products that national banks may provide as principal or are insurance products that they may not provide as principal. Special rules govern the ability of national banks (and their subsidiaries) to underwrite and sell title insurance.

### *Consumer Protection Regulations for Retail Insurance Sales*

Title III amends the Federal Deposit Insurance Act to require the federal banking agencies to issue (to the extent they deem appropriate) consumer protection regulations governing the retail sale of insurance products by, or on the premises of, insured depository institutions and their subsidiaries. The regulations must prohibit the illegal tying of bank and insurance products; require certain disclosures; prohibit misleading advertising; require, to the extent practicable, the separation of insurance sales and deposit-taking activities; and establish a process for receiving and processing consumer complaints alleging a violation of the regulations.

## Title IV

Title IV amends the Home Owners' Loan Act to close the unitary thrift loophole, which allowed commercial firms to control a federally insured savings association. It prohibits any company that acquired control of a savings association after May 4, 1999, from engaging in commercial activities. Companies that controlled only a single savings association before May 4, 1999 (or pursuant to an application filed before that date), may continue to engage in any type of financial or commercial activity.

## Title V

Title V requires that financial institutions (as defined in the GLB Act) disclose to their customers, at the time a customer relationship is established, the institution's policies regarding the disclosure of confidential customer information to affiliates and third parties. It also generally prohibits a financial institution from disclosing any nonpublic personal information about a consumer to an unaffiliated third party unless the institution informs the consumer that such information may be shared with third parties and allows the consumer to "opt out" of such sharing arrangements. In addition, Title V prohibits financial institutions from disclosing a customer's account number or access code for a deposit, transaction, or credit card account to unaffiliated third parties for use in marketing programs.

Title V also prohibits persons, with certain exceptions, from obtaining customer information from a financial institution (as defined in the GLB Act), or from a customer of a financial institution, through the use of false, fictitious, or fraudulent statements or representations.

## Title VI

Title VI effects a number of changes in the organization, membership, and powers of the Federal Home Loan Bank (FHLB) System. For example, Title VI amends the Federal Home Loan Act to permit insured depository institutions having less than $500 million in assets to become a member of the FHLB System without satisfying the qualified thrift lender test. It also amends that act to allow the FHLB System to make long-term advances to insured depository institutions having less than $500 million in assets for purposes of funding small businesses, small farms, and small agribusinesses.

## Title VII

Title VII makes a number of miscellaneous amendments to the federal banking laws and mandates a number of studies.

### *CRA Sunshine Provisions*

Title VII amends the Federal Deposit Insurance Act to require that the parties to certain agreements related to the Community Reinvestment Act (CRA) disclose the agreement to the public and the appropriate federal banking agency, and report annually to the appropriate federal banking agency on any payments made or actions taken pursuant to the agreement. It exempts certain types of agreements from coverage as a CRA-related agreement, including individual mortgage loans and agreements entered into by an insured depository institution (or affiliate) with an entity or person that has not commented or testified on the CRA or discussed or contacted the institution or affiliate concerning the CRA.

### *Small Bank CRA Examination Cycle*

Title VII establishes a four-year CRA examination cycle for small insured depository institutions ($250 million or less in total assets) that received a "satisfactory" rating at their most recent CRA examination, and a five-year cycle for small institutions that received an "outstanding" rating at their most recent examination. However, the Board and the other federal banking agencies may conduct a CRA examination of a small insured depository institution at any time for reasonable cause or in connection with an application by the institution to establish a deposit facility.

### *Federal Reserve CRA Study*

Title VII directs the Board to conduct a comprehensive study of the Community Reinvestment Act, focusing on the default, delinquency, and profitability of loans made in conformity with that act. In conducting the study, the Board must consult with the chairmen of and ranking members of the House Committee on Banking and Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs.

### *ATM Fee Disclosure*

Title VII amends the Electronic Funds Transfer Act to require that automatic teller machine (ATM) operators imposing an ATM surcharge prominently post a notice to that effect on or at the ATM and inform consumers (through an on-screen message or paper receipt) of the surcharge amount before the consumer is irrevocably committed to completing the transaction. Issuers of ATM cards must also inform consumers at the time a card is issued that a surcharge may be imposed by a third party.

*Plain Language Requirement*

Title VII requires that the federal banking agencies use ‘‘plain language’’ in drafting all proposed and final rules to be published in the *Federal Register* .

*Audits of the Federal Reserve Banks and the Board*

Title VII amends the Federal Reserve Act to require that the Board obtain an annual independent audit of the financial statements of the Board and each Federal Reserve Bank.

*Authorization to Release Reports*

Title VII amends the Federal Reserve Act to allow the Board to release confidential supervisory information concerning any entity subject to examination by the Board to any other federal or state agency with supervisory authority over the entity; any officer, director or receiver of the entity; and any other person that the Board determines to be proper.

## Federal Reserve Retirement Portability Act

On December 12, 1999, the President signed the Federal Reserve Retirement Portability Act, Public Law 106-168, which amends the Federal Employee Retirement System Act of 1986. Under the amendment, employees who worked for the Board of Governors after 1988 and participated in the ‘‘Bank’’ Benefit Structure of the Retirement Plan for Employees of the Federal Reserve System may transfer retirement credit for this service to the Federal Employees Retirement System if they later work for a federal government agency. The act also allows employees transferring to the Board from other federal agencies to withdraw their funds from the Federal Thrift Savings Plan and roll the funds over to the Board’s Thrift Plan.

## Consolidated Appropriation for Fiscal Year 2000

The Consolidated Appropriation for Fiscal Year 2000, Public Law 106-168, was enacted on December 12, 1999. A section of the act amends the Federal Reserve Act to require the Federal Reserve Banks to transfer $3,752,000,000 from their surplus funds to the Board for transfer to the general fund of the Treasury. The amendment authorizes the Board to determine the amount that each Federal Reserve Bank must pay in fiscal year 2000. It also prohibits any Federal Reserve Bank from replenishing its surplus fund by the amount of any transfer it makes under this section.

## Act to Amend the Federal Reserve Act

On December 6, 1999, the President signed Public Law 106-122, which amends the Federal Reserve Act to expand the types of instruments a Federal Reserve Bank may tender as collateral security to obtain Federal Reserve notes. Under this amendment, acceptable forms of collateral are expanded to include loans made under section 10B of the Federal Reserve Act. This amendment increases the Federal Reserve System’s flexibility in providing discount window credit while continuing to meet its obligations to collateralize Federal Reserve notes. ■

# Regulatory Simplification

In 1978 the Board of Governors established a program of regulatory review to help minimize the burden of regulation on banking organizations. The objectives of the program are to ensure that all regulations, existing and proposed, represent the best course of action; to afford interested parties the opportunity to participate in the design of regulations and to comment on them; and to ensure that regulations are written in simple, clear language. Staff members regularly review Federal Reserve regulations for their adherence to these objectives and their consistency with the Regulatory Flexibility Act, which also requires that consideration be given to the economic consequences of regulation on small business. In its review process, the Board also follows the mandates of section 303 of the Riegle Community Development and Regulatory Improvement Act.

In 1999 the Board, as part of this review process, proposed revisions to Regulation B. It also proposed revisions to several consumer protection regulations to permit the electronic delivery of disclosures that are required to be given in writing. In addition, it amended Regulation A to establish a special lending program to accommodate liquidity needs during the century data change period.

## *Comprehensive Revisions Proposed*

### Regulation B

In August the Board published proposed revisions to Regulation B, which implements the Equal Credit Opportunity Act. The act makes it unlawful for creditors to discriminate against applicants on the basis of race, color, religion, national origin, marital status, sex, age, and other specified bases. The Board began the process of reviewing the regulation by issuing an advance notice of proposed rulemaking in March 1998; the proposed revisions take into account comments received at that time.

The proposed revisions would remove the general prohibition against creditors noting characteristics of applicants for nonmortgage credit such as race, sex, and national origin; they would not remove the prohibition against taking such information into account when extending credit. Creditors that choose to collect such information would be required to disclose that fact to applicants, and the proposal includes a model disclosure form. The revisions would require creditors to retain certain records concerning preapproved credit solicitations and would lengthen from twelve to twenty-five months the record-retention period for most applications for business credit.

## *Other Regulatory Activity*

### Electronic Disclosure

In August the Board issued for comment proposals that would permit financial institutions and others to provide federally mandated disclosures to consumers by electronic communication if the consumer consents. The proposals are modified from proposed rules (and an interim rule under Regulation E) issued in March 1998. They would authorize the electronic delivery of disclosures that under Regulations B (Equal Credit Opportunity), E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings) must be given in writing.

The proposals are an outgrowth of the 1996 comprehensive review of Regulation E, during which the Board determined that electronic communication of information required by federal laws governing financial services could reduce compliance costs without adversely affecting consumer protections.

With some exceptions, before obtaining a consumer's consent, financial institutions and others would have to provide to the consumer—through a standardized disclosure statement—certain information about electronic disclosures, including what type of disclosures would be provided electronically and how the consumer could receive and retain the disclosures.

Electronic disclosures could be delivered to a consumer's e-mail address or made available at another location such as an institution's web site. If an institution chooses to make disclosures available at a web site, it must notify a consumer when the information has been posted.

The proposals generally would require that when business is transacted in person, as is typical for mortgage loan closings, automobile loans and leases, and door-to-door sales involving credit, disclosures be made on paper. Most other disclosures could be delivered electronically, if the institution provides the disclosure statement about electronic delivery and obtains both the consumer's consent and the consumer's confirmation that his or her computer equipment meets the technical requirements necessary to receive and retain electronic disclosures.

## Century Date Change Special Liquidity Facility

In July the Board amended Regulation A (Extensions of Credit by Federal Reserve Banks) to establish a special lending program to be in effect from October 1, 1999, through April 7, 2000. Under the program, Federal Reserve Banks could extend credit at a rate 150 basis points above the Federal Open Market Committee's targeted federal funds rate to eligible depository institutions to accommodate liquidity needs during the century date change period.

The special credit facility was designed to ensure that depository institutions would have adequate liquidity to meet any unusual demands during the period around the century date change. Among other things, it was intended to increase institutions' confidence in committing to supplying loans to other financial institutions and businesses through the rollover period.

In setting the interest rate on the loans at 150 basis points above the federal funds rate target, the Board judged that the spread was high enough to ensure that depository institutions would still have an incentive to seek funds in the private sector but low enough to provide a reasonable backstop should strains develop in funding and credit markets. The Board imposed no restrictions on the use and duration of the loans and applied the same collateral requirements as those for regular discount window loans. ■