Federal Reserve Operations

Consumer and Community Affairs

In 2001, the Division of Consumer and Community Affairs of the Federal Reserve Board was active in several important areas:

- Curbing abusive lending practices
- Fostering research in community development and consumer economics
- Preparing for a review of the regulations that implement the Community Reinvestment Act
- Expanding access to consumer information.

In addition, the division continued its work in drafting regulations that govern providers of consumer financial services; reviewing applications for mergers and acquisitions; monitoring fair lending activities and compliance with the Community Reinvestment Act; supporting community development activities throughout the System; analyzing data gathered under the Home Mortgage Disclosure Act; monitoring compliance with consumer protection regulations; and addressing consumer complaints.

Curbing Abusive Lending

In December, the Board of Governors revised the provisions of Regulation Z (Truth in Lending) that implement the Home Ownership and Equity Protection Act (HOEPA). Enacted in 1994 in response to evidence of abusive lending practices in the home-equity-lending markets, the act imposes substantive limitations on, and additional disclosure requirements in connection with, home equity loans that have interest rates above a certain level or fees above a certain amount. It also authorizes the Board to expand HOEPA's coverage to more loans and to prohibit certain acts and practices in mortgage lending. The Board had published proposed revisions to Regulation Z in December 2000.

The final revisions broaden the scope of loans subject to HOEPA's protections by adjusting the price triggers that determine coverage under the act. The rate-based trigger was lowered two percentage points for first-lien loans (from 10 to 8 percentage points) but was kept at 10 percentage points for subordinate-lien loans. The fee-based trigger was revised to count as fees any amounts paid at closing for optional credit insurance and similar debt-protection products obtained in connection with the mortgage.

The revisions also restrict certain acts and practices in home-secured transactions. For example, creditors may not refinance their HOEPA loans within one year of extension if the refinancing is not in the borrower's interest. To strengthen the existing prohibition against extending credit on the basis of homeowner equity without regard to ability to repay, creditors must verify and document the homeowner's repayment ability. The disclosures that must be given three days before closing to borrowers obtaining HOEPA-covered loans must state the total amount borrowed and must indicate whether that amount includes payment for optional credit insurance or similar products.

Fostering Research

The Federal Reserve continues to foster research in community development and consumer economics. In April, the System's Community Affairs Offices held a second biennial research conference, "Changing Financial Markets and Community Development." The conference featured the work of economists and other scholars on the delivery of financial services to lower-income populations and small businesses; presentations were made on the Community Reinvestment Act, predatory lending, credit scoring, wealth creation, and alternative financial services. The importance of financial literacy and consumer education was discussed by Board Chairman Alan Greenspan in his keynote address. The proceedings of the conference, including speeches, papers, and discussant statements, are available on the web site of the Federal Reserve Bank of Chicago, at http://www.chicagofed.org/cedric/2001/sessionone.cfm. Members of the Board's Community Affairs staff, in partnership with research colleagues at the Board and the Reserve Banks, are now planning for the 2003 research conference, which will focus on "Sustainable Community Development: What Works, What Doesn't, and Why."

Also during the year, the Reserve Banks sponsored programs focused on emerging issues in community development to encourage research and facilitate discussion among academics and practitioners. Topics included

- "Smart Growth and Community Development: Working Together Smartly" (Philadelphia, Richmond, and Atlanta Reserve Banks)
- "Smart Codes: A Local Perspective on Planning and Growth" (St. Louis Reserve Bank)
- "Making Small Cities and Towns Work" (Philadelphia and Richmond Reserve Banks)
- "New Roads and e-Roads: Market Innovations in Community Development" (Dallas Reserve Bank).

On the consumer economics side, members of the Board's Consumer Policies staff conducted research on a wide range of subjects. Studies on households with high-cost home-secured loans and consumers' choice of financial institutions for home-secured loans were conducted in support of the division's efforts to address concerns about abusive lending practices. Studies on low-income and underserved consumers, including research on reasons consumers do not have checking accounts and on changes in account ownership over time, supported Federal Reserve initiatives regarding financial access for the unbanked. Other research focused on electronic banking, consumers' complaints about credit card problems, consumers' satisfaction with the Federal Reserve's complaint process, and financial literacy. The division staff received an award from the Association for Financial Planning and Counseling Education for research on the ability of low-income households to save.

Preparing for the Community Reinvestment Act Review

The current regulations implementing the Community Reinvestment Act (CRA) were adopted in 1995 by the supervisory agencies that have CRA responsibilities—the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). The regulations reflect the agencies' efforts

to (1) emphasize an institution's actual performance in addressing its CRA responsibilities rather than the process, (2) promote consistency in evaluations, and (3) eliminate unnecessary burden on institutions. To this end, CRA examinations focus on the quantitative aspects of an institution's performance, such as the number and dollar amount of loans and investments made; they also include a review of qualitative aspects, such as whether the bank is innovative in meeting the credit needs of the community.

The regulations require large institutions to collect, report, and disclose data on small-business, small-farm, and community development loans and, for institutions already reporting Home Mortgage Disclosure Act data, data on home mortgage lending outside metropolitan areas.[1] Large retail institutions are evaluated on their record of providing loans, investments, and services to their communities. Small institutions, in contrast, are evaluated under a streamlined approach that focuses on their lending; some small institutions elect to have their investment and service activities reviewed as well in order to be considered for an "outstanding" CRA rating. The regulations also include a community development test for limited-purpose and wholesale banks and an option for any bank to be examined under a strategic plan.

When they adopted the regulations, the supervisory agencies committed to conducting a full review in 2002 to determine whether their stated goals are being achieved. The agencies began the review process in July 2001 by publishing an advance notice of proposed rulemaking.

By the end of 2001, the agencies had received approximately 400 comments in response to the notice. These comments will be taken into account in the agencies' analysis for determining whether regulatory changes are needed to increase the CRA regulations' effectiveness.

Expanding Access to Consumer Information

The Board substantially expanded the Spanish-language offerings of its consumer education program in 2001: Spanish-language versions of material on three subjects—mortgages, vehicle leasing, and consumer complaints—were launched on the Board's public web site, and Spanish-language versions of two consumer brochures—*Looking for the Best Mortgage* and *How to File a Consumer Complaint*—were released. The materials can be found at http://www.federalreserve.gov/consumers.htm.

In 2001, the Board also completed a major revision of its consumer brochure on credit cards, *Shop—The Credit Card You Pick Can Save You Money*, incorporating information on new disclosure requirements under Regulation Z and information from the re-instituted Survey of Credit Card Plans conducted by the Board. A design review of all the Board's consumer education publications is under way to ensure that the materials are meeting consumers' needs. In addition to enhancing its own consumer education program, the Board also worked with other agencies on resources to help consumers make decisions on financial privacy (see box) and avoid abusive lending practices.

In recognition of the importance of financial education in increasing economic opportunity, the Community

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1. A large institution is an institution that as of December 31 of the previous two calendar years either had total assets of $250 million or more or was affiliated with a holding company that had total banking and thrift assets of $1 billion or more.

Financial Information and Consumers' Rights to Privacy

> *Gramm–Leach–Bliley also contains very important and far-reaching privacy provisions. . . . Our objective is to devise disclosure requirements and consumer "opt-out" procedures that protect consumer privacy without overwhelmingly burdening financial institutions or consumers.*
>
> Laurence H. Meyer, *Member*, Board of Governors

July 1, 2001, marked the deadline for financial companies—banks, brokers, and insurance companies, among others—to provide privacy notices to their existing customers. Companies were required to tell their customers

- What kinds of personal information the company collects (for example, income, assets, and account balances)
- How the company uses the information, and whether it intends to make the information available to nonaffiliated third parties (such as mortgage brokers, direct marketers, or nonprofit organizations)
- What customers can do to limit some of that information sharing
- How the company safeguards personal nonpublic information against fraudulent access.

Consumers must now be given a privacy notice at the time they enter into a customer relationship with the company—for instance, when they open a checking account. And consumers, whether or not they have actually become "customers" (for example, consumers who have simply filled out an application), must be given a notice before their personal financial information is shared with a third party. In addition to this initial notice, customers, as long as they remain customers, must be given an annual notice describing the company's privacy policies and practices.

Consumers must be given an opportunity to tell the company not to share the information—that is, they must be allowed to "opt out." Opting out must be reasonably convenient—accomplished by checking a box on an application, returning a preaddressed reply form, or calling a toll-free telephone number, for example. And consumers must be allowed a "reasonable" length of time to respond (generally thirty days).

The opt-out right does not apply to all types of personal information. For example, it does not apply to a consumer's telephone number if that number is published in a telephone directory. The right also does not apply in certain situations—for example, consumers may not stop their banks from sharing information needed to process their credit card or check transactions, to comply with a court order, or to prevent fraud. A financial company may also disclose personal financial information to comply with federal, state, or local requirements—such as a local law requiring mortgage documents to be recorded in public records—without providing consumers an opt-out right.

Affairs Offices at the Board and the Reserve Banks offer resources and programs to promote personal financial literacy skills. In 2001, the Community Affairs staff at the Board organized workshops for Board employees on preparation for home ownership and on the effective use of credit. The Dallas Reserve Bank launched an interactive web-based version of *Building Wealth: A Beginner's Guide to Securing Your Financial Future*, a program to help

Origins of the New Rights to Financial Privacy

Financial companies share information about customers for a variety of reasons. In some instances, they may do so simply in the course of providing basic services to their customers—when they process credit card payments or arrange for the printing of personalized checks, for example. They may also use the information in offering additional services or introducing new banking products. Some consumers want to take advantage of these opportunities and are willing to have their personal financial information shared with third parties. Others prefer to limit the promotional materials they receive and do not want marketers and others to have such information.

Concern about consumer privacy led to passage of federal legislation governing the protection and disclosure of nonpublic personal information by financial companies as part of the Gramm–Leach–Bliley Act. Regulations implementing the act's privacy provisions were issued in June 2000 and became effective the following November. Eight federal agencies have responsibilities for enforcing the privacy provisions: the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (which collectively make up the Federal Financial Institutions Examination Council, or FFIEC); the Securities and Exchange Commission; the Federal Trade Commission; and the Commodity Futures Trading Commission.

Compliance with the Privacy Provisions

Financial companies supervised by the FFIEC agencies are subject to examination to ensure that they are complying with the provisions of the Gramm–Leach–Bliley Act. Examination procedures were developed by the FFIEC, and examinations began in July 2001 as part of regular consumer compliance examinations. As of the end of 2001, few violations had been found. Of those that were found, many concerned not giving notices on time or giving notices that did not contain all of the necessary information.

To help financial institutions in their efforts, the Board, working with the other agencies, has issued a set of frequently asked questions for financial institutions (available at http://www.federalreserve.gov/boarddocs/press/general/2001/200112122/attachment.pdf).

The eight federal agencies hosted a daylong workshop, "Get Noticed: Effective Financial Privacy Notices," in December 2001 to discuss how financial institutions can provide consumers with more effective notice of their privacy policies and practices. Information on the workshop is available at http://www.ftc.gov/bcp/workshops/glb/index.html.

Consumer Education

The Board and the other agencies have prepared information for consumers explaining their financial privacy rights under Gramm–Leach–Bliley. The information is available at http://www.federalreserve.gov/pubs/privacy.

consumers develop a plan for building personal wealth that includes setting financial goals, budgeting, saving and investing, and managing debt (http://www.dallasfed.org/htm/wealth/index.html). The Cleveland Reserve Bank continues to support the Consumer Federation of America's "Cleveland Saves" program to help low- and moderate-income families create personal savings plans. The New York and San Francisco Reserve Banks, in cooperation with a

national nonprofit organization dedicated to the economic self-sufficiency of inner-city residents, are developing programs focused on enhancing economic as well as computer literacy.

Regulatory Matters

In March 2001, the Board revised Regulation E to implement amendments to the Electronic Fund Transfer Act concerning ATM fees. Under the amendments, ATM operators that impose a fee on consumers for providing electronic fund transfer (EFT) services must post a notice to that effect in a prominent location on or at the ATM where the transfer is initiated. Before a consumer commits to completing the transaction, the operator must disclose that a fee will be imposed and the amount of the fee. When a consumer contracts with a financial institution for an EFT service, such as obtaining an ATM or debit card, the institution's initial disclosures must include notice that a fee may be charged for transfers initiated at an ATM operated by another entity.

Also in March, the Board published interim rules establishing standards for the electronic delivery of federally mandated disclosures under five consumer protection regulations: Regulation B (Equal Credit Opportunity), Regulation E (Electronic Fund Transfers), Regulation M (Consumer Leasing), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings). In keeping with the Electronic Signatures in Global and National Commerce Act (the "E–Sign Act"), which was enacted in June 2000, financial institutions, creditors, and others may, under the Board's interim rules, deliver disclosures electronically if they obtain the consumer's consent. The interim rules are not final; they serve as guidance until final rules are adopted.

In addition to these rulemaking activities, the Board took the following regulatory and interpretive actions during the year:

- Raised from $465 to $480 the total dollar amount of points and fees that trigger additional requirements for certain mortgage loans under HOEPA, to reflect changes in the consumer price index (CPI), effective in January 2002

- Increased from $31 million to $32 million the exemption threshold for depository institutions required to collect data in the year 2002 under the Home Mortgage Disclosure Act, to reflect changes in the consumer price index for urban wage earners and clerical workers (CPI–W), as prescribed by the statute

- Revised the official staff commentary for Regulation E to provide guidance on transactions that involve electronic check conversion, whereby a consumer authorizes a merchant's use of a check to capture encoded information that is then used to initiate an electronic debit from the consumer's account. The commentary revisions also provide guidance on computer-initiated bill payments, the authorization of recurring debits from a consumer's account, and telephone-initiated transfers.

CRA Bank Examinations and Activities

The Community Reinvestment Act requires the Board and other banking agencies to encourage financial institutions to help meet the credit needs of the local communities in which they do business, consistent with safe and sound business practices. To carry out this

mandate, the Federal Reserve has a three-faceted program that includes

- Examining institutions to assess compliance with the CRA
- Analyzing applications for mergers and acquisitions from state member banks and bank holding companies in relation to CRA performance
- Disseminating information on community development techniques to bankers and the public through Community Affairs Offices at the Reserve Banks.

Examinations for Compliance with the CRA

The Federal Reserve assesses the CRA performance of state member banks during regularly scheduled examinations for compliance with consumer protection regulations. By law, small banks (banks with assets of less then $250 million) that are rated "satisfactory" for CRA performance are examined not more than once every forty-eight months, and those that are rated "outstanding" for CRA purposes are examined not more than once every sixty months. During the 2001 reporting period, the Federal Reserve conducted 183 CRA examinations.[2] Of the banks examined, 29 were rated "outstanding" in meeting community credit needs, 151 were rated "satisfactory," 1 was rated "needs to improve," and 2 were rated as being in "substantial noncompliance."

Also during 2001, the Federal Reserve worked with the other agencies that have CRA responsibilities (the FDIC, OCC, and OTS) and issued the Board's Regulation G (Disclosure and Reporting of CRA-Related Agreements), the implementing regulation for the CRA Sunshine provisions of the Gramm–Leach–Bliley Act. The act requires insured depository institutions and nongovernmental entities or persons who are parties to CRA-related agreements to make certain of those agreements public and to file annual reports about their activities under the agreements.

2. The 2001 reporting period was from July 1, 2000, through June 30, 2001.

Analysis of Applications in Relation to CRA Performance

Actions on bank and bank holding company applications during 2001 included the following:

- In February, the Board approved an application by FleetBoston Corp. (Boston, Mass.) to acquire Summit Bancorp (Princeton, N.J.).
- Also in February, the Board approved an application by MetLife, Inc. (New York, N.Y.), to become a bank holding company by acquiring Grand Bank, N.A. (Kingston, N.J.). This was the first application by an insurance company to become simultaneously a bank holding company and a financial holding company under the Gramm–Leach–Bliley Act.
- In April, the Board approved an application by Countrywide Credit Industries, Inc. (Calabasas, Calif.), to acquire Treasury Bank, Ltd. (Washington, D.C.). This was the first application by a nonbanking financial company engaged primarily in mortgage banking activities to become simultaneously a bank holding company and a financial holding company under the Gramm–Leach–Bliley Act.
- In July, the Board approved an application by Citigroup, Inc. (New York,

N.Y.), to acquire European American Bank (Uniondale, N.Y.).

- Also in July, the Board approved an application by Citigroup, Inc. (New York, N.Y.), to acquire Grupo Financiero Banamex Accival, S.A. de C.V. and Banco Nacional de Mexico, S.A. (both in Mexico City, Mexico).

- In August, the Board approved an application by First Union Corp. (Charlotte, N.C.) to acquire Wachovia Corp. (Winston–Salem, N.C.). SunTrust Banks, Inc. (Atlanta, Ga.), submitted a competing bid for Wachovia, which it withdrew after Wachovia shareholders voted against SunTrust's proposal.

Comments from the public on each of these applications in relation to CRA performance raised allegations primarily about predatory lending, insufficient lending to lower-income areas, or inadequate banking services in lower-income areas. In each case, the Board found that the CRA records of the depository institutions were consistent with approval. In the case of the acquisition of European American Bank, the Board ordered an on-site examination of Citigroup's subprime-lending affiliates. The Board also stipulated that Citigroup must report quarterly for two years on the status of litigation involving subprime lending and on their compliance with court orders or court-approved settlements.

During the year, the Board acted on fourteen other bank and bank holding company applications that involved protests by members of the public concerning the performance of insured depository institutions in relation to the CRA. The Federal Reserve also reviewed three applications involving institutions having less than "satisfactory" CRA ratings (that is, "needs to improve" or "substantial noncompliance") and another thirty-nine applications involving other issues related to the CRA, fair lending, or compliance with consumer credit protection laws.[3]

Dissemination of Community Development Information

The Community Affairs Offices at the Reserve Banks continue to hold regular roundtable discussions with financial institutions in their Districts on issues related to the Community Reinvestment Act and community development. During 2001, some of the Banks sponsored training for lenders and community groups on the disclosure and reporting requirements for CRA-related agreements. (Also see the next section, "Community Affairs.")

Community Affairs

The System's Community Affairs program supports the economic growth objectives of the Federal Reserve by providing information and technical assistance to facilitate efficient markets in historically underserved communities. The year 2001 marked twenty years since the program's inception.

Community Affairs Offices throughout the System continued outreach activities and programs in rural markets. The Federal Reserve Banks of Atlanta, Cleveland, Richmond, Kansas City, and Minneapolis sponsored conferences to foster workforce development and encourage integration of community-

3. In addition, one application involving a CRA protest, another application involving an adverse CRA rating, and nine applications involving other CRA issues, fair lending issues, or compliance with consumer credit protection regulations were withdrawn in 2001.

based research, policies, and practices with community development activities. The Board's staff continued to work with the Rural Home Loan Partnership, an interagency group committed to increasing affordable housing in rural communities.

The San Francisco, Minneapolis, and Chicago Reserve Banks convened meetings and workshops for bankers, developers, and tribal representatives to provide information on the legal and policy aspects of financing housing and small businesses on Native American tribal lands. The Board's Community Affairs staff continued to participate in a task force with representatives of other federal agencies, nonprofit organizations, financial institutions, and other entities to promote financial literacy programs for members of Native American communities.

Recognizing the importance of support services to workforce development, the Community Affairs Offices participated in programs to improve access to child care. The Seattle Branch of the San Francisco Reserve Bank facilitated development of a micro-loan fund for child-care providers unable to secure conventional lending, and the New York and Philadelphia Reserve Banks sponsored a conference on investment and lending models for child-care facilities.

The Community Affairs program has expanded its reach to diverse communities and populations through effective use of information technology and communication tools. The Boston Reserve Bank cosponsors a web site to support faith-based community developers (http://www.faithandcommunityatwork.com), and the Dallas Reserve Bank publishes *e–Perspectives*, an electronic version of its community affairs newsletter (http://www.dallasfed.org / htm / pubs / perspectonline.html).

The preservation of affordable housing remains a central concern of the Community Affairs program. During 2001, Board staff served in various capacities to support housing activities conducted by external partners. They served as liaison to the advisory board for the Local Initiatives Support Corporation's Center for Home Ownership and assisted with planning an annual summit on housing issues. They also provided support to Board member Edward Gramlich, who chairs the board of directors of the Neighborhood Reinvestment Corporation—a national nonprofit organization charged by the Congress with revitalizing older, distressed communities.

Also during the year, the Board's Community Affairs Office engaged in interagency efforts to raise awareness of issues having national scope. For example, staff members worked with other agencies to publish *Crossing the Bridge to Self-Employment: A Federal Microenterprise Resource Guide*.

Through the programs described above, the Federal Reserve System during 2001 sponsored more than 300 conferences and workshops, conducted approximately 1,500 outreach meetings, facilitated research, and distributed more than 250,000 community economic development publications.

Consumer Advisory Council

The Consumer Advisory Council, whose members represent consumer and community organizations, the financial services industry, academic institutions, and state agencies, advises the Board of Governors on matters concerning laws that the Board administers and other issues related to consumer financial services. Council meetings are open to the public.

In 2001, the Council met in March, June, and October. The rules implementing the Community Reinvestment Act, scheduled for review by banking and thrift institution regulators in 2002, were a major topic at all three meetings. In March and June, Council members commented on the definition of "assessment area," the investment test, and the service test. They agreed that the assessment area definition needs to recognize that technological change has affected how and where financial institutions conduct business. Regarding the investment and service tests, members concluded that investments are important but challenging and difficult to make and that the service test provides opportunities for lenders to find innovative ways to serve communities and build banking relationships. In October, members offered views on the definition of small-business and community-development lending and on whether loan originations should receive more credit than loan purchases under the lending test.

The proposed amendments to Regulation Z, designed to broaden the scope of mortgage loans subject to the Home Ownership and Equity Protection Act, were a key topic at the March and June meetings. In March, Council members discussed expanding the dollar test applied to the points and fees trigger to include amounts paid at loan closing for single-premium credit life insurance. The June discussion focused on a proposal that creditors be prohibited from refinancing a zero-interest or low-interest loan into a higher-rate loan during the first five years of the loan unless the refinancing is in the borrower's interest; members considered the difficulty of defining "borrower's interest" and of identifying low-cost loans.

In March and June, the Council discussed the Board's proposed changes to Regulation C to improve the quality, clarity, and utility of data collected under the Home Mortgage Disclosure Act. At both meetings, members focused on the proposed requirements regarding the reporting of the annual percentage rate (APR) on home mortgage loans and discussed the burdens and benefits of having lenders report pricing and other data. Some members asserted that the reliability and validity of APR data for pricing analysis was questionable, but others believed that the reporting of the data would facilitate public debate and enable pricing concerns to be more readily addressed.

Also discussed during 2001 were the interim final rules governing the electronic delivery of disclosures required under Regulations B (Equal Credit Opportunity), E (Electronic Fund Transfers), M (Consumer Leasing), Z (Truth in Lending), and DD (Truth in Savings). In June and October, Council members discussed the requirement that an e-mail message be sent to the consumer when a disclosure is placed on a company's web site and supported flexibility in the rules for delivery of these alerts. They also discussed the challenges of re-delivering returned e-mail messages and provided differing views on the requirement that an institution maintain disclosures on a web site for ninety days.

In October, the Council began to identify issues for an upcoming review by the Board of Regulation Z. Members discussed the differences in disclosure requirements for open- and closed-end lending and noted that greater flexibility exists for open-end disclosures. Future discussions will focus on the types of disclosures that are important for credit card products and on streamlining the disclosures for closed-end mortgage loans to facilitate consumer comparisons of loan costs among lenders.

HMDA Data and Mortgage Lending Patterns

The Home Mortgage Disclosure Act requires that mortgage lenders covered by the act 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, met the asset threshold at the end of the preceding year, and originated at least one home purchase loan (or refinancing) in the preceding year. For 2000, the asset threshold was $30 million; for 2001, it was $31 million. Mortgage companies are covered if (1) they were located in or made loans in metropolitan areas, (2) had assets of more than $10 million (when combined with the assets of any parent company) at the end of the preceding year or originated 100 or more home purchase loans and refinancings in the preceding year, and (3) their home purchase loans (and refinancings) accounted for 10 percent or more of their total loans by dollar volume.

In 2001, a total of 6,704 depository institutions and affiliated mortgage companies and 1,009 independent mortgage companies reported HMDA data for calendar year 2000. Lenders submitted information about the geographic location of the properties related to loans and loan 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 (FFIEC) processed the data and produced disclosure statements on behalf of the Department of Housing and Urban Development (HUD) and the FFIEC member agencies.[4]

The FFIEC prepared individual disclosure statements for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity. In 2001, the FFIEC prepared 52,776 disclosure statements, reporting data for calendar year 2000. Each institution made its disclosure statement public in July, 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 by the FFIEC member agencies, the reporting institutions, the public, the Department of Justice, and HUD. 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.[5]

The data reported for 2000 covered 19.2 million loans and applications, about 16 percent fewer than in 1999. The decline was due primarily to a decline of about 30 percent in refinancing activity. The number of home purchase loans extended in 2000 compared with 1999 increased 8 percent for Asians and 7 percent for Hispanics but fell 1 percent for blacks, 5 percent for Native Americans, and 6 percent for whites. Between 1993 and 2000, the number of home purchase loans extended increased 138 percent for Hispanics, 109 percent for Native Ameri-

4. The FFIEC member agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration.

5. On behalf of the nation's seven 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.

cans, 89 percent for blacks, 84 percent for Asians, and 25 percent for whites.

For most income categories, the number of home purchase loans extended was lower in 2000 than in 1999; the number made to lower-income applicants fell 4 percent, but the number made to upper-income applicants rose 3 percent. From 1993 through 2000, the number of home purchase loans to lower-income and upper-income applicants increased 79 percent and 56 percent respectively.

In 2000, 31 percent of Hispanic applicants and 27 percent of black applicants for home purchase loans sought government-backed mortgages; the comparable figure for white and Native American applicants was 14 percent, and for Asian applicants 9 percent. Twenty-five percent of lower-income applicants for home purchase loans, compared with 9 percent of upper-income applicants, applied for government-backed mortgages.

Overall, the denial rate for conventional (that is, non-government-backed) home purchase loans was 27 percent in 2000. The rate rose steadily from 1993 through 1998 but has now fallen slightly (about 1 percentage point) for the second consecutive year. Denial rates for conventional home purchase loans in 2000 were 45 percent for black applicants, 42 percent for Native American applicants, 31 percent for Hispanic applicants, 22 percent for white applicants, and 12 percent for Asian applicants. Except for Asian applicants, each of these rates was lower than the comparable rate for 1999.

Economic Effects of the Electronic Fund Transfer Act

As required by the Electronic Fund Transfer Act (EFTA), the Board monitors the effects of the act on institutions' costs as well as the benefits of the act for consumers.

The proportion of U.S. households using EFT services has grown over the past decade at an annual rate of 3 percent, according to data from the Survey of Consumer Finances (the most recent data available from these triennial surveys were gathered in 1998; data from the 2001 survey are not yet available). Approximately 85 percent of households use one or more EFT services—for example, they use an ATM or debit card, direct deposit, or direct payment.

Automated teller machines remain the most widely used EFT service. About two-thirds of U.S. households have an ATM card. In 2001, the average number of ATM transactions a month exceeded 1.1 billion, a slight increase over the preceding year. The number of installed ATMs rose about 19 percent, to about 324,000.

Direct deposit is also widely used. About 60 percent of U.S. households have funds deposited directly into their transaction accounts (checking or savings). Use of the service is particularly common in the public sector, accounting for 78 percent of social security payments, 98 percent of federal salary and retirement payments, and 33 percent of federal income tax refunds during fiscal year 2001.

A less widely used EFT payment mechanism is direct bill-paying. About 36 percent of U.S. households have payments automatically deducted from their transaction accounts.

About one-third of U.S. households have debit cards, which are used at merchant terminals to debit their transaction accounts. Point-of-sale (POS) systems account for a fairly small share of electronic transactions, but their use continued to grow rapidly in 2001. From 2000 to 2001, the average number of POS transactions a month rose about 34 per-

cent, from about 258.9 million to about 348.0 million, and the number of POS terminals rose about 30 percent, to about 3.6 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 act to consumers are also difficult to measure, because the protections afforded by the act cannot be isolated from protections that would have been provided in the absence of regulation. The available evidence suggests that there have been no serious consumer problems in relation to the act (see the section "Agency Reports on Compliance with Consumer Protection Laws and Regulations").

Compliance Activities

The Federal Reserve conducts compliance examinations to carry out its responsibility for ensuring that state member banks and certain foreign banking organizations comply with federal laws and regulations concerning fair lending and consumer protections. The Board provides consumer compliance training for the System's specialized examiners and participates in compliance-related activities of the Federal Financial Institutions Examination Council.

Compliance Examinations

During the 2001 reporting period (July 1, 2000, through June 30, 2001), the Federal Reserve conducted 343 consumer compliance examinations—261 examinations of state member banks and 82 examinations of foreign banking organizations.[6] To ensure that supervisory resources are targeting higher-risk areas, a consumer compliance risk-focused supervision program was fully implemented in 2001. The program emphasizes evaluating the appropriateness of an institution's risk-management practices and tailors supervisory activities to fit the institution's risk profile. The program also incorporates various monitoring procedures that are designed to identify high-risk institutions and to facilitate a more continuous supervisory process.

Fair Lending

Pursuant to a 1991 amendment to the Equal Credit Opportunity Act, the Board refers to the Department of Justice any violation of the act that it has reason to believe constitutes a "pattern or practice" of discrimination. During 2001 the Board referred one case involving disparate treatment in the underwriting of automobile loans.

In May the Board supplemented the interagency procedures for fair lending examinations by adopting alternative procedures for banks having low-discrimination-risk profiles. Typically, such banks are stable community banks, commonly specializing in commercial or agricultural lending, that are located in suburban or rural markets having a low percentage of minority residents. The alternative procedures are expected to reduce the resources devoted to these banks and to facilitate the allocation of resources for more intensive analysis of higher-risk institutions.

6. 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 engage in relatively few activities that are covered by consumer protection laws.

Examiner Training

Reserve Bank examiners receive training in consumer protection laws, fair lending laws, and the Community Reinvestment Act as well as in complaint analysis and investigation. During the 2001 reporting period, 221 examiners were trained in thirteen sessions of varying lengths. Offerings included basic and advanced compliance courses and courses on fair lending, the Community Reinvestment Act, and commercial lending. The consumer compliance curriculum is continually monitored and updated to reflect regulatory and marketplace changes.

Participation in FFIEC Activities

Through cooperation among its member agencies, the FFIEC develops uniform examination principles, standards, procedures, and report formats. In 2001, the FFIEC issued a revised report format and standardized tables for use in CRA performance evaluations; host-state loan-to-deposit ratios for determining compliance with section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994; and documents providing answers to frequently asked questions about Regulation P (Consumer Privacy) and the CRA.

Agency Reports on Compliance with Consumer Protection Laws and Regulations

The Board is required to report annually on compliance with consumer protection laws and regulations by entities supervised by the various federal agencies. Summarized in this section are data collected from the twelve Federal Reserve Banks, the FFIEC member agencies, and other federal supervisory agencies.[7]

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 83 percent of the institutions examined during the 2001 reporting period were in compliance with Regulation B, compared with 81 percent for the 2000 reporting period. Of the institutions not in full compliance, 20 percent had five or fewer 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, and the name and address of the federal agency that enforces compliance
- Provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the adverse action
- Collect information for monitoring purposes about the race or national origin, sex, marital status, and age of the 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.

Four formal enforcement actions containing provisions relating to Regula-

7. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2001 reporting period was from July 1, 2000, through June 30, 2001.

tion B were issued during the 2001 reporting period—three by the FDIC and one by the OCC. The Federal Trade Commission (FTC) filed one action and continued other litigation against two mortgage lenders for alleged violations of the Equal Credit Opportunity Act (ECOA). The alleged violations include, among other things, failing to take written applications for mortgage loans, failing to provide rejected applicants with written notice of adverse action, and failing to collect required information about the race or national origin, sex, marital status, and age of applicants.

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 (SBA), 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 violations of the ECOA mostly attributable to creditors' failure to collect information for monitoring purposes and failure to comply with rules regarding adverse action notices. No formal enforcement actions containing provisions relating to Regulation B were initiated by these agencies.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 2001 reporting period were in compliance with Regulation E, compared with 94 percent for the 2000 reporting period. The most frequent violations involved the failure to comply with the following requirements:

- Investigate an alleged error promptly after receiving a notice of error
- Determine whether an error actually occurred, and transmit the results of the investigation and determination to the consumer within ten business days
- Credit the customer's account in the amount of the alleged error within ten business days of receiving the error notice if more time is needed to conduct the investigation
- Provide initial disclosures at the time a consumer contracts for an electronic fund transfer service or before the first electronic fund transfer involving the consumer's account is made.

In 2001, the FDIC issued three formal enforcement actions containing provisions relating to Regulation E. The FTC continued its efforts to educate consumers and businesses in this area and released a new brochure, *Electronic Check Conversion*, that gives consumers information about this new form of electronic banking.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2001 reporting period were in full compliance with Regulation M. This level of compliance is comparable to the level during the 2000 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The agencies did not issue any formal enforcement actions containing provisions relating to Regulation M.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 79 percent of the institutions examined during the 2001 reporting period were in compliance with Regulation Z, compared with 77 percent for the 2000 reporting period. Of the institutions not in full compliance, 75 percent had five or fewer violations, compared with 64 percent in 2000. The most frequent violations involved the failure to take one or more of the following actions:

- Accurately disclose the finance charge, payment schedule, annual percentage rate, security interest in collateral, or amount financed
- Disclose the annual percentage rate on a periodic statement using the term "annual percentage rate"
- Provide disclosures within three business days of application as required for applications for residential mortgages covered by the Real Estate Settlement Procedures Act
- Ensure that disclosures reflect the terms of the legal obligation between the parties
- Provide the index value for adjustments to variable-rate loans.

Four formal enforcement actions containing provisions relating to Regulation Z were issued during the 2001 reporting period—three by the FDIC and one by the OCC. In addition, 218 institutions supervised by the Federal Reserve, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund a total of approximately $891,000 to consumers in 2001 because of improper disclosures.

In 2001, the FTC continued its efforts to curb abusive practices by some subprime mortgage lenders, initiating one new action and pursuing two ongoing litigations against mortgage lenders for alleged violations of the Truth and Lending Act (TILA) and the Home Ownership and Equity Protection Act. In addition, the FTC obtained settlements in two cases that alleged violations of the TILA and Regulation Z—one involving vacation travel packages and the other, Internet-access products and services.

The DOT is currently investigating cases involving four different air carriers regarding possible violations of the TILA. All four cases involve the timeliness of processing requests for credit card refunds. In 2001, 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 had 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.

Regulation AA (Unfair or Deceptive Acts or Practices)

The three banking regulators with responsibility for enforcing Regulation AA's Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—reported that 99 percent of institutions examined during the 2001 reporting period were in compliance. Of the institutions not in full compliance, the most frequently cited violations involved

- Failing to provide a clear, conspicuous disclosure regarding a cosigner's liability for a debt

- Entering into a consumer credit contract containing a nonpossessory security interest in household goods.

No formal enforcement actions containing provisions relating to Regulation AA were issued during the 2001 reporting period.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 88 percent of institutions examined during the 2001 reporting period were in compliance with Regulation DD. Of the institutions not in full compliance, the most frequently cited violations involved

- Advertisements that were inaccurate or misleading (or both)
- Use of the phrase "annual percentage yield" in an advertisement without disclosing additional terms and conditions of customer accounts
- Failure to provide all applicable information on account disclosures.

No formal enforcement actions containing provisions relating to Regulation DD were issued during the 2001 reporting period.

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency complaints it receives that involve other creditors and businesses.

During 2001, the Federal Reserve fully implemented an automated system for generating letters designed to help Reserve Banks expedite responses to consumer complaints. The letter-generation system is a component of the Complaints Analysis Evaluation System and Reports (CAESAR) database, which is used to track complaints and inquiries. The CAESAR system produces

Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System, 2001

Subject	State member banks	Other institutions[1]	Total
Regulation B (Equal Credit Opportunity)	59	27	86
Regulation E (Electronic Fund Transfers)	41	55	96
Regulation H (Bank Sales of Insurance)	0	0	0
Regulation M (Consumer Leasing)	0	1	1
Regulation P (Privacy of Consumer Financial Information)	14	19	33
Regulation Q (Payment of Interest)	0	0	0
Regulation Z (Truth in Lending)	300	560	860
Regulation BB (Community Reinvestment)	3	2	5
Regulation CC (Expedited Funds Availability)	22	28	50
Regulation DD (Truth in Savings)	38	55	93
Fair Credit Reporting Act	178	270	448
Fair Debt Collection Practices Act	8	13	21
Fair Housing Act	8	5	13
Flood insurance rules	2	5	7
Regulations T, U, and X	0	0	0
Real Estate Settlement Procedures Act	7	11	18
Unregulated practices	1,359	1,412	2,771
Total	**2,039**	**2,463**	**4,502**

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

Consumer Complaints Received by the Federal Reserve System, by Subject of Complaint, 2001

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	15	1	0	3	4	1
Credit cards	19	1	0	1	13	2
Other loans	25	1	1	8	5	0
Other type of complaint						
Real estate loans	22	1	1	7	10	0
Credit cards	797	39	7	25	213	460
Other loans	254	13	2	75	94	28
Deposits	608	30	5	99	257	112
Electronic fund transfers	41	2	0	5	17	7
Trust services	25	1	2	8	11	0
Other	233	11	12	75	79	18
Total	**2,039**	**100**	**30**	**306**	**703**	**628**

acknowledgment letters based on information maintained in the database but also allows Reserve Banks to tailor letters to particular circumstances.

Besides conducting training for Reserve Bank staff in complaint analysis and investigation during the year, Board staff also held sessions on the CAESAR query facility, which allows the System to track individual complaints as well as to aggregate data for purposes of trend analysis.

Also continuing in 2001 was the System's residency program for Reserve Bank staff who come to the Board for several weeks at a time to work with complaint staff on projects and to gain familiarity with complaint operations in Washington.

Complaints against State Member Banks

In 2001 the Federal Reserve received a total of 4,502 complaints—3,875 by mail, 545 by telephone, 10 in person, and 72 electronically via the Internet. Complaint volume was reduced in the fourth quarter because of problems in the national mail system, including mail facilities in the Washington metropolitan area.

About 45 percent of the complaints were against state member banks (see tables). Of the complaints against state member banks, 56 percent involved credit transactions: 3 percent alleged discrimination on a basis prohibited by law (race, color, religion, national

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	1	0	6	13	28
0	0	0	0	0	3	8	27
0	0	1	1	1	8	6	31
0	1	0	1	2	0	18	40
1	59	6	0	1	25	807	1,604
1	30	9	1	7	7	401	655
1	80	19	0	12	23	509	1,117
0	6	1	2	2	1	55	96
0	0	3	0	1	0	14	39
1	21	10	1	3	13	632	865
4	**197**	**49**	**7**	**29**	**86**	**2,463**	**4,502**

origin, sex, marital status, age, the fact that the applicant's income comes from a public assistance program, or the fact that the applicant has exercised any right under the Consumer Credit Protection Act), and 53 percent concerned other credit-related practices, such as the imposition of annual membership fees on credit card accounts, the amount of interest banks charge on credit card accounts, or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Thirty percent of the complaints against state member banks involved disputes about interest on deposits and general deposit account practices, and the remaining 14 percent concerned disputes about electronic fund transfers, trust services, or other practices. Information on the outcomes of the investigations of these complaints is provided in the table.

During 2001, the System completed investigations of 181 complaints against state member banks that were pending at year-end 2000 and found three violations of regulations. In the vast majority of cases, the banks had correctly handled customers' accounts; notwithstanding, banks chose to reimburse or otherwise accommodate consumers in more than half of these cases.

The Federal Reserve received more than 1,800 inquiries about consumer credit and banking policies and practices during the year. In responding to these inquiries, the Board and the Reserve Banks gave specific explana-

tions of laws, regulations, and banking practices and provided relevant printed materials on consumer issues.

To assess satisfaction with the System's handling of complaints, the Board sends complainants follow-up questionnaires. Because of mail disruptions during the fourth quarter of 2001, analysis of data for the entire year was impossible. However, data for the first three quarters show that consumers were satisfied or very satisfied with the System's handling of their complaints.

Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board continues to monitor complaints about banking practices that are not subject to existing regulations and to focus on those complaints that concern possible unfair or deceptive practices. In 2001 the Board received a wide range of complaints about unregulated practices. The category that received the most complaints involved credit cards: Consumers complained about penalty charges (125), interest rates and terms (118), other miscellaneous problems involving credit cards (113), and customer service problems (101). The remainder of the complaints concerned a wide range of unregulated practices in other areas, including such matters as check-cashing problems experienced by non–account holders, consumer dissatisfaction with reduced availability of branch tellers, and the marketing practice of banks' sending what appear to be "live" checks in the mail.

Complaint Referrals to HUD

In 2001 the Federal Reserve, in accordance with a memorandum of understanding between the Department of Housing and Urban Development and the federal bank regulatory agencies, referred nine complaints to HUD that alleged state member bank violations of the Fair Housing Act. Of the six investigations completed by the Federal Reserve, five revealed no evidence of unlawful discrimination. The parties in the sixth complaint were seeking resolution through the courts; the Federal Reserve does not intervene in consumer cases that are in litigation. ■

Banking Supervision and Regulation

The U.S. banking system maintained its overall financial strength in 2001 despite having weathered some of the most challenging operating conditions in a decade. An already slowing economy slid into recession, dampening consumer confidence and equity markets generally. Conditions became even worse in the aftermath of the September 11 terrorist attacks in New York and Washington, D.C. The effects of the attacks and the bursting of the high-tech bubble, together with the largest chapter 11 bankruptcy ever (filed by domestic energy-trading company Enron) and events in Argentina, exacerbated a deterioration in credit conditions.

Nevertheless, banking industry net income rose 6 percent during the year. Asset growth continued, and the return on assets remained at a historically high level. Net interest margins narrowed slightly, particularly at community banks, in response to very low market interest rates and reluctance by banks to fully reflect lower rates in their core deposit pricing. Monetary easing induced a record volume of mortgage loan originations and refinancings, which contributed to strong growth in fee income. However, depressed financial markets constrained larger banks' ability to generate revenue from non-traditional banking activities, particularly investment banking, asset management, private equity investments, and trading. Even with reduced market-sensitive revenues, total non-interest income improved somewhat, buttressed by securities gains (versus losses a year earlier).

Credit costs mounted as banks raised provisioning rates in excess of net charge-off rates, both of which reached the highest levels since 1992. Commercial net charge-off rates surged, reflecting the adverse effect on corporate earnings of a retrenchment in business investment, particularly investment in equipment and software. With unemployment rates and personal bankruptcies rising, consumer net charge-off rates rose moderately. Compared with the previous year, the banking industry's nonperforming assets grew 28 percent, to $44.9 billion, or 1.1 percent of loans and foreclosed assets, still well below the peak that prevailed during the last recession. Through this period, banks maintained adequate loss reserves and improved their capital ratios.

The generally benign effect of relatively stressful events on the financial condition of U.S. banks in 2001 may reflect, at least in part, the progress that banks and their regulators have made in identifying and responding promptly to emerging weakness. Many banking organizations, particularly large organizations, have developed and are implementing more sophisticated risk-measurement and risk-management systems that help them evaluate and price credit risk better and identify changing levels of risk as they occur.

Through the Basel Committee on Banking Supervision, the Federal Reserve and other bank supervisors worldwide are building on banks' internal risk-measurement systems in revising regulatory capital requirements for internationally active banks. In January 2001, the Basel Committee issued for public comment a proposal to base capital requirements on an institution's internal credit-risk ratings and other factors,

such as its estimates of expected loss. This development effort continues.

The terrorist attacks of September 11 temporarily disrupted many interbank and securities settlement activities and strained the activities of key institutions in these markets before communications and operating systems were fully restored. Throughout the period, Federal Reserve System supervisory staff facilitated communications within the banking and regulatory systems and worked to minimize the disruptive effects. The experience highlighted the need to review and strengthen contingency plans within the financial system and its oversight process. That work is also actively under way.

November 2001 marked the second anniversary of enactment of the Gramm–Leach–Bliley Act, which allows bank holding companies to become "financial holding companies" (FHCs) and to conduct a broad range of banking, securities, and insurance-underwriting activities. As the "umbrella supervisor" of all FHCs, the Federal Reserve relies as much as possible on the supervisory efforts of an institution's primary bank supervisor and nonbank functional regulator(s) to ensure that any nonbank activities do not present unacceptable risks to affiliated banks. By year-end, 567 domestic bank holding companies and 23 foreign banking organizations had received FHC status, suggesting potentially widespread interest in the expanded powers provided by the legislation. To date, however, many FHCs are such in name only, conducting little or no expanded activity permissible under the law (see box, "Organizational Evolution: Results of the Gramm–Leach–Bliley Act").

Uncertainty is a key factor in any commercial activity, and 2001 presented significant challenges to many banks. Nevertheless, the U.S. banking system remains strong in its ability to deal with adversities and to continue supporting domestic and worldwide economic growth.

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 and consumer protection and civil rights laws.[1]

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 companies in the United States.

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system and the structure of the system through its administration of the Bank Holding Company

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 protection and civil rights laws. To carry out this responsibility, the Federal Reserve trains a number of its bank examiners in the evaluation of institutions with regard to such compliance. The chapter of this volume covering consumer and community affairs describes these regulatory responsibilities. Compliance with other banking statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Federal Reserve Banks, whose examiners also check for safety and soundness.

Act, the Bank Merger Act (with regard to state member banks), the Change in Bank Control Act (with regard to bank holding companies and state member banks), and the International Banking Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

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, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of holding companies and their nonbank subsidiaries. Pre-examination planning and on-site review of operations are integral parts of the overall effort to ensure the safety and soundness of financial institutions. Whether it is an examination or an inspection, 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 2001, 970 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12.1 percent of all insured U.S. commercial banks and held approximately 25.9 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year; exceptions are certain well-capitalized, well-managed institutions having assets of less than $250 million, which may be examined once every eighteen months.

During 2001 the Federal Reserve Banks conducted 534 examinations of state member banks (some of them jointly with state agencies), and state banking departments conducted 264 independent examinations of state member banks.

Bank Holding Companies

At year-end 2001, a total of 6,318 U.S. bank holding companies were in operation. These organizations controlled 6,420 insured commercial banks and held approximately 94.2 percent of all insured commercial bank assets.

Organizational Evolution: Results of the Gramm–Leach–Bliley Act

With passage of the Gramm–Leach–Bliley Act (GLBA) in 1999, the Congress removed long-standing legal impediments to the combining of banking, insurance, and securities activities within a single financial institution. Since then, more than 550 domestic bank holding companies have elected to become financial holding companies (FHCs). In addition, a few U.S. securities firms and one large insurance company have elected financial holding company status. Data collected by the Federal Reserve (summarized in the table) document the increase in the number of domestic financial holding companies since the act's implementation. They also show a substantial increase in U.S. financial holding company assets associated with GLBA activities.

Many of the largest bank holding companies are FHCs; most domestic FHCs, however, are relatively small. As of December 31, 2001, domestic FHCs reported $6.1 trillion in total assets, or about 80 percent of U.S. bank holding company assets. Many large FHCs have used the authority granted by the GLBA to conduct securities underwriting and merchant banking activities; several have also engaged in insurance underwriting. About one-fifth of domestic financial holding companies have established insurance agencies under GLBA authority; insurance brokerage is the only financial activity that many smaller FHCs are conducting under the act.

Twenty-three foreign banking organizations had also received FHC status as of December 31, 2001. Sixteen of these companies were conducting financial activities under GLBA authority as of year-end 2001, primarily as broker–dealers (thirteen) and merchant banks (nine). Five of the sixteen had insurance underwriting subsidiaries, and two were operating insurance agencies.

Federal Reserve guidelines call for annual inspections of large bank holding companies as well as smaller companies that have significant nonbank assets. In judging the financial condition of the subsidiary banks owned by holding companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. In 2001, Federal Reserve examiners conducted 1,212 bank holding company inspections, of which 1,118 were on site and 94 were off site, and state examiners conducted 79 independent inspections.

Small, non-complex 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.[2] The program permits a more flexible approach to supervision of those entities in a risk-focused environment. Each such holding company is subject to off-site review once during the examination cycle for the com-

2. Certain modifications to this supervisory program will be adopted at the beginning of 2002. These modifications will extend the program to *all* bank holding companies that have less than $1 billion in consolidated assets.

Domestic FHCs and their activities under GLBA authority

Item	2000		2001	
	June 30	Dec. 31	June 30	Dec. 31
Number of FHCs				
Large	74	91	112	114
Small	250	371	416	453
Using GLBA authority				
Large	36	44	58	58
Small	28	47	60	77
GLBA activities, by number of FHCs and related assets or investments (billions of dollars)				
Securities underwriting activities				
Number	31	35	41	39
Assets	529	519	619	668
Merchant banking activities				
Number	16	16	21	25
Carrying value of investments	5	8	9	8
Insurance underwriting activities				
Number	7	11	15	21
Assets	114	116	327	342
Insurance agency activities				
Number				
Large	13	19	30	33
Small	25	43	58	68

NOTE. Large financial holding companies (FHCs) are defined here as those with assets of $1 billion or more; small FHCs, those with assets of less than $1 billion.

pany's lead bank. In 2001 the Federal Reserve conducted 2,594 reviews of these companies.

Financial Holding Companies

As of year-end 2001, 567 domestic bank holding companies and 23 foreign banking organizations had received financial holding company status. Of the domestic institutions, 34 had consolidated assets of $15 billion or more, 80 between $1 billion and $15 billion, 54 between $500 million and $1 billion, and 399 less than $500 million.

Specialized Examinations

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

With passage of the Gramm–Leach–Bliley Act in 1999, the Federal Reserve ceased conducting routine annual examinations of securities underwriting and dealing activities through so-called section 20 subsidiaries of bank holding companies. Under the act, the Federal Reserve is generally required to rely on the supervisory activities of the "functional regulator" for broker–dealer sub-

sidiaries unless the Board has cause to believe that a broker–dealer poses a material risk to an insured depository affiliate. No such examinations for cause were conducted during 2001.

The Federal Reserve has developed a series of case studies to educate System personnel responsible for supervising nonbank activities about communications with, and reliance on the supervisory activities of, functional regulators (that is, regulators for securities, commodities, and insurance activities).

Information Technology

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of the banking institutions it examines as well as certain independent data centers that provide information technology services to these institutions. In 2000, the information technology reviews of banking institutions were integrated into the overall process of supervision, and thus all safety and soundness examinations are now expected to include a review of information technology risks and activities. During the year, the Federal Reserve was the lead agency in one examination of a large, multiregional data processing servicer examined in cooperation with the other federal banking agencies.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for institutions that together hold more than $15 trillion of assets in various fiduciary capacities. During on-site examinations of fiduciary activities, the institution's compliance with laws, regulations, and general fiduciary principles and potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2001, Federal Reserve examiners conducted 177 on-site trust examinations.

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 the institution's operations and its compliance with relevant securities regulations. During 2001, the Federal Reserve conducted on-site examinations at 33 of the 108 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 acting as a national securities depository.

Government and Municipal Securities Dealers and Brokers

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations governing dealing and brokering in government securities. Thirty-nine state member banks and 9 state branches of foreign banks have notified the

Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2001 the Federal Reserve conducted 11 examinations of broker–dealer activities in government securities at these institutions.

The Federal Reserve is also responsible for ensuring compliance with the Securities Act Amendments of 1975 by state member banks and bank holding companies that act as municipal securities dealers. Of the 31 entities that dealt in municipal securities during 2001, 10 were examined during the year.

Securities Credit Lenders

Under the Securities Exchange Act of 1934, the Federal Reserve Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. In addition to examining banks under its jurisdiction for compliance with the Board's margin regulations as part of its general examination program, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to those regulations. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration, the National Credit Union Administration, or the Office of Thrift Supervision.

At the end of 2001, 802 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 183 of these lenders, and the remaining 619 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 273 lenders from its on-site inspection program. The securities credit activities of the remaining 346 lenders were subject to either a biennial or triennial inspection. Sixty-five inspections were conducted during the year, compared with 147 in 2000.

Enforcement Actions and Civil Money Penalties

In 2001 the Federal Reserve initiated 21 enforcement cases involving 30 separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. The Board of Governors collected $66.4 million in civil money penalties, which included a substantial collection from the BCCI case, a long-standing litigation matter. All funds collected were remitted to the U.S. Department of the Treasury.

All final enforcement orders issued by the Board and all written agreements executed by the Reserve Banks in 2001 are available to the public and can be accessed from the Board's public web site (http://www.federalreserve.gov/boarddocs/enforcement).

In addition to formal enforcement actions, the Reserve Banks in 2001 completed 111 informal enforcement actions, such as resolutions with boards of directors and memorandums of understanding.

Risk-Focused Supervision

In recent years the Federal Reserve has created several 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.

Regional Banking Organizations

The risk-focused supervision program for regional banking organizations applies to institutions having a functional management structure, a broad array of products, and operations that span multiple supervisory jurisdictions. For smaller regional banking organizations, the supervisory program may be implemented with a point-in-time inspection; for larger institutions, the program may take the form of a series of targeted reviews. For the largest, most complex institutions, the process is continuous, as described in the next section. To minimize burden on the institution, work is performed off site to the greatest extent possible. Additionally, to reduce the number of information requests to the institution, examiners make use of public and regulatory financial reports, market data, information from the automated surveillance screening systems (see later section "Surveillance and Monitoring Programs"), and internal management reports.

Large, Complex Banking Organizations

The Federal Reserve applies a risk-focused supervision program to large, complex banking organizations (LCBOs).[3] 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) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the central point of contact, has responsibility for only one LCBO, and is supported by specialists skilled in evaluating the risks of LCBO business activities and functions), and (4) promoting Systemwide and interagency information-sharing through an automated system.

Supporting the supervision process is an automated application and database—the Banking Organization National Desktop (BOND)—which is being developed to facilitate real-time, secure information-sharing and collaboration across the Federal Reserve System and with certain other federal and state regulators. The final stage of phase I of BOND development was implemented during 2001, and work was begun on phase II, which will add functionality that promotes analysis across institutions.

The events of September 11, 2001, directly and adversely affected the functioning of U.S. payment and clearing systems, requiring an extraordinary cooperative and coordinated effort among bank supervisory agencies both domestically and internationally. In addition to providing supervisory guidance for regulated institutions during the crisis, LCBO supervisory staffs across the Federal Reserve System facilitated the sharing of information among financial regulatory agencies worldwide; in many instances, examiners were sent on site to lend assistance to and assess the status of key institutions.

Community Banks

The risk-focused supervision program for community banks emphasizes that certain elements are critical to the suc-

3. For an overview of the Federal Reserve's LCBO program, see the article by Lisa M. DeFerrari and David E. Palmer, "Supervision of Large Complex Banking Organizations," in the *Federal Reserve Bulletin*, vol. 87 (February 2001), pp. 47–57.

cess of the risk-focused 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. The framework for risk-focused supervision of community banks was developed jointly with the Federal Deposit Insurance Corporation and has been adopted by the Conference of State Bank Supervisors.

Surveillance and Monitoring Programs

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. The screening systems analyze supervisory data and regulatory financial reports to identify companies that appear to be weak or deteriorating. This analysis helps to direct examination resources to institutions exhibiting higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities. Also used in the monitoring process are quarterly Bank Holding Company Performance Reports prepared by the Federal Reserve.

During 2001, the Federal Reserve refined its surveillance program for small bank holding companies to respond to changes in supervisory procedures for these institutions. The revised screening systems focus on identifying potential problems at parent companies and nonbank subsidiaries that could adversely affect affiliated insured depository institutions. In particular, the screens address parent company cash flow, intercompany transactions, parent company leverage, and consolidated capital ratios. Also during the year the Federal Reserve revised the Bank Holding Company Performance Report to incorporate new information on sources of nonbank income and on insurance activities.

The Federal Reserve works with the other federal banking agencies to enhance and coordinate surveillance activities through the Task Force on Surveillance Systems of the Federal Financial Institutions Examination Council (FFIEC).[4]

International Activities

The Federal Reserve supervises the foreign branches of member banks; overseas investments by member banks, Edge Act and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. It also supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and 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 2001 the

4. The member agencies of the FFIEC are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

Federal Reserve examined 3 foreign branches of state member banks and 7 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. Examiners also make visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their efforts to implement corrective measures or to test their adherence to safe and sound banking practices.

Foreign Branches of Member Banks

At the end of 2001, 64 member banks were operating 937 branches in foreign countries and overseas areas of the United States; 34 national banks were operating 725 of these branches, and 30 state member banks were operating the remaining 212. In addition, 18 nonmember banks were operating 22 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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 that are broader than those of member banks because they may invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

Edge Act and agreement corporations numbered 75 and were operating 17 branches at year-end 2001. These corporations are examined annually.

U.S. Activities of Foreign Banks

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

As of year-end 2001, 208 foreign banks from 56 countries were operating 287 state-licensed branches and agencies (of which 13 were insured by the Federal Deposit Insurance Corporation) as well as 51 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 15 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 90 U.S. commercial banks. Further, 23 foreign banks and certain of their affiliates were granted financial holding company status.

Altogether, these U.S. offices of foreign banks at the end of 2001 controlled approximately 19.0 percent of U.S. commercial banking assets. These foreign banks also operated 181 representative offices; an additional 97 foreign banks operated in the United States solely through a representative office.

State-licensed and federally licensed branches and agencies of foreign banks 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 289 examinations during 2001.

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

The Federal Reserve, in cooperation with the other federal banking agencies and with state banking agencies, conducts a joint program for supervising the U.S. operations of foreign banking organizations. The program has two main parts. One part focuses on the examination process for those foreign banking organizations 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 organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. During 2001 the program was refined further in light of experience in using it over the past five years.

Technical Assistance

In 2001 the Federal Reserve System continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by System staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2001 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 in a number of foreign jurisdictions exclusively for foreign supervisory authorities. System staff 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, the Basel Committee on Banking Supervision, and the Financial Stability Institute.

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 Federal Financial Institutions Examination Council.

Capital Adequacy Standards

During 2001 the Federal Reserve, together with the other federal bank-

ing agencies, issued a final rule that amended the capital standards for recourse, direct credit substitutes, and residual interests in asset securitizations. The agencies also continued discussions on a possible notice of proposed rulemaking to simplify the risk-based capital framework. The Federal Reserve revised its policy of generally applying its capital adequacy guidelines to top-tier U.S. bank holding companies owned by foreign banks qualifying as financial holding companies under the Gramm–Leach–Bliley Act. Finally, the agencies continued to work on developing final rules governing securities borrowing transactions and claims on securities firms.

Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

On November 29, 2001, the Federal Reserve, together with the other federal banking agencies, issued a final rule to amend their respective risk-based and leverage capital standards for the treatment of recourse obligations, direct credit substitutes, and residual interests that expose banks, bank holding companies, and thrift institutions to credit risk. The final rule combined two earlier proposals on these matters that had overlapped in some respects. It makes use of external credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in asset securitizations. The rule requires that institutions hold risk-based capital in an amount equal to the amount of residual interests that arise in securitizations (or other transfers of assets) and that are retained on the balance sheet. In addition, credit-enhancing interest-only strips receivables, either purchased or retained, are limited to 25 percent of tier 1 capital. Amounts exceeding 25 percent are to be deducted from tier 1 capital, which will have the effect of reducing the leverage ratio as well as the risk-based capital ratios. The portion of the rule dealing with interest-only strips receivables will go into effect at the end of 2002.

Simplified Capital Framework for Non-Complex Institutions

In November 2000, the federal banking agencies published an advance notice of proposed rulemaking and solicited comments on proposals for creating a simpler capital framework for non-complex domestic financial institutions. Most comments did not support significant substantive changes to the existing framework. After considering the comments, the agency staffs in 2001 decided not to proceed with a simplified capital approach. Instead, they are continuing discussions on possible ways to modify the regulatory capital rules more broadly.

Supervisory Policy on the Application of Capital Requirements to Bank Holding Companies Owned by Foreign Banking Organizations

In January 2001, the Federal Reserve revised its policy of subjecting all top-tier U.S. bank holding companies to the U.S. minimum regulatory capital requirements. A limited exception was made for top-tier U.S. bank holding companies owned by foreign banks qualifying as financial holding companies under the Gramm–Leach–Bliley Act. For a foreign bank to qualify as a financial holding company, the Board must have determined that it is well capitalized and well managed under standards comparable to those applied to U.S. banks owned by bank holding companies qualifying as financial hold-

ing companies. A top-tier U.S. bank holding company owned by such a foreign bank will continue to be required to report its capital under the U.S. capital adequacy guidelines for bank holding companies but will not be required to meet the regulatory minimums. Minimum levels of capital for these organizations will instead be determined on a supervisory basis. In making this revision, the Federal Reserve determined that relying on the capital strength of the consolidated foreign bank, as well as requiring subsidiary banks to meet appropriate capital and management standards, is consistent with the Federal Reserve's supervisory assessment process for domestic bank holding companies.

Capital for Nonfinancial Equity Investments

In February 2001, the Federal Reserve, together with the OCC and the FDIC, issued a proposal concerning the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies, and financial holding companies. The proposal represented a modification of a proposal that had been issued in March 2000. Under the revised proposal, a capital charge would be imposed that would increase in steps as the banking organization's level of concentration in equity investments increased. Agency monitoring also would increase as the level of concentration in equity investments increased.

Securities Borrowing Transactions

In December 2000, the Federal Reserve, together with the FDIC and the OCC, issued an interim rule to revise the capital treatment of cash collateral that is posted in connection with securities borrowing transactions. The change was intended to align the capital requirements for these transactions more appropriately with the risk involved and to level the playing field for banking organizations vis-à-vis their domestic and foreign competitors. Among the public comments submitted by the due date of January 19, 2001, support for the interim rule was unanimous. The interim rule remains in effect.

Claims on Securities Firms

In December 2000, the federal banking agencies proposed to reduce from 100 percent to 20 percent the risk weight accorded to claims on, and claims guaranteed by, qualifying securities firms in countries that are members of the Organisation for Economic Co-operation and Development. The change would bring the risk weight in line with a 1998 revision to the Basel Capital Accord. Qualifying U.S. securities firms would be broker–dealers registered with the Securities and Exchange Commission (SEC) that are in compliance with the SEC's net capital rule and meet certain other requirements. Work continued during 2001, and the agencies expect to issue a final rule in the first quarter of 2002.

Fiduciary Activities

In February 2001, the Federal Reserve issued guidance concerning the integration of trust and transfer agency examinations into safety and soundness examinations. Fiduciary activities and related services generally include traditional trust services—such as personal trust, corporate trust, and transfer agent services—and employee benefit account products and services, as well as custodial and securities lending services and clearing-and-settlement, asset-management, and investment-advisory activities. The intent of the guidance is

to improve integration of the supervisory assessment of banking organizations' fiduciary activities into the overall safety and soundness supervision process and to focus supervisory resources on areas of greatest risk.

Securities Activities of State Member Banks

On May 14, 2001, the Federal Reserve issued guidance to examiners and other supervisory personnel regarding changes to the permissible securities activities of state member banks under the Gramm–Leach–Bliley Act. The act authorized well-capitalized state member banks to underwrite, deal in, and invest in municipal revenue bonds without limitation as to the level of these activities that may be conducted relative to the bank's capital. Until that time, state member banks could, without capital limitation, underwrite, deal in, or invest in only general obligation municipal bonds backed by the full faith and credit of an issuer having general powers of taxation.

Joint Agency Advisory on Rate-Sensitive Deposits

In May 2001, the Federal Reserve, together with the other federal banking agencies, issued an interagency advisory outlining the risk-management procedures that banking organizations should follow in assessing and controlling the risks associated with significant reliance on brokered and rate-sensitive deposits. The advisory states that deposits raised through intermediary sources, such as deposit brokers, the Internet, and other automated service providers, may be less stable than traditional deposits, primarily because depositors making deposits through intermediary sources may not have other relationships with the depository institution and may rapidly shift funds to another institution or investment in search of a higher return. The advisory states that banking organizations should employ appropriate systems to identify and control this risk. Such systems include appropriate funds-management policies, adequate due diligence in assessing deposit brokers and financial risks, reasonable control and limit structures, adequate information systems, and contingency funding plans.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision (Basel Committee), the Federal Reserve in 2001 participated in efforts to revise the international capital regime and to develop international supervisory guidance. The Federal Reserve's goals in these activities are to advance sound supervisory policies for internationally active banking institutions and to improve the stability of the international banking system. The efforts are described in the following sections.

Capital Adequacy

The Federal Reserve continued to participate in a number of technical working groups of the Basel Committee in efforts to develop a new capital accord. These groups, in grappling with a number of difficult issues, released several consultative papers during 2001:

- In January, the Basel Committee issued for public consultation a series of papers setting forth proposals for a new capital accord. This consultative package laid the groundwork for formal and informal discussions with the banking industry and other interested parties on a revised international capital framework.

- In continuing its work on a new capital accord, and in response to public comments on the January consultative package, the Basel Committee issued for further consultation a number of technical working papers, including "Internal Ratings-Based (IRB) Treatment of Expected Losses and Future Margin Income" (July); "Risk-Sensitive Approaches for Equity Exposures in the Banking Book for IRB Banks" (August); "Pillar 3—Market Discipline" (September); "Regulatory Treatment of Operational Risk" (September); "Internal Ratings-Based Approach to Specialized Lending Exposures" (October); and "Treatment of Asset Securitizations" (October).

Risk Management

The Federal Reserve contributed to a number of supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2001. These documents were generally aimed at improving the supervision of banks' risk-management practices. The paper "Review of Issues Relating to Highly Leveraged Institutions" (issued in February) set forth sound risk-management practices when dealing with highly leveraged institutions. "Risk Management Principles for Electronic Banking" (issued in May) was intended to help banking institutions expand their existing risk-management policies and practices to cover their electronic-banking activities. The paper "Customer Due Diligence for Banks" (issued in October) provides guidance on effective controls and procedures for getting to know customers. The consultative paper "Sound Practices for the Management and Supervision of Operational Risk" (issued in December) solicited banking industry comments on a proposed range of sound practices for the management of operational risk.

Joint Forum

In its work with the Basel Committee, the Federal Reserve also continued its participation in the Joint Forum, a group made up of representatives of the committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Joint Forum works to increase mutual understanding of issues related to the supervision of firms operating in each of the financial sectors. In this regard, the Federal Reserve contributed to two Joint Forum papers issued in November 2001: "Risk Management Practices and Regulatory Capital," which compares current industry practices in all three sectors, and "Core Principles: Cross-Sectoral Comparison," which identifies similarities and differences among the core principles of the three sectors.

Internal Control, Accounting, and Disclosure

The Federal Reserve participates in the Basel Committee's Task Force on Accounting Issues and its Transparency Group and represents the Basel Committee at international meetings on the issues addressed by these groups. In particular, during 2001 the Federal Reserve represented the Basel Committee at meetings of the committee of the International Accounting Standards Board (IASB) that works to improve accounting guidance concerning financial instruments. In addition, a representative of the Federal Reserve was appointed a member of the IASB's Standards Advisory Council.

During 2001 the Federal Reserve also contributed to a letter and several papers

on internal control, accounting, and disclosure issued by the Basel Committee, including the following:

- "Comment Letter on Fair Value Accounting"—In this letter (issued in September) the IASB solicited views on the benefits and costs associated with a fair value accounting model for financial instruments. The Basel Committee recommended that the IASB explore additional disclosure of fair value information and improve standards for loan loss allowances and disclosures about credit risk in lieu of introducing a comprehensive fair value accounting model at this time.

- "The Relationship Between Banking Supervisors and Banks' External Auditors"—This joint paper by the Basel Committee and the International Auditing Practices Committee (to be issued in January 2002) provides guidance on ways to strengthen the relationship between bank auditors and supervisors and incorporates the Basel Committee's core principles for effective banking supervision.

- "Internal Audit in Banks and the Supervisor's Relationship with Auditors"—This paper (issued in August) sets forth objectives and principles for an effective bank internal-audit function, the role of internal audit, and the banking supervisors' views on ways to strengthen the relationship between banking supervisors and internal and external auditors.

Staff members also supported the Basel Committee's Task Force on Accounting Issues in the development of comment letters on major proposals of the International Federation of Accountants (IFAC) and of IFAC's International Auditing Practices Committee (IAPC). Staff also represented the Basel Committee's Task Force on Accounting Issues at meetings with representatives of the IAPC and the International Forum on Accountancy Development to encourage the adoption of enhanced international auditing standards and practices.

In December the Board sent a comment letter to the IASB on an international proposal to adopt fair value accounting. The comment letter attached a staff research report that explored a number of issues arising from the proposal's suggestion that banks and other companies use their internal credit-grading systems to estimate fair values when certain criteria are met.

Gramm–Leach–Bliley Act

The Gramm–Leach–Bliley Act (GLBA) repealed those provisions of the Glass–Steagall Act and the Bank Holding Company Act that restricted the ability of bank holding companies to affiliate with securities firms and insurance companies. The provisions of GLBA, and the Federal Reserve's final rule, which was adopted in January 2001, establish conditions that a bank holding company or a foreign bank must meet to be deemed a financial holding company and to engage in expanded activities.

In addition to controlling depository institutions, financial holding companies may engage in securities underwriting and dealing, serve as an insurance agent and insurance underwriter, act as a futures commission merchant, and engage in merchant banking. Permissible activities also include activities that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities and activities that the Federal Reserve determines are complementary to a financial activity and do not pose a

substantial risk to the safety and soundness of depository institutions or the financial system generally.

On January 2, 2001, the Federal Reserve and the Department of the Treasury issued an interim rule defining the following as permissible activities: lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities; providing any device or other instrumentality for transferring money or other financial assets; and arranging, effecting, or facilitating financial transactions for the account of third parties. In addition, in February 2001 the Federal Reserve and the Department of the Treasury extended the comment period for a December 2000 proposal that would include real estate brokerage and real estate management as permissible activities under GLBA.

Under GLBA, the Federal Reserve has supervisory oversight authority and responsibility for bank holding companies, including those that operate as financial holding companies. The statute streamlines the Federal Reserve's supervision for all bank holding companies and sets forth parameters for the relationship between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve's relations with regulators of depository institutions and its relations with functional regulators (that is, regulators for insurance, securities, and commodities). During 2001, the Federal Reserve continued its efforts to ensure that supervisory policies applied to banking institutions are consistent with the provisions of GLBA.

In its role as the holding company supervisor, the Federal Reserve in 2001 hosted two cross-sector meetings with representatives of the banking agencies, securities and commodities and futures authorities, and state insurance commissions. Cross-sector forums provide an opportunity for multiple supervisors (both federal and state) to discuss issues of common interest and to enhance communication and cooperation. At the October meeting, the group focused on the impact and implications of the September 11 terrorist attacks on each of the sectors. Three cross-sector meetings are scheduled for 2002.

Merchant Banking Activities

On January 31, 2001, the Board and the Secretary of the Treasury jointly adopted a final rule governing merchant banking investments made by financial holding companies.[5] The rule implements provisions of GLBA that permit financial holding companies to make investments as part of a bona fide securities underwriting or merchant or investment banking activity. The Board and the Secretary incorporated a number of amendments to the final rule to address issues raised by public commenters, to reduce potential regulatory burdens, and to clarify the application of the rule. These changes included expanding the definition of "securities affiliate" to include a department or division of a bank registered as a municipal securities dealer; modifying the provisions defining prohibited routine management and operation of portfolio companies; adopting a sunset provision for the investment thresholds under the interim rule and eliminating the dollar-based threshold for the review of a financial holding company's merchant banking activities; streamlining the rule's reporting and recordkeeping requirements; broadening the definition

5. "Merchant banking" investments may be made in any type of ownership interest and in any type of nonfinancial entity (portfolio company) and may represent any amount of the equity of a portfolio company.

of "private equity" funds and clarifying the rule's application to such funds; and adopting several safe harbors to the presumptions in the rule governing the definition of "affiliate" for purposes of sections 23A and 23B of the Federal Reserve Act. The final rule became effective February 15, 2001.

Information-Security Standards

Under section 501(b) of GLBA, the federal banking agencies are required to issue standards for information security. In February 2001, after soliciting public comment on a June 2000 proposal, the agencies published "Interagency Guidelines Establishing Standards for Safeguarding Customer Information." The guidelines require banks and holding companies to establish a written information-security program and to control the risk of unauthorized access or other threats to the security and confidentiality of customer information.

Financial Subsidiary Provisions

On August 16, 2001, the Board adopted a final rule implementing the financial subsidiary provisions of GLBA for state member banks. The act authorizes state member banks that comply with the requirements of the rule to control, or hold an interest in, a financial subsidiary, which may conduct certain financial activities that the parent bank may not conduct directly. The final rule is substantially similar to the interim rule adopted by the Board in March 2000.

Federal Financial Institutions Examination Council

During 2001, the Federal Reserve continued its active participation as a member of the Federal Financial Institutions Examination Council. Among other things, the FFIEC issued substantial revisions to the Call Report; a statement regarding a major revision of article 9 of the Uniform Commercial Code; a policy statement on methodologies and documentation in connection with allowances for loan and lease losses; and guidance on risk-management issues.

Bank Call Reports

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

For the 2001 reporting period, the FFIEC implemented substantial revisions to the Call Report to streamline the reporting requirements and to add new items that focus on areas of increasing supervisory concern. The principal revisions included

- Combining the three separate report forms for banks of various sizes that have only domestic offices (FFIEC 032, 033, and 034) into a single form (designated FFIEC 041), while retaining the separate form for banks having foreign offices (FFIEC 031)

- Eliminating a number of data items that were no longer warranted

- Introducing a revised regulatory capital schedule that takes a step-by-step "building block" approach to computing the key elements of the capital ratios for all banks

- Collecting new information on asset sales and certain nontraditional bank activities. In addition, collection of the Annual Report of Trust Assets (FFIEC 001) and the Annual Report of International Fiduciary Activities (FFIEC 006) was discontinued and a streamlined fiduciary-activities schedule was added to the Call Report. Also, the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) was revised, effective with the June 2001 report, to maintain consistency with the Call Report.

In October, the Federal Reserve and the other federal banking agencies proposed a few revisions to the Call Report to facilitate effective supervision. The revisions would, effective with the March 2002 report, add a few items to conform with changes in generally accepted accounting principles, specifically, the reporting requirements of Statement of Financial Accounting Standard No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*. The revisions would also add several items to address new safety and soundness considerations.

Revisions to Article 9 of the Uniform Commercial Code

On February 28, 2001, the FFIEC issued a statement regarding a major revision of article 9 of the Uniform Commercial Code and its effect on financial institutions. Article 9 governs transactions involving the granting of credit secured by personal property. Revised article 9 contains a number of new or revised rules for secured transactions that affect financial institutions' procedures, systems, documentation, and the enforceability of security interests. In the statement, the FFIEC advised financial institutions and their legal counsel to consider carefully the changes in state law brought about by revised article 9 in order to ensure the attachment and perfection of their existing and future security interests.

Risk-Management Controls in the Use of Electronic Financial Services

In August 2001, the Federal Reserve issued a new policy, developed by the FFIEC member agencies, addressing authentication in an electronic banking environment. In recognition of the importance of effective authentication measures in reducing the risk of fraud and strengthening information-security programs, the guidance describes risk-management issues that banks should consider as they design and update their on-line customer-authentication systems. The main portion of the guidance gives background information and describes sound risk-management measures. Processes for verifying the identity of prospective customers and authenticating existing customers who use on-line systems, such as Internet banking services, are discussed, and details are provided concerning various authentication technologies and issues to consider when implementing these processes.

Efforts to Enhance Transparency and Bank Regulatory Financial Reports

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and

financial organizations to improve market discipline and foster stable financial markets. Effective market discipline can be an important complement to bank supervision and regulation. As financial institutions make more information available, market participants are able to make better evaluations of counterparty risk and better adjustments to the availability and pricing of funds. Thus, transparency can promote efficiency in financial markets and sound practices by banks. The Federal Reserve also seeks to strengthen audit and control standards for banks; the quality of management information and financial reporting is dramatically affected by internal control systems, including internal and external audit programs.

To advance these objectives, the Federal Reserve works with other regulators, the accounting profession, and a wide variety of market participants, both domestically and internationally.

Interagency Guidance on the Allowance for Loan and Lease Losses

In July 2001, the Federal Reserve, the Securities and Exchange Commission, and the other federal banking agencies issued joint guidance regarding documentation of the allowance for loan and lease losses. The Federal Reserve and the other federal banking agencies issued the guidance as an FFIEC policy statement, and the SEC issued parallel guidance as Staff Accounting Bulletin 102. The guidance clarifies the agencies' expectations in regard to documentation supporting the methodology used to calculate allowances for loan and lease losses (ALLL). It requires that a financial institution's ALLL methodology be consistent with generally accepted accounting principles (GAAP) and all outstanding supervisory guidance. Further, the methodology should be systematic, consistently applied, and auditable; validated periodically; and modified as needed to incorporate new events or findings. The guidance also provides examples of appropriate documentation and illustrations showing how the guidance should be implemented.

Interagency Guidance on Loans Held for Sale

In March the Federal Reserve, the other federal banking agencies, and the National Credit Union Administration issued guidance regarding the appropriate treatment of loans that an institution intends to sell. Consistent with GAAP, the guidance requires an institution to record a charge-off against the ALLL when it decides to sell loans whose fair value has declined for any reason other than a change in the general market level of interest or foreign exchange rates.

Private-Sector Working Group on Public Disclosure

The Private-Sector Working Group on Public Disclosure, a group composed of senior executives from major domestic and foreign banking organizations and securities firms, was established by the Federal Reserve to recommend ways to enhance public financial statement disclosures. The SEC and OCC also participated in the effort. In January, the working group released a report recommending enhanced and more-frequent public disclosure of financial information by banking and securities firms. Subsequently, the Federal Reserve, SEC, and OCC issued supervisory guidance encouraging banking organizations and securities firms to follow these recommendations. Private-sector efforts, such as those of the working group, and official regulatory

initiatives can help foster consensus and advance thinking on what constitutes sound or best practice regarding public disclosure.

Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies submit periodic regulatory financial reports. These reports, the FR Y–9 and FR Y–11 series, provide information essential to the supervision of the organizations and to the formulation of regulations and supervisory policies. The Federal Reserve also uses the information in responding 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 provides standardized financial statements for the consolidated bank holding company. The reports are used to detect emerging financial problems, review performance and conduct pre-inspection analysis, monitor and evaluate risk profiles and capital adequacy, evaluate proposals for bank holding company mergers and acquisitions, and analyze the holding company's overall financial condition.

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.

In March 2001, the Federal Reserve implemented numerous revisions to the FR Y–9C report that streamlined the reporting requirements. The streamlining was part of the Federal Reserve's effort to achieve the objectives set forth in section 307(c) of the Riegle Community Development and Regulatory Improvement Act of 1994, which directs the banking agencies to review the information that institutions report in the Call Report and the bank holding company reports and eliminate requirements that are not warranted for safety and soundness or other public policy purposes.

As part of the streamlining process, the Federal Reserve made changes to other FR Y–9 and FR Y–11 series reports to introduce more uniformity to certain aspects of regulatory reporting. The changes not only increased uniformity within the holding company reports but also brought several reporting items into closer alignment with the Call Report and the Thrift Financial Report. Other modifications to the holding company reports were made so that their form and content would more closely resemble the manner in which information is presented in financial statements that banking organizations prepare in accordance with generally accepted accounting principles for other financial reporting purposes.

Besides streamlining the FR Y–9C reporting requirements by eliminating information no longer of significant value, the Federal Reserve also improved the relevance of the FR Y–9C by identifying new types of information that are expected to be critical to the Federal Reserve's future supervisory data needs. The improvements focus on new activities and other recent developments that may expose institutions to new or different types of risk.

In light of the Gramm–Leach–Bliley Act and the increased involvement of banking organizations in merchant banking and equity investment in nonfinancial companies, the Federal Reserve implemented the new Consolidated Bank Holding Company Report of Equity Investments in Nonfinancial Companies (FR Y–12), effective September 30, 2001.

Supervisory Information Technology

The Supervisory Information Technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates management of information technology within 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.

SIT works through assigned staff at the Board of Governors and the Reserve Banks and through a committee structure that ensures that key staff members throughout the Federal Reserve System participate in identifying requirements and setting priorities for IT initiatives. SIT also houses the management of the National Information Center, a comprehensive repository for vital supervision information.

SIT Activities

In 2001 SIT revised and updated the operating plan for the ongoing approval and reassessment of IT projects, which was prepared in 2000. It is developing a capital planning and information technology investment guide to ensure that IT investments in proposed projects and products support the function's strategic goals. SIT is undertaking an enterprise document management project to identify, implement, and deploy a common document-management technology for the supervision function on a System-wide basis. In 2001, as part of its project-management training for Board and Reserve Bank staff, it also revised and updated the project managers' handbook, which draws on the best practices in private industry and government.

Enhancements to the National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking-structure data and documents. NIC includes the National Examination Data (NED) system, software that provides supervisory personnel and state banking authorities with access to NIC data, and the Central Document and Text Repository (CDTR), which contains documents supporting the supervisory process.

In 2001 much work was accomplished to make the NED system available over the web and to add functionality to further support the supervision of banking institutions. Implementation of this new version of NED is planned for the second quarter of 2002.

In September, new structure report forms were put into use to capture changes in the organizational structure of bank holding companies (FR Y–10) and foreign banking organizations (FR Y–10F). Also, extensive revisions were made to NIC to support the collection of data and the quality of reports. In addition, an Internet-based reporting mechanism was implemented to allow bank holding companies to submit reports electronically. During the year, progress was made on enhancements to the CDTR so that it will be able to handle more documents, accept documents from other agencies, and permit

web-based access. Implementation is planned for June 2002.

Staff Training

The System Staff Development Program trains staff members at the Board of Governors, the Reserve Banks, and state banking departments who have supervisory and regulatory responsibilities; students from foreign supervisory authorities attend training sessions on a space-available basis. The program's goal is, in part, to provide greater cross-training. Training is offered at the basic, intermediate, and advanced levels in 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., as well as at other locations and are sometimes held jointly with other regulators.

The Federal Reserve System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in relation to various emerging issues as well as in specialized areas such as trust activities,

Training Programs for Banking Supervision and Regulation, 2001

Program	Number of sessions conducted	
	Total	Regional
Schools or seminars conducted by the Federal Reserve		
Core schools		
Banking and supervision elements	10	8
Operations and analysis	6	5
Bank management	4	1
Report writing	20	20
Management skills	9	9
Conducting meetings with management	16	16
Other schools		
Loan analysis	6	5
Examination management	5	3
Real estate lending seminar	3	2
Specialized lending seminar	3	1
Senior forum for current banking and regulatory issues	4	4
Banking applications	1	. . .
Principles of fiduciary supervision	2	1
Commercial lending essentials for consumer affairs	3	3
Consumer compliance examinations I	3	1
Consumer compliance examinations II	2	1
CRA examination techniques	2	1
Fair lending examination techniques	3	2
Foreign banking organizations	5	5
Information systems continuing education	2	. . .
Capital markets seminars	11	8
Technology risk integration	24	24
Leadership dynamics	4	4
Seminar for senior supervisors of foreign central banks [1]	. . .	. . .
Other agencies conducting courses [2]		
Federal Financial Institutions Examination Council	37	3
The Options Institute	1	1

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

. . . Not applicable.

Student Examination Results, First Track, 2001

Result	Core proficiency	Specialty			
		Safety and soundness	Consumer affairs	Trust	Information technology
Passed	35	25	8	3	1
Failed	19	4	9	1	3
Total	**54**	**29**	**17**	**4**	**4**

NOTE. These examinations are for examiners hired before February 28, 1998.

international banking, information technology, municipal securities dealing, 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 2001 the Federal Reserve trained 2,832 students in System schools, 645 in schools sponsored by the FFIEC, and 15 in other schools, for a total of 3,492, including 234 representatives of foreign central banks (see accompanying table). The number of training days in 2001 totaled 18,483.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 445 state examiners were trained—277 in Federal Reserve courses, 166 in FFIEC programs, and 2 in other courses.

A staff member seeking an examiner's commission follows one of two training tracks. One track, for staff members hired before February 28, 1998, involves a "core proficiency examination" as well as a specialty examination in an area of the student's choice—safety and soundness, consumer affairs, trust, or information technology. Students on this track had to complete the commissioning requirements by December 31, 2001. In 2001, 35 examiners passed the core proficiency examination (see table).

The other track, for staff members hired after February 27, 1998, involves a "first proficiency examination" as well as a "second proficiency examination" in one of the four specialty areas. The table below reflects 2001 pass rates for the second track. At the end of 2001, the System had 1,242 field examiners, of which 861 were commissioned.

Student Examination Results, Second Track, 2001

Result	First proficiency	Second proficiency			
		Safety and soundness	Consumer affairs	Trust	Information technology
Passed	199	49	17	5	3
Failed	3	11	4	0	0
Total	**202**	**60**	**21**	**5**	**3**

NOTE. These examinations are for examiners hired after February 27, 1998.

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, each in relation to bank holding companies, financial holding companies, member banks, and foreign banking organizations, as appropriate. 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.

In November 2001, revisions to Regulation K—which governs the foreign operations of U.S. banking organizations and the U.S. operations of foreign banking organizations—were implemented. In general, the revisions streamlined foreign branching procedures for U.S. banking organizations, authorized expanded activities at foreign branches of U.S. banks, and implemented recent statutory changes. Changes were also made to the provisions governing permissible foreign activities of U.S. banking organizations, including securities activities, and investments made under general consent procedures. In addition, the revisions streamlined the application procedures applicable to foreign banks seeking to expand their operations in the United States.

Bank Holding Company Act

Under the Bank Holding Company Act, a corporation or similar organization must obtain the Federal Reserve's approval before forming a bank holding company through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies other activities permissible for bank holding companies; depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.

Bank holding companies generally may engage in only those activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the act. Since 1996, the act has provided an expedited prior-notice procedure for certain permissible nonbank activities and for acquisitions of small banks and nonbank entities. Since that time the act has also permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

When reviewing a bank holding company application or notice to engage in an activity that requires prior approval, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm being 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. Data on decisions regard-

Decisions by the Federal Reserve on Domestic and International Applications, 2001

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	28	0	0	0	0	3	170	59	260
Merger of bank holding company	8	0	0	0	0	6	40	22	76
Acquisition or retention of bank	19	0	0	0	0	6	86	39	150
Acquisition of nonbank	0	0	62	0	0	7	0	124	193
Merger of bank	10	0	0	0	0	9	106	0	125
Change in control	0	0	0	0	0	3	0	111	114
Establishment of a branch, agency, or representative office by a foreign bank	12	0	4	3	0	0	9	0	28
Other	360	0	29	56	0	69	1,081	155	1,750
Total	**437**	**0**	**95**	**59**	**0**	**103**	**1,492**	**510**	**2,696**

ing domestic and international applications in 2001 are shown in the accompanying table.

Since 2000, the Bank Holding Company Act has permitted the creation of a special type of bank holding company called a financial holding company. Financial holding companies are allowed to engage in a broader range of nonbank activities than are traditional bank holding companies: Among other things, they may affiliate with securities firms and insurance companies and engage in certain merchant banking activities. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve System; most declarations are acted on by one of the Reserve Banks under authority delegated by the Board of Governors. In 2001, 135 domestic financial holding company declarations and 3 foreign bank declarations were approved.

Financial holding companies do not have to obtain the Board's prior approval to engage in or acquire a company engaged in new financial activities under GLBA. Instead, the financial holding company must notify the Board within thirty days after commencing a new activity or acquiring a company engaged in a new activity. A financial holding company also may engage in certain other activities that have been determined to be financial in nature or incidental to a financial activity or that are determined to be complementary to a financial activity.

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger 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 primary jurisdiction. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposed merger. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction. During 2001 the Federal Reserve approved 125 merger applications.

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors; by using standard terminology in assessing competitive factors in merger cases, the four agencies have sought to ensure consistency in administering the act. The Federal Reserve submitted 653 reports on competitive factors to the other agencies in 2001.

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 bank holding companies. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank or bank holding company being acquired; the effect of the proposed change on competition in any relevant market; the completeness of information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the federal deposit insurance funds. As part of the process, the Federal Reserve may contact other regulatory or law enforcement agencies for information about 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 being acquired.

In 2001 the Federal Reserve approved 114 proposed changes in control of state member banks and bank holding companies.

International Banking Act

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

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. It also considers whether the home country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information

concerning its operations and activities will be made available to the Board, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law.

In 2001 the Federal Reserve approved 28 applications by foreign banks to establish branches, agencies, and representative offices in the United States.

Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only an after-the-fact notification to the Board, large and other significant investments require the prior approval of the Board. Excluding proposals relating to recent large domestic mergers, the Federal Reserve in 2001 approved 26 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 1 application to acquire an Edge Act corporation, 3 to extend the corporate existence of an established Edge Act corporation, and 12 to establish or acquire a new agreement corporation.

Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers 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, that bank may open additional branches in that country without prior approval from the Federal Reserve. Excluding proposals related to recent large domestic mergers, the Federal Reserve in 2001 acted on proposals involving 1,399 new or merger-related domestic branches and granted prior approval for the establishment of 13 foreign branches.

State member banks also must obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including certain securities- and insurance-related activities that the parent bank may not conduct directly. In 2001, 6 applications for financial subsidiaries were approved.

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 the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's

capital adequacy guidelines. In 2001 the Federal Reserve reviewed 20 stock repurchase proposals by bank holding companies; all were approved by a Reserve Bank under delegated authority.

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 includes 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 states the deadline for comments. The Board's public web site (http://www.federalreserve.gov) continues to provide information relevant to the applications process.

Timely Processing of Applications

The Federal Reserve sets internal target time frames for the processing of applications. The setting of targets promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. Generally, the length of the target period ranges from twelve to sixty days, depending on the type of application or notice filed. In 2001, 92 percent of applications were processed within the established time period.

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 2001, 80 percent of the applications processed were handled under delegated authority.

Enforcement of Other Laws and Regulations

The Board's enforcement responsibilities also extend to financial disclosures by state member banks; securities credit; and efforts, under the Bank Secrecy Act, to counter money laundering.

Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 2001, twenty-three state member banks were registered with the Board under the Securities Exchange Act.

Securities Credit

Under the Securities Exchange Act, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided

by securities brokers and dealers when the credit is used to 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 the Board's securities credit regulations. The SEC, 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, and 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 2001 the foreign list was revised in March and September.

Anti–Money Laundering

The Department of the Treasury's regulation (31 CFR 103) implementing the Currency and Foreign Transactions Reporting Act (commonly referred to as the Bank Secrecy Act) requires banks and other types of financial institutions to file certain reports and maintain certain records. These documents record information on persons involved in large currency transactions and on suspicious activity related to possible violations of federal law, including money laundering and other financial crimes. The act is a primary tool in the fight against money laundering; its requirements inhibit 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 to the specific requirements of the Bank Secrecy Act (BSA), the Board's Regulation H (12 CFR 208.63) requires each banking organization supervised by the Federal Reserve to develop a written program for BSA compliance 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 personnel as appropriate. To monitor compliance, each Reserve Bank has designated a senior, experienced examiner as the Bank Secrecy Act and anti-money-laundering contact. During examinations of state member banks and U.S. branches and agencies of foreign banks, specially trained examiners review the institution's compliance with the act.

The Board has a special investigations section in the Division of Banking Supervision and Regulation that conducts financial investigations, provides expertise to the U.S. law enforcement community for investigation and training initiatives, and offers training to various foreign central banks and government agencies; section staff speak at banking conferences to promote best practices in the industry. Internationally,

the section has provided anti-money-laundering training and technical assistance to countries in Asia; in Eastern Europe, including the newly independent states; in South and Central America; and in the Caribbean. Staff members have also participated in numerous multilateral anti-money-laundering initiatives such as the Financial Action Task Force and the Basel Committee on Banking Supervision.

In 2001, the Federal Reserve continued to provide expertise and guidance to the Bank Secrecy Act Advisory Group, a committee established by the Congress at the Department of the Treasury to seek measures to reduce unnecessary burdens created by the act and to increase the utility of data gathered under the act to aid regulators and law enforcement. The Federal Reserve also assisted the Treasury Department in providing feedback to financial institutions on the reporting of suspicious activity.

Since the terrorist attacks of September 11, the Federal Reserve has played an important role in many joint activities with bank supervisory and law enforcement authorities and the banking community, both domestically and abroad, to combat money laundering and terrorist financing. In addressing the mandates of the anti-money-laundering provisions of the USA PATRIOT Act, the Federal Reserve issued a supervisory letter in November to all domestic and foreign banking organizations under its supervision. The letter described the act's provisions, highlighted those provisions needing immediate attention by financial institutions and supervisory staff, and described the new rules that would be issued under the act.

At the request of Treasury staff and consistent with statutory requirements for consultation, the Federal Reserve has been actively assisting in the development of these new rules. Of the twenty working groups established by the Treasury Department to carry out the different regulatory projects required by the act, Federal Reserve staff are involved in fifteen. The Federal Reserve also established a PATRIOT Act Working Group composed of senior, experienced Bank Secrecy Act/anti-money-laundering examiners from throughout the System. This group, which is charged with overseeing the System's implementation of the new law, worked on drafting new examination procedures and developing a new training curriculum for examiners who conduct Bank Secrecy Act and anti-money-laundering examinations.

Loans to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must

Loans by State Member Banks to their Executive Officers, 2000 and 2001

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
2000			
October 1–December 31	702	59,232,000	5.5–20.8
2001			
January 1–March 31	633	65,663,000	2.0–21.0
April 1–June 30	710	51,109,000	3.9–18.0
July 1–September 30	665	56,830,000	4.6–19.5

SOURCE. Call Reports.

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 for 2001.

Federal Reserve Membership

At the end of 2001, 3,058 banks were members of the Federal Reserve System and were operating 49,102 branches. These banks accounted for 38 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 considerable attention in 2001 to improving security, operational efficiency, and service quality. This chapter describes those efforts as well as other activities affecting the Reserve Banks.

Major Initiatives

Since the terrorist attacks on September 11, the Federal Reserve has reevaluated its contingency and business continuity plans and operations and is taking steps to enhance them. All information technology infrastructures—both within and outside the Federal Reserve's control—that support critical operations are being reexamined to ensure that they have appropriate security, redundancy, and diversity. Experience gained from preparing for the century date change and in the aftermath of the attacks is being applied to strengthen further the Federal Reserve's national incident-response procedures and communications.

In 2001, the Federal Reserve Banks made an ambitious commitment to reduce System costs in certain areas significantly over the next three years. To achieve this objective, they initiated several cost-reduction projects in the information technology, accounting, and human resources functions.

Among the cost-reduction projects are several to centralize or standardize common information technology utilities and resources. The Reserve Banks are also collaborating on several projects to eliminate duplication of efforts in application development and to identify commercially available alternatives to software planned for development. These efforts will enable the Banks to be more cost effective while continuing to provide high-quality, reliable services.

Another cost-reduction project begun during the year was a concentrated multiyear effort to reduce employee benefit costs by consolidating health and welfare plans and their administration, by outsourcing, and by implementing cost-effective benefit-plan design strategies. The savings from these efforts are expected to fully offset enhancements of employee benefits that are intended to make employment at the Federal Reserve more attractive and thus improve the institution's ability to compete for and retain the skilled professionals, technical staff, and key executives needed to carry out the Federal Reserve's mission.

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 taxes that would have been paid and the 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] Over the past ten years, the

1. Along with income taxes and the return on equity, the PSAF is made up of three additional 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

September 11 and the Payments System

We are blessed with a financial system that is creative, that is flexible, that is innovative. Banks—including the central bank—were there when they were needed and did what was required with dispatch. We should be proud of the banking system's role in minimizing the economic fallout of that tragic day.

Alan Greenspan, *Chairman*, Board of Governors

For several days after the terrorist attacks on September 11, 2001, communications and connectivity problems disrupted portions of the nation's payments system infrastructure, requiring many banks, securities dealers, and settlement utilities in lower Manhattan to relocate their operations to contingency sites. Although most backup procedures worked as planned, telecommunications problems impaired some firms' ability to communicate with counterparties and employees and to transmit payment and settlement instructions. Transportation problems in the Manhattan area also made it difficult to move employees to contingency sites.

Disruptions to the payments system due to telecommunications and transportation problems resulted in payment delays and liquidity dislocations among financial market participants for several days. As one indication of liquidity dislocations, from September 12 to 14, the balances that depository institutions held in their Federal Reserve accounts averaged ten times their usual level, with more than 70 percent of those balances held by just six institutions, compared with the 20 percent this group normally holds. Disruptions in large payment flows also resulted from problems in the clearance and settlement of U.S. government securities transactions and the redemption of maturing commercial paper transactions.

Although electronic funds transfer systems, such as Fedwire, CHIPS, the automated clearinghouse (ACH), and credit and debit card networks, were not directly affected by the attacks, some participants experienced connectivity problems, resulting in a decline in payments activity. The value of aggregate daily payments over CHIPS, for example, was lower than normal through September 14 but recovered the following week, while the value of government securities transfers over the Fedwire securities transfer system remained low through the week of Septem-

Federal Reserve Banks have recovered 99.8 percent of their priced services costs, including the PSAF (table).

Overall, fees charged in 2001 for priced services increased approximately 5.2 percent from 2000.[2] Revenue from priced services was $926.5 million, other income related to priced services was $33.9 million, and costs related to priced services were $901.9 million, resulting in net revenue of $58.5 million and a recovery rate of 95.0 percent of costs, including the PSAF.[3]

the Board of Governors that are related to priced services; in the pro forma statements at the end of the 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 revenue, and income before taxes—can be linked to the pro forma statements at the end of the chapter. *Other income* is revenue from investment of clearing balances, net of earnings credits, an amount

ber 17. Although the value of Fedwire funds transfers initially declined on September 11, the value of transfers increased materially starting on September 12 and remained high throughout the month.

The Federal Reserve responded to these disruptions in a variety of ways. On the morning of September 11, the Federal Reserve announced, "The Federal Reserve System is open and operating. The discount window is available to meet liquidity needs." Depository institutions affected by the disruptions to the payments system borrowed heavily from the window for several days. In addition, the Federal Reserve provided a large volume of reserves through open market operations. Daylight and overnight overdrafts also increased dramatically, reflecting the difficulties that account holders experienced in managing their Federal Reserve accounts as a result of payments system disruptions. In view of these difficulties, the Reserve Banks waived daylight overdraft fees and overnight overdraft penalty fees from September 11 through 21 for all account holders. To support the direct provision of U.S. dollar liquidity to foreign-based entities, the Federal Reserve arranged currency swaps with the Bank of Canada, the Bank of England, and the European Central Bank.

The Federal Reserve also worked closely with the financial industry to restore connectivity and the normal flow of payments. The Board used its authority under the Telecommunications Service Priority program to expedite emergency provision of telecommunications circuits for the Reserve Banks and several key payment providers and market utilities in the New York City area. In addition, the Federal Reserve extended the operating hours of the Fedwire funds and securities transfer systems to give financial institutions and their customers more time to process each day's intended payments. The Federal Reserve also executed a significant number of off-line Fedwire funds payment orders on behalf of institutions that were experiencing connectivity problems. Finally, the Reserve Banks continued to credit the value of all check deposits to depositing institutions' accounts, even if the Reserve Banks could not present the checks to (and debit the accounts of) paying banks because airplanes were grounded. As a result of the decision to credit these deposits, daily check float, which normally is less than $1 billion, peaked at $47.4 billion on September 13, providing an additional significant source of liquidity to the banking system.

Check Collection

Federal Reserve Bank operating expenses and imputed costs for commercial check services in 2001 totaled $754.4 million, compared with $680.1 million in 2000. Revenue from check operations totaled $764.7 million, and other income amounted to $28.5 million. Net income from check services was $38.9 million, a $44.4 million, or 53.3 percent, decrease compared with 2000 net income.

The Reserve Banks handled 16.9 billion checks in 2001, a decrease of 0.5 percent from 2000 (see table). The volume of checks deposited that required processing by the Reserve Banks increased 0.8 percent, a slightly slower rate than the 1.1 percent increase in 2000. The volume of fine-sort checks,

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 revenue* is revenue plus net income on clearing balances minus total cost.

Priced Services Cost Recovery, 1992–2001

Millions of dollars except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity	Total costs	Cost recovery (percent)[3]
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	833.0	104.2
2000	922.8	**818.2**	98.4	**916.6**	**100.7**
2001	960.4	901.9	109.2	1,011.1	95.0
1992–2001	8,293.0	7,782.2	523.7	8,305.9	99.8

NOTE. In this and the following tables, components may not sum to totals or yield percentages shown because of rounding. Amounts in bold are restatements due to errors in previously reported data.

1. Includes revenue from services of $8,025.2 million and other income and expense (net) of $267.8 million for the ten-year period.

2. Includes operating expenses of $6,861.3 million, imputed costs of $552.4 million, and imputed income taxes of $275.0 million for the ten-year period. Also, the effect of one-time accounting changes net of taxes of $74.1 million and $19.4 million is included for 1993 and 1995 respectively.

3. Revenue from services divided by total costs.

which are presorted by the depositing banks according to paying bank, declined 10.4 percent, compared with a 10.7 percent decrease in 2000.

The Reserve Banks continued to encourage the use of electronic check products to make the collection system more efficient. In 2001, the percentage of all checks presented electronically by the Reserve Banks to paying banks was 21.7 percent (approximately 3.7 billion checks), compared with 20.4 percent in 2000. The Reserve Banks captured images of 8.1 percent of the checks they collected, compared with 7.2 percent in 2000.

To assess the potential benefits, in terms of error corrections and operational processes, of keeping image copies of all checks processed, the New York Reserve Bank's Utica office continued a pilot project to capture images of the checks processed on all its high-speed check sorters. The Minneapolis Bank's Helena Branch concluded its pilot project to use check images to expedite check returns; lessons learned during the project are being incorporated into new proposals to exploit technology and reduce transportation costs in check clearing.

During 2001, the Federal Reserve Banks continued a five-year check modernization project to install uniform software and hardware for check processing, check imaging, and check adjustments in forty-five Reserve Bank offices and to give depository institutions web-based access to check services. The project costs are expected to be recovered over the long run because the modernization effort will increase operating efficiency and make it possible to offer additional services to depository institutions.

Automated Clearinghouse

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled $67.7 million in 2001. Revenue from

Activity in Federal Reserve Priced Services, 2001, 2000, and 1999

Thousands of items

Service	2001	2000	1999	Percent change	
				2000 to 2001	1999 to 2000
Commercial checks	16,905,016	16,993,800	17,075,008	–.5	–.5
Funds transfers	115,308	111,175	105,408	3.7	5.5
Securities transfers	6,708	5,666	5,147	18.4	10.1
Commercial ACH	4,448,361	3,812,191	3,343,615	16.7	14.0
Noncash services	412	519	613	–20.7	–15.3
Cash transportation	18	19	18	–5.3	5.6

NOTE. 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 services,* 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.

ACH operations and other income totaled $79.4 million, resulting in net income of $11.9 million. The Reserve Banks processed 4.4 billion commercial ACH transactions (worth $12.7 trillion), an increase of 16.7 percent from 2000.

In 2000, the Board approved a new approach to pricing ACH transactions that the Reserve Banks deliver through and receive from private-sector ACH operators (PSOs). Among other things, the Board authorized the Reserve Banks to initiate discussions with the PSOs to negotiate the structure and level of fees that the Reserve Banks charge the PSOs for processing inter-operator transactions as well as the fees that the Reserve Banks pay the PSOs. Negotiations continued into 2001, and a new inter-operator fee structure became effective on October 1. On that same date, the Reserve Banks also implemented a new pricing method for their depository institution ACH customers. Monthly fixed fees were increased, and per-item fees were decreased. The new method better corresponds to the Reserve Banks' ACH cost structure, which is characterized by high fixed and low variable costs.

In August, the Reserve Banks began the process of consolidating at two Reserve Bank offices the support for ACH operations once provided by each of the twelve Federal Reserve Banks. Support activities being consolidated include ensuring the timely and accurate processing of payments, maintaining the integrity of the ACH application, monitoring file processing, and responding to customers' questions. The consolidation, which is expected to reduce ACH costs while maintaining service quality, is scheduled to be complete by the end of the first quarter of 2002.

Fedwire Funds Transfer and Net Settlement

Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and net settlement services totaled $56.7 million in 2001. Revenue from these operations totaled $61.8 million, and other income amounted to $2.0 million, resulting in net income of $7.1 million.

Funds Transfer

The Fedwire funds transfer system allows depository institutions to draw

Fees Paid by Depository Institutions for Selected Federal Reserve Priced Services, 2000 and 2001

Dollars

Item	2000	2001
FEDWIRE FUNDS TRANSFERS, BY VOLUME TIER[1]		
Tier *(number of transfers per month)*[2]		
1 *(1 to 2,500)*	.33	.33
2 *(2,501 to 80,000)*	.24	.24
3 *(80,001 and more)*	.17	.16
Off-line surcharge	15.00	15.00
NET SETTLEMENT, BY TYPE OF SERVICE		
Net settlement sheet		
Entries, each	.95	.95
Files, each	12.00	12.00
Minimum per month	60–175	60–100
FEDWIRE SECURITIES		
Account maintenance		
Per issue	.45	.45
Per account	15.00	15.00
Transfers, each[2]	.70	.70
Off-line surcharge	18.00	25.00
NONCASH COLLECTION		
Bonds, each	40.00	40.00
Deposit envelopes *(per envelope of coupons)*[3]		
1–5	4.75	4.75
6–50	2.50	2.50
Cash letters *(flat fee, by number of envelopes of coupons)*[3]		
1–5	7.50	7.50
6–50	15.00	15.00
Return items, each	15.00	20.00

NOTE. Rates for 2000 are as of April 3.

1. Rates apply only to their specified volume tiers.
2. Originated and received.
3. Deposits and cash letters may contain no more than 50 envelopes of coupons.

on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions. The number of Fedwire funds transfers originated by depository institutions increased 3.7 percent in 2001, to 115,308 million. In August, the Reserve Banks reduced the transfer fee for the highest-volume tier while keeping other fees unchanged (table). The off-line funds transfer surcharge also remained unchanged.[4]

In September, the Reserve Banks began the final phase of consolidating the operations of the Fedwire funds transfer service.[5] The consolidation is expected to reduce operating costs upon its completion in August 2002.

Net Settlement

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' net settlement service to settle their transactions. The Reserve Banks provide settlement services to approximately 70 local and national private arrangements, including local check clearinghouse associations, automated clearinghouse networks, and credit card processors. In 2001, the Reserve Banks processed more than 417,000 settlement entries for these arrangements, and fees remained at their 2000 levels.

Fedwire Securities Service

The Fedwire securities service allows depository institutions to transfer securities issued by the U.S. Treasury, federal government agencies, and other entities electronically to other institutions in the United States. Reserve Bank operating expenses and imputed costs for providing this service totaled \$19.5 million in 2001. Revenue totaled \$19.0 million, and other income amounted to \$0.7 million, resulting in net income of \$0.2 million. Approximately 6,708 million transfers were processed on the

4. Depository institutions that do not have an electronic connection to the Fedwire funds transfer system can originate transfers via "off-line" telephone instructions.

5. The first phase of this and the Fedwire securities service consolidation was completed in March 1999.

system during the year, an increase of 18.4 percent from 2000.[6] The basic per-transfer fee for transfers originated and received by depository institutions and the monthly account maintenance fees were unchanged in 2001, while the off-line securities transaction surcharge was increased from $18.00 to $25.00.

In September, the Reserve Banks began the final phase of consolidation of the Fedwire securities service in an effort to reduce costs. The consolidation is expected to be complete in August 2002.

The Government National Mortgage Association (Ginnie Mae) announced plans in 2001 to have its securities clear and settle on the Fedwire securities transfer system. The conversion is expected to be complete by March 2002.

Noncash Services

The Federal Reserve provides a service to collect and process municipal bearer bonds and coupons issued by state and local governments (referred to as "non-cash" items). The service, which has been centralized at one Federal Reserve office, processed 412,000 noncash transactions in 2001.

Operating expenses and imputed costs for noncash services totaled $1.6 million in 2001. Revenue from noncash operations totaled $2.0 million, resulting in net income of $0.4 million. The return-item fee was increased from $15 to $20, and the other collection fees remained the same.

Special Cash Services

The Reserve Banks charge fees for providing special cash-related services, such as currency packaged in a non-standard way. These services—collectively referred to as "special cash services"—account for a very small proportion (less than 1 percent) of the total cost of cash services provided by the Reserve Banks to depository institutions. Operating expenses and imputed costs for special cash services totaled $2.1 million in 2001. Revenue and other income totaled $2.3 million, resulting in net income of $0.2 million.

Float

Federal Reserve float decreased in 2001 to a daily average of $604.6 million, from a daily average of $774.2 million in 2000. The Federal Reserve recovers the cost of float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

Currency volume in the Federal Reserve System continued to be high in 2001. Reserve Banks received 33.5 billion notes from circulation in 2001, a slight increase from the 33.3 billion notes received in 2000, the Y2K flowback year (when depository institutions returned the extra vault cash they had held in anticipation of the century date change). Reserve Banks also made payments of 34.3 billion notes to circulation in 2001, a 7 percent increase from 2000.

The Federal Reserve Bank of San Francisco officially opened the Phoenix

6. The expenses, revenues, 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 securities service also provides account maintenance, transfer, and settlement services for U.S. Treasury securities. When the Reserve Banks provide these services, they act as fiscal agents of the United States. The Treasury Department assesses fees on depository institutions for some of these services. For details, see the section "Fiscal Agency Services" later in this chapter.

cash-processing center on September 4. The center will operate as a satellite office of the Los Angeles Branch.

Developments in Fiscal Agency and Government Depository Services

The total cost of providing fiscal agency and depository services to the Treasury in 2001 amounted to $246.5 million, compared with $262.5 million in 2000 (table). The cost of providing services to other government agencies was $38.9 million, compared with $39.4 million in 2000. In 2001, the Reserve Banks requested reimbursement by the Treasury and other government agencies of $285.4 million for fiscal agency and depository expenses, a decrease of $16.6 million from 2000.

Fiscal Agency Services

As fiscal agents, Reserve Banks provide to the Treasury 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.

Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities in 2001 (Treasury Direct,

Expenses of Federal Reserve Banks for Fiscal Agency and Depository Services, 2001, 2000, and 1999

Thousands of dollars

Agency and service	2001	2000	1999
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Savings bonds	69,569.8	70,786.7	70,285.8
Treasury Direct	37,326.6	41,259.3	40,446.2
Commercial book entry	9,998.1	13,924.6	15,744.2
Marketable Treasury issues	11,366.8	14,224.3	13,715.1
Definitive securities and Treasury coupons	610.9	1,069.3	4,886.7
Other services	150.7	132.5	100.4
Total	129,022.9	141,404.7	145,178.4
Financial Management Service			
Treasury tax and loan and Treasury general account	31,106.0	38,649.0	34,971.0
Government check processing	30,310.2	31,866.9	33,365.4
Automated clearinghouse	9,665.2	10,799.1	11,263.4
Government agency check deposits	2,272.9	2,218.8	2,422.7
Fedwire funds transfers	199.2	182.9	187.7
Other services	30,771.5	27,015.4	20,423.5
Total	104,324.9	110,732.2	102,633.7
Other Treasury			
Total	13,149.8	10,362.8	7,786.8
Total, Treasury	246,497.5	262,499.7	255,598.9
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	13,197.2	16,463.7	18,643.9
U.S. Postal Service			
Postal money orders	11,255.0	9,213.5	6,623.3
Miscellaneous agencies			
Other services	14,434.0	13,747.1	13,983.0
Total, other agencies	38,886.2	39,424.3	39,250.2
Total reimbursable expenses	**285,383.7**	**301,924.0**	**294,849.1**

Fedwire book-entry system, marketable issues, definitive securities, and Treasury coupons) totaled $59.3 million, a 15.9 percent decrease from 2000. The Reserve Banks processed nearly 258,000 tenders for Treasury securities, compared with 220,000 in 2000, and handled 2.8 million reinvestment requests, compared with 2.0 million in 2000.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire system, which provides custody and transfer, and Treasury Direct, which provides custody services only.[7] Almost all book-entry Treasury securities, 97.5 percent of the total par value outstanding at year-end 2001, were maintained on Fedwire; the remainder were maintained on Treasury Direct. The Reserve Banks in 2001 originated 7.8 million Fedwire transfers of Treasury securities, a 1.9 percent increase from 2000.

On behalf of Treasury Direct customers, the Reserve Bank designated to handle sales sold nearly 15,000 securities worth $699.9 million, compared with more than 16,000 securities worth $581.2 million in 2000, collecting almost $510,000 in fees on behalf of the Treasury, a decrease of 8.4 percent from the almost $557,000 in fees collected in 2000.

Savings Bonds

Reserve Bank operating expenses for savings bond activities totaled $69.6 million in 2001, a decrease of 1.7 percent from 2000. The Banks printed and mailed 37.8 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 3.3 percent increase from 2000. They also processed nearly 5.5 million original-issue transactions for the Series I (inflation-indexed) savings bond and 26.2 million original-issue transactions for the Series EE savings bond. In addition, the Banks processed approximately 563,000 redemption, reissue, and exchange transactions, a 1.0 percent decrease from 2000. Reserve Bank staff responded to 1.6 million service calls from owners of savings bonds, a 4.4 percent increase from 2000.

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 payments in 2001 totaled $31.1 million. The Federal Reserve enhanced the Treasury tax and loan program at midyear 2001 by enabling the Treasury to invest funds with eligible depository institutions throughout the afternoon rather than just in the morning, adding approximately $3.0 million to Treasury's investment income. It also worked with the Treasury to develop a pilot program whereby the Treasury could place investments with depository institutions for a set term, the interest rate being determined by auction.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payments in 2001

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

amounted to $42.4 million. The Banks processed 900.4 million ACH transactions for the Treasury, an increase of 7.4 percent from 2000. They also processed 345.8 million paper government checks, an increase of 32.0 percent from 2000. In addition, the Banks issued nearly 435,000 paper fiscal agency checks, a decrease of 17.4 percent from 2000.

During the year, a Reserve Bank assisted Treasury's efforts to facilitate electronic payments to the federal government. The Bank began sending ACH debits and making related accounting entries for Treasury's Pay.gov web site and began converting checks received by the Treasury at the point of sale at four overseas military bases.

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. One such service is the provision of food coupon services for the Department of Agriculture. Reserve Bank operating expenses for food coupon services in 2001 totaled $13.2 million, 19.8 percent lower than in 2000. The Banks redeemed 587 million food coupons, a decrease of 14.5 percent from 2000. The Federal Reserve System is consolidating food coupon processing and expects 2001 consolidations to save more than $500,000 per year.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. In 2001, they processed 229.4 million postal money orders, approximately the same number as in 2000.

Information Technology

The Federal Reserve continued in 2001 to provide highly reliable and secure electronic services and expanded its electronic access options to depository institutions. Significant progress was made on the System's project to implement frame relay technology on Fednet, the telecommunications network that supports both external electronic connections between the Federal Reserve and depository institutions and internal communications among Reserve Banks. The improvements will improve the speed, reliability, and performance of the depository institutions' electronic connections during contingencies and will also increase the capacity and flexibility to support new electronic services using web-based technologies. The Reserve Banks continued to improve electronic access options for depository institutions and to offer web-based applications for check imaging, cash ordering, and savings bonds processing. The Banks plan to offer other new web-based services over the next several years.

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 engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section "Federal Reserve Bank 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 provides an assertion letter to its board of directors annually 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.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2001 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $1.3 million. In order to ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Bank or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2001 the Reserve Banks engaged PwC for advisory services totaling $0.9 million, $0.7 million of which was for project management advisory services related to the System's check modernization project. The Board believes that these advisory services do not directly affect the preparation of the financial statements audited by PwC and are not incompatible with the services provided by PwC as an independent auditor.

In 2001, the examinations by the Board's Division of Reserve Bank Operations and Payment Systems of the Reserve Banks, using a format consistent with the integrated COSO framework, assessed the efficiency and effectiveness of operations, the reliability of financial reporting, compliance with applicable laws and regulations, and the safeguarding of assets. The annual attention at each Reserve Bank includes an assessment of the effectiveness of the Bank's internal audit function.

Each year, to assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division also 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 distributions of net earnings of the Federal Reserve Banks for 2000 and 2001.

Income in 2001 was $31,871 million, compared with $33,964 million in 2000. Total expenses were $2,718 million ($1,834 million in operating expenses, $250 million in earnings credits granted to depository institutions, and $295 million in assessments for expenditures by the Board of Governors). The cost of new currency was $339 million. Revenue from priced services was $926.5 million.

The profit and loss account showed a net loss of $1,117 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 $428 million, $18 million more than in 2000; the rise reflects an increase in the capital and surplus of member banks and a conse-

Income, Expenses, and Distribution of Net Earnings
of Federal Reserve Banks, 2001 and 2000

Millions of dollars

Item	2001	2000
Current income	31,871	33,964
Current expenses	2,085	1,972
Operating expenses[1]	1,834	1,586
Earnings credits granted	250	385
Current net income	29,786	31,992
Net additions to (deductions from, –) current net income	−1,117	−1,492
Cost of unreimbursed services to Treasury	0	8
Assessments by the Board of Governors	634	624
For expenditures of Board	295	188
For cost of currency	339	436
Net income before payments to Treasury	28,035	29,868
Dividends paid	428	410
Transferred to surplus	518	4,115
Payments to Treasury[2]	27,089	25,344

1. Includes a net periodic credit for pension costs of $331 million in 2001 and $393 million in 2000.

2. Interest on Federal Reserve notes.

quent 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 $27,089 million in 2001, up from $25,344 million in 2000; 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 volume, table 5 details the income and expenses of each Federal Reserve Bank for 2001, and table 6 shows a condensed statement for each Bank for the years 1914 through 2001. 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 2001 amounted to $559,323 million, an increase of $31,184 million from 2000 (see table). Holdings of U.S. government securities increased $31,152 million, and holdings of loans increased $32 million.

The average rate of interest earned on the Reserve Banks' holdings of government securities declined to 5.46 percent, from 6.20 percent in 2000, and the average rate of interest earned on loans declined to 3.18 percent, from 6.27 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 1996 through 2001.

Federal Reserve Bank Premises

In 2001, construction of the Atlanta Reserve Bank's new headquarters building and the San Francisco Bank's new cash-processing center in Phoenix was completed.

Securities and Loans of Federal Reserve Banks, 1999–2001

Millions of dollars except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]
Average daily holdings[3]			
1999	495,606	495,384	221
2000	528,139	527,774	365
2001	559,323	558,926	397
Earnings			
1999	28,227	28,216	11
2000	32,760	32,737	23
2001	30,536	30,523	13
Average interest rate (percent)			
1999	5.70	5.70	5.02
2000	6.20	6.20	6.27
2001	5.46	5.46	3.18

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 Board approved a new building program for the Chicago Bank's Detroit Branch. The Bank relocated its check-processing function from its headquarters building to leased space near Midway Airport in Chicago and sold its Westgate warehouse in suburban Chicago.

Design work for the Dallas Bank's new Houston Branch building continued. The Kansas City Bank continued to analyze the long-term planning options for its headquarters facility, and the St. Louis Bank initiated a similar analysis of its headquarters facility.

The San Francisco Bank began a study of the long-term business needs and planning options for its Seattle and Portland Branches. The lease on the Cleveland Bank's regional check-processing center in Columbus, Ohio, was renewed.

The multiyear renovation program and the cleaning and repair of the exterior stonework continued at the New York Bank's headquarters building. An improvement program for the main chiller plant in the headquarters building continued. Also, the improvements to the New York Bank's leased office facility in New York City were completed.

At all facilities, security enhancement programs were undertaken as a result of the events of September 11. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2001 and 2000

Millions of dollars

Item	2001		2000	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	860.8		667.0	
Investment in marketable securities	7,747.3		6,002.6	
Receivables	76.5		74.9	
Materials and supplies	3.1		3.2	
Prepaid expenses	30.5		35.2	
Items in process of collection	1,772.1		4,094.6	
Total short-term assets		10,490.3		10,877.4
Long-term assets (Note 2)				
Premises	473.0		471.9	
Furniture and equipment	176.1		171.2	
Leases and leasehold improvements	88.1		65.3	
Prepaid pension costs	760.8		659.9	
Total long-term assets		1,498.0		1,368.3
Total assets		11,988.3		12,245.7
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	8,524.5		**6,886.1**	
Deferred-availability items	1,855.7		**3,878.1**	
Short-term debt	20.8		113.2	
Short-term payables	89.2		.0	
Total short-term liabilities		10,490.3		10,877.4
Long-term liabilities				
Long-term debt	519.7		443.0	
Postretirement/postemployment benefits obligation	257.8		243.9	
Total long-term liabilities		777.4		686.9
Total liabilities		11,267.7		11,564.3
Equity		720.6		681.4
Total liabilities and equity (Note 3)		11,988.3		12,245.7

NOTE. Components may not sum to totals because of rounding. Amounts in bold are restatements due to errors in previously reported data.

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

Pro Forma Income Statement for Federal Reserve Priced Services, 2001 and 2000

Millions of dollars

Item	2001		2000	
Revenue from services provided to depository institutions (Note 4)		926.5		881.5
Operating expenses (Note 5)		814.9		**716.5**
Income from operations		111.7		**165.1**
Imputed costs (Note 6)				
Interest on float	15.5		12.8	
Interest on debt	32.0		31.5	
Sales taxes	12.6		9.3	
FDIC insurance	.0	60.1	.0	53.6
Income from operations after imputed costs		51.6		**111.4**
Other income and expenses (Note 7)				
Investment income	273.3		411.8	
Earnings credits	−239.4	33.9	−370.5	41.3
Income before income taxes		85.4		**152.7**
Imputed income taxes (Note 8)		26.9		**48.1**
Net income		58.5		**104.6**
MEMO: Targeted return on equity (Note 9)		109.2		98.4

NOTE. Components may not sum to totals because of rounding. Amounts in bold are restatements due to errors in previously reported data.

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, 2001

Millions of dollars

Item	Total	Commercial check collection	Funds transfer and net settlement	Fedwire securities	Commercial ACH	Noncash services	Cash services
Revenue from services (Note 4)	926.5	764.7	61.8	19.0	76.9	2.0	2.2
Operating expenses (Note 5)	814.9	684.3	50.3	18.4	58.5	1.3	2.0
Income from operations	111.7	80.4	11.4	.6	18.4	.7	.2
Imputed costs (Note 6)	60.1	52.2	3.1	1.0	3.8	.1	.0
Income from operations after imputed costs	51.6	28.2	8.4	−.4	14.6	.6	.2
Other income and expenses, net (Note 7)	33.9	28.5	2.0	.7	2.5	.0	.1
Income before income taxes	85.4	56.7	10.4	.3	17.2	.6	.2
Imputed income taxes (Note 8)	26.9	17.9	3.3	.1	5.4	.2	.1
Net income	58.5	38.9	7.1	.2	11.8	.4	.2
MEMO: Targeted return on equity (Note 9)	109.2	90.2	7.4	2.3	8.9	.2	.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.

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2000

Millions of dollars

Item	Total	Commercial check collection	Funds transfer and net settlement	Fedwire securities	Commercial ACH	Noncash services	Cash services
Revenue from services (Note 4)	881.5	728.6	61.9	17.8	68.8	2.3	2.1
Operating expenses (Note 5)	**716.5**	**595.5**	**49.5**	14.0	53.6	1.7	2.1
Income from operations	**165.1**	**133.1**	**12.4**	3.8	15.2	.6	.0
Imputed costs (Note 6)	53.6	**46.3**	**3.1**	**.8**	3.3	**.1**	.0
Income from operations after imputed costs	**111.4**	**86.8**	**9.3**	3.0	11.9	.4	.0
Other income and expenses, net (Note 7)	41.3	34.7	2.7	.8	2.9	.1	.1
Income before income taxes	**152.7**	**121.5**	**12.0**	3.8	14.8	**.6**	.1
Imputed income taxes (Note 8)	**48.1**	**38.3**	**3.8**	1.2	4.7	.2	.0
Net income	**104.6**	**83.2**	**8.2**	2.6	**10.1**	.4	.1
MEMO: Targeted return on equity (Note 9)	98.4	80.8	7.5	1.9	8.0	.2	.1

NOTE. Components may not sum to totals because of rounding. Amounts in bold are restatements due to errors in previously reported data.

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

FEDERAL RESERVE BANKS

NOTES TO PRO FORMA FINANCIAL STATEMENTS FOR PRICED SERVICES

(1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as 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 $101.0 million in 2001 and $115.5 million in 2000 and corresponding increases in this asset account.

(3) Liabilities and Equity

Under the matched-book capital structure for assets, short-term assets are financed with short-term payables and short-term debt in 2001 and only short-term debt in 2000. 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 $4.9 million in 2001 and $4.2 million in 2000. 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 2001 and 2000 as follows (in millions):

	2001	2000
Check	43.5	40.3
ACH	4.4	3.7
Funds transfer	3.5	4.3
Book entry	1.9	1.1
Noncash services	.1	.1
Special cash services	.0	.1
Total	53.4	49.6

(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 2001 in millions of dollars:

Total float	1,056.3
Unrecovered float	112.3
Float subject to recovery	944.0
Sources of recovery of float	
Income on clearing balances	94.4
As-of adjustments	451.7
Direct charges	505.3
Per-item fees	(107.4)

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; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2001. The 2001 float levels were unusually high because of the effect of September 11 events.

(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.

(8) Income Taxes

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

(9) 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).

The Board of Governors and the Government Performance and Results Act

Under the Government Performance and Results Act of 1993 (GPRA), 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. Although it is not covered by the act, the Board of Governors has chosen to voluntarily comply with the act.

Strategic and Performance Plans

The Board's most recent strategic plan in the GPRA format, released in December 2001, covers the period 2001–05. Like the earlier plan, which covered 1997–2002, the most recent 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 the evaluation of performance.

The Board's most recent performance plan covers its 1998–99 budget.[1] The plan sets forth specific targets for some of the performance measures identified in the strategic plan (except those associated with the monetary policy function). It also describes the operational processes and resources needed to meet those targets and discusses validation and verification of results.

The strategic and performance plans are available on the Board's public web site (http://www.federalreserve.gov/boarddocs/rptcongress). The Board's mission statement and a summary of the goals and objectives set forth in the strategic and performance plans are given below.

Mission

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

Goals and Objectives

The Federal Reserve has three primary goals with interrelated and mutually reinforcing elements:

Goal

To conduct monetary policy that promotes the achievement of maximum sustainable long-term growth; price stability fosters that goal.

Objectives

- Stay abreast of recent developments and prospects in the U.S. economy

1. The Board's budget covers two calendar years (making it slightly incongruent with the act's requirement that a performance plan be submitted for each fiscal year). Neither a performance plan for 2000–01 nor a performance report for 1998–99 was prepared, as staff attention was diverted to matters associated with the century date change and the Gramm–Leach–Bliley Act. A performance plan for 2002–03 will be issued in the second quarter of 2002.

and financial markets and in those abroad, so that monetary policy decisions will be well informed
- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets and improve the quality of the data used to gauge economic performance, through developmental research activities
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure
- Contribute to the development of U.S. international policies and procedures, in cooperation with the 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.

Objectives

- Provide comprehensive and effective supervision of U.S. banks, bank and financial holding companies, U.S. operations of foreign banking organizations, and related entities
- Promote overall financial stability, manage and contain systemic risk, and ensure that emerging financial crises are identified early and successfully resolved
- Improve efficiency and effectiveness and reduce burden on supervised institutions
- Promote equal access to banking services
- Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (Truth in Lending, Truth in Savings, Consumer Leasing, and Electronic Funds Transfer) to carry out congressional intent, striking the proper balance between protection of consumers and burden to the industry.

Goal

To provide high-quality professional oversight of Reserve Bank operations and to foster the integrity, efficiency, and accessibility of U.S. payment and settlement systems.

Objectives

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility
- Produce high-quality assessments of Federal Reserve Bank operations, projects, and initiatives that assist Federal Reserve management in fostering and strengthening sound internal control systems and efficient and effective performance
- Conduct research and analysis that contributes to policy development and/or increases the Board's and others' understanding of payment system dynamics and risk.

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 representatives 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. These and similar planning efforts can significantly lower the government's costs for data processing and other activities as well as depository institutions' costs for complying with federal regulations. ■

2. The FFIEC consists of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, 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

One federal law was enacted during 2001 that significantly affects the Federal Reserve System and the institutions it supervises. In addition, legislation was proposed by the Board of Governors that would, if enacted, facilitate check truncation and enhance the efficiency of the nation's payments system as a whole.

USA PATRIOT Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act), Public Law 107-56, enacted on October 26, 2001, adds to and amends existing laws, including laws pertaining to financial institutions, to enhance domestic security following the September 11, 2001, attacks. Title III of the act amends various federal banking laws and other laws related to financial institutions or products, principally the Bank Secrecy Act but also the Bank Holding Company Act of 1956, the Fair Credit Reporting Act, and the Right to Financial Privacy Act. In addition, the USA PATRIOT Act amends the Federal Reserve Act to authorize certain System personnel to act as law enforcement officers and carry firearms to protect and safeguard System premises and staff.

Title III of the act directs certain government agencies, principally the Department of the Treasury in consultation with the Board of Governors of the Federal Reserve System, to take steps to investigate and curtail money laundering and other activities that might be undertaken to finance terrorist actions or disrupt legitimate banking operations. The following discussion summarizes title III and describes the portions that bear significantly on the Federal Reserve System and the institutions it supervises.

Title III requires a broad range of financial institutions in the United States to establish anti-money-laundering programs, including policies, procedures, controls, and audit functions.[1] Covered financial institutions must establish controls that are reasonably designed to detect instances of money laundering through certain correspondent or private banking accounts. In addition, these institutions generally may not establish or administer correspondent accounts in the United States for, or on behalf of, a foreign shell bank.

Title III also directs the Secretary of the Treasury (Secretary), in consultation with the Board of Governors and the Securities and Exchange Commission (SEC), to issue regulations that generally would require securities brokers and dealers to submit suspicious activity reports regarding suspected money-laundering transactions. The Secretary and the federal financial regulators must also issue joint regulations for financial institutions regarding the verification of customer identification upon account opening.

Under title III, the Secretary, in consultation with certain other government officials, including the Chairman of the Board of Governors, may impose

1. Financial institutions supervised by the Board and other federal financial regulators are subject to existing regulations that direct the institutions to implement anti-money-laundering programs.

special measures to address money-laundering problems associated with specific foreign jurisdictions, foreign financial institutions, and transactions involving such jurisdictions or institutions. Title III also amends the Bank Holding Company Act and the Bank Merger Act to reflect the Board's practice of considering the effectiveness of an institution's anti-money-laundering activities when evaluating certain applications under these acts.

Title III directs the Secretary, in consultation with certain agencies and parties, including the Chairman, to evaluate certain provisions of the USA PATRIOT Act and to report to the Congress on the findings. The report must include recommendations for any additional legislative action. Moreover, the Secretary, the SEC, and the Board must submit joint recommendations to the Congress on regulations that would apply certain provisions of the Bank Secrecy Act to registered and unregistered investment companies and on whether personal holding companies should be required to disclose their beneficial owners when conducting certain actions at domestic financial institutions.

Proposed Check Truncation Act

In December, the Board proposed that Congress adopt legislation to facilitate check truncation.[2] The proposed legislation, titled the Check Truncation Act, is designed to foster payment system innovation and enhance payment system efficiency by reducing some of the legal impediments to check truncation that exist under current law. If enacted, the proposed legislation would enable banks to expand the use of electronics in the collection and return of checks, reducing the industry's reliance on transportation to move checks across the nation. Details are available on the Board's web site at http://www.federalreserve.gov/paymentsys.htm. ■

2. *Check truncation* refers to any of a number of arrangements in which the original paper checks are removed from the collection or return process before reaching either paying or depositary banks, respectively, or reaching their customers.