
Federal Reserve Operations

Consumer and Community Affairs

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

- Supervising banks to ensure their compliance with the regulations
- Writing and interpreting regulations to implement federal laws intended to protect and inform consumers
- Investigating complaints from the public about bank compliance with the regulations
- Promoting community development in historically underserved markets.
- Analyzes applications for mergers and acquisitions by state member banks and bank holding companies in relation to CRA performance
- Disseminates information on community development techniques to bankers and the public through Community Affairs Offices at the Reserve Banks.

Examination for Compliance with the CRA

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

Supervision for Compliance with Consumer Protection and Community Reinvestment Laws

Activities Related to the Community Reinvestment Act

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

The Federal Reserve assesses the CRA performance of state member banks during examinations for compliance with consumer protection regulations. By statute, banks with assets of less than \$250 million that were rated "satisfactory" for CRA performance in their most recent examination are examined not more than once every forty-eight months, and those that were rated "outstanding" for CRA purposes in their most recent examination are examined not more than once every sixty months. Banks with assets of \$250 million or more that were rated "satisfactory" or "outstanding" in their most recent examination are examined not more than once every twenty-four months. During the 2002 reporting period, the Federal Reserve conducted 312 CRA examinations. Of the banks examined, 40 were rated "outstanding" in meeting community credit needs, 270 were rated "satisfactory," 1 was rated "needs to improve," and 1 was rated as being in "substantial noncompliance."¹

- Examines state member banks to assess compliance with the CRA

1. The 2002 reporting period was from July 1, 2001, through June 30, 2002.

*Analysis of Applications for
Mergers and Acquisitions in
Relation to the CRA*

During 2002, the Board of Governors considered applications for several significant banking mergers:

- In June, the Board approved an application by Royal Bank of Canada (Montreal, Canada) and RBC Centura Bank, Inc. (Rocky Mount, North Carolina), to acquire Eagle Bancshares, Inc., and its subsidiary, Tucker Federal Bank (both in Tucker, Georgia).
- In October, the Board approved an application by Citigroup, Inc. (New York, New York), to acquire Golden State Bancorp, Inc. (San Francisco, California).
- In December, the Board approved an application by Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank Nederland Utrecht, The Netherlands) to acquire VIB Corp. and its subsidiary, Valley Independent Bank (both in El Centro, California).

Comments were received from the public on each of these applications. Many commenters expressed concern that the proposed merger or acquisition could lead to decreased lending levels in low-income communities, including mortgage, small-business, and community development lending; abusive lending practices; the provision of costly and inadequate banking services to low-income consumers; and the closure of branch offices in low-income communities.

In the case of the Royal Bank of Canada application, the bank subsidiary of Eagle Bancshares, Tucker Federal

Bank, had received a CRA rating in 2001 of “needs to improve” from its primary supervisor, the Office of Thrift Supervision. The Board considered information indicating that Tucker Federal Bank’s CRA performance had improved since then and noted that Tucker would be merged into RBC Centura Bank (which had a CRA rating of “satisfactory”) upon consummation of the merger of the holding company.

In the Citigroup case, many of the public commenters’ concerns related to the activities of Citigroup’s subprime lending subsidiaries. A special examination of those activities, by the Federal Reserve Bank of New York, was still under way at the time. In acting on the application, the Board noted that a careful review of the record indicated that Citigroup, on balance, had a satisfactory record of compliance and concluded that the ongoing examination of the subprime subsidiaries did not warrant delay or denial. The Board indicated that many of the issues raised by commenters could be more adequately addressed through the special examination. The Board noted, moreover, that if violations or other concerns were identified during the special examination, the Board has broad authority to enforce compliance with fair lending and other applicable laws through the supervisory process.

In the third application, the Board found that the CRA record of the depository institution was consistent with approval.

The Board acted on other bank and bank holding company applications that involved protests by members of the public concerning CRA performance; one also involved a bank having a CRA rating lower than “satisfactory.” Another thirty-three applications raised other issues related to CRA, fair lend-

ing, or compliance with consumer credit protection laws and regulations.²

Other Consumer Compliance Activities

The Division of Consumer and Community Affairs' Compliance Oversight Section supports and oversees the supervisory efforts of the Federal Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Section staff provide guidance and expertise to the Reserve Banks on consumer protection regulations, enforcement techniques, examiner training, and emerging issues. They develop, update, and revise examination policies, procedures, and guidelines and review Reserve Bank supervisory reports and work products. Section staff also participate in interagency activities designed to promote uniformity in examination principles and standards.

Examinations are the Federal Reserve's primary means of enforcing bank compliance with consumer protection laws. During the reporting period, the Reserve Banks conducted 387 consumer compliance examinations—316 of state member banks and 71 of foreign banking organizations.³ To assess the effectiveness of

the Reserve Banks' consumer compliance supervision program, Division staff visited each Reserve Bank during the year to review documents developed by Reserve Bank consumer compliance examiners during bank examinations and other supervisory activities.

Also during 2002, the Board issued guidance for Reserve Bank examiners on consumer protection laws and regulations. For example, the Board clarified the signature provisions of Regulation B, which implements the Equal Credit Opportunity Act, and provided supplemental guidance to assist examiners in writing CRA performance evaluations for large banks.

Fair Lending

Under the Equal Credit Opportunity Act, the Board refers any violation that it has reason to believe constitutes a "pattern or practice" of discrimination to the Department of Justice. During 2002 the Board made six such referrals. Two involved violations of the prohibition against requiring an applicant's spouse to sign a credit obligation (unless the spouse is a co-applicant or the spouse's signature is necessary under state law to permit the creditor to take possession of the property in case of default). Two other referrals involved discrimination on the basis of marital status by lenders that combined the income of married joint applicants but not the income of unmarried joint applicants. One of the two lenders was also found to have priced loans on the basis of marital status. A fifth referral resulted from a lender's practice of failing to consider child support a source of income and imposing a minimum income requirement, which had a disparate impact on the basis of sex. The sixth referral involved a lender that

2. In addition, nine applications involving other CRA issues, fair lending issues, or compliance with consumer credit protection laws and regulations were withdrawn in 2002. Other applications were handled by the Reserve Banks under authority delegated to them by the Board.

3. 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.

engaged in a pattern or practice of redlining (discouraging loan applications from consumers living in minority neighborhoods) in a major city.

In 2001 the Board supplemented interagency procedures for fair lending examinations with 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 facilitate the allocation of resources for more-intensive analysis of institutions that have higher-risk profiles. During 2002, roughly 25 percent of all fair lending examinations were conducted using the alternative procedures.

Flood Insurance

The National Flood Insurance Reform Act of 1994 substantially amended the National Flood Insurance Act of 1968, which created the National Flood Insurance Program (NFIP). The amendments sought to increase compliance with federal flood insurance requirements, increase participation in the NFIP, increase income to the National Flood Insurance Fund, and decrease the financial burden on the federal government, taxpayers, and victims resulting from floods. Under the amendments, the Federal Reserve Board and the other federal financial institution supervisory agencies are required to impose civil money penalties when they find a pattern or practice of violations of the NFIP. Any such civil money penalties are remitted to the Federal Emergency Management Agency for deposit in the National Flood Mitigation Fund.

During the 2002 reporting period, the Board imposed civil money penalties on

two state member banks for violations of the Board's Regulation H, which implements the National Flood Insurance Act: In October 2001, a consent order assessing penalties of \$10,500 was issued against McIlroy Bank and Trust (Fayetteville, Arkansas), and in April 2002, a consent order assessing penalties of \$10,000 was issued against Community Bank of Granbury (Granbury, Texas).

Coordination with Other Federal Banking Agencies

Member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.⁴ In 2002, the FFIEC issued examiner guidance under the Real Estate Settlement Procedures Act regarding settlement service mark-ups and unearned fees. The FFIEC is in the process of revising examination procedures related to the Truth in Lending Act, the Home Ownership and Equity Protection Act, the Home Ownership Counseling Act, and the Homeowners Protection Act.

In 2001, the Federal Reserve joined with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) to publish an advance notice of proposed rulemaking, seeking public comment on a wide range of questions related to revising the Community Reinvestment Act. In 2002, the agencies reviewed the comments and weighed various possible amendments to the

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.

regulations. At year-end 2002, they were reaching a final decision about whether to issue a proposed rule and, if so, what changes to propose. They were weighing whether any change with the potential for substantial benefits would be justified in light of the burdens of implementation.

Also in 2002, the Board, the OCC, and the FDIC conducted the annual update for the host-state loan-to-deposit ratios used to determine compliance with section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

Consumer and CRA Training for Bank Examiners

Ensuring that financial institutions comply with laws and regulations that protect consumers and encourage community reinvestment is an important part of the bank examination and supervision process. As the number and complexity of consumer financial transactions grow, training for examiners of the state member banks under the Federal Reserve's supervisory responsibility becomes even more important.

Federal Reserve bank examiners are employees of the Federal Reserve Banks, which carry out compliance supervision under authority delegated by the Board. Their training, however, is a shared responsibility of the Board and the Reserve Banks. Individuals seeking to become commissioned examiners for the Federal Reserve must complete a formal course of training. Assistant examiners complete three levels of course work, with attention to internal controls, information technology, risk management, risk-focused examination techniques, and integrated supervision concepts. In addition to passing two proficiency examinations, examiners must exhibit strong analytical, critical-

thinking, and decisionmaking skills. Commissioned examiners serve as "examiners in charge" of bank examinations.

To help ensure that supervision staff have the knowledge and skills needed to be successful in an evolving financial industry, the System must continually identify, develop, coordinate, and review training and development opportunities. At least every three years, Board and Reserve Bank staff review the core consumer affairs curriculum, updating subject matter and adding new elements as appropriate. Each course is updated periodically to take account of major technical changes as well as changes in instructional delivery techniques. The staff also look for opportunities to deliver courses via alternative channels such as the Internet or other distance-learning technologies.

The core consumer affairs curriculum comprises five courses focused on various consumer laws, regulations, and examining concepts. In 2002, these courses were offered in twelve sessions to more than 200 consumer compliance examiners:

- *Consumer Compliance Examinations I.* Emphasizes examination procedures and the practical application of banking regulations; focuses on the consumer laws and regulations that govern financial institution operational procedures and non-real-estate lending. The course is geared toward assistant examiners with three to six months of examination experience.
- *Consumer Compliance Examinations II.* Equips assistant examiners with the fundamental skills needed to determine compliance with the basic elements of consumer laws and regulations governing real estate transactions; also covers System policies

on all major aspects of the consumer compliance risk-focused examination process. Assistant examiners have six to twelve months of examination experience when they complete the course.

- *Fair Lending Examination Techniques*. Provides assistant examiners with the skills and knowledge needed to plan and conduct a risk-focused fair lending examination. Assistant examiners generally have eighteen months of examination experience when they complete the course.
- *Community Reinvestment Act Examination Techniques*. Prepares assistant examiners to write performance evaluations for the CRA portion of consumer compliance examinations. Students must be familiar with the CRA regulation and CRA examination procedures.
- *Commercial Lending Essentials for Consumer Affairs*. Optional training opportunity. Familiarizes assistant examiners with basic techniques for underwriting and pricing commercial loans, including identifying the bank's credit culture and risk profile.

In addition to providing core training, the training program emphasizes the importance of continuing professional development. Opportunities for continuing development might include special projects and assignments, self-study programs, rotational assignments, instructing at System schools, or mentoring.

Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA) 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 (1) they are located in metropolitan areas, (2) they met the asset threshold at the end of the preceding calendar year (for 2001, assets of more than \$31 million; for 2002, more than \$32 million), and (3) they originated at least one home purchase loan (or refinancing) in the preceding calendar year. For-profit mortgage companies are covered if (1) they are located in metropolitan areas, (2) they had assets of more than \$10 million (when combined with the assets of any parent company) at the end of the preceding calendar year or originated 100 or more home purchase loans and refinancings in the preceding calendar year, and (3) their home purchase loan originations and refinancings accounted for 10 percent or more of their total loans by dollar volume in the preceding calendar year.

In 2002, a total of 6,659 depository institutions and affiliated mortgage companies and 972 independent mortgage companies reported HMDA data for calendar year 2001. Lenders submitted information about the disposition of loan applications, the geographic location of the properties related to loan applications and loans, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The FFIEC processed the data and produced disclosure statements on behalf of the FFIEC member agencies and the Department of Housing and Urban Development (HUD).

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 2002, the FFIEC prepared more than 53,000 disclosure statements, reporting

data for calendar year 2001.⁵ Each institution made its disclosure statement public in July, and reports containing aggregate data for all mortgage and home improvement loans in each of 330 metropolitan areas were made available at central depositories.⁶ FFIEC member agencies, the reporting institutions, HUD, the Department of Justice (DOJ), and members of the public use these data. The data also assist HUD, the DOJ, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.

The HMDA data reported for 2001 covered 27.6 million loans and applications, about 44 percent more than in 2000. The greater volume was due primarily to an increase of about 120 percent in refinancing activity. The number of home purchase loans covered by HMDA and extended in 2001, compared with 2000, increased 8 percent for Hispanics, 4 percent for Asians, and 1 percent for whites but fell 7 percent for blacks. The precise change for Native Americans could not be determined because of reporting errors in the 2000 data. Over the period 1993 through 2001, the number of home purchase loans extended increased 158 percent for Hispanics, 92 percent for Asians, 76 percent for blacks, 28 percent for Native Americans, and 26 percent for whites.

For each income category, the number of home purchase loans reported

was higher in 2001 than in 2000; the increase was 2 percent for lower-income and higher-income applicants and 4 percent for middle-income applicants. From 1993 through 2001, the number of home purchase loans to lower-, middle-, and upper-income applicants increased 82 percent, 50 percent, and 60 percent respectively.

In 2001, 32 percent of Hispanic applicants and 29 percent of black applicants for home purchase loans reported under HMDA sought government-backed mortgages; the comparable figures were 16 percent for white and for Native American applicants and 8 percent for Asian applicants. Twenty-seven percent of lower-income applicants for home purchase loans, compared with 9 percent of higher-income applicants, applied for government-backed mortgages in 2001.

Overall, the denial rate for conventional home purchase loans (that is, loans that are not government-backed) was 21 percent in 2001. The rate rose steadily from 1993 through 1998 but has fallen since then. In 2001, denial rates for conventional home purchase loans reported under HMDA were 36 percent for black applicants, 35 percent for Native American applicants, 23 percent for Hispanic applicants, 16 percent for white applicants, and 11 percent for Asian applicants. Each of these rates was lower than the comparable rate for 2000.

Agency Reports on Compliance with Consumer Protection Laws and Regulations

The Board is required to report annually on compliance with consumer protection laws by entities supervised by the various federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the

5. The FFIEC also compiles information on applications for private mortgage insurance (PMI) similar to the information on home mortgage lending collected under HMDA. Lenders typically require PMI for conventional mortgages that involve small down payments.

6. Central depository sites include libraries, universities, and city planning offices. A list of the sites can be found at www.ffiec.gov/hmdacf/centdep/default2.cfm.

FFIEC member agencies, and other federal enforcement agencies.⁷

*Regulation B
(Equal Credit Opportunity)*

The FFIEC agencies reported that 83 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation B, the same percentage as for the 2001 reporting period. Of the institutions not in full compliance, 81 percent had five or fewer violations. The most frequent violations involved 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 and sex 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.

Three formal enforcement actions containing provisions relating to Regulation B were issued during the 2002

reporting period—two by the OTS and one by the OCC. The Federal Trade Commission settled one action and continued its litigation against a mortgage lender for alleged violations of the Equal Credit Opportunity Act (ECOA) and Regulation B. The alleged violations include failing to take written applications for mortgage loans, failing to provide rejected applicants with written notice of adverse action, failing to collect required information about the race or national origin and sex of applicants for mortgage loans; and, when providing notice of adverse action, failing to give the name and address of the federal agency that administers compliance with the ECOA.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission, the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA’s examination and enforcement activities revealed violations of the ECOA mostly related to creditors’ failure to collect information in mortgage applications for monitoring purposes and failure to comply with rules regarding adverse action notices. No formal enforcement actions relating to Regulation B were initiated by these agencies.

*Regulation E
(Electronic Fund Transfers)*

The FFIEC agencies reported that approximately 92 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation E, compared with 95 percent for the 2001 reporting period.

7. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2002 reporting period was from July 1, 2001, through June 30, 2002.

The most frequent violations involved failure to comply with the following requirements:

- Determine whether an error occurred, and transmit the results of the investigation 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
- Report the results of the investigation to the consumer within three business days after its completion.

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

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2001 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The agencies did not issue any formal enforcement actions relating to Regulation M during the reporting period.

Regulation P (Privacy of Consumer Financial Information)

July 2001 through June 2002 marked the first full year of implementation of Regulation P. Examinations found few violations, and no formal enforcement actions were issued.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 77 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation Z, compared with 79 percent for the 2001 reporting period. Of the institutions not in full compliance, 73 percent had five or fewer violations, compared with 75 percent for the 2001 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- Accurately disclose the finance charge, taking any prepaid finance charges into account
- Accurately disclose the number, amounts, and timing of payments scheduled to repay the obligation
- Ensure that if the disclosed finance charge (which affects other disclosures) is understated, the amount disclosed is understated by no more than \$100
- Ensure that disclosures reflect the terms of the legal obligation between the parties
- Provide the index value for the periodic adjustments to variable-rate loans.

Three formal enforcement actions containing provisions relating to Regulation Z were issued during the 2002 reporting period—two by the OTS and one by the OCC. In addition, 174 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 \$1.2 million

to consumers for the 2002 reporting period. During the reporting period, the FTC continued its efforts to curb abusive practices by some subprime mortgage lenders, entering into three settlements, initiating three legal actions, and pursuing litigation against one creditor for alleged violations of the Truth and Lending Act (TILA) and the Home Ownership and Equity Protection Act.

The Department of Transportation (DOT) concluded its investigation of five cases involving air carriers for possible violations of the TILA. All five cases involved the timeliness of processing requests for credit card refunds. Four of the cases were closed with warning letters; in the fifth case, DOT entered into a consent order that directed the carrier to cease and desist from further violations of the refund provisions of the TILA and assessed a civil penalty of \$25,000. In addition, 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. The case remained pending because the principal of the company was serving a prison sentence for an unrelated airline bankruptcy fraud conviction.

*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 insti-

tutions examined during the 2002 reporting period were in compliance, the same proportion as for the 2001 reporting period. Among 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, a practice barred by Regulation AA.

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

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

The FFIEC agencies reported that 90 percent of institutions examined during the 2002 reporting period were in compliance with Regulation CC, compared with 91 percent for the 2001 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the failure to take one or more of the following actions:

- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- Provide a written notice explaining why an exception to the institution's availability policy was invoked
- Provide a written notice when the depository bank extended the time for making funds available for withdrawal

- Follow special procedures when invoking the exception for large-dollar deposits.

No formal enforcement actions relating to Regulation CC were issued during the reporting period.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 87 percent of institutions examined during the 2002 reporting period were in compliance with Regulation DD, compared with 88 percent for the 2001 reporting period. Among 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 notice before maturity for automatically renewing time accounts having a term of more than one month.

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

Implementation of Statutes Designed to Inform and Protect Consumers

Changes in the Collection of Data on Home Mortgage Loans

The past decade has witnessed important developments in mortgage markets, spurred in part by improvements in

technology and information-processing capabilities. Prominent among these developments have been the movement to risk-based pricing of mortgage credit and the growth of new channels for loan applications, funding, and origination. In 2002, the Board took note of these changes in carrying out a review of Regulation C, which implements the Home Mortgage Disclosure Act (HMDA).

The express purposes of HMDA are to

- Provide the public and government officials with data that will help show whether lenders are serving the home-lending needs of the neighborhoods and communities in which they are located
- Help government officials target public investment to promote private investment where it is needed
- Provide data that assist in identifying possible discriminatory lending patterns and enforcing antidiscrimination statutes.

Regulation C requires lenders to report data about each mortgage loan application or origination (including loan amount, type, and purpose), each applicant or borrower (including race or ethnicity, sex, and income), and each property (including location and occupancy status). These data are made available to the public after identifying information is removed to protect consumers’ privacy.

In 2002, the Board concluded that significant changes to Regulation C were needed to keep pace with developments in the mortgage-lending market. One change was to broaden the types of data collected to include data on loan pricing. This change will aid both in

detering discrimination and in helping data users better understand the mortgage market, particularly the subprime market. Over the years, the focus of concerns about discrimination has shifted from lenders' decisions to approve or deny applications to lenders' loan-pricing practices. The widespread adoption of risk-based pricing has focused attention on the fairness of lenders' pricing decisions. Obtaining information about loan pricing is critical to ensuring the continued utility of the HMDA data.

Beginning January 1, 2004, lenders will report rate spreads for loans that exceed a certain price threshold (for first lien loans, prices must be reported if the difference between the loan's annual percentage rate and the yield on Treasury securities with comparable maturities is 3 percentage points or more; for subordinate lien loans, if the difference is 5 percentage points or more). Lenders will also report whether a loan meets the price-based triggers of the Home Ownership and Equity Protection Act, which requires that borrowers of high-priced loans be given special disclosures and other protections.

The Board also revised Regulation C to reflect another major change in the mortgage market—the increasing availability of preapproval programs. Preapproval programs offer the possibility of conditional approval of a mortgage loan before a borrower has chosen a property, enabling the borrower to demonstrate to potential home sellers that the borrower will likely be able to obtain a loan. Regulation C will require lenders to report preapproval requests that are evaluated under programs in which the lender gives approved applicants a written commitment letter, good for a set period and for up to a fixed dollar amount. Beginning January 1, 2004, lenders will identify preapproval

requests that are approved and result in loan originations as well as requests that are denied. Lenders may, but will not be required to, report preapproval requests that are approved but not accepted by the applicant.

In addition, the Board revised the categories for identifying the race and national origin of applicants and borrowers to conform to categories used by the Bureau of the Census and other federal agencies. Following guidance provided by the Office of Management and Budget, the Board will permit an applicant to select more than one race and will distinguish between race and Hispanic ethnicity; these changes take effect January 1, 2004.

In response to the growing number of telephone applications and the increasing proportion of loan applications for which information on applicant race, ethnicity, or sex is missing, the Board mandated collection of such data on telephone applications; this rule, which parallels the rule for mail and Internet applications, took effect January 1, 2003.

Finally, the Board made several changes to improve the consistency and utility of the HMDA data. These changes include simplifying the definitions of loan types and distinguishing loans for manufactured homes from loans for site-built homes.

Revisions to Truth in Lending Regulations

In April 2002, the Board revised the official staff commentary to Regulation Z (Truth in Lending) to clarify how creditors that place Truth in Lending Act disclosures in the same document as the credit contract can satisfy the requirement to provide the disclosures before consummation and in a form the consumer can keep. The revi-

sions also provide guidance on disclosing costs for certain credit insurance policies.

The Board also took the following regulatory actions during the year:

- Raised from \$480 to \$488 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act, effective in January 2003, to reflect changes in the consumer price index, as prescribed by the statute.
- Maintained at \$32 million the exemption threshold for depository institutions required to collect data in 2003 under the Home Mortgage Disclosure Act, in keeping with the consumer price index for urban wage earners and clerical workers (CPI-W), as prescribed by the statute.

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' compliance costs and the benefits of the act to consumers.

Approximately 85 percent of U.S. households have or use one or more electronic fund transfer (EFT) service—for example, an ATM card, a debit card, or direct deposit. The proportion of households using EFT services has grown over the past ten years at an annual rate of 2 percent to 3 percent, according to data from the Board's Survey of Consumer Finances (the most recent data available were from 1998; data from the 2001 survey are to be released in 2003).

Automated teller machines remain the most widely used EFT service. About two-thirds of U.S. households have an

ATM card. In 2002, the number of ATM transactions per month averaged almost 1.2 billion, an increase of nearly 3 percent from 2001. The number of installed ATMs rose nearly 9 percent, to about 352,000.

Direct deposit is also widely used. About 60 percent of U.S. households have funds deposited directly into their checking or savings accounts. Use of the service is particularly common in the public sector: Approximately 72 percent of all government payments in fiscal year 2002 were made using electronic funds transfer, including 79 percent of social security payments, 98 percent of federal salary and retirement payments, and 39 percent of federal income tax refunds.

Direct bill payment is a less widely used EFT payment mechanism. About 36 percent of U.S. households have payments automatically deducted from their accounts.

About one-third of U.S. households use debit cards, which consumers use at merchant terminals to debit their checking or savings accounts. These point-of-sale (POS) systems account for a fairly small share of electronic transactions, but their use has continued to grow rapidly. The average number of POS transactions per month rose almost 39 percent, from 304.0 million in 2001 (revised from previously reported data) to 421.7 million in 2002, though the number of POS terminals fell, to 3.5 million.

Electronic check conversion is a variation of electronic funds transfer whereby a check is used as the source of information for a one-time electronic payment from the consumer's checking account via EFT. During 2002, Board staff helped develop and distribute consumer information to explain the process (www.federalreserve.gov/pubs/checkconv/default.htm).

The incremental costs associated with the Electronic Fund Transfer Act are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure because they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with the EFTA (see the section “Agency Reports on Compliance with Consumer Protection Laws and Regulations”).

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency complaints that involve other creditors and businesses. Each Reserve Bank investigates complaints against state member banks in its District.

The Board provides guidance to the Reserve Banks on complaint program policies and procedures through advisory letters and periodic updates to the Consumer Complaint Manual. In 2002, the Board issued guidance and new codes for identifying complaints and inquiries about electronic check conversion transactions and the sale of insurance by state member banks. The Board also clarified procedures for investigating complaints alleging unlawful credit discrimination. In addition, the Board established supplemental procedures to help the Reserve Banks focus and expedite investigations.

In 2002 the Board initiated a workflow study of the Federal Reserve’s complaint-handling process to identify ways to maximize efficiency and effectiveness. The study is expected to be completed by early spring 2003.

The Board also established an advisory group to assess the Federal Reserve’s complaints and inquiry database—Complaints Analysis Evaluation System and Reports (CAESAR). The advisory group is organized into two subcommittees: one to develop and implement improvements to data entry and reporting processes, and the other to analyze the adequacy of the complaint and inquiry code structure. Enhancements to CAESAR will be implemented in the first quarter of 2003.

Complaints against State Member Banks

In 2002 the Federal Reserve received just over 5,700 complaints from consumers. The majority (63 percent) related to practices that are not subject to federal regulation (see next section, “Unregulated Practices”). About 48 percent of the complaints received were against state member banks (see tables). Of the complaints against state member banks, 66 percent involved loan functions: 3 percent alleged discrimination on a basis prohibited by law (race, color, religion, national 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 a right under the Consumer Credit Protection Act), and 63 percent concerned other credit-related practices, such as the imposition of annual membership fees, or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Twenty-four percent of the complaints against state member banks involved disputes about interest on deposits and general deposit account practices, and the remaining 10 percent concerned disputes about electronic fund transfers, trust services, or other

Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System, 2002

Subject	State member banks	Other institutions ¹	Total
Regulation B (Equal Credit Opportunity)	66	36	102
Regulation C (Home Mortgage Disclosure Act)	0	1	1
Regulation E (Electronic Fund Transfers)	64	76	140
Regulation H (Bank Sales of Insurance)	0	0	0
Regulation M (Consumer Leasing)	0	0	0
Regulation P (Privacy of Consumer Financial Information)	12	4	16
Regulation Q (Payment of Interest)	0	0	0
Regulation Z (Truth in Lending)	617	374	991
Regulation BB (Community Reinvestment)	2	1	3
Regulation CC (Expedited Funds Availability)	29	25	54
Regulation DD (Truth in Savings)	72	48	120
Fair Credit Reporting Act	375	201	576
Fair Debt Collection Practices Act	64	17	81
Fair Housing Act	1	5	6
Flood insurance rules	3	10	13
Regulations T, U, and X	0	0	0
Real Estate Settlement Procedures Act	20	14	34
Unregulated practices	1,440	2,128	3,568
Total	2,765	2,940	5,705

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

practices. Information on the outcomes of the investigations of these complaints is provided in the table.

During 2002, the Federal Reserve completed the investigation of 86 complaints against state member banks that were pending at year-end 2001 and found four violations of regulations. In the vast majority of cases, the bank had correctly handled the customer's account; notwithstanding, the bank in many cases chose to reimburse or otherwise accommodate the consumer.

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

Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices that are not subject to existing regulations, focusing on those that concern possible unfair or deceptive practices. In 2002 the Board received more than 1,400 complaints that involved unregulated practices. The categories that received the most complaints involved checking and credit card accounts: Consumers alleged that unauthorized withdrawals were made from their checking accounts (101), disputed amounts withdrawn (155), and complained about insufficient-funds charges and procedures (141); they also complained about fees associated with credit card accounts (149) and about debt-collection tactics (109). The remainder

Consumer Complaints Received by the Federal Reserve System,
by Subject of Complaint, 2002

Subject of complaint	Complaints against state member banks					
	Total		Not investigated		Investigated	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer	Bank legally correct	
					No reimbursement or other accommodation	Goodwill reimbursement or other accommodation
Loans						
Discrimination alleged						
Real estate loans	19	1	2	1	6	0
Credit cards	20	1	8	1	8	2
Other loans	27	1	0	2	12	0
Other type of complaint						
Real estate loans	508	18	16	37	211	92
Credit cards	1,007	37	7	7	340	429
Other loans	227	8	10	22	91	29
Deposits	658	24	21	83	272	112
Electronic fund transfers	64	2	3	5	20	15
Trust services	30	1	1	4	11	1
Other	205	7	7	21	84	22
Total	2,765	100	75	183	1,055	702

of the complaints concerned unregulated practices in other areas: Consumers complained about credit denials attributed to credit history, failure to remove the lien on property for which the mortgage had been paid off, and poor customer service.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2002 the Federal Reserve referred to HUD ten complaints alleging state member bank violations of the Fair Housing Act. In two of the ten cases the Federal Reserve’s investigations revealed no evidence of illegal discrimination. In a third case the bank had made an error regarding the consumer’s

adverse action notice, which the bank subsequently corrected. The remaining seven cases are pending.

Advice from the Consumer Advisory Council

The Board’s Consumer Advisory Council—whose members are drawn from consumer and community organizations, the financial services industry, academic institutions, and state agencies—advises the Board on matters concerning laws administered by the Board and other issues related to consumer financial services. Council meetings are open to the public.

In 2002, the Council met in March, June, and October. The rules implementing the Community Reinvestment Act (CRA) were a major topic at the March

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 the courts	Possible bank violation—bank took corrective action	Matter in litigation			
0	0	0	2	0	8	19	38
0	1	0	0	0	0	7	27
0	1	2	1	0	9	10	37
0	75	13	10	11	43	498	1,006
1	79	16	8	1	119	795	1,802
1	42	4	1	4	23	521	748
2	74	27	10	14	43	475	1,133
0	6	0	9	1	5	76	140
0	2	4	0	3	4	21	51
2	14	9	0	2	44	518	723
6	294	75	41	36	298	2,940	5,705

and June meetings. In March, Council members commented on the investment test, data collection, and the small-bank test. Some members considered the existing investment test to be sufficient, while others preferred that a separate community development test replace the investment test. Regarding data collection for small-business and small-farm lending, some members emphasized that gathering quality data is a substantial burden for small banks and questioned the overall benefits of collecting detailed data. Members also commented on the appropriate size-definition of “small bank.” In June, Council members considered the effectiveness of the evaluation criteria for community development performance in terms of changing community dynamics. Members also noted the importance of con-

text in evaluating a bank’s CRA performance and emphasized that bankers should review the performance context with regulators at the beginning of examinations.

In March, Council members discussed Regulation C, which implements the Home Mortgage Disclosure Act. They provided views on issues still under review after the Board’s January 2002 revisions to the regulation, including the appropriate threshold for collecting price data on higher cost loans; a proposal to require lenders to ask telephone applicants their race, ethnicity, and sex; and a proposal to report lien status for applications and originated loans. A discussion of Regulation B, which implements the Equal Credit Opportunity Act, focused on proposed changes to the definition of “creditor”

and the prohibition against data notation for non-mortgage credit. Members provided both supporting and opposing views on removing the prohibition against data notation.

In June, Council members discussed the rules implementing the privacy provisions of the Gramm–Leach–Bliley Act. Members commented on the effectiveness of the required privacy notices in light of the notices’ length and complexity. Other comments concerned the low rates of response to the notices. Also in June, Council members discussed financial literacy and noted the challenges of designing and delivering financial literacy training in an environment of technological advances and expanding financial products. They emphasized that no single solution or design works for all consumers and that a broad approach to training and delivery systems is necessary to reach those in need of training.

At the October meeting, the amendments proposed by the Department of Housing and Urban Development to its Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA), were a topic of discussion. Council members focused on whether the proposed “guaranteed mortgage package agreement” and the proposed revisions to the good-faith estimate would benefit financial institutions and consumers during the mortgage selection process. Members also addressed inconsistencies between the Board’s Truth in Lending Act disclosure rules and HUD’s proposed RESPA rules.

The Council also discussed identity theft and access to credit cards during the October meeting. Regarding identity theft, members considered the adequacy of current laws and whether potential legislative, regulatory, or industry solutions would be effective in combating identify theft. Many members agreed

that limiting the use and display of personal identifiers (such as social security numbers) and providing additional tools to identity-theft victims to clear their credit records would be beneficial. The discussion of access to credit cards focused on consumers who may not have the ability to repay their debt, particularly students.

Promotion of Community Development in Historically Underserved Markets

In 2002, the community affairs function within the Federal Reserve System expanded its activities to promote economic growth and financial literacy in historically underserved markets. The structure and mission of the community affairs program was conceived to help financial institutions meet their responsibilities under the Community Reinvestment Act, and Community Affairs Offices around the System continued during the year to hold CRA roundtables with bankers and community development organizations to increase understanding of CRA-related policy issues and investment tools. However, community affairs programs have broadened to respond to the evolving financial and regulatory needs of diverse groups and communities. Reserve Bank Community Affairs Offices focus on providing information and investment opportunities to low- and moderate-income communities within their Districts, while the Board’s Community Affairs Office brings a national perspective, engaging in projects that have significant implications for public policy. In 2002, System community affairs programs also addressed financial education, financial services for Native Americans, banking for immigrant communities, emerging issues and opportu-

nities in community development, and community development finance.

Promotion of Financial Education

Consumers who are well informed on financial matters are generally able to make better decisions for their families, increasing their economic security and well-being. In turn, secure families are better able to contribute to vital, thriving communities, further fostering community economic development. As a consequence, financial education has risen on the agendas of educators, community groups, businesses, government agencies, and policymakers.

The Board supported a wide range of activities promoting financial education in 2002, including conducting research, sponsoring meetings, providing training, and preparing educational materials. Staff in the Board's Division of Consumer and Community Affairs prepared articles for the *Journal of Family and Consumer Sciences* and the *Federal Reserve Bulletin* ("Financial Literacy: An Overview of Practice, Research, and Policy," www.federalreserve.gov/pubs/bulletin/2002/1102lead.pdf) summarizing efforts in research, fieldwork, and public policy that further the goal of creating financially literate consumers.

Research initiated by Board staff investigated consumers' financial management practices and their engagement in the financial services marketplace, consumers' choices of financial institutions for home-secured loans, consumers' efforts at comparison shopping, and consumers' complaint actions with respect to problems with credit cards.

During the year, partnerships with other agencies and organizations were formed to undertake a variety of financial education initiatives. Board staff collaborated with the National Endow-

ment for Financial Education in a national symposium on financial literacy and provided training on consumer credit management for Air Force Command financial specialists. Consumer education materials on financial privacy, developed in collaboration with other government agencies, were launched during National Consumer Protection Week 2002 (www.federalreserve.gov/pubs/privacy/default.htm).

Across the Federal Reserve System, Community Affairs Offices organized programs to heighten employee awareness of fundamental financial management concepts. At the Board, community affairs staff organized lunch-and-learn sessions on savings and budgeting and joined with staff of the Management Division to identify best practices in employee financial education. The Federal Reserve Bank of St. Louis held information sessions focused on employee housing and credit resources, and several Reserve Banks hosted Consumer Protection Week activities for their employees.

Reserve Banks in Atlanta, Boston, Chicago, Cleveland, Philadelphia, and San Francisco supported financial education initiatives in their Districts. For example, the San Francisco Reserve Bank published a compendium of financial literacy resources for bankers interested in offering financial education programs that serve their local markets (www.frbsf.org/community/webresources/bankersguide.pdf). The Chicago Reserve Bank coordinated asset-building workshops in Illinois and southeastern Wisconsin to provide information on investment approaches for low- and moderate-income persons. And the Boston, Atlanta, and Chicago Reserve Banks hosted workshops in their communities on the benefits of the federal Earned Income Tax Credit and Assets for Independence programs as

Lending in Indian Country

Overcoming challenges to development requires leadership, commitment, creativity, and flexibility. . . . [T]he vision of tribal leaders and the involvement of partners have helped to bring the new ideas, as well as the capital and technical assistance, necessary to create viable economies in Indian Country.

Mark W. Olson, *Member*, Board of Governors
November 18, 2002

Extension of economic development into underserved communities often rests on gaining an understanding of local culture and history. With such an understanding, lenders, developers, and local leaders can bridge the information and credit gaps to facilitate the flow of capital and other resources that support growth and development.

Understanding local culture and history is especially critical to overcoming the challenges of lending on Indian reservations and tribal lands, collectively known as Indian Country. In many Native American communities, misunderstanding, mistrust, and discrimination have historically hindered the development of the infrastructures—governmental, physical, educational, and financial—needed to support market-based economies. Further, many tribal communities are underserved by financial institutions, a situation that limits their access to the credit and capital vital to their growth and development. As a result, many tribal communities struggle with significant social and economic challenges, as seen in high rates of unemployment, inadequate housing, and low educational attainment.

Sovereignty is a central issue in economic development in Indian Country. As

sovereign nations, Native American communities have the right to self-govern and to adjudicate contractual disputes in their own tribal courts. While the exercise of sovereignty preserves the right of tribal self-governance, it also creates a complex legal environment that results in uncertainty for lenders and investors, who seek consistency in their evaluation of risk and the likely return on investment. At the same time, some tribal members are unfamiliar with the requirements and expectations of lenders and other private-sector investors. These competing forces—the business need for certainty and predictability on one hand and unfamiliarity with lender and investor needs on the other—can disrupt the flow of information between Native American communities and the banking industry, impairing the operation of an efficient market.

The Role of the Federal Reserve

Staff of the Community Affairs Offices (CAOs) at the Board of Governors and several Federal Reserve Banks have worked with tribal leaders and bankers for nearly a decade to address the factors that hinder lending and discourage financial investments in Indian Country. CAO staff

wealth-creation vehicles for low-income families.

Programs in Cooperation with Native Americans

In 2002, the community affairs function addressed credit and lending barriers

faced by Native American populations through sponsorship of the Federal Reserve System's first national conference on banking opportunities on Indian reservations and tribal lands (see box "Lending in Indian Country"). System staff continued to facilitate meetings and workshops and to convene task forces to

have sought to increase communication and highlight opportunities for profitable relationships and development in Indian Country by creating mutually beneficial partnerships. They have fostered the exchange of information through workshops on sovereign lending, articles in Reserve Bank newsletters, assistance in designing a financial training curriculum for Native American students, and support for the development of regulations and procedures that govern secured credit transactions. At the national level, CAO staff at the Board have served on federal task forces that helped develop policy to improve funding opportunities in Indian Country.

Through ongoing relationships with tribal leaders and bankers, the Federal Reserve has gained valuable insight into the cultural and legal issues and the concerns of all parties. This insight led to recognition by the Federal Reserve and its Native American partners of a need for a national dialogue on lending in Indian Country.

Pathway to a National Conference

To promote a national dialogue, the Federal Reserve and its tribal partners began planning a conference that could serve as a catalyst, stimulating new partnerships and creative initiatives in Native American communities across the country. An advisory committee made up of tribal leaders, lenders, community development practitioners, attorneys, and academics knowledgeable about Indian Country issues was formed by the Community Affairs Officers

of the Board and participating Reserve Banks (the Reserve Banks of Chicago, Kansas City, Minneapolis, and San Francisco). The committee helped ensure that agenda topics were culturally sensitive and accurately portrayed the credit needs and concerns of Native American communities and at the same time emphasized the critical role of banks in creating economic opportunity in Indian Country. To promote the partnerships between lenders and communities that are essential to the growth and stabilization of local economies, the conference agenda was developed to highlight ways in which creative economic development efforts—financed by leveraging funds from government loan and guarantee programs with bank credit—can result in safe, sound lending transactions.

The conference, held on November 18–20, 2002, in Scottsdale, Arizona, drew more than 400 participants. It provided a forum for financiers, tribal leaders, and economic developers to discuss innovative development opportunities in Indian Country. The conference format employed “talking circles,” a discussion method unique to the Native American culture that invites tribal members to enter into dialogue following each plenary session. Breakout sessions addressed related issues integral to development in Indian Country, including commercial codes, bank formation, regulatory matters, and wealth-building strategies. The breakout sessions afforded an opportunity to explore more fully the topics addressed in panel discussions, enabling the building of partnerships to effect sustainable economic revitalization in Indian Country.

discuss financing of housing and small businesses on tribal lands and financial literacy within tribal communities. Through a national interagency Native American task force, Board staff began planning for a policy development forum on financial literacy in Indian Country scheduled for May 2003.

Banking for Immigrant Communities

Major demographic changes and population shifts have been the impetus for several Federal Reserve initiatives involving immigrant banking markets. Seven Reserve Banks—Atlanta, Boston,

Chicago, Dallas, Kansas City, New York, and Richmond—sponsored programs and outreach meetings during 2002 to heighten financial institutions' awareness of the credit and financial service needs of Hispanic communities. English and Spanish versions of materials on Electronic Transfer Accounts (an account designed by the U.S. Treasury for recipients of federal benefits), the *matricula consular* card for Mexican nationals seeking banking services, and financial literacy (“Building Wealth: A Beginner’s Guide to Securing Your Financial Future”) are available on the Dallas Reserve Bank’s web site (at www.dallasfed.org/htm/ca/pubs.html). Through other activities, the Chicago Reserve Bank addressed the needs of the Asian-American community, and the Minneapolis Reserve Bank, the needs of Islamic and Hmong immigrant communities.

Emerging Issues and Opportunities

The Federal Reserve in 2002 conducted programs and held conferences on emerging issues in community development to encourage research and discussion among academics and practitioners. Among the topics discussed were

- Community development and smart growth (affordable housing, brown-fields redevelopment, transit systems, and urban revitalization)
- Microenterprise development in small cities and towns
- Entry-level employment opportunities in technology for low- and moderate-income persons
- Financial innovation in community development

- Loss mitigation and foreclosure prevention
- Sustaining and revitalizing communities affected by economic downturns.

Community Development

Federal Reserve outreach activities and programs in rural markets continued in 2002. Initiatives included conferences on community development challenges and opportunities for rural residents and business owners, rural policy, and opportunities for public–private partnerships to further economic development in rural communities. Board staff continued to work with the Rural Home Loan Partnership, an interagency group committed to increasing affordable housing in rural communities.

Small-business development is an important component of efforts to rebuild and strengthen communities. Several Reserve Banks held workshops to provide information on opportunities for business development and partnerships with local community development organizations. Reserve Banks also provided technical assistance and information on the mechanics of accessing tax credits for small businesses and for commercial development. Board staff participated on a task force sponsored by the Department of Commerce to explore development and capital formation for minority microentrepreneurs.

The community affairs function continued to expand its presence in the international arena. Board staff participated with the Organisation for Economic Co-operation and Development (OECD), a body of international groups working to build partnerships and identify collaborative approaches to development, and delivered remarks at an OECD conference in England on the use of private finance for community build-

ing. Board staff also held meetings with officials from Indonesia, Japan, Yugoslavia, New Zealand, and Russia to discuss community development policies and strategies.

The preservation of affordable housing remains a central issue for the Federal Reserve. During 2002, Board staff served in various capacities to support the housing activities of the Federal Reserve's external partners. For exam-

ple, Board staff served as the Federal Reserve liaison to the Local Initiatives Support Corporation advisory board's Center for Home Ownership. Board staff also provided support to Governor Edward Gramlich in his role as chairman of the board of directors for the Neighborhood Reinvestment Corporation, a national nonprofit organization charged by Congress with revitalizing older, distressed communities. ■

Banking Supervision and Regulation

The U.S. banking system exhibited considerable strength in 2002, producing record earnings while absorbing significant deterioration in asset quality, lackluster revenues from financial-market activities, and the effects of economic weakness more generally. This remarkable performance is attributable in part to historically low interest rates; it also reflects the benefits of fundamentally strong balance sheets and prudent capitalization as well as the industry's continuing enhancements to risk-management processes and capabilities.

Industry earnings rose 20 percent for the year, supported by robust growth in low-cost core deposits, continued profitability from consumer lending and mortgage banking operations, and improved operating efficiency. Elevated credit costs and reversals in market-sensitive lines of business offset some of this improvement.

Nonperforming assets rose over the year, particularly at large, complex institutions. The rise was fueled by a series of high-profile bankruptcies and continuing weak economic growth. The effect on banks of these bankruptcies was somewhat muted, however, as bondholders rather than banks absorbed much of the credit costs associated with these high-profile borrowers. Credit-protection instruments also played a role in reducing bank credit losses. Banks thus appear to have benefited significantly from their ability to disperse risk through credit derivatives, the syndicated loan market, loan sales, and securitization activities, combined with better risk-management and risk-measurement systems.

Net interest margins widened moderately for the year, a result of low interest rates and growth in low-cost core deposits. Demand for business loans was weak, leading to a \$70 billion (or 7 percent) decline in aggregate commercial and industrial loans outstanding. With supply boosted by historically low mortgage rates, banks added significantly to their holdings of one- to four-family mortgage loans and pass-through securities. Loans outstanding under home equity lines of credit grew nearly 40 percent, the third consecutive year that these balances have risen by more than 20 percent. Commercial real estate lending, especially lending to finance non-farm nonresidential properties, multifamily housing, and new construction, also grew rapidly.

The economic environment also affected the way in which banks funded their operations. During this period of low interest rates and soft equity prices, many households shifted funds into interest-bearing bank transaction accounts at the same time many banks undertook significant initiatives to bolster core deposit growth. By the end of 2002, money market deposit accounts and savings deposits accounted for nearly 30 percent of the industry's funding. Capital remains a key strength of the industry, as the total risk-based capital ratio remained at about 12.7 percent.

Non-interest revenues from the origination of mortgages for sale to others were a major positive for the industry, as were service charges on rapidly growing deposit accounts. Market-sensitive revenues were again weak, consistent with the overall softness in equity markets. Most banks supported their earn-

ings by taking significant securities gains, in some cases associated with adjustments to the institution's interest rate risk profile.

Banks also reported significant gains in operating efficiency, attributable in part to a change in accounting practice that reduced expenditures to amortize goodwill. Special charges offset some of these gains at a small number of large institutions related to restructuring and potential litigation-related expenses.

Work continued toward finalizing a new international capital standard, with approval of the new framework expected in 2003 and implementation of the new rules in 2007. This year's efforts included an unprecedented coordinated effort among supervisors and bankers in the G-10 countries to assemble detailed information on the risk profiles of individual banks and the measured risks associated with these positions.

Bankers and supervisors enter 2003 in a strong position but with a cautious outlook. Both the positive and negative influences seen in 2002 appear likely to subside. By year-end 2002, asset quality was showing signs of some improvement at most banks and possible signs of economic improvement and some recovery in equity markets were emerging. Charge-offs on consumer loans remained generally stable, as available evidence continued to suggest that household debt burdens were manageable. Bankers expect credit quality to stabilize and ultimately to improve in the coming year, although an uncertain economy and geopolitical concerns may continue to affect the activities and outlook of both households and businesses. Despite these uncertainties, the fundamental strengths of the industry leave it well positioned to support, and benefit from, an economic recovery.

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 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

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 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, the U.S. branches and agencies of foreign banks, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of 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 regula-

tions. The table provides information on the examinations and inspections conducted by the Federal Reserve during the past five years.

State Member Banks

At the end of 2002, 949 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 27 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.

Bank Holding Companies

At year-end 2002, a total of 5,963 U.S. bank holding companies were in operation, of which 5,135 were top-tier bank holding companies. These organizations controlled 6,278 insured commercial banks and held approximately 94 percent of all insured commercial bank assets in the United States.

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

State Member Banks and Holding Companies, 1998–2002

Entity/Item	2002	2001	2000	1999	1998
<i>State member banks</i>					
Total number	949	970	991	1,010	994
Total assets (billions of dollars)	1,863	1,823	1,645	1,423	1,312
Number of examinations	814	816	899	858	820
By Federal Reserve System	550	561	610	551	511
By state banking agency	264	255	289	307	309
<i>Top-tier bank holding companies</i>					
Large (assets of more than \$1 billion)					
Total number	329	312	309	283	273
Total assets (billions of dollars)	7,483	6,905	6,213	5,625	5,136
Number of inspections	439	413	352	332	290
By Federal Reserve System ¹	431	409	346	329	281
On site	385	372	309	298	262
Off site	46	37	37	31	19
By state banking agency	8	4	6	3	9
Small (assets of \$1 billion or less)					
Total number	4,806	4,816	4,800	4,831	4,880
Total assets (billions of dollars)	821	768	716	679	647
Number of inspections	3,726	3,486	3,347	3,064	3,257
By Federal Reserve System	3,625	3,396	3,264	2,973	3,178
On site ²	264	730	835	684	723
Off site	3,361	2,666	2,429	2,289	2,455
By state banking agency	101	90	83	91	79
<i>Financial holding companies</i>					
Domestic	602	567	462	...	...
Foreign	30	23	21	...	...

NOTE. Data for prior periods have been updated.

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

2. In 2002, the supervisory program for small bank holding companies was revised, resulting in more

inspections being performed off site versus on site. See text section “Bank Holding Companies” for more information.

... Not applicable.

companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the burden on banking organizations.

Small, noncomplex bank holding companies—those that have consolidated assets of \$1 billion or less—are subject to a special supervisory program that was implemented in 1997 and modified in 2002.² The program permits a more flexible approach to supervision

of such companies. If all of a company’s subsidiary depository institutions have composite and management ratings of “satisfactory” or better, and if no material outstanding issues at the holding company or consolidated level are otherwise indicated, only a composite rating and a management rating based on the ratings of the lead subsidiary depository institution are assigned to the company. In 2002, the Federal Reserve conducted 3,361 reviews of such bank holding companies. If a company’s subsidiary depository institutions have ratings lower than “satisfactory” or other significant supervisory issues, a more thorough off-site review of the organization is conducted using surveillance results and other information. If the informa-

2. Refer to SR letter 02–01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex.

tion obtained off site from these sources is not sufficient to determine the overall financial condition of the holding company and to assign the composite and management ratings, the holding company is subject to increased supervisory review that may include an on-site review and off-site monitoring.

While the 2002 modifications to the special supervisory program principally affect the supervision of small holding companies, they also promote more-effective use of targeted on-site reviews to fulfill the requirements for, when necessary, the full-scope inspection of larger holding companies—those with consolidated assets of \$1 billion to \$5 billion. In general, the modifications direct Reserve Banks to use surveillance results and other information to focus attention and resources on holding companies that warrant increased scrutiny.

Financial Holding Companies

Under the Gramm–Leach–Bliley Act, 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 of 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).

As of year-end 2002, 602 domestic bank holding companies and 30 foreign banking organizations had financial holding company status. Of the domestic institutions, 37 financial holding companies had consolidated assets of \$15 billion or more; 90, between \$1 bil-

lion and \$15 billion; 85, between \$500 million and \$1 billion; and 390, 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, that 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 subsidiaries 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 2002.

Information Technology Activities

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised financial institutions as well as certain independent data centers that provide information technology services to these institutions. Several years ago, the information technology reviews of banking institutions were integrated into the overall supervisory process, and thus all safety and soundness examinations

Adoption of Rules Governing Transactions with Affiliates

In 2002, the Federal Reserve Board issued a new regulation that addresses transactions between insured depository institutions and their affiliates. The new regulation—Regulation W (Transactions between Member Banks and Their Affiliates)—implements sections 23A and 23B of the Federal Reserve Act. It takes effect April 1, 2003.

Background

Sections 23A and 23B of the Federal Reserve Act are designed to protect depository institutions from losses in transactions with their affiliates. They also limit a depository institution's ability to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net. Section 23A subjects covered transactions between depository institutions and their affiliates (for example, loans from a depository institution to or for the benefit of an affiliate, and purchases of assets by a depository institution from an affiliate) to quantitative limits and collateral requirements. Section 23B requires that depository institutions conduct most transactions with affiliates on terms and under circumstances that are substantially the same as those granted to nonaffiliates—that is, a depository institution may not grant its affiliate more favorable terms and conditions than it would grant a similarly situated nonaffiliate in a comparable transaction. This provision is commonly referred to as the "market terms requirement."

Before adoption of Regulation W, the statutory provisions of sections 23A and 23B of the Federal Reserve Act had been implemented by means of Board interpretations and informal staff guidance. Having a comprehensive and consistent application of the statutory provisions became especially important with passage in 1999 of the Gramm–Leach–Bliley Act (GLBA). GLBA not only provided for broader affiliations among financial services providers

but emphasized, in the statutory and regulatory frameworks it established, the importance of limitations on affiliate transactions as a means of protecting depository institutions from losses in their transactions with affiliates.

Key Provisions of Regulation W

Key provisions of Regulation W, and some of the important exemptions from the rule, are described below.

Derivatives Transactions and Intraday Credit

Derivatives transactions between a depository institution and its affiliates are not subject to the quantitative limitations and collateral requirements of section 23A. They are, however, subject to the market terms requirement of section 23B. In addition, depository institutions are required to adopt policies and procedures under section 23A to manage the credit exposure arising from their derivatives transactions with affiliates.

Intraday extensions of credit by depository institutions to affiliates also are subject to the market terms requirement of section 23B. However, such extensions of credit are exempt from the quantitative limits and collateral requirements of section 23A if the depository institution adopts policies and procedures to manage its credit exposure to affiliates in such transactions and has no reason to believe that the affiliate receiving intraday credit would have difficulty repaying the loan.

Scope of Application— Foreign Banking Organizations

To help ensure a competitive playing field for U.S. depository institutions vis-à-vis foreign banking organizations operating in the United States, Regulation W applies to transactions between the U.S. branches and

agencies of a foreign bank and the foreign bank's affiliates engaged in the United States in securities underwriting and dealing, insurance underwriting, merchant banking, and insurance company investment. The issue of competitive equity arises most strongly in connection with these activities—activities that a U.S. bank cannot engage in directly or through an operating subsidiary.

Scope of Application— Financial Subsidiaries

Congress amended section 23A in 1982 to provide that under the statute, subsidiaries of a depository institution generally are not affiliates of the institution. This provision was based on the premise that subsidiaries of a depository institution generally are consolidated with the depository institution and are engaged only in activities that the depository institution may conduct directly.

In 1999, GLBA authorized depository institutions to own financial subsidiaries that engage in activities that the parent institution may not conduct directly. GLBA also amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank—and thus subjected transactions between the bank and its financial subsidiaries to the limitations of sections 23A and 23B. Section 23A, as amended by GLBA, defines a financial subsidiary as a subsidiary of any state or national bank that is engaged in an activity that is not permissible for national banks (other than a subsidiary that federal law specifically authorizes national banks to control). A subsidiary of a financial subsidiary is also a financial subsidiary.

Exceptions to the definition of a financial subsidiary are included in Regulation W for (1) insurance agency subsidiaries of banks, (2) subsidiaries of state-chartered banks that engage in activities that the parent state bank may engage in directly under federal and state law, and (3) subsidiaries of state-chartered banks that engage in activities that the subsidiary

was legally conducting before Regulation W was issued.

Loan Purchases

For some years, the Board has allowed a depository institution to purchase a loan from an affiliate if the institution makes an independent evaluation of the borrower's creditworthiness before the affiliate extends the loan and if the institution commits to purchasing the loan before the affiliate extends the loan. In 1995, Board staff expressly limited the availability of this exemption to institutions whose loan purchases from any one affiliate represented no more than 50 percent of the dollar amount of the loans made by that affiliate. This condition was designed to prevent bank holding companies from using the exemption extensively to fund their non-bank lending affiliates.

Regulation W retains this 50 percent limitation but allows the institution's primary federal regulator, on a case-by-case basis, to restrict loan purchases even more if appropriate to protect the safety and soundness of the institution.

At the time Regulation W was adopted, the Board sought comment on a proposed rule that would prevent a depository institution from using this exemption if its purchases of loans from an affiliate under the exemption exceeded 100 percent of the institution's capital stock and surplus.

Conclusion

A key premise of the Gramm–Leach–Bliley Act is that sections 23A and 23B of the Federal Reserve Act limit the risk to depository institutions of the broader affiliations permitted by GLBA and make extensive prior-transaction review by the bank regulatory agencies unnecessary. In light of the greater role of these statutory provisions in risk management, Federal Reserve examiners and other supervisory staff have been directed to review inter-company transactions for compliance with the statute and Regulation W frequently and rigorously.

are now expected to include a review of information technology risks and activities. During 2002, the Federal Reserve was the lead agency in two examinations of large, multiregional data processing servicers 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 2002, Federal Reserve examiners conducted 194 on-site fiduciary 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 2002, the Federal Reserve conducted on-site examinations at 30 of the 98 state member banks and bank holding companies that were registered as transfer agents. Also during

the year the Federal Reserve examined 1 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-five state member banks and 10 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2002 the Federal Reserve conducted 9 examinations of broker-dealer activities in government securities at these institutions. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring compliance with the Securities Act Amendments of 1975 by state member banks and bank holding companies that act as municipal securities dealers, which are examined pursuant to the Municipal Securities Rule-making Board's rule G-16 at least once each two calendar years. Of the 27 entities that dealt in municipal securities during 2002, 8 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 2002, 795 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 166 of these lenders, and the remaining 629 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 281 lenders from its on-site inspection program. The securities credit activities of the remaining 348 lenders were subject to either biennial or triennial inspection. One hundred twenty-seven inspections were conducted during the year, compared with 65 in 2001.

Enforcement Actions and Civil Money Penalties

In 2002 the Federal Reserve completed 18 enforcement cases involving 32 separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. The Board of Governors collected \$60,829 in civil money penalties. All funds collected were remitted to the Department of the Treasury.

All final enforcement orders issued by the Board and all written agreements executed by the Reserve Banks in 2002 are available to the public and are posted on the Board's web site www.federalreserve.gov/boarddocs/

enforcement). In addition to formal enforcement actions, the Reserve Banks in 2002 completed 116 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 risk.

Regional Banking Organizations

The risk-focused supervision program for regional banking organizations applies to institutions having a management structure organized by function or business line, 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, it 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 minimize the number of requests for information from the institution, examiners make use of public and regulatory financial reports, market data, information from automated surveillance screening systems (see section "Surveillance and Risk Assessment"), 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 are judged, on the basis of their shared risk characteristics, to 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 inter-agency information-sharing through an automated system.

Supporting the supervision process is an automated application and database—the Banking Organization National Desktop (BOND)—that was developed to facilitate real-time, secure information-sharing and collaboration across the Federal Reserve System and with certain other federal and state regulators. During 2002, BOND was enhanced to include the capability of searching and accessing supervisory documents using web-based technology. BOND performance and functionality were also improved to promote analysis across institutions.

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

During the year, the Federal Reserve, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission formed an inter-agency working group to assess whether, in light of the post-September 11 risk environment, additional guidance on business resumption is needed. The agencies held a series of meetings with financial institutions and core clearing and settlement organizations to discuss lessons learned and the need for improving the resilience of the financial system after a wide-scale disruption. In September 2002, the working group published for comment a Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.⁴ The agencies are continuing to work with representatives of the industry to identify sound practices and plan to issue a final paper in 2003.

Community Banks

The risk-focused supervision program for community banks emphasizes the review of activities having the highest level of risk to an institution and provides a tiered approach to the examination of these activities. Examination procedures are tailored to the characteristics of the bank, keeping in mind its size, complexity, and risk profile. The examination procedures entail both off-site and on-site work, including planning, 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 and findings of the examination. The framework for risk-focused super-

4. *Federal Register*, vol. 67, no. 172 (Sept. 5, 2002), pp. 56835–56842.

vision 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 Risk Assessment

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 that exhibit higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

In addition to using automated screening systems, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports for use in monitoring and inspecting supervised banking organizations. The reports contain, for individual bank holding companies, financial statistics and comparisons with peer companies. They are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP). During 2002, information on securitization and asset sales activities was added to the report to help examiners and analysts evaluate the potential risks of these activities. Among the new information collected is detail on the volume and composition of securitization activities, the volume and composition of retained credit exposures, and delinquencies of and net losses on securitized assets. Also during the year the Federal Reserve substantially expanded the information on

insurance activities collected via the report.

Historically, paper copies of the Bank Holding Company Performance Reports have been provided to individual bank holding companies and to state banking agencies. Effective with the March 2002 report, paper distribution was replaced by electronic distribution of non-confidential information via the Board's National Information Center web site. The change was made to improve the efficiency and timeliness of distribution of the reports and to provide broader access to the reports by public users.

The Federal Reserve works through the Federal Financial Institutions Examination Council (FFIEC) Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.⁵ During the year, the task force added to the Uniform Bank Performance Report several items on securitization activities substantially similar to the items added to the Bank Holding Company Performance Report. Also during the year, the task force adopted a web-based distribution system for the Uniform Bank Performance Report.

International Activities

The Federal Reserve supervises the foreign branches of and 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

5. The member agencies of the FFIEC are the Board of Governors, 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).

conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

Foreign 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 2002 the Federal Reserve examined 1 foreign branch of a state member bank and 4 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.

At the end of 2002, 61 member banks were operating 855 branches in foreign countries and overseas areas of the United States; 31 national banks were operating 652 of these branches, and 30 state member banks were operating the remaining 203. In addition, 16 nonmember banks were operating 17 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 25A of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, most of which are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions, and (2) make foreign investments that are broader than those made by 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 80 and were operating 12 branches at year-end 2002. 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 2002, 193 foreign banks from 55 countries were operating 253 state-licensed branches and agencies (of which 10 were insured by the

Federal Deposit Insurance Corporation) as well as 52 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 16 Edge Act and agreement corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 86 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2002 controlled approximately 18 percent of U.S. commercial banking assets. These foreign banks also operated 92 representative offices; an additional 57 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 conducts a joint program for supervising the U.S. operations of foreign banking organizations in cooperation with the other federal banking agencies and state banking agencies. 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. The Federal Reserve conducted or participated with state and federal regulatory authorities in 307 examinations during 2002.

Technical Assistance

In 2002 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 2002 was concentrated in Latin America, Asia, 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 2002, the Federal Reserve, together with the other federal banking agencies, issued two final rules amending the agencies' regulatory capital guidelines and issued guidance on a number of policy topics. One final rule established the regulatory capital treatment of equity investments in nonfinancial companies held by banking organizations. The other final rule reduced from 100 percent to 20 percent the risk weight applied, under the agencies' risk-based capital guidelines, to certain claims on qualifying securities firms. The Federal Reserve, together with the other federal banking agencies, also issued policy guidance on management of country risk and asset securitization and draft guidance on credit card lending. The Federal Reserve also clarified that preferred stock covered by certain hedging arrangements is not includable in regulatory capital. In addition, the Federal Reserve issued guidance introducing a new statistical loan-sampling methodology for community banks.

Capital for Nonfinancial Equity Investments

In January, the Federal Reserve, together with the OCC and the FDIC, adopted a final rule governing the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies, and financial holding companies. The final rule subjects covered equity investments to a capital charge that increases in steps as the banking organization's level of concentration in equity investments increases. Agency monitoring also increases as the level of concentration in equity investments increases. A summary of the key provisions of

the new capital rule was published in SR letter 02-4 on March 4, 2002.

Claims on Securities Firms

In April, the federal banking agencies issued final rules amending the risk-based capital standards for banks, bank holding companies, and savings associations by reducing from 100 percent to 20 percent the risk weight accorded to certain claims on, and claims guaranteed by, qualifying securities firms having high investment-grade ratings in countries that are members of the Organisation for Economic Co-operation and Development. The change brings the risk weight in line with a 1998 revision to the Basel Capital Accord. Qualifying U.S. securities firms are broker-dealers registered with the Securities and Exchange Commission (SEC) that are in compliance with the SEC's net capital rule. The Board's final rule also applies a 20 percent risk weight to certain collateralized claims on qualifying securities firms.

Management of Country Risk

In February, the Federal Reserve and the other federal banking agencies published guidance for banking organizations concerning the elements of an effective country risk management process. The interagency guidance builds on the findings of a 1998 study by the Interagency Country Exposure Review Committee on the country risk management practices of U.S. banks, supplementing and strengthening previous guidance and ensuring that banking organizations' management of risks arising from their international activities are appropriately and adequately addressed during the examination process. The guidance was contained in SR letter 02-5, issued March 8, 2002.

Credit Card Lending

In July, under the auspices of the Federal Financial Institutions Examination Council, the federal banking agencies issued draft guidance on account management and loss allowance for credit card lending. The draft guidance describes the agencies' expectations regarding prudent risk-management practices for credit card activities, particularly with regard to credit-line management, over-limit accounts, and workouts. It also addresses income recognition and loss-allowance practices in connection with credit card lending.

Hedging of Preferred Stock Issued through Special-Purpose Entities

In March, the Federal Reserve issued guidance clarifying that preferred stock issued through special entities owned by bank holding companies is not includable in tier 1 capital if it is covered by certain hedging derivatives contracts. To be included in tier 1 capital, the Federal Reserve requires that the provisions of such preferred stock permit a banking organization to defer dividends for up to five years, a feature that allows bank holding companies to conserve cash in times of financial and liquidity pressure. Some hedging derivatives contracts contravene this policy by requiring a bank holding company to make contract payments on the derivative to its counterparty during periods of deferral on the preferred stock while providing for the deferral of payments to the bank holding company by the counterparty.

Statistical Loan Sampling at Community Banks

In October, the Federal Reserve issued guidance introducing a statistical sampling method to increase the compre-

hensiveness and effectiveness of credit review in examinations of certain community banks. In addition, the guidance clarified that loan reviews conducted as part of full-scope Federal Reserve examinations are expected to comply with existing Federal Reserve guidance or with the new loan-sampling guidance.

Securitization Guidance

In May 2002, the federal banking agencies released several policy statements on securitization-related issues. The guidance builds on the agencies' final rules for "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," which were issued in November 2001. The agencies also issued a question-and-answer document responding to some questions that have arisen regarding their rules.

- One policy statement clarified the risk-based capital treatment of accrued interest receivables for banking organizations that securitize credit card receivables through trusts and record as an on-balance-sheet asset the interest and fee income due on the securitized receivables. Because such amounts of interest and fee income generally must be paid to the trust for payment to holders of senior positions in a securitization before any amount is returned to the banking organization, the banking organization must treat the accrued interest receivable as a residual for purposes of risk-based capital. This treatment results in the banking organization's being required, under the recourse provisions of the agencies' capital rules, to hold "dollar-for-dollar" capital against the receivable amount.

- In another policy statement, the agencies advised examiners and banking organizations that the use by banking organizations of adverse supervisory actions or negative changes in supervisory thresholds as triggers for the early amortization or transfer of servicing in securitizations constitutes an unsafe and unsound banking practice. Examples of such supervisory triggers include a downgrade in a banking organization's CAMELS rating, an enforcement action, or a downgrade in a bank's "prompt corrective action" capital category. The supervisory concern arises because a banking organization that triggers such a provision is likely to already be subject to financial and liquidity pressure. Triggering an early amortization or transfer of servicing in a securitization can create or exacerbate liquidity and earnings problems that may lead to further deterioration in the banking organization's financial condition.
- A third policy statement was intended to aid examiners and banking organizations in identifying instances of "implicit recourse," a term that generally refers to a banking organization's providing greater credit support to a securitization than is required contractually. Because banking organizations' risk-based capital requirements generally are based on their maximum credit exposure under contract, such capital requirements do not capture the additional credit risk being undertaken by the organization through its implicit recourse actions. This guidance identifies several types of implicit recourse and supervisory actions that the agencies may take to address banking organizations' provision of implicit recourse.

Interagency Advisory on Accounting for Accrued Interest Receivable Related to Credit Card Securitizations

In December 2002, the Federal Reserve and the other federal banking agencies issued guidance regarding the appropriate accounting treatment for financial institutions that record an asset commonly referred to as accrued interest receivable (AIR) in connection with the securitization of credit card receivables. Consistent with generally accepted accounting principles, the guidance clarifies that when the terms of the securitization legally isolate the institution's (seller's) right to the AIR, the seller generally should report the AIR as a subordinated retained interest when accounting for the sale of credit card receivables. This means that the value of the AIR, at the date the receivables are transferred to the trust, must be adjusted on the basis of its relative fair (market) value.

Business Continuity

In 2002, in response to the events of September 11, 2001, the Federal Reserve developed a business-continuity risk profile that provides a consistent framework for benchmarking business-continuity programs and serves as a tool in conducting targeted examinations of business-continuity planning. Federal Reserve examiners plan to pilot test the business-continuity risk profile in 2003, with the goal of identifying areas for improvement at individual institutions and developing a profile of business-continuity programs at large, complex banking organizations supervised by the Federal Reserve.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision (Basel Committee), the Federal Reserve in 2002 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 worked to develop a revised consultative paper based on further deliberations of the committee and on comments received by the committee on its January 2001 consultative paper and on technical papers subsequently issued by the working groups. The committee and working groups also continued formal and informal communication with the banking industry and other interested parties, including the launching of a third quantitative impact study, referred to as QIS 3. QIS 3 was undertaken with the goal of ensuring the efficacy of the Basel Committee's proposals and gathering information helpful in assessing whether further modifications are necessary before the committee's planned release of a revised consultative paper in spring 2003.

In addition, in October 2002, a committee working group issued a second working paper on asset securitization,

following issuance of a first paper in October 2001. The purpose of the second paper was to discuss and seek feedback on some revisions to the securitization framework discussed in the two consultative papers. In December 2002, a committee working group issued a paper on pillar III—market discipline—in order to seek feedback on the latest proposals on disclosure.

Risk Management

The Federal Reserve contributed to several supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2002. These documents were generally aimed at improving the supervision of banking organizations' risk-management practices. The paper "Management and Supervision of Cross-Border Electronic Banking Activities" (issued in October) was prepared for the purposes of identifying banks' risk-management responsibilities with respect to cross-border banking and focusing attention on the need for effective home country supervision of, and continued international cooperation regarding, electronic banking. The paper "Sound Practices for the Management and Supervision of Operational Risk" (issued in July) outlines a set of principles that provide a framework for the effective management and supervision of operational risk. The framework is intended for use by banks and supervisory authorities when evaluating policies and practices related to the management of operational risk. The report "Supervisory Guidance in Dealing with Weak Banks" (issued in March) provides practical guidance for banking supervisors in their work with weak banks. The guidance includes discussions of problem identification, cor-

rective action, resolution techniques, and exit strategies.

Internal Control, Accounting, and Disclosure

The Federal Reserve participates in the Basel Committee's Task Force on Accounting Issues and the Transparency Group and represents the Basel Committee at international meetings on the issues addressed by these groups. In particular, the Federal Reserve in 2002 represented the Basel Committee at meetings of the committee of the International Accounting Standards Board (IASB) that works to improve guidance on accounting for financial instruments. In addition, a representative of the Federal Reserve participates in the IASB's Standards Advisory Council.

During 2002 the Federal Reserve also contributed to several reports, papers, and comment letters on internal control, accounting, and disclosure that were issued by the Basel Committee, including a proposed amendment to the International Accounting Standard on financial instruments, the International Accounting Standard on disclosures for financial statements of financial institutions, guidance on international loan-loss reserving, and a survey of bank disclosure practices.

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.

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, together with the Federal Reserve's implementing regulations, 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, a financial holding company 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. During 2002, 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 holding company supervisor, the Federal Reserve in 2002 continued to host 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. Topics discussed in 2002 included corporate gov-

ernance, the initiatives of the Securities and Exchange Commission in implementing the Sarbanes–Oxley Act, and other topics of mutual interest across the sectors.

Sarbanes–Oxley Act

In October 2002, the Federal Reserve issued a supervisory letter (SR letter 02–20) to give banking organizations information on the provisions of the Sarbanes–Oxley Act that set forth standards for audits, financial reporting and disclosure, and corporate governance at public companies. The provisions apply to public companies, including banks and bank holding companies, that have a class of securities registered under section 12 of the Securities Exchange Act of 1934 or are otherwise required to file periodic reports under section 5(d) of the 1934 act. The Federal Reserve staff is working with the other banking agencies to clarify the applicability of Sarbanes–Oxley to banking organizations. The staff is also considering the need for additional standards to reaffirm the important duties and responsibilities of banking organizations’ boards of directors and executive officers.

Efforts to Enhance Transparency

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 serve as an important complement to bank supervision and regulation. The more informative the information released by financial institutions, the better the evaluation of counterparty risks by market participants can be and the better their adjustments to the availability and pricing of funds will be.

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.

During 2002, the Federal Reserve Board commented on a proposed Financial Accounting Standards Board (FASB) standard concerning special-purpose entities. The Board supports FASB’s objective to increase transparency, particularly with respect to off-balance-sheet risk exposures that special-purpose entities can pose to organizations and market participants.

To further advance objectives related to transparency, the Federal Reserve works with other regulators, the accounting profession, and a wide variety of market participants, both domestically and internationally. During 2002, the Federal Reserve also worked with the Securities and Exchange Commission to coordinate an enforcement action against an institution for deficiencies in public and regulatory reports and internal controls. Additionally, the Federal Reserve provided guidance to financial organizations that faced possible interruption in audit services as a result of problems at a large accounting firm.

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 series and the FR Y–11 and FR 2314 series for non-bank subsidiaries, provide information essential to the supervision of the organizations and the formulation of regula-

tions 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 nonbank subsidiary 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 2002, several revisions to the FR Y-9C report were implemented to make it consistent with revisions to the bank Call Report and to conform to changes in generally accepted accounting principles. Also, the relevance of the FR Y-9 series of reports was improved by revising the existing items and adding new items related to new activities and other developments that may expose institutions to new or different types of risk. In addition, a new report (FR Y-9ES) was created to collect information annually from bank holding companies that are employee stock ownership plans.

In December 2002, the nonbank reporting framework for non-functionally-regulated nonbank subsidiaries of U.S. bank holding companies was streamlined.⁶ The revised framework provides

essential information for supervising and regulating nonbank subsidiaries and reduces burden. Under the new framework, bank holding companies file a detailed report (FR Y-11 or FR 2314) for their more-significant nonbank subsidiaries quarterly or annually, depending on total assets or other reporting criteria. Bank holding companies must also file, annually, an abbreviated, four-item report (FR Y-11S or FR 2314S) for their smaller nonbank subsidiaries. The smallest nonbank subsidiaries, nearly three-fifths of all nonbank subsidiaries, are now exempt from all filing requirements.

In addition, functionally regulated nonbank subsidiaries generally are no longer required to file individual nonbank subsidiary reports with the Federal Reserve. In keeping with provisions of the Gramm-Leach-Bliley Act, the Federal Reserve will rely on reports and information provided to the primary regulator. The Federal Reserve will continue to collect limited information on nonbank subsidiaries of bank holding companies on a consolidated basis in FR Y-9 reports.

Federal Financial Institutions Examination Council

During 2002, the Federal Reserve continued its active participation as a member of the Federal Financial Institutions Examination Council. Among other activities, the FFIEC revised the bank Call Reports, issued a revised examination framework for information technology service providers, and revised the information systems manual.

nonbank subsidiaries, which are entities whose primary regulator is an organization other than the Federal Reserve, namely, the Securities and Exchange Commission, the Commodity Futures Trading Commission, state insurance commissioners, or state securities departments.

6. Non-functionally-regulated nonbank subsidiaries are distinguished from functionally regulated

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 (Call Reports). Call Reports are the primary source of data for the supervision and regulation of banks and for 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 by many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community.

For the 2002 reporting period, the FFIEC implemented several revisions to the Call Report. The principal revisions included

- Breaking down several existing balance sheet and income statement items into greater detail to facilitate supervision and to implement two new accounting standards
- Collecting new information on the fair value of credit derivatives, the volume of merchant credit card sales, and the amount of past-due loans and leases held for sale.

The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the June 2002 report, to maintain consistency with the Call Report.

In November, the Federal Reserve and the other federal banking agencies proposed a small number of revisions to the Call Report for March 2003 report-

ing. The revisions would add several items related to bank credit card activities, break down two existing items to provide more detail to address safety and soundness considerations, and add a supplement to the report that would enable the agencies to collect a limited amount of data from certain banks in the event of an immediate and critical need for specific information. The proposed revisions also include a few processing changes to implement a new Call Report business model the agencies plan to institute in 2004.

Information Technology

Also in 2002, the FFIEC issued a revised framework for the interagency examination program for information technology service providers. Examinations of these providers of information technology and processing services to financial institutions are conducted by the Federal Reserve or other financial institution supervisory agencies under the Bank Service Company Act. The revised framework is designed to promote a more risk-based rationale for conducting such examinations by identifying and analyzing material supervisory risks to financial institutions that use the services of these companies. It includes risk-focused criteria for determining the examination schedule and the scope of the exams. The revised framework was implemented as a two-year pilot program that began in January 2002.

In addition, in 2002 the FFIEC began to prepare for the issuance of revisions to the FFIEC information systems manual, last updated in 1996. A project plan for the development of individual booklets to replace the current manual's chapters was established. Federal Reserve and other agency examiners participated in field testing the booklets

on technology service providers, information security, and business continuity. Field testing of booklets on outsourcing, audits, electronic banking, wholesale payment systems, retail payment systems, and Fedline is scheduled for early 2003. Booklets on management, development and programming, and operations are scheduled for development in 2003.

Supervisory Information Technology

The Supervisory Information Technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates the 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 leverages the resources and expertise available more broadly within the Federal Reserve System
- Practices that maximize supervision's business value and cost effectiveness are identified, analyzed, and approved for implementation.

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

SIT Project Management

In 2002, the SIT project management staff made significant progress in identifying opportunities for enhancing business value through the use of information technology. In March, the supervision function received approval to implement a Systemwide technology platform for scheduling examination resources. The staff provided substantial resources and leadership in developing a business case and evaluating technology alternatives for the deployment of an enterprise document management system. Staff members also provided substantial assistance and resources to support modernization of the Shared National Credit Program. The modernization is an interagency effort aimed at reducing examination costs and improving the timeliness and reliability of data associated with the review of large, syndicated credit facilities of commercial banks. The staff continued to assess opportunities to improve the delivery of information technology services for supervision in conjunction with efforts of Board and Reserve Bank internal IT providers.

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, which provides supervisory personnel and state banking authorities with access to NIC data, and the Central Document and Text Repository, which contains documents supporting the supervisory process.

In 2002, the NED system was modified in accordance with a policy change regarding the supervision program for small bank holding companies, to com-

plement the web-enabled NED application, and to add functionality that further supports the supervision of banking institutions. Changes to the production application were also made to accommodate changes in the commercial bank Call Report and the bank holding company FR Y-9 reports. A new version of the Central Document and Text Repository was implemented to handle a larger volume of documents.

Staff Development

The Federal Reserve System's 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 in the agencies. 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., and at other locations and are sometimes held jointly with other regulators.

The System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System's involvement includes assisting in the development of basic and advanced training in relation to emerging issues as well as in specialized areas such as trust activities, 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 2002 the Federal Reserve trained 2,748 students in System schools, 492 in schools sponsored by the FFIEC, and 52 in other schools, for a total of 3,292, including 214 representatives of foreign central banks (table). The number of training days in 2002 totaled 16,824.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 454 state examiners were trained—345 in Federal Reserve courses, 92 in FFIEC courses, and 17 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination, as well as a second proficiency examination in one of three specialty areas: safety and soundness, consumer affairs, or information technology (table). At the end of 2002, the System had 1,234 field examiners, of which 892 were commissioned (table).

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 as they apply to bank holding companies, financial holding companies, member banks, and foreign banking organizations. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of U.S. banking at the local, regional, and national levels; the international operations of domestic banking organizations; and the U.S. banking operations of foreign banks.

Bank Holding Company Act

Under the Bank Holding Company Act, a corporation or similar organization

Training Programs for Banking Supervision and Regulation, 2002

Program	Number of sessions conducted	
	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
Core schools		
Banking and supervision elements	9	7
Operations and analysis	7	5
Bank management	4	1
Report writing	16	16
Management skills	10	10
Conducting meetings with management	18	18
Other schools		
Loan analysis	5	3
Examination management	8	6
Real estate lending seminar	2	1
Specialized lending seminar	1	0
Senior forum for current banking and regulatory issues	2	2
Banking applications	1	0
Principles of fiduciary supervision	3	1
Commercial lending essentials for consumer affairs	3	3
Consumer compliance examinations I	2	0
Consumer compliance examinations II	2	2
CRA examination techniques	2	2
Fair lending examination techniques	3	2
Foreign banking organizations	3	3
Information systems continuing education	2	0
Capital markets seminars	13	10
Technology risk integration	13	13
Leadership dynamics	7	6
Seminar for senior supervisors of foreign central banks ¹	1	1
<i>Other agencies conducting courses²</i>		
Federal Financial Institutions Examination Council	34	3
The Options Institute	2	2

1. Conducted jointly with the World Bank.

2. Open to Federal Reserve employees.

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.

When reviewing a bank holding company application or notice 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 to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant’s ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on deci-

Results of Proficiency Examinations, 2002

Result	First proficiency exam	Second proficiency exam		
		Safety and soundness	Consumer affairs	Information technology
Passed	133	82	29	3
Failed	17	15	0	2
Total	150	97	29	5

sions regarding domestic and international applications in 2002 are shown in the accompanying table.

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 also has 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.

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 securit-

ies firms and insurance companies and may 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 upon by one of the Reserve Banks under delegated authority. In 2002, 82 domestic financial holding company declarations and 7 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 certain new financial activities that are permissible under the Gramm-Leach-Bliley Act. Instead, the financial holding company must notify the Board within thirty days after commencing the new activity or acquiring a company engaged in the new activity. A financial holding company may also 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.

Trends in Reserve Bank Supervision Levels, 1998–2002

Type of staff	2002	2001	2000	1999	1998
Field examination staff	1,234	1,242	1,172	1,216	1,250
Commissioned field staff	892	861	786	893	933

Decisions by the Federal Reserve on Domestic and International Applications, 2002

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	6	0	0	0	0	0	144	58	208
Merger of bank holding company	2	0	0	0	0	2	28	12	44
Acquisition or retention of bank	7	1	0	0	0	2	85	41	136
Acquisition of nonbank	0	0	3	0	0	8	0	101	112
Merger of bank	7	0	0	0	0	1	78	0	86
Change in control	0	0	1	0	0	0	0	160	161
Establishment of a branch, agency, or representative office by a foreign bank	2	0	0	19	0	0	0	0	21
Other	58	0	0	54	0	88	464	453	1,117
Total	82	1	4	73	0	101	799	825	1,885

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 2002, the Federal Reserve approved 86 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 proposals, the four agencies have sought to ensure consistency in administering the Bank Merger Act. The Federal Reserve submitted 515 reports on competitive factors to the other agencies in 2002.

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 acquiring persons.

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

In 2002, the Federal Reserve approved 161 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 2002, the Federal Reserve approved 21 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 after-the-fact notification to the Board, large and other significant investments require the prior approval of the Board. Excluding proposals relating to large domestic mergers, the Board in 2002 approved 23 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 1 application to acquire an Edge Act corporation, 1 application to extend the corporate exist-

ence of an existing Edge Act corporation, and 1 application 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 nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2002, the Federal Reserve acted on new and merger-related branch proposals for 836 domestic branches and granted prior approval for the establishment of 5 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities- and insurance agency-related activities. In 2002, 3 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 2002,

the Federal Reserve reviewed 10 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 contains announcements of applications and notices received by the Federal Reserve but not yet acted on. For each pending application and notice, the related H.2A contains the deadline for comments. In 2002, the Board's web site (www.federalreserve.gov) continued to provide information on orders and announcements.

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 12 days to 60 days, depending on the type of application or notice filed. In 2002, 93 percent of decisions were made within the target time period.

Enforcement of Other Laws and Regulations

The Federal Reserve'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 2002, 17 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. With respect to compliance with Regulation U, the federal banking agencies examine banks under their respective jurisdictions; the Farm Credit Administration, the National Credit Union Administration, and the Office of Thrift Supervision examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Since 1990 the Board has published a nonexclusive list of foreign stocks that are eligible for margin treatment at broker-dealers on the same basis as domestic margin securities. In 2002 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, or BSA) 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, terrorism, 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, 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 designates senior, experienced examiners as BSA and anti-money-laundering contacts. During examinations of state member banks and U.S. branches and agencies of foreign banks, examiners review the institution's compliance with the BSA and determine whether adequate procedures and controls to guard against money laundering are in place.

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 also speak at banking conferences to promote best practices in the industry with respect to anti-money-laundering initiatives. Internationally, section staff have provided anti-money-laundering training and technical assistance to countries in Asia, eastern Europe, South and Central America, and the Caribbean. Staff members have also participated extensively in numerous multilateral anti-money-laundering initiatives such as the Financial Action Task Force and the Basel Committee on Banking Supervision.

In 2002, the Federal Reserve continued to provide expertise and guidance to the BSA Advisory Group, a committee established by the Congress at the Department of the Treasury that seeks to reduce unnecessary burdens created by the BSA 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, 2001, and continuing through 2002, 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. The Federal Reserve Bank of New York created a dedicated e-mail system for financial institutions to report matches on the law enforcement list of "suspected terrorists" and, at the request of law enforcement and pursuant to subpoenas, searched the records of Fedwire for information related to the terrorist acts. In addition, multi-agency teams led by various U.S. government agencies were deployed to foreign countries to analyze bank and other financial records. On several of these occasions, senior Reserve Bank examiners traveled and worked with the teams. In the wake of the terrorist attacks, the FBI formed a multi-agency law enforcement task force to trace the transactions and assets of terrorists; staff of the Special Investigations Section participate in the task force.

To address the mandates of the USA PATRIOT Act, the Federal Reserve issued a number of supervisory letters to all domestic and foreign banking organizations under its supervision on such topics as private and correspondent

Extensions of Credit by State Member Banks to their Executive Officers, 2001 and 2002

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>2001</i>			
October 1–December 31	727	64,965,000	1.0–20.0
<i>2002</i>			
January 1–March 31	620	65,557,000	2.0–19.8
April 1–June 30	632	69,260,000	3.0–19.8
July 1–September 30	740	78,073,000	2.0–19.8
October 1–December 31	644	72,668,000	2.0–19.8

SOURCE. Call Reports.

banking as well as new information-sharing protocols. The letters described the act's requirements in these areas and the new rules that have been or will be issued.

At the request of Treasury Department staff, and consistent with statutory requirements for consultation, the Federal Reserve continues to actively assist in the development of many other new rules related to the PATRIOT Act. The Federal Reserve's Patriot Act Working Group, which is composed of senior, experienced Bank Secrecy Act/anti-money-laundering examiners from throughout the System, met several times during 2002. The group worked on interim examination procedures relative to the act's provisions and are continuing to develop a new training curriculum for examiners.

Extensions of Credit to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information for 2002.

Federal Reserve Membership

At the end of 2002, 2,977 banks were members of the Federal Reserve System and were operating 50,095 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 and their Branches carry out a number of System operations, including operating a nationwide payments system, distributing the nation's currency and coin, and serving as fiscal agent and depository to the United States.

Major Initiatives

During 2002, the Federal Reserve System took a number of significant steps to enhance further its resilience in case of emergency. It worked to ensure market liquidity, continuity of Federal Reserve operations, and effective Federal Reserve communications. In addition, it supported two efforts to increase the resilience of the private sector's financial system infrastructure.

While the Reserve Banks have historically worked to ensure the continuity of their operations, they undertook several projects in 2002 to reassess the adequacy of their business-continuity plans and to make them more robust. The Banks strengthened their ability to provide liquidity by enhancing backup for open market operations and the discount window. As a result, the Federal Reserve is better positioned to provide necessary market liquidity, helping to ensure that payment systems and financial markets can continue to function smoothly during a financial crisis.

In addition, the Reserve Banks evaluated their Fedwire contingency plans, their business-continuity planning process, staff concentration and leadership succession, telecommunications and network contingency, and the physical security of their facilities and personnel. Moreover, the Reserve Banks are better

positioned to meet public demand for cash in the event of an emergency.

During the year, the Reserve Banks and the Board also reviewed and enhanced their mechanisms for crisis communications between the Board, Federal Reserve offices, other government agencies, financial industry participants, System employees, the media, and the general public.

The events of September 11, 2001, illustrated the interdependence among participants in the financial system and the way that business concentration, both market-based and geographic, can intensify disruptions. The New York Reserve Bank contributed to two white papers on these matters that the Board, together with other regulatory agencies, published for comment during the year. One paper discussed sound practices to increase the resilience of critical U.S. financial markets in the face of a regional disaster. The other paper considered potential structural changes in the way settlement services for government securities are provided and presented a framework for discussing issues that need to be further explored. In response to public comments on the latter paper, the Board in November created a private-sector working group to explore ways the clearing banks for government securities could substitute for each other should the services of either be interrupted or terminated. The working group was asked to submit a report to the Board before the end of 2003.

The Reserve Banks also worked to improve the efficiency of their operations through a strategy of standardization and consolidation of a variety of information systems, operations, and

programs. For example, the Reserve Banks are standardizing and consolidating a number of financial management applications for budgeting, cost accounting, and accounts payable. In addition, efforts are under way to move separate human resources information and payroll systems in each of the twelve Districts into common systems located in a single District. The Reserve Banks have also initiated efforts to consolidate their electronic access customer-support function as well as human resources operations into fewer sites. Finally, the Reserve Banks are implementing a standard health insurance program and have adopted a standard prescription drug plan. The expected benefits of these consolidations and standardized programs include lower administrative and operating costs and improved functionality.

Developments in Federal Reserve Priced Services

The Monetary Control Act of 1980 requires that the Federal Reserve set fees for providing “priced services” to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the 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

1. In addition to income taxes and the return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance by the Federal Deposit Insurance Corporation. Also allocated to priced services are assets and personnel costs of the Board of Governors that are related to priced

years, the Federal Reserve Banks have recovered 98.8 percent of their priced services costs, including the PSAF (table).

Overall, fees charged in 2002 for priced services increased approximately 1.3 percent from 2001.² Revenue from priced services amounted to \$916.3 million, other income related to priced services was \$2.1 million, and costs related to priced services totaled \$891.7 million, resulting in net income of \$26.6 million and a recovery rate of 93.3 percent of costs, including the PSAF.³

Commercial Check Collection Service

In 2002, operating expenses and imputed costs for the Reserve Banks’ check collection service totaled \$751.2 million, while revenue amounted to \$759.2 million and other income was \$1.7 million, resulting in net income of \$9.7 million. In 2001, by comparison, operating expenses and imputed costs totaled \$754.4 million, while revenue amounted to \$764.7 million and other income was \$28.5 million, resulting in net income of \$38.9 million. The decline in check service revenue in 2002

services; in the pro forma statements at the end of this chapter, Board expenses are included in operating expenses and Board assets are part of long-term assets.

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

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

Priced Services Cost Recovery, 1993–2002

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
1993	774.5	820.4	17.5	837.9	92.4
1994	767.2	760.2	21.0	781.2	98.2
1995	765.2	752.7	31.5	784.2	97.6
1996	815.9	746.4	42.9	789.3	103.4
1997	818.8	752.8	54.3	807.1	101.5
1998	839.8	743.2	66.8	809.9	103.7
1999	867.6	775.7	57.2	832.9	104.2
2000	922.8	818.2	98.4	916.6	100.7
2001	960.4	901.9	109.2	1,011.1	95.0
2002	918.3	891.7	92.5	984.3	93.3
1993–2002	8,450.5	7,963.0	591.4	8,554.4	98.8

NOTE. In this and other tables in this chapter, components may not sum to totals or yield percentages shown because of rounding. Amount in bold is a restatement due to errors in previously reported data.

1. For the ten-year period, includes revenue from services of \$8,183.0 million and other income and expense (net) of \$267.5 million.

2. For the ten-year period, includes operating expenses of \$7,114.7 million, imputed costs of \$489.7 million, and imputed income taxes of \$265.1 million. Also includes the effect of one-time accounting changes net of taxes of \$74.1 million for 1993 and \$19.4 million for 1995.

3. Revenue from services divided by total costs.

was largely the result of declining volume and customers' moving to lower-margin products. The Reserve Banks handled 16.6 billion checks in 2002, a decrease of 1.9 percent from 2001 (table). The decline in Reserve Bank check volume appears to be consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.⁴ Although the Reserve Banks took steps to reduce check operating costs in 2002, the reductions were largely offset by

lower-than-expected returns on pension credits.

To address the apparent continuing decline in check volumes, the Reserve Banks are developing a business and operational strategy that will position the service to achieve its financial and payment system objectives over the long term. In 2002, the Banks contracted with a consultant to analyze their check-processing infrastructure. The analysis defined criteria for balancing efficient provision of service in a declining-volume environment with the need to provide an adequate level of service nationwide. The Banks have used these criteria to develop potential options as to the number, location, and operational capabilities of its check-processing sites. Subsequently, the Reserve Banks announced that they are reducing their check service operating costs through a combination of measures: streamlining their check-management structures, reducing staff, decreasing the number of check-processing locations, and increas-

4. The Federal Reserve System's recent retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. See Geoffrey R. Gerdes and Jack K. Walton II, "The Use of Checks and Other Noncash Payment Instruments in the United States," *Federal Reserve Bulletin*, vol. 88 (August 2002), pp. 360–74. (The article is available on the Board's web site at www.federalreserve.gov/pubs/bulletin/default.htm.) During the late 1990s, the volume of checks processed by the Reserve Banks rose, albeit slowly, suggesting that the proportion of interbank checks cleared through the Reserve Banks increased.

Activity in Federal Reserve Priced Services, 2002, 2001, and 2000

Thousands of items

Service	2002	2001	2000	Percent change	
				2001 to 2002	2000 to 2001
Commercial check	16,586,804	16,905,016	16,993,800	-1.9	-.5
Funds transfer	117,133	115,308	111,175	1.6	3.7
Securities transfer	8,480	6,708	5,666	26.4	18.4
Commercial ACH	4,986,152	4,448,361	3,812,191	12.1	16.7
Noncash	333	412	519	-19.2	-20.7
Cash transportation	9	18	19	-52.5	-7.0

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 were assessed; and in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

Amount in bold is restatement of previously reported data.

ing processing capacity in other locations. The Reserve Banks will continue to provide check services nationwide.

The volume of checks for which the Federal Reserve office that serves the depositing bank is not the office that serves the paying bank increased 4.4 percent, from 3.6 billion in 2001 to 3.7 billion in 2002. Of all the checks presented by the Reserve Banks to paying banks, 22.0 percent (approximately 3.6 billion checks) were presented electronically, compared with 21.7 percent in 2001. The Reserve Banks captured images of 8.1 percent of the checks they collected, the same percentage as in 2001.

The Reserve Banks continued in 2002 a check modernization project begun in 2000 to install uniform software and hardware for check processing, check imaging, and check adjustments in all Reserve Bank offices and to give depository institutions web-based access to check services. The Reserve Banks expect to recover the cost of the project over the long run because the modernization effort will increase operating efficiency and make it possible to offer additional services to depository institutions.

Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled \$62.5 million in 2002. Revenue from ACH operations and other income totaled \$71.8 million, resulting in net income of \$9.3 million. The Reserve Banks processed 5.0 billion commercial ACH transactions (worth \$13.1 trillion), an increase of 12.1 percent from 2001.

Consolidation of customer support activities to two Reserve Bank offices was completed during 2002. These two Banks now share responsibility for supporting all ACH operations, including ensuring the timely and accurate processing of payments, maintaining the integrity of the ACH application, monitoring file processing, and responding to customers' questions. Before consolidation, these responsibilities were handled by each of the twelve Reserve Banks.

Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds

and National Settlement Services totaled \$53.5 million in 2002. Revenue from these operations totaled \$58.6 million, and other income amounted to \$0.1 million, resulting in net income of \$5.2 million.

Fedwire Funds Service

The Reserve Banks' Fedwire Funds Service allows depository institutions to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Reserve Banks. In 2002, the number of Fedwire funds transfers originated by depository institutions increased 1.6 percent from 2001, to approximately 117.1 million. The Reserve Banks reduced the transfer fees for each of the volume-based tiers (table). The off-line funds transfer surcharge remained unchanged.⁵

The final phase of consolidation of the operations of the Fedwire Funds Service was completed in May. Also during 2002, the Reserve Banks improved the resilience of the service by increasing the readiness of a third data processing center. In the event of an outage at the primary or secondary site or at both sites, resources at the third site are available to support same-day recovery of Fedwire applications. This enhancement adds to the already robust contingency capabilities provided by the primary and secondary sites. The three sites are distant from each other.

In December, the Board requested comment on a proposal to expand the operating hours for the on-line Fedwire Funds Service. Under the proposal, the

Fees Paid by Depository Institutions for Selected Federal Reserve Priced Services, 2001 and 2002

Dollars

Item	2001	2002
FEDWIRE FUNDS TRANSFERS, BY VOLUME TIER¹		
Tier (<i>number of transfers per month</i>) ²		
1 (1 to 2,500) .....	.33	.31
2 (2,501 to 80,000) .....	.24	.22
3 (80,001 and more) .....	.16	.15
Off-line surcharge	15.00	15.00
NATIONAL SETTLEMENT SERVICES		
Entries, each .....	.95	.80
Files, each	12.00	14.00
Minimum per month	60-100	60-100
FEDWIRE SECURITIES TRANSFERS		
Account maintenance		
Per issue .....	.45	.41
Per account	15.00	15.00
Transfers, each ²		
Off-line surcharge .....	.70	.66
Off-line surcharge	25.00	25.00
NONCASH COLLECTION		
Bonds, each		
Deposit envelopes (<i>per envelope of coupons</i>) ³		
1-5	4.75	4.75
6-50	2.50	2.50
Cash letters (<i>flat fee, by number of envelopes of coupons</i>) ³		
1-5	7.50	7.50
6-50	15.00	15.00
Return items, each	20.00	20.00

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.

service would open at 9:00 p.m. eastern time (ET), three and one-half hours earlier than the current opening time of 12:30 a.m. ET. The earlier opening time is intended to facilitate the functioning and continued development of the payments system and to increase efficiency and reduce risk in making payments and settlements. The proposal does not affect the Fedwire Securities Service.

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

National Settlement Service

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' National Settlement Service to settle their transactions. The Reserve Banks provide settlement services to approximately seventy local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2002, the Reserve Banks processed more than 415,000 settlement entries for these arrangements.

Fedwire Securities Service

The Fedwire Securities Service allows participants to electronically transfer securities issued by the U.S. Treasury, federal government agencies, and other entities to other participants in the United States.⁶ Reserve Bank operating expenses and imputed costs for providing this service totaled \$21.5 million in 2002. Revenue and other income totaled \$23.8 million, resulting in net income of \$2.3 million. Approximately 8.5 million transfers were processed by the service during the year, an increase of 26.4 percent from 2001. The basic per-transfer fee for transfers originated and received by participants and the monthly account maintenance fees were lowered, while the off-line securities transaction surcharge remained unchanged.

Conversion of Government National Mortgage Association (Ginnie Mae)

6. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. When the Reserve Banks provide transfer, account maintenance, and settlement services for U.S. Treasury securities, they are acting 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.

securities to the Fedwire system was completed in March; the securities are now transferred and settled on the Fedwire Securities Service. The final phase of consolidation of the operations of the Fedwire Securities Service, an effort to reduce costs, was completed in May. Operational support for processing joint custody collateral was also consolidated in May.

Also during 2002, the Reserve Banks increased the readiness of a third data processing center for the Fedwire Securities Service to serve as a backup in the event of an outage at the primary or secondary site or both. Processing resources at the third site are available to support same-day recovery of the Fedwire applications. This enhancement to the third site adds to the already robust contingency capabilities provided by the primary and secondary sites. The three sites are distant from each other.

Noncash Collection Service

The Reserve Banks provide 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 is centralized at one Federal Reserve office, processed 333,000 noncash transactions in 2002. Operating expenses and imputed costs for noncash operations totaled \$1.5 million in 2002, and revenue totaled \$1.7 million, resulting in net income of \$0.2 million.

Special Cash Services

The Reserve Banks charge fees for providing special cash-related services, such as packaging currency in a nonstandard 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 to depository institutions by the Reserve Banks. Operating expenses and imputed costs for special cash services totaled \$1.4 million in 2002. Revenue and other income also totaled \$1.4 million, resulting in no net income.

Float

Federal Reserve float decreased in 2002 to a daily average of -\$318.6 million, from a daily average of \$604.6 million in 2001.⁷ The Federal Reserve includes the cost of or income from float associated with priced services as part of the fees for those services.

Developments in Currency and Coin

The Reserve Banks received 34.7 billion notes from circulation in 2002, a 3.1 percent increase from 2001, and made payments of 35.4 billion notes to circulation in 2002, a 2.9 percent increase from 2001. The Banks received 43.4 billion coins from circulation in 2002, a 9.3 percent increase from 2001, and made payments of 58.6 billion coins to circulation in 2002, a 3.0 percent increase from 2001.

The Reserve Banks enhanced their national business-continuity framework for the cash services function during the year. This effort included the refinement of operating procedures, expansion of the crisis partner network for the Banks, and continuation of cash contingency testing.

Also during the year, the Federal Reserve worked closely with the Bureau of Engraving and Printing as prepara-

tions continued for the introduction of a new currency design, which includes new and enhanced security features.

Developments in Fiscal Agency and Government Depository Services

The total cost of providing fiscal agency and depository services to the Treasury and other government agencies in 2002 amounted to \$308.5 million, compared with \$285.4 million in 2001 (table). The majority of these costs were incurred on behalf of the Treasury. Treasury-related costs were \$269.4 million in 2002, compared with \$246.5 million in 2001, an increase of 9.3 percent. The cost of providing services to other government agencies was \$39.1 million, compared with \$38.9 million in 2001. In 2002, as in 2001, the Treasury and other government agencies reimbursed the Reserve Banks for costs to provide these services.

Fiscal Agency Services

As fiscal agents, the 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. Additionally, the Reserve Banks support Treasury and other government agencies in their efforts to modernize government payment and accounting systems.

Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities (Fedwire Securities Service, TreasuryDirect, marketable issues, and

7. Float results from differences in the timing of exchanges of debits and credits (settlements) between entities in financial transactions.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2002, 2001, and 2000

Thousands of dollars

Agency and service	2002	2001	2000
DEPARTMENT OF THE TREASURY			
<i>Bureau of the Public Debt</i>			
Savings bonds	68,888.3	69,569.8	70,786.7
TreasuryDirect and Treasury coupons	33,953.6	36,610.1	42,372.4
Commercial book entry	8,830.1	9,998.1	13,924.6
Marketable Treasury issues	14,597.6	11,366.8	14,224.3
Computer applications and infrastructure development and support	2,349.6	222.4	...
Other services	2,385.8	1,255.7	96.8
Total	131,005.0	129,022.9	141,404.7
<i>Financial Management Service</i>			
Treasury tax and loan and Treasury general account	30,111.0	31,106.0	38,649.0
Government check processing	30,284.4	30,310.2	31,866.9
Automated clearinghouse	6,280.0	9,665.2	10,799.1
Government agency deposits	2,082.2	2,272.9	2,218.8
Fedwire funds transfers	201.4	199.2	182.9
Computer applications and infrastructure development and support	46,782.6	27,281.3	21,209.6
Other services	8,173.1	3,490.2	5,805.8
Total	123,914.7	104,324.9	110,732.2
<i>Other Treasury</i>			
Total	14,471.2	13,149.8	10,362.8
Total, Treasury	269,390.9	246,497.5	262,499.7
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	10,240.8	13,197.2	16,463.7
U.S. Postal Service			
Postal money orders	12,381.6	11,255.0	9,213.5
Miscellaneous agencies			
Other services	16,494.1	14,434.0	13,747.1
Total, other agencies	39,116.5	38,886.2	39,424.3
Total reimbursable expenses	308,507.4	285,383.7	301,924.0

NOTE. Amounts in bold are restatements due to reclassification of previously reported data.

... Not applicable.

Treasury coupons) totaled \$57.4 million, a 1.0 percent decrease from 2001. The Reserve Banks processed 167,000 tenders for Treasury securities (excluding tenders processed by the Treasury, which were previously included in this figure), compared with 181,000 in 2001, and handled 2.5 million reinvestment requests, compared with 2.8 million in 2001.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire Securities Service, which provides custody and transfer services, and TreasuryDirect, which

provides custody services only.⁸ Almost 98 percent of the total par value of Treasury securities outstanding at year-end 2002 was held by the Fedwire Securities Service. The Reserve Banks in 2002 originated 8.3 million transfers of Treasury securities, a 6.2 percent increase from 2001.

TreasuryDirect customers may sell their securities for a fee through Sell-Direct, a program operated by one of the Reserve Banks. The Bank sold nearly

8. TreasuryDirect was designed for individuals who plan to hold their securities until maturity.

14,000 securities worth \$589.8 million in 2002, compared with nearly 15,000 securities worth \$699.9 million in 2001. It collected more than \$464,000 in fees on behalf of the Treasury, a decrease of 9.1 percent from the almost \$510,000 in fees collected in 2001.

Savings Bonds

Reserve Bank operating expenses for savings bond activities totaled \$68.9 million in 2002, a decrease of 1.0 percent from 2001. The Banks printed and mailed 37.2 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 1.5 percent decrease from 2001. They issued nearly 4.7 million new Series I (inflation-indexed) savings bonds and 27.9 million new Series EE savings bonds. In addition, the Banks processed approximately 618,000 redemption, reissue, and exchange transactions, a 9.7 percent increase from 2001. Reserve Bank staff responded to 1.6 million service calls from owners of savings bonds, approximately the same number as in 2001.

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 2002 totaled \$30.1 million. The Federal Reserve enhanced the Treasury tax and loan program at midyear by pilot testing the Term Investment Option, whereby the Treasury can place investments with depository institutions for a set term, the

interest rate being determined by auction. This pilot program added approximately \$3.0 million to the Treasury's investment income.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payments amounted to \$38.8 million in 2002. The Banks processed 883.2 million ACH transactions for the Treasury, a decrease of 1.9 percent from 2001, and nearly 140,000 Fedwire funds transfers, a decrease of 10.2 percent from 2001. They also processed 289.3 million paper government checks, a decrease of 16.3 percent from 2001. In addition, the Banks issued 368,000 fiscal agency checks, a decrease of 15.5 percent from 2001.

During the year, the Reserve Banks assisted Treasury's efforts to facilitate electronic payments to the federal government. The Banks operate Pay.gov, a Treasury program that allows members of the public to pay the government over the Internet. The Banks also operate the Treasury's Paper Check Conversion program, whereby checks written to government agencies are converted at the point of sale into ACH transactions. In 2002, the first full year of operation for both programs, the Reserve Banks originated nearly 215,000 ACH transactions through the programs, a significant increase from the 10,000 originated in 2001.

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 2002 totaled \$10.2 million, 22.4 percent lower than in 2001. The Banks redeemed 500.5 million food coupons, a decrease of 14.7 percent from 2001.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. In 2002, they processed 216.5 million postal money orders, a decrease of 5.6 percent from 2001.

Electronic Access

The Federal Reserve continued in 2002 to improve electronic access for depository institutions and to offer web-based applications for imaging checks, ordering cash, and processing savings bonds. Specifically, the Reserve Banks made the strategic decision to deliver services using web-based technologies in the next two years and to discontinue development of the FedLine for Windows NT operating system. This strategic direction will allow the Banks to provide more-flexible access to the full array of financial information and transaction services, including high-risk Fedwire and ACH, and to improve the quality of financial services.

To complement the move to web-based electronic access, the Reserve Banks plan to consolidate the customer support function for electronic access at each Reserve Bank to two sites during 2003 and 2004. The consolidation is expected to improve the efficiency and consistency of customer support.

Information Technology

Implementation of frame relay technology on the telecommunications network connecting the Reserve Bank offices to

each other and to depository institutions is substantially complete. The technology has improved the speed, reliability, and performance of the depository institutions' electronic connections during contingencies as well as the capacity and flexibility to support new electronic services using web-based technologies.

Also, several major cost-reduction initiatives to centralize or standardize information technology utilities and resources common to the Reserve Banks have begun. Projects are under way to standardize certain local area network components as well as desktop hardware and software to facilitate interoperability, improve network efficiency, and increase productivity. Certain Reserve Banks are supporting common information technology functions such as desktop standardization and management, remote access, and incident response. These initiatives are expected to contribute to a System effort to reduce information technology costs over the long term.

Examinations of the Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section "Federal Reserve Banks Combined Financial Statements"). The public accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. Within this framework, each Reserve Bank 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 2002 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$1.0 million. 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 2002 the Reserve Banks engaged PwC for advisory services totaling \$176,600 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.

The Board's annual examination of the Reserve Banks in 2002 included a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division staff monitors the activities of each Reserve Bank on an ongoing basis and conducts on-site reviews according to the division's risk-assessment methodology. The 2002 examination also included assessing the efficiency and effectiveness of the 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 2001 and 2002.

Income in 2002 was \$26,760 million, compared with \$31,871 million in 2001. Expenses totaled \$2,862 million (\$2,071 million in operating expenses, \$156 million in earnings credits granted to depository institutions, \$205 million in assessments for expenditures by the Board of Governors, and \$430 million for the cost of new currency). Revenue from priced services was \$916.3 million.

The profit and loss account showed a net profit of \$2,149 million. The profit was due primarily to unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled \$484 million, \$56 million more than in 2001; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled \$24,496 million in 2002,

Income, Expenses, and Distribution of Net Earnings of the Federal Reserve Banks, 2002 and 2001

Millions of dollars

Item	2002	2001
Current income	26,760	31,871
Current expenses	2,227	2,085
Operating expenses ¹	2,071	1,834
Earnings credits granted	156	250
Current net income	24,533	29,786
Net additions to (deductions from, -) current net income	2,149	-1,117
Assessments by the Board of Governors	635	634
For expenditures of Board	205	295
For cost of currency	430	339
Net income before payments to Treasury	26,048	28,035
Dividends paid	484	428
Transferred to surplus	1,068	518
Payments to Treasury ²	24,496	27,089

1. Includes a net periodic credit for pension costs of \$157 million in 2002 and \$331 million in 2001.

2. Interest on Federal Reserve notes.

down from \$27,089 million in 2001; 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 Reserve Bank for 2002, and table 6 shows a condensed statement for each Bank for the years 1914 through 2002. 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 2002 amounted to \$621,834 million, an increase of \$62,511 million from 2001 (table). Holdings of U.S. government securities increased \$62,795 million, and holdings of loans decreased \$284 million.

The average rate of interest earned on the Reserve Banks’ holdings of government securities declined to 4.11 percent, from 5.46 percent in 2001, and the average rate of interest earned on loans declined to 1.94 percent, from 3.18 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 1999 through 2002.

Federal Reserve Bank Premises

In 2002, design work continued for the Dallas Reserve Bank’s new Houston Branch building and the Chicago Bank’s Detroit Branch building. Also, the Board approved the purchase of property for the new Detroit Branch building and a new building program for the Kansas City Bank. The St. Louis Reserve Bank

Securities and Loans of the Federal Reserve Banks, 2000–2002

Millions of dollars except as noted

Item and year	Total	U.S. government securities ¹	Loans ²
<i>Average daily holdings³</i>			
2000	528,139	527,774	365
2001	559,323	558,926	397
2002	621,834	621,721	113
<i>Earnings⁴</i>			
2000	32,760	32,737	23
2001	30,536	30,523	13
2002	25,527	25,525	2
<i>Average interest rate (percent)</i>			
2000	6.20	6.20	6.27
2001	5.46	5.46	3.18
2002	4.11	4.11	1.94

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.

4. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.

continued to analyze its long-term planning options for its headquarters facility.

The multiyear renovation program at the New York Reserve Bank's headquarters building continued, including the cleaning and repair of the exterior stonework. The improvement program

for the main chiller plant in the headquarters building was completed, and the annex building in New York City was sold.

At all facilities, security enhancement programs were undertaken as a result of the events of September 11, 2001. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2002 and 2001

Millions of dollars

Item	2002	2001	
<i>Short-term assets</i> (Note 1)			
Imputed reserve requirements on clearing balances	1,047.8	860.8	
Investment in marketable securities ..	9,051.3	7,747.3	
Receivables	78.7	76.5	
Materials and supplies	3.4	3.1	
Prepaid expenses	34.8	30.5	
Items in process of collection	<u>6,958.6</u>	<u>1,772.1</u>	
Total short-term assets	17,174.7		10,490.3
<i>Long-term assets</i> (Note 2)			
Premises	475.0	473.0	
Furniture and equipment	179.2	176.1	
Leases and leasehold improvements ..	91.2	88.1	
Prepaid pension costs	<u>809.2</u>	<u>760.8</u>	
Total long-term assets	<u>1,554.6</u>		<u>1,498.0</u>
Total assets	18,729.3		11,988.3
<i>Short-term liabilities</i>			
Clearing balances and balances arising from early credit of uncollected items	10,550.2	8,524.5	
Deferred-availability items	6,886.4	1,855.7	
Short-term debt .....	.0	20.8	
Short-term payables	<u>83.9</u>	<u>89.2</u>	
Total short-term liabilities	17,520.5		10,490.3
<i>Long-term liabilities</i>			
Long-term debt .....	.0	519.7	
Postretirement/postemployment benefits obligation	<u>272.3</u>	<u>257.8</u>	
Total long-term liabilities	<u>272.3</u>		<u>777.4</u>
Total liabilities	17,792.8		11,267.7
Equity	<u>936.4</u>		<u>720.6</u>
Total liabilities and equity (Note 3) ...	18,729.3		11,988.3

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

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

Pro Forma Income Statement for Federal Reserve Priced Services, 2002 and 2001

Millions of dollars

Item	2002	2001
Revenue from services provided to depository institutions (Note 4)	916.3	926.5
Operating expenses (Note 5)	<u>876.0</u>	<u>814.9</u>
Income from operations	40.2	111.7
Imputed costs (Note 6)		
Interest on float	-6.8	15.5
Interest on debt .....	.0	32.0
Sales taxes	11.4	12.6
FDIC insurance	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs	35.6	51.6
Other income and expenses (Note 7)		
Investment income	148.9	273.3
Earnings credits	<u>-146.8</u>	<u>-239.4</u>
Income before income taxes	37.7	85.4
Imputed income taxes (Note 8)	<u>11.0</u>	<u>26.9</u>
Net income	26.6	58.5
MEMO: Targeted return on equity (Note 9) ...	92.5	109.2

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, 2002

Millions of dollars

Item	Total	Com- mercial check collection	Fedwire funds	Fedwire securities	Com- mercial ACH	Noncash services	Cash services
Revenue from services (Note 4)	916.3	759.2	58.6	23.7	71.7	1.7	1.4
Operating expenses (Note 5)	<u>876.0</u>	<u>744.3</u>	<u>50.7</u>	<u>20.3</u>	<u>58.0</u>	<u>1.4</u>	<u>1.4</u>
Income from operations	40.2	14.9	7.9	3.5	13.7	.2	-0
Imputed costs (Note 6)	<u>4.6</u>	<u>2.9</u>	<u>.7</u>	<u>.3</u>	<u>.7</u>	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs	35.6	12.0	7.3	3.1	13.0	.2	-0
Other income and expenses, net (Note 7)	<u>2.1</u>	<u>1.7</u>	<u>.1</u>	<u>.0</u>	<u>.2</u>	<u>.0</u>	<u>.0</u>
Income before income taxes ..	37.7	13.7	7.4	3.2	13.2	.2	-0
Imputed income taxes (Note 8)	<u>11.0</u>	<u>4.0</u>	<u>2.2</u>	<u>.9</u>	<u>3.9</u>	<u>.1</u>	<u>-0</u>
Net income	26.6	9.7	5.2	2.3	9.3	.2	-0
MEMO: Targeted return on equity (Note 9)	92.5	78.2	5.5	2.2	6.5	.1	.1

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

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

FEDERAL RESERVE BANKS

NOTES TO 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. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in 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 \$48.4 million in 2002 and \$101.0 million in 2001 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 clearing balances in 2002 and short-term payables and short-term debt in 2001. Long-term assets are financed with clearing balances in 2002, and in 2001 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 adjust-

ment 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 \$5.1 million in 2002 and \$4.9 million in 2001. 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 2002 and 2001 as follows (in millions):

	2002	2001
Check	40.3	43.5
ACH	4.1	4.4
Fedwire funds	3.3	3.5
Fedwire securities	1.9	1.9
Noncash services .....	.1	.1
Special cash services .....	.1	.0
Total	49.7	53.4

(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. There was no debt in 2002 because clearing balances fund short-term and long-term debt. 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 cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each ser-

vice 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 2002 in millions of dollars:

Total float	-9.3
Unrecovered float	<u>68.6</u>
Float subject to recovery	-77.9
Sources of recovery of float	
Income on clearing balances	-8.2
As-of adjustments	-309.3
Direct charges	430.8
Per-item fees	-809.8

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for 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 2002.

(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 to prepare, in consultation with the Congress and outside stakeholders, a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not covered by the act, the Board of Governors is voluntarily complying with many of the act's mandates.

Strategic and Performance Plans and Performance Report

The Board's current strategic plan in the GPRA format, released in December 2001, covers the period 2001–05. The document articulates the Board's mission, sets forth major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. The strategic plan also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation.

The 2002–03 performance plan and the 2000–01 performance report were posted on the Board's public web site in November 2002 for access by the Congress, the public, and the General Accounting Office. The performance plan sets forth specific targets for some of the performance measures identified in the strategic plan (except those associated with the monetary policy function). The performance plan also describes the operational processes and resources needed to meet those targets

and discusses validation of data and verification of results. The performance report indicates that the Board generally met its goals for 2000–01. A scheduling problem with state bank regulatory agencies was cited as a reason for not meeting all of the goals. Accordingly, the Board is implementing a new scheduling system that will help resolve the problem.

The strategic plan, performance plan, and performance report are available on the Board's public web site (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 and the price stability that fosters that goal.

Objectives

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets and in those abroad, so that monetary policy decisions will be well informed
- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities
- 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, foreign banking organizations with U.S. operations, 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 help Federal Reserve management foster and strengthen sound internal control systems and efficient and effective performance
- Conduct research and analysis that contributes to policy development and 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 mandated 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 transcend the jurisdiction of each agency. 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.¹ In addition, a coordinating committee of representatives of the chief financial

officers of the five agencies has been created to address and report on issues related to those general goals and objectives that cross agency functions, programs, and activities. This working group has been meeting since June 1997. These and similar planning efforts can eliminate redundancy and significantly lower the government's costs for data processing and other activities, as well as lower depository institutions' costs for complying with federal regulations, while enhancing public access to the data. ■

1. 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

On November 26, 2002, President Bush signed the Terrorism Risk Insurance Act of 2002 into law. Section 301 of that act amended section 11 of the Federal Reserve Act (12 U.S.C. 248) to enhance the Board's ability to respond to emergency situations. Before the amendment, the Federal Reserve Act allowed the Board to take five types of actions only upon the affirmative vote of at least five Board members. Among the actions requiring supermajority approval was Board authorization of a Federal Reserve Bank to extend credit to a nondepository institution in unusual and exigent circumstances under section 13(3) of the Federal Reserve Act. *See* 12 U.S.C. §343; *see also* 12 U.S.C. §§248(b), 347a, and 461(b)(3) and (b)(4).

These five-member voting requirements could have impaired the Board's ability to act in an emergency. The Terrorism Risk Insurance Act amended these requirements in two respects. First, it allows fewer than five Board members, by unanimous vote, to approve any action that would otherwise require a

five-member vote if fewer than five members are in office at the time of the action (that is, if more than two seats on the Board are vacant). Second, it allows those members of the Board that are available to approve a loan to a nondepository institution under section 13(3) of the Federal Reserve Act if these available members unanimously determine that (1) unusual and exigent circumstances exist and the borrower is unable to secure adequate credit accommodations from other sources; (2) action on the loan is necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the U.S. financial system; (3) all available telephonic, telegraphic, and other means have been used to attempt to contact the other members of the Board; and (4) action on the loan request is necessary before the other Board members can be contacted. At least two Board members must be available and participate in the emergency loan approval, and any loan made by a Reserve Bank under this emergency procedure must be payable upon demand. ■