
Federal Reserve Operations

Consumer and Community Affairs

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

- writing and interpreting regulations to implement federal laws that protect and inform consumers
- supervising banks to ensure their compliance with the regulations
- investigating complaints from the public about bank compliance with regulations
- promoting community development in historically underserved markets

These responsibilities are carried out by the members of the Board of Governors, the Board's Division of Consumer and Community Affairs, and the consumer and community affairs staff 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

- examines state member banks to assess their compliance with the CRA

- 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

Examinations for Compliance with the CRA

The Federal Reserve assesses and rates the CRA performance of state member banks in the course of examinations carried out at a frequency set by statute.¹ During the 2003 reporting period, the Federal Reserve conducted 313 CRA examinations. Of the banks examined, 42 were rated "outstanding" in meeting community credit needs, 270 were rated "satisfactory," none were rated "needs to improve," and 1 was rated as being in "substantial noncompliance."²

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

Under the Bank Holding Company Act and the Bank Merger Act, the Board

1. 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" 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.

2. The 2003 reporting period was July 1, 2002, through June 30, 2003.

considers applications for which CRA protests are raised or significant issues exist regarding CRA or consumer compliance. Other cases are decided by the Reserve Banks under delegated authority.

During 2003, the Board of Governors considered applications for several significant banking mergers:

- An application by Royal Bank of Canada (Toronto, Canada) and RBC Banks, Inc. (Rocky Mount, North Carolina), to acquire Admiralty Bancorp, Inc. (Palm Beach Gardens, Florida), was approved in January.
- An application by M&T Bank Corporation (Buffalo, New York) to acquire Allfirst Financial, Inc. (Baltimore, Maryland), was approved in March.
- An application by SouthTrust Corporation (Birmingham, Alabama) to acquire Founders Bancshares, Inc. (Dallas, Texas), was approved in March.
- Two applications by The Royal Bank of Scotland Group, plc (Edinburgh, Scotland), and Citizens Financial Group, Inc. (Providence, Rhode Island), to acquire Port Financial Corp. (Brighton, Massachusetts) and Thistle Group Holdings, Co. (Philadelphia, Pennsylvania), were approved in June and December respectively.
- An application by Cathay Bancorp, Inc., to acquire GBC Bancorp (both in Los Angeles, California) was approved in September.
- Applications by Wells Fargo & Company (San Francisco, California) to acquire Pacific Northwest Bancorp (Seattle, Washington) and Two Rivers

Corporation (Grand Junction, Colorado) were approved in October.

Comments from the public were received on each of these applications. Most of the commenters expressed concerns that lending to lower-income communities and populations was insufficient and that the institutions had failed to address the convenience and needs of affected communities. Commenters also raised issues relating to potentially abusive lending practices involving subprime and payday lenders; the potentially adverse effects of branch closings; failure of minority-owned and -operated institutions to adequately serve other minority populations; and alleged fraud.

In addition to considering these applications for significant banking mergers, the Board acted on twelve other bank and bank holding company applications that involved protests by members of the public concerning the performance of insured depository institutions under the CRA. The Board also reviewed two applications that involved institutions having CRA ratings lower than satisfactory and another thirty applications involving other issues related to the CRA, fair lending, or compliance with consumer credit protection laws.³

Other Consumer Compliance Activities

The Division of Consumer and Community Affairs supports and oversees the supervisory efforts of the Federal Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Division staff provide guidance and expertise to the

3. In addition, two applications involving adverse CRA ratings and three involving other CRA or compliance issues were withdrawn in 2003.

Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. They develop and update examination policies, procedures, and guidelines and review Reserve Bank supervisory reports and work products. They also participate in interagency activities that 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 2003 reporting period, the Reserve Banks conducted 402 consumer compliance examinations—368 of state member banks and 34 of foreign banking organizations.⁴

The Board periodically issues guidance for Reserve Bank examiners on consumer protection laws and regulations. In addition to updating examination procedures for a number of regulations in concert with the other federal financial institution regulatory agencies, the Board in 2003 revised the Federal Reserve's procedures for reviewing compliance with the Children's Online Privacy Protection Act. Further, the Board updated its risk-focused supervision program to facilitate the sharing of information about risks in the consumer compliance area with examiners in other specialty areas (for example, safety and soundness, trust, and information technology). The Board also issued exam-

iner guidance for reviewing mortgage-servicing disclosures and a checklist to assist examiners in reviewing financial institutions' web sites for compliance with consumer protection laws.

Fair Lending

The Board has a responsibility to ensure that the banks under its jurisdiction comply with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. The ECOA prohibits creditors from discriminating against an applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in good faith, any right under the Consumer Credit Protection Act. Congress assigned responsibility for administrative enforcement of the ECOA to the Board for banks under its jurisdiction, to other regulators for creditors that they regulate, and to the Federal Trade Commission for all other creditors.

The Fair Housing Act covers credit for the purchase, construction, improvement, maintenance, or repair of a dwelling. It makes it unlawful for a creditor to deny any form of financial assistance, or to discriminate in fixing the amount, interest rate, or any other terms or conditions of any financial assistance, on the basis of race, color, religion, national origin, handicap, familial status, or sex.

The ECOA also obligates the Board and other agencies with enforcement responsibilities under the act to refer any pattern or practice of ECOA violations to the Department of Justice. When a violation of the ECOA also violates the Fair Housing Act, the matter may be referred to the Department of Urban

4. 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.

Development. To promote consistency in the way fair lending issues are analyzed throughout the System, Division of Consumer and Community Affairs staff coordinate the investigation of potential fair lending violations with Reserve Bank staff and develop recommendations for the division director regarding whether referral is necessary or appropriate.

During 2003, division staff received and reviewed seven reports from Reserve Banks regarding possibly referable violations. Four of the reports involved possible discrimination in underwriting standards on the basis of age or gender; the other three involved apparent discriminatory loan-pricing practices. In three of the underwriting standards cases, the staff concluded that referral was not warranted; the other four cases remained under consideration at year-end.

Since 1994, the Federal Reserve has used a two-stage statistical regression program to help assess fair lending compliance by high-volume mortgage lenders. The program uses reported HMDA data for a stage one analysis to identify banks having significant disparities between minority and non-minority applicants' loan denial rates; it then targets these banks for a stage two analysis that considers extensive additional information taken from a sample of a bank's loan files. The program produces statistically reliable results even in cases in which the number of denied applicants in a protected class is relatively small.

Flood Insurance

The National Flood Insurance Act imposes certain requirements for loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood haz-

ards. Under the Federal Reserve's Regulation H, which implements the act, state member banks in general are prohibited from making, extending, increasing, or renewing any such loan unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan. The act requires the Federal Reserve to impose civil money penalties when it finds a pattern or practice of violations. The money is turned over to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2003, the Board imposed civil money penalties on eleven state member banks for violations of the flood insurance rules. The penalties, which were assessed via consent orders, ranged from \$1,750 to \$34,100.

Coordination with Other Federal Banking Agencies

The member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.⁵ In 2003, the FFIEC issued revised examination procedures for determining compliance with Regulation Z (Truth in Lending); Regulation M (Consumer Leasing); the Real Estate Settlement Procedures Act; the homeownership counseling provisions of the Housing and Urban Development Act; and Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). Additionally, the FFIEC issued an updated edition of its

5. 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.

booklet “A Guide to HMDA Reporting: Getting It Right!” which is designed to assist financial institutions in accurately reporting HMDA data.

The FFIEC member agencies maintain a database of local community contacts that can help the agencies’ examination staffs develop community profiles, identify opportunities for financial institutions to meet local credit needs, and help provide a context for evaluating institutions’ CRA performance. The FFIEC significantly upgraded the community contacts database in 2003 to facilitate the sharing of information among the agencies and to streamline the process by which the data are accessed and maintained.

Ten federal agencies—the FFIEC member agencies, the Federal Trade Commission, the Department of Housing and Urban Development, the Department of Justice, the Federal Housing Finance Board, and the Office of Federal Housing Enterprise Oversight—collaborated in 2003 to develop a consumer education brochure titled “Putting Your Home on the Loan Line Is Risky Business.” The brochure cautions consumers to carefully consider the terms of equity-based loans before using their home equity to address financial problems.

During the year the Board, the OCC, and the FDIC also updated 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.

Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervisory 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. The consumer affairs curriculum comprises courses on various consumer protection laws, regulations, and examination concepts. In 2003, these courses were offered in ten sessions to more than 200 Federal Reserve consumer compliance examiners.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2003, the staff revised two core courses to incorporate changes in policy and laws. The courses reviewed were

- *Introduction to Consumer Compliance Examinations*. Emphasizes examination procedures and the practical application of banking regulations, and focuses on the consumer laws that govern financial institutions’ non-real-estate lending and operational procedures. Geared toward assistant examiners with three to six months of examination experience.
- *Consumer Compliance Examinations II*. Equips assistant examiners with the skills needed to determine compliance with the basic elements of consumer laws governing real estate transactions; also covers System policies on all major aspects of the consumer compliance risk-focused examination process. For assistant examiners with six to twelve months of examination experience.

Also in 2003, a new course that will be added to the core curriculum, CA Risk-Focused Examination Techniques, was pilot-tested. The course is designed

to enhance examiners' analytical, decisionmaking, and leadership skills.

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

The training staff also look for opportunities to deliver courses via alternative channels such as the Internet or other distance-learning technologies. For example, a live videoconference curriculum, which included a session discussing recent revisions to the HMDA data reporting requirements, was implemented during the year. In addition, the staff assisted in developing online materials for the consumer affairs portion of the Banking and Supervision Elements course, a foundation course for assistant examiners from all examination specialty areas.

Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA) requires that mortgage lenders collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. A depository institution generally is covered by the act if (1) it is located in a metropolitan area, (2) it met the asset threshold at the end of the preceding calendar year (for 2001, assets of more than \$31 million; for 2002 and 2003, more than \$32 million), and (3) it originated at least one home purchase loan (or refinancing) in the preceding calendar year. A for-profit mortgage company is covered if (1) it has offices in a metropolitan area, (2) it 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 it originated 100 or more home purchase loans or refinancings in the preceding calendar year, and (3) its home purchase loan originations and refinancings accounted for 10 percent or more of its total loans by dollar volume in the preceding calendar year.

In 2003, a total of 6,767 depository institutions and affiliated mortgage companies and 1,004 independent mortgage companies reported HMDA data for calendar year 2002. Lenders submitted information about the disposition of loan applications, the geographic location of the properties related to loans and loan applications, 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 for 2002. In 2003, the FFIEC prepared more than 57,000 disclosure statements.⁶ In July, each institution made its disclosure statement public, and reports containing aggregate data for all mortgage and home improvement loans in each of the 337 metropolitan areas in the United States were made available at central depositories.⁷ These data are used by

6. 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.

7. Central depository sites include libraries, universities, and city planning offices. A list of

FFIEC agencies, the reporting institutions, HUD, the Department of Justice (DOJ), and members of the public. They 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 2002 covered 31 million loans and loan applications, about 13 percent more than in 2001. The greater volume was due primarily to an increase of about 22 percent in refinancing activity. The number of covered home purchase loans extended in 2002, compared with 2001, increased 11 percent for Hispanics, 18 percent for Asians, 2 percent for blacks, 23 percent for Native Americans, and 3 percent for whites. Over the period 1993 through 2002, the number of loans extended for home purchase increased 186 percent for Hispanics, 126 percent for Asians, 80 percent for blacks, 57 percent for Native Americans, and 30 percent for whites.

For each income category, the number of home purchase loans reported was higher in 2002 than in 2001; the increase was 4.5 percent for lower-income applicants, 3.2 percent for middle-income applicants, and 4.1 percent for upper-income applicants. From 1993 through 2002, the number of home purchase loans to lower-, middle-, and upper-income applicants increased 91 percent, 54 percent, and 66 percent respectively.

In 2002, 27 percent of Hispanic applicants and 28 percent of black applicants for home purchase loans reported under HMDA sought government-backed mortgages; the comparable figures were 14 percent for white applicants, 19 percent for Native American applicants, and 6 percent for Asian appli-

cants. Twenty-five percent of lower-income applicants for home purchase loans, compared with 7 percent of upper-income applicants, applied for government-backed mortgages.

Overall, the denial rate for conventional home purchase loans (that is, loans that are not government-backed) was 14 percent in 2002. The rate rose steadily from 1993 through 1998 but has fallen since then. In 2002, denial rates for conventional home purchase loans reported under HMDA were 26 percent for black applicants, 23 percent for Native American applicants, 18 percent for Hispanic applicants, 12 percent for white applicants, and 10 percent for Asian applicants. Each of these rates was lower than the comparable rate for 2001.

Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the FFIEC member agencies, and other federal enforcement agencies.⁸

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 84 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation B, compared with 83 percent for the 2002 reporting period. The most frequent violations involved failure to take one or more of the following actions:

8. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2003 reporting period was July 1, 2002, through June 30, 2003.

sites can be found at www.ffiec.gov/hmdacf/centdep/default2.cfm.

- collect information for monitoring purposes about the race or national origin and sex of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- note on the application form when an applicant chooses not to provide monitoring information regarding race or national origin and sex
- 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
- notify the credit applicant of the action taken within the time frames specified in the regulation
- provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the adverse action

Three formal enforcement actions containing provisions relating to Regulation B were issued during the 2003 reporting period—two by the OCC and one by the OTS. During 2003, the Federal Trade Commission continued litigation against a mortgage lender for alleged violations of the ECOA and Regulation B as well as enforcement efforts against other organizations.

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 that most Regulation B violations involved creditors' failure to provide timely or complete notifications of denial or failure to identify the FCA as the federal agency that administers compliance. These agencies did not initiate any formal enforcement actions relating to Regulation B during 2003, although the FCA indicated that its supervisory process requires corrective actions for violations noted.

Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 94 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation E, compared with 92 percent for the 2002 reporting period. The most frequent violations involved failure to comply with one or more of the following requirements:

- determine whether an error occurred, and transmit the results of the investigation to the consumer within ten business days
- provide initial disclosures at the time a consumer contracts for an electronic fund transfer service that contain required information, including limitations on the types of transfers permitted and error resolution procedures
- 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
- when a determination is made that no error has occurred, provide a written explanation and note the consumer's

right to request documentation supporting the institution's findings

In 2003, the Federal Trade Commission filed and settled one case in federal district court involving violations of the Electronic Fund Transfer Act (EFTA). The defendants had conditioned the extension of credit to consumers on agreement to compulsory electronic funds transfers from consumer accounts, in violation of the EFTA. The settlement requires the defendant to cancel and cease collections on approximately \$24 million in final court judgments against consumers, bars misrepresentations about the terms of any contract, and requires the defendants to give consumers the option to switch their method of payment.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2002 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 period.

Regulation P (Privacy of Consumer Financial Information)

The FFIEC agencies reported that 97 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation P. The most frequent violations involved failure to comply with one or more of the following requirements:

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

The OCC issued one formal enforcement action containing provisions relating to the privacy regulations during the 2003 reporting period.

Regulation Z (Truth in Lending)

The FFIEC agencies reported that 78 percent of the institutions examined during the 2003 reporting period were in compliance with Regulation Z, compared with 77 percent for the 2002 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- accurately disclose the finance charge, using that term, and provide a brief definition of "finance charge"
- accurately disclose the amount financed, appropriately subtracting any prepaid finance charges
- ensure that disclosures reflect that the creditor has or will acquire a security interest in the property identified
- on certain residential mortgage transactions, provide a good faith estimate of the required disclosures before consummation, or not later than three business days after receipt of the loan application

Four formal enforcement actions containing provisions relating to Regulation Z were issued during the 2003 reporting period—three by the OCC and one by the OTS. In addition, 147 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 \$1.3 million to consumers. The FTC continued its enforcement activities to halt certain illegal practices of subprime lenders. The agency entered into two settlements, issued one new complaint (currently in litigation), and pursued two ongoing lawsuits for alleged violations of the Truth in Lending Act and the Federal Trade Commission Act.

*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—along with the NCUA reported that 99 percent of institutions examined during the 2003 reporting period were in compliance, the same proportion as for the 2002 reporting period. The few violations involved one or both of the following actions:

- failing to provide a clear and conspicuous disclosure regarding a cosigner's liability for a debt
- entering into a consumer credit contract containing a nonpossessory security interest in household goods

No formal enforcement actions 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 2003 reporting period were in compliance with Regulation CC, the same proportion as for the 2002 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 available on the next business day the lesser of \$100 or the aggregate amount of checks deposited that are not subject to next-day availability
- follow special procedures when invoking the exception for large-dollar deposits
- make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- when placing an exception hold on an account other than a new account, provide the customer with a notice containing certain information within prescribed time periods

The OTS issued one formal enforcement action containing provisions relating to Regulation CC during the 2003 reporting period.

*Regulation DD
(Truth in Savings)*

The FFIEC agencies reported that 89 percent of institutions examined during the 2003 reporting period were in compliance with Regulation DD, compared with 87 percent for the 2002

reporting period. Among the institutions not in full compliance, the most frequently cited violations involved

- failing to provide account disclosures containing certain required information
- using the phrase “annual percentage yield” in an advertisement without disclosing additional terms and conditions of customer accounts
- providing advertisements that were inaccurate or misleading (or both).

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

Implementation of Statutes Designed to Inform and Protect Consumers

Changes to Regulation B

In February 2003, following a comprehensive review of the regulation and staff commentary, the Board published a final rule amending Regulation B, which implements the Equal Credit Opportunity Act (ECOA). Two significant revisions were made, one relating to the general prohibition against a creditor’s noting an applicant’s personal characteristics and the other to prescreened credit solicitations. The final rule took effect in April 2003, and compliance becomes mandatory on April 15, 2004.

Data Collection in Connection with Nonmortgage Credit

Because the ECOA makes it unlawful for creditors to consider any prohibited basis of discrimination in extending credit, Regulation B has generally prohibited creditors from inquiring about,

or noting, an applicant’s sex, race, color, religion, and national origin. The premise for this prohibition is that if creditors are not allowed to inquire about or note applicants’ personal characteristics, they are less likely to consider that information unlawfully in credit transactions.

The Board’s proposal to remove this prohibition in connection with non-mortgage credit elicited strong comments from those favoring removal and those opposed. In the final rule, the Board generally retained the prohibition restricting creditor access to information about applicants’ personal characteristics. It did, however, create an exception that allows a creditor to collect information on applicant characteristics for the limited purpose of conducting a self-test.

A self-test is a program, practice, or study designed and used by a creditor specifically to determine its compliance with the ECOA. Under the ECOA, because the results of the self-test are privileged, they may not be obtained in an examination or investigation of the creditor, or in any proceeding or lawsuit alleging a violation of the ECOA or Regulation B. Certain other information—such as whether a creditor conducted a self-test and the methodology or the scope of the test—is not privileged. The purpose of the self-test privilege, which was added to the ECOA by Congress in 1996, was to encourage institutions to undertake candid and complete self-tests for possible fair lending violations and to act decisively to correct any discovered problems. The privilege applies only if the creditor takes appropriate corrective action when the creditor determines that it is more likely than not that a violation occurred.

Under the exception adopted by the Board, creditors will be able to develop compliance programs that use appli-

cant data in a controlled and targeted manner. The constraints imposed by the self-test provision help ensure that personal information such as race and ethnicity is not used to discriminate on a prohibited basis, but that it is collected and used to monitor compliance with the ECOA and to serve as a basis for appropriate corrective action.

Prescreened Credit Solicitations

There has long been a concern that prescreened solicitations could provide the means for creditors to circumvent or evade the ECOA and defeat its purposes by excluding prospective applicants on a prohibited basis. The issue arises in part because the ECOA generally protects credit applicants—persons who have, at a minimum, requested credit—from discrimination. In the case of prescreened solicitations, the creditor identifies prospective customers and solicits an application from those who meet its criteria.

With advances in technology that facilitate the building of databases, the use of prescreened solicitations has become more common and more sophisticated. Prescreened solicitations can be used to target those consumers who are most likely to use a particular credit product or those segments of the population most likely to respond to the offer of credit. Conversely, prescreened solicitations can be used to exclude some consumers from receiving offers of credit.

Under the final rule, creditors are required to retain information about the criteria used to select potential customers, the text of any solicitation mailing, and any complaints received about the solicitation. This requirement will allow the Board and other enforcement agencies to monitor creditors' solicitation

practices systematically on the basis of information that creditors currently maintain. For example, under the Fair Credit Reporting Act, creditors that use information in consumer reports to select recipients for offers of credit are required to retain records pertaining to the selection criteria for three years after the date the offer is made to the consumer.

Other Regulatory Actions

The Board also took the following regulatory actions during 2003:

- In March the Board revised the official staff commentary to Regulation Z (Truth in Lending) to give guidance on certain fees associated with credit cards; the replacement of an existing credit card with one or more cards; the disclosure of private mortgage insurance premiums; and the selection of the appropriate Treasury yield for determining whether a mortgage loan is covered by the Home Ownership and Equity Protection Act of 1994.
- In August the Board raised from \$488 to \$499 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 2004, to reflect changes in the consumer price index, as prescribed by the statute.
- In December the Board raised to \$33 million the threshold for depository institutions required to collect data in 2004 under the Home Mortgage Disclosure Act, to reflect changes in the consumer price index, 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 the costs of compliance to financial institutions and the benefits of the act to consumers.

According to data from the most recent Survey of Consumer Finances (conducted in 2001), approximately 88 percent of U.S. families in that year had or used one or more EFT services—for example, an ATM card, a debit card, direct deposit, or direct payment—up from approximately 85 percent in 1998. Automated teller machines (ATMs) remained the most widely used EFT service; approximately 70 percent of U.S. families had an ATM card. In 2003, the number of ATM transactions per month averaged approximately 902 million, and the number of installed ATMs rose nearly 5.4 percent from 2002, to 371,000.

Direct deposit is also widely used. About 67 percent of U.S. families have funds deposited directly into their checking or savings account. Use of the service is particularly common in the public sector; during fiscal year 2003, approximately 74 percent of all government payments were made using EFT, including 80 percent of social security payments, 98 percent of federal salary and retirement payments, and 41 percent of federal income tax refunds.

About 47 percent of U.S. families use debit cards, which consumers can use at merchant terminals to pay for purchases. Approximately 15.6 billion debit card transactions took place in 2002, an increase of approximately 25 percent from the previous year's volume. Direct payment is a less widely used EFT payment mechanism; about 40 percent of U.S. families have payments automatically deducted from their accounts.

The incremental costs associated with the EFTA are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure, as they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with the EFTA (see "Agency Reports on Compliance with Consumer Protection Laws" earlier in this chapter).

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 2003, the Board issued guidance on releasing information in response to Privacy Act and Freedom of Information Act requests. The Board also revised its policy and special procedures for Reserve Bank investigations of complaints alleging credit discrimination and streamlined the review process.

Complaints and inquiries received by the Federal Reserve System are entered into its online database, Complaint Analysis Evaluation System and Reports (CAESAR). The CAESAR Users Advisory Group released a new version of the CAESAR data entry system in 2003. Enhancements included features that allow Board and Reserve Bank staff to identify emerging consumer concerns; to document dollar amounts

Consumer Complaints against State Member Banks, by Subject of Complaint, 2003

Subject of complaint	Total		Not investigated	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer
Loans				
Discrimination alleged				
Real estate loans	16	1	0	0
Credit cards	11	1	0	1
Other loans	11	1	1	1
Other type of complaint				
Real estate loans	521	19	9	44
Credit cards	971	36	1	66
Other loans	207	8	3	19
Deposits	637	24	14	102
Electronic fund transfers	38	1	1	1
Trust services	24	1	0	5
Other	208	8	7	35
Total	2,644	100	36	274

returned to consumers as a result of complaint investigations; and to more quickly update and retrieve data in the CAESAR database. The advisory group also completed an analysis of the Federal Reserve System’s code structure and its statistical reports for consumer complaints. As a result of that analysis, new codes and enhanced reports were implemented.

The advisory group is currently developing requirements for a web-based CAESAR database application that will streamline the complaint process to better serve the System’s business needs and to facilitate the sharing of complaint information with consumer compliance supervisory staff. The web-based system will enable the Federal Reserve to eliminate duplicative automation tools at the Reserve Banks and disseminate information to and from other System applications—

improvements that will help consumer complaints and consumer compliance staff carry out their supervisory and risk-management responsibilities.

In September the Board held a conference for Reserve Bank officers and managers in charge of the complaint program. The conference covered policy and program changes recently implemented by the Board; issues related to investigation of complaints alleging credit discrimination; Reserve Bank complaint programs in general; and the Board’s proposal to create a national complaint web site. It also included presentations on complaint trends and demonstrations by Board and Reserve Bank staff of automation tools currently used in an integrated compliance risk environment as well as a demonstration by the Office of the Comptroller of the Currency of its automated complaints and inquiry database.

Consumer Complaints—Continued

Bank legally correct		Investigated					Pending, December 31
No reim- bursement or other accommo- dation	Goodwill reimburse- ment or other accommo- dation	Customer error	Bank error	Factual or contractual dispute— resolvable only by the courts	Possible bank violation— bank took corrective action	Matter in litigation	
6	0	0	3	0	1	0	6
2	2	0	1	0	0	0	5
2	2	0	0	0	0	0	5
213	107	0	87	14	11	7	29
275	431	5	90	7	2	5	89
75	46	1	29	7	4	8	15
241	131	0	70	25	4	9	41
11	9	0	6	1	7	0	2
12	0	0	1	0	0	3	3
51	19	1	16	8	2	4	65
888	747	7	303	62	31	36	260

Complaints against
State Member Banks

In 2003 the Federal Reserve received almost 5,500 complaints from consumers by mail, by telephone, and electronically via the Internet. About 48 percent of the complaints (2,644) were against state member banks (see tables); the remainder were referred to other agencies. 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 interest rate charged on credit card accounts

or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Twenty-four percent of the complaints 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 practices. Information on the outcome of investigations of these complaints is provided in the table.

During 2003, the Federal Reserve System completed investigations of 286 complaints against state member banks that were pending at year-end 2002, finding ten violations. In most cases, the bank had handled the customer's account correctly but nevertheless chose to reimburse or otherwise accommodate the customer.

The Federal Reserve also handled almost 1,700 inquiries about consumer

Consumer Complaints against State Member Banks, by Classification, 2003

Classification	Number
Regulation B (Equal Credit Opportunity) ...	38
Regulation C (Home Mortgage Disclosure Act)	0
Regulation E (Electronic Fund Transfers) ...	38
Regulation H (Bank Sales of Insurance)	0
Regulation M (Consumer Leasing)	0
Regulation P (Privacy of Consumer Financial Information)	13
Regulation Q (Payment of Interest)	0
Regulation Z (Truth in Lending)	318
Regulation BB (Community Reinvestment) ..	1
Regulation CC (Expedited Funds Availability)	19
Regulation DD (Truth in Savings)	35
Fair Credit Reporting Act	150
Fair Debt Collection Practices Act	9
Fair Housing Act	1
Flood insurance rules	27
Regulations T, U, and X	0
Real Estate Settlement Procedures Act	19
Unregulated practices	1,976
Total	2,644

credit and banking policies and practices during 2003. In responding to these inquiries, the Board and Reserve Banks gave specific explanations of laws, regulations, and banking practices and provided relevant print 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 practices that are possibly unfair or deceptive. In 2003 the Board received almost 2,000 complaints against state member banks that involved unregulated practices. The categories that received the most complaints involved checking accounts, credit card accounts, and real estate loans. Consumers complained about insufficient-funds charges and procedures (136 complaints) and

disputed amounts withdrawn (115); they complained about fees associated with credit card accounts (114), interest rates and terms (109), and escrow account problems (96). The remainder of the complaints concerned a wide range of unregulated practices in other areas, including credit card fraud, the amount charged for late payments, and credit denials attributed to credit history.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2003 the Federal Reserve referred eleven complaints to HUD that alleged state member bank violations of the Fair Housing Act. In six of the eleven cases the Federal Reserve’s investigations revealed no evidence of illegal discrimination. In one case, the bank had made an error in handling the customer’s construction-permanent loan payments, which it had subsequently corrected. The remaining four cases were pending at year-end.

Advice from the Consumer Advisory Council

The Board’s Consumer Advisory Council—whose members represent consumer and community organizations, the financial services industry, academic institutions, and state agencies—advises the Board of Governors on matters concerning laws and regulations that the Board administers and on other issues related to consumer financial services. Council meetings are open to the public. (For a list of members of the Council, see the section “Federal Reserve System Organization.”)

In 2003, the Council met in March, June, and October. In March, Council members discussed bounced-check pro-

tection services and how those services should be treated under Regulation Z (Truth in Lending). The discussion focused on whether the fees that banks charge to cover overdrafts on customers' accounts are finance charges. Council members who believed that the fees are finance charges argued that Regulation Z applies to bounced-check protection and that, consequently, fee disclosures are required. The disclosures, they said, would make consumers aware of the high cost of these services. Other members asserted that because financial institutions make no promise to pay overdrafts and have no written agreement with the customer to pay overdrafts, overdraft fees are not finance charges and hence are not covered by Regulation Z.

Other discussion of Regulation Z in March focused on credit card disclosures and on the type of cost information that is most useful to consumers. Members discussed, but did not reach consensus on, whether disclosing the dollar amount of fees on periodic statements or disclosing the annual percentage rate, which reflects both the interest and other fees charged, is the better way to inform consumers about the cost of credit.

Predatory lending was a topic at the March and June meetings. The March discussion focused on the effectiveness of state and local laws in reducing predatory lending practices. While many Council members favored reliance on state and local laws, others noted those laws' lack of uniformity and believed that federal regulators are in the best position to establish and enforce effective laws to combat abusive practices. In June, Council members discussed efforts to counter the tactics of abusive lenders and to provide assistance to consumers who experience the consequences of predatory lending. Several

members emphasized the significant role the Federal Reserve and other federal agencies can play in preventing predatory practices.

In June, Council members also discussed the 1996 amendments to the Fair Credit Reporting Act, which preempted the states from enacting laws or regulations pertaining to the availability of information for underwriting purposes, procedures for dispute resolution, and the marketing of credit information. Some members asserted that because the credit reporting system is a national system, uniform national standards are necessary to maintain its viability. Other members believed that states have an important role in protecting the public and are in the best position to respond to local concerns about credit information. Despite differing views, members agreed on the critical importance of accurate reporting, given the devastating effect that errors in credit information can have, particularly on the lives of low-income individuals.

Also in June, Council members discussed the lengthy and complex privacy notices that financial institutions use to comply with the privacy portions of the Gramm–Leach–Bliley Act. After reviewing a proposed “short-form” notice, members strongly supported the concept of short-form privacy notices but urged the federal financial institution regulators to obtain customer comment on the notices before moving forward.

At the October meeting, members discussed the effect on nonprofit organizations of a decline in operating income and funding sources. Council members cited possible reasons for the diminished capacity of nonprofit organizations to serve the needs of their communities and suggested ways in which nonprofits could mitigate the effects of cutbacks by major funding sources.

The Council also discussed payroll cards and convenience checks issued in connection with credit card accounts. Members considered whether the Truth in Lending Act's consumer protections for credit cards should extend to convenience checks and whether Regulation Z disclosures are adequate. With respect to payroll cards, which employers use to make salary and other compensation payments to employees, the discussion focused on whether requirements of the Electronic Fund Transfer Act and Regulation E should or should not apply.

Promotion of Community Economic Development in Historically Underserved Markets

During 2003, the community affairs function within the Federal Reserve System engaged in a variety of initiatives to promote community economic development that benefit low- and moderate-income communities and populations. Activities included conducting research, preparing publications, sponsoring conferences and seminars, and providing advisory services, all of which facilitate the delivery of pertinent information to both general and targeted audiences.

As a decentralized function, the community affairs programs at the Board and each of the twelve Reserve Banks design activities that are responsive to the communities in the regions they serve. Reserve Bank Community Affairs Offices focus on providing information and promoting awareness of investment opportunities to financial institutions, government agencies, and organizations that serve low- and moderate-income communities and populations, while the Board's Community Affairs Office engages in activities that have national implications for public policy. Spe-

cific topics addressed by the System's community affairs programs in 2003 included personal financial education, evaluating the effectiveness of various community economic development strategies, identifying sources of funding and investment for community development, the challenges to creating sustainable community economic development organizations, and creating policies that support the development of minority-owned small businesses.

While the Federal Reserve has sponsored activities related to financial literacy for many years, the System increased its visibility in this area in 2003 by sponsoring a national awareness campaign on personal financial education. Various programs were undertaken by the Board and the Reserve Banks to support national, regional, and local financial education efforts. (See related box "Spotlight on Financial Education.")

To promote effective community economic development strategies, the community affairs function undertook several significant initiatives. The System's third biennial community affairs research conference in April focused on evaluating the efficacy of various community development efforts. Titled *Seeds of Growth—Sustainable Community Development: What Works, What Doesn't, and Why*, the conference attracted nearly 350 attendees and provided a forum for discussion of the strengths and weaknesses of programs, projects, partnerships, and policies related to development in lower-income neighborhoods. The conference papers and other community development research studies are posted on the System's research repository web site, the Community and Economic Development Research Information Center (CEDRIC) (www.chicagofed.org/cedric/cedric_index.cfm).

The Board's Community Affairs Office, in partnership with the Chicago, Kansas City, Philadelphia, and St. Louis Reserve Banks, undertook an initiative designed to foster learning and highlight models of community economic development. The web-based database *Lessons Learned: Community and Economic Development Case Studies* (www.chicagofed.org/cedric/lesle_index.cfm) provides detailed case studies that identify a community development issue, present one community's solution, describe the results, and offer "lessons learned" to community developers addressing similar concerns in their communities. Residing on the CEDRIC web site, the database is an efficient means for exchanging information among community development professionals, giving them the benefit of the experiences of their counterparts throughout the country.

Another web-based resource, the Fiscal Impact Tool, was launched in 2003 to support community and economic development activity in mid-size communities. This analytic tool enables community economic developers to conduct a cost-benefit analysis of a proposed development project by estimating its effect on local sales and property tax revenues and on costs to local government. The tool, which is available through the Board's web site (www.federalreserve.gov/forms/fiscalimpactrequest.cfm), can aid decisionmakers in determining the economic value of a proposed activity for their community.

The community affairs area has been a source of information on creative financing of community economic development for many years, and in 2003, efforts in this area expanded. The Community Affairs Offices at both the San Francisco Reserve Bank and the Board developed new resources relat-

ing to community development investments. San Francisco's Center for Community Development Investments, drawing on the expertise of an advisory board of community economic development professionals, offers an in-depth discussion of various investment vehicles used to finance community development. As a centralized resource for information, contacts, and training opportunities, the center seeks to expand access to information on the funding tools that can support economic growth in low- and moderate-income communities (www.sf.frb.org/cdinvestments/index.html).

Similarly, the Board's community affairs program developed a web site that gives guidance on the types of investments certain banking institutions may engage in to support community economic development and public welfare benefits (www.federalreserve.gov/communityaffairs/cdi/default.htm). In addition, several Reserve Banks partnered with a nonprofit organization, Wall Street Without Walls, to help increase awareness of the capital markets' role in funding community economic development. In 2003, the Boston, Richmond, and Atlanta Reserve Banks cosponsored seminars that gave an overview of the benefits of and challenges associated with accessing the capital markets to fund development in lower-income neighborhoods and populations.

Given the important role of public policy in effecting change in underserved communities, the community affairs function engaged in activities to examine challenges relating to the community development field. The Board's Community Affairs Office addressed the sustainability of community economic development organizations in a policy forum cohosted with the Aspen Institute, a national research

Spotlight on Financial Education

No matter who you are, making informed decisions about what to do with your money will help build a more stable financial future for you and your family.

Alan Greenspan, *Chairman*, Board of Governors
May 2003

The growing complexity of the financial services marketplace—in terms of both the products offered and the number and variety of providers—has in recent years focused the attention of government agencies and consumer and community groups on the importance of financial education. In addition, ongoing interest in protecting consumers from abusive and deceptive lending practices has underscored the role of education as a line of defense against entanglement in unsuitable financial arrangements that can have detrimental, even devastating, effects.

Consistent with its interest in economic growth, consumer protection, and community development, the Federal Reserve System has long been an active supporter of educational programs that provide practical information on how the economy and the banking industry function. More recently, this interest has extended to personal financial education as a way of helping consumers develop the skills that can lead to financial success for themselves and their families. To underscore this message, the Community Affairs and Public Information Offices of the Federal Reserve System in 2003 collaborated to raise awareness of the importance of personal financial management and to highlight some of the resources available to consumers.

The collaboration resulted in the nationwide campaign “There’s a Lot to Learn about Money.” This multifaceted campaign was launched in May 2003 with a public service announcement featuring Chairman Greenspan, who has spoken often of the importance of education in developing sound financial decisionmaking skills. Electronic and print media and

video were used to broaden consumers’ access to information on personal financial education and to help establish the Federal Reserve System as a central source of information. A toll-free number was established to respond to inquiries generated by the announcement, and a brochure describing strategies for taking charge of one’s finances was sent to interested callers. For consumers who like to obtain their information electronically, a robust central Federal Reserve web site was launched, linking to specially prepared educational tools and resource information on the web sites of the twelve Reserve Banks (www.federalreserveeducation.org/fined/index.cfm).

The campaign attracted the attention of other central banks that are also seeking ways to help consumers better manage their finances. During the year, Board staff met with officials of the central banks of Canada, England, Finland, and Malaysia to discuss the Federal Reserve’s various roles in supporting personal financial education.

The System undertook numerous projects during the year to reinforce the campaign’s objectives. For example, the Board and several Reserve Banks partnered with a national nonprofit financial education organization, Operation HOPE, to emphasize the importance of understanding and managing finances to students in inner-city public schools. In one partnership activity, Chairman Greenspan and the president of the Richmond Reserve Bank recounted for middle school students in Washington, D.C., the ways in which financial education, as well as their interest in finances, has affected their lives. Simi-

larly, the presidents of the Boston, Cleveland, Chicago, St. Louis, Kansas City, and Dallas Banks spoke with students in those cities.

The Community Affairs Offices at several Reserve Banks used their research capacity, publications, and work with local organizations to raise awareness of regional efforts that support financial education. The Cleveland Reserve Bank surveyed organizations offering personal financial education programs in the Fourth District to increase understanding of the breadth of providers of such programs. The survey led to the convening of regional roundtables at which financial educators in Cleveland, Pittsburgh, and Cincinnati discussed opportunities for partnerships to leverage resources and increase efficiency in delivering financial education. The Atlanta and Kansas City Banks sponsored initiatives to help establish regional networks. The Boston Bank collaborated with a group serving a low-income Hispanic community in Springfield, Massachusetts, to develop a curriculum that meets the information needs of residents of the neighborhood. The New York, Philadelphia, Atlanta, St. Louis, Minneapolis, Dallas, and San Francisco Banks hosted train-the-trainer sessions—some focused on youth, Hispanic, faith-based, and Native American populations—to help increase the effectiveness of organizations that provide financial education in their communities.

Research having indicated that the workplace is an effective venue for financial education, the Community Affairs Offices at the Board and the Boston, Atlanta, St. Louis, and Dallas Banks in 2003 conducted seminars for employees on personal financial management strategies and consumer protection issues. The Board hosted sessions on budgeting and saving, reading and correcting credit reports, using the Board's benefit programs to meet savings goals, and understanding the implications of identity theft.

In addition to providing practical information, the Federal Reserve System is contributing to policy development, public information, and research on financial education. Staff have conducted research on savings patterns among low-income households and on households without checking accounts and have shared the results with researchers and practitioners in those areas.

As an extension of long-standing efforts to support community economic development in Native American communities, the Community Affairs Offices at the Board and the Minneapolis, Kansas City, and San Francisco Reserve Banks in May 2003 cosponsored a policy forum on financial education for residents of Indian Country. Together with a coalition of tribal leaders, bankers, and Native American nonprofit development and policy organizations, the Federal Reserve is working to facilitate partnerships that can provide financial education and improve access to financial services on reservations. Task forces have been established to work on specific initiatives, including developing a national training strategy, designing research to evaluate the effectiveness of programs, and formulating a national outreach initiative to promote financial literacy in Indian Country.

To contribute to the limited body of research, the Board is collaborating with the Department of Defense on a longitudinal study of the efficacy of the personal financial education the department provides to military personnel. The study will assess financial behaviors and changes in financial status over time to determine whether and how financial education contributes to positive outcomes.

In recognition of the role that financial education plays in the successful functioning of households and of the broader economy, the Federal Reserve will continue to seek opportunities to highlight its interest and to pursue initiatives that will contribute to better informed and more knowledgeable consumers of financial services.

and leadership development organization. Featuring preliminary findings of research on these topics conducted by the institute, the event explored some of the challenges that confront the community economic development field relating to organizational infrastructure and capitalization. Forum participants—leaders of prominent national community development organizations—described, from their particular perspectives, the fundamental issues that define the mission and future of their organizations. The Cleveland Reserve Bank sponsored a conference on the evolution of community economic development as policy has shifted from program-driven to market-based strategies for addressing redevelopment challenges in lower-income neighborhoods.

The Board's community affairs program also participated in an interagency policy initiative involving minority small business development in 2003. As part of the initiative, the agencies issued a joint policy paper that examines ways in which their policies and regulations can be more effective in supporting access to capital and technical assistance by minority business owners.

Outreach Activities

The Board engages in outreach activities throughout the year to provide information to the public about the Board's responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consumers, to promote community development and consumer education, and to foster discussion of public policy issues. Board staff periodically meet with financial institutions, community groups, and other members of the public in formal and informal settings. The Board sponsors and participates in meetings, conferences, and seminars for the general public and for targeted audiences. This year, the Board participated in the Congressional Black Caucus Foundation's 2003 annual legislative conference, which provides a national forum for examining strategies and viable solutions to public policy issues facing African Americans. Board staff distributed consumer education materials provided by the Federal Reserve System and used the opportunity to inform conference attendees about the Federal Reserve and its multifaceted responsibilities. ■

Banking Supervision and Regulation

Insured commercial banks in 2003 experienced record earnings and built stronger balance sheets while adapting to significant changes in the business climate. Net income reached \$100 billion, up 14 percent from the preceding year. Historically low interest rates, along with the resilience of the U.S. household sector, continued to support strong mortgage origination revenues and healthy growth of mortgage-related assets early in the year. Lower interest rates created the opportunity for banks to sell their higher-yielding investment securities at a premium, realizing gains that further supported earnings in the first half of the year. Although the steeper yield curve began to dampen mortgage origination activity in the latter half of the year, continuing recovery in the U.S. economy sparked equity markets and bolstered fees related to financial market activities. Moreover, asset quality improved steadily during the year, allowing banks to set aside less of their income for future credit losses.

Net interest margins—the pretax rate of profitability on earning assets—contracted significantly during the year, for several reasons. New mortgage-related assets carried historically low yields, the same reason refinancing was attractive to mortgage borrowers. Normal repricing of interest-sensitive assets, coupled with rate-motivated acceleration of prepayments, reduced asset yields. By liquidating higher-yielding investment securities in order to record gains in current income, banks effectively traded future margin income for current-period revenues. Finally, premium pricing on money market and savings deposit accounts, although contrib-

uting to deposit growth, also limited the benefit of lower rates for overall funding costs.

Commercial lending and market-sensitive revenues were weak throughout the year, reflecting cautious improvement in economic activity and equity markets. The latter showed some recovery late in the year. Growth in commercial real estate loans remained rapid in 2003, exceeding 9 percent for the seventh consecutive year and reaching 11.1 percent of the industry's assets.

Non-interest expense grew only moderately. At the same time, banks were able to realize benefits from cost-cutting measures. Salary and benefits expense per employee grew 6.4 percent for the year.

Core deposits, especially money market and savings accounts, experienced remarkable growth. These deposits offer banks greater funding stability and attractive interest rate risk characteristics in addition to growth in deposit fees. As a strategic objective, banks actively competed to attract these deposits, offering attractive rates and investing in branches and other delivery systems. Depositors for their part appeared content to hold assets in the form of these highly liquid insured deposits while interest rates remained low and, during the first half of the year, while equity prices remained weak. Money market and savings balances funded 30.6 percent of bank assets at year-end, up from 28.9 percent a year earlier. This funding provided support to the acquisition of residential mortgage and home equity loans and, in the first half of the year, mortgage-backed securities.

A steeper yield curve in midyear eroded a significant portion of unrealized gains on banks' investment securities and also slowed the pace of mortgage refinancing. Responding to these market changes, banks strategically reduced their holdings of long-term securities during the latter half of the year, although not by enough to offset the acquisitions earlier in the year. The effect was most pronounced in mortgage pass-through securities, which declined about 6.5 percent during the second half of 2003. Banks also issued new long-term fixed-rate debt, prepaid higher-cost pre-existing term debt, and acquired interest rate derivatives to hedge against possible future increases in market interest rates.

Capitalization remained a key source of strength for the industry. Banks added \$42.5 billion in equity (net) during the year. Aggregate regulatory capital ratios remained well above minimums, while nearly 99 percent of insured commercial banks were well capitalized at year-end 2003. Dividend payout increased only slightly for the year—77.4 percent of earnings, versus 76.4 percent in 2002—despite the introduction of more-favorable federal tax treatment of dividend income.

Nonperforming assets and net charge-offs declined steadily through the year, each having earlier reached a peak level in September 2002. Although this decline was influenced by positive macroeconomic developments, it was also supported by secondary markets for troubled loans that remained deep and liquid through the year. At the same time, banks strengthened their credit risk management and measurement capabilities and were able to call on a wider range of credit risk mitigation instruments and techniques to manage the extent of their risk-taking. Problem

loans remained somewhat elevated at year-end 2003, with nonperforming assets representing 0.94 percent of loans and related assets. Nonetheless, the peak levels reached in this credit cycle did not approach the extremes of the early 1990s.

The number of insured commercial banks fell by 121 institutions, to 7,761, principally because of acquisitions and consolidation of related bank charters by multibank organizations. Two banks, with combined assets of \$1.4 billion, failed in 2003.

Significant acquisitions of banking institutions and major business lines were an important development in 2003. Bank of America and FleetBoston announced their proposed merger late in 2003, and J.P. Morgan Chase and Bank One announced their proposed merger just after year-end. Each of these institutions would have assets in the vicinity of \$1 trillion. Assuming that these transactions are consummated, the three largest bank holding companies in the United States would together account for \$3.2 trillion in assets, or 37 percent of the assets of all reporting bank holding companies.

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 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.

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 compli-

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 regulations. 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 2003, 935 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.

ance. 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.

State Member Banks and Holding Companies, 1999–2003

Entity/Item	2003	2002	2001	2000	1999
<i>State member banks</i>					
Total number	935	949	970	991	1,010
Total assets (billions of dollars)	1,912	1,863	1,823	1,645	1,423
Number of examinations	822	814	816	899	858
By Federal Reserve System	581	550	561	610	551
By state banking agency	241	264	255	289	307
<i>Top-tier bank holding companies</i>					
Large (assets of more than \$1 billion)					
Total number	365	329	312	309	283
Total assets (billions of dollars)	8,295	7,483	6,905	6,213	5,625
Number of inspections	454	439	413	352	332
By Federal Reserve System ¹	446	431	409	346	329
On site	399	385	372	309	298
Off site	47	46	37	37	31
By state banking agency	8	8	4	6	3
Small (assets of \$1 billion or less)					
Total number	4,787	4,806	4,816	4,800	4,831
Total assets (billions of dollars)	847	821	768	716	679
Number of inspections	3,453	3,726	3,486	3,347	3,064
By Federal Reserve System	3,324	3,625	3,396	3,264	2,973
On site ²	183	264	730	835	684
Off site	3,141	3,361	2,666	2,429	2,289
By state banking agency	129	101	90	83	91
<i>Financial holding companies</i>					
Domestic	612	602	567	462	...
Foreign	32	30	23	21	...

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.

commercial banks and held approximately 26 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 2003, a total of 6,038 U.S. bank holding companies were in operation, of which 5,152 were top-tier bank holding companies. These organizations controlled 6,298 insured commercial banks and held approximately 96 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 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 2003, the Federal Reserve conducted 3,324 reviews of such bank holding companies. If a company's subsidiary depository institutions have ratings lower than "satisfactory" or have other significant supervisory issues, a more thorough off-site review of the organization is conducted using surveillance results and other information. If the information 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.

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 (www.federalreserve.gov/boarddocs/SRLETTERS/2002/sr0201.htm).

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 also 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 2003, 612 domestic bank holding companies and 32 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 45 had consolidated assets of \$15 billion or more; 98, between \$1 billion and \$15 billion; 93, between \$500 million and \$1 billion; and 376, 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.

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 are now expected to include a review of information technology risks and activities. During 2003 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 \$14 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 2003 Federal Reserve examiners conducted 164 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 2003 the Federal Reserve conducted on-site examinations at 27 of the 92 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-three state member banks and 9 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2003 the Federal Reserve conducted 10 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 24 entities that dealt in municipal securities

during 2003, 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 2003, 700 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 215 of these lenders, and the remaining 485 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 269 lenders from its on-site inspection program. The securities credit activities of the remaining 216 lenders were subject to either biennial or triennial inspection. Eighty-nine inspections were conducted during the year, compared with 127 in 2002.

Enforcement Actions and Civil Money Penalties

In 2003 the Federal Reserve completed 44 enforcement cases involving 62 separate actions. The actions included cease-and-desist orders, written agreements,

removal and prohibition orders, and civil money penalties.

In 2003 the Board of Governors assessed \$103.1 million in civil money penalties. All civil money penalties assessed by the Board are remitted, as directed by statute, either to the U.S. Department of the Treasury or to the Federal Emergency Management Agency.

All final enforcement orders issued by the Board and all written agreements executed by the Reserve Banks 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 2003 completed 141 informal enforcement actions, such as board of directors resolutions and memoranda of understanding. These informal actions are not available to the public.

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 programs 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 risks.

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 Off-Site Monitoring”), 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.

In support of the supervision of domestic banking organizations and foreign banking organizations (FBOs) with a U.S. banking presence, there is an automated application—the Banking Organization National Desktop (BOND)—which was developed to facilitate real-time, secure electronic information-sharing and collaboration among federal and certain state banking regulators. During 2003, BOND was comprehensively updated to provide information on regional and community banking organizations; to allow for seamless integration with other Federal Reserve national information systems, such as the National Examination Database (NED), Central Document and Text Repository (CDTR), Performance Report Information and Surveillance Monitoring (PRISM), and the National Information Center (NIC); and to enable the addition of supervisory documents to the CDTR and FBO rating data to NED. Other revisions facilitate analysis across business activities and help document the sharing of confidential supervisory information on FBOs and domestic banking organizations having a global presence with foreign regulators.

In April 2003, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC) published “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.” An interagency working group had been formed in 2002 to assess whether, in light of the post-September 11 risk environment, additional guidance on business resumption was needed. The agencies held a series of meetings with financial institutions and core clearing and settlement organizations to discuss lessons learned and

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.

the need to improve 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 strengthening resilience. The final paper incorporated comments received on that draft and additional discussions with industry representatives. In 2003, the Federal Reserve began to develop a process for assessing the implementation by financial institutions of the sound practices presented in the paper.

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 supervision of community banks was developed jointly with the Federal Deposit Insurance Corporation (FDIC) and has been adopted by the Conference of State Bank Supervisors.

Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. 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. The Federal Reserve also monitors various market indices, including equity prices, debt spreads and ratings, and measures of expected default frequency to gauge market perceptions of the risks in banking organizations.

In addition to using automated screening systems, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) 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). BHCPRs are made available to the public on the Board's National Information Center web site (www.ffiec.gov/nic/).

During 2003, a web version of the Performance Report Information and Surveillance Monitoring application was implemented. PRISM is a querying tool for Federal Reserve analysts that accesses and displays financial, surveillance, and examination data. In the analytical module, users can customize the presentation of financial data for banks, bank holding companies, and other financial institutions that are drawn from data in several types of reports—Call Report, Uniform Bank Performance Report, FR Y-9, and Bank Holding Company Performance Report, among others. In the surveillance module, users

can generate reports summarizing the results of System surveillance screens for banks and bank holding companies. Users can also use PRISM to generate customized surveillance screens, and all PRISM reports can be transferred to Excel spreadsheets.

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.

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 the investments by bank holding companies in export trading companies. It also supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

Foreign 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. The examinations abroad are conducted with the cooperation of the supervisory authorities of the countries in which they take place; when appropriate, the examinations are 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 2003, 56 member banks were operating 818 branches in foreign countries and overseas areas of the United States; 32 national banks were operating 622 of these branches, and 24 state member banks were operating the remaining 196. In addition, 17 nonmember banks were operating 19 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, as 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 78 and were operating 11 branches at year-end 2003. 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 2003, 190 foreign banks from 54 countries were operating 240 state-licensed branches and agencies (of which 8 were insured by the Federal Deposit Insurance Corporation) as well as 51 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 16 Edge Act and agreement corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 85 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2003 controlled approximately 18 percent of U.S. commercial banking assets. These foreign banks also operated 73 representative offices; an additional 60 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 addresses the examination process for those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 269 examinations during 2003.

Technical Assistance

In 2003 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 2003 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 Super-

vision, and the Financial Stability Institute.

Supervisory Policy

The Federal Reserve's supervisory policy function is responsible for developing guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Staff members participate in international supervisory forums and provide support for the work of the Federal Financial Institutions Examination Council.

Capital Adequacy Standards

During 2003 the Federal Reserve, together with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued an interim rule amending the agencies' regulatory capital guidelines, an advance notice of proposed rulemaking on regulatory capital standards for internationally active banking organizations, and guidance on credit card lending; revised the appraisal guidelines; and issued an advisory on mortgage banking activities. The Federal Reserve also clarified the reporting and capital treatment of trust preferred stocks.

Asset-Backed Commercial Paper Programs and Early Amortization Provisions

In October the Federal Reserve and the other federal banking agencies adopted an interim rule with a request for comments that amended the agencies' risk-based capital standards by providing an interim capital treatment for assets in asset-backed commercial paper (ABCP) programs that are consolidated onto the balance sheets of sponsoring banking

organizations as a result of Financial Accounting Standards Board Financial Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). The comment period ended on November 17, 2003. The interim capital treatment allows sponsoring banking organizations to remove the consolidated ABCP program assets from their risk-weighted asset bases for purposes of calculating their risk-based capital ratios. Sponsoring banking organizations must continue to hold risk-based capital against all other risk exposures arising in connection with ABCP programs, including direct credit substitutes, recourse obligations, residual interests, long-term liquidity facilities, and loans, in accordance with existing risk-based capital standards. In addition, any minority interests in ABCP programs that are consolidated as a result of FIN 46 are to be excluded from sponsoring banking organizations' minority interest component of tier 1 capital and, hence, from total risk-based capital.

The interim capital treatment is in effect only for the regulatory reporting periods ending September 30 and December 31, 2003, and March 31, 2004. In addition, the interim capital treatment does not alter the accounting rules for balance sheet consolidation, nor does it affect the denominator of the tier 1 leverage capital ratio calculation, which continues to be based primarily on on-balance-sheet assets as reported under generally accepted accounting principles (GAAP). Thus, as a result of FIN 46, banking organizations must include all assets of consolidated ABCP programs in on-balance-sheet assets for purposes of calculating the tier 1 leverage capital ratio. The interim risk-based capital treatment will expire on April 1, 2004.

Concurrent with the issuance of the interim rule, the agencies also published

a notice of proposed rulemaking that would amend their risk-based capital standards by removing the April 1, 2004, sunset provision in order to permit sponsoring banking organizations to continue to exclude from their risk-weighted asset base those assets in ABCP programs that are consolidated onto sponsoring banking organizations' balance sheets as a result of FIN 46. The comment period ended on November 17, 2003. The removal of the sunset provision is contingent upon the agencies' implementing proposed risk-based capital requirements for liquidity facilities having an original maturity of one year or less that organizations provide to ABCP programs, regardless of whether the organization sponsors the program or must consolidate the program under GAAP. This treatment recognizes that such facilities expose banking organizations to credit risk and is consistent with the industry's practice of internally allocating economic capital against this risk associated with such facilities. A separate capital charge on liquidity facilities provided to an ABCP program would not be required of banking organizations that are required to (or of other banks that choose to) consolidate the program for purposes of risk-based capital. In addition, the agencies proposed a risk-based capital charge for certain types of securitizations of revolving retail credit facilities (for example, credit card receivables) that incorporate early-amortization provisions.

Proposed Advance Rulemaking of the Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

In August the Federal Reserve, along with the OCC, FDIC, and OTS, issued for public comment an advance notice of proposed rulemaking (ANPR) setting

forth the agencies' current views on a proposed framework for implementing revisions to the Basel Capital Accord in the United States. In particular, the ANPR described significant elements of the advanced internal ratings-based approach for credit risk and the advanced measurement approaches for operational risk (together, the advanced approaches). The ANPR specified criteria for determining which banking organizations would be required to use the advanced approaches and the criteria, supervisory standards, and disclosure requirements the banking organizations would be required to meet. Other organizations meeting the criteria would be permitted to use the advanced approaches. Under the advanced approaches, banking organizations would use internal estimates of certain risk components as key inputs in determining their regulatory capital requirements. The ANPR included a number of questions intended to highlight for the industry certain areas for which comment was particularly requested.

Concurrent with the issuance of the ANPR, the federal banking agencies issued for public comment draft supervisory guidance on internal ratings-based systems for corporate credits and advanced measurement approaches for operational risk. The guidance described supervisory expectations for institutions that are considering developing advanced measurement systems. The guidance on corporate credit set forth essential components and characteristics of an internal ratings-based system, including expectations vis-à-vis assignment of internal ratings, quantification, data maintenance, and control and oversight mechanisms. The draft supervisory guidance on operational risk measurement approaches outlined critical expectations vis-à-vis corporate governance,

the elements of operational risk management, and the primary components of an advanced measurement approach.

The comment period for the ANPR and the draft supervisory guidance ended on November 3, 2003. The Federal Reserve received more than 100 comments on the two issuances. Work is continuing on both the framework and the guidance.

Guidance on the Reporting and Capital Treatment of Trust Preferred Stocks

In July the Board issued SR Letter 03-13, which instructed bank holding companies to continue to follow the existing guidelines for the reporting and capital treatment of trust preferred stocks when preparing bank holding company regulatory reports even though these treatments may not concur with the most current treatment of trust preferred stocks set forth in FIN 46. Under existing procedures, bank holding companies report trust preferred stocks as minority interest in the equity accounts of a consolidated subsidiary and include trust preferred stocks in tier 1 capital. The interpretation of FIN 46 would have resulted in bank holding companies' reflecting subordinated debt issued to the trusts on their consolidated balance sheets under generally accepted accounting principles instead of the preferred stocks issued by the trusts to third-party investors.

Credit Card Lending

In January the Federal Reserve, along with the OCC, the FDIC, and the OTS, jointly issued Account Management and Loss Allowance Guidance. The guidance describes the agencies' expectations regarding prudent risk-management practices for credit card

activities, particularly with respect to credit-line management, over-limit accounts, and workouts. It also addresses income recognition and loss-allowance practices in connection with credit card lending.

Regulation W

In SR Letter 03-2, which was issued in January, the Federal Reserve summarized the significant issues resolved with the adoption of Regulation W. Regulation W, which implements sections 23A and 23B of the Federal Reserve Act, includes seventy years' worth of interpretative guidance furnished by the Federal Reserve concerning statutory requirements. The nine significant issues resolved by the issuance of Regulation W are (1) the conditions for derivatives transactions, (2) the conditions for intraday credit transactions, (3) the definition of financial subsidiaries as affiliates of banks, (4) the exemption for general-purpose credit card transactions, (5) the application of sections 23A and 23B to certain activities of U.S. branches and agencies of foreign banks, (6) the conditions for the exemption of a bank's purchase of loans from its affiliates, (7) the exemption of certain bank loans to a third party secured by securities issued by a mutual fund affiliate of the bank, (8) an exemption that would permit a banking organization to engage more expeditiously in certain internal reorganization transactions, and (9) new valuation rules.

Appraisal Guidelines

In October the Federal Reserve and the other federal banking agencies issued a joint statement on the independence of the collateral valuation process (SR Letter 03-18). The purpose of the statement is to serve as a reminder to

regulated institutions that there needs to be an effective, independent real estate appraisal and evaluation program for all their lending functions, including all real-estate-related financial transactions originated or purchased by a regulated institution for its own portfolio or as assets held for sale. The statement should be read in conjunction with each agency's appraisal and with real-estate-lending regulations and the 1994 Interagency Appraisal and Evaluation Guidelines.

Mortgage Banking Activities

The Federal Reserve, along with the OCC, the FDIC, and the OTS, issued an interagency advisory on mortgage banking activities in February. The purpose of the guidance (SR Letter 03-4) was to address the weaknesses in risk management, valuation, and modeling of hedging practices related to mortgage-servicing assets (MSAs) noted in recent examinations. These weaknesses include the use of unsupported or inappropriate valuation assumptions; inadequate stratification, amortization, and impairment practices; and weak oversight and controls. Additional examiner scrutiny is warranted when such weaknesses are encountered. Banking organizations were reminded of the expectation that they fully comply with generally accepted accounting principles and with accounting guidance regarding servicing assets that was issued previously. The banking agencies expect institutions to perform mortgage-banking operations in a safe and sound manner. Management should ensure that detailed policies and procedures are in place to monitor and control mortgage-banking activities, including loan production, pipeline and warehouse administration, secondary market transactions, servicing operations, and management of MSAs.

Business Continuity

In April the Federal Reserve, along with the Office of the Comptroller of the Currency and the Securities and Exchange Commission, published an interagency paper titled "Sound Practices to Strengthen the Resilience of the U.S. Financial System." The paper identifies four sound practices for organizations that provide core clearing and settlement services and firms that play significant roles in critical financial markets. The sound practices focus on the back-up capacity necessary for recovery and resumption of clearing and settlement of material open transactions and are designed to minimize the immediate systemic effects of a wide-scale disruption of critical financial markets. They build on long-standing principles of business continuity planning and reflect actions identified by industry members in meetings and in comments on a draft of the paper that was published during 2002.

The sound practices include the identification of all clearing and settlement activities that support critical financial markets and the determination of appropriate recovery and resumption objectives (that is, within the business day on which the disruption occurs). They provide that covered organizations should maintain sufficient geographically dispersed resources to meet recovery and resumption objectives. They also provide that recovery and resumption arrangements should be in routine use or subject to sufficient testing to ensure that they are effective.

Core clearing organizations are expected to implement the sound practices by the end of 2004, and firms that play significant roles in critical markets are expected to implement the sound practices during 2006, although the implementation period may have to be

extended in some cases. Implementation plans should incorporate interim milestones against which progress can be measured. Financial firms not deemed to be a core clearing and settlement organization or a firm that plays a significant role in critical markets are encouraged to review and consider implementing the sound practices.

Anti-Tying Restrictions

In August the Federal Reserve requested public comment on an interpretation of the anti-tying restrictions in section 106 of the Bank Holding Company Act Amendments of 1970 and related supervisory guidance. Section 106 generally prohibits a bank from conditioning the availability or price of one product on the customer's obtaining another product from the bank or an affiliate. The Board's proposed interpretation of section 106 provides banking organizations and their customers a comprehensive guide to the special anti-tying restrictions applicable to banks under section 106. The related supervisory guidance describes the types of policies and procedures that should help banks ensure and monitor their compliance with section 106.

Discount Window Guidance

In July the Federal Reserve and the other federal banking, thrift, and credit union regulatory agencies issued guidance on the appropriate use of the Federal Reserve's primary credit discount window program in depository institutions' liquidity risk management and contingency planning. The guidance provided background on the Federal Reserve's discount window programs and reiterated well-established supervisory policies on sound contingency planning in relation to liquidity. It also

discussed sound practices in using primary credit program borrowings in liquidity contingency planning.

Commodities Derivatives Authority

In June the Federal Reserve approved a modification to Regulation Y that allows bank holding companies engaged in permissible derivatives activities to transfer title to commodities underlying derivatives contracts on an instantaneous, pass-through basis. Prior to this modification, a bank holding company could take and make delivery only on physically settled derivatives involving commodities that a state member bank is permitted to own, such as investment-grade corporate debt securities, U.S. government and municipal securities, foreign exchange, and certain precious metals. For all other types of physically settled derivatives, the bank holding company was required to make reasonable efforts to avoid delivery, and the contract was required to have assignment, termination, or offset provisions.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision, the Federal Reserve in 2003 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 work-

ing groups of the Basel Committee in efforts to develop a new capital accord. In April the Basel Committee published 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 Basel Committee received more than 200 comments on the consultative paper.

Also during 2003, the Federal Reserve and other U.S. bank regulatory agencies participated in the third international Quantitative Impact Study conducted by the Basel Committee to evaluate the possible effects of the proposed revised capital standards. The study, which involved 22 large U.S. banking organizations and more than 350 banks worldwide, has helped guide the committee in developing capital requirements for banks' individual portfolios and sub-portfolios. During the second half of the year the technical working groups analyzed the comments and data gathered through the study and developed additional modifications to the capital proposals. U.S. authorities plan to conduct a fourth study during 2004 before issuing new capital regulations for public comment.

In addition, the Basel Committee decided to base the revised framework on unexpected losses rather than combined unexpected and expected losses, which had served as the basis for earlier proposals. The committee solicited additional public comment through December 31, 2003, on this fundamental change to the proposed capital framework.

Risk Management

The Federal Reserve contributed to several supervisory policy papers,

reports, and recommendations issued by the Basel Committee during 2003. These documents were generally aimed at improving the supervision of banking organizations' risk-management practices.

- "Principles and Management and Supervision of Interest Rate Risk," (issued in September) revised an earlier version of the paper on the basis of comments received from institutions, industry associations, supervisory authorities, and others.
- "Management and Supervision of Cross-Border Electronic Banking Activities" (issued in July) and "Risk Management for Electronic Banking" (issued in July) were 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.
- "Management and Supervision of Operational Risk" (issued in February) outlines a set of principles that provide a framework for the effective management and supervision of operational risk, for use by banks and supervisory authorities when evaluating operational-risk-management policies and practices.

International Accounting and Disclosure

The Federal Reserve participates in the Basel Committee's Task Force on Accounting Issues and its Transparency Group and represents the Basel Committee at international meetings on the issues addressed by these groups. In

particular, a Federal Reserve official in 2003 represented the Basel Committee at meetings of a 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 is a member of the IASB's Standards Advisory Council.

During 2003, the Federal Reserve and the Basel Committee provided comments on the IASB's amendments to statements 32 and 39. The amendments addressed key issues related to financial instruments, including loan-loss allowances, fair-value accounting, and hedge accounting. The Federal Reserve and the Basel Committee also worked with the International Federation of Accountants to promote stronger international audit standards and greater participation by public interest groups in the audit-standard-setting process. The Transparency Group is developing guidance on improving disclosure, for the purpose of enhancing market discipline. The group's current focus is on developing and finalizing "Pillar 3" proposals that would improve disclosures in support of the revised international capital accord.

Joint Forum

In its work with the Basel Committee (BCBS), 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 (IOSCO), and the International Association of Insurance Supervisors (IAIS). The Joint Forum works to increase mutual understanding of issues related to the supervision of firms operating in each of the financial sectors. The Joint Forum issued three papers during 2003: "Initiatives by the BCBS, IAIS, and

IOSCO to Combat Money Laundering and the Financing of Terrorism" (June), "Trends in Risk Integration and Aggregation" (August), and "Operational Risk Transfer across Financial Sectors" (August).

Securities Underwriting Authority

In February the Federal Reserve issued an interpretation concerning securities underwriting by banking organizations that are subject to the Bank Holding Company Act. The interpretation clarifies that a banking organization that wishes to engage in underwriting securities that are to be distributed in the United States must either be a financial holding company or have authority to engage in underwriting activity under section 4(c)(8) of the Bank Holding Company Act.

Sarbanes–Oxley Act

The Federal Reserve is actively involved in evaluating the effect of the Sarbanes–Oxley Act on financial institutions. In May, in conjunction with the OCC and the OTS, the Federal Reserve issued SR Letter 03–8, Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations. The interagency statement responded to questions that the agencies had received as to whether the agencies expected small, non-public banking organizations to comply with the Sarbanes–Oxley Act and the recent corporate governance proposals of the New York Stock Exchange and Nasdaq.

In issuing this interagency statement, the banking agencies reiterated their long-standing endorsement, through regulation and guidance, of sound corporate governance and auditing policies and practices for all banking organi-

zations under their supervision. They stated that their regulatory approach, as well as the approach adopted by Congress in the Sarbanes–Oxley Act, has sought to balance the goal of strong corporate governance with the recognition that smaller, non-public banking organizations typically have fewer resources and less-complex operations than public organizations.

The Federal Reserve also provided comments to the Securities and Exchange Commission and the Public Company Accounting Oversight Board on their efforts to promote enhanced standards for management and external auditors to follow when considering internal control matters. In addition, the Federal Reserve is working with the FDIC and other banking agencies to consider what changes should be made to the regulations implementing the Federal Deposit Insurance Corporation Improvement Act to promote strong internal controls and consistency with Sarbanes–Oxley requirements.

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 data 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 and internal and external audit programs.

As part of ongoing efforts to address bank supervisory issues and enhance supervision through guidance that encourages sound practices, the Federal Reserve, together with the other banking agencies, in March amended the guidance on internal audit and outsourcing. SR Letter 03–5 conformed supervisory guidance to the independence rules for external auditors promulgated under the Sarbanes–Oxley Act. In addition, the policy strengthened and refined guidance intended to enhance corporate governance at regulated institutions.

The Federal Reserve worked closely with the other banking agencies in reviewing the American Institute of Certified Public Accountants' exposure draft of a proposed statement of position, "Allowance for Credit Losses," which was issued for public comment in June. A joint comment letter was submitted in October.

In August the Federal Reserve, along with the other federal bank and thrift regulatory agencies, issued final rules governing their authority to take disciplinary actions against independent public accountants and accounting firms that perform the audit and attestation services required by section 36 of the Federal Deposit Insurance Act. The final rules, which took effect on October 1, 2003, establish procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of \$500 million or more. The rules permit immediate suspensions in limited circumstances.

Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies submit periodic regulatory financial reports. These reports provide information essential to the supervision of the organizations and the formulation of regulations and supervisory policies. The Federal Reserve also uses the information in responding to requests from 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, FR Y-11 and FR 2314, aid 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. The FR Y-8 report collects information on transactions between an insured depository institution and its affiliate that are subject to section 23A of the Federal Reserve Act. It enhances the Federal Reserve's ability to monitor bank exposures to affiliates and to ensure compliance with section 23A of the Federal Reserve Act.

In March 2003, 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 existing items and adding new items related to companies acquired by bank holding companies that are involved in significant acquisitions. In addition, mandatory electronic submission of several reports—FR Y-9C, FR Y-9LP, FR Y-9SP, and FR Y-9ES—was implemented, resulting in more-efficient data collection and dissemination.

In June the FR Y-8 was revised to collect additional information to be used in monitoring compliance with section 23A and to assist in monitoring derivatives transactions and establishing policy for regulating such transactions. The report was also revised to reflect interpretations and definitions in Regulation W, the rule that comprehensively implements sections 23A and 23B of the Federal Reserve Act.

Federal Financial Institutions Examination Council

The Federal Reserve continued its participation on the Federal Financial Institutions Examination Council over 2003. The FFIEC serves as a coordinating body for the federal banking agencies and the National Credit Union Administration. State supervisory authorities also participate in some FFIEC initiatives. During 2003, the FFIEC focused on coordinating the agencies' efforts to identify and eliminate outdated, unnecessary, or unduly burdensome regulations. This initiative is pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The FFIEC also initiated a project to modernize and streamline the way in which the banking agencies collect, process, and distribute quarterly bank financial reports. In addition, the FFIEC continued its efforts related to examiner training and education, consumer compli-

ance issues, bank surveillance processes, and information sharing. A few initiatives are highlighted below.

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 banking system. Call Report data, which also serve as benchmarks for the financial information required by many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community.

The Call Report modernization project is intended to improve the timeliness and quality of supervisory data and to enhance market discipline through more timely access by the public. Proposed enhancements to the data collection and disclosure process include requiring electronic submission of Call Reports to a central data repository, accelerating the filing deadline for reports, and requiring data validation checks to be performed by respondents as a condition of the accepted filing of the reports. The central repository is expected to be ready for testing in late 2004.

Call Report changes implemented in 2003 include the reporting of insurance-related income, credit enhancements for securitizations, accrued fees and finance charges on credit cards, and the fair value of derivatives at small banks having derivatives contracts. Also, a proposal was issued in November to revise

the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) to include additional information on derivatives contracts.

Information Technology

In 2003 the FFIEC completed the first year of a two-year pilot test of its revised framework for the interagency examination program for information technology service providers. Examinations of 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 promotes a 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 examinations.

During the year, the FFIEC also issued revisions to the FFIEC information systems examination manual, last updated in 1996. Booklets on six topics (which will replace the current chapters in the manual) were issued: information security; business continuity planning; information technology audit; e-banking; FedLine; and supervision of technology service providers. Also in 2003, the Federal Reserve and the other agencies began developing the final six booklets planned to update the manual: retail payments; outsourcing; operations; wholesale payments; management; and development and acquisition. Agency examiners field-tested all but the wholesale payments booklet in 2003, and all six remaining booklets are scheduled for publication in 2004.

Supervisory Information Technology

Under the direction of the division's chief technology officer, 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
- adequate resources are devoted to interagency working groups on supervisory initiatives (for example, Call Report modernization for the FFIEC central data repository)
- 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, cost effectiveness, and quality 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 2003, the SIT project management staff, in partnership with other Federal

Reserve System staff, made significant progress in identifying opportunities for enhancing business value through the use of information technology. The supervision function completed implementation of a Systemwide technology platform for scheduling examination resources. Staff members continue to provide 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. In conjunction with efforts of Board and Reserve Bank internal IT providers, the staff has also supported supervision and regulation projects to assess opportunities in the areas of electronic applications, administrative systems, and learning management systems to improve the delivery of information technology services for supervision.

National Information Center

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

In 2003, a secure, web-enabled version of the NED application was put into operation. The application was updated to reflect changes in OCC and FDIC examination processes and changes in the commercial bank Call Report and the bank holding company FR Y-9 reports. The secure web ver-

sion of NED is expected to be made available to state banking departments in early 2004. Also in 2003, the CDTR was modified to include examination reports from other agencies and expanded to include reports of regional and community examinations filed by the Reserve Banks. Significant resources continue to be devoted in support of Call Report modernization for the FFIEC central data repository initiative, with expected implementation in the fourth quarter of 2004.

Staff Development

The Federal Reserve System’s staff development program trains staff mem-

bers at the Board of Governors, the Reserve Banks, and state banking departments who have supervisory and regulatory responsibilities and students from foreign supervisory authorities. Training is offered at the basic, intermediate, and advanced levels in several disciplines within bank supervision: safety and soundness, information technology, international banking, and consumer affairs. Classes are conducted in Washington, D.C., as well as at Reserve Banks and other locations.

The Federal Reserve System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System’s involvement includes developing and implementing

Training Programs for Banking Supervision and Regulation, 2003

Program	Number of sessions conducted	
	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
Core schools		
Banking and supervision elements	5	4
Operations and analysis	4	3
Bank management	4	2
Report writing	16	16
Management skills	10	9
Conducting meetings with management	13	13
Other schools		
Loan analysis	4	3
Examination management	5	5
Real estate lending seminar	3	3
Senior forum for current banking and regulatory issues	1	1
Banking applications	1	0
Principles of fiduciary supervision	2	1
Commercial lending essentials for consumer affairs	2	2
Introduction to consumer compliance examinations	2	0
Consumer compliance examinations II	2	2
CRA examination techniques	2	2
Fair lending examination techniques	2	2
Foreign banking organizations	2	2
Information systems continuing education	3	2
Capital markets seminars	8	6
Technology risk integration	8	8
Leadership dynamics	6	5
Seminar for senior supervisors of foreign central banks ¹	1	1
<i>Other agencies conducting courses²</i>		
Federal Financial Institutions Examination Council	44	1
The Options Institute	1	1

1. Conducted jointly with the World Bank.

2. Open to Federal Reserve employees.

Trends in Reserve Bank Supervision Levels, 1999–2003

Type of staff	2003	2002	2001	2000	1999
Field examination staff	1,239	1,234	1,242	1,172	1,216
Commissioned field staff	936	892	861	786	893

basic and advanced training in relation to various emerging issues as well as in specialized areas such as 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 2003, the Federal Reserve trained 1,952 students in System schools, 384 in schools sponsored by the FFIEC, and 19 in other schools, plus 283 representatives of foreign central banks, for a total of 2,638. (See accompanying table.) The number of training days in 2003 totaled 13,768.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 309 state examiners were trained—209 in Federal Reserve courses, 95 in FFIEC programs, and 5 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination and also a second proficiency examination in one of the following three specialty areas: safety and soundness, consumer affairs, or information technology. In 2003, 121 examiners passed the first proficiency examination. In the second proficiency examination, 55 examiners passed the safety and soundness examination, 41 passed the consumer affairs examination, and 1 passed the information technology examination. The overall pass rate for these proficiency examinations

was 79 percent. At the end of 2003, the System had 1,239 field examiners, of which 936 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 in relation 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 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

Decisions by the Federal Reserve on Domestic and International Applications, 2003

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	14	0	0	0	0	3	152	53	222
Merger of bank holding company	6	0	0	0	0	4	25	12	47
Acquisition or retention of bank	27	0	0	0	0	2	95	33	157
Acquisition of nonbank	0	0	25	0	0	14	0	70	109
Merger of bank	6	0	0	0	0	7	59	0	72
Change in control	0	0	0	0	0	1	0	119	120
Establishment of a branch, agency, or representative office by a foreign bank	3	0	0	13	0	0	0	0	16
Other	287	0	0	53	0	131	1,106	348	1,925
Total	343	0	25	66	0	162	1,437	635	2,668

Reserve approval in advance of their commencement.

In 2003, the Board allowed bank holding companies engaged in permissible derivatives activities to transfer title to commodities underlying derivatives contracts on an instantaneous, pass-through basis. In addition, the Board expanded the degree to which bank holding companies may process, store, and transmit nonfinancial data as they process, store, and transmit financial data.

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 com-

petitive effects of the proposal, and the applicant's ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on decisions regarding domestic and international applications in 2003 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 has also permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

Since 2000, the Bank Holding Company Act has permitted the creation of a special type of bank holding company called a financial holding company. Financial holding companies are allowed to engage in a broader range of nonbank activities than are traditional bank holding companies. Among other things, they may affiliate with securities firms and insurance companies and engage in certain merchant banking activities. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve System; most declarations are acted upon by one of the Reserve Banks under delegated authority. In 2003, forty-one domestic financial holding company declarations and two 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 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 the company. 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. In 2003, the Board determined that certain limited physical commodity trading activities are complementary to the financial activity of engaging regularly as principal in commodity derivatives activities.

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 2003, the Federal Reserve approved seventy-two 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 related to the proposal. 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 506 reports on competitive factors to the other agencies in 2003.

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 2003, the Federal Reserve approved 120 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 2003, the Federal Reserve approved sixteen 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 related to large domestic mergers, the Board in 2003 approved sixteen proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved eleven applications to make additional investments through an Edge Act corporation, one application to extend the corporate existence of an existing Edge Act corpora-

tion, and no applications 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 2003, the Federal Reserve acted on new and merger-related branch proposals for 1,646 domestic branches and granted prior approval for the establishment of 4 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 2003, no 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 2003,

the Federal Reserve reviewed eleven 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 made known to the public by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release and in the *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve upon which action has not yet been taken. For each pending application and notice, the related H.2A contains the deadline for comments. In 2003, the Board's public web site (www.federalreserve.gov) continued to provide information on orders and announcements. The web site was also expanded to include an online guide for U.S. and foreign banking organizations submitting applications or notices to the Federal Reserve.

Timely Processing of Applications

The Federal Reserve sets internal target time frames for the processing of applications. The setting of internal targets promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. Generally, the length of the target period ranges from twelve

days to sixty days, depending on the type of application or notice filed. In 2003, 83 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 2003, fifteen 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 secu-

rities. 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 2003 the foreign list was revised in March and September.

Anti-Money Laundering

The Department of the Treasury 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 an important tool in the fight against money laundering; its requirements inhibit money laun-

dering 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. In 2003, the division created an Anti-Money Laundering Policy and Compliance Section, which is responsible for BSA and USA Patriot Act matters and works closely with various units at the Treasury Department, including the Financial Crimes Enforce-

ment Network and the Office of Foreign Assets Control.

Staff of both sections 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 eastern and southern Africa, Asia, South and Central America, and the Caribbean. Staff members have also participated in numerous multilateral anti-money-laundering initiatives such as the Financial Action Task Force.

In 2003, the Federal Reserve continued to provide expertise and guidance to the BSA Advisory Group, a committee established by Congress at the Treasury Department 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 2003, the Federal Reserve has played an important role in many joint activities with bank supervisory and law enforcement authorities and the banking community, both domestically and abroad, to combat money laundering and terrorist financing. In 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 continue to participate in the task force.

To address the mandates of the USA Patriot Act, the Federal Reserve issued a number of supervisory letters to domestic and foreign banking organizations

Extensions of Credit by State Member Banks to their Executive Officers, 2002 and 2003

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>2002</i>			
October 1–December 31	650	74,514,000	0.0–19.8
<i>2003</i>			
January 1–March 31	618	82,776,000	0.0–20.0
April 1–June 30	751	80,895,000	0.0–21.0
July 1–September 30	649	74,584,000	0.0–18.0
October 1–December 31	590	66,901,000	0.0–18.0

SOURCE. Call Reports.

under its supervision on such topics as private and correspondent banking and the 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 USA 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, continues to work on examination procedures relative to the act's provisions and 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 2003.

Federal Reserve Membership

At the end of 2003, 2,890 banks were members of the Federal Reserve System and were operating 50,425 branches. These banks accounted for 37 percent of all commercial banks in the United States and for 70 percent of all commercial banking offices. ■

Federal Reserve Banks

The Federal Reserve Banks contribute to the setting of national monetary policy and are involved in the supervision and regulation of banks and other financial entities. They also operate a nationwide payments system, distribute the nation's currency and coin, and serve as fiscal agent and depository to the United States.

Major Initiatives

During 2003, the Federal Reserve Banks continued efforts to improve the efficiency of their operations through strategies aimed at standardizing and consolidating operations, information systems, and programs. Major milestones associated with two key initiatives in the check-processing operation were reached: the end of the check modernization project and the launch of a check restructuring effort to reduce the number of Federal Reserve check-processing locations.

The check modernization effort reengineered check-processing hardware and software to provide the Reserve Banks with common processing, imaging, and adjustment systems and to enable the Banks to offer services via the Internet.

Check restructuring, which was announced early in 2003, will better align the Federal Reserve check-processing infrastructure with the decline in the use of checks, provide greater flexibility in managing check operations, and improve resource allocation. The Reserve Banks expect to reduce, by year-end 2004, the number of check-processing locations from forty-

five to thirty-two and the number of check-adjustment locations from forty-three to twelve.

Spurred in part by aggressive multi-year cost-containment targets, the Reserve Banks also undertook a number of initiatives during the year to increase efficiency in the support services and customer support areas. In information technology, savings were realized through such initiatives as centralization of e-mail server administration and management, standardization of desktop PC configurations, and standardization of server management. In human resources, the Reserve Banks expect to have centralized most of their payroll and benefits functions by year-end 2004, and in accounting, the Banks have successfully adhered to a multiyear plan to hold costs to 1997 spending levels. In addition, the Banks have undertaken initiatives to reduce customer support costs. In early 2004, the Banks will complete an effort to consolidate electronic-access customer support at two sites.

The events of September 11, 2001, illustrated the interdependence among participants in the financial system and the way that market-based and geographic concentration can intensify disruptions. The New York Reserve Bank contributed to two efforts to address these matters, which the Board, together with other regulatory agencies, has been pursuing since September 11. One effort involved the development of sound practices to strengthen the resilience of critical U.S. financial markets in the face of a regional disaster. A final paper on sound practices was published jointly by the Board, the Office of the Comptroller

of the Currency, and the Securities and Exchange Commission in April 2003.

The other effort concerned strengthening the resilience of clearing and settlement in the government securities market. A private-sector working group created by the Board in 2002 to explore ways in which resilience might be strengthened submitted its report in December 2003 (and the Board published the report in early January 2004). The report contains recommendations for mitigating risks to the financial system resulting from the interruption or termination of the services of a clearing bank for government securities due to operational or non-operational problems. The Board endorsed the recommendations.

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

years, the Federal Reserve Banks have recovered 97.8 percent of their priced services costs, including the PSAF (table).

Overall, the price index for priced services decreased 0.9 percent from 2002. Revenue from priced services amounted to \$886.9 million, other income related to priced services was $-\$5.2$ million, and costs related to priced services totaled \$931.3 million, resulting in net income of $-\$49.6$ million and a recovery rate of 85.1 percent of costs, including the PSAF.²

Commercial Check Collection Service

In 2003, operating expenses and imputed costs for the Reserve Banks’ commercial check collection service totaled \$803.2 million, while revenue amounted to \$742.2 million and other income was $-\$4.3$ million, resulting in net income of $-\$65.3$ million. In 2002, by comparison, operating expenses and imputed costs 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. The decline in check service revenue in 2003 was largely the result of declining volume and customers’ moving to lower-margin products. The Reserve Banks handled 15.8 billion checks, a decrease of 4.7 percent from the

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 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. 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, 1994–2003

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
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
2003	881.7	931.3	104.7	1,036.1	85.1
1994–2003	8,557.7	8,074.0	678.5	8,752.6	97.8

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

1. For the ten-year period, includes revenue from services of \$8,312.7 million and other income and expense (net) of \$245.1 million.

2. For the ten-year period, includes operating expenses of \$7,382.6 million, imputed costs of \$440.3 million, and imputed income taxes of \$231.6 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.

16.6 billion checks handled in 2002 (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.³ Overall, the price index for check services increased 3.2 percent from 2002.

In response to the apparent continuing decline in check volumes, the Reserve Banks took further steps in 2003 to reduce check service operating costs by implementing a business and

operational strategy that will position the service to achieve its financial and payment system objectives over the long term. The strategy will reduce operating costs through a combination of measures: streamlining management structures, reducing staff, decreasing the number of check-processing locations, and increasing processing capacity at some locations. The Banks will continue to provide check services nationwide, but by the end of 2004, the number of sites at which checks are processed will be reduced to thirty-two, down from forty-five. Additionally, the number of locations at which check adjustments are made will be reduced from forty-three to twelve. Of the thirteen offices that will no longer process checks, the five regional sites dedicated solely to processing checks will close. These changes are expected to reduce annual operating costs for the check service by about \$60 million in 2005.

The volume of checks for which the Federal Reserve office that serves the

3. 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, 2003, 2002, and 2001

Thousands of items

Service	2003	2002	2001	Percent change	
				2002 to 2003	2001 to 2002
Commercial check	15,805,894	16,586,804	16,905,016	-4.7	-1.9
Funds transfer	125,936	117,133	115,308	7.5	1.6
Securities transfer	10,071	8,480	6,708	18.8	26.4
Commercial ACH	5,588,381	4,986,152	4,448,361	12.1	12.1
Noncash	280	333	412	-15.8	-19.2

NOTE. Activity in *commercial check* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfer* and *securities transfer*, the number of transactions originated on line and off

line; in *commercial ACH*, the total number of commercial items processed; and in *noncash*, the number of items on which fees were assessed.

depositing bank is not the office that serves the paying bank was slightly less than the 3.7 billion in 2002. Of all the checks presented by the Reserve Banks to paying banks, 22.7 percent (approximately 3.6 billion checks) were presented electronically, compared with 22.0 percent in 2002. The Banks captured images of 9.3 percent of the checks they collected, an increase from 8.1 percent in 2002.

In 2003, the Reserve Banks completed a multiyear check modernization project that standardized their software and hardware for check processing, check imaging, and check adjustments. They also made available to depository institutions web-based access to check services. These investments are expected to increase operating efficiency and to enhance the Reserve Banks' ability 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 \$60.6 million in 2003. Revenue from ACH operations totaled \$68.7 million and other income totaled -\$0.4 million,

resulting in net income of \$7.7 million. The Reserve Banks processed 5.6 billion commercial ACH transactions (worth \$14.0 trillion), an increase of 12.1 percent from 2002. Overall, the price index for ACH services decreased 13.1 percent from 2002.

During 2003, the Reserve Banks increased the number of countries to which they provide international ACH funds transfers from the United States by initiating limited production services to Switzerland and the United Kingdom. The Banks also prepared to offer limited production services to Austria, Germany, the Netherlands, and Mexico in 2004.

Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled \$47.1 million in 2003. Revenue from these operations totaled \$51.4 million, and other income amounted to -\$0.3 million, resulting in net income of \$4.0 million. During 2003, the Reserve Banks improved the resilience of the services by establishing a third level of backup personnel to support Fedwire applications.

Fedwire Funds Service

The Fedwire Funds Service allows participants to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Banks. In 2003, the number of Fedwire funds transfers originated by depository institutions increased 7.5 percent from 2002, to approximately 125.9 million.

In May, the Board announced that it will expand the operating hours for the online Fedwire Funds Service. The service will open three and one-half hours earlier—at 9:00 p.m. eastern time the previous calendar day rather than the current opening time of 12:30 a.m. eastern time. Full implementation of the expanded operating hours will occur in May 2004. The impetus for the expansion of operating hours was industry requests to achieve greater overlap of U.S. wholesale payments system operating hours with those of Asia-Pacific markets.

National Settlement Service

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' National Settlement Service to settle their transactions. This service is provided to approximately seventy local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2003, the Reserve Banks processed more than 422,000 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,

government-sponsored enterprises, and certain international organizations to other participants in the United States.⁴ Reserve Bank operating expenses and imputed costs for providing this service totaled \$18.4 million in 2003. Revenue from the service totaled \$21.9 million, and other income totaled $-\$0.1$ million, resulting in net income of \$3.4 million. Approximately 10.1 million transfers of Treasury and other securities were processed by the service during the year, an increase of 18.8 percent from 2002. Fedwire Securities Service transfer fees for both Treasury and non-Treasury securities were reduced in 2003, while the service incorporated new fees associated with automated claim adjustment processing and a joint custody origination surcharge (table).

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 280,000 noncash transactions in 2003. In 2003, the Reserve Banks simplified the pricing structure for the Noncash Collection Service by charging a single price regardless of deposit size. The Banks now charge a single fee per cash letter of \$13.00 and a single fee per coupon envelope of \$4.50. The Banks also increased the return-item fee to

4. 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.

Fees Paid by Depository Institutions for Selected Federal Reserve Priced Services, 2002 and 2003

Dollars

Item	2002	2003
FEDWIRE FUNDS TRANSFERS, BY VOLUME TIER¹		
Tier (<i>number of transfers per month</i> ²)		
1 (1 to 2,500) .....	.31	.30
2 (2,501 to 80,000) .....	.22	.20
3 (80,001 and more) .....	.15	.10
Off-line surcharge	15.00	15.00
NATIONAL SETTLEMENT SERVICES		
Entries, each .....	.80	.80
Files, each	14.00	14.00
Minimum per month	60-100	60-100
FEDWIRE SECURITIES TRANSFERS		
Account maintenance		
Per issue .....	.41	.40
Per account	15.00	15.00
Transfers, each ² .....	.66	.40
Off-line surcharge	25.00	25.00

1. Rates apply only to their specified volume tiers.

2. Originated and received.

\$35.00 and the bond-collection fee to \$55. Operating expenses and imputed costs for noncash operations totaled \$1.7 million in 2003, and revenue totaled \$2.3 million, resulting in net income of \$0.6 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 Banks. Operating expenses and imputed costs for special cash services totaled \$504,284 in 2003. Revenue and other income totaled \$400,112, resulting in

net income of −\$104,172. Two Reserve Banks provided special cash services during 2003 but had discontinued these services by year-end. The Banks will not provide special cash services in 2004.

Float

The Federal Reserve had daily average credit float of \$43.0 million in 2003 and \$318.6 million in 2002.⁵ 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 Federal Reserve Banks received 35.7 billion notes from circulation in 2003, a 2.9 percent increase from 2002, and made payments of 36.6 billion notes to circulation during the year, a 3.2 percent increase from 2002. They received 48.1 billion coins from circulation in 2003, a 10.8 percent increase from 2002, and made payments of 61.5 billion coins to circulation, a 5.3 percent increase from 2002.⁶

In October the Reserve Banks began issuing to depository institutions the Department of the Treasury’s redesigned \$20 note, which features new and enhanced security features, including subtle background colors. In connection with the release of the new currency, the Federal Reserve and the Bureau of Engraving and Printing conducted a global campaign to raise public awareness of the new note’s design and security features.

5. Credit float occurs when the Reserve Banks receive settlement for items prior to providing credit to the depositing institution.

6. Percentages reflect restatements of previously reported data.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2003, 2002, and 2001

Thousands of dollars

Agency and service	2003	2002	2001
DEPARTMENT OF THE TREASURY			
<i>Bureau of the Public Debt</i>			
Savings bonds	66,403.7	68,888.3	69,569.8
TreasuryDirect and Treasury coupons	33,013.5	33,953.6	36,610.1
Commercial book entry	4,836.3	8,830.1	9,998.1
Marketable Treasury issues	16,802.6	14,597.6	11,366.8
Computer applications and infrastructure development and support	7,836.7	2,349.6	222.4
Other services	1,460.7	2,385.8	1,255.7
Total	130,353.4	131,005.0	129,022.9
<i>Financial Management Service</i>			
Treasury tax and loan and Treasury general account	27,083.2	30,111.0	31,106.0
Government check processing	25,624.7	30,284.4	30,310.2
Automated clearinghouse	6,253.9	6,280.0	9,665.2
Government agency deposits	2,217.6	2,082.2	2,272.9
Fedwire funds transfers	187.3	201.4	199.2
Computer applications and infrastructure development and support	75,511.9	46,782.6	27,281.3
Other services	10,602.8	8,173.1	3,490.2
Total	147,481.5	123,914.7	104,324.9
<i>Other Treasury</i>			
Total	13,913.5	14,471.2	13,149.8
Total, Treasury	291,748.5	269,390.9	246,497.5
OTHER ENTITIES			
Department of Agriculture			
Food coupons	7,791.4	10,240.8	13,197.2
U.S. Postal Service			
Postal money orders	10,959.5	12,381.6	11,255.0
All other entities			
Other services	16,508.2	16,494.1	14,434.0
Total, other entities	35,259.2	39,116.5	38,886.2
Total reimbursable expenses	327,007.7	308,507.4	285,383.7

Also during the year the Federal Reserve Board requested public comment on its proposed currency recirculation policy, which is designed to reduce depository institutions' overuse of Federal Reserve cash-processing services. The proposed policy, which would affect approximately one hundred institutions that have large cash businesses, includes two key elements: (1) a custodial inventory program that provides an incentive to depository institutions to hold currency in their vaults and (2) a fee to institutions that deposit and order currency within the same week.

Developments in Fiscal Agency and Government Depository Services

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2003 amounted to \$327.0 million, compared with \$308.5 million in 2002 (table). The majority of these costs were incurred on behalf of the Treasury. Treasury-related costs were \$291.7 million in 2003, compared with \$269.4 million in 2002, an increase of 8.3 percent. The cost of providing services to other entities was

\$35.3 million, compared with \$39.1 million in 2002. In 2003, as in 2002, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing 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 systems.

Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities (Fedwire Securities Service, TreasuryDirect, marketable issues, and Treasury coupons) totaled \$54.7 million, a 4.8 percent decrease from 2002. The Reserve Banks processed nearly 140,000 tenders for Treasury securities, compared with 167,000 in 2002, and handled 2.2 million reinvestment requests, compared with 2.5 million in 2002.

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.⁷ Almost 98 percent of the total par value of Treasury securities outstanding at year-end 2003 was held by the Fedwire Securities Service. The Reserve Banks in 2003 originated 9.4 million transfers of Treas-

ury securities, a 12.7 percent increase from 2002.

TreasuryDirect customers may sell their securities for a fee through Sell Direct, a program operated by one of the Reserve Banks. That Bank sold more than 14,000 securities worth \$671.6 million in 2003, compared with nearly 14,000 securities worth \$589.8 million in 2002. It collected more than \$491,000 in fees on behalf of the Treasury, an increase of 6 percent from the almost \$464,000 in fees collected in 2002.

Savings Bonds

Reserve Bank operating expenses for savings bond activities totaled \$66.4 million in 2003, a decrease of 3.6 percent from 2002. The Banks printed and mailed 40.1 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 7.6 percent increase from 2002. They issued more than 7.0 million Series I (inflation-indexed) savings bonds and 28.6 million Series EE savings bonds. Reissued or exchanged bonds accounted for the remaining bonds printed. The Banks processed approximately 569,000 redemption, reissue, and exchange transactions, a 7.9 percent decrease from 2002. Reserve Bank staff responded to 1.7 million service calls from owners of savings bonds, a 4.9 percent increase from 2002. Starting in 2004, the Reserve Banks will reduce the number of Federal Reserve sites that provide savings bond and retail marketable Treasury securities services. The consolidation will be managed to minimize the effect on investors as these services move toward all-electronic processing.

Depository Services

The Reserve Banks maintain the Treasury's funds account, accept deposits of

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

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 2003 totaled \$27.1 million. These operations include the Treasury Tax and Loan program, which allows the Treasury to invest balances with qualifying depository institutions. The Federal Reserve enhanced the program in 2003 by making the Term Investment Option a permanent feature. The Term Investment Option allows the Treasury to place investments with depository institutions for a set term, the interest rate being determined by auction. The program added approximately \$2.8 million to the Treasury's investment income in 2003.

Payments Processed for the Treasury

Reserve Bank operating expenses related to government payments amounted to \$34.3 million in 2003. The Banks processed 914.0 million ACH transactions for the Treasury, an increase of 3.5 percent from 2002, and 667,000 Fedwire funds transfers, an increase of 55.1 percent from 2002.⁸ They also processed 266.9 million paper government checks, a decrease of 7.7 percent from 2002. In addition, the Banks issued 311,000 fiscal agency checks, a decrease of 15.5 percent from 2002.

The Reserve Banks also assist Treasury with its continued efforts to facilitate electronic payments. The Banks operate Pay.gov, a Treasury program that allows members of the public to make payments to the federal government over the Internet. They also oper-

ate the Treasury's Paper Check Conversion program, whereby checks written to government agencies are converted at the point of sale into ACH transactions. In 2003, the Reserve Banks originated nearly 1.2 million ACH transactions through the two programs, a significant increase from the nearly 215,000 originated in 2002, which was the first full year for both programs.

The Banks operate Treasury's Automated Standard Application for Payment (ASAP), which processed \$384.2 billion in Fedwire funds transfers and ACH payments in 2003, compared with \$360.0 billion in 2002. In December, the Reserve Banks implemented ASAP.gov, which allows grant recipients to request payments on the Internet. The Reserve Banks also operate Treasury's Intra-governmental Payments and Collection application (IPAC), which transfers funds and descriptive data between federal agencies. In 2003, IPAC processed nearly one million transactions, with a total value of nearly \$41.9 trillion, compared with nearly \$37.4 trillion in 2002.

Services Provided to Other Entities

The Reserve Banks provide fiscal agency and depository services to other domestic and international entities when required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute. One such service is the provision of food coupon services for the Department of Agriculture. In 2003, operating expenses for food coupon services declined to \$7.8 million, 24.0 percent lower than in 2002. The Banks redeemed 286.6 million food coupons, a decrease of 42.7 percent from 2002.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. In 2003, they processed

8. The latter percentage reflects restatement of previously reported data.

198.3 million postal money orders, a decrease of 8.4 percent from 2002.

Electronic Access

The Federal Reserve continues to improve the ability of depository institutions to access an array of web-based applications for check imaging, cash ordering, savings bond processing, and accounting information. With improvements in the technology enabling the security of web applications, the Reserve Banks plan to continue to expand the delivery of web-based services to include funds transfer services through Fedwire and ACH and to complete the migration of all remaining services provided through FedLine DOS to FedLine for the Web.

To complement the move to web-based electronic access, the Reserve Banks are completing consolidation of the electronic-access customer support function to two offices. The consolidation will improve the efficiency and consistency of customer support while ensuring the continued delivery of high-quality electronic-access support services.

Information Technology

In 2003, the Federal Reserve Banks continued several major cost-reduction initiatives to centralize or standardize common information technology utilities and resources. Projects are under way to standardize certain local area network components, telephone private branch exchange systems, remote access, and desktop hardware and software. In addition to reducing costs over the long term, these initiatives are expected to facilitate interoperability, improve network efficiency, and increase productivity.

During the year, the Federal Reserve also expanded its criteria for participation in the telecommunications national

security/emergency preparedness programs offered by the National Communications System. In partnership with the Securities and Exchange Commission and the Commodity Futures Trading Commission, the Federal Reserve extended sponsorship to clearing and settlement utilities, key financial institutions, and key market participants.

The Reserve Banks initiated efforts to improve the resilience of the Fedwire telecommunications network and are working with telecommunications vendors and other government agencies to identify policies that would improve the resilience of the telecommunications infrastructure for critical financial services functions.

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, management of each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to 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.

Income, Expenses, and Distribution of Net Earnings
of the Federal Reserve Banks, 2003 and 2002

Millions of dollars

Item	2003	2002
Current income	23,793	26,760
Current expenses	2,463	2,227
Operating expenses ¹	2,342	2,071
Earnings credits granted	121	156
Current net income	21,330	24,533
Net additions to (deductions from, -) current net income	2,481	2,149
Assessments by the Board of Governors	805	635
For expenditures of Board	297	205
For cost of currency	508	430
Net income before payments to Treasury	23,006	26,048
Dividends paid	518	484
Transferred to surplus	467	1,068
Payments to Treasury ²	22,022	24,496

1. Includes net periodic pension costs of \$60 million in 2003 and a credit for net periodic pension costs of \$157 million in 2002.

2. Interest on Federal Reserve notes.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2003 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$1.4 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 Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2003 the Reserve Banks did not engage PwC for non-audit services other than a miscellaneous purchase of educational and research materials at a rate available to the general public.

The Board's annual examination of the Reserve Banks in 2003 included a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division personnel monitor the activities of each Reserve Bank on an ongoing basis and conduct

on-site reviews based on the division's risk-assessment methodology. The 2003 examinations 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

Securities and Loans of the Federal Reserve Banks, 2001–2003

Millions of dollars except as noted

Item and year	Total	U.S. government securities ¹	Loans ²
<i>Average daily holdings³</i>			
2001	559,323	558,926	397
2002	621,834	621,721	113
2003	683,438	683,294	144
<i>Earnings⁴</i>			
2001	30,536	30,523	13
2002	25,527	25,525	2
2003	22,598	22,597	1
<i>Average interest rate (percent)</i>			
2001	5.46	5.46	3.18
2002	4.11	4.11	1.94
2003	3.31	3.31	1.00

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.

net earnings of the Federal Reserve Banks for 2002 and 2003.

Income in 2003 was \$23,793 million, compared with \$26,760 million in 2002. Expenses totaled \$3,268 million (\$2,342 million in operating expenses, \$121 million in earnings credits granted to depository institutions, \$297 million in assessments for expenditures by the Board of Governors, and \$508 million for the cost of new currency). Revenue from priced services was \$887 million. The profit and loss account showed a net profit of \$2,481 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 \$518 million, \$34 million more than in 2002; 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 \$22,022 million in 2003,

down from \$24,496 million in 2002; 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 2003 and table 6 shows a condensed statement for each Bank for the years 1914 through 2003. 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 Federal Reserve Banks’ average daily holdings of securities and loans during 2003 amounted to \$683,438 million, an increase of \$61,604 million from 2002 (table). Holdings of U.S. government securities increased \$61,573 million, and holdings of loans increased \$31 million. The average rate of interest

earned on the Reserve Banks' holdings of government securities declined to 3.31 percent, from 4.11 percent in 2002, and the average rate of interest earned on loans declined to 1.00 percent, from 1.94 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 2000 through 2003.

Federal Reserve Bank Branches

In 2003, the Board voted to approve a proposal by the St. Louis Federal Reserve Bank to change substantively the nature of the Louisville and Little Rock Branches to a community outreach focus with no operations. Both Branches will maintain their presence in leased office space to accommodate the boards of directors and the community outreach programs, thereby eliminating the need for the existing Branch buildings. The Reserve Bank's board of directors and the Financial Services Policy Committee reviewed and endorsed the proposal. In the past, Reserve Bank Branch responsibilities typically included a larger array of operations than is the case today. For example, most Branches in the 1980s performed ACH, off-line Fedwire, and fiscal services and processed food coupons in addition to cash and checks. Reserve Banks have since consolidated many of their operations, and operations at most Branches are limited to cash and check processing.

Check operations at the Louisville and Little Rock Branches will be eliminated as part of the ongoing check restructuring initiative. With the elimination of check operations, cash would

have been the only operation remaining at the two Branches. Management at the St. Louis Reserve Bank concluded that the most cost-effective solution would be to consolidate currency processing at two other Reserve Bank offices and outsource the paying and receiving functions to a cash depot (to be carried out by either an armored carrier or a financial institution).

With this consolidation and outsourcing arrangement, the Louisville and Little Rock Branches will operate on a public and community affairs model and will be responsible for such activities as director recruitment, economic information gathering, community outreach, and economic and financial education. Each Branch will maintain its economic policy input through meetings of the Branch board of directors, will arrange strategic opportunities for public appearances by senior Federal Reserve officials, and will maintain contacts with local politicians and business leaders.

Federal Reserve Bank Premises

In 2003, the final designs for the Dallas Federal Reserve Bank's new Houston Branch and the Chicago Bank's Detroit Branch buildings were approved, and construction of both new buildings began. Also, the Board approved the purchase of property for the new Kansas City Bank building, the Bank retained design and construction consultants for the project, and the project's design was initiated.

The Board also approved the purchase of a parking garage and a warehouse for the St. Louis Reserve Bank to be used for staff parking and for remote screening of deliveries, as well as the Bank's long-term plan to construct an addition to its current headquarters facility. In addition, the Board approved the Richmond Reserve Bank's purchase of

an office building as a relocation site for critical System staff. Internal renovation of the building was essentially completed in 2003.

Also during the year the Board approved a building program for the San Francisco Bank's Seattle Branch that includes a new building for the Branch's cash operation and Branch administration and the lease or purchase of a building for the Branch's retail payments operation. The Bank continued to interview potential design consultants and evaluate possible sites for the project.

In addition, the Board approved the purchase of property behind the Dallas Bank for construction of a remote vehicle-screening and shipping/

receiving facility and projects at several Banks to prepare facilities for the consolidation of certain retail payments activities.

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

Security enhancement programs were undertaken in 2003 at several facilities as a result of the events of September 11, 2001. The programs included a project to improve external perimeter security for the Boston Bank that involved restoration of Bank property necessitated by construction of the recently completed Central Artery/Tunnel, an underground roadway. ■

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2003 and 2002

Millions of dollars

Item	2003	2002
<i>Short-term assets (Note 1)</i>		
Imputed reserve requirements on clearing balances	1,296.4	1,047.8
Investment in marketable securities ...	11,332.5	9,051.3
Receivables	77.1	78.7
Materials and supplies	2.3	3.4
Prepaid expenses	35.6	34.8
Items in process of collection	<u>5,271.9</u>	<u>6,958.6</u>
Total short-term assets	18,015.8	17,174.7
<i>Long-term assets (Note 2)</i>		
Premises	494.6	475.0
Furniture and equipment	179.4	179.2
Leases and leasehold improvements ..	103.2	91.2
Prepaid pension costs	<u>787.9</u>	<u>809.2</u>
Total long-term assets	<u>1,565.1</u>	<u>1,554.6</u>
Total assets	19,580.9	18,729.3
<i>Short-term liabilities</i>		
Clearing balances and balances arising from early credit of uncollected items	11,788.1	10,550.2
Deferred-availability items	6,448.3	6,886.4
Short-term debt .....	.0	.0
Short-term payables	<u>78.1</u>	<u>83.9</u>
Total short-term liabilities	18,314.4	17,520.5
<i>Long-term liabilities</i>		
Long-term debt .....	.0	.0
Postretirement/postemployment benefits obligation	<u>287.5</u>	<u>272.3</u>
Total long-term liabilities	<u>287.5</u>	<u>272.3</u>
Total liabilities	18,601.9	17,792.8
Equity	<u>979.0</u>	<u>936.4</u>
Total liabilities and equity (Note 3) ...	19,580.9	18,729.3

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, 2003 and 2002

Millions of dollars

Item	2003	2002
Revenue from services provided to depository institutions (Note 4)	886.9	916.3
Operating expenses (Note 5)	<u>941.6</u>	<u>876.0</u>
Income from operations	-54.7	40.2
Imputed costs (Note 6)		
Interest on float	-7	-6.8
Interest on debt .....	.0	.0
Sales taxes	12.1	11.4
FDIC insurance	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs	-66.1	35.6
Other income and expenses (Note 7)		
Investment income	108.0	148.9
Earnings credits	<u>-113.2</u>	<u>-146.8</u>
Income before income taxes	-71.3	37.7
Imputed income taxes (Note 8)	-21.7	<u>11.0</u>
Net income	-49.6	26.6
MEMO: Targeted return on equity (Note 9) ...	104.7	92.5

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

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

Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2003

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)	886.9	742.2	51.4	21.9	68.7	2.3	.4
Operating expenses (Note 5)	<u>941.6</u>	<u>822.0</u>	<u>44.8</u>	<u>16.6</u>	<u>56.4</u>	<u>1.4</u>	<u>.5</u>
Income from operations	-54.7	-79.8	6.7	5.3	12.3	.9	-1
Imputed costs (Note 6)	<u>11.4</u>	<u>9.7</u>	<u>.6</u>	<u>.3</u>	<u>.8</u>	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs	-66.1	-89.5	6.0	5.1	11.5	.9	-1
Other income and expenses, net (Note 7)	<u>-5.2</u>	<u>-4.3</u>	<u>-.3</u>	<u>-.1</u>	<u>-.4</u>	<u>-.0</u>	<u>-.0</u>
Income before income taxes ..	-71.3	-93.8	5.7	4.9	11.1	.9	-1
Imputed income taxes (Note 8)	-21.7	-28.5	1.7	1.5	3.4	.3	-0
Net income	-49.6	-65.3	4.0	3.4	7.7	.6	-1
MEMO: Targeted return on equity (Note 9)	104.7	89.4	5.4	2.2	7.5	.2	.1

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

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

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 expenses of \$21.3 million in 2003 and credits to expenses of \$48.4 million in 2002 and corresponding decrease or increase 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 2003 and 2002. 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 fur-

nished 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 \$6.4 million in 2003 and \$5.1 million in 2002. 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 2003 and 2002 as follows (in millions):

	2003	2002
Check	38.9	40.3
ACH	3.3	4.1
Fedwire funds	2.1	3.3
Fedwire securities	1.1	1.9
Noncash services .....	.1	.1
Special cash services .....	.0	.1
Total	53.4	49.7

(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 2003 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 2003 in millions of dollars:

Total float	285.2
Unrecovered float	<u>6.9</u>
Float subject to recovery	278.3
Sources of recovery of float	
Income on clearing balances	27.9
As-of adjustments	-328.3
Direct charges	624.8
Per-item fees	-702.7

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 2003.

(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 budgets and performance reports. Though not covered by the act, the Board of Governors is voluntarily complying with many of the act's mandates.

Strategic Plan, Performance Budget, and Performance Report

The Board's latest strategic plan in the GPRA format, to be released in early 2004, covers the period 2004–08. 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. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation.

The 2004–05 performance budget and the 2002–03 performance report will be posted on the Board's public web site in early 2004 for access by the Congress, the public, and the General Accounting Office. The performance budget sets forth specific targets for some of the performance measures identified in the strategic plan. The performance budget also describes the operational processes and resources needed to meet those targets and discusses data validation and verification of results. The performance

report for 2002-03 should be completed in April 2004.

When completed, the strategic plan, performance budget, and performance report will be 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 plan and performance budget 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 five 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

- Promote overall financial stability, manage and contain systemic risk, and ensure that emerging financial problems are identified early and successfully resolved before they become crises.
- Provide a safe, sound, competitive, and accessible banking system through comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations, and related entities.
- Enhance efficiency and effectiveness, while remaining sensitive to the burden on supervised institutions, by addressing the supervision function's procedures, technology, resource allocation, and staffing issues.
- Promote adherence by domestic and foreign banking organizations supervised by the Federal Reserve with

applicable laws, rules, regulations, policies, and guidelines through a comprehensive and effective supervisory program.

Goal

To enforce the consumer financial services laws fully and fairly, protect and promote the rights of consumers under these laws, and encourage banks to meet the credit needs of consumers, including those in low- and moderate-income neighborhoods.

Objectives

- Maintain a strong consumer compliance supervision and complaint investigation program that protects consumers and reflects the rapidly changing financial services industry.
- Implement statutes designed to inform and protect consumers that reflect congressional intent while achieving the proper balance between consumer protection and industry costs.
- Promote equal access to banking services.
- Promote community development in historically underserved areas.

Goal

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.
- Conduct research and analysis that contributes to policy development and increases the Board's and others'

understanding of payment system dynamics and risk.

Goal

To provide high-quality professional oversight of Reserve Banks.

Objective

- Produce high-quality assessments of Federal Reserve Bank operations, projects, and initiatives in order to help Federal Reserve management foster and strengthen sound internal control systems and efficient and effective performance.

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 plan and the performance budget. Much of the Board's formal effort to plan jointly has been made through the Federal Financial Institu-

tions Examination Council (FFIEC), a group made up of the five federal agencies that regulate depository institutions.¹ In addition, a coordinating committee 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 institution 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

Check 21 Act

On October 28, 2003, President Bush signed the Check Clearing for the 21st Century Act (the Check 21 Act) into law. The Check 21 Act, which becomes effective on October 28, 2004, will facilitate check truncation and the exchange of checks in electronic format.¹ The act authorizes the creation and use of a new negotiable instrument called a “substitute check.” A substitute check is a paper reproduction of an original check that contains an image of the front and back of the original check, is MICR-encoded, and is otherwise able to be processed in the same way as the original check. The act provides that a properly prepared substitute check is the legal equivalent of the original check for all purposes. The act does not require banks to create substitute checks or to accept delivery of electronic check images; instead, the act simply requires banks to accept properly prepared substitute checks. By empowering banks to create machine-readable substitute checks that are legally equivalent to original checks, the Check 21 Act enables banks to truncate original paper checks early in the collection process, process them electronically, and, where necessary, create substitute checks for delivery to banks that do not accept checks electronically.

The Check 21 Act includes new warranties and an indemnity that protect recipients of substitute checks, includ-

ing both banks and customers, in the event of losses arising from the use of substitute checks. The Check 21 Act also includes expedited recredit procedures to help consumers who receive substitute checks resolve problems related to those checks. Furthermore, the act requires banks to provide a consumer awareness disclosure regarding substitute checks and substitute-check rights to consumers who receive those checks.

Within nine months of its enactment, the Check 21 Act also requires the Board to publish model language to assist banks in complying with the act’s consumer notice requirement. Further, the Check 21 Act empowers the Board to prescribe such regulations as it deems necessary to implement, prevent evasion of, or facilitate compliance with the provisions of the Check 21 Act.

FACT Act

On December 4, 2003, President Bush signed the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) into law. The act amends the Fair Credit Reporting Act (FCRA) to (1) enhance the ability of consumers to combat identity theft and (2) increase the accuracy of consumer reports. The FACT Act also imposes obligations on institutions that sell or share certain consumer information and restricts the use and disclosure of sensitive medical information. In addition, the FACT Act includes other provisions that are designed to limit the use of certain information received from affiliates for marketing purposes. Lastly, the FACT Act establishes uniform national standards

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

in key areas of regulation regarding consumer report information to further promote the efficient operation of national credit markets. To allow a reasonable time to implement the newly enacted requirements, the act sets delayed effective dates for some provisions and, for other provisions, requires the Board and the Federal Trade Commission (FTC) to set effective dates through joint regulations. Certain provisions of the act require implementing regulations. The dates for compliance with those regulations will be established by the federal banking agencies, the National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), and the FTC, as appropriate.

The Board is charged with performing various responsibilities under the FACT Act. Certain sections of the act require the Board to prescribe regulations or guidelines that implement the newly enacted requirements with respect to entities subject to the Board's jurisdiction. To develop many of these rules, the Board must consult and coordinate with the other federal banking agencies, the NCUA, the SEC, and the FTC. The act also requires the Board to undertake several studies on issues regarding the uses of information about consumers and the delivery of financial products and services to consumers, particularly products involving credit or insurance.

Identity Theft Prevention

The FACT Act includes several provisions that are designed to prevent identity theft and assist a consumer who has been a victim of identity theft restore the accuracy of his or her credit history. For example, the FACT Act requires the following:

- A consumer reporting agency, upon a request from a consumer and subject

to certain conditions, must place a fraud alert in the consumer's file and provide the alert along with any credit score generated from that file. Active-duty military personnel also may request that a consumer reporting agency place an "active-duty alert" in their files.

- A consumer reporting agency, upon a request from a consumer and subject to certain conditions, must block the reporting of any information which the consumer identifies as resulting from an incident of identity theft that has been reported to the appropriate law enforcement authority. The consumer reporting agency also must promptly notify the furnisher of the information identified by the consumer that the information may be a result of identity theft.
- A consumer reporting agency must notify a user of a consumer report about a discrepancy in a consumer's address if the user requests the report using an address for the consumer that substantially differs from the address in the file the consumer reporting agency maintains. The federal banking agencies, the NCUA, and the FTC are directed to prescribe guidance that describes reasonable policies and procedures that, in general, a user of a consumer report must employ to reconcile a discrepancy in a consumer's address.
- Businesses accepting credit cards or debit cards must print no more than the last five digits of the card number or the expiration date of the card on any electronically printed receipt provided to the cardholder at the point of sale.

The act charges the federal banking agencies, the NCUA, and the FTC with

establishing “red flag guidelines” for use by financial institutions to identify possible instances of identity theft and to protect account holders, customers, and institutions from the risks associated with identity theft. The act also requires the FTC, in consultation with the federal banking agencies, to prepare a model summary of the rights of consumers with respect to identity theft prevention, and mandates that the consumer reporting agencies provide the summary when a consumer expresses a belief that he or she is the victim of identity theft.

Accuracy of Consumer Credit Reports

The FACT Act includes several provisions that are designed to enhance a consumer’s access to information in his or her consumer report and to improve the accuracy of that information. For example, the FACT Act

- allows a consumer to request that any nationwide consumer reporting agency or nationwide specialty consumer reporting agency provide the consumer with one free consumer credit report during any twelve-month period, if certain conditions are satisfied;
- allows a consumer to obtain his or her credit score, as well as certain information relating to the credit score, from any consumer reporting agency;
- requires any person who makes or arranges consumer loans and uses a credit score in connection with a consumer’s application for a loan to make the credit score, as well as certain information about the score, available to the consumer;

- requires a financial institution that regularly furnishes information to a nationwide consumer reporting agency regarding credit extended to a customer to provide a notice, in writing, to the customer if the institution has furnished or will furnish negative information about him or her to a consumer reporting agency;
- requires a person that furnishes information about a consumer to a consumer reporting agency to maintain reasonable policies and procedures to ensure the accuracy and integrity of the furnished consumer information, in accordance with regulatory guidelines prescribed by the federal banking agencies, the NCUA, and the FTC, as appropriate; and
- requires a person that furnishes information about a consumer to a consumer reporting agency, upon request by the consumer, to reinvestigate a dispute concerning the accuracy of information contained in a consumer report under certain circumstances, as prescribed by the federal banking agencies, the NCUA, and the FTC.

Limits on the Use and Sharing of Medical Information

The FACT Act adds to the existing provisions of the FCRA that govern the sharing and use of medical information. Among other things, the FACT Act

- prohibits a consumer reporting agency from providing a third party with a consumer report containing medical information about a consumer unless the information is relevant to the consumer’s employment or a credit transaction involving the consumer and the consumer specifically consents, in

writing, to the release of such information; and

- generally prohibits a creditor from obtaining or using medical information about a consumer in connection with any determination of the consumer's eligibility for credit.

Promotion of Financial Literacy and Education

The FACT Act establishes the Financial Literacy and Education Commission, to be composed of a representative from each of the federal banking agencies. The commission is charged with developing a national strategy for improving the financial literacy and education of persons in the United States. The commission also is authorized to take appropriate actions to streamline, improve, or

augment the financial literacy and education programs, grants, and materials of the federal government, including developing financial education curricula for all Americans.

Relation to State Laws

The FACT Act makes permanent the preemption provisions of the FCRA that were scheduled to terminate, or "sunset," on December 31, 2003, including the provision that generally preempts any state law requirement regarding the exchange of information about a consumer among affiliated persons. Section 711 of the FACT Act also specifies that several of the act's new protections preempt state laws "with respect to the conduct required by" those provisions of the act. ■