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 state member banks to ensure their compliance with the regulations,
- investigating complaints from the public about state member bank compliance with regulations, and
- 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 of the Federal Reserve Banks.

Implementation of Statutes Designed to Inform and Protect Consumers

The Board of Governors writes regulations to implement federal laws involving consumer financial services and fair lending. The Board revises and updates these regulations to address the introduction of new products, to implement legislative changes to existing laws, and to address problems consumers may encounter in their financial transactions. To interpret and clarify the regulations, Board staff issues commentaries and other guidance. In addition, the staff may undertake studies on aspects of consumer financial products and services at the request of Congress.

During 2004, the Board issued final rules implementing provisions of the Fair and Accurate Credit Transactions Act, an act that significantly amends the Fair Credit Reporting Act. The Board also issued guidance on the standards it and the Federal Deposit Insurance Corporation (FDIC) will use when determining whether to take supervisory or enforcement actions in cases involving the unfair and deceptive trade practices provisions of the Federal Trade Commission Act. The Board produced two reports for Congress summarizing the findings of Board studies on the disclosure of fees related to debit card purchases and on the ability of consumers to avoid receiving unsolicited written offers of credit or insurance. In addition, the Board revised its Truth in Lending Act regulation and the associated commentary, issued interim final rules incorporating technical changes to the regulation implementing the Community Reinvestment Act, raised certain thresholds that would trigger additional requirements under the Home Ownership and Equity Protection Act, and issued a final rule revising the disclosure tables that the federal financial regulatory agencies use to publicly release Home Mortgage Disclosure Act data reported by covered institutions.

Fair and Accurate Credit Transactions Act

In December 2003, the President signed the Fair and Accurate Credit Transactions Act (the FACT Act) into law. The FACT Act amends the Fair Credit
Reporting Act (FCRA) in numerous respects, including making permanent an FCRA provision that preempts states from enacting laws in seven areas addressed by the FCRA. The FACT Act also includes provisions to address identity theft, the accuracy of consumer reports, the duties of furnishers of information, the ability of consumers to opt out of receiving marketing solicitations from an organization when the solicitation is based on information provided to that organization by its affiliate, and the ability of creditors to obtain or use medical information in connection with determining credit eligibility. (The FACT Act also established the Financial Literacy and Education Commission. See “Promotion of Community Economic Development in Historically Underserved Markets” later in this chapter.)

The FACT Act requires the Board to issue regulations or guidelines to implement various provisions of the statute. In 2004, the Board issued three final rules: one pertaining to effective dates for certain provisions of the FACT Act, one pertaining to the furnishing of negative information to consumer reporting agencies, and one pertaining to the disposal of consumer information. The Board is currently working on several additional regulations or guidelines required by the FACT Act.

Effective Dates

In February, the Board and the Federal Trade Commission (FTC) issued joint final rules to implement section 3 of the FACT Act, which required these agencies to establish effective dates for provisions of the act that did not already contain specific effective dates. The Board and the FTC had jointly adopted interim rules in December 2003 that established December 31, 2003, as the effective date for the preemption provisions of the FACT Act, as well as for provisions authorizing the agencies to adopt rules or take other actions to implement the FACT Act. The final joint rules the agencies adopted in February 2004 included the same schedule of effective dates contained in the interim rules. The Board’s final rule amended its Regulation V, which implements the FCRA.

Also in December 2003, the Board and the FTC had issued for comment proposed joint rules that would establish a schedule of effective dates for other provisions of the FACT Act that did not contain effective dates. After reviewing the comments on the proposal, the agencies, in the February 2004 joint final rules, established March 31, 2004, as the effective date for provisions of the FACT Act that did not require significant changes to business procedures. For those FACT Act provisions that would likely entail significant changes to business procedures, the agencies established December 1, 2004, as the effective date, to allow a reasonable time for the industry to establish systems that comply with the statute.

Furnishing of Negative Information

In June, the Board issued a final rule amending Regulation V to add model notices that financial institutions may use to comply with the notice requirement for furnishing negative information to nationwide consumer reporting agencies. Under section 217 of the FACT Act, a financial institution that furnishes negative information about credit extended to a customer (such as information on a customer’s delinquencies or late payments) to a nationwide consumer reporting agency is required
to provide a clear and conspicuous written notice to the customer about furnishing negative information. The required notice is a one-time notice, and a financial institution may provide the notice before, or no later than thirty days after, furnishing the negative information to a nationwide consumer reporting agency. Section 217 of the FACT Act became effective on December 1, 2004.

The FACT Act required the Board to issue a concise model form not to exceed thirty words that institutions may, but are not required to, use to comply with the notice requirement. The Board’s final rule added two model notices to Regulation V. One notice may be used by financial institutions that give the notice before furnishing negative information to a nationwide consumer reporting agency. The other may be used by financial institutions that give the notice after furnishing negative information to a nationwide consumer reporting agency. The Board also amended Regulation V to incorporate a statutory safe harbor relating to the use of the model notices. The safe harbor in the FACT Act provides that a financial institution will be considered to be in compliance with the notice requirement if the institution uses the model notice issued by the Board, or if it uses the model notice and rearranges the format. The Board also provided additional guidance about using the model notices, including guidance on how financial institutions may rearrange the format of the notices without losing the safe harbor from liability that the model notices provide.

**Disposal of Consumer Information**

In December, the Board along with the other federal financial regulatory agencies issued interagency final rules to require financial institutions to adopt measures for properly disposing of consumer information derived from consumer reports (such as credit reports). The agencies’ final rules implement section 216 of the FACT Act by amending the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (revised the Interagency Guidelines Establishing Standards for Information Security), which were adopted in 2001 (as appendix D-2 of Regulation H). The National Credit Union Administration, the FTC, and the Securities and Exchange Commission adopted similar standards for their institutions.

The interagency guidelines currently require financial institutions to protect customer information by implementing information security programs. An institution’s information security program must include measures for the proper disposal of “customer information.” Such information is generally defined as nonpublic personal information about a “customer,” namely, an individual who obtains a financial product or service to be used primarily for personal, family, or household purposes, and who has a continuing relationship with the financial institution. The final rules amend the interagency guidelines to require institutions to also include measures for the proper disposal of “consumer information,” which is generally defined as information that is a consumer report (such as a credit report), or that is derived from a consumer report about an individual (regardless of whether that individual is a customer), and that is maintained or otherwise possessed by, or on behalf of, the institution for a business purpose. The final rules will take effect on July 1, 2005; however, financial institutions do not need to modify existing contracts with their service providers until July 1, 2006.
Interagency Guidance on Unfair and Deceptive Practices

In March, the Board and the FDIC jointly issued a statement outlining the standards the agencies will use to determine when state-chartered banks are engaging in unfair or deceptive trade practices. Such practices are illegal under section 5 of the Federal Trade Commission Act. The Board and the FDIC will apply these standards when weighing the need to take supervisory or enforcement actions and when seeking to ensure that unfair or deceptive practices do not recur. The statement also provides best practices and general guidance to state-chartered banks to help them manage risks relating to unfair or deceptive acts or practices, as well as to help them avoid engaging in such acts or practices. The best practices address some of the business areas that have the greatest potential for unfair or deceptive acts and practices: advertising and solicitation, servicing and collections, and managing and monitoring employees and third-party service providers.

Board Study of the Disclosure of Point-of-Sale Debit Fees under the Electronic Fund Transfer Act

In November, the Board issued a report summarizing the results of its study of the disclosure of fees related to debit card purchases. The study focused specifically on the debit fees that a financial institution may impose when a customer engages in a point-of-sale (POS) debit transaction and provides a personal identification number (PIN). These fees are referred to as “PIN fees.” Some members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs requested the study because they were concerned that consumers may be unaware of the existence or the source of PIN fees. The primary conclusions of the study address four principal areas: (1) the prevalence of PIN fees; (2) the degree of compliance by depository institutions with current disclosure requirements under the Electronic Fund Transfer Act (EFTA), as implemented by the Board’s Regulation E; (3) the adequacy of existing disclosures and the likely benefits and costs of new requirements for disclosure statements; and (4) the feasibility of real-time disclosure (namely, disclosing PIN fees at the time of a transaction on a POS terminal display).

Prevalence of PIN Fees

The Board estimated that in 2004 about 15 percent of all customers with debit cards had accounts that were subject to PIN fees. Because customers can modify their behavior to avoid PIN fees (for example, by using a signature instead of a PIN to secure a transaction), the fraction of customers with debit cards who actually pay these fees is likely between 10 percent and 15 percent.

Degree of Compliance by Depository Institutions

The EFTA and the Board’s Regulation E require depository institutions to disclose certain fees to consumers on the initial disclosure of account terms, on change-in-terms notices, and on periodic statements of account activity. The Board found that more than 95 percent of depository institutions satisfy all the current regulatory requirements for any electronic funds transfer, and that an even higher percentage satisfy the specific requirements for the disclosure of PIN fees at the point of sale.
Adequacy of Existing Disclosures

Consumer and other data suggest that the PIN fee information in initial disclosures and in change-in-terms notices is of limited value to consumers. Some consumers first learn of debit fees from their periodic statements, and many institutions’ periodic statements do not identify the recipient of a debit fee. These findings suggest that improving periodic statements, and potentially initial disclosures and change-in-terms notices, could be a relatively low-cost way to provide consumers with better information about the PIN fees their depository institutions impose.

Feasibility of Real-Time Disclosures

The Board found that disclosing debit fees in real time at a POS terminal (for example, showing fee information on a POS terminal display before a customer commits to a method of payment) would involve the most extensive changes to the infrastructure of the payments system. Although such disclosures would improve consumers’ knowledge of debit fees, these improvements would be achieved at extremely high costs.

Board Study of Prescreened Solicitations under the Fair Credit Reporting Act

In December, the Board issued a report to Congress summarizing the Board’s study of unsolicited written offers of credit or insurance in which the sender of the offer has prescreened the recipients for creditworthiness and suitability on the basis of consumer credit records in the files of consumer reporting agencies. The FCRA allows consumer credit records to be used for these so-called prescreened solicitations. In section 213(e) of the FACT Act, Congress directed the Board to study the ability of consumers to avoid (or opt out of) receiving written offers of credit or insurance in connection with transactions the consumer did not initiate. The Board also studied the potential effect on consumers of any further restrictions on providing them with such written offers of credit or insurance. In particular, Congress directed the Board to address the following five issues: (1) the availability to consumers of opt-out mechanisms, that is, methods for consumers to opt out of having their names and other information used for prescreened solicitations; (2) the extent to which consumers use existing opt-out mechanisms; (3) the benefits to consumers of receiving written offers; (4) the costs to consumers of receiving written offers, or any adverse effects on consumers from receiving the offers; and (5) the potential effects on certain factors, such as the cost and availability of credit, if further restrictions were imposed on the ability of creditors and insurers to make written offers.


The Board found that currently about 6 percent of consumers with credit records have opted out of receiving prescreened written offers of credit or insurance. Further, most consumers who elect to opt out use the statutory mechanisms provided in section 604 of the FCRA, which governs the use of prescreening techniques. Beyond that statutory provision, industry groups and individual companies have voluntarily established ways for consumers to eliminate their name from the listings companies use to make prescreened written offers of credit or insurance. These voluntary mechanisms are important in the marketplace; an estimated one-third of the
individuals on the opt-out lists of the national consumer reporting agencies used a voluntary mechanism to request that their personal information not be used for prescreened offers.

Benefits and Costs of Receiving Written Offers

The Board found that the benefits to consumers of receiving prescreened written offers of credit or insurance are significant. Because prescreened offers must be “firm offers” of credit or insurance, a consumer generally receives offers for only those products for which he or she is likely qualified. Consequently, consumers shopping for credit or insurance are able to quickly identify products suitable for them. These prescreened offers also contain pricing and product information, often in a form that allows a consumer to compare the terms of products offered with those of accounts he or she already holds—and with products offered by other companies. Thus, the widespread availability of pricing and product information in prescreened offers helps to make the market for these products more competitive, an advantage that benefits all consumers.

For creditors and insurers, the ability to tailor offers of credit or insurance to consumers’ pricing and product preferences at a relatively low cost enhances competition and marketing efficiency. Moreover, by having access to credit record information for the purposes of prescreening, creditors and insurers are better able to control certain risks related to offering these products. In a competitive market, cost savings for creditors and insurers translate into lower prices and wider credit and insurance availability for consumers, possibly benefiting traditionally underserved consumers.

The Board found that prescreened written solicitations for credit and insurance carry some potential costs for consumers, including the inconvenience of receiving unwanted mail, the possibility of identity theft, the possible loss of privacy, and the potential for additional debt burden. Although these are important considerations, the Board did not find that restricting written offers of credit or insurance would mitigate these problems; the alternatives to prescreening may even exacerbate some of them.

Potential Effects of Further Restrictions

The Board found that written offers of credit or insurance sent directly to consumers have the potential to increase competition in the market for those consumer financial services. The primary benefits of competition are lower prices and an increased availability of the product or service in question. As a result, the Board concluded that actions undertaken to restrict the ability of lenders and insurers to provide written offers of credit or insurance to consumers would, on balance, result in a less competitive marketplace and thus relatively higher prices and the reduced availability of credit or insurance.

Other Regulatory Actions

The Board also took the following regulatory actions during 2004:

- In March, the Board revised Regulation Z (Truth in Lending) and its official staff commentary to add an interpretative rule of construction clarifying that the word “amount” referred to a numerical amount. The revisions also provided guidance on consumers’ exercise of rescission rights for certain home-secured loans.
• In July, the Board and the other federal financial regulatory agencies issued joint interim final rules containing technical changes to their regulations implementing the Community Reinvestment Act (CRA). The changes conform those regulations to changes in (1) the Standards for Defining Metropolitan and Micropolitan Statistical Areas, published by the U.S. Office of Management and Budget in December 2000; (2) the census tracts designated by the U.S. Bureau of the Census; and (3) the Board’s Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The joint interim rules did not make substantive changes in the requirements of the CRA regulations. The Board’s regulation implementing the CRA is Regulation BB.

• In August, the Board amended the official staff commentary to Regulation Z to raise from $499 to $510 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act. As prescribed by the statute, the increased amount (effective January 2005) reflects changes in the consumer price index.

• In December, the Board raised to $34 million the exemption threshold for depository institutions required to collect data in 2005 under HMDA and Regulation C. As prescribed by the statute, the increased threshold reflects changes in the consumer price index.

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 triennial Survey of Consumer Finances (conducted in 2001), approximately 88 percent of U.S. families in that year used or had access to 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. ATMs were 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 was almost as widely used. About 67 percent of U.S. families had funds deposited directly into their checking or savings account. Use of the service is particularly common in the public sector; during fiscal year 2004, approximately 75 percent of all government payments were made using EFT, including 81 percent of Social Security payments, 98 percent of federal salary and retirement payments, and 45 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 16.2 billion debit card transactions took place in 2003, an increase of approximately 21 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 EFTA. (See “Agency Reports on Compliance with Consumer Protection Laws” later in this chapter.)

**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, and
- 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 conducted by staff at the twelve Reserve Banks. During the 2004 reporting period, the Reserve Banks conducted 242 CRA examinations. Of the banks examined, 43 were rated “outstanding” in meeting community credit needs, 198 were rated “satisfactory,” none was rated “needs to improve,” and 1 was rated as being in “substantial noncompliance.”

**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 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 2004, the Board of Governors considered applications for several significant banking mergers and acquisitions. The Board sponsored four public meetings in connection with two of these applications. For the application by Bank of America Corporation (Charlotte, North Carolina) to acquire Fleet Financial Group, Inc. (Boston, Massachusetts), public meetings were held at the Federal Reserve Banks of Boston and San Francisco. Two public meetings

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1. The 2004 reporting period was July 1, 2003, through June 30, 2004.
were held at the Federal Reserve Banks of New York and Chicago in connection with the merger of J.P. Morgan Chase & Company (New York, New York) with Bank One Corporation (Chicago, Illinois). Members of the public submitted numerous comments on these two applications during the thirty-day comment period allocated for such applications. The public meetings, however, allowed the public to enter oral or written testimony into the record of information considered by the Board. The Board approved the application by Bank of America Corporation in March and the application by J.P. Morgan Chase & Company in June. Several other significant applications are summarized below.

- An application by NewAlliance Bancshares (New Haven, Connecticut) to acquire New Haven Savings Bank (New Haven, Connecticut) was approved in February.

- Three applications by National City Corporation (Cleveland, Ohio) were approved in March, June, and August.

- An application by Regions Financial Corporation (Birmingham, Alabama) to acquire Union Planters Corporation (Memphis, Tennessee) was approved in June.

- An application by Royal Bank of Scotland and Citizens Financial Group (both in Providence, Rhode Island) to acquire Charter One Financial Group, Inc. (Cleveland, Ohio), was approved in August.

- An application by Wachovia Corporation (Charlotte, North Carolina) to acquire SouthTrust Corporation (Birmingham, Alabama) was approved in October.

The public submitted comments 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; the failure of minority-owned and operated institutions to adequately serve other minority populations; the loss of local ownership; institutions’ alleged attempts to circumvent state consumer laws; and alleged fraud.

In addition to considering these applications for significant banking mergers and acquisitions, the Board acted on thirteen other bank and bank holding company applications that involved protests by members of the public concerning the performance under the CRA of insured depository institutions. The System also approved one application that involved an institution having a CRA rating of lower than satisfactory and another thirty-three applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.2

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 Reserve Banks on consumer protection

2. In addition, five applications involving other CRA or compliance issues were withdrawn.
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 compliance with consumer protection laws. During the 2004 reporting period, the Reserve Banks conducted 329 consumer compliance examinations—305 of state member banks and 24 of foreign banking organizations (FBOs).3

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 revised the procedures that Federal Reserve consumer compliance examiners are to use when assessing whether a compliance or CRA examination of an FBO or special-purpose bank is necessary. Further, the Board updated its risk-focused supervision program to reflect new regulations and the level of risk associated with existing regulations. The Board also completed a pilot program for an interdisciplinary electronic banking profile to identify and monitor risk factors associated with the rapid changes in electronic banking.

**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 all creditors from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in good faith, any right under the Consumer Credit Protection Act. As provided by the ECOA, the Board enacted Regulation B to fully implement the act for the banks under its jurisdiction and periodically reviews that regulation and modifies it as needed. 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, repair, or maintenance of a dwelling. Under the act, it is unlawful for a creditor to deny any form of financial assistance, or 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.

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3. The foreign banking organizations examined by the Federal Reserve are organizations operating under section 25 or 25A of the Federal Reserve Act (Edge Act and agreement corporations) and state-chartered commercial lending companies owned or controlled by foreign banks. These institutions are not subject to the Community Reinvestment Act and typically engage in relatively few activities that are covered by consumer protection laws.
(DOJ). When a violation of the ECOA also violates the Fair Housing Act, the matter may be referred to the Department of Housing and Urban Development. To promote consistency in how 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 2004, division staff received and analyzed six reports from Reserve Banks regarding possible referral matters. Four of these reports had to do with potentially discriminatory underwriting standards affecting applicants on the basis of marital status or sex; the other two matters involved apparent discriminatory loan-pricing practices on the basis of marital status. In two of the six cases, the Board determined that referrals were not warranted; two cases were referred to the DOJ; and two cases are pending.

In early 2004, division staff, together with staff from the Board’s Legal Division and the Federal Reserve Bank of New York, negotiated a consent order to finalize an investigation of a major holding company subsidiary. The order addressed issues raised during the investigation, including regulatory compliance violations, the making of loans that were unsafe and unsound and that borrowers could not afford, and misleading and incorrect statements made by lending personnel to examiners. In addition to a substantial civil money penalty, the consent order provided for extensive corrective measures, including the payment of restitution to victims.

The ECOA prohibits not only practices that constitute intentional discriminatory treatment of credit applicants on a prohibited basis but also practices that have an unintended but unjustified discriminatory “disparate impact.” In 2004, division staff determined that a lender’s adoption of a “housing proxy” debt payment constituted a disparate-impact violation of the ECOA on the basis of the prohibited characteristic of age. The lender had been adding a multi-hundred-dollar payment to the monthly debt of persons who applied for credit but reported no housing cost on their loan application—and for whom no housing cost appeared on their credit bureau report. This proxy practice was shown to adversely affect a disproportionate number of younger applicants, and the lender failed to demonstrate an adequate “business-necessity” justification for its adoption of the proxy.

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 in their loan-denial rates for loan applications submitted by members of a protected class and those submitted by members of a nonprotected class; the program 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 small.

**Flood Insurance**

The National Flood Insurance Act imposes certain requirements on loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood hazards. Under 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 of the regulation. The civil money penalties are turned over to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2004, the Board imposed civil money penalties on three state member banks. The penalties, which were assessed via consent orders, ranged from $3,250 to $10,000.

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. In 2004, the FFIEC issued revised examination procedures for determining compliance with the fair lending provisions of Regulation B (which implements the Equal Credit Opportunity Act), the Homeowners Protection Act, and the new subpart D of Regulation CC. Subpart D implements the Check Clearing for the 21st Century Act, or Check 21. Regulation CC continues to implement the Expedited Funds Availability Act. In addition to issuing revised examination procedures to implement Check 21, staff from the FFIEC member agencies developed a Check 21 web site to provide examiners and the financial industry with educational tools, reference materials, and answers to frequently asked questions (www.ffiec.gov/exam/check21).

The FFIEC also issues guidance to the agencies’ consumer compliance examination staff and to supervised financial institutions. To ensure that CRA performance evaluations are comprehensive and include facts and data to support the evaluation results, the FFIEC in 2004 developed interagency guidance on examiners’ use of data tables in CRA evaluations. Additionally, the FFIEC member agencies developed interagency guidance on overdraft protection programs, which was released for public comment in 2004. Finally, in response to a review of preliminary 2004 HMDA data submissions, the FFIEC issued guidance to HMDA data reporters regarding proper collection and reporting of the new data fields being collected for the first time in 2004.

The Board and the FDIC issued joint guidance outlining standards the two agencies will consider when determining whether specific acts or practices at state-chartered banks are unfair or deceptive. 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 for
which the Federal Reserve has supervisory responsibility becomes even more important. The consumer affairs curriculum comprises courses on various consumer protection laws, regulations, and examining concepts. In 2004, these courses were offered in eleven sessions to more than 225 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 2004, staff conducted curriculum reviews for two courses to incorporate technical changes in policy and laws, along with changes in instructional delivery techniques. The two courses reviewed were

- **Community Reinvestment Act Examination Techniques.** Equips assistant examiners and others to write the performance evaluation for the CRA portion of a consumer compliance bank examination.

- **Commercial Lending Essentials for Consumer Affairs.** Equips assistant examiners with the basic techniques to underwrite and price commercial loans.

Staff members also look for opportunities to deliver courses via alternative channels such as the Internet or other distance-learning technologies. The two courses discussed above are now taught using several instructional methods: classroom instruction focusing on case studies, specially developed computer-based instruction, electronic bulletin boards, and vendor-delivered online instruction. Additionally, the new examiner training on the consumer compliance aspects of the Check 21 Act was delivered on both an interactive web site and an interactive CD-ROM.

In 2004, the consumer affairs function added a new course to the core curriculum, Consumer Affairs Risk-Focused Examination Techniques. 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, the opportunity to instruct at System schools, and mentoring programs.

**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 statistical area, (2) it met the asset threshold at the end of the preceding calendar year (for 2002 and 2003, assets of more than $32 million; for 2004, assets of more than $33 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 statistical 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 refinancing in the preceding calendar year, and (3) in the preceding calendar year, its home purchase loan origination and refinancings accounted for at least 10 percent of its total loans by dollar vol-
ume, or if such loans equaled at least $25 million.

In 2004, a total of 6,935 depository institutions and affiliated mortgage companies and 1,186 independent mortgage companies reported HMDA data for calendar year 2003. 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 statistical area in which the lender had offices and reported loan activity for 2003. In 2004, the FFIEC prepared 65,808 disclosure statements.5 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 statistical areas in the United States were also made available to the public at central depositories.6 These data are used by the 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 2003 covered about 42 million loans and loan applications, about 33 percent more than in 2002. The greater volume was due primarily to an increase of about 41 percent in refinancing activity. The number of covered home purchase loans extended in 2003, compared with 2002, increased 16 percent for Asians, 18 percent for Hispanics, 15 percent for blacks, and 11 percent for whites. Native Americans experienced a 5 percent decline in such lending from 2002 through 2003. Over the period from 1993 through 2003, the number of home purchase loans extended to Hispanics rose 236 percent; to Asians, 163 percent; to blacks, 106 percent; to Native Americans, 50 percent; and to whites, 44 percent. For each income category, the number of home purchase loans reported was higher in 2003 than in 2002; the increase was 6 percent for lower-income applicants; 8.6 percent for middle-income applicants; and 13 percent for upper-income applicants. From 1993 through 2003, the number of home purchase loans to lower-, middle-, and upper-income applicants increased by 102 percent, 68 percent, and 88 percent, respectively.

In 2003, 19 percent of Hispanic applicants and 21 percent of black applicants for home purchase loans reported under HMDA applied for government-backed mortgages; the comparable figures for Asians, whites, and Native Americans were 4 percent, 12 percent, and 15 percent, respectively. Twenty-one percent of lower-income applicants for home purchase loans, compared with 5 percent of upper-income applicants, applied for government-backed mortgages.

Overall, the denial rate in 2003 for conventional home purchase loans

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

6. Central depository sites include libraries, universities, and city planning offices. A list of sites can be found at www.ffiec.gov/hmdacf/centdep/default2.cfm.
(that is, loans that are not government-backed) was 14 percent, a rate unchanged from 2002. The denial rate rose from 1993 through 1998 but has fallen since then. In 2003, denial rates for conventional home purchase loans reported under HMDA declined slightly for black applicants, to 24 percent; the rates rose modestly for Native Americans and Asians, to 24 percent and 11 percent, respectively. Denial rates for whites and Hispanics remained the same from 2002 to 2003, at 12 percent and 18 percent, respectively.

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.7

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 88 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation B, compared with 84 percent for the 2003 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- note on the application form when an applicant chooses not to provide monitoring information regarding race or national origin and sex
- notify the credit applicant of the action taken within the time frames specified in the regulation
- 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
- collect information for monitoring purposes about the race, color, religion, national origin, or sex of an applicant

During 2004, the Federal Trade Commission (FTC) entered into one settlement with a telecommunications corporation for alleged violations of the ECOA and Regulation B. The defendants were required to pay civil money penalties of $1.125 million and provide injunctive relief. Additionally, the FTC continued litigation against a mortgage lender for alleged violations of the ECOA and Regulation B, and continued its 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

7. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2004 reporting period was July 1, 2003, through June 30, 2004.
creditors’ providing inadequate statements of specific reasons for denial or involved creditors’ failure to request or provide information for government-monitoring purposes. These agencies did not initiate any formal enforcement actions relating to Regulation B during 2004, 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 95 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation E, compared with 94 percent for the 2003 reporting period. The most frequent violations involved failure to comply with the following requirements:

- determine whether an error occurred, and transmit the results of the investigation to the consumer within ten business days

- 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

- provide initial disclosures that a consumer may retain, at the time he or she contracts for an electronic fund transfer service or before the first electronic fund transfer involving the consumer’s account is made

- 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

In 2004, the FTC settled two cases in federal district court involving violations of the Electronic Fund Transfer Act (EFTA). In one case, the complaint alleged that the defendants had deceptively marketed videos and charged consumers’ credit and debit cards on a recurring basis, without obtaining written authorization from the consumers to initiate preauthorized electronic fund transfers from their accounts, in violation of the EFTA. Under the stipulated court order in this case, defendants were required to pay approximately $1.1 million in combined consumer redress and civil penalties and were barred from a range of unlawful activities. In the second case, the complaint alleged that the defendants initiated recurring automatic charges from consumers’ accounts at the conclusion of a “free” trial period associated with a variety of offered services, without disclosing the cancellation policy or obtaining the consumers’ written authorization. The court order in this case included injunctive relief and required payment of $2.4 million.

**Regulation M**
*(Consumer Leasing)*

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2003 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 96 percent of the institutions exam-
ined during the 2004 reporting period were in compliance with Regulation P, compared with 97 percent for the 2003 reporting period. The most frequent violations involved failure to comply with 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

• provide a clear and conspicuous annual privacy notice to customers

• disclose the institution’s information-sharing practices in initial, annual, and revised privacy notices

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

Regulation Z
(Truth in Lending)

The FFIEC agencies reported that 84 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation Z, compared with 78 percent for the 2003 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 payment schedule for closed-end credit

• 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

• ensure that disclosures reflect the terms of the legal obligation between the parties, and when any information necessary for an accurate disclosure is unknown, ensure that the creditor states that the disclosure is an estimate

• ensure that disclosures reflect that the creditor has or will acquire a security interest in the property identified

The OCC issued one formal enforcement action containing provisions relating to Regulation Z during the 2004 reporting period. In addition, 114 institutions supervised by the Federal Reserve and the FDIC were required, under the Interagency Enforcement Policy on Regulation Z, to refund a total of approximately $500,000 to consumers.

The FTC continued its enforcement activities to halt unlawful subprime-lending practices. The FTC filed two federal district court actions (currently in litigation) and continued litigating three cases; all five cases concern alleged violations of the Truth in Lending Act, Regulation Z, and the Federal Trade Commission Act. The defendants in these cases include mortgage brokers, a mortgage corporation, a finance company, and a tax-shelter consulting firm.

The FCA’s examination and enforcement activities revealed that most Regulation Z violations involved inadequate or incorrect disclosures for closed-end credit. FCA examiners determined that all violations had been or were being corrected or adequately addressed by the respective institutions.
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 more than 99 percent of the institutions examined during the 2004 reporting period were in compliance with Regulation AA, which is comparable to the level of compliance for the 2003 reporting period. The few violations involved the following actions:

• failing to provide a clear and conspicuous disclosure regarding a cosigner’s liability for a debt

• entering into a consumer credit obligation that contains a waiver of exemption, or enforcing provisions in a purchased consumer credit obligation that contains such a waiver, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation

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 93 percent of institutions examined during the 2004 reporting period were in compliance with Regulation CC, compared with 90 percent for the 2003 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

• 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

• make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation

• provide training to each employee that performs duties subject to this regulation, and establish procedures to ensure and monitor employee compliance

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

Regulation DD
(Truth in Savings)

The FFIEC agencies reported that 92 percent of institutions examined during the 2004 reporting period were in compliance with Regulation DD, compared with 89 percent for the 2003 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved

• using the phrase “annual percentage yield” in an advertisement without disclosing additional terms and conditions of customer accounts;

• failing to provide account disclosures containing certain required information;
• failing to provide timely maturity notification for time deposits;
• failing to provide account disclosures clearly and conspicuously, in writing, and in a form that the consumer may keep; and
• providing an advertisement that did not disclose that fees could reduce the earnings on the account.

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

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. Complaints and inquiries received by the Federal Reserve System are entered into its online database, Complaint Analysis Evaluation System and Reports (CAESAR).

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 2004, the Board issued guidance about new codes for the CAESAR database. The new codes will be used to track consumer concerns about emerging issues, such as stored-value cards, reaffirmed debt, the Check Clearing for the 21st Century Act, and the Fair and Accurate Credit Transactions Act. Additional guidance on the CAESAR database was issued to strengthen the documentation of complaint investigations. In addition to the CAESAR guidance, the Board issued guidance on new procedures that are intended to better focus the scope of complaint investigations and improve the quality and timeliness of responses to consumers.

During 2004, the CAESAR Users Advisory Group finalized business and technical requirements for a web-based CAESAR application that will streamline the System’s consumer complaint process. These requirements entailed the development of new reports for analyzing and monitoring complaint trends. In addition, the advisory group developed a new consumer code structure for the web-based system to allow users to classify consumer complaints in more detail and identify investigation findings more easily.

Complaints against State Member Banks

In 2004 the Federal Reserve received approximately 5,130 complaints from consumers—by mail, by telephone, in person, and electronically via the Internet (see tables). About 45 percent of the

<table>
<thead>
<tr>
<th>Classification</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulation B (Equal Credit Opportunity)</td>
<td>36</td>
</tr>
<tr>
<td>Regulation C (Home Mortgage Disclosure Act)</td>
<td>1</td>
</tr>
<tr>
<td>Regulation E (Electronic Fund Transfers)</td>
<td>75</td>
</tr>
<tr>
<td>Regulation H (Bank Sales of Insurance)</td>
<td>2</td>
</tr>
<tr>
<td>Regulation M (Consumer Leasing)</td>
<td>0</td>
</tr>
<tr>
<td>Regulation P (Privacy of Consumer Financial Information)</td>
<td>17</td>
</tr>
<tr>
<td>Regulation Q (Payment of Interest)</td>
<td>1</td>
</tr>
<tr>
<td>Regulation Z (Truth in Lending)</td>
<td>215</td>
</tr>
<tr>
<td>Regulation BB (Community Reinvestment)</td>
<td>1</td>
</tr>
<tr>
<td>Regulation CC (Expedited Funds Availability)</td>
<td>25</td>
</tr>
<tr>
<td>Regulation DD (Truth in Savings)</td>
<td>28</td>
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<tr>
<td>Fair Credit Reporting Act</td>
<td>155</td>
</tr>
<tr>
<td>Fair Debt Collection Practices Act</td>
<td>24</td>
</tr>
<tr>
<td>Fair Housing Act</td>
<td>3</td>
</tr>
<tr>
<td>Flood insurance rules</td>
<td>11</td>
</tr>
<tr>
<td>Regulations T, U, and X</td>
<td>4</td>
</tr>
<tr>
<td>Real Estate Settlement Procedures Act</td>
<td>12</td>
</tr>
<tr>
<td>Unregulated practices</td>
<td>1,708</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,318</strong></td>
</tr>
</tbody>
</table>
Consumer Complaints against State Member Banks, by Subject of Complaint, 2004

<table>
<thead>
<tr>
<th>Subject of complaint</th>
<th>Total</th>
<th>Not investigated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent</td>
</tr>
<tr>
<td>Loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discrimination alleged</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real estate loans</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>Credit cards</td>
<td>13</td>
<td>1</td>
</tr>
<tr>
<td>Other loans</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>Other type of complaint</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real estate loans</td>
<td>463</td>
<td>20</td>
</tr>
<tr>
<td>Credit cards</td>
<td>892</td>
<td>38</td>
</tr>
<tr>
<td>Other loans</td>
<td>174</td>
<td>8</td>
</tr>
<tr>
<td>Deposits</td>
<td>460</td>
<td>20</td>
</tr>
<tr>
<td>Electronic fund transfers</td>
<td>75</td>
<td>3</td>
</tr>
<tr>
<td>Trust services</td>
<td>30</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>188</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>2,318</td>
<td>100</td>
</tr>
</tbody>
</table>

complaints (2,318) were against state member banks. Of the complaints against state member banks, 68 percent involved consumer loans; 2 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 66 percent concerned other credit-related practices, such as the imposition of annual membership fees on credit card accounts, the amount of interest banks charge on credit card accounts, or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Twenty percent of the complaints involved disputes about interest on deposits and other deposit account practices; the remaining 12 percent concerned disputes about electronic fund transfers, trust services, or other practices. Information on the outcomes of the investigations of these complaints is provided in the table.

During 2004, the Federal Reserve System completed the investigation of 125 complaints against state member banks that were pending at year-end 2003, finding no violations of regulations. In 84 percent of the state member bank complaints investigated in 2004, the banks had correctly handled a customer’s account. In 44 percent of these cases, the banks nevertheless chose to reimburse or otherwise accommodate the customer.

The Federal Reserve also handled more than 1,600 inquiries about consumer credit and banking policies and practices during 2004. In responding to these inquiries, the Board and the Reserve Banks gave specific explanations of laws, regulations, and banking practices and provided relevant printed materials on consumer issues.
Unregulated Practices
As required by section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices that are not subject to existing regulations, focusing on those that concern possible unfair or deceptive practices. In 2004 the Board received approximately 1,700 complaints against state member banks that involved unregulated practices. The categories that received the most complaints involved real estate loans, credit card accounts, and checking accounts. Consumers most frequently complained about escrow account problems (78 complaints); other complaints involved customer service problems (75), debt collection practices (70), insufficient-funds charges and procedures (67), loan and deposit account fees (64), and interest rates and terms (61). 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 disputes about the amount withdrawn from checking accounts.

Complaint Referrals to HUD
In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2004 the Federal Reserve referred six complaints to HUD that alleged state member bank violations of the Fair Housing Act. In five of the six cases the Federal Reserve’s investigations revealed no evidence of illegal discrimination. The remaining case was 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 2004, the council met in March, June, and October. In March, council members discussed the Board’s proposal to provide more uniform and consistent guidance on what constitutes a “clear and conspicuous” disclosure for its consumer regulations. The discussion focused on whether the standards and guidance in Regulation P, which implements the financial privacy provisions of the Gramm–Leach–Bliley Act, could be used as the model for providing clear and conspicuous standards. While members applauded the Board’s effort to make disclosures more understandable, they did not support adopting the Regulation P standard as a means of providing more consistent standards and guidance for consumer protection disclosures.

The council also discussed the January 2004 General Accounting Office (GAO) study on predatory lending. The GAO recommended that Congress consider making certain statutory changes to consumer financial services and fair lending laws. Members commented on a proposal that would grant the Board the authority to routinely monitor and, as necessary, examine nonbank mortgage lending subsidiaries of bank and financial holding companies to potentially deter predatory lending. Members who supported this proposal believed that the Federal Reserve has the ability and the expertise to conduct rigorous and consistent examinations. Others did not favor the recommendation.

The Community Reinvestment Act (CRA) was a topic at each of the three meetings. The discussions focused on regulatory changes proposed by the Board and three other federal financial institution regulators (the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation). The agencies proposed changing the criteria for designation as a small bank and adding a caveat that abusive asset-based lending might reduce a bank’s CRA rating. Some members expressed concern about the proposal to change the criteria for small-bank designation because a larger number of banks would qualify for a more limited CRA examination, and some banks located in rural geographic areas might not have incentives to participate in community and economic development initiatives. Further, some members asserted that additional regulation of regulated depository institutions is not necessary and should instead be targeted at unregulated and unsupervised bank affiliates and other loosely supervised organizations.

In June, council members discussed an ongoing review to identify outdated and unduly burdensome regulatory requirements pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Members did not reach consensus on the necessity of the Truth in Lending Act provision giving consumers a three-day right to rescind certain mortgage loan transactions before financial institutions disburse the funds, nor did they agree on the importance of Home Mortgage Disclosure Act data from small banks and rural areas. Members agreed that the CRA provisions of the Gramm–Leach–Bliley Act, which require financial institutions and other community-based organizations that are parties to certain written CRA agreements to make the
agreements available to the public and their primary regulator, serve no useful purpose. Furthermore, the provisions have created a data collection and reporting burden for all parties involved in the agreements. Another topic of discussion at the June meeting was the remittance market, or the transfer of funds by immigrant workers to families and friends in their native countries (see the related box “Remittances and Immigrant Markets: Opportunities and Challenges” later in this chapter). Members emphasized the importance of lowering the cost of remittances and of providing immigrants with access to banking services—especially for lower-income immigrant workers who regularly send money to their home countries.

Courtesy overdraft protection, frequently referred to as bounced-check protection, was a topic at the June and October meetings. The courtesy overdraft protection services offered by some financial institutions are covered under the Truth in Savings Act. Some members had concerns about the adequacy of disclosures, the need for additional regulatory coverage, and deceptive marketing practices for these services. Council members discussed whether the Truth in Savings Act or the Truth in Lending Act is the most effective way to inform and protect consumers. Some council members asserted that bounced-check protection programs are short-term extensions of credit that fit the definition of credit under the Truth in Lending Act; others believed that the programs do not qualify as credit extensions because there is no loan application, underwriting, note, or annual percentage rate calculation in connection with the service.

At the October meeting, members discussed anti-predatory-lending laws. Members reviewed various state and federal legislative approaches, including the Home Ownership and Equity Protection Act (HOEPA), which was established to respond to predatory mortgage lending practices and to protect consumers from these abusive lending practices. Members had differing opinions on whether state laws or federal legislation is the most effective means of addressing predatory lending. Some members believed that state laws provide the necessary protections for deterring predatory lending practices—protections that HOEPA does not offer. Other members strongly preferred federal legislation that preempts state laws because of its uniform application and consistency. The council also discussed proposed amendments to Regulation E, which implements the Electronic Fund Transfer Act. Members commented on a revision that would require that payroll card accounts, established on behalf of a consumer for the purpose of providing salary, wages, and other employee compensation on a recurring basis, be covered by Regulation E. Specific comments addressed whether periodic statements should apply to payroll cards. Some members agreed that employers issuing payroll cards either directly or through service providers should provide periodic statements to employees. Other members noted that payroll cards are a low-profit service for financial institutions; the additional costs associated with providing payroll statements could discourage institutions from offering the cards.

**Promotion of Community Economic Development in Historically Underserved Markets**

During 2004, the community affairs function within the Federal Reserve System engaged in a variety of initiatives to promote community economic develop-
ne that benefit low- and moderate-income communities and populations. The function continued to focus on financial literacy and education, the sustainability of community development organizations, emerging and immigrant markets, and community economic development. Activities included conducting research, publishing newsletters and articles, sponsoring conferences and seminars, and providing advisory services, all of which helped to deliver 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. At the Reserve Banks, 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 implications for public policy.

In 2004, Board staff actively participated in interagency working groups created to fulfill the legislative mandates of the U.S. Department of the Treasury’s Financial Literacy and Education Commission (the commission), established under the Fair and Accurate Credit Transactions Act (the FACT Act). The commission consists of the chiefs of twenty federal agencies; Governor Edward Gramlich represents Chairman Alan Greenspan as the Board’s member. Board staff participated on two of the commission’s working groups: one to help design and launch a web site to link consumers with financial education resources available from federal government agencies, and one to frame a national strategy for the federal government to improve the level of financial literacy among American consumers. In October, the web site www.MyMoney.gov and a toll-free number (1-888-my-money [1-888-696-6639]) were launched to provide consumers with easy access to information resources. The national strategy working group will continue its work, incorporating public remarks submitted in response to a request for comment and finalizing the national strategy in a report to Congress due in June 2005.

Consistent with the national goal to increase financial literacy among consumers, community affairs staff assisted in the planning and delivery of financial and consumer education programs to Board employees. Four programs were offered in 2004, and a web site for online personal finance education was established for Board employees.

Board staff use surveys and focus groups to learn about what issues are important to consumers and to test and develop educational materials. Last year Board staff updated the “Consumer’s Guide to Mortgage Settlement Costs” and the “Choosing a Credit Card” brochures and issued two new publications dealing with checks and the new Check 21 provisions: the “Consumer Guide to Check 21 and Substitute Checks” and “What You Should Know About Your Checks.” The Board, in cooperation with the other federal bank, thrift, and credit union regulators, produced materials on “phishing,” “Internet Pirates Are Trying to Steal Your Personal Financial Information,” and on bounced-check fees, “Protecting Yourself from Overdraft and Bounced-Check Fees.” These publications are available on the Board’s consumer information web site [www.federalreserve.gov/consumers.htm].

Board staff are involved in ongoing research projects related to financial
privacy disclosures, consumers’ use of electronic banking services and stored-value cards, remittances and immigrants’ use of financial services (see the related box “Remittances and Immigrant Markets: Opportunities and Challenges”), and the role of financial education in community development. Board staff are also working with the Department of Defense on a longitudinal study on the effects of financial education conducted on military installations.

Board staff assisted with national financial education initiatives throughout the year. The director of the Division of Consumer and Community Affairs served as an adviser to the board of Operation HOPE, a national non-profit organization dedicated to delivering financial education programs to low-income populations through schools and community centers, as well as to communities suffering from natural disasters. In addition, staff participated in two national forums: one sponsored by the National Endowment for Financial Education to explore strategies for promoting positive financial management behaviors, and another convened by the Government Accountability Office (formerly the General Accounting Office) to define the federal government’s role in personal financial education.

System financial education projects supplemented the Board’s efforts. The community affairs and public information officers at the Reserve Banks collaborated with the U.S. Conference of Mayors to explore strategies for establishing financial education initiatives in cities throughout the country. The resulting “Dollar WiSe” initiative enables cities to create programs that meet the needs of their citizens. For example, the campaign in Detroit, Michigan, focuses on providing financial education training to community educators, while the program in Providence, Rhode Island, offers programs to teach seniors about credit card use, predatory lending, and financial planning. By serving as advisers to the mayors in the nearly thirty-five cities involved in the campaign, the Federal Reserve Banks are helping to increase the public’s awareness of and access to resources for financial literacy and education. In addition, Federal Reserve System community affairs staff continued to work closely with national leaders from the Native American community to develop a financial education policy and other resources that are responsive to the unique needs of residents in Indian Country. Board staff hosted a meeting of the Native American Financial Education Task Force in December. The meeting provided an opportunity for the five committees of the task force to focus on the financial education needs of Native Americans and on how to deliver education resources to these communities.

The Community Affairs Offices at the Reserve Banks continued their financial education initiatives. The Federal Reserve Bank of Cleveland worked with bank and community partners in Cleveland, Pittsburgh, and Cincinnati to form regional collaborations to develop and deliver financial education resources. The Federal Reserve Bank of Minneapolis was instrumental in forming the Montana Financial Education Coalition. The Federal Reserve Bank of Boston partnered with a community group to provide train-the-trainer workshops to social service workers, hosted a conference on best practices, and worked with Operation HOPE to launch a financial literacy campaign in the schools in Providence, Rhode Island. In addition, the Federal Reserve Bank of Kansas City sponsored a number of financial education events that specifically targeted youth, Native Ameri-
Remittances and Immigrant Markets: Opportunities and Challenges

The provision of remittance services is a potentially effective method by which mainstream financial institutions can attract unbanked immigrants.

Ben S. Bernanke, Member, Board of Governors
April 16, 2004

Immigrant workers typically send a large portion of their earnings back to their home countries. The United States is the largest source country for these cross-border funds transfers, known as remittances: About $32 billion was remitted in 2003, according to a recent report from the Inter-American Dialogue. (As used in this article, the term remittances refers specifically to the international transfer of funds between individuals.) Because they are such a significant flow of funds, remittances have attracted the attention of lawmakers, bankers, consumer and community groups, and domestic and international banking agencies.

The Inter-American Development Bank’s Multilateral Investment Fund reports that the highest volume of remittance traffic—an estimated 100 million transactions each year—occurs between the United States and Latin America. Billions in Motion, a 2002 report published by the Pew Hispanic Center, described a typical remitter in the United States as a thirty-seven-year-old, lower-skilled immigrant from Mexico or another Latin American country who earns less than $30,000 annually, has not completed high school, does not have a credit card, does not own his or her home, and is among the 43 percent of Latino immigrants who do not have a bank account.

The process of remitting funds has changed significantly since 1990, when many immigrants used informal networks, such as friends and family, to transfer funds. Today, money-transfer organizations are the dominant providers of remittance services. But these firms typically charge service fees as high as 15 percent of the transfer, thus eroding the amount of money an immigrant’s family receives. Many factors influence the fees charged, including the service provider’s operating costs and geographic coverage.

To facilitate cost-effective funds transfers to Canada, Mexico, and five transatlantic countries, the Reserve Banks offer FedACH International products to banks. These products allow banks to send international credit transactions electronically via the same process used to send domestic transactions. Intended primarily for international corporate payments, the products provide a potentially less costly way for consumers to remit funds. In 2004, the service was expanded to include Mexico.

The Reserve Banks worked cooperatively with the Central Bank of Mexico to make it easier for Mexican retail banking systems to support remittances—an effort that may also encourage consumers in the United States and Mexico to develop banking relationships.

Along with the other Federal Financial Institutions Examination Council agencies, the Federal Reserve Board examined the role of the Community Reinvestment Act in encouraging banks to provide financial services to immigrants—who are typically a low-income, underserved population. As a result of policy guidance issued in June 2004, banks that offer remittance services may receive CRA credit if these services are affordable and meet the needs of the lower-income remitters in their markets.

For banks, immigrants and remittances present a market opportunity. The Remittance Marketplace, a 2004 report from the
Pew Hispanic Center, found that only about 3 percent of remittance transactions to Mexico were conducted through banks. Despite recent efforts by banks and credit unions to increase account ownership among Hispanic markets, the report also found that 8 million Latinos remain “unbanked.”

Banks, however, need to understand the many issues involved in serving immigrants. For example, many immigrants are uncomfortable using banks and do not understand how banks charge for their services. In 2004, the Federal Reserve System undertook several initiatives to share information on reaching immigrant markets.

- The Federal Reserve Bank of Chicago launched the Center for the Study of Financial Access for Immigrants, which hosted a national conference, “Financial Access for Immigrants: Learning from Diverse Perspectives,” in collaboration with the Brookings Institution. In addition, the Chicago Reserve Bank’s Community Affairs Office convened several forums throughout the Seventh District to gain insight into the social, economic, and other issues that inhibit immigrants from using banks.
- The Federal Reserve Bank of Atlanta hosted “Payments in the Americas,” a conference that explored the policy and regulatory challenges of providing remittance services. Staff from the Board and the Atlanta Reserve Bank are also sponsoring focus groups with Mexican immigrants to learn about the factors influencing their banking and remitting behaviors.
- Federal Reserve Board staff participated on a remittances panel at the 2004 conference of the American Council of Consumer Interests. The panel addressed consumer information, disclosure, and protection issues.
- The Federal Reserve Bank of Boston’s Community Affairs Office conducted in-depth market research on immigrant communities in the First District. The office’s other financial education initiatives targeted Hispanic communities in Boston, Massachusetts, and Providence, Rhode Island.

As the U.S. population becomes more diverse, the Federal Reserve System will continue to work with policymakers, community groups, and bankers to ensure that immigrants have fair and equal access to the U.S. financial system. The following Reserve Bank publications provide more information on remittances and immigrant banking.

- “Banking Unbanked Immigrants through Remittances,” Communities and Banking, Federal Reserve Bank of Boston, Fall 2003, www.bos.frb.org/commdev/index.htm

In recent years, reduced funding and changing priorities among government and philanthropic organizations have diminished access to resources for many community development organizations. As it did in 2003, the Board’s Community Affairs Office convened meetings of federal government officials and national community development leaders to explore the sustainability and capitalization of community economic development finance (CEDF) organizations. The Board’s Community Affairs Office convened a policy forum in April with the Aspen Institute, a national research and leadership development organization. The forum discussed Aspen’s research on the attributes of industries, organizations, and products that achieve scale and become self-sustaining. The research compared and contrasted the funding and business strategies of sustainable enterprises with those of CEDF institutions, identifying areas where the field needs to focus efforts to increase its future viability. The forum assembled leaders from financial institutions, government agencies, foundations, and membership associations.

Reserve Bank Community Affairs Offices explored new sources of capital to increase the sustainability of CEDF organizations. The Federal Reserve Bank of San Francisco expanded the scope of its Center for Community Development Investments; the Bank’s staff worked closely with an advisory board of industry experts to develop a web site of resources, training, and technical assistance on community development investments. The System’s Community Affairs Offices also continued to work with the Wall Street Without Walls initiative to help community development organizations increase their access to the capital markets for funding. The Federal Reserve Banks of Chicago, San Francisco, and New York hosted training events that attracted nearly 370 community development leaders interested in understanding the requirements of the capital markets. In addition, the Community Affairs Office of the Boston Reserve Bank collaborated with Wall Street Without Walls and Southern New Hampshire University to sponsor the inaugural session of the “Capital Markets Training Institute” in Manchester, New Hampshire. Participants at this three-day event learned how they can use the capital markets to fulfill their organizations’ missions more efficiently and learned how to adapt their operations to allow their organizations to access the capital markets. Demonstrating the ongoing commitment of the System’s Community Affairs Offices, the director of the Board’s Division of Consumer and Community Affairs began serving on the Walls Street Without Walls advisory board in 2004.

Reserve Bank efforts also explored ways to increase the effectiveness of community development finances in their Districts. The Federal Reserve Bank of Dallas sponsored “Momentum Texas: The Texas Community Development Finance Summit” to examine the state’s strategies for securing and using community economic development funds. The Cleveland Reserve Bank organized a policy summit, “Recapitalization of Communities,” in
which regional and national community
development leaders discussed chal-
lenges to and opportunities for attracting
new capital to fund CEDF institutions’
initiatives for infrastructure develop-
ment, wealth-building, and other asset-
accumulation programs.

The System’s Community Affairs
Offices remain committed to increasing
the role of research in their work. Prepa-
rations have begun for the biennial com-

munity affairs research conference in
April 2005: Chairman Greenspan will
be a keynote speaker at the two-day
event. System community affairs staff
collaborated with their research col-
leagues at the Board and the Cleveland
Reserve Bank to identify and review
papers that would best address the con-
ference’s theme, “Promises and Pitfalls:
As Consumer Finance Options Multiply,
Who Is Being Served and at What
Cost?” Studies chosen will assess the
impact that consumer behavior, alterna-
tive financial services providers, finan-
cial education, and other factors have on
consumers’ access to and experiences
with the financial sector.

The New York, Philadelphia, and
Cleveland Reserve Banks collaborated
to host a community development
finance research conference in Decem-
ber. The conference commissioned
papers from leading researchers on a
broad range of topics, including strat-
gies for asset creation among lower-
income populations, the role of micro-
lending in community development,
methods for measuring the impact of
community development, and the rela-
tionship between subprime markets and
predatory lending. In addition, scholars
and practitioners explored the roles of
alternative depository institutions and
public policy in helping traditionally
underserved populations and commu-
nities access capital for asset accumu-
lation and development. Senator Hillary
Rodham Clinton was the keynote
speaker.

The Board’s Community Affairs
Office continued to improve and support
its Fiscal Impact Tool (FIT), a web-
based modeling tool designed to support
the evaluation of prospective com-
munity and economic development projects
in midsize 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 reve-
nues and on costs to local government.
Available at no cost on the Board’s
web site [www.federalreserve.gov/forms/
fiscalimpactrequest.cfm], FIT can aid
decisionmakers in determining the eco-

nomic value of a proposed activity for
their community.

The Board’s Community Affairs
Office, in partnership with the Chi-
cago, Kansas City, Philadelphia,
Richmond, and St. Louis Reserve
Banks, continued to develop best-
practice case studies for the web-based
database Lessons Learned: Community
and Economic Development Case
Studies [www.chicagofed.org/cedric/
lesle_index.cfm]. The database 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 simi-
lar concerns in their communities. The
database can be accessed on the Sys-
tem’s research repository web site, the
Community and Economic Develop-
ment Research Information Center
(CEDRIC).

Outreach Activities
The Board engages in outreach activi-
ties throughout the year to provide infor-
mation 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 targeted audiences. This year, the Board again participated in the Congressional Black Caucus Foundation’s 2004 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

Earnings of insured commercial banks exceeded the $100 billion mark for the second consecutive year in 2004 amid significant changes in the interest rate environment, an end to the boom period in mortgage refinancings, and several mergers among large bank holding companies.

At $106.7 billion, profits rose 6.4 percent from 2003, fueled by growth in loans (11.0 percent overall) and investment securities (6.4 percent) and by a decline in provisions for loan loss (22.3 percent). The net interest margin on all earning assets fell 7 basis points, to 3.72 percent, low by historical standards. Non-interest income grew modestly overall (3.9 percent) despite lower revenues from mortgage originations and soft trading income. Servicing income, income from fiduciary activities, and deposit fees accounted for most of the growth. Expenses rose sharply (9.4 percent), significantly influenced by nonrecurring items related to mergers and the creation of litigation reserves at a few large institutions.

Return on total shareholders’ equity fell a full percentage point, to a still-strong 14.27 percent. The decline in this profitability ratio was due primarily to significant merger-related increases in equity that were largely offset by increases in merger-related intangible assets.\(^1\) Return on assets fell only slightly, to 1.35 percent, the third consecutive year in which this ratio exceeded 1.30 percent.

Loans grew a remarkable 11.0 percent, or $480 billion, in 2004, with most growth occurring in commercial real estate ($131 billion), home equity ($114 billion), residential mortgages ($89 billion), and credit card loans ($61 billion). The growth of commercial real estate lending was even more rapid than in the past few years, with construction lending up 25.2 percent and loans secured by nonfarm nonresidential properties up 10.7 percent. Home equity loans grew an extraordinary 40.2 percent, the fifth consecutive year in which their growth exceeded 20 percent. The growth of residential mortgages came mostly in the first half of the year and slowed considerably once short-term market interest rates began to rise in June. Some of the increase in credit card lending was technical in nature, related to the reclassification of balances from credit-card-related securities to loans as accounting treatments were harmonized at newly merged large banks. Commercial and industrial (C&I) loans rose $37 billion, or 4.3 percent, for the year despite having declined modestly in the first quarter amid weak loan demand.

Holdings of investment securities grew less rapidly than loans, expanding 6.4 percent overall (or $93 billion) for the full year while experiencing substantial shifts as the year progressed in response to changing market conditions. Essentially all the net growth for the year could be attributed to mortgage

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1. The number and size of bank-related merger transactions significantly affected the aggregation of commercial bank reports of income and condition (Call Reports) in 2004. The data used in this discussion have been adjusted to address the effects of purchase accounting and, in particular, push-down accounting for bank subsidiaries of large holding companies acquired by other bank holding companies.
pass-through securities acquired during the first quarter. Reacting to changes in the interest rate environment, banks sold off $36 billion (or 5.9 percent) of their mortgage pass-through securities holdings in the second and third quarters and then purchased roughly the same amount during the fourth quarter as longer-term interest rates stabilized. Banks also sold off a modest proportion of their structured mortgage securities (for example, collateralized mortgage obligations) and asset-backed securities in the third quarter and then acquired additional foreign-issued debt securities during the fourth quarter. These repositioning transactions came in response to actual and anticipated movements in market interest rates (together with unexpected stability in longer-term rates, leading to a flatter yield curve) and the associated volatility in the carrying value of mortgage-servicing assets.

Supporting this robust asset growth, core deposits continued their recent strong expansion. Money market deposit account (MMDA) deposits and savings deposits grew $270 billion, or 11.7 percent, slightly exceeding the remarkable growth rate for loans. Noteworthy increases were evident among other core deposit categories, including other transaction accounts (up $6.1 billion) and demand deposits (up $24.5 billion). The increase in demand deposits was influenced by an inflow of balances from corporate customers in the latter half of the year as short-term market interest rates rose, boosting earnings credits on compensating balances.2 Time deposits under $100,000 grew less significantly ($10.5 billion, or 1.6 percent); the bulk of the increase came in the final quarter of the year as consumers sought to take advantage of rising interest rates. Time deposits over $100,000 rose $128.3 billion, or 21.5 percent, and foreign deposits grew $125 billion, or 16.8 percent; these categories include large-denomination deposits raised in wholesale and offshore money markets, which, along with a modest rise in short-term non-deposit borrowings (4.6 percent), accommodated the growth in assets.

Influenced by both balance sheet changes and movements in market interest rates, net interest margins narrowed 7 basis points, to 3.72 percent. Yields on domestic real estate loans—including commercial real estate and home equity loans—fell 25 basis points despite higher short-term interest rates. Overall yields on securities holdings rose modestly—in part because of rising short-term interest rates—while yields on C&I loans held steady at 6.00 percent amid reports that bankers were easing their lending standards through the year. Changes in the effective rates for credit cards and other consumer loans were mixed. Funding costs reflected some resistance to higher interest rates, as the effective cost of MMDA and savings deposits remained essentially unchanged from 2003, at 0.73 percent, while the effective cost of other deposits and borrowings declined 20–30 basis points.

Equity-to-assets ratios rose a full percentage point in 2004, primarily as a result of the merger-related increases in shareholders’ equity noted earlier. Regulatory capital ratios, in contrast, remained relatively steady, as the merger-related increase in equity was

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2. Although banks are prohibited from paying interest on transaction accounts held by commercial customers, these customers in many cases receive “earnings credits” on their transaction balances that may be used to offset service charges they incur. The amounts of such earnings credits are determined by a number of factors, including the size of collected balances and prevailing short-term market interest rates.
largely offset by goodwill-related intangible assets, which are deducted from regulatory capital measures. Dividends paid by commercial banks fell sharply, declining $18 billion, or 23.4 percent. Most of the decline (61 percent) came in dividends paid to the five largest bank holding companies (Citigroup, JPMorgan Chase, Bank of America, Wachovia and Wells Fargo, all on a merger-adjusted basis) by their commercial bank subsidiaries; dividend payments from the holding companies to their shareholders rose.

Already-strong asset quality improved further in 2004 according to all conventional measures. Nonperforming assets fell to 0.62 percent of loans and related assets, well below both the 0.94 percent rate for 2003 and the previous credit-cycle low point in 1997–99 (0.75 percent). Net charge-offs fell to 0.63 percent of loans, from 0.88 percent in 2003, roughly in line with the 1997–99 period. Reserves fell in absolute terms (4.2 percent), but reserve coverage of nonperforming assets still improved substantially.

Reflecting ongoing consolidation in the industry, the number of insured commercial banks declined by 142 (on a net basis), to 7,621. Still, some 122 new charters were granted in 2004 (105 of these by state authorities), a sign of the continuing attractiveness of commercial bank charters. Assuming a minimum initial capitalization of $8 million, these newly chartered institutions attracted nearly $1 billion of new capital into the banking industry.

Consistent with the industry’s strong earnings and balance sheets, only three banks failed in 2004 (combined assets of roughly $200 million), one more than in 2003. The number of problem banks (that is, those receiving a supervisory rating of 4 or 5 on overall condition) declined by 28, to 90 institutions.

Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies, including financial holding companies formed under the authority of the 1999 Gramm–Leach–Billey 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, including their compliance with laws and regulations.3

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

3. The Board’s Division of Consumer and Community Affairs coordinates the Federal Reserve’s supervisory activities with regard to compliance with consumer protection and civil rights laws. Those activities are described in the chapter “Consumer and Community Affairs.” Compliance with other banking laws 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.
activities with other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

Supervision for Safety and Soundness

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

Examinations and Inspections

The Federal Reserve conducts examinations of state member banks, the U.S. branches and agencies of foreign banks, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of bank 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 banking organizations. 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 assessment of the quality of the organization’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 2004, 919 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 15 percent of all insured commercial bank assets in the United States. The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year; exceptions are certain well-capitalized, well-managed organizations having assets of less than $250 million, which may be examined once every eighteen months.

Bank Holding Companies

At year-end 2004, a total of 5,863 U.S. bank holding companies were in operation, of which 5,151 were top-tier bank holding companies. These organizations controlled 6,235 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. 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 2004 the Federal Reserve conducted 3,703 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

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.

4. Refer to SR Letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or non-complex. [www.federalreserve.gov/boarddocs/SRLETTERS/2002/sr0201.htm]
company is subject to increased supervisory review that may include an on-site review and off-site monitoring.

**Financial Holding Companies**

Under the Gramm–Leach–Bliley Act, bank holding companies that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in full-scope securities underwriting, merchant banking, and insurance underwriting and sales activities. The statute streamlines the Federal Reserve’s supervision of all bank holding companies, including financial 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 2004, 600 domestic bank holding companies and 36 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 34 had consolidated assets of $15 billion or more; 110, between $1 billion and $15 billion; 82, between $500 million and $1 billion; and 374, less than $500 million.

**Anti-Money-Laundering Examinations**

The U.S. Department of the Treasury regulations (31 CFR 103) implementing the Bank Secrecy Act (BSA) generally require banks and other types of financial institutions to file certain reports and maintain certain records that are useful in criminal or regulatory proceedings.

The BSA and separate Board regulations require banking organizations supervised by the Board to file reports on suspicious activity related to possible violations of federal law, including money laundering, terrorist financing, and other financial crimes. In addition, BSA and Board regulations require that banks develop written programs on BSA compliance and that the programs be formally approved by bank boards of directors. An institution’s compliance program must (1) establish a system of internal controls to ensure compliance with the BSA, (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.

The Federal Reserve is responsible for examining supervised institutions for compliance with various anti-money-laundering regulations. During examinations of state member banks and U.S. branches and agencies of foreign banks and, when appropriate, inspections of bank holding companies, 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 Anti-Money-Laundering Policy and Compliance Section of the Board’s Division of Banking Supervision and Regulation is responsible for BSA/anti-money-laundering matters. The section develops BSA policies and examination guidance and oversees the Federal Reserve Banks’ implementation of this guidance.

**Business Continuity**

In 2004 the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions. Throughout
the year, the Federal Reserve monitored financial institutions’ progress toward implementing the sound practices identified in the April 2003 “Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System,” a joint publication with the Office of the Comptroller of the Currency (OCC) and the Securities and Exchange Commission (SEC), which specifies 2005–06 implementation dates. The agencies also began analyzing the risks associated with business continuity testing, in order to develop examiner guidance, and continue to coordinate efforts to ensure a consistent supervisory approach toward implementation of the sound practices.

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

Information Technology Activities
In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised banking organizations as well as certain independent data centers that provide information technology services to these organizations. Several years ago, the information technology reviews of banking organizations 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 2004 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 organizations that together hold more than $24 trillion of assets in various fiduciary capacities, including custodial capacities. During on-site examinations of fiduciary activities, the organization’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 2004 Federal Reserve examiners conducted 163 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 an organization’s operations and its compliance with relevant securities regulations. During 2004 the Federal Reserve conducted on-site examinations at 21 of the 86 state member banks and bank holding companies that were reg-
istered 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. Twenty-eight state member banks and 7 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury’s regulations. During 2004 the Federal Reserve conducted 6 examinations of broker-dealer activities in government securities at these organizations. These examinations are generally conducted concurrently with the Federal Reserve’s examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring 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 Rulemaking Board’s rule G-16 at least once every two calendar years. Of the 22 entities that dealt in municipal securities during 2004, 6 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 (OTS).

At the end of 2004, 679 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 215 of these lenders, and the remaining 464 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 245 lenders from its on-site inspection program. The securities credit activities of the remaining 219 lenders were subject to either biennial or triennial inspection. Fifty-five inspections were conducted during the year, compared with 89 in 2003.

**Enforcement Activities and Special Investigations**

The Federal Reserve has enforcement authority over the banking organizations it supervises and their affiliated parties. Enforcement action may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include orders to cease and desist, written agreements, removal and prohibition orders, and civil money penalties. Informal enforcement actions include memorandums of understanding and board of directors resolutions.

In 2004 the Federal Reserve completed 64 formal enforcement actions, including the issuance of cease-and-
desist orders, written agreements, and removal and prohibition orders and the imposition of civil money penalties. Civil money penalties totaling $188 million were assessed. All civil money penalties, as directed by statute, are remitted either to the Department of the Treasury or to the Federal Emergency Management Agency. Enforcement orders, which are issued by the Board, and written agreements, which are executed by the Reserve Banks, are public information and are posted on the Board’s web site [www.federalreserve.gov/boarddocs/enforcement]. In addition to formal enforcement actions, the Reserve Banks completed 102 informal enforcement actions in 2004. Information about these actions is not available to the public.

The Special Investigations Section of the Division of Banking Supervision and Regulation conducts financial investigations, provides expertise to U.S. law enforcement in connection with financial crimes investigations, and offers training to foreign and domestic government agencies. Board staff also work with law enforcement, the financial industry, and other regulatory agencies on various task forces and groups established to combat bank fraud and other financial crimes.

Risk-Focused Supervision Programs
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 organizations 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 organizations, it may take the form of a series of targeted reviews. For the largest, most complex organizations, the process is continuous, as described in the next section. To minimize burden on the organization, work is performed off-site to the greatest extent possible. Additionally, to minimize the number of requests for information from organizations, examiners make use of public and regulatory financial reports, market data, information from automated screening systems (see the 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). 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 organizations to keep current the Federal Reserve’s assessment of each organization’s condition,

(3) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization’s risk profile (the team leader is the central point of contact, has responsibility for only one LCBO, and is supported by specialists skilled in evaluating the risks of LCBO business activities and functions), and (4) promoting Systemwide and interagency information-sharing through automated systems.

Community Banks

The risk-focused supervision program for community banks emphasizes the review of activities posing the greatest risk to an organization and provides for a tiered approach to the examination of those activities. Examination procedures are tailored to the bank’s characteristics, keeping in mind its size, complexity, and risk profile. The examination entails both off-site and on-site work, including planning, completing a pre-examination visit, preparing a detailed scope-of-examination memorandum, documenting the work done, and preparing 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 that monitor supervisory data and regulatory financial reports in order to analyze the financial condition and performance of state member banks and bank holding companies between on-site examinations and inspections. This analysis aids in directing examination resources to those organizations that exhibit relatively high-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 has systems that monitor market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations.

In addition 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 are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP) and contain, for individual bank holding companies, financial statistics and comparisons with peer companies. BHCPRs are available to the public via the Board’s National Information Center web site (www.ffiec.gov/nic).

During 2004 the web-based Performance Report Information and Surveillance Monitoring (PRISM) application received major upgrades. PRISM is a querying tool used by Federal Reserve analysts to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial data drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, Bank Holding Company Performance Reports, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of surveillance screens for banks and bank holding companies. The upgrades established direct links between PRISM and other automated supervisory tools (the Bank-
ing Organization National Desktop, or BOND, and the National Examination Database), expanded the number of surveillance screens available from BOND, and enhanced the range of regulatory data available for querying.

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.6

International Activities

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

Foreign Operations of U.S. Banking Organizations

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

At the end of 2004, 56 member banks were operating 763 branches in foreign countries and overseas areas of the United States; 32 national banks were operating 706 of these branches, and 24 state member banks were operating the remaining 57. In addition, 16 nonmember banks were operating 17 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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

6. The member agencies of the FFIEC are the Board of Governors, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. State supervisory authorities also participate in some FFIEC initiatives.
At year-end 2004, 79 banking organizations, operating 9 branches, were chartered as Edge Act or agreement corporations. These corporations are examined annually.

**U.S. Activities of Foreign Banks**

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

As of year-end 2004, 188 foreign banks from 54 countries were operating 228 state-licensed branches and agencies (of which 8 were insured by the FDIC) as well as 51 branches licensed by the OCC (of which 5 had FDIC insurance). These foreign banks also directly owned 14 Edge Act and agreement corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 88 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2004 controlled approximately 16 percent of U.S. commercial banking assets. These foreign banks also operated 68 representative offices; an additional 56 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 256 examinations in 2004.

**Technical Assistance**

In 2004 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 2004 was concentrated in Latin America, Asia, and former Soviet bloc countries.

During the year, the Federal Reserve offered training courses exclusively for foreign supervisory authorities in Washington, D.C., and in a number of foreign jurisdictions. System staff also took part in technical assistance and training missions led by the International Mone-
Supervisory Policy

The Federal Reserve’s supervisory policy function is responsible for developing guidance for examiners and banking organizations as well as regulations for banking organizations under the Federal Reserve’s supervision. Staff members participate in international supervisory forums and provide support for the work of the FFIEC.

Capital Adequacy Standards

During 2004 the Federal Reserve, together with the OCC, the FDIC, and the OTS (collectively, the federal banking agencies), issued a final rule on capital requirements for asset-backed commercial paper programs. The agencies also continued to consider possible revisions to their risk-based capital adequacy regulations to reflect the new Basel II framework and issued proposed guidance for internal-ratings-based systems that may be used to determine capital for retail credit risk. In addition, the Federal Reserve requested public comment on a proposed rule concerning the treatment of trust preferred securities in the tier 1 capital of bank holding companies.

Asset-Backed Commercial Paper Programs

In July the Federal Reserve and the other federal banking agencies adopted a final rule that amended the agencies’ risk-based capital rules for asset-backed commercial paper (ABCP) programs. The rule permits banking organizations to continue to exclude from their risk-weighted asset base, for purposes of calculating their risk-based capital ratios, ABCP program assets 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). 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 the sponsoring banking organization’s minority interest component of tier 1 capital and, hence, from risk-based capital. The amended 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. 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 their tier 1 leverage capital ratio.

In addition, the rules impose a risk-based capital charge on liquidity facilities having an original maturity of one year or less that organizations provide to ABCP programs by imposing a 10 percent credit conversion factor on such facilities. 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 the risk associated with such facilities. A separate capital charge on liquidity facilities provided to an ABCP program is not required of banking organizations that consolidate the program for purposes of risk-based capital.

Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

In August 2003 the Federal Reserve, together with the other federal banking agencies, issued for public comment an advance notice of proposed rulemaking and draft supervisory guidance setting forth the agencies’ views on implementing the Basel II framework in the United States. The proposed plan would allow banking organizations that meet specific criteria to use their own estimates of certain risk parameters as key inputs in determining their regulatory capital requirements.

Over the course of 2004, working both independently and with the member countries of the Basel Committee on Banking Supervision, the federal banking agencies continued to modify the methodologies in the Basel II framework. In October the agencies issued proposed guidance on internal-ratings-based systems that may be used to determine regulatory capital for retail credit risk under the Basel II framework. The proposed guidance describes the agencies’ views on the components and characteristics of a qualifying internal-ratings-based system for measuring the credit risk associated with retail exposures, including residential mortgages, consumer credit cards, automobile loans, personal loans, and some small business loans. The comment period was scheduled to end in January 2005. (For more information on the Basel II framework, see the box “Implementing the Basel II Framework in the United States.”)

Capital Treatment of Trust Preferred Securities

In May the Federal Reserve Board proposed to allow the continued inclusion of outstanding and prospective issuances of trust preferred securities in the tier 1 capital of bank holding companies while imposing stricter quantitative limits and clarifying qualitative standards for capital instruments included in regulatory capital. The stricter quantitative limits would apply to the aggregate amount of trust preferred securities, cumulative perpetual preferred stock, and minority interests in the equity accounts of certain consolidated subsidiaries (collectively, restricted core capital elements) included in bank holding company tier 1 capital. The proposed rule would make explicit a general expectation that internationally active bank holding companies would limit the amount of restricted core capital elements to 15 percent of the sum of core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability, consistent with a 1998 Basel agreement. Other bank holding companies would be subject to a 25 percent limit on the amount of restricted core capital elements. The proposal provides for a three-year transition period for compliance with the stricter quantitative limits.

These revisions were proposed to address supervisory concerns, competitive equity considerations, and changes in generally accepted accounting principles. They would have the effect of strengthening the definition of regulatory capital for bank holding companies. A final rule is to be issued in early 2005.
Bank-Owned Life Insurance

In December 2004, the Federal Reserve and the other federal banking agencies issued guidance on the safety-and-soundness and risk-management implications of purchases and holdings of life insurance by banks and savings associations. The guidance addresses the unique characteristics of bank-owned life insurance (BOLI) as well as the need for a comprehensive pre- and post-purchase analysis of the risks and rewards of BOLI.

Bank Holding Company Rating System

To more closely align the supervisory rating system for bank holding companies with its supervisory practices, the Federal Reserve in December 2004 adopted a revised bank holding company rating system, effective January 1, 2005. The increased complexity of the U.S. banking industry has necessitated a shift over time in the focus of the Federal Reserve’s supervisory practices for bank holding companies away from historical analyses of financial condition toward more-forward-looking assessments of risk management and financial factors. Under the revised rating system, each bank holding company is assigned a composite rating based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The three main components of the new RFI/C (D) rating system are Risk management, Financial condition, and potential Impact of the parent company and nondepository subsidiaries (collectively, nondepository entities) on the subsidiary depository institution(s). The rating of a fourth component, Depository institution, will generally mirror the primary regulator’s assessment of the subsidiary depository institution(s), as had been the case for the bank rating under the previous rating system, BOPEC (Bank, Other subsidiaries, Parent, Earnings, Capital).

To provide a consistent framework for assessing risk management, the risk-management component of the new rating system is supported by four subcomponents that reflect the effectiveness of the banking organization’s risk management and controls: board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. The financial-condition component is similarly supported by four subcomponents that reflect an assessment of the quality of the banking organization’s capital, assets, earnings, and liquidity. A simplified version of the rating system that requires only the assignment of the risk-management component rating and composite rating (C) will be applied to noncomplex bank holding companies having assets of less than $1 billion.

Bank Secrecy Act and Anti-Money Laundering

The Federal Reserve in 2004 issued a number of supervisory letters to domestic and foreign banking organizations on such topics as examination procedures for customer identification programs and the imposition of “special measures” by the Department of the Treasury on certain jurisdictions and foreign financial institutions suspected of being of “primary money laundering concern.”

The Federal Reserve is actively working with the other federal and state banking agencies to develop interagency Bank Secrecy Act/anti-money-laundering examination procedures to be
Implementing the Basel II Framework in the United States

We are embarking on an effort to achieve considerably more precision in correlating the riskiness of an institution’s activities and its regulatory capital.

Roger Ferguson, Vice Chairman, Board of Governors
November 2004

Preparation continued during 2004 for implementation in the United States of a new international agreement on capital adequacy for banking organizations. The new agreement, familiarly known as Basel II, sets forth a framework for ensuring that banks hold adequate capital against risk and builds on the initial international capital agreement adopted in 1988.

The original Basel Capital Accord, though widely considered to have achieved its principal objectives of promoting financial stability and providing an equitable basis for competition among internationally active banks, has in recent years been viewed as too simple to address the activities of today’s large, complex banking organizations. Basel II creates a stronger framework for these organizations through minimum capital requirements that are more sensitive to each organization’s risk profile and that reinforce incentives for strong risk management.

The Basel II framework contains provisions addressing credit risk (the risk of loss due to failure of a counterparty to meet its obligations) and operational risk (the risk of loss resulting from inadequate or failed internal processes, people, or systems or from external events). It relies on three pillars—minimum capital requirements, supervisory review, and market discipline—and is the basis on which revisions to existing U.S. capital adequacy regulations and standards are being developed.

Scope of Application in the United States
Final rules for application of the Basel II framework in the United States are still being developed. It is expected that only a small number of large, internationally active U.S. banking organizations will be subject to the new framework. Those institutions would be required to use the most advanced options of the framework for determining their risk-based capital requirements (the advanced internal-ratings-based approach, or A-IRB, for credit risk and the advanced measurement approaches, or AMA, for operational risk). Other U.S. banking organizations would not be required to adopt Basel II but could opt to do so, provided they could demonstrate the ability to develop the risk measures required as inputs to determine capital requirements. Those banks not adopting Basel II would continue to operate under existing capital rules.

Implementation Plan and Timetable
The U.S. banking and thrift agencies have been coordinating their efforts to implement the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of the G-10 countries plus Luxembourg and has its secretariat at the Bank for International Settlements in Basel, Switzerland. See www.bis.org/publ/bchb107.htm.

1. The final agreement, titled “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” and published in June 2004, was developed by the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of the G-10 countries plus Luxembourg and has its secretariat at the Bank for International Settlements in Basel, Switzerland. See www.bis.org/publ/bchb107.htm.


3. Basel I is updated in 1996 to account for market risk.
ment Basel II. The new rules are expected to take effect on January 1, 2008; before then, institutions subject to the new rules will be required to conduct a year of parallel calculations—that is, to simultaneously calculate capital requirements according to the Basel II-based rules and the current rules. Both supervisors and bankers have much to accomplish before the target 2008 date, including the writing of final rules and guidance by the agencies and the development and execution of an acceptable, detailed written plan for implementation by each adopting institution.

Revision of Regulations

Comments on an advance notice of proposed rulemaking issued in August 2003 that set forth possible revisions to the capital adequacy regulations are currently being reviewed. Importantly, all U.S. banking organizations would continue to be subject to leverage ratio requirements and to prompt corrective action regulations, which closely link enforcement actions to banks’ capital levels.

The agencies expect that a notice of proposed rulemaking on possible revisions to the regulations will be published in mid-2005. Final rules are expected in the second quarter of 2006. The agencies are also considering possible changes to risk-based capital regulations for U.S. institutions not subject to the Basel II-based regulations; these changes are expected to become effective at the same time as the Basel II-based regulations.

Qualification for Using Advanced Approaches

The agencies have issued guidance setting forth their ideas about the qualification process for Basel II in the United States. The development of a detailed written plan for implementing the A-IRB and AMA approaches for determining risk-based capital requirements is seen as among the most significant steps institutions can take in advance of the issuance of final rules and associated guidance. The qualification process will be iterative. The plans will serve as instruments of communication between institutions and their supervisors in their home country and other jurisdictions. They are expected to include a self-assessment by the institution, a gap analysis (based on the self-assessment) identifying areas needing additional work, an action plan for addressing shortcomings, objectively measurable milestones, and an assessment of resources needed.

Issuance of Supervisory Guidance

During 2005 the agencies will continue to develop supervisory guidance concerning the various portfolios and risk exposures addressed by Basel II; draft supervisory guidance on corporate and retail credit risk and operational risk has already been published. The guidance will set forth supervisory expectations for banking organizations adopting the Basel II-based rules, for example, the components and characteristics of an acceptable risk-measurement and risk-management infrastructure.

Completion of Quantitative Studies

In 2004 the agencies began a fourth Quantitative Impact Study (QIS-4) to evaluate the potential effects of U.S. implementation of the Basel II framework and a “loss data collection exercise” (LDCE) focused on operational risk. About thirty banking organizations are participating in QIS-4; about twenty are participating in the LDCE. These studies are intended to help banking organizations and their supervisors better understand the implications of the Basel II framework for regulatory capital and may provide some insight on implications of the new approaches for competition within the banking industry.
released in 2005. The Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) has participated in this initiative.

To support this work and to provide a forum for the federal banking agencies to discuss matters related to Bank Secrecy Act/anti-money-laundering examination and training, a Bank Secrecy Act Working Group was formed in 2004 under the FFIEC. The working group, which also includes FinCEN and state bank regulators, complements other interagency and international efforts, such as the Bank Fraud Working Group, the Financial Action Task Force, and various supervisors committees within the Basel Committee on Banking Supervision.

The Federal Reserve participates in another such group, the BSA Advisory Group, which was established by statute to seek ways to reduce unnecessary burden created by the BSA and to increase the utility of data gathered under the act to aid regulators and law enforcement. In addition, through this group, the Federal Reserve assists the Treasury Department in providing feedback to financial institutions on the reporting of suspicious activity. Finally, staff of the Division of Banking Supervision and Regulation engage in outreach to the financial services industry by, for example, speaking at banking conferences to promote best practices to combat money laundering and terrorist financing.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision, the Federal Reserve in 2004 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 organizations and to improve the stability of the international banking system. The efforts are described in the following sections.

Capital Adequacy

During 2004 the Federal Reserve continued to participate in a number of technical working groups of the Basel Committee in efforts to develop the revised Basel framework (familiarly referred to as Basel II), which was published in June, and to address issues not fully resolved in that framework. In particular, the Federal Reserve participated in a joint Basel Committee–International Organization of Securities Commissions (IOSCO) working group on the trading book to review issues related to counterparty credit risk, double default effects (reflecting the low probability that both a borrower and its guarantor will default at the same time), and the definition of the trading book.

Risk Management

The Federal Reserve contributed to several supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2004 that were generally aimed at improving the supervision of banking organizations’ risk-management practices.

- “Consolidated Know-Your-Customer Risk Management,” issued in October, provides guidance to help international banking organizations establish centralized processes for sharing information and for coordinating and promulgating customer due diligence policies and procedures on a consolidated basis. The guidance, which builds on Basel Committee publications issued in 2001 and 2003, also encourages government jurisdictions
to facilitate consolidated customer due diligence risk management by providing a legal framework that allows overseas subsidiaries and affiliates of banking organizations to share information with their head offices or parent banks.

- “Principles for the Management and Supervision of Interest Rate Risk,” issued in July, describes the pillar 2 (supervisory review) approach to calculating interest rate risk under Basel II. The paper reflects comments received on a September 2003 consultative paper.

- “Implementation of Basel II: Practical Considerations,” issued in July, discusses the costs and benefits of Basel II implementation from the point of view of non-G10 countries, focusing in particular on potential changes to the legal and regulatory framework and on resource and training requirements.

- In January the Basel Committee issued changes to the internal-ratings-based approach to securitization exposures under Basel II, in response to industry concerns related to the complexity of the proposal and the operational burdens of implementation.

- In January the Basel Committee announced its decision to base the Basel II framework on unexpected losses rather than a combination of unexpected and expected losses, in response to industry requests and comments. However, under the framework, banks would be required to compare provisions with expected losses and to deduct any deficiency from capital. Excess provisions would be eligible for inclusion in tier 2 capital, subject to a cap.

- “Principles for the Home-Host Recognition of AMA Operational Risk Capital,” issued in January, addresses industry concerns about practical impediments to the cross-border implementation of the advanced measurement approaches for operational risk, an element of the Basel II framework.

**Joint Forum**

In its work with the Basel Committee, the Federal Reserve also continued its participation in the Joint Forum—a group made up of representatives of the committee, IOSCO, and the International Association of Insurance Supervisors. The Joint Forum works to increase mutual understanding of issues related to the supervision of firms operating in each of the financial sectors. The Joint Forum issued three publications in 2004:

- “Credit Risk Transfer,” issued in October, reviews the rapid growth in credit risk transfer products, such as single-name credit default swaps and collateralized debt obligations, and concludes that these markets have provided banking organizations with significantly more liquid and efficient methods of trading and diversifying their credit risks. The report notes that although these products do not raise immediate and significant financial stability concerns, financial organizations should adopt appropriate risk-management practices when conducting business in these products.

- “Outsourcing in Financial Services,” issued in August, discusses the key issues and risks associated with financial firms’ outsourcing of significant parts of their regulated and unregulated activities to third parties and sets
forth principles to help firms mitigate these risks.

- “Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis,” issued in May, outlines the findings of a working group established to follow up on recommendations contained in a 1999 report that provided advice to supervisors on enhancing financial institutions’ public disclosures of their financial risks.

**International Accounting and Disclosure**

The Federal Reserve participates in the Basel Committee’s Accounting Task Force and represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. In particular, officials of the Federal Reserve represent the Basel Committee at meetings that address financial instruments accounting and disclosure issues associated with international accounting standards. In addition, an official of the Federal Reserve is a member of the Standards Advisory Council of the International Accounting Standards Board (IASB).

During 2004 the Federal Reserve had a key role in development of the Basel Committee’s comments on the IASB’s proposed amendment to the guidance in International Accounting Standard 39 on the optional use of fair value accounting for financial instruments. In addition, the Federal Reserve strongly supported the Basel Committee’s efforts to develop guidance on improving disclosure for the purpose of enhancing market discipline. This support contributed to the finalization of pillar 3 guidance on improved disclosures in support of Basel II.

The Federal Reserve and the Basel Committee also worked with other international regulatory organizations, such as IOSCO, the International Association of Insurance Supervisors, the World Bank, and the Financial Stability Forum, as part of an organization called the Monitoring Group, to promote stronger international audit standards and practices. This effort led to the adoption by the International Federation of Accountants (IFAC) of comprehensive reforms that will result in greater public oversight of IFAC’s audit-standard-setting activities.

**Sarbanes–Oxley Act**

During 2004 the Federal Reserve continued to evaluate the effects of the Sarbanes–Oxley Act on banking organizations. The effort involved the Federal Reserve’s working closely with banking organizations and their external auditors to better understand the challenges they are encountering in complying with the sections of the act that relate to internal controls. It also involved dialogue with the SEC and the Public Company Accounting Oversight Board (PCAOB) on various interpretative issues related to these matters.

In addition, an official of the Federal Reserve serves on the Standing Advisory Group of the PCAOB, which is advising the PCAOB as it develops standards for the external audits of publicly traded companies in the United States. The Federal Reserve also continued in 2004 to work with the FDIC and other banking agencies to consider changes that should be made to the regulations implementing the Federal Deposit Insurance Corporation Improvement Act to promote strong internal controls and consistency with the Sarbanes–Oxley Act requirements.
Efforts to Enhance Transparency

As part of ongoing efforts to promote sound accounting and disclosure practices by banking organizations, the Federal Reserve, together with the other banking agencies, in February issued guidance on the appropriate accounting treatment for obligations under certain types of deferred compensation agreements (see SR Letter 04-4). In March the Federal Reserve and the other banking agencies issued guidance identifying current sources of generally accepted accounting principles (GAAP) and supervisory guidance that should be used by banking organizations in determining their allowance for loan and lease losses (see SR Letter 04-5). The Federal Reserve also worked with foreign supervisors in developing pillar 3 of the Basel II framework, which aims to enhance banking organizations’ public disclosure of their risk exposures, capital, and capital adequacy.

In October the Federal Reserve submitted a comment letter to the Financial Accounting Standards Board (FASB) on its “Fair Value Measurements Exposure Draft.” In addition, Federal Reserve staff provided comments to FASB on an accounting interpretation that addressed impairment of securities.

Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies periodically submit reports providing financial and structure information. This information is essential to the supervision of the organizations and the formulation of regulations and supervisory policies. The information is also used 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 bank holding companies on a consolidated and parent-only basis. 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 reports—FR Y-11, FR 2314, and FR Y-7N—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 act.

In March 2004, several revisions to the FR Y-9C report were implemented for the purpose of collecting preliminary data from selected large bank holding companies on a voluntary basis, improving the reporting of trust preferred securities, and collecting from some of the largest bank holding companies the addresses of their web pages displaying risk disclosures. In September and December the electronic filing process for the FR Y-9 series of reports was enhanced to require respondents to perform data validation checks prior to filing.

In May revisions were made to clarify the language in the reporting forms and instructions for three

In June the FR Y-8 was revised to allow for collection of additional information to be used in monitoring compliance with section 23A of the Federal Reserve Act 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 act.

Commercial Bank Regulatory Financial 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 Federal Reserve and the other banking agencies have begun a Call Report modernization project to improve the timeliness and quality of supervisory data and to enhance market discipline by ensuring 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, moving forward the deadline for filing reports, and requiring respondents to validate their data before filing. The effort to set up a central data repository is currently in the testing phase, and the repository is expected to be operational in 2005.

No significant changes were made to the Call Report in 2004. A proposal was issued in April to make two instructional clarifications to the report.

Also in 2004, the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002) was revised, effective in March, to include additional information on derivatives contracts. A proposal was issued in August to revise the Country Exposure Report (FFIEC 009) and the Country Exposure Information Report (FFIEC 009a) to harmonize U.S. data with data on cross-border exposures collected by other countries.

Federal Financial Institutions Examination Council

During 2004 the Federal Financial Institutions Examination Council focused on coordinating the agencies’ efforts in the area of Bank Secrecy Act examination and training by enhancing communication and cooperation with FinCEN, an agency within the Treasury Department whose mission is to safeguard the financial system from terrorist financing, money laundering, and other financial crimes. It also continued its efforts to identify and eliminate outdated, unnecessary, or unduly burdensome regulations, pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The FFIEC made significant progress on 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 compliance issues, bank surveillance processes, and information-sharing.

**Supervisory Information Technology**

Under the direction of the division’s chief technology officer, the supervisory information technology (SIT) function within the Division of Banking Supervision and Regulation facilitates the management of information technology within the Federal Reserve System’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 and the federal bridge investigation initiatives);
- the supervision function’s use of technology leverages the resources and expertise available more broadly within the Federal Reserve System; and
- practices that maximize the supervision function’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, as well as through a Systemwide committee structure, to ensure that key staff members throughout the System participate in identifying requirements and setting priorities for IT initiatives.

**SIT Project Management**

In 2004 the SIT project management staff, in partnership with other Federal Reserve System staff, developed a strategic plan for 2005–09 that identifies opportunities for enhancing business value through the use of information technology. Another major activity was development of a program to ensure compliance with the Federal Information Security Management Act. In addition, staff members supported modernization of the Shared National Credit program as well as assessments of opportunities in the areas of electronic applications, administrative systems, and learning management systems to improve information technology services in conjunction with efforts of Board and Reserve Bank internal IT providers.

**National Information Center**

The National Information Center (NIC) is the Federal Reserve’s comprehensive repository for supervisory, financial, and banking structure data and documents. NIC includes the structure data system; the National Examination Database (NED), 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 2004 the structure data system was modified to adhere to the industry standards for use of NAICS (North American Industry Classification System) business activity codes. Changes were
made to NED to accommodate the new bank holding company supervisory rating system and to provide user interoperability with PRISM and the CDTR. The CDTR was expanded to contain examination reports for regional and community banking organizations prepared by Reserve Banks. Significant resources continue to be devoted to Call Report modernization for the FFIEC Central Data Repository initiative, with implementation expected in 2005.

Banking Organization National Desktop

Supervision of domestic banking organizations and the U.S. operations of foreign banking organizations is supported by an automated application—the Banking Organization National Desktop (BOND)—that facilitates secure, real-time electronic information sharing and collaboration among federal and state banking regulators. During 2004 BOND was enhanced to improve its usability, reduce administrative burden, increase the effectiveness of management reporting, and facilitate the sharing of information related to Basel II and the tracking of parallel-owned banks or bank holding companies (that is, organizations in the United States and another country that have the same controlling shareholder). Other enhancements included financial holding company compliance monitoring, improved data quality edits, the addition of applications data, and changes to accommodate the new RFI/C (D) rating scheme for bank holding companies (see the section “Bank Holding Company Rating System”). BOND has been updated to include seamless links to the Federal Reserve’s Applications Management and Processing System and to a new system for accessing data on the Shared National Credit program, an interagency effort that aims to reduce examination costs and improve the timeliness and reliability of data associated with the review of large, syndicated credit facilities of commercial banks. At year-end 2004, BOND had 2,850 registered users across the Federal Reserve System, the OCC, the FDIC, and ten state banking departments.

Staff Development

The Federal Reserve System’s staff development program trains staff members at the Board, the Reserve Banks, and state banking departments who have supervisory and regulatory responsibilities as well as 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 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 2004 the Federal Reserve trained 2,365 students in System schools, 721 in schools sponsored by the FFIEC, and 20 in other schools, for a total of 3,106, including 293 representatives of foreign
Training Programs for Banking Supervision and Regulation, 2004

<table>
<thead>
<tr>
<th>Program</th>
<th>Number of sessions conducted</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td><strong>Schools or seminars conducted by the Federal Reserve</strong></td>
<td></td>
</tr>
<tr>
<td>Core schools</td>
<td></td>
</tr>
<tr>
<td>Banking and supervision elements</td>
<td>8</td>
</tr>
<tr>
<td>Operations and analysis</td>
<td>5</td>
</tr>
<tr>
<td>Bank management</td>
<td>1</td>
</tr>
<tr>
<td>Report writing</td>
<td>12</td>
</tr>
<tr>
<td>Management skills</td>
<td>9</td>
</tr>
<tr>
<td>Conducting meetings with management</td>
<td>13</td>
</tr>
<tr>
<td>Other schools</td>
<td></td>
</tr>
<tr>
<td>Credit risk analysis</td>
<td>5</td>
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<tr>
<td>Examination management</td>
<td>6</td>
</tr>
<tr>
<td>Real estate lending seminar</td>
<td>4</td>
</tr>
<tr>
<td>Senior forum for current banking and regulatory issues</td>
<td>2</td>
</tr>
<tr>
<td>Basel II corporate activities</td>
<td>1</td>
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<tr>
<td>Basel II retail activities</td>
<td>1</td>
</tr>
<tr>
<td>Principles of fiduciary supervision</td>
<td>2</td>
</tr>
<tr>
<td>Commercial lending essentials for consumer affairs</td>
<td>1</td>
</tr>
<tr>
<td>Consumer compliance examinations I</td>
<td>2</td>
</tr>
<tr>
<td>Consumer compliance examinations II</td>
<td>2</td>
</tr>
<tr>
<td>CRA examination techniques</td>
<td>2</td>
</tr>
<tr>
<td>CRA risk-focused examinations</td>
<td>2</td>
</tr>
<tr>
<td>Fair lending examination techniques</td>
<td>2</td>
</tr>
<tr>
<td>Foreign banking organizations</td>
<td>1</td>
</tr>
<tr>
<td>Information systems continuing education</td>
<td>5</td>
</tr>
<tr>
<td>Capital markets seminars</td>
<td>9</td>
</tr>
<tr>
<td>Technology risk integration</td>
<td>6</td>
</tr>
<tr>
<td>Leadership dynamics</td>
<td>6</td>
</tr>
<tr>
<td>Internal bank ratings and credit risk modeling</td>
<td>2</td>
</tr>
<tr>
<td>Seminar for senior supervisors of foreign central banks¹</td>
<td>8</td>
</tr>
<tr>
<td>and seven other international courses</td>
<td></td>
</tr>
<tr>
<td><strong>Other agencies conducting courses²</strong></td>
<td></td>
</tr>
<tr>
<td>Federal Financial Institutions Examination Council</td>
<td>65</td>
</tr>
<tr>
<td>The Options Institute</td>
<td>2</td>
</tr>
</tbody>
</table>

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

central banks (see table). The number of training days in 2004 totaled 17,738.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 410 state examiners were trained—242 in Federal Reserve courses, 158 in FFIEC programs, and 10 in other courses.

A staff member seeking an examiner’s commission is required to take a first proficiency examination, which tests knowledge of a core body of information, and also a second proficiency examination in one of three specialty areas: safety and soundness, consumer affairs, or information technology. In 2004, 135 examiners passed the first proficiency examination. In the second proficiency examination, 87 examiners passed the safety and soundness examination, 29 passed the consumer affairs examination, and 6 passed the information technology examination. The overall pass rate for these examinations was 79 percent. At the end of 2004, the System had 1,223 field examiners, of which 950 were commissioned (see table).
Year-End Reserve Bank Supervision Levels, 2000–2004

<table>
<thead>
<tr>
<th>Type of staff</th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
<th>2001</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Field examination staff</td>
<td>1,223</td>
<td>1,239</td>
<td>1,234</td>
<td>1,242</td>
<td>1,172</td>
</tr>
<tr>
<td>Commissioned field staff</td>
<td>950</td>
<td>936</td>
<td>892</td>
<td>861</td>
<td>786</td>
</tr>
</tbody>
</table>

Regulation of the U.S. Banking Structure

The Federal Reserve administers several federal statutes in relation to bank holding companies, financial holding companies, member banks, and foreign banking organizations—the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, and the International Banking Act. In administering these statutes, the Federal Reserve acts on a variety of proposals that would 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 activities permissible for bank holding companies; depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant’s ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on decisions regarding domestic and international applications in 2004 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 Bank Holding Company 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 com-
Decisions by the Federal Reserve on Domestic and International Applications, 2004

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Direct action by the Board of Governors</th>
<th>Action under authority delegated by the Board of Governors</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Approved</td>
<td>Denied</td>
<td>Permitted</td>
</tr>
<tr>
<td>Formation of bank holding company ........</td>
<td>9</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Merger of bank holding company ........</td>
<td>14</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Acquisition or retention of bank ..........</td>
<td>16</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Acquisition of nonbank ........</td>
<td>0</td>
<td>0</td>
<td>31</td>
</tr>
<tr>
<td>Merger of bank ........</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Change in control ....</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Establishment of a branch, agency, or representative office by a foreign bank ....</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other ........</td>
<td>134</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total ..........</td>
<td>178</td>
<td>0</td>
<td>34</td>
</tr>
</tbody>
</table>

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. In 2004, 47 domestic financial holding company declarations and 5 foreign bank declarations were approved.

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the 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 organizations, 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. In 2004 the Federal Reserve approved 80 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 terminol-
ogy 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 534 reports on competitive factors to the other agencies in 2004.

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 the 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 relevant individuals.

In 2004 the Federal Reserve approved 125 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 Federal Reserve, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law.

In 2004 the Federal Reserve approved 9 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 Federal Reserve, large and other significant investments require prior approval. In 2004 the Federal Reserve approved 27 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 14 applications to make additional investments through an Edge Act or agreement corporation, 5 applications to extend the corporate existence of or acquire an Edge Act corporation, and 4 applications to establish or acquire an agreement corporation.

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 2004 the Federal Reserve reviewed 16 stock repurchase proposals by bank holding companies; all were approved by a Reserve Bank under delegated authority.

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 2004 the Federal Reserve acted on new and merger-related branch proposals for 1,428 domestic branches and granted prior approval for the establishment of 34 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 2004, 2 applications for financial subsidiaries were approved.

Public Notice of Federal Reserve Decisions

Certain 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. The Board’s web site [www.federalreserve.gov] provides information on orders and announcements as well as a 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 to sixty days, depending on the type of application or notice filed. In 2004, 92 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 extensions of credit to executive officers.

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 SEC. At the end of 2004, 15 state member banks were registered with the Board under the Securities Exchange Act.

Securities Credit

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

Several regulatory agencies enforce the Board’s securities credit regulations. The SEC, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. With respect to compliance with Regulation U, the federal banking agencies examine banks under their respective jurisdictions; the Farm Credit Administration, the National Credit Union Administration, and the OTS examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Since 1998, the Board has published a list of foreign stocks that meet the requirements of section 220.11 of Regulation T (Credit by Brokers and Dealers), thereby making them eligible for margin treatment at broker-dealers on the same basis as domestic margin securities. In March 2004 the Board removed all the stocks from its Foreign Margin Stock List because the stocks had not been recertified under procedures approved by the Board in 1990. Foreign stocks may also qualify as margin securities by being deemed to have a “ready market” under the SEC’s net capital rule (17 CFR 240.15c3-3) (see the March 3, 2004, press release at [www.federalreserve.gov/boarddocs/press/all/2004/].
Extensions of Credit by State Member Banks to their Executive Officers, 2003 and 2004

<table>
<thead>
<tr>
<th>Period</th>
<th>Number</th>
<th>Amount (dollars)</th>
<th>Range of interest rates charged (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>October 1–December 31</td>
<td>590</td>
<td>66,901,000</td>
<td>0.0–18.0</td>
</tr>
<tr>
<td>2004</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>January 1–March 31</td>
<td>545</td>
<td>62,624,000</td>
<td>0.0–18.0</td>
</tr>
<tr>
<td>April 1–June 30</td>
<td>576</td>
<td>79,207,000</td>
<td>0.0–18.0</td>
</tr>
<tr>
<td>July 1–September 30</td>
<td>479</td>
<td>72,401,000</td>
<td>0.0–19.8</td>
</tr>
<tr>
<td>October 1–December 31</td>
<td>476</td>
<td>53,083,000</td>
<td>0.0–20.8</td>
</tr>
</tbody>
</table>

Source: Call Reports.

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 2004.

Federal Reserve Membership

At the end of 2004, 2,794 banks were members of the Federal Reserve System and were operating 51,864 branches. These banks accounted for 37 percent of all commercial banks in the United States and for 73 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

In 2004, the Federal Reserve Banks continued to pursue efficiencies in their operations, including the provision of priced services, and in support and overhead.

The Reserve Banks are processing a declining number of checks as consumers and businesses make more payments electronically. Because of the decline, the Banks have found it challenging to fully recover their costs as required by the Monetary Control Act of 1980. In response, the Banks are fundamentally restructuring their check operations. During the year, they completed the first phase of a check restructuring initiative, reducing the number of Federal Reserve check-processing and check-adjustment locations. The initiative has reduced Reserve Bank check operating expenses and staffing levels; since 1999, the number of employees processing checks has declined about 25 percent, to approximately 4,000 at the end of 2004. As the market for check collection services continues to decline, the Banks will pursue additional restructuring efforts and staffing reductions to achieve full cost recovery. (For a broad discussion of the Reserve Banks’ response to today’s environment, see the box “Reserve Bank Services in a Changing Payments Market.”)

In addition to acting to control costs for priced services, the Reserve Banks have undertaken a number of projects to reduce support and overhead costs. They have consolidated operations locally and nationally, adopted more-efficient practices, and adjusted staffing levels commensurate with a shrinking base of internal customers requiring support services. Reserve Bank support and overhead costs, including national support services, decreased $68 million, or 6 percent, from 2003 to 2004.1 Over the same period, ANP associated with support and overhead areas declined 700, or 8 percent.2

Over the past several years, the Reserve Banks have consolidated their employee health and welfare plans, human resources information systems, and payroll-processing operations. These plans, systems, and operations previously were unique to each Bank and were managed and administered from each Reserve Bank head office. Although some of the consolidations are not yet complete, each has already generated significant cost savings. The savings resulting from staff reductions in support and overhead functions is expected to be $3.9 million when fully implemented in 2006. The savings resulting from lower vendor fees and

1. National support services include functions and projects managed by a Reserve Bank on behalf of the other Reserve Banks.
2. ANP is the number of employees during a year in terms of full-time positions.
Reserve Bank Services in a Changing Payments Market

More payments in the United States are now being made electronically than by check. The number of checks written annually peaked in the mid-1990s at around 50 billion. By 2003, the number was down to about 37 billion. In contrast, the number of payments made electronically via credit and debit cards, the automated clearing-house (ACH), and electronic benefit transfer cards was about 45 billion in 2003, up from approximately 15 billion in the mid-1990s.

The shift largely reflects a growing consumer and business preference for making payments electronically, particularly by debit card. It has also been spurred by the financial services industry through its use of new technologies, introduction of new products and services, and adoption of operating rules and standards that support the greater use of electronic payments. For example, recent industry rule changes have enabled businesses to use the information on a consumer’s check to transfer funds electronically using the ACH, a process now commonly known as check conversion.

The Federal Reserve has supported and helped facilitate this ongoing transition to a more-electronic payments system. Its Payments System Development Committee, chaired by Vice Chairman Roger Ferguson and Minneapolis Federal Reserve Bank President Gary Stern, has promoted a wide-ranging dialogue on improving the payments system by sponsoring several conferences and seminars and by conducting other outreach activities.

The Federal Reserve also worked with the financial services industry, the legal community, consumer and business representatives, and Congress to enact the Check Clearing for the 21st Century Act (Check 21), which facilitates (but does not mandate) the greater use of electronics in the processing of checks. The Board amended two of its regulations concerned with check processing (Regulations J and CC) to implement the law and has worked closely with the Reserve Banks and the industry to educate the public about the implications of Check 21 for consumers. The Board also clarified the application of the consumer protections in Regulation E to electronic payments made via check conversion.1

The ongoing shift to electronic payments has affected the Reserve Banks’ check-processing operations. The number of checks collected annually through the Banks has fallen nearly 20 percent since

from lower plan costs due to consolidation of health and welfare plans is expected to be $25 million in 2005.

The other significant initiative affecting Reserve Bank check operations in 2004 was the introduction of products, services, and associated infrastructure related to the Check Clearing for the 21st Century Act (Check 21), which took effect in October. Check 21 is intended to foster payments system innovation and to increase payments system efficiency by reducing legal impediments to check truncation.

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

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1999, to fewer than 14 billion in 2004. And the decline is accelerating, as the Banks processed 12 percent fewer checks in 2004 than in 2003. As a result, the revenue the Banks earn from providing check collection services to depository institutions has begun to decline. Over the past five years, the Banks also made a significant investment in modernizing and improving the longer-term efficiency of their check-processing operations.

This combination of market and business factors has challenged the Reserve Banks’ ability to meet the expectations of the Monetary Control Act of 1980 (MCA). The MCA requires that the Banks set fees for providing payment services (including check collection services) to depository institutions to recover, over the long run, all the direct, indirect, and imputed costs of providing the services, including the taxes that would have been paid and the return on equity that would have been earned had the services been provided by a private firm.

To better meet the MCA requirements, the Reserve Banks have undertaken a range of cost-reduction and revenue-generation initiatives as part of a long-term business strategy to facilitate the greater use of electronics in check processing. These initiatives have included streamlining management structures, reducing staffing levels, increasing productivity, and selectively raising fees. To better align their operations with a declining check market, the Banks also have begun to fundamentally restructure the location and nature of their national check-processing operations. The number of offices at which checks are processed was reduced from forty-five at the beginning of 2003 to thirty-two by the end of 2004. A further reduction, to twenty-three offices, will be completed in early 2006. As part of these changes, five regional sites dedicated solely to processing checks have been closed. Additional restructuring will occur in response to continued market changes in the use of checks.

Major improvements in the operational efficiency and productivity of Reserve Bank check-collection operations have resulted from these initiatives. The Cincinnati check-processing office, for example, now processes both its own usual volume and the checks previously processed at the Indianapolis, Louisville, and Charleston offices. The number of employees providing check-collection services has been reduced to approximately 4,000, about one-fourth fewer than in 1999 and the lowest level since enactment of MCA. Although the one-time charges associated with the restructuring efforts have been substantial, the costs of ongoing operations have decreased. As a result, the Reserve Banks expect to recover fully all the costs of providing check-collection services in 2005 and to continue to meet their broader statutory obligations over the longer term.

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). Over the past ten years, the Federal Reserve Banks have recovered 97.5 percent of their priced services costs, including the PSAF (table).

3. 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.
Priced Services Cost Recovery, 1995–2004
Millions of dollars except as noted

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue from services</th>
<th>Operating expenses and imputed costs</th>
<th>Targeted return on equity</th>
<th>Total costs</th>
<th>Cost recovery (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>765.2</td>
<td>752.7</td>
<td>31.5</td>
<td>784.2</td>
<td>97.6</td>
</tr>
<tr>
<td>1996</td>
<td>815.9</td>
<td>746.4</td>
<td>42.9</td>
<td>789.3</td>
<td>103.4</td>
</tr>
<tr>
<td>1997</td>
<td>818.8</td>
<td>752.8</td>
<td>54.3</td>
<td>807.1</td>
<td>101.5</td>
</tr>
<tr>
<td>1998</td>
<td>839.8</td>
<td>743.2</td>
<td>66.8</td>
<td>809.9</td>
<td>103.7</td>
</tr>
<tr>
<td>1999</td>
<td>867.6</td>
<td>775.7</td>
<td>57.2</td>
<td>832.9</td>
<td>104.2</td>
</tr>
<tr>
<td>2000</td>
<td>922.8</td>
<td>818.2</td>
<td>98.4</td>
<td>916.6</td>
<td>100.7</td>
</tr>
<tr>
<td>2001</td>
<td>960.4</td>
<td>901.9</td>
<td>109.2</td>
<td>1,011.1</td>
<td>95.0</td>
</tr>
<tr>
<td>2002</td>
<td>918.3</td>
<td>891.7</td>
<td>92.5</td>
<td>984.3</td>
<td>93.3</td>
</tr>
<tr>
<td>2003</td>
<td>881.7</td>
<td>931.3</td>
<td>104.7</td>
<td>1,036.1</td>
<td>85.1</td>
</tr>
<tr>
<td>2004</td>
<td>914.6</td>
<td>842.6</td>
<td>112.4</td>
<td>955.0</td>
<td>95.8</td>
</tr>
<tr>
<td>1995–2004</td>
<td>8,705.1</td>
<td>8,156.4</td>
<td>769.9</td>
<td>8,926.5</td>
<td>97.5</td>
</tr>
</tbody>
</table>

**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 $8,444.2 million and other income and expense (net) of $261.0 million.

Overall, the price index for priced services increased 6.7 percent from 2003. Revenue from priced services amounted to $865.9 million, other income related to priced services was $48.7 million, and costs related to priced services were $842.6 million, resulting in net income of $72.0 million. In 2004, the Reserve Banks recovered 95.8 percent of total costs of $955 million, including the PSAF.4

**Commercial Check Collection Service**

In 2004, operating expenses and imputed costs for the Reserve Banks’ commercial check collection service totaled $709.6 million, of which $45.3 million was attributable to the transportation of commercial checks between Reserve Bank check-processing centers. Revenue amounted to $719.7 million, of which $45.8 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was $40.5 million. The resulting net income was $50.5 million. Check service revenue in 2004 declined $22.3 million from 2003, largely because of declining volume and customers’ moving to lower-priced products.

The Reserve Banks handled 13.9 billion checks in 2004, a decrease of 12.0 percent from the 15.8 billion checks handled in 2003 (table). The decline in Reserve Bank check volume is consistent with nationwide trends (interest on debt, interest on float, sales taxes, and the Federal Deposit Insurance Corporation assessment), imputed income taxes, and the targeted return on equity.

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4. 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...
Activity in Federal Reserve Priced Services, 2002–2004

<table>
<thead>
<tr>
<th>Service</th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003 to 2004</td>
</tr>
<tr>
<td>Commercial check</td>
<td>13,904,382</td>
<td>15,805,894</td>
<td>16,586,804</td>
<td>−12.0</td>
</tr>
<tr>
<td>Funds transfer</td>
<td>128,270</td>
<td>125,936</td>
<td>117,133</td>
<td>1.9</td>
</tr>
<tr>
<td>Securities transfer</td>
<td>9,208</td>
<td>10,071</td>
<td>8,480</td>
<td>−8.6</td>
</tr>
<tr>
<td>Commercial ACH</td>
<td>6,486,091</td>
<td>5,588,381</td>
<td>4,986,152</td>
<td>16.1</td>
</tr>
<tr>
<td>Noncash</td>
<td>211</td>
<td>280</td>
<td>333</td>
<td>−24.7</td>
</tr>
</tbody>
</table>

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

away from the use of checks and toward greater use of electronic payment methods. Overall, the price index for check services increased 8.7 percent from 2003.

In response to the continuing decline in check volume, the Reserve Banks took further steps in 2004 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. In 2004, check-processing facilities were closed at some locations and the work moved to others. Checks that would have been processed in Miami are now processed in Jacksonvil


Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated
clearinghouse (ACH) services totaled $64.0 million in 2004. Revenue from ACH operations totaled $71.1 million and other income totaled $4.0 million, resulting in net income of $11.1 million. The Banks processed 6.5 billion commercial ACH transactions (worth $12.5 trillion), an increase of 16.1 percent from 2003. Overall, the price index for ACH services decreased 10.2 percent from 2003.

In 2004, the Reserve Banks began offering international ACH funds transfer service from the United States to Austria, Canada, Germany, Mexico, and the Netherlands. The Banks also offer service to Switzerland and the United Kingdom.

**Fedwire Funds and National Settlement Services**

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled $50.7 million in 2004. Revenue from these operations totaled $54.1 million, and other income amounted to $3.0 million, resulting in net income of $6.5 million.

**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 2004, the number of Fedwire funds transfers originated by depository institutions increased 1.9 percent from 2003, to approximately 128.3 million. In May, the Banks expanded the operating hours for the online service. The service is now open three and one-half hours earlier—at 9:00 p.m. eastern time the preceding calendar day rather than the previous opening time of 12:30 a.m.

Eastern time. The impetus for the expansion of operating hours was industry requests to achieve greater overlap of wholesale payments system operating hours in U.S. and 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 2004, the Reserve Banks processed slightly fewer than 435,000 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. Reserve Bank operating expenses and imputed costs for providing this service totaled $16.9 million in 2004. Revenue from the service totaled $19.3 million, and other income totaled $1.1 million, resulting in net income of $3.4 million. Approximately 9.2 million transfers of Treasury and other securities

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6. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. The Treasury Department assesses fees on depository institutions for some of the transfer, account maintenance, and settlement services for U.S. Treasury securities provided by the Reserve Banks. For details, see the section “Debt Services” later in this chapter.
were processed by the service during the year, a decrease of 8.6 percent from 2003. In 2004, the fee for securities transfers decreased from $0.40 to $0.32, and the surcharge for offline transfers increased from $25 to $28.

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 “noncash” items). The service, which is centralized at one Federal Reserve office, processed slightly less than 211,000 noncash transactions in 2004, representing a 24.7 percent decline in volume from 2003. Operating expenses and imputed costs for noncash operations totaled $1.4 million in 2004, and revenue and other income totaled $1.9 million, resulting in net income of $0.5 million. The fee for return items increased from $20 to $35.

In October, the Board requested comment on a proposal to withdraw from the noncash collection service at year-end 2005. The volume of coupons and bonds presented for collection is declining, a result of a continuing decline in the number of physical municipal securities outstanding since passage of the Tax Equity and Fiscal Responsibility Act of 1982, which removed tax advantages for investors and effectively led to the end of issuance of bearer municipal securities.

Float
The Federal Reserve had daily average credit float of $76.4 million in 2004, compared with $43.0 million in 2003.\(^7\)

The Federal Reserve includes the cost of or income from float associated with priced services as part of the fees for those services.

Developments in Currency and Coin
The Reserve Banks received 37.5 billion Federal Reserve notes from circulation in 2004, a 5.1 percent increase from 2003, and made payments of 37.9 billion notes into circulation, a 3.6 percent increase from 2003. They received 55.7 billion coins from circulation in 2004, a 15.6 percent increase from 2003, and made payments of 67.5 billion coins into circulation, a 9.8 percent increase from 2003.\(^8\)

In October 2004, the Reserve Banks began issuing the redesigned $50 Federal Reserve note, which has enhanced security features and subtle background colors. In connection with issuance of the new notes, the Federal Reserve and the Bureau of Engraving and Printing conducted a public education campaign to raise awareness of the note’s design and security features.

In 2003, the Board requested comments on a proposed cash-recirculation policy intended to change its cash-services policy to reduce overuse of Reserve Bank cash-processing services. Currently, many depository institutions order currency late in the week to meet temporary, cyclical demand and then return the currency to a Federal Reserve facility several days later to minimize their holdings of vault cash, which does not earn interest. The process repeats each week, and the Federal Reserve facility receiving the returned currency must process it each time. To test the effectiveness of a program that supports

\(^7\) Credit float occurs when the Reserve Banks receive settlement for items prior to providing credit to the depositing institution.

\(^8\) Percentages reflect restatements of previously reported data.
the proposed cash-recirculation policy, the Banks established eleven custodial inventory sites in 2004. Custodial inventories allow depository institutions to transfer a portion of their cash holdings to the books of a Reserve Bank and are intended to encourage depository institutions to recirculate fit currency rather than return it to the Federal Reserve for processing. The program will operate for six months, after which the Federal Reserve will evaluate the program’s effectiveness in promoting currency recirculation.

In 2004, the Federal Reserve also established a group to study the potential effects of the proposed cash-recirculation policy on the quality of currency in circulation. The group is working with the vending industry and manufacturers of currency-handling equipment to evaluate the importance of currency quality for their industries.

Developments in Fiscal Agency and Government Depository Services

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

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2004 amounted to $369.8 million, compared with $327.0 million in 2003 (table). Treasury-related costs were $341.4 million in 2004, compared with $291.7 million in 2003, an increase of 17 percent. The cost of providing services to other entities was $28.4 million, compared with $35.3 million in 2003. In 2004, as in 2003, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing these services.

The most significant development in relation to the fiscal agency service in 2004 was the Reserve Banks’ consolidation of operations that support the Treasury’s retail securities programs, through which retail investors purchase and hold marketable Treasury securities and savings bonds. As the Treasury replaced paper processes in retail securities with more-efficient electronic processes, fewer operations sites were needed. In December 2003, the Treasury directed the Banks to consolidate their retail securities operations from seven sites to two. The consolidation has proceeded ahead of schedule and should be completed late in 2005. The Banks expect that in 2006, annual operating costs for the retail securities operations will decline significantly because of lower personnel costs.

Debt Services

The Reserve Banks auction, provide safekeeping for, and transfer marketable Treasury securities. Reserve Bank operating expenses for these activities totaled $23.4 million in 2004, an 8.3 percent increase from 2003. The Banks processed more than 156,000 tenders for Treasury securities, compared with 140,000 in 2003, and handled 2 million reinvestment requests, compared with 2.2 million in 2003. The Banks originated 10.7 million transfers of Treasury securities in 2004, a 13.6 percent increase from 2003. As of December 31, 2004, the Reserve Banks’ Fedwire Securities Service maintained custody of $3.9 trillion (par value) of Treasury securities.
Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2002–2004

Thousands of dollars

<table>
<thead>
<tr>
<th>Department of the Treasury</th>
<th>2004</th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bureau of the Public Debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treasury retail securities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings bonds</td>
<td>72,385.1</td>
<td>66,403.7</td>
<td>68,888.3</td>
</tr>
<tr>
<td>TreasuryDirect and Treasury coupons</td>
<td>30,872.7</td>
<td>33,013.5</td>
<td>33,953.6</td>
</tr>
<tr>
<td>Treasury securities safekeeping and transfer</td>
<td>6,267.0</td>
<td>4,836.3</td>
<td>8,830.1</td>
</tr>
<tr>
<td>Treasury auction</td>
<td>17,159.5</td>
<td>16,802.6</td>
<td>14,597.6</td>
</tr>
<tr>
<td>Computer infrastructure development and support</td>
<td>5,935.1</td>
<td>7,836.7</td>
<td>2,349.6</td>
</tr>
<tr>
<td>Other services</td>
<td>1,709.8</td>
<td>1,460.7</td>
<td>2,385.8</td>
</tr>
<tr>
<td>Total</td>
<td>134,329.1</td>
<td>130,353.4</td>
<td>131,005.0</td>
</tr>
<tr>
<td>Financial Management Service</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government check processing</td>
<td>24,245.4</td>
<td>25,624.7</td>
<td>30,284.4</td>
</tr>
<tr>
<td>Automated clearinghouse</td>
<td>5,352.9</td>
<td>6,253.9</td>
<td>6,280.0</td>
</tr>
<tr>
<td>Fedwire funds transfers</td>
<td>111.6</td>
<td>187.3</td>
<td>201.4</td>
</tr>
<tr>
<td>Other payment-related services</td>
<td>33,646.9</td>
<td>23,630.8</td>
<td>20,172.1</td>
</tr>
<tr>
<td>Collection services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax and other revenue collections</td>
<td>34,248.4</td>
<td>29,782.9</td>
<td>26,361.3</td>
</tr>
<tr>
<td>Other collection-related services</td>
<td>12,922.8</td>
<td>12,532.6</td>
<td>10,296.4</td>
</tr>
<tr>
<td>Cash management services</td>
<td>21,835.8</td>
<td>18,227.8</td>
<td>17,310.8</td>
</tr>
<tr>
<td>Computer infrastructure development and support</td>
<td>52,673.3</td>
<td>24,575.3</td>
<td>7,592.6</td>
</tr>
<tr>
<td>Other services</td>
<td>6,931.6</td>
<td>6,666.2</td>
<td>5,415.8</td>
</tr>
<tr>
<td>Total</td>
<td>191,968.6</td>
<td>147,481.5</td>
<td>123,914.7</td>
</tr>
<tr>
<td>Other Treasury</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>15,106.1</td>
<td>13,913.5</td>
<td>14,471.2</td>
</tr>
<tr>
<td>Total, Treasury</td>
<td>341,403.7</td>
<td>291,748.5</td>
<td>269,390.9</td>
</tr>
<tr>
<td>Other Federal Agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Department of Agriculture</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food coupons</td>
<td>4,519.0</td>
<td>7,791.4</td>
<td>10,240.8</td>
</tr>
<tr>
<td>U.S. Postal Service</td>
<td>7,774.6</td>
<td>10,959.5</td>
<td>12,381.6</td>
</tr>
<tr>
<td>Other agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other services</td>
<td>16,104.0</td>
<td>16,508.2</td>
<td>16,494.1</td>
</tr>
<tr>
<td>Total, other agencies</td>
<td>28,397.5</td>
<td>35,259.2</td>
<td>39,116.5</td>
</tr>
<tr>
<td>Total reimbursable expenses</td>
<td>369,801.2</td>
<td>327,007.7</td>
<td>308,507.4</td>
</tr>
</tbody>
</table>

In support of the Treasury’s retail securities programs, the Reserve Banks operate TreasuryDirect, a program that allows retail investors to purchase and hold Treasury securities directly with the Treasury instead of through a broker. As the program was designed for investors who plan to hold their securities to maturity, TreasuryDirect provides custody services only. Reserve Bank operating expenses for TreasuryDirect totaled $30.9 million in 2004, compared with $33.0 million in 2003. In 2004, investors purchased 13.7 billion of Treasury securities through TreasuryDirect.

As of December 31, 2004, TreasuryDirect held $62.2 billion (par value) of marketable Treasury securities. TreasuryDirect customers may sell their securities for a fee through SellDirect, a program operated by one of the Reserve Banks. That Bank sold approximately 15,000 securities worth $673.3 million in 2004, compared with more than 14,000 securities worth $671.6 million in 2003. It collected approximately $504,000 in fees on behalf of the Treasury, an increase of 2.6 percent from the more than $491,000 in fees collected in 2003.
Reserve Bank operating expenses for issuing, servicing, and redeeming savings bonds totaled $72.4 million in 2004, an increase of 9 percent from 2003. The Banks printed and mailed more than 35 million savings bonds, an 11.4 percent decrease from 2003. They issued more than 4.2 million Series I (inflation indexed) bonds and 25.4 million Series EE bonds. Reissued or exchanged bonds accounted for the remaining bonds printed. The Banks processed about 601,000 redemption, reissue, and exchange transactions, a 5.8 percent increase from 2003.

Payments Services
The Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments totaled $63.4 million in 2004, compared with $55.7 million in 2003. The Banks processed 940 million ACH payments for the Treasury, an increase of 3.0 percent from 2003, and 876,000 Fedwire funds transfers, a decrease of 11.5 percent from 2003 (the latter percentage reflects a restatement of previously reported data). They also processed 234.1 million paper government checks, a decline of 12.3 percent from 2003. In addition, the Banks issued more than 278,000 fiscal agency checks, a decrease of 10.4 percent from 2003.

In addition to processing payments, the Reserve Banks operate programs to help the Treasury increase the use of electronic payments. They operate a program that enables recipients of federal grants to request payments using the Internet. This application, the Automated Standard Application for Payment, processed $404.7 billion in Fedwire funds transfers and ACH payments in 2004, compared with $384.2 billion in 2003. The Banks also operate Treasury’s stored value card program, which provides salary and allowance payments to military personnel, via a smart card, for use at military bases. In 2004, the Banks worked with the Treasury on plans for a web-based application to allow federal agencies and vendors to electronically exchange purchase orders and invoices and initiate ACH payments. The operating costs for these three programs totaled $15.4 million in 2004, compared with $14.3 million in 2003.

Collection Services
The Reserve Banks support several Treasury programs to collect funds owed the government. Reserve Bank operating expenses related to these programs totaled $47.2 million in 2004, compared with $42.3 million in 2003. The Banks operate the Federal Reserve Electronic Tax Application (FR-ETA) as an adjunct to the Treasury’s Electronic Federal Tax Payment System (EFTPS). EFTPS allows businesses and individual taxpayers to pay their taxes electronically. Because EFTPS uses the automated clearinghouse to collect funds, tax payments must be scheduled at least one day in advance. Some business taxpayers, however, do not know their tax liability until the tax due date. FR-ETA, for wire payments, allows these taxpayers to use EFTPS by providing a same-day electronic federal tax payment alternative. FR-ETA collected $344.8 billion for the Treasury in 2004, compared with $275.8 billion in 2003.

The Reserve Banks also operate Pay.gov, a Treasury program that allows members of the public to make payments to the federal government over the Internet. They also operate the Treasury’s Paper Check Conversion and Electronic Check Processing programs, whereby checks written to government
agencies are converted at the point of sale or at lockbox locations into automated clearnghouse transactions. In 2004, the Reserve Banks originated more than 1.9 million ACH transactions through these programs, a 58.3 percent increase from the 1.2 million originated in 2003.

Cash Management Services
The Treasury maintains its bank account at the Reserve Banks and invests the funds it does not need for making current payments with qualified depository institutions through the Treasury Tax and Loan (TT&L) program, which the Reserve Banks operate. Reserve Bank operating expenses related to this program totaled $21.8 million in 2004, compared with $18.2 million in 2003. The investments either are callable on demand or are for a set term. In 2004, the Reserve Banks placed a total of $17.1 billion in immediately callable investments. The rate for term investments is set at Term Investment Option (TIO) auctions; the Reserve Banks held 45 TIO auctions in 2004, placing $309 billion in term investments, compared with 12 auctions placing $66 billion in 2003. In 2004, the Treasury’s investment income, which comes from the TT&L program, was $87 million.

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. The majority of the work is securities-related.

Electronic Access
In November 2004, the Reserve Banks announced the general availability of FedLine Advantage, the next-generation platform for providing PC-based electronic access to Federal Reserve financial services. The new platform uses web technology to provide financial institutions with more-efficient access to such payments services as the Fedwire Funds Service, the Fedwire Securities Service, and FedACH Services. To complement the transition to web-based electronic access, the Reserve Banks completed consolidation of the electronic-access customer support function to two offices. The consolidation will improve the efficiency and consistency of customer support.

Information Technology
In 2004, the Federal Reserve Banks completed an initiative to standardize desktop hardware and software across Banks. In addition to reducing costs over the long term, the standardization is expected to facilitate interoperability, increase productivity, and improve the Federal Reserve’s ability to respond to cyber security threats. Projects are now under way to standardize local area network components and telephone private branch exchange systems and to implement reduced-cost wide area network telecommunications services.

In partnership with the agencies that make up the Financial and Banking Information Infrastructure Committee, the Federal Reserve continued in 2004 to sponsor clearing and settlement utilities, key financial institutions, and key market participants in the national security/emergency preparedness programs offered by the Department of Homeland Security’s National Communications System, which coordinates the preparedness of critical telecommunications services to meet natural disasters and national emergencies. During the year, the Federal Reserve participated in
the President’s National Security Telecommunications Advisory Committee Financial Services Task Force, which in April 2004 released a report on network resilience in support of critical financial services. The Reserve Banks are currently 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. In 2004, the Reserve Banks enhanced their assessments under the COSO framework, strengthening the key control assertion process, consistent with the requirements of the Sarbanes–Oxley Act of 2002. 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.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $2.0 million. To ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve 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 2004 the Reserve Banks did not engage PwC for non-audit services other than a training session at one Reserve Bank that was obtained at a rate available to the general public.

The Board’s annual examination of the Reserve Banks includes 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 2004 examinations also included assessing the efficiency and effectiveness of the internal audit function. To assess compliance with the policies established by the Federal Reserve’s Federal Open Market Committee (FOMC), the division also reviews the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, PwC audits the schedule of participated asset and liability accounts and the related schedule of participated
Income, Expenses, and Distribution of Net Earnings of the Federal Reserve Banks, 2004 and 2003

 Millions of dollars

<table>
<thead>
<tr>
<th>Item</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current income</td>
<td>23,540</td>
<td>23,793</td>
</tr>
<tr>
<td>Current expenses</td>
<td>2,239</td>
<td>2,463</td>
</tr>
<tr>
<td>Operating expenses(^1)</td>
<td>2,123</td>
<td>2,342</td>
</tr>
<tr>
<td>Earnings credits granted</td>
<td>116</td>
<td>121</td>
</tr>
<tr>
<td>Current net income</td>
<td>21,301</td>
<td>21,330</td>
</tr>
<tr>
<td>Net additions to (deductions from, (\text{=}) current net income</td>
<td>918</td>
<td>2,481</td>
</tr>
<tr>
<td>Assessments by the Board of Governors</td>
<td>776</td>
<td>805</td>
</tr>
<tr>
<td>For expenditures of Board</td>
<td>272</td>
<td>297</td>
</tr>
<tr>
<td>For cost of currency</td>
<td>504</td>
<td>508</td>
</tr>
<tr>
<td>Net income before payments to Treasury</td>
<td>21,443</td>
<td>23,006</td>
</tr>
<tr>
<td>Dividends paid</td>
<td>582</td>
<td>518</td>
</tr>
<tr>
<td>Transferred to surplus</td>
<td>2,783</td>
<td>467</td>
</tr>
<tr>
<td>Payments to Treasury(^2)</td>
<td>18,078</td>
<td>22,022</td>
</tr>
</tbody>
</table>

1. Includes a net periodic pension credit of $37 million in 2004 and net periodic pension costs of $58 million in 2003.

2. Interest on Federal Reserve notes.

... income accounts at year-end. The FOMC receives the external audit reports and the report on the division’s examination.

**Income and Expenses**

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 2003 and 2004.

Income in 2004 was $23,540 million, compared with $23,793 million in 2003. Expenses totaled $3,015 million ($2,123 million in operating expenses, $116 million in earnings credits granted to depository institutions, $272 million in assessments for expenditures by the Board of Governors, and $504 million for the cost of new currency). Revenue from priced services was $866 million. The profit and loss account showed a net profit of $918 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 $582 million, $64 million more than in 2003; 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 $18,078 million in 2004, down from $22,022 million in 2003; 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 2004 and table 6 shows a condensed statement for each Bank for the years 1914 through 2004. A detailed account of the assessments and expenditures of the Board of Governors appears in the section “Board of Governors Financial Statements.”
Securities and Loans of the Federal Reserve Banks, 2002–2004

Millions of dollars except as noted

<table>
<thead>
<tr>
<th>Item and year</th>
<th>Total</th>
<th>U.S. government securities</th>
<th>Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average daily holdings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>621,834</td>
<td>621,721</td>
<td>113</td>
</tr>
<tr>
<td>2003</td>
<td>683,438</td>
<td>683,294</td>
<td>144</td>
</tr>
<tr>
<td>2004</td>
<td>719,647</td>
<td>719,494</td>
<td>153</td>
</tr>
<tr>
<td>Earnings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>25,527</td>
<td>25,525</td>
<td>2</td>
</tr>
<tr>
<td>2003</td>
<td>22,598</td>
<td>22,597</td>
<td>1</td>
</tr>
<tr>
<td>2004</td>
<td>22,347</td>
<td>22,344</td>
<td>3</td>
</tr>
<tr>
<td>Average interest rate (percent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>4.11</td>
<td>4.11</td>
<td>1.94</td>
</tr>
<tr>
<td>2003</td>
<td>3.31</td>
<td>3.31</td>
<td>1.00</td>
</tr>
<tr>
<td>2004</td>
<td>3.11</td>
<td>3.11</td>
<td>1.74</td>
</tr>
</tbody>
</table>

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.

Holdings of Securities and Loans
The Federal Reserve Banks’ average daily holdings of securities and loans during 2004 amounted to $719,647 million, an increase of $36,209 million from 2003 (table). Holdings of U.S. government securities increased $36,200 million, and holdings of loans increased $9 million. The average rate of interest earned on the Reserve Banks’ holdings of government securities declined to 3.11 percent, from 3.31 percent in 2003, and the average rate of interest earned on loans increased to 1.74 percent, from 1.00 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 2001 through 2004.

Federal Reserve Bank Premises
In 2004, construction continued on the new buildings for the Dallas Federal Reserve Bank’s Houston Branch and the Chicago Bank’s Detroit Branch.

Security enhancement programs prompted by the events of September 11, 2001, continue at several facilities. One such project is an ongoing external perimeter security improvement project at the Boston Bank that involves restoration of the Bank’s property after recently completed construction of the Central Artery, an underground roadway.

The Kansas City Bank purchased property and retained design and construction consultants for its new headquarters building project. The Board approved the project’s schematic design, and work continues on the final design. The Board approved the St. Louis Bank’s purchase of a building to be renovated as a business-continuity relocation facility.

The Richmond Bank purchased and renovated a building as a relocation site for critical staff. Design work on additional security improvements continued.

The Dallas Bank continues to pursue the purchase of property behind its head-
quarters building for the construction of a remote vehicle screening and shipping/receiving facility.

As part of its long-term facility redevelopment program, the St. Louis Bank purchased and renovated a parking garage for staff parking and a warehouse for remote screening of deliveries. The Bank retained design consultants for expansion of the Bank’s headquarters building, and design work began.

The San Francisco Bank retained design and construction consultants for the new Seattle Branch building and finalized an agreement to purchase property for the new building. Design work has begun.

The multiyear renovation program continued at the New York Bank’s headquarters building.

Several Banks continue to implement facility renovation projects to accommodate the consolidation of check activities.

Agreements were reached in 2004 to sell the buildings housing the New York Bank’s Buffalo Branch, the St. Louis Bank’s Louisville Branch, and the Chicago Bank’s Milwaukee facility. Administration activities for the Buffalo and Louisville Branches will be moved to leased space.
Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2004 and 2003

Millions of dollars

<table>
<thead>
<tr>
<th>Item</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Short-term assets (Note 1)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imputed reserve requirements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>on clearing balances</td>
<td>1,115.7</td>
<td>1,296.4</td>
</tr>
<tr>
<td>Imputed investments</td>
<td>9,691.9</td>
<td>11,332.5</td>
</tr>
<tr>
<td>Receivables</td>
<td>75.8</td>
<td>77.1</td>
</tr>
<tr>
<td>Materials and supplies</td>
<td>1.9</td>
<td>2.3</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>31.8</td>
<td>35.6</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>6,107.1</td>
<td>5,271.9</td>
</tr>
<tr>
<td><strong>Total short-term assets</strong></td>
<td>17,024.1</td>
<td>18,015.8</td>
</tr>
<tr>
<td><strong>Long-term assets (Note 2)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premises</td>
<td>471.8</td>
<td>494.6</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>152.8</td>
<td>179.4</td>
</tr>
<tr>
<td>Leases, leasehold improvements, and long-term prepayments</td>
<td>107.9</td>
<td>103.2</td>
</tr>
<tr>
<td>Prepaid pension costs</td>
<td>795.4</td>
<td>787.9</td>
</tr>
<tr>
<td><strong>Total long-term assets</strong></td>
<td>1,528.0</td>
<td>1,565.1</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>18,552.1</td>
<td>19,580.9</td>
</tr>
<tr>
<td><strong>Short-term liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Clearing balances and balances arising from early credit of uncollected items</td>
<td>11,909.5</td>
<td>11,788.1</td>
</tr>
<tr>
<td>Deferred-availability items</td>
<td>5,354.3</td>
<td>6,448.3</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>.0</td>
<td>.0</td>
</tr>
<tr>
<td>Short-term payables</td>
<td>92.2</td>
<td>78.1</td>
</tr>
<tr>
<td><strong>Total short-term liabilities</strong></td>
<td>17,355.9</td>
<td>18,314.4</td>
</tr>
<tr>
<td><strong>Long-term liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt</td>
<td>.0</td>
<td>.0</td>
</tr>
<tr>
<td>Postretirement/postemployment benefits obligation</td>
<td>268.6</td>
<td>287.5</td>
</tr>
<tr>
<td><strong>Total long-term liabilities</strong></td>
<td>268.6</td>
<td>287.5</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>17,624.5</td>
<td>18,601.9</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td>927.6</td>
<td>979.0</td>
</tr>
<tr>
<td><strong>Total liabilities and equity (Note 3)</strong></td>
<td>18,552.1</td>
<td>19,580.9</td>
</tr>
</tbody>
</table>

**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, 2004 and 2003

**Millions of dollars**

<table>
<thead>
<tr>
<th>Item</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from services provided to depository institutions (Note 4)</td>
<td>865.9</td>
<td>886.9</td>
</tr>
<tr>
<td>Operating expenses (Note 5)</td>
<td>800.6</td>
<td>941.6</td>
</tr>
<tr>
<td>Income from operations</td>
<td>65.3</td>
<td>−54.7</td>
</tr>
<tr>
<td>Imputed costs (Note 6)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on float</td>
<td>−1.1</td>
<td>−7.7</td>
</tr>
<tr>
<td>Interest on debt</td>
<td>11.6</td>
<td>12.1</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>11.4</td>
<td>11.4</td>
</tr>
<tr>
<td>FDIC insurance</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Income from operations after imputed costs</td>
<td>53.8</td>
<td>−66.1</td>
</tr>
<tr>
<td>Other income and expenses (Note 7)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>156.8</td>
<td>108.0</td>
</tr>
<tr>
<td>Earnings credits</td>
<td>−108.1</td>
<td>−113.2</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>102.5</td>
<td>−71.3</td>
</tr>
<tr>
<td>Imputed income taxes (Note 6)</td>
<td>30.6</td>
<td>−21.7</td>
</tr>
<tr>
<td>Net income</td>
<td>72.0</td>
<td>−49.6</td>
</tr>
<tr>
<td><strong>Memo: Targeted return on equity (Note 6)</strong></td>
<td>112.4</td>
<td>104.7</td>
</tr>
</tbody>
</table>

**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, 2004

**Millions of dollars**

<table>
<thead>
<tr>
<th>Item</th>
<th>Total</th>
<th>Commercial check collection</th>
<th>Fedwire funds</th>
<th>Fedwire securities</th>
<th>Commercial ACH</th>
<th>Noncash services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from services (Note 4)</td>
<td>865.9</td>
<td>719.7</td>
<td>54.1</td>
<td>19.3</td>
<td>71.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Operating expenses (Note 5)</td>
<td>800.6</td>
<td>678.5</td>
<td>47.2</td>
<td>15.2</td>
<td>58.6</td>
<td>1.2</td>
</tr>
<tr>
<td>Income from operations</td>
<td>65.3</td>
<td>41.2</td>
<td>6.9</td>
<td>4.1</td>
<td>12.5</td>
<td>.6</td>
</tr>
<tr>
<td>Imputed costs (Note 6)</td>
<td>11.4</td>
<td>9.7</td>
<td>7</td>
<td>3</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Income from operations after imputed costs</td>
<td>53.8</td>
<td>31.4</td>
<td>6.2</td>
<td>3.8</td>
<td>11.8</td>
<td>.6</td>
</tr>
<tr>
<td>Other income and expenses, net (Note 7)</td>
<td>48.7</td>
<td>40.5</td>
<td>3.0</td>
<td>1.1</td>
<td>4.0</td>
<td>.1</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>102.5</td>
<td>71.9</td>
<td>9.2</td>
<td>4.9</td>
<td>15.8</td>
<td>.7</td>
</tr>
<tr>
<td>Imputed income taxes (Note 6)</td>
<td>30.6</td>
<td>21.4</td>
<td>2.8</td>
<td>1.4</td>
<td>4.7</td>
<td>.2</td>
</tr>
<tr>
<td>Net income</td>
<td>72.0</td>
<td>50.5</td>
<td>6.5</td>
<td>3.4</td>
<td>11.1</td>
<td>.5</td>
</tr>
<tr>
<td><strong>Memo: Targeted return on equity (Note 6)</strong></td>
<td>112.4</td>
<td>93.6</td>
<td>6.8</td>
<td>2.9</td>
<td>8.9</td>
<td>.2</td>
</tr>
</tbody>
</table>

**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 a portfolio of investments, shown as imputed investments. For 2003, imputed investments were assumed to be three-month Treasury bills.

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 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 a credit to expenses of $7.5 million in 2004 and expenses of $21.3 million in 2003 and a corresponding increase and decrease in this asset account.

(3) Liabilities and Equity

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

Equity is imputed at 5 percent of total assets based on the Federal Deposit Insurance Corporation’s definition of a well-capitalized institution for deposit insurance premium purposes.

(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 $7.6 million in 2004 and $6.4 million in 2003. 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 2004 and 2003 as follows (in millions):

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check</td>
<td>33.5</td>
<td>38.9</td>
</tr>
<tr>
<td>ACH</td>
<td>3.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Fedwire funds</td>
<td>25</td>
<td>2.1</td>
</tr>
<tr>
<td>Fedwire securities</td>
<td>1.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Noncash services</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>40.8</td>
<td>45.5*</td>
</tr>
</tbody>
</table>

(6) Imputed Costs

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

Interest is imputed on the debt assumed necessary to finance priced-service assets; however, no debt was

*Restatement of previously reported total.
imputed in 2004 or 2003. The sales taxes and FDIC assessment that the Federal Reserve would have paid had been a private-sector firm are also among the components of the PSAF.

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.

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses 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 2004 in millions of dollars:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total float</td>
<td>−13.5</td>
</tr>
<tr>
<td>Unrecovered float</td>
<td>19.4</td>
</tr>
<tr>
<td>Float subject to recovery</td>
<td>−33.0</td>
</tr>
<tr>
<td>Sources of recovery of float</td>
<td></td>
</tr>
<tr>
<td>Income on clearing balances</td>
<td>−3.3</td>
</tr>
<tr>
<td>As-of adjustments</td>
<td>−62.8</td>
</tr>
<tr>
<td>Direct charges</td>
<td>823.4</td>
</tr>
<tr>
<td>Per-item fees</td>
<td>−915.9</td>
</tr>
</tbody>
</table>

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 2004.

(7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2004 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. For 2003, the investment income is based on the yield of the three-month Treasury bill. In both years, the return is 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 a discounted average coupon-equivalent yield on three-month Treasury bills in 2004 and the average federal funds rate in 2003 to the required portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.
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 Congress and outside stakeholders, a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not covered by the act, the Board of Governors is voluntarily complying with many of the act’s mandates.

Strategic Plan, Performance Plan, and Performance Report

The Board’s latest strategic plan in the GPRA format, released in August 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 plan and the 2002–03 performance report were posted on the Board’s public website in August 2004 for access by Congress, the public, and the Government Accountability Office (formerly the General Accounting Office). The performance plan sets forth specific targets for some of the performance measures identified in the strategic plan. The performance plan also describes the operational processes and resources needed to meet those targets and discusses data validation and verification of results. The performance report indicates that the Board generally met its explicit goals for 2002–03.

The strategic plan, performance plan, and performance report are available on the Board’s public website [www.federalreserve.gov/boarddocs/]. The Board’s mission statement and a summary of the goals and objectives set forth in the strategic plan and performance plan 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 U.S. Department of the Treasury and other agencies.
• Promote an 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 supervision 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 provide high-quality professional oversight of Reserve Banks

Objective
• Produce high-quality assessments of Federal Reserve Bank operations, projects, and initiatives to help Federal Reserve management foster and strengthen sound internal control systems and efficient and effective performance.
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. Support and assist the Board in overseeing U.S. dollar payment and securities settlement systems against relevant policy objectives and standards.
- Conduct research and analysis that contributes to policy development and increases the Board’s and others’ understanding of payment system dynamics and risk.

Interagency Coordination
Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As mandated by GPRA 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 of activities with the U.S. Department of the Treasury and other agencies is evident throughout both the strategic plan and the performance plan. Given the degree of similarity in the agencies’ missions and the existence of the Federal Financial Institutions Examination Council (FFIEC), the most formal coordination effort has occurred jointly with the other depository institution regulatory agencies. In addition, a coordinating committee of the depository institution regulatory agencies was created to address and report on issues of mutual concern. This interagency working group has been meeting since June 1997 to work on issues related to those general goals and objectives that cross agency functions, programs, and activities. Whether interagency coordination was effected through the FFIEC, the coordinating group, or interaction between agency staff, the results have been positive—resulting in improved planning for the agencies and substantial benefits to the public.

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 Proposals

In 2004, the Board of Governors proposed and supported a number of legislative initiatives that would reduce regulatory burden on financial institutions and benefit consumers without undermining the safety and soundness of insured depository institutions, consumer protection, or other important public policy principles, such as the principle of competitive fairness. The Board recommended that Congress adopt legislation that, among other things, would remove restrictions on the payment of interest on balances held at Federal Reserve Banks and on demand deposits. The Board also recommended that Congress adopt legislation that would give the Board greater flexibility in setting reserve requirements for depository institutions and would ease restrictions on interstate branching by banks. These proposals are summarized below.

Interest on Depository Institution Balances Held at Federal Reserve Banks
The Board is obliged by law to establish reserve requirements for certain deposits held at depository institutions, for the purpose of implementing monetary policy. Banks, thrift institutions, and credit unions may satisfy their reserve requirements by holding vault cash, a balance in an account at a Federal Reserve Bank, or a combination thereof. Unnecessary restrictions on the payment of interest on balances at Reserve Banks could distort market prices and lead to economically wasteful efforts to circumvent the restrictions. The payment of interest on balances at Reserve Banks would remove a substantial portion of the incentive for depository institutions to engage in avoidance measures, and the resulting improvements in efficiency could be expected to eventually be passed through to bank borrowers and depositors. When depository institutions keep their balances at Reserve Banks as low as possible to minimize the cost of holding these non-interest-bearing assets, their actions could lead to volatility in the federal funds rate. Payment of interest on balances at Reserve Banks could help eliminate the need for these actions and help ensure that the Federal Reserve can continue to implement monetary policy using existing procedures. The Board therefore recommended legislation that explicitly authorizes the payment of interest on balances held by depository institutions at Federal Reserve Banks.

Interest on Demand Deposits
The Board restated in 2004 its longstanding recommendation that Congress repeal the statutory prohibition against the payment of interest on demand deposits. Since the advent of NOW accounts, the prohibition has effectively applied only to checking accounts held by businesses and other for-profit entities. At the time it enacted the Depression-era legislation, Congress was concerned that large money center banks were bidding deposits away from smaller community banks to make loans to stock market speculators, depriving rural areas of financing. This rationale no longer appears applicable, as funds flow freely around the country and among banks of all sizes to find the
most profitable lending opportunities. The prohibition against the payment of interest on demand deposits distorts the pricing of transaction deposits and associated bank services; to compete for businesses’ liquid assets, banks have set up complicated procedures for implicitly paying interest. The prohibition also distorts the pricing of other bank products. Because banks cannot pay explicit interest on demand deposits, they often try to attract those deposits by pricing other bank services below their actual cost. When services are offered below cost, they tend to be overused to the extent that the benefits of consuming them are less than the costs to society of producing them.

The prohibition against the payment of interest on demand deposits has also led to the introduction of deposit “sweep” services, which permit institutions and their customers to avoid the prohibition’s effects to a large extent. Banks spend resources—and charge fees—for nightly sweeping businesses’ excess demand deposits into money market investments. The progress of computer technology has reduced the cost of sweep services, but the expenses are not trivial, particularly when systems must be upgraded or the diverse systems of merging banks must be integrated. From the standpoint of the overall economy, such expenses are a waste of resources and would be unnecessary if the payment of interest on demand deposits was allowed.

Depository Institution Reserve Requirements

The Federal Reserve Act requires that banks and other depository institutions maintain reserves against certain types of deposit accounts, also for the purpose of implementing monetary policy. Currently, the Board is constrained in its flexibility to adjust reserve requirements: By law, the ratio of required reserves to transaction account deposits above a certain level must be set between 8 percent and 14 percent. The Board in 2004 supported a legislative proposal to increase the range within which it may set transaction account reserve requirements, so that it could lower the requirements to zero percent if, at some point in the future, the Board believes it in the best interests of monetary policy to do so. Lower reserve requirement ratios could be possible if explicit statutory authority to pay interest on balances held by depository institutions at Federal Reserve Banks were to be granted concurrently with greater flexibility in setting reserve requirements.

Interstate Branching

Currently, national and state banks are permitted to expand into additional states through the acquisition of another bank. However, if they do not acquire another bank, they may open a branch in an additional state only if the host state has adopted legislation that expressly permits de novo interstate branching (an “opt-in requirement”). As of 2004, only eighteen states had enacted legislation expressly authorizing interstate branching.

The restriction on de novo branching is an obstacle to interstate banking, particularly for small banks that seek to operate across state lines, and may limit competition and access to banking services. Branch entry into new markets leads to less concentration in local banking markets, which in turn results in better banking services for households and small businesses, lower interest rates on loans, and higher interest rates on deposits. Allowing banks to operate freely across state lines also benefits
customers as they become more mobile and live, work, and operate in multiple states. The restriction also places banks at a competitive disadvantage in relation to federal savings associations, which are allowed to open de novo branches in any state.

In light of the benefits, the Board recommended that Congress eliminate the opt-in requirement for interstate branching by banks and affirmatively authorize national and state banks to establish interstate branches on a de novo basis. Under the Board’s proposal, the establishment and operation of new interstate branches by banks would continue to be subject to the other regulatory provisions and conditions established by Congress for de novo interstate branches, including the financial, managerial, and Community Reinvestment Act requirements set forth in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

A special exception in existing law allows companies to own an FDIC-insured industrial loan company (ILC) without being subject to the type of consolidated supervision and activities restrictions generally applicable to the owners of insured banks. The number, size, and powers of ILCs generally were limited when the ILC exception was adopted in 1987; however, the number and size of ILCs operating under this exception recently have increased significantly, and some states have granted ILCs essentially all the powers of commercial banks.

If legislative changes were to permit ILCs to branch de novo on an interstate basis, companies that are not supervised or regulated on a consolidated basis would be able to operate a nationwide banking institution. Such a result would be inconsistent with the basis on which the exception for ILCs initially was granted—that the activities of these institutions were, and would remain, limited in scope. In addition, allowing companies to own an ILC that operates a nationwide banking franchise without being subject to the type of consolidated supervision generally required of the owners of other insured banks would raise significant safety and soundness concerns and place commercial banks and their owners at a substantial competitive disadvantage. Moreover, because any type of firm, including a commercial or retail firm, may own an ILC, permitting these institutions to branch de novo nationwide has the potential to undermine seriously the separation of banking and commerce.

For these reasons, the Board’s proposal would require the owners of ILCs that establish interstate branches to operate within the same supervisory regime that generally applies to other companies that own insured banks. Importantly, the Board’s proposal would not alter the rights of companies that own ILCs that continue to operate on a limited basis.