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*Federal Reserve Operations*

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## *Banking Supervision and Regulation*

The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of financial institutions and the stability of the financial markets.

In 2005, U.S. banking organizations reported record earnings and maintained strong asset quality. However, banking organizations also faced some challenges during the year. Throughout the year, a flattening yield curve placed pressure on bank net interest margins, necessitating adjustments to balance-sheet positions and interest-rate risk management strategies at many institutions. In September, banking organizations in several Gulf Coast states faced extraordinary challenges in the aftermath of Hurricanes Katrina and Rita. For the most part, the banking organizations supervised by the Federal Reserve in the affected areas resumed operations expeditiously. The Federal Reserve and the other federal banking agencies encouraged banking organizations to be flexible in responding to the needs of borrowers and other customers in communities and regions affected by the disasters. At year-end, the ramifications of the hurricanes on banking organizations had not been fully quantified. The federal banking agencies continue to work with the banking organizations in the affected regions as they deal with the after-effects of the storms.

During the latter half of the year, personal bankruptcy filings rose sharply as a result of consumers accelerating their filings before the effective date

of the 2005 amendments to the Bankruptcy Code. These filings temporarily increased loan losses—particularly within credit card portfolios—but had little effect on the industry's sound loan quality. The number of consumer bankruptcy filings is expected to diminish in 2006.

Rapid growth in home equity lines of credit, nontraditional residential mortgages, and commercial real estate loans raised some supervisory concerns in 2005 and led the federal banking agencies to issue or propose guidance on sound risk-management practices for these lines of business. Nevertheless, delinquencies in these and most other loan segments remained low, and nonperforming asset ratios reached very low levels during the year.

While banks and supervisors have traditionally ranked credit and market risks as top concerns, in recent years these risks often have been overshadowed by compliance and other operational risks. Some of the largest banking organizations have experienced rapid growth and significantly expanded their products and services, heightening supervisory concern about whether these organizations' compliance risk management practices are keeping pace. One significant area of concern for supervisors is compliance with anti-money-laundering laws and regulations. In 2005, the Federal Reserve, in conjunction with the other federal banking agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), issued the *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual* to help strengthen

enforcement of these laws and further promote consistent examination approaches among supervisors.

Federal Reserve staff continue to devote considerable effort to revising domestic and international capital standards. In 2006, the U.S. banking agencies expect to issue a notice of proposed rulemaking (NPR) setting forth their views and seeking public comment with respect to the U.S. implementation of the Basel II capital accord, an international agreement among banking supervisors that was issued in June 2004.<sup>1</sup> The Federal Reserve is also working with the other federal banking agencies to develop supervisory guidance for both examiners and the banking industry.

The U.S. banking organizations expect that only a small number of large, internationally active U.S. banking organizations will be subject to the Basel II framework. The vast majority of banking organizations are expected to remain on the existing risk-based capital framework (Basel I). To update Basel I and mitigate some of the consequences of the differences between Basel I and Basel II, the federal banking agencies in October jointly published an advance notice of proposed rulemaking that contains proposed revisions to Basel I that would enhance its risk sensitivity.

### **Scope of Responsibilities for Supervision and Regulation**

The Federal Reserve is the federal supervisor and regulator of all U.S. bank

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1. The agreement, titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," was developed by the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of thirteen countries. The November 2005 updated version is available on the web site of the Bank for International Settlements ([www.bis.org](http://www.bis.org)).

holding companies, including financial holding companies formed under the authority of the 1999 Gramm-Leach-Bliley Act, and 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.<sup>2</sup>

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

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system and the structure of the system through its administration of the Bank Holding Company Act, the Bank Merger Act (with regard to state member banks), the Change in Bank Control Act (with regard to bank holding companies and state member banks), and the International Banking Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with the other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

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2. 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.

## Supervision for Safety and Soundness

To promote 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. Preexamination planning and on-site review of operations are integral parts of the overall effort to ensure the safety and soundness of banking organizations. Whether an examination or an inspection is being conducted, the review of operations 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

State Member Banks and Holding Companies, 2001–2005

Entity/Item	2005	2004	2003	2002	2001
<i>State member banks</i>					
Total number	907	919	935	949	970
Total assets (billions of dollars)	1,318	1,275	1,912	1,863	1,823
Number of examinations	783	809	822	814	816
By Federal Reserve System	563	581	581	550	561
By state banking agency	220	228	241	264	255
<i>Top-tier bank holding companies</i>					
<i>Large (assets of more than \$1 billion)</i>					
Total number	394	355	365	329	312
Total assets (billions of dollars)	10,261	8,429	8,295	7,483	6,905
Number of inspections	501	500	454	439	413
By Federal Reserve System <sup>1</sup>	496	491	446	431	409
On site	457	440	399	385	372
Off site	39	51	47	46	37
By state banking agency	5	9	8	8	4
<i>Small (assets of \$1 billion or less)</i>					
Total number	4,760	4,796	4,787	4,806	4,816
Total assets (billions of dollars)	890	852	847	821	768
Number of inspections	3,420	3,703	3,453	3,726	3,486
By Federal Reserve System	3,233	3,526	3,324	3,625	3,396
On site <sup>2</sup>	170	186	183	264	730
Off site	3,063	3,340	3,141	3,361	2,666
By state banking agency	187	177	129	101	90
<i>Financial holding companies</i>					
Domestic	591	600	612	602	567
Foreign	38	36	32	30	23

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.

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

To manage the supervisory process, the Federal Reserve follows a risk-focused approach that seeks to focus supervisory resources 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. The key features of the supervision program for large complex banking organizations (LCBOs) 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 so that the Federal Reserve's assessment of each organization's condition is current, (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 System-wide and interagency information-sharing through automated systems.

For other banking organizations, the risk-focused supervision program provides that examination procedures should be tailored to each bank's size, complexity, and risk profile. Examinations entail both off-site and on-site work, including planning, pre-examination visits, detailed documentation, and examination reports tailored to the scope and findings of the examination.

### *State Member Banks*

At the end of 2005, 907 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, although certain well-capitalized, well-managed organizations having assets of less than \$250 million may be examined once every eighteen months. The Federal Reserve conducted 563 exams of state member banks in 2005.

### *Bank Holding Companies*

At year-end 2005, a total of 5,860 U.S. bank holding companies were in operation, of which 5,154 were top-tier bank holding companies. These organizations controlled 6,160 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.<sup>3</sup> The program permits a more flexible approach to the supervision of these companies. In 2005, the Federal Reserve conducted 496 inspections of large bank holding companies and 3,233 inspections of small, noncomplex bank holding companies.

### *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 a wider range of financial activities, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales. 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 firms).

As of year-end 2005, 591 domestic bank holding companies and 38 foreign banking organizations had financial

holding company status. Of the domestic financial holding companies, 39 had consolidated assets of \$15 billion or more; 115, between \$1 billion and \$15 billion; 82, between \$500 million and \$1 billion; and 355, 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/anti-money-laundering (AML) 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 its supervised institutions for compliance with various anti-money-laundering laws and regulations. During examinations of state member banks and U.S. branches and agencies of foreign banks and, when appropriate,

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3. Refer to SR Letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex ([www.federalreserve.gov/boarddocs/srletters/](http://www.federalreserve.gov/boarddocs/srletters/)).

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.

### Quantitative Risk Management

To better coordinate the System's existing advanced risk-management and risk-measurement efforts, the division created a quantitative risk management group in early 2005. This new group will focus on Basel II quantification and validation, and will play a broader role by helping the System set priorities on the allocation of quantitative resources, identifying important issues at both systemic and institutional levels, collaborating on original research and data analysis with colleagues in the Federal Reserve's economic research divisions, and generally providing input on quantitative matters. In 2005, the group participated in the fourth Basel II Quantitative Impact Study (QIS-4) and other interagency efforts, participated in Basel Committee on Banking Supervision (Basel Committee) working groups and projects, and assisted with quantitative training for examiners and other staff.

### Business Continuity

In 2005, 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 provided some guidance to help firms that are implementing the sound practices verify their efforts. In addition, the agencies continue to closely coordinate efforts to ensure a consistent supervisory approach for business-continuity 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. All safety and soundness examinations are expected to include a review of information technology risks and activities. During 2005, the Federal Reserve was the lead agency in 2 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 \$26 trillion of assets in various fiduciary or custodial capacities. During on-site examinations of fiduciary activities, an 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 2005, Federal Reserve examiners conducted 119 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 2005, the Federal Reserve conducted on-site examinations at 24 of the 77 state member banks and bank holding companies that were registered as transfer agents. In 2005, the Federal Reserve also 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 2005, the Federal Reserve conducted 9 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 that both state member banks and bank holding companies that act as municipal securities dealers comply with the Securities Act Amendments of 1975. Municipal securities dealers 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 2005, 7 were examined during the year.

#### *Securities Credit Lenders*

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. As part of its general examination program, the Federal Reserve examines the banks under its jurisdiction for compliance with the Board's Regulation U. In addition, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to Regulation U. 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 2005, 628 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 216 of these lenders, and the remaining 412 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 181 lenders from its on-site inspection program. The securities credit activities of the remaining 231 lenders were subject to either biennial or triennial inspection. Eighty inspections were conducted during the year, compared with 55 in 2004.

### Enforcement Actions and Special Examinations

The Federal Reserve has enforcement authority over the banking organizations it supervises and their affiliated parties. Enforcement actions may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. In 2005, the Federal Reserve completed 64 formal enforcement actions. Civil money penalties totaling \$40.2 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 made public and posted on the Board's web site ([www.federalreserve.gov/boarddocs/enforcement](http://www.federalreserve.gov/boarddocs/enforcement)).

In addition to formal enforcement actions, the Reserve Banks completed 95 informal enforcement actions in 2005. Informal enforcement actions include memoranda of understanding

and board of directors resolutions. Information about these actions is not available to the public.

### Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. This analysis helps to direct examination resources to institutions that exhibit higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

Since 1994, the Federal Reserve's screening systems have included a set of two models that together are known as the System to Estimate Examination Ratings (SEER). These models use econometric techniques to estimate, for each bank, a supervisory rating and probability of failure using the supervisory information and financial data banks report on their Reports of Condition and Income (Call Reports). During 2005, the Federal Reserve completed an initiative to enhance the SEER models; this effort resulted in a new off-site monitoring tool known as the Supervision and Regulation Statistical Assessment of Bank Risk model. The new model is scheduled for implementation in early 2006. To supplement these screens that use financial and supervisory data, the Federal Reserve also monitors various 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.

The Federal Reserve also prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised

banking organizations. The reports contain, for individual bank holding companies, financial statistics and comparisons with peer companies. BHCPRs are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP). BHCPRs are made available to the public on the National Information Center web site, which can be accessed at [www.ffiec.gov](http://www.ffiec.gov).

During 2005, the surveillance function implemented two major upgrades to its web-based Performance Report Information and Surveillance Monitoring (PRISM) application. 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 information drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, BHCPRs, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of System surveillance screens for banks and bank holding companies. The upgrades enhanced the range of regulatory data available for queries, expanded the number of surveillance screens, added new search options, and improved the user interface.

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.<sup>4</sup>

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

## 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*

To examine the international operations of state member banks, Edge Act and agreement corporations, and bank holding companies, the Federal Reserve generally conducts its examinations or inspections 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 2005, 55 member banks were operating 748 branches in foreign countries and overseas areas of the United States; 34 national banks were operating 693 of these branches, and 21 state member banks were operating the remaining 55. In addition, 16 nonmember banks were operating 20 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 permissible for member banks.

At year-end 2005, 70 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 2005, 183 foreign banks from 54 countries were operating 220 state-licensed branches and agen-

cies (of which 8 were insured by the Federal Deposit Insurance Corporation) as well as 50 branches licensed by the OCC (of which 4 had FDIC insurance). These foreign banks also directly owned 12 Edge Act and agreement corporations and 2 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 67 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2005 controlled approximately 18 percent of U.S. commercial banking assets. These foreign banks also operated 73 representative offices; an additional 52 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.

In cooperation with the other federal and state banking agencies, the Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations. 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 man-

ner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 338 examinations in 2005.

### Technical Assistance

In 2005, the Federal Reserve continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by Federal Reserve staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2005 was concentrated in Latin America, Asia, and former Soviet bloc countries. The Federal Reserve, along with the OCC, FDIC, and Department of the Treasury, was also an active participant in the newly launched Middle East and North Africa (MENA) Financial Regulators' Training Initiative, which is part of the U.S. government's Middle East Partnership Initiative.

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 Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, the Basel Committee, and the Financial Stability Institute.

The Federal Reserve is also an associate member of the Association of Supervisors of Banks of the Americas (ASBA), an umbrella group of bank supervisors from countries in the Western Hemisphere. The group, headquartered in Mexico, promotes communication and cooperation among bank supervisors in the region; coordinates training programs throughout Latin

America, with the help of national banking supervisors and international agencies; and aims to help members develop banking laws, regulations, and supervisory practices that conform to international best practices. For the past three years, a Federal Reserve official has served as chairman of the board of directors of ASBA; the Federal Reserve also contributes significantly to ASBA's organizational management and to its training and technical assistance activities.

### 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, such as the Basel Committee and the International Accounting Standards Board (IASB), and provide support for the work of the FFIEC.

### Capital Adequacy Standards

During 2005, the Federal Reserve, OCC, FDIC, and OTS continued to draft proposed revisions to their risk-based capital adequacy regulations to reflect the June 2004 international agreement on capital adequacy for banking organizations, commonly known as Basel II. The agencies also issued an advance notice of proposed rulemaking (ANPR) on potential changes to the Basel I framework; these proposed changes would affect banking organizations not subject to Basel II. Further, the agencies issued joint interagency guidance on capital requirements for asset-backed commercial paper (ABCP) programs, and they are developing a proposal to revise the

capital requirements for trading book positions subject to the market risk capital rule. In addition, the Federal Reserve adopted a final rule on the treatment of trust preferred securities in the tier 1 capital of bank holding companies.

*Risk-Based Capital Standards  
for Certain Internationally Active  
Banking Organizations*

During 2005, the agencies continued to prepare for the U.S. implementation of Basel II. In early 2006, the U.S. banking agencies expect to make available a notice of proposed rulemaking (NPR) setting forth their views on Basel II and seeking public comment on the U.S. plan for implementing the agreement.

The agencies expect that only a small number of large, internationally active U.S. banking organizations will be required to use the Basel II framework. In April, the agencies announced preliminary results from the fourth quantitative impact study (QIS-4), which evaluated the potential impact of implementing Basel II at the approximately thirty banking organizations that participated in the study. The preliminary results of QIS-4 showed a larger overall decline and a greater dispersion in regulatory capital requirements than had been originally expected. QIS-4 results also indicated that participating institutions have additional work to do to complete the systems and processes they need to have in place before Basel II is implemented. Partly as a result of concerns identified in the analysis of QIS-4 results, the agencies announced on September 30 additional prudential safeguards and a one-year delay in the timeline for Basel II implementation in the United States.

The NPR will maintain the basic minimum risk-based capital ratio format of regulatory capital divided by risk-

weighted assets, with the minimum for tier 1 capital set at 4 percent and the minimum for total qualifying capital set at 8 percent. The components of tier 1 and total qualifying capital have been adjusted to an unexpected-loss basis consistent with the denominator. The primary difference between the current rules and the proposed Basel II rule is the internal-ratings-based methodologies Basel II uses to calculate risk-weighted assets; the proposed rule also contains the Basel II advanced measurement approach for operational risk. Banking organizations using the methods set forth in the NPR would also be subject to certain public disclosure requirements to foster transparency and market discipline. All banking organizations, including those using the internal-ratings-based approach for credit risk and the advanced measurement approach for operational risk, would continue to be subject to the tier 1 leverage ratio requirement and the market risk capital rule, if applicable, as well as the prompt corrective action rules.

*Risk-Based Capital Standards  
for Banking Organizations Not Subject  
to Basel II*

On October 20, the agencies issued for public comment an ANPR that considers modifications to the existing risk-based capital framework, or Basel I, which would continue to apply to banking organizations not subject to Basel II. The changes seek to enhance the risk sensitivity of Basel I by increasing the number of risk-weight categories, permitting greater use of external ratings as an indicator of credit risk for externally rated exposures, expanding the types of guarantees and collateral that may be recognized, and modifying the risk weights associated with residential mortgages. The ANPR also discusses

approaches that would change the credit-conversion factor for certain types of commitments, assign a risk-based capital charge to certain securitizations with early-amortization provisions, and assign a higher risk weight to loans that are 90 days or more past due or in nonaccrual status and to certain commercial real estate exposures. The agencies are also considering modifying the risk weights on certain other retail and commercial exposures. The comment period for the ANPR will end in January 2006.

#### *Asset-Backed*

##### *Commercial Paper Programs*

On August 4, the agencies issued “Inter-agency Guidance on the Eligibility of Asset-Backed Commercial Paper Program Liquidity Facilities and the Resulting Risk-Based Capital Treatment.” The guidance reiterates the agencies’ position that the primary function of an eligible ABCP liquidity facility should be to provide liquidity—not to enhance credit. The guidance clarifies (1) the application of the asset-quality test set forth in the agencies’ risk-based capital rules for determining the eligibility of an ABCP liquidity facility and (2) the resulting risk-based capital treatment of such a facility for banking organizations. An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are 90 days or more past due, in default, or below investment grade. This test implies that the banking organization providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets. The guidance clarifies that an ABCP liquidity facility meets the asset-quality test if, at all times throughout the transaction, (1) the liquidity provider has access to certain types of acceptable credit enhancements

that support the liquidity facility and (2) the notional amount of such credit enhancements exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade that the liquidity provider may be obligated to fund under the facility.

#### *Other Capital Issues*

In March, the Board adopted a final rule that allows for the continued inclusion of trust preferred securities in the tier 1 capital of bank holding companies, subject to stricter quantitative limits and clearer qualitative standards. The final rule revised the quantitative limits applied to the aggregate amount of certain core capital elements that may be included in tier 1 capital and revised the qualitative standards for capital instruments included in regulatory capital, consistent with long-standing Board policies.

Board staff members are working with the other agencies to develop a proposal to implement a revised, more risk-sensitive methodology for determining the capital charge for positions subject to the market risk capital rule. The proposal will address the issues identified in the July 2005 paper “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects,” which was published by the Basel Committee and the International Organization of Securities Commissioners (IOSCO).

The Board’s staff also conduct supervisory analyses of innovative capital instruments and novel transactions in order to determine the appropriate supervisory and regulatory capital treatment and to identify and address supervisory concerns. These reviews frequently require staff to review the various funding strategies proposed in

## **New Bank Secrecy Act/Anti-Money Laundering Examination Manual**

*This interagency manual is a significant step toward consistency in the area of anti-money-laundering examination. The new manual promotes a shared understanding of the Bank Secrecy Act and anti-money-laundering regulations and supervisory expectations.*

Susan Schmidt Bies, *Member*, Board of Governors  
June 2005

The release of the *Bank Secrecy Act/Anti-Money Laundering Examination Manual* on June 30, 2005, marked an important milestone for the federal banking agencies in their effort to enhance the consistent application of the Bank Secrecy Act (BSA). The five federal financial institutions regulatory agencies<sup>1</sup> developed the new manual, in collaboration with the

Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). The state banking agencies and Treasury's Office of Foreign Assets Control (OFAC) also contributed to this initiative.

In the manual, the agencies emphasize that banking organizations are responsible for establishing and implementing risk-based policies, procedures, and processes to comply with the BSA and to safeguard their operations from money laundering and terrorist financing. The agencies focus on a banking organization's sound risk assessment so that the banking organization can develop an anti-money-laundering program calibrated to its own risk profile. The agencies further

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

applications for acquisitions and other transactions that institutions submit to the Federal Reserve.

### **Bank-Owned Life Insurance**

In 2005, an interagency working group issued "Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance." The interpretations clarify financial reporting, credit-exposure limits, concentration limits, and the appropriate methods for calculating the amount of insurance a banking organization may purchase.

### **Bank Holding Company Rating System**

In January, the Federal Reserve adopted a revised bank holding company rating system known as RFI/C(D). The three main components of the 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 fourth component, Depository institution, generally mirrors the primary regulator's assessment of the subsidiary depository institution(s). The revised rating system reflects the shift that has

emphasize that the primary role of the examiner is to evaluate the adequacy of a banking organization's controls and not to second-guess individual, transaction-level decisions.

To promote a greater understanding of the BSA and anti-money-laundering (BSA/AML) requirements outlined in the manual, the Federal Reserve, along with the other federal banking agencies, FinCEN, and the OFAC, participated in a series of outreach events following the manual's release. The events, intended for the banking industry and federal and state banking agency examination staff, consisted of nationwide conference calls, regional outreach meetings, and a simultaneous broadcast via the Internet. More than 23,000 bankers and examiners participated in these sessions, where they also had the opportunity to ask questions and receive feedback on specific issues.

Moving forward, the agencies will ensure that the manual provides the industry and examiners with relevant, up-to-date information. The manual will be revised in response to changes in law or regulation,

other guidance, or evolving risks or controls. The agencies will hold periodic discussions with banking industry representatives so that issues related to the manual may be raised. These sessions will be held through the Bank Secrecy Act Advisory Group (BSAAG), which is a public-private partnership sponsored by the Department of the Treasury devoted to evaluating BSA-related matters. Specifically, the meetings will be held through a BSAAG subcommittee on examination issues, co-chaired by the Federal Reserve.

The Federal Reserve recognizes that banking organizations have invested significant resources to comply with the BSA and related regulations in order to deter and detect money laundering and terrorist financing. Both the banking industry and the regulatory agencies share the goal of combating the threats these crimes pose to the U.S. financial system. The Federal Reserve remains committed to ensuring that supervisory expectations for BSA/AML compliance are clearly understood by banking organizations and examiners.

occurred over time in the Federal Reserve's supervisory practices: a shift away from historical analyses of a BHC's financial condition toward more-forward-looking assessments of its risk management and financial factors. One year into the implementation of the new ratings system, Federal Reserve supervisors have found it to be an effective tool for communicating key supervisory points to banking organizations.

### Bank Secrecy Act and Anti-Money Laundering

In June 2005, the FFIEC issued a new examination manual that compiles

existing regulatory requirements, supervisory expectations, and sound practices for BSA/AML compliance. To foster consistency, the manual includes the examination procedures that each agency's examiners are expected to follow. (For more information, see the box "New Bank Secrecy Act/Anti-Money Laundering Examination Manual.")

In March and April, the Federal Reserve, FDIC, OCC, OTS, NCUA, and FinCEN issued guidance to clarify the requirements of the BSA/AML regulations for banking organizations that provide banking services to money-services businesses operating in the United States.

### International Guidance on Supervisory Policies

As a member of the Basel Committee, the Federal Reserve in 2005 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.

#### *Capital Adequacy*

To address issues not fully resolved in the Basel II framework, the Federal Reserve in 2005 continued to participate in a number of Basel Committee working groups, including a joint Basel Committee–IOSCO working group reviewing 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 positions that are subject to a market risk capital requirement.

#### *Risk Management*

The Federal Reserve contributed to several supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2005 that were generally aimed at improving the supervision of banking organizations' risk-management practices.<sup>5</sup>

- “Home-Host Information Sharing for Effective Basel II Implementation,” issued as a consultative document in November by the Basel Committee, in association with the Core Principles Liaison Group
- “Enhancing Corporate Governance for Banking Organizations,” issued in July (to update guidance published in 1999)
- “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects,” issued in July by the Basel Committee and IOSCO
- “Compliance and the Compliance Function in Banks,” issued in April

#### *Core Principles for Effective Banking Supervision*

The Core Principles, developed by the Basel Committee in 1997, have become the de facto international standard for sound prudential regulation and supervision of banks. During 2005, the Federal Reserve participated in a Basel Committee effort to update the Core Principles in light of the significant changes that have occurred in international banking regulation and the experience that has been gained since the principles were last revised in 1999.

#### *Joint Forum*

In 2005, the Federal Reserve also continued its participation in the Joint Forum—a group made up of representatives of the Basel Committee, IOSCO, and the International Association of Insurance Supervisors. The Joint Forum is a forum for supervisors to discuss their experiences with financial conglomerates. The Federal Reserve contributed to several supervisory policy

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5. Papers issued by the Basel Committee can be accessed via the Bank for International Settlements web site at [www.bis.org](http://www.bis.org).

papers, reports, and recommendations issued by the Joint Forum during 2005.<sup>6</sup>

- “High-Level Principles for Business Continuity,” issued in December
- “Credit Risk Transfer,” issued in March
- “Outsourcing in Financial Services,” issued in February

### *International Accounting and Disclosure*

The Federal Reserve participates in the Basel Committee’s Accounting Task Force (ATF) 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 IASB.

The IASB issued an amendment in June that reflects extensive Basel Committee and European Central Bank comments. The amended fair value option (FVO) rule in International Accounting Standard (IAS) 39 allows an organization to irrevocably elect, at inception, a fair value measurement for certain financial instruments, with gains and losses from changes in fair value recorded in current earnings. The FVO rule amendment to IAS 39 will become effective January 1, 2006.

During 2005, the Federal Reserve had a key role in the development of ATF’s consultative document “Supervisory Guidance on the Use of the Fair Value Option by Banks under International Financial Reporting Standards,” issued for public comment in July. The document provides guidance for the prudential supervision of banks in their implementation of the FVO rule under the amended IAS 39.

The Federal Reserve also provided input on ATF’s proposed consultative document “Sound Credit Risk Assessment and Valuation for Loans,” which was issued for comment in November. The guidance consists of ten principles addressing supervisory expectations for and supervisory evaluations of a banking organization’s establishment and support of its loan-loss allowance accounts.

### Response to 2005 Hurricanes

In 2005, the Federal Reserve worked cooperatively with the other federal banking agencies, state banking agencies, and other organizations to determine the operating status of financial institutions located in the areas affected by Hurricanes Katrina, Rita, and Wilma. The agencies encouraged banks to work with consumer and commercial customers experiencing difficulties due to the storms. The agencies promptly released joint guidance on regulatory and reporting issues to assist examiners and banking organizations affected by the hurricanes. In addition, the Federal Reserve, in consultation with the other federal banking agencies, issued responses to questions frequently asked by financial institutions about whether certain BSA provisions applied when providing services to victims of Hurricane Katrina. The agencies also exercised their authority under section 2 of the Depository

6. Papers issued by the Joint Forum can be accessed via the Bank for International Settlements web site at [www.bis.org](http://www.bis.org).

tory Institutions Disaster Relief Act of 1992 to waive statutory and regulatory appraisal requirements for transactions that involve real property in major disaster areas, when waiving the appraisal requirements would facilitate disaster recovery and would be consistent with safe and sound banking practice.

In an effort to provide the industry and examiners with further guidance on a growing number of hurricane-related issues, the FFIEC established a formal Katrina working group composed of senior supervision officials from each of the FFIEC agencies. The Katrina working group published frequently asked questions (FAQs) and developed examiner guidance that will be issued in early 2006. Because of the severity and scale of Katrina and the other natural disasters in 2005, the working group's efforts are expected to continue into 2006. The Katrina working group has established a user-friendly, web-based "frequently asked questions" forum on the FFIEC's web site ([www.ffiec.gov](http://www.ffiec.gov)).

### Credit Risk Management

The Federal Reserve works with the other federal banking agencies to develop guidance on credit risk management.

#### *Real Estate Appraisals*

In September, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued FAQs on the requirements of the agencies' real estate appraisal regulations and on the October 2003 interagency statement "Independence of Appraisal and Evaluation Functions." The agencies also issued FAQs in March to help institutions comply with the agencies' appraisal regulations and real estate

lending requirements when financing residential construction in a tract development.

#### *Home Equity Lending*

In May, the Federal Reserve and the other federal financial institutions regulatory agencies issued "Interagency Credit Risk Management Guidance on Home Equity Lending" to promote sound risk management in banks' home equity lending. The guidance addressed the agencies' concerns about the easing of underwriting standards as lenders compete to attract home equity lending business—sometimes by offering products with high loan-to-value ratios, requiring only limited documentation of a borrower's assets and income, using automated valuation models to a greater extent, or relying on loans originated by third parties. The guidance advances sound underwriting standards, controls over third-party originations, a robust collateral-valuation process, and account and portfolio management practices.

#### *Nontraditional Mortgage Products*

In December, the Federal Reserve and the other federal financial institutions regulatory agencies issued for public comment "Proposed Interagency Guidance on Nontraditional Mortgage Products." Nontraditional mortgage products typically include payment-option adjustable-rate mortgages and interest-only mortgages. These mortgage products allow for principal-payment deferral and negative amortization. Institutions may also combine these products with other risk-layering practices, such as less stringent underwriting standards, reduced loan documentation, or simultaneous second-lien loans. The proposed interagency guidance emphasizes that an

institution needs to develop and maintain adequate risk-management practices to monitor and control the risk associated with these products. The proposed guidance also contains recommended practices for providing consumers with information about the terms and risks of nontraditional mortgage products. Comments on the proposal are due March 29, 2006.

### *Commercial Real Estate Concentrations*

During 2005, the Federal Reserve and the federal financial institutions regulatory agencies developed proposed interagency guidance, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices." The proposed guidance, to be issued for public comment in January 2006, will respond to the agencies' concerns about rising commercial real estate (CRE) concentrations, particularly at small to medium-sized institutions. This guidance will reinforce the agencies' existing real estate lending guidelines and provide criteria for identifying institutions that have CRE lending concentrations and that should therefore employ heightened risk-management practices. Comments on the proposal are due April 13, 2006.

### *Overdraft Protection*

In February, the Federal Reserve, FDIC, NCUA, and OCC issued interagency guidance to assist insured depository institutions in the responsible disclosure and administration of overdraft-protection services. The guidance (1) seeks to ensure that institutions adopt adequate policies and procedures to address the credit, operational, and other risks associated with overdraft-protection services; (2) alerts institu-

tions offering these services to the need to comply with all applicable federal and state laws; and (3) sets forth examples of best practices that are currently observed in, or recommended by, the industry.

### *Small Bank Holding Company Threshold*

In September, the Board requested comment on a proposal to raise the asset-size threshold used to determine whether a bank holding company qualifies for (1) the Board's Small Bank Holding Company Policy Statement and (2) an exemption from the Board's risk-based and leverage capital adequacy guidelines for bank holding companies. The proposal would raise that threshold from \$150 million to \$500 million in consolidated assets. The proposal would also modify the qualitative criteria used in determining whether a bank holding company that is under the asset-size threshold nevertheless would not qualify for the policy statement or the exemption from the capital guidelines. In addition, the proposal would clarify the treatment under the policy statement of subordinated debt associated with trust preferred securities. Final action on this proposal is expected in early 2006.

### *Economic Growth and Regulatory Paperwork Reduction Act of 1996*

The Federal Reserve, OCC, FDIC, and OTS are in the process of reviewing agency regulations as required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). EGRPRA requires that the banking agencies review their regulations every ten years to identify any unnecessary regulatory requirements imposed on insured depository institu-

tions and eliminate these requirements, as appropriate. This review is in addition to the Board's periodic review of each of its regulations.

The agencies met with representatives from the banking industry and from consumer groups around the country to listen to their concerns and to solicit their suggestions for reducing regulatory burden. The agencies have received public comments on several of their regulations and expect to issue a final report in 2006.

### Sarbanes-Oxley Act

During 2005, the Federal Reserve continued to evaluate the effects of the Sarbanes-Oxley Act (SOX) on banking organizations. Federal Reserve accounting staff reviewed material internal control weaknesses and deficiencies at certain public banking organizations and are now drafting supervisory guidance for examiners and inspectors. The guidance will instruct examiners and inspectors to consider internal control information, including findings generated by the requirements of section 404 of SOX, in the overall risk-assessment process.

In addition, an official of the Federal Reserve serves on the Standing Advisory Group of the Public Company Accounting Oversight Board (PCAOB); the group 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 2005 to work with the FDIC and other federal 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 SOX requirements.

### 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. In addition, foreign banking organizations must periodically submit reports to the Federal Reserve.

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, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze the holding company's overall financial condition. The nonbank subsidiary reports—FRY-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.

In March, several revisions to the FR Y-9C and FR Y-9SP reports were implemented in order to identify private equity merchant banking activity, identify firms providing auditing services to the bank holding company, collect information on subordinated notes payable to trusts issuing trust preferred securities (changes affected the FR Y-9C balance sheet), and collect information on non-voting equity capital (changes affected

the FR Y-9SP). In September, the FR Y-9C was modified to collect information on purchased impaired loans in response to Statement of Position 03-3 of the American Institute of Certified Public Accountants, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," and to collect information related to the Government National Mortgage Association (GNMA) optional repurchase program for mortgage loans (rebooked loans backing GNMA securities).

Effective December 31, revisions to the Annual Report of Foreign Banking Organizations (FR Y-7) reorganized the form and instructions, expanded information collected on foreign companies held under the authority of section 2(h)(2) of the Bank Holding Company Act, added language to the confidentiality section, and clarified the instructions pursuant to Regulation K.

In December, a new report was implemented: the Supplement to the Reports of Changes in Organizational Structure (FR Y-10S). In this report, bank holding companies, financial holding companies, and state member banks not owned by bank holding companies report their SEC registration status and whether they are subject to the requirements of section 404 of SOX. They also report their six-digit CUSIP number to help the Federal Reserve compare regulatory data with market data.

## 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 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 under the auspices of the FFIEC have completed the Call Report modernization project. Through the use of new open data exchange standards (known as "eXtensible Business Reporting Language," or XBRL), the new Central Data Repository (CDR) system improves the timeliness and quality of supervisory data and enhances market discipline by ensuring that the public has more timely access to the data. This is the first wide-scale application of XBRL. Enhancements to the data-collection and -disclosure process include requiring banks to submit their Call Report data electronically to the CDR, moving forward the deadline for filing reports, and requiring respondents to validate their data before filing. The effort to set up the CDR was completed and became operational on October 1.

The FFIEC issued for public comment the proposed changes to the 2006 Call Report. The agencies planned to implement some changes effective March 31, 2006, and to defer implementation on other issues until September 30, 2006, and March 31, 2007, pending final interagency approval.

## Supervisory Information Technology

Under the direction of the division's chief technology officer, the supervisory information technology (SIT) function within the division facilitates the management of information technology

across the Federal Reserve System's overall supervision function. SIT works through assigned staff at the Board and the Reserve Banks, as well as through a System-wide committee structure, to ensure that key staff members throughout the System participate in identifying requirements and setting priorities for IT initiatives.

In 2005, the SIT function worked on the following strategic projects and initiatives: (1) refine and institutionalize processes governing IT investments to ensure that all technology investments are aligned with business needs and that accountability for business success is clearly defined and accepted; (2) improve the security of information-sharing technologies and provide for seamless collaboration in interagency efforts; (3) develop a measurement-based management and investment culture; (4) identify opportunities to converge and streamline IT applications, including key administrative systems, to provide consistent and seamless information; (5) develop a foundation for evaluating technologies (such as portals, search engines, and content management tools) to improve access to these systems and to integrate supervisory and management information systems that support both office-based and field staff; (6) enhance the information security framework for the supervisory function; and (7) participate in the selection of a learning management system that will enhance the delivery of online examiner training.

### National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data and supervisory 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; the Banking Organization National Desktop (BOND), an application that facilitates secure, real-time electronic information-sharing and collaboration among federal and state banking regulators for the supervision of banking organizations; and the Central Document and Text Repository, which contains documents supporting the supervisory processes.

During 2005, the NED application was modified to incorporate information from consumer affairs and Community Reinvestment Act examinations, thereby eliminating a separate legacy system. In early 2006, NED will be enhanced to begin collecting important BSA information in an automated format to support the Federal Reserve's enforcement activities.

In 2005, the BOND application was enhanced to improve usability, reduce administrative burden, and increase the effectiveness of management reporting. BOND was also updated to accommodate the new FR Y-10S reporting form (see the section "Bank Holding Company Regulatory Financial Reports"). At year-end 2005, BOND had approximately 2,700 registered users across the Federal Reserve System, the OCC, the FDIC, and eleven state banking departments. In 2005, significant resources were also devoted to the FFIEC Call Report modernization initiative (see the section "Commercial Bank Regulatory Financial Reports").

### Staff Development

The System Staff Development Program trains staff members at the Board, the Reserve Banks, state banking departments, and foreign supervisory authorities. Training is offered at the basic, intermediate, and advanced levels in

Training Programs for Banking Supervision and Regulation, 2005

Program	Number of sessions conducted	
	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
<i>Core schools</i>		
Banking and supervision elements .....	7	5
Operations and analysis .....	6	5
Bank management .....	4	2
Report writing .....	12	12
Management skills .....	9	7
Conducting meetings with management .....	10	10
<i>Other schools</i>		
Credit risk analysis .....	5	4
Examination management .....	6	4
Real estate lending seminar .....	3	3
Senior forum for current banking and regulatory issues .....	3	3
Assessing capital adequacy .....	1	1
Basel II corporate activities .....	2	1
Basel II operational risk .....	1	1
Basel II retail activities .....	2	0
Principles of fiduciary supervision .....	2	2
Commercial lending essentials for consumer affairs .....	1	1
Consumer compliance examinations I .....	2	0
Consumer compliance examinations II .....	2	2
CRA examination techniques .....	2	1
CRA risk-focused examination techniques .....	3	3
Fair lending examination techniques .....	2	2
Foreign banking organizations seminar .....	1	1
Information systems continuing education .....	4	4
Asset liability management (ALM1) .....	2	2
Asset liability management (ALM2) .....	1	1
Fundamentals of interest rate risk management .....	5	5
Trading and operations .....	1	1
Technology risk integration .....	3	3
Leadership dynamics .....	7	6
Fundamentals of fraud .....	5	5
Information technology seminars <sup>1</sup> .....	13	13
Seminar for senior supervisors of foreign central banks <sup>2</sup> and ten other international courses .....	35	27
<i>Self-study or online learning<sup>3</sup></i>		
Orientation (core and specialty) .....	0	0
Self-study modules (26 modules) .....	0	0
<i>Other agencies conducting courses<sup>4</sup></i>		
Federal Financial Institutions Examination Council .....	70	12
The Options Institute .....	1	1

1. Held at Chicago IT Lab.

2. Conducted jointly with the World Bank.

3. Self-study programs do not involve group sessions.

4. Open to Federal Reserve employees.

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

Results of First Proficiency and Second Proficiency Examinations, 2005

Result	First proficiency	Second proficiency		
		Safety and soundness	Consumer affairs	Information technology
Passed .....	155	65	18	2

markets, payment systems risk, white-collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for supervisors from developing countries.

In 2005, the Federal Reserve trained 3,296 students in System schools, 946 in schools sponsored by the FFIEC, and 11 in other schools, for a total of 4,253, including 266 representatives of foreign central banks and supervisory agencies (see the table on the preceding page). The number of training days in 2005 totaled 18,441.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 473 state examiners were trained—267 in Federal Reserve courses, 203 in FFIEC programs, and 3 in other courses.

A staff member seeking an examiner’s commission is required to take a first proficiency examination as well as a second proficiency examination in one of the following three specialty areas: safety and soundness, consumer affairs, or information technology. In 2005, 155 examiners passed the first proficiency examination (see Results of Examinations table). In the second proficiency examination, 65 examiners passed the safety and soundness examination, 18 examiners passed the consumer affairs examination, and 2 examiners passed the information technology examination. The average pass rate for the first proficiency examination was 79 percent. The average pass rate for the

second proficiency examinations was 78 percent.

**Regulation of the U.S. Banking Structure**

The Federal Reserve administers several federal statutes that apply 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, the Federal Reserve Act, and the International Banking Act. In administering these statutes, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of the U.S. banking system at the local, regional, and national levels; the international operations of domestic banking organizations; or the U.S. banking operations of foreign banks. The proposals include bank holding company formations and acquisitions, bank mergers, and other transactions involving bank or nonbank firms. In 2005, the Federal Reserve acted on 1,283 proposals, which represented 3,442 individual applications filed under the five administered statutes.

**Bank Holding Company Act**

Under the Bank Holding Company Act, a corporation or similar legal entity must obtain the Federal Reserve’s approval before forming a bank holding com-

pany 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 the nonbanking 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 may consider 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. In 2005, the Federal Reserve acted upon 512 applications filed by bank holding companies to acquire a bank or a nonbank firm, or to otherwise expand their activities.

Bank holding companies generally may engage in only those nonbanking 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 permit-

ted 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.

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 bank holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2005, the Federal Reserve reviewed 6 stock-repurchase proposals by bank holding companies.

The Federal Reserve also reviews elections from bank holding companies seeking financial holding company status under the authority granted by the Gramm-Leach-Bliley Act. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve. In 2005, 35 domestic financial holding company declarations and 3 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. The Federal Reserve has primary jurisdiction if the institution surviving the merger is a state member bank. 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 communities 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 2005, the Federal Reserve approved 58 merger applications under the act.

When the FDIC, OCC, or OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors related to the proposal. By using standard terminology in assessing competitive factors in merger proposals, the four agencies have sought to ensure consistency in administering the Bank Merger Act. The Federal Reserve submitted 472 reports on competitive factors to the other agencies in 2005.

### Change in Bank Control Act

The Change in Bank Control Act requires individuals and certain other parties that seek 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 2005, the Federal Reserve

approved 111 changes in control of state member banks and bank holding companies.

### Federal Reserve Act

Under the Federal Reserve Act, a member bank may be required to seek prior Federal Reserve approval before expanding its operations domestically or internationally. 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, among other things, 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 2005, the Federal Reserve acted on new and merger-related branch proposals for 2,435 domestic branches, and granted prior approval for the establishment of 5 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities and insurance agency-related activities. In 2005, 2 applications for financial subsidiaries were approved.

### 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 2005, the Federal Reserve approved 43 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 11 applications to make additional investments through an Edge Act or agreement corporation, 3 applications to establish an Edge Act or agreement corporation, and 2 applications to extend the corporate existence of an Edge Act corporation.

### 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 2005, the Federal Reserve approved 10 applications by foreign banks to establish branches, agencies, or representative offices in the United States.

### Public Notice of Federal Reserve Decisions

Certain decisions by the Federal Reserve that involve an acquisition by 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; 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](http://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.

**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 2005, 18 state member banks were registered with the Board under the Securities Exchange Act of 1934.

**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 NCUA, and the OTS examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Extensions of Credit by State Member Banks to their Executive Officers, 2004 and 2005

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>2004</i>			
October 1–December 31 .....	479	53,340,000	0.0–20.8
<i>2005</i>			
January 1–March 31 .....	414	54,737,000	0.0–21.2
April 1–June 30 .....	530	117,416,000	0.0–20.6
July 1–September 30 .....	504	56,969,000	0.0–21.6
October 1–December 31 .....	485	57,422,000	0.0–18.0

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 2005.

### **Federal Reserve Membership**

At the end of 2005, 2,698 banks were members of the Federal Reserve System and were operating 52,639 branches. These banks accounted for 37 percent of all commercial banks in the United States and for 72 percent of all commercial banking offices. ■

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## *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 and technologies, 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.

During 2005, the Board, with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA), issued joint guidance on overdraft-protection programs. The guidance is intended to help insured depository institutions responsibly administer and provide appropriate disclosures for these programs. To improve the uniformity and adequacy of information consumers receive about overdraft-protection services, the Board also issued final rules amending its Truth in Savings Act regulation (Regulation DD) and the associated commentary. The Board, FDIC, and OCC jointly revised certain provisions of their rules implementing the Community Reinvestment Act (CRA). In addition, the Board amended its regulation implementing the Electronic Fund Transfer Act (Regulation E) to address the regulation's coverage of electronic check conversion services; a separate interim final rule under Regulation E dealt with payroll card accounts. The Board issued final rules with the FDIC, NCUA, OCC, and Office of Thrift Supervision (OTS) to implement provisions of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) that govern the use of medical information in connection with credit-eligibility determinations. Furthermore, the Board raised the threshold that triggers additional requirements under the Home Ownership and Equity Protection Act (HOEPA) and raised the exemption threshold for depository institutions required to collect data under the Home Mortgage Disclosure Act (HMDA).

## Interagency Guidance on Overdraft-Protection Programs

In February, the Board issued guidance jointly with the FDIC, NCUA, and OCC on overdraft-protection programs at insured depository institutions. These services, sometimes referred to as “bounced-check protection” or “courtesy overdraft protection,” pay customer’s checks or allow other overdrafts when a customer has insufficient funds in his or her account. Typically, an overdraft-protection program is an automated service provided to transaction account customers as an alternative to a traditional overdraft line of credit.

In June 2004, the agencies published for comment proposed interagency guidance on overdraft-protection programs, in response to concerns about the marketing, disclosure, and implementation of these programs. The final guidance responds to comments the agencies received from consumer and community groups, individual consumers, depository institutions, trade associations, vendors offering overdraft-protection products, other industry representatives, and state agencies.<sup>1</sup>

The final joint guidance has three primary sections: Safety and Soundness Considerations, Legal Risks, and Best Practices. The safety and soundness discussion seeks to ensure that financial institutions offering overdraft-protection programs have adequate policies and procedures to address the credit, operational, and other risks associated with these programs. The legal risks discussion alerts institutions to the importance

of complying with all applicable federal and state laws, and it advises institutions to have legal counsel review their overdraft-protection programs—before implementation—to ensure the overall compliance of the programs. The best practices section addresses the marketing and communication of overdraft-protection programs as well as disclosures and other operational aspects of these programs.

## Amendments to Regulation DD (Truth in Savings)

In May, the Board published final amendments to Regulation DD, which implements the Truth in Savings Act, and to the regulation’s official staff commentary. The amendments address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their deposit accounts, and some of the amendments specifically address overdraft-protection programs, which are offered by many depository institutions.

To address concerns about the marketing of overdraft services, the Board expanded the regulation’s prohibition against misleading advertisements to cover institutions’ communications with current customers about their existing accounts. The Board also revised the staff commentary to the regulation to provide examples of misleading advertisements for overdraft-protection services. To help consumers distinguish overdraft-protection services from the traditional lines of credit offered by an institution, the final rule requires that institutions promoting the payment of overdrafts include, in their advertisements, certain disclosures about the terms of the service.

In addition, the final rule includes provisions to enhance the uniformity and adequacy of the cost disclosures

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1. In 2004, the agencies, along with the OTS, produced a consumer publication, “Protecting Yourself from Overdraft and Bounced-Check Fees,” which is available in English and Spanish. Both versions are available on the Board’s consumer information web site ([www.federalreserve.gov/consumers.htm](http://www.federalreserve.gov/consumers.htm)).

institutions provide to consumers about overdraft and returned-item fees. Institutions that promote the payment of overdrafts in an advertisement must separately disclose, on their periodic statements, the total dollar amount imposed on the account for paying overdrafts and the total dollar amount of fees charged for returning items unpaid. These disclosures must be provided for the statement period and for the calendar year to date, for any account to which the advertisement applies. To help institutions comply with this requirement, the staff commentary provides specific examples of when an institution is promoting the payment of overdrafts in an advertisement. The final rule also requires institutions to state, in their account-opening disclosures, the categories of transactions for which an overdraft fee may be imposed, for example, by specifying that fees are imposed for overdrafts created by checks, ATM withdrawals, or other electronic transactions, as applicable.

The amendments to Regulation DD become effective on July 1, 2006.

### Community Reinvestment Act Rules

In July, the Board, FDIC, and OCC approved a joint final rule to revise certain provisions of their rules implementing the Community Reinvestment Act (CRA). (Regulation BB is the Board's CRA regulation.) The revised rules are intended to reduce regulatory burden on community banks and make CRA evaluations more effective tools for encouraging banks to meet community development needs.

The final rules raise the small bank asset-size threshold from less than \$250 million in assets to less than \$1 billion in assets without regard to holding company affiliation. Accordingly,

the new rules reduce data collection and reporting burden for "intermediate small banks" (banks with assets at least \$250 million and less than \$1 billion) and, at the same time, encourage these banks to engage in meaningful community development lending, investment, and services.

Under the new rules, intermediate small banks will no longer need to collect and report CRA loan data. Nevertheless, examiners will continue to evaluate bank lending activity during their CRA examinations of intermediate small banks and will disclose those results in the public evaluation. Intermediate small banks will be evaluated under two separately rated tests: (1) the small bank lending test and (2) a new, flexible community development test that includes an evaluation of community development loans, investments, and services in light of the community's needs and the bank's capacity. Satisfactory ratings are required on both tests to obtain an overall satisfactory CRA rating.

For banks of any size, the new rules expand the definition of community development to include activities that revitalize or stabilize designated disaster areas and distressed or underserved rural areas. By doing so, the agencies seek to recognize banks' community development efforts in these areas and encourage further efforts in other rural areas. The rules also clarify when a bank's (or its affiliate's) discrimination or other illegal credit practices will adversely affect an evaluation of its CRA performance. The joint final rule became effective September 1, 2005.

### FACT Act Rules on Medical Information

In November, the Board, FDIC, NCUA, OCC, and OTS issued final rules under

the Fair Credit Reporting Act (FCRA). (The Board's rules are Regulation V and Regulation FF.) The rules create exceptions to the statutory prohibition against creditors' obtaining or using medical information in connection with their credit-eligibility determinations. The final rules also address the sharing of medically related information among affiliates.

Section 411 of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) amended the FCRA to provide that a creditor may not obtain or use medical information in connection with any determination of a consumer's eligibility, or continued eligibility, for credit, except as permitted by regulations. The FACT Act requires the agencies to prescribe regulations that permit creditors to obtain and use medical information for credit-eligibility purposes when necessary and appropriate to protect legitimate operational, transactional, risk-management, and other needs. The final rules permit creditors to obtain and use medical information that is typically considered in credit underwriting. Under the final rules, all creditors can rely upon the exceptions for obtaining and using medical information.

Section 411 of the FACT Act also amended the FCRA to limit the ability of creditors and others to share medically related information among their affiliates, except as permitted by the statute or by regulation or order. The final rules specify the circumstances in which certain creditors may share medically related information among affiliates without becoming consumer reporting agencies, which are subject to additional requirements.

Final rules will become effective April 1, 2006.

## Amendments to Regulation E (Electronic Fund Transfers)

In December, the Federal Reserve Board announced final amendments to Regulation E, which implements the Electronic Fund Transfer Act. The amendments clarify the responsibilities of parties involved in electronic check conversion transactions and require that consumers receive written notification in advance of these transactions. Additional revisions to the regulation's official staff commentary provide guidance on pre-authorized transfers from consumers' accounts, error resolution, and disclosures at ATMs.

Among other provisions, the final rule specifies that merchants and other payees that convert consumers' check payments into electronic fund transfers must provide the consumer with a notice and obtain his or her authorization for the electronic fund transfer. Merchants and other payees must also notify consumers that

- if a check is converted to an electronic fund transfer, funds may be debited from their accounts as soon as the same day that payment is received and
- the check will not be returned to them by their financial institution.

Revisions to the official staff commentary on Regulation E clarify the error resolution obligations of financial institutions and clarify the disclosure obligations of ATM operators with respect to the fees they charge a consumer for initiating an electronic fund transfer or for using an ATM to make a balance inquiry.

The mandatory compliance date for the final rule is January 1, 2007.

### *Interim Final Rule Governing Payroll Cards*

In December, the Board adopted a separate interim final rule on payroll card accounts. Under the interim final rule, payroll card accounts that are established to provide salary, wages, or other employee compensation on a recurring basis are accounts covered by Regulation E. The interim final rule grants flexibility to financial institutions that must provide account transaction information to payroll card users. The interim final rule will become effective July 1, 2007.

### Other Regulatory Actions

The Board also took the following regulatory actions during 2005:

- In March, the Board and the other federal financial regulatory agencies adopted in final form, without change, joint interim rules making technical changes to the agencies' regulations implementing the Community Reinvestment Act (CRA). The joint interim rules had been published for comment in July 2004. (Regulation BB is the Board's CRA regulation.) The changes conform the CRA regulations to changes in (1) the Standards for Defining Metropolitan and Micropolitan Statistical areas, published by the U.S. Office of Management and Budget; (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 final rule did not make substantive changes to the requirements of the CRA regulations.
- In August, the Board amended the official staff commentary to Regula-

tion Z to raise from \$510 to \$528 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act (HOEPA). As prescribed by that statute, the increased amount (effective January 1, 2006) reflects changes in the consumer price index.

- In December, the Board amended the official staff commentary to Regulation C to raise to \$35 million the exemption threshold for depository institutions required to collect data in 2006 under HMDA. As prescribed by that 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 what effects the act has on compliance costs for financial institutions, as well as the benefits of the act to consumers.

According to data from the most recent triennial Survey of Consumer Finances (conducted in 2004), approximately 91 percent of U.S. families that year used or had access to one or more EFT services, for example, automated teller machine (ATM) services, debit card services, or direct deposit or payment services—up from approximately 88 percent in 2001. The 2004 Survey of Consumer Finances also reported that approximately 74 percent of U.S. families had an ATM card. In 2004, the number of ATM transactions per month averaged approximately 919 million, and the number of installed ATMs rose about 3 percent from 2003, to 383,000.

About 71 percent of U.S. families had funds deposited directly into their checking or savings account by direct deposit in 2004. Use of the service appears even more common in the public sector; during fiscal year 2005, approximately 76 percent of all government payments were made using EFT, including 81 percent of Social Security payments, 99 percent of federal salary and retirement payments, and 49 percent of federal income tax refunds.

About 59 percent of U.S. families had debit cards in 2004; consumers can use these cards at merchant terminals to pay for purchases. Approximately 17.6 billion debit card transactions took place in 2004, an increase of approximately 9 percent from the previous year's volume. Direct payment appears to be the least widely used EFT payment mechanism. About 47 percent of U.S. families had payments automatically deducted from their accounts in 2004.

The incremental costs associated with the EFTA are difficult to quantify because it is difficult to determine 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 2005 reporting period, the Reserve Banks conducted 163 CRA examinations. Of the banks examined, 35 were rated "outstanding" in meeting community credit needs, 127 were rated "satisfactory," none was rated "needs to improve," and 1 was rated as being in "substantial noncompliance."<sup>2</sup>

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

During 2005, the Board of Governors considered applications for several significant banking mergers, including the application by Citigroup, Inc., New York, New York, to acquire First Ameri-

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2. The 2005 reporting period was July 1, 2004, through June 30, 2005.

can Bank, Bryan, Texas. The Board approved Citigroup's application in March, after considering information from ongoing examinations of Citigroup, publicly disclosed investigations, and domestic and foreign financial supervisory authorities, in addition to confidential information on Citigroup's compliance with anti-money-laundering laws. Citigroup acknowledged some deficiencies in its compliance and internal controls for the areas being investigated and stated that it had developed plans to address those weaknesses. The Board noted the improvements Citigroup had made to parts of its compliance structure; the Board also expected that the company would fully implement its plan to enhance oversight of its operations. To that end, the Board further expected that Citigroup would not undertake significant expansion during this implementation period.

Several other significant applications are listed below.

- An application by Wells Fargo & Co., San Francisco, California, to acquire First Community Capital Corporation, Houston, Texas, was approved in June.
- An application by Capital One Financial Corporation (Capital One), McLean, Virginia, to acquire Hibernia Bancorporation, New Orleans, Louisiana, was approved in August. The Board considered information on pending lawsuits or investigations undertaken by the attorneys general of Minnesota and West Virginia relating to Capital One's marketing of its credit cards.
- An application by Bank of America Corporation, Charlotte, North Carolina, to acquire MBNA Corporation, Wilmington, Delaware, was approved

in December. A total of thirteen comments were submitted in opposition to the application.

The public submitted comments on each of these applications. Most of the commenters expressed concerns that an institution's lending to lower-income communities and minority populations was insufficient or that the institution failed to address the convenience and needs of affected communities. Many of the comments referenced the new pricing information on residential mortgage loans that was required to be reported for 2004 Home Mortgage Disclosure Act (HMDA) data; the new data raised concerns that minority applicants were more likely than nonminority applicants to receive high-cost mortgages.<sup>3</sup> Other commenters raised concerns about potentially predatory lending practices by subprime and payday lenders, as well as the potential adverse effects of branch closings.

In total, the Board acted on twenty-three bank and bank holding company applications that involved protests by members of the public concerning the CRA performance of insured depository institutions. The Board also reviewed twenty-nine applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.<sup>4</sup>

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3. "High-cost mortgages" refers to mortgage loans whose annual percentage rates (APRs) are 3 percent or more over the yield on comparable Treasury securities on first liens, and 5 percent or more over that yield on subordinate liens. Interest rate spreads that exceed these two thresholds are required to be reported under Regulation C, which implements the Home Mortgage Disclosure Act (HMDA).

4. In addition, four applications involving consumer compliance issues were withdrawn.

## 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 provides guidance and expertise to the Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. They develop and update examination policies, procedures, and guidelines, as well as 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 2005 reporting period, the Reserve Banks conducted 239 consumer compliance examinations—220 of state member banks and 19 of foreign banking organizations (FBO).<sup>5</sup>

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 issued guidance that Federal Reserve consumer compliance examiners are to use when evaluating cases that

may involve any pattern or practice of flood insurance violations.

## *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 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 (DOJ). When a violation of the ECOA

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5. 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.

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 2005, division staff received and analyzed five reports from Reserve Banks regarding possible referral matters. Three of these reports dealt with potentially discriminatory underwriting standards—two involved potential discrimination on the basis of applicants' marital status and one involved potential discrimination on the basis of an applicant's sex. In one report, a bank's apparent discriminatory loan-pricing practices affected borrowers on the basis of their marital status. The fifth report involved discriminatory redlining on the basis of race. In one of the cases, the Board determined that a referral was not warranted; one case was referred to DOJ; and three cases are pending.

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 black and Hispanic applicants and those submitted by white applicants; 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. As a result of 2002 amendments to Regulation C and the receipt of expanded HMDA data for 2004, the regression program has been modified.

Differences among groups of loan applicants are now identified using two additional criteria: (1) the incidence of higher-priced lending and (2) differences in the mean spread paid by borrowers who obtained higher-priced loans. The modified statistical program, like the denial-rate review, can target lenders for a more intensive fair lending review that would include the collection and assessment of additional loan-level information, such as credit scores and debt-to-income and loan-to-value ratios.

### *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 payable to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2005, the Board imposed civil money penalties on ten state member banks. The penalties, which were assessed via consent orders, totaled \$219,810.

### *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.<sup>6</sup> In 2005, the FFIEC revised examination procedures for the Fair Credit Reporting Act (FCRA) to reflect amendments to the FCRA by the Fair and Accurate Credit Transactions Act (the FACT Act). The FFIEC also issued examination procedures on the Federal Communications Commission's telemarketing rules and its CAN-SPAM Act (Controlling the Assault of Non-Solicited Pornography and Marketing Act). The new procedures address the requirements each of these rules lays out for electronic communications with consumers. Finally, the Board, OCC, and FDIC issued examination procedures for reviewing the Community Reinvestment Act (CRA) performance of intermediate small banks. Following the issuance of new CRA regulations last year, these agencies also published for comment proposed questions and answers on their new regulations.

The FFIEC issues guidance to the agencies' consumer compliance examination staff and to supervised financial institutions. The agencies issued final guidance on overdraft-protection programs (see "Interagency Guidance on Overdraft-Protection Programs" earlier in this chapter). In addition, the Board, OCC, and FDIC issued new templates for preparing CRA performance evaluations for intermediate small banks; these agencies also revised the existing templates in order to reflect the amended definition of community development that now applies to all banks, as the term is defined in the new CRA regulations.

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

Finally, the Board, OCC, and FDIC 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 supervision process. As the number and complexity of consumer financial transactions grow, training for examiners of the state member banks under the Federal Reserve's supervisory responsibility becomes even more important. The consumer affairs curriculum is composed of six courses focused on various consumer protection laws, regulations, and examining concepts. In 2005, these courses were offered in ten sessions to more than 190 consumer compliance examiners and System staff members.

Board and Reserve Bank staff regularly review the consumer affairs curriculum, updating subject matter and adding new elements as appropriate. During 2005, staff conducted a curriculum review of the Commercial Lending Essentials for Consumer Affairs course to incorporate different instructional methods (for example, an expanded case study). This course provides consumer compliance examiners with a basic understanding of how a loan officer underwrites and prices commercial loans.

In addition to providing core training, the examiner curriculum emphasizes the importance of continuing professional development (CPD). 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), enacted by Congress in 1975, requires most mortgage lenders located in metropolitan areas to collect data about their housing-related lending activity, report the data annually to the government, and make the data publicly available. In 1989, Congress expanded the data required by HMDA to include information about loan applications that did not result in a loan origination, as well as information about the race, sex, and income of applicants and borrowers. Since 1989, mortgage markets have changed dramatically as information technology has improved, permitting more-efficient and more-accurate risk assessment and management. These developments have made it feasible for institutions to lend to higher-risk borrowers, albeit at prices commensurate with the higher risk. In the past, many of the borrowers who now receive higher-priced loans were often denied lower-priced credit.

Although a positive development, the growth of the subprime market has also raised public policy concerns. One concern is whether consumers who obtain higher-priced loans are sufficiently informed about the loan options available to them, allowing them to shop effectively and protect themselves from unfair or deceptive lending practices. This concern has contributed to an ongoing debate about how adequate and effective proposed or existing mortgage lending disclosures and limitations are in protecting consumers from abuse. In addition, the wider range of loan prices available in today's marketplace has raised concerns about whether price

variations reflect, even in part, unlawful discrimination rather than legitimate risk- and cost-related factors.

In response to these concerns, the Federal Reserve updated Regulation C, the regulation that implements HMDA. The revisions, which were effective in 2004, required lenders to collect price information for loans they originated in the higher-priced segment of the home loan market. Lenders report the number of percentage points (if any) by which a loan's annual percentage rate (known as the "APR") exceeds a threshold; the threshold is 3 percentage points above the yield on comparable Treasury securities for first-lien loans, and 5 percentage points above that yield for junior-lien loans. Loans with rates above this threshold are referred to as "higher-priced loans." The HMDA data collected in 2004 and released to the public in 2005 provide the first publicly available loan-level data about loan prices.

An article published by Federal Reserve staff in the Summer 2005 issue of the *Federal Reserve Bulletin* uses the 2004 data to describe the market for higher-priced loans and patterns of lending across loan products, geographic markets, and borrowers and neighborhoods of different races and incomes.<sup>7</sup> Relatively few lenders account for most higher-priced originations. In 2004, only 500 of the 8,850 reporting home lenders made 100 or more higher-priced loans; the 10 home lenders with the largest volume accounted for about 40 percent of all such loans. Higher-priced lending is also concentrated by price: in 2004 the vast majority of higher-priced loans had annual percentage rates within 1 or 2 percentage points of the reporting thresholds. Furthermore, a relatively

7. The complete article is available at [www.federalreserve.gov/pubs/bulletin/2005/05index.htm](http://www.federalreserve.gov/pubs/bulletin/2005/05index.htm).

small share of loan originations are higher-priced loans—16 percent in 2004.

The prevalence of higher-priced lending varies widely, however. First, it varies by product type. For example, 15.5 percent of first-lien refinance loans were higher-priced in 2004 compared with 27.4 percent of comparable junior-lien loans. Manufactured-home loans show the greatest incidence of higher pricing across all loan products, a result consistent with the elevated credit risk associated with such lending. Second, higher-priced lending varies widely by geography. Most of the metropolitan areas with the greatest incidence of higher-priced lending are in the southern region of the country (in many metropolitan areas in the South and Southwest, 30 to 40 percent of homebuyers who obtained conventional loans in 2004 received higher-priced loans), whereas metropolitan areas with the lowest incidence are much more dispersed. Third, the incidence of higher-priced borrowing varies greatly among borrowers of different races and ethnicities (see related box “2004 HMDA Data and Fair Lending”). All of these patterns are expected to be the subject of further research.

### 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.<sup>8</sup>

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8. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2005 reporting period was July 1, 2004, through June 30, 2005.

### Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 85 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation B, compared with 88 percent for the 2004 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- collect information for monitoring purposes about the race, ethnicity, and sex of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- notify a credit applicant of the action taken on his or her loan request within the time frames specified in the regulation
- provide a written notice of denial or other adverse action to a credit applicant that contains the specific reason for the adverse action, along with other required information

During this reporting period, the OTS issued two cease-and-desist orders against savings associations for their alleged violations of the ECOA and Regulation B, as well as other consumer regulations. For these violations, the associations paid civil money penalties that totaled \$17,500. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation B during the reporting period.

The Federal Trade Commission (FTC) entered into one settlement with a mortgage corporation for its alleged violations of the ECOA and Regulation B, as well as other statutes. The defendants were required to pay consumer restitution for their alleged violations of the Truth in Lending Act (see the discussion under Regulation Z).

## 2004 HMDA Data and Fair Lending

The 2004 HMDA data included, for the first time, information on “higher-priced loans,” or loans whose pricing (interest rates and fees) exceeded certain thresholds. An analysis of this new data offers some insights about where higher-priced lending is more prevalent and what types of borrowers are more likely to receive a higher-priced loan. While these statistics alone cannot explain the reasons why higher-priced lending was concentrated in some geographic areas or among some borrowers, the 2004 data are still an important tool for fair lending enforcement.

The incidence of higher-priced borrowing—the proportion of borrowers who obtain higher-priced loans—varies widely by race and ethnicity. In 2004, blacks and Hispanics were much more likely than non-Hispanic whites to receive higher-priced loans, and Asians were less likely than non-Hispanic whites to receive such loans. For example, 32 percent of black borrowers, and 20 percent of Hispanic borrowers, received higher-priced home purchase loans, but only 9 percent of non-Hispanic white borrowers did. In other words, black homebuyers received higher-priced loans more than three times as often as non-Hispanic white homebuyers, and Hispanic homebuyers received higher-priced loans more than two times as often. In general, differences of this magnitude persist across borrowers with different income levels and across neighborhoods with different median incomes (for example, low-income versus middle-income). The differences in the incidence of higher-priced loans shrink minimally when individual borrowers are matched by, for example, their income, the amount of their loan, and the location of the property being financed—which are the principal loan-pricing factors reported in the HMDA data.

In large part, the differences in what groups of borrowers were more likely to receive a higher-priced loan reflect the segmentation of the home loan market. That

is, a major reason that black and Hispanic borrowers were much more likely than non-Hispanic white borrowers to obtain higher-priced mortgage loans is the fact that black and Hispanic borrowers were much more likely to obtain mortgage loans from institutions that specialize in higher-priced lending.

Some, perhaps much, of the market segmentation and the related price differences for mortgages are the result of differences in legitimate price-determining factors, such as a borrower’s credit risk. Credit risk is typically measured by a borrower’s credit score, his or her debt-to-income ratio, the loan-to-value ratio, and other information. But the HMDA data do not include this type of information. Therefore, the data do not yield any conclusions about the reasons behind racial and ethnic differences in the incidence of higher-priced lending; the data also cannot be used to prove (or disprove) the legitimacy of any speculated reasons for these differences.

Notwithstanding the limitations of the HMDA loan-pricing data, the data can be used to improve enforcement of the laws that prohibit racial and ethnic discrimination in mortgage lending: the Federal Reserve and the other agencies that enforce these laws can use the data as a screening tool to determine which institutions’ pricing practices warrant scrutiny. For example, Board staff used the 2004 data to determine (1) which lenders exhibited a highly statistically significant difference in their higher-priced lending to black and Hispanic borrowers, on the one hand, and to non-Hispanic white borrowers, on the other, and (2) when that difference could not be explained by a difference in borrower income, loan amount, or property location. Board staff shared statistical reports about the identified lenders with the relevant state and federal agencies, who can use the data, as appropriate, in their fair lending enforcement and supervision efforts.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission (SEC), the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA’s examination activities revealed that most Regulation B violations involved either creditors’ providing inadequate statements of specific reasons for denial or creditors’ failure to request or provide information for government-monitoring purposes. As reported by the SEC, the National Association of Securities Dealers, Inc., (NASD) found that one of its member firms could not produce evidence that its customers were notified about the denial of their applications for margin accounts. In addition, a different NASD firm could not demonstrate that it sent required annual margin disclosure statements to its customers. However, none of these other agencies initiated any formal enforcement actions relating to Regulation B during 2005.

#### *Regulation E (Electronic Fund Transfers)*

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation E, which is comparable to the level of compliance for the 2004 reporting period. The most frequent violations involved failure to comply with the following requirements:

- determine whether an error occurred within ten business days of receiving a notice of error from a consumer

- report the results of an error investigation to the consumer within three business days
- give the consumer provisional credit for the amount of the alleged error when the investigation cannot be completed within 10 business days

The OTS issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation E. The savings association paid a civil money penalty of \$10,000 for the violations. The other FFIEC agencies and the SEC did not issue any formal enforcement actions relating to Regulation E during the period.

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

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2004 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The FFIEC agencies did not issue any formal enforcement actions relating to Regulation M during the period.

#### *Regulation P (Privacy of Consumer Financial Information)*

The FFIEC agencies reported that 97 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation P, compared with 96 percent for the 2004 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
- 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

The OCC issued a civil money penalty of \$180,000 to a mortgage company subsidiary of a national bank for its failure to properly and securely dispose of confidential customer information. The OTS issued one cease-and-desist order to a former institution-affiliated party for violations of Regulation P and another consumer regulation. The individual paid a civil money penalty of \$2,000 for the violations. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation P during the reporting period.

### *Regulation Z (Truth in Lending)*

The FFIEC agencies reported that 80 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation Z, compared with 84 percent for the 2004 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- accurately disclose the finance charge in closed-end credit transactions
- accurately disclose the annual percentage rate (APR) in closed-end credit transactions

In addition, 93 banks supervised by the Federal Reserve and the FDIC were required, under the Interagency Enforcement Policy on Regulation Z, to reimburse a total of approximately \$591,000 to consumers for understating the annual percentage rate or the finance charge in their consumer loan disclosures.

The OCC entered into a formal agreement with a bank and its mortgage company subsidiary for violations of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Federal Trade Commission Act. The subsidiary was required to reimburse borrowers who were harmed and was directed to set aside at least \$14 million to fund these reimbursements.

The OCC also issued a prohibition and cease-and-desist order, as well as a civil money penalty of \$20,000, against a former bank vice president for making tax lien loans that violated the Home Ownership Equity Protection Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Federal Trade Commission Act. The OCC had previously ordered the bank to reimburse affected customers and had issued a cease-and-desist order against the company that marketed, originated, and serviced the loans.

The OTS issued five cease-and-desist orders for violations of a number of consumer regulations, including Regulation Z, during the reporting period. Three of the banks paid civil money penalties totaling \$18,900. The FDIC issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation Z. The

other FFIEC agencies did not issue any formal enforcement actions relating to Regulation Z during the reporting period.

The FTC settled charges against an individual defendant and a group of mortgage brokers for their alleged violations of the Truth in Lending Act and Regulation Z, the Federal Trade Commission Act, and other statutes. Under the consent judgment, the individual defendant will cease making misrepresentations about home mortgage refinancing offers and cease future violations of Regulation Z. The defendant was also required to pay \$128,300 in consumer restitution. In another case, the FTC settled charges, through a stipulated order, against a mortgage corporation for its alleged violations of the Truth in Lending Act and Regulation Z, the Federal Trade Commission Act, and other statutes. The stipulated order requires the defendant to pay \$750,000 in consumer restitution; the order also set up a \$350,000 performance fund to be used if the defendant fails to comply with the order. In addition, the order bars the defendant from making or servicing any home-secured loans and includes other injunctions.

The FTC continued litigation against a mortgage broker and its principals for their alleged violations of the Truth in Lending Act, Regulation Z, and the Federal Trade Commission Act, in connection with advertisements for extremely low mortgage rates. In 2004, the court entered a stipulated preliminary injunction against the defendants. In 2005, the court held the defendant's chief executive officer in civil contempt of that order; he was subsequently arrested under a bench warrant. The court released this individual after he paid \$275,000 in sanctions and agreed to pay \$400,000 in consumer restitution,

among other terms. Litigation is ongoing in this case.

The FTC settled charges against a finance company, seven related companies, and their principals for their alleged violations of the Truth in Lending Act and Regulation Z, the Federal Trade Commission Act, and other statutes. The final order shut down the companies and permanently bars them and their principals from participating in any lending or direct-deposit business and from offering or selling ancillary products. The FTC will receive a \$10.5 million claim in the consolidated bankruptcy case against the companies, 50 percent of the assets in receivership, and two suspended judgments totaling approximately \$674,000. Finally, the FTC continues litigation against two related companies and their officers for their alleged violations of the Truth in Lending Act, Regulation Z, and the Federal Trade Commission Act. The companies are alleged to have engaged in misrepresentation about merchandise refunds and, when consumers were owed refunds, to have failed to promptly credit their credit card accounts.

The FCA's examination and enforcement activities revealed that most Regulation Z violations involved inadequate or incorrect disclosures for closed-end credit. The other agencies that enforce Regulation Z—the Department of Transportation and the Grain Inspection, Packers, and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise.

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

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2005 reporting

period were in compliance with Regulation AA, which is comparable to the level of compliance for the 2004 reporting period. 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 2005 reporting period were in compliance with Regulation CC, which is comparable to the level of compliance for the 2004 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
- provide required information when placing an exception hold on an account

The OTS issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation CC. The other FFIEC agencies did not issue any formal enforcement actions related to Regulation CC during the reporting period.

*Regulation DD  
(Truth in Savings)*

The FFIEC agencies reported that 91 percent of institutions examined dur-

ing the 2005 reporting period were in compliance with Regulation DD, compared with 92 percent for the 2004 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the following actions:

- using the phrase “annual percentage yield” in an advertisement without disclosing required additional terms and conditions for customer accounts
- providing account disclosures that did not contain all required information
- failing to provide timely maturity notification for time deposits

The OTS issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation DD. The other FFIEC agencies did not issue any formal enforcement actions related to Regulation DD 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. In 2005, the Federal Reserve received 460 consumer complaints about regulated practices by state member banks—complaints were received by mail, by telephone, in person, and electronically via the Internet.

**Complaints against  
State Member Banks**

Of the 460 complaints about regulated practices, 78 percent involved consumer

loans: 5 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 73 percent concerned other credit-related practices, such as credit card disclosures, preapproved solicitations, and billing error resolution. Seventeen percent of the complaints involved disputes about interest on deposits and other deposit account practices, including electronic fund transfers; the remaining 5 percent concerned disputes about trust services or other practices. (See tables.)

In 95 percent of the complaints against state member banks regarding regulated practices that were investigated in 2005, the banks had correctly handled the customer's account. The remaining 5 percent of the complaints against state member banks resulted in a finding that the bank had violated a consumer protection regulation. The

most common violations involved real estate loans, deposit accounts, and electronic fund transfers.

*Unregulated Practices*

As required by section 18(f) of the Federal Trade Commission Act, the Board continued to monitor complaints about banking practices that are not subject to existing regulations and to focus on those that concern possible unfair or deceptive practices. In 2005, the Board received more than 1,300 complaints against state member banks that involved unregulated practices. The categories that received the most complaints involved checking accounts and credit cards. Consumers most frequently complained about insufficient funds charges and procedures (95 complaints); other issues concerned interest rates and terms on credit cards (95), customer service (83), and fraud (57). The remainder of the complaints concerned a wide range of unregulated practices involving credit cards, including banks' refusals to close accounts when requested to do so by customers, the amounts banks charge for late payments, and the unsolicited offers banks send to consumers.

Consumer Complaints against State Member Banks, by Classification, 2005

Classification	Number
Regulation B (Equal Credit Opportunity) . . . .	29
Regulation C (Home Mortgage Disclosure Act) . . . . .	0
Regulation E (Electronic Fund Transfers) . . . .	30
Regulation H (Bank Sales of Insurance) . . . . .	2
Regulation M (Consumer Leasing) . . . . .	0
Regulation P (Privacy of Consumer Financial Information) . . . . .	4
Regulation Q (Payment of Interest) . . . . .	0
Regulation Z (Truth in Lending) . . . . .	187
Regulation BB (Community Reinvestment) . . . .	2
Regulation CC (Expedited Funds Availability) . . . . .	18
Regulation DD (Truth in Savings) . . . . .	37
Fair Credit Reporting Act . . . . .	96
Fair Debt Collection Practices Act . . . . .	40
Fair Housing Act . . . . .	2
Flood Insurance . . . . .	3
Regulations T, U, and X . . . . .	4
Real Estate Settlement Procedures Act . . . . .	6
<b>Total</b> . . . . .	<b>460</b>

*Complaint Referrals to HUD*

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2005 the Federal Reserve referred three complaints to HUD that alleged state member bank violations of the Fair Housing Act.

**Advice from the Consumer Advisory Council**

The Board's Consumer Advisory Council—whose members represent consumer and community organizations,

## Complaints against State Member Banks that Involve Regulated Practices, 2005

Subject of complaint	All complaints		Complaints involving violations	
	Number	Percent	Number	Percent
<b>Total</b> .....	<b>460</b>	<b>100</b>	<b>22</b>	<b>5</b>
Loans				
Discrimination alleged				
Real estate loans .....	5	1	0	0
Credit cards .....	11	2	0	0
Other loans .....	7	1	0	0
Other type of complaints				
Real estate loans .....	42	9	7	17
Credit cards .....	257	56	3	1
Other loans .....	38	8	2	5
Deposits	50	11	4	8
Electronic fund transfers .....	26	6	4	15
Trust services .....	1	1	0	0
Other .....	23	5	2	9

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 held three times a year and are open to the public. (For a list of members of the council, see the section “Federal Reserve System Organization.”)

In 2005, the council met in March, June, and October. In March, council members discussed the Board’s proposed amendments to Regulation E, which implements the Electronic Fund Transfer Act (EFTA). Members focused on proposed revisions to cover payroll cards as “accounts” under Regulation E; the revisions would require financial institutions to provide written periodic statements to consumers who use payroll cards. Some members asserted that providing written periodic statements to these consumers posed operational problems for lenders, because payroll card users are often not bank customers. Other members believed that payroll cards are a major

monetary asset for many unbanked consumers—and consumers should receive periodic statements for these accounts, regardless of any statement-delivery or other concerns.

In March and June, the council discussed the advance notice of proposed rulemaking (ANPR) to revise Regulation Z, which implements the Truth in Lending Act (TILA). Members commented on the current content and format of disclosures for credit card accounts and also pointed out that competition between credit card companies has led to consumers being offered complicated and confusing products that they may not understand. Members commented on the disclosure table known as the “Schumer box,” which is provided with credit card applications and solicitations. Although including a Schumer box on credit card applications and solicitations has been a successful way for lenders to disclose the associated fees, the design and format of the box could still be improved. Members also discussed whether the TILA amendments included in the Bankruptcy Abuse and Prevention and Consumer

Protection Act of 2005 should be implemented as part of the ongoing regulatory review of Regulation Z. All members agreed that developing the Bankruptcy Act TILA disclosures in conjunction with the review of Regulation Z would be beneficial.

The Home Mortgage Disclosure Act (HMDA) was a topic of discussion at both the March and October meetings. In March, council members discussed revisions to Regulation C (HMDA's implementing regulation) that require federally insured depository and for-profit nondepository lenders to collect, report, and publicly disclose loan-price data for certain higher-priced home mortgage loans. Many lenders and community groups expressed concerns about the release and interpretation of the new HMDA data. They emphasized that the Federal Reserve System's community affairs staff could promote a better understanding of the data by supporting education efforts and starting a dialogue between lenders and community groups. In October, members noted that the new HMDA pricing data show a higher incidence of higher-priced lending among minorities; members also believed that more research on opportunities for reaching underserved individuals, including low-income and minority borrowers, is needed.

The proposed revisions to the financial agencies' regulations implementing the Community Reinvestment Act (CRA) were discussed at the March and June meetings. Members' comments primarily focused on community development in rural areas. Prior to July 19, 2005, the CRA rules considered community development in rural areas as eligible for CRA credit if the activities targeted low- or moderate-income census tracts or populations. However, rural areas are frequently categorized as middle-income tracts because of the

uneven distribution of income levels within those census tracts. Members generally agreed that, in rural areas, the definition of community development should be expanded to be more responsive to the community development needs of those areas, regardless of their overall income levels. Members also focused on the community development test for branching services; they did not agree with the proposed rule change that would eliminate CRA credit for branching by banks with assets of between \$250 million and \$1 billion. They believed that a branching test should be required for intermediate small banks under the revised CRA proposal.

In June, council members from financial institutions discussed the scope and variety of recent information security breaches involving customer information, and they explored the challenges of finding solutions for safeguarding customer information. Members generally agreed that federal regulation (1) is needed to address information security problems on a national basis and (2) should cover entities beyond financial institutions. Entities that are not subject to regulatory oversight should be required to meet federal guidelines for establishing security programs and providing notice to customers and law enforcement agencies when breaches occur.

In October, pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), members provided comments on consumer protection laws and regulations that may have become outdated, unnecessary, or unduly burdensome. Members commented on the rules governing the asset-size exemption for reporting HMDA data, TILA's provisions addressing the right to rescind certain mortgage loan transactions, the Gramm-Leach-Bliley Act (GLB Act) requirements for

sending annual privacy notices, and the CRA rule requiring federal regulators' prior approval for establishing branches. Members agreed that the requirements for HMDA reporting and TILA's right-of-rescission rules were important and should be retained without change. Members suggested that the rules concerning GLB Act privacy notices and the CRA notice requirements for establishing branches could be simplified.

Nontraditional mortgage loan products were also discussed at the October meeting. During the past two years, the number of consumers obtaining non-traditional mortgages, such as payment-option adjustable-rate mortgages or interest-only mortgages, has significantly increased. Council members noted that these products are complex; require extensive education on the part of consumers, as well as extensive disclosures by lenders; and are often offered without considering sound underwriting criteria for the loan. Members expressed concern that some lenders do not provide consumers with disclosures that explain the full range of risks involved in repaying the loan. Members highlighted the need for more-extensive consumer financial education, which should be balanced with clear disclosures from lenders, understandable and less complex products, and underwriting standards that assess borrowers' suitability for nontraditional loan products. Hurricane Katrina was another topic of discussion at the October meeting. Members discussed a wide range of issues connected with the impact of the hurricane, commending the performance of the Federal Reserve and the other bank regulatory agencies in addressing immediate issues. However, members noted that the Gulf Coast region now needs long-term rebuilding and revitalization strategies to supplement the shorter-term "piecemeal"

responses that occurred immediately after the disaster. Members encouraged the Federal Reserve Board to take a leadership role in bringing federal policymakers together for a dialogue about long-term goals and solutions.

### **Promotion of Consumer Education and Community Economic Development in Historically Underserved Markets**

In 2005, the community affairs function within the Federal Reserve System supported several initiatives to promote community economic development and fair access to credit for low- and moderate-income communities and populations. The function continued to focus on financial literacy and education, the sustainability of community development organizations, policies to help low-income individuals build their assets, and community economic development. Activities included conducting research, publishing newsletters and articles, sponsoring conferences and seminars, and supporting the dissemination of information to both general and targeted audiences.

As a decentralized function, the Community Affairs Offices (CAOs) at the Board and each of the twelve Reserve Banks design activities in response to the needs of communities in the regions they serve. At the Reserve Banks, CAOs 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; the Board's CAO engages in activities and explores issues that have public policy implications.

Promoting well-educated and informed consumers is vital to supporting

consumer protection and efficient financial market operations. Accordingly, the Board has a long-standing commitment to providing consumers with information that helps them know their rights and responsibilities in relation to financial services, including how they can use disclosures to shop and compare products and providers. The Federal Reserve maintains a consumer information web site ([www.federalreserve.gov/consumers.htm](http://www.federalreserve.gov/consumers.htm)) that includes educational materials related to the Board's consumer regulations. In 2005, the consumer publication "How to File a Consumer Complaint about a Bank" was substantially revised and updated to reflect the current marketplace.

Last year, Board staff continued to be involved with an interagency working group drafting a national strategy for financial education. The working group was created to fulfill the legislative mandate of the Financial Literacy and Education Commission (the commission), established by the Fair and Accurate Credit Transactions Act (the FACT Act). The thirteen-agency working group, led by Treasury Department staff, is charged with developing a national strategy to promote basic financial literacy and education. The working group has sought the participation of government, private, nonprofit, and public institutions in this effort. In 2005, Board staff submitted comments to Treasury Department staff, who are writing the final strategy. Board staff also worked with the other agencies to update the [www.MyMoney.gov](http://www.MyMoney.gov) web site; the update links the web site to the Federal Reserve's consumer education materials. The globalization of the financial services industry has made financial education an international, as well as a national, concern. In November, Board staff shared insights on financial education and consumer protection regulation at a conference hosted by the

European Credit Research Institute in Belgium, and at the Third International Forum on Financial and Consumer Protection and Education in Malaysia.

Recognizing the importance of providing access to consumer and financial education to its employees, the Board offered several informational seminars in conjunction with its Workplace Financial Education Task Force, chaired by the director of the Division of Consumer and Community Affairs. Four programs were offered in 2005: identity theft, alternative and interest-only mortgage loans, credit reports, and an orientation to money and finances for Take Your Sons and Daughters to Work Day. Staff also assisted in the design and launch of a tax resources web site on the Board's intranet.

Board staff continued to be involved in national financial education initiatives throughout the year. The division's director serves as an adviser to the board of Operation HOPE, a national nonprofit organization dedicated to delivering financial education programs to low-income populations with a particular focus on communities suffering from natural disasters. Currently, a member of the Board of Governors serves on the board of directors of NeighborWorks America (the trade name of the Neighborhood Reinvestment Corporation). Community Affairs staff participate in strategic planning for the NeighborWorks Center for Homeownership Education and Counseling, with the objective of developing national standards for financial counseling and training to promote homeownership among low- and moderate-income populations. To further support consumers' informed decision making about mortgage credit, Board staff developed an information brochure describing the implications of interest-only loans, a popular product in high-cost housing markets. The bro-

chure describes the rate and payment adjustments inherent in the terms of these loans. Board and Reserve Bank staff also continued to support the Conference of Mayors' financial education program, Dollar Wi\$e. In various cities throughout the country, the program seeks to increase the awareness of the importance of personal financial management. Membership in the campaign doubled in 2005, with seventy-one cities now participating.

The CAOs at the Reserve Banks remained active in financial education initiatives during 2005. The Federal Reserve Bank of Kansas City actively promoted workplace financial education by convening employers in Kansas City and Denver to discuss the advantages of providing financial education to employees. In partnership with the Atlanta Reserve Bank, Kansas City staff also published a brochure identifying the characteristics of an effective financial education program ([www.kc.frb.org/comaffrs/Workshops/FEBrochure.pdf](http://www.kc.frb.org/comaffrs/Workshops/FEBrochure.pdf)). The Oklahoma City Branch of the Kansas City Reserve Bank collaborated with the Oklahoma Jump\$tart Coalition to host a conference of local financial-education service providers and community members to identify strategies for expanding financial education throughout the state. In an effort to expand the scope of the regional financial education collaboratives it has helped establish in key cities in the Fourth District, the Cleveland Reserve Bank hosted a conference that underscored effective strategies for measuring success and conducting research on financial education.

Complementing the System's financial education efforts, various CAOs partnered with CFED, a national non-profit organization formerly known as the Corporation for Enterprise Development, to host a series of events

delving into asset-building and wealth-accumulation strategies for lower-income individuals. The San Francisco, New York, Boston, and Philadelphia Reserve Banks cohosted two conferences with CFED in San Francisco and New York that highlighted private-sector innovations as well as local and national policies that facilitate and encourage savings and investment among lower-income consumers. In addition, the Board and the Richmond Reserve Bank cohosted a forum of national research and policy experts to discuss opportunities for improving asset-building among lower-income populations.

Building on prior years' efforts to help community development financing organizations grow and survive, the Federal Reserve System and the Aspen Institute collaborated on a series of conferences. Research by the Aspen Institute, a national research and leadership development organization, was the foundation for conference discussions about the industry and how to increase its impact. One event, sponsored by the Chicago Reserve Bank, explored various business models that have led to successful community development finance programs. Another event, cohosted by the Boston Reserve Bank, explored whether socially responsible investments can be used to fund community development institutions and help them operate more effectively. Board staff also participated in an international conference, sponsored by the Social Enterprise Initiative at Harvard Business School, on effective business strategies for serving lower-income populations. Staff presented a case study of a community development financial institution, highlighting the role banking regulation and policy had in motivating private investment in these institutions, as well as the business strategies these

institutions adopted to respond to the credit and financial services needs of their lower-income markets.

The System's CAOs remain committed to increasing research and data on community economic development. In 2005, the System hosted its biennial community development research conference, "Promises and Pitfalls: As Consumer Finance Options Multiply, Who Is Being Served and at What Cost?" The Research and Community Affairs staffs at the Board and the Cleveland Reserve Bank collaborated on the event. Papers presented at the conference assessed the impact that consumer behavior, alternative financial services providers, financial education, and other factors have on consumers' access to and experiences with the financial sector. In one paper, System staff studied data from focus groups with Mexican immigrants who remitted money to family members in Mexico. Those results are being used to help immigrants connect with the banking system and thereby increase market efficiencies for both financial institutions and consumers. The results are also being used in interagency efforts to educate consumers about the remittance channels available to them. A call for papers for the System's 2007 research conference has been issued. The 2007 conference will address the effectiveness of the Community Reinvestment Act (CRA) in promoting access to and encouraging community and economic development, in light of the dramatic changes that have occurred in the financial services industry in the thirty years since the CRA was enacted.<sup>9</sup>

In addition to participating in the System research conference, several CAOs

at Reserve Banks have expanded their programs to include research and data collection. The Boston Reserve Bank launched a series of community economic development papers that offer in-depth coverage of current community economic development issues. The Boston Bank also created a new series of data resources on the socioeconomic characteristics of lower-income communities in New England ([www.bos.frb.org/commdev/index.htm](http://www.bos.frb.org/commdev/index.htm)). The New York Reserve Bank published research on whether stored-value cards are an effective electronic payment tool for unbanked consumers; the Bank also published a paper on using the earned income tax credit to encourage savings and banking system participation by unbanked consumers ([www.ny.frb.org/regional/commdev.html](http://www.ny.frb.org/regional/commdev.html)). To bridge the gap between community economic development theory and practice, the San Francisco Reserve Bank launched a new community development journal that features articles and commentary by researchers, policymakers, and practitioners ([www.sf.frb.org/publications/community/](http://www.sf.frb.org/publications/community/)). Research by Board staff on the financial education programs offered to military personnel by the Department of Defense (DoD) continued. Staff collected data from recipients of the DoD's financial education program as support for a longitudinal study to assess the impact of DOD's programs on the financial management behavior of the recipients.

Finally, Board staff undertook efforts to help the public understand and use the new Home Mortgage Disclosure Act (HMDA) data. Public interest in HMDA data increased significantly in 2005, with the release of previously uncollected data on the pricing of home mortgage loans. To address potential concerns and questions about the new HMDA data, Board staff

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9. The web site for the 2005 conference (including conference papers), as well as the 2007 call for papers, can be accessed at [www.federalreserve.gov/community.htm](http://www.federalreserve.gov/community.htm).

worked collaboratively with other agencies to develop questions and answers about the insights and limitations the new data provide. (See the Board's March 31, 2005, press release at [www.federalreserve.gov/newsevents.htm](http://www.federalreserve.gov/newsevents.htm).) These questions and answers were designed to both help interested parties use the data objectively and to discourage individuals and groups from forming conclusions about mortgage lending patterns that are not supported by the data.

### **Outreach Activities**

The Board engages in outreach activities throughout the year to provide information to the public about the Board's responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consum-

ers, 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 2005 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. ■

## *Federal Reserve Banks*

In addition to contributing to the setting of national monetary policy and supervising and regulating banks and other financial entities (discussed in preceding chapters), the Federal Reserve Banks operate a nationwide payments system, distribute the nation's currency and coin, and serve as fiscal agents and depositories for the United States.

### **Developments in Federal Reserve Priced Services**

In operating a nationwide payments system, the Federal Reserve Banks provide numerous services to depository institutions, including collecting and processing checks, operating an automated clearinghouse service, transferring funds and securities, and providing settlement services. The Reserve Banks charge fees for providing these "priced services."

The Monetary Control Act of 1980 requires that the Federal Reserve establish fees for priced services provided to depository institutions so as to recover, over the long run, all direct and indirect costs actually incurred as well as the imputed costs that would have been incurred, including financing costs, taxes, and certain other expenses, and the return on equity (profit) that would have been earned if a private business firm had provided the services. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).<sup>1</sup> Over

the past ten years, the Reserve Banks have recovered 98.4 percent of their priced services costs, including the PSAF (table). In 2005, the Board approved changes, to be effective in 2006, to the method for calculating the target return on equity measure in the PSAF.

Overall, the price index for priced services increased 8.4 percent from 2004 to 2005. Revenue from priced services amounted to \$901.0 million, other income was \$93.7 million, and costs were \$834.7 million, resulting in net income from priced services of \$160.0 million. In 2005, the Reserve Banks recovered 106.1 percent of total costs of \$937.7 million, including the PSAF.<sup>2</sup>

### **Commercial Check Collection Service**

In 2005, operating expenses and imputed costs for the Reserve Banks' commercial check collection service totaled \$688.6 million, of which \$39.0 million was attributable to the transportation of commercial checks

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

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

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

## Priced Services Cost Recovery, 1996–2005

Millions of dollars except as noted

Year	Revenue from services <sup>1</sup>	Operating expenses and imputed costs <sup>2</sup>	Targeted return on equity	Total costs	Cost recovery (percent) <sup>3</sup>
1996 .....	815.9	746.4	42.9	789.3	103.4
1997 .....	818.8	752.8	54.3	807.1	101.5
1998 .....	839.8	743.2	66.8	809.9	103.7
1999 .....	867.6	775.7	57.2	832.9	104.2
2000 .....	922.8	818.2	98.4	916.6	100.7
2001 .....	960.4	901.9	109.2	1,011.1	95.0
2002 .....	918.3	891.7	92.5	984.3	93.3
2003 .....	881.7	931.3	104.7	1,036.1	85.1
2004 .....	914.6	842.6	112.4	955.0	95.8
2005 .....	994.7	834.7	103.0	937.7	106.1
1996–2005 .....	8,934.6	8,238.4	841.4	9,080.0	98.4

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 \$8,606.3 million and other income and expense (net) of \$328.3 million.

2. For the ten-year period, includes operating expenses of \$7,585.1 million, imputed costs of \$341.4 million, and imputed income taxes of \$312.0 million.

3. Revenue from services divided by total costs.

between Reserve Bank check-processing centers. Revenue amounted to \$740.3 million, of which \$42.9 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was \$77.1 million. The resulting net income was \$128.7 million. Check service revenue in 2005 increased \$20.6 million from 2004, largely because of price increases and a slower-than-anticipated reduction of check-processing volume.

The Reserve Banks handled 12.2 billion checks in 2005, a decrease of 12.3 percent from the 13.9 billion checks handled in 2004 (table). The decline in Reserve Bank check volume is consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.<sup>3</sup> Overall, the price index for check

services increased 10.2 percent from 2004.

In response to the continuing decline in check volume, the Reserve Banks in 2005 continued to reduce check service operating costs through a combination of measures, including closing some check-processing sites and increasing capacity at others. Checks that once would have been processed in Birmingham are now processed in Atlanta. Detroit check processing has been consolidated to Cleveland; Salt Lake City to Denver; Portland to Seattle; and Houston and Oklahoma City to Dallas.

Of all the checks presented by the Reserve Banks to paying banks in 2005, 25.2 percent (approximately 3.1 billion checks) were presented electronically, compared with 23.1 percent in 2004. The Banks captured images of 11.8 percent of the checks they col-

3. The Federal Reserve System's retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. For details, see Federal

Reserve System, "The 2004 Federal Reserve Payments Study: Analysis of Noncash Payments Trends in the United States, 2000–2003" (December 2004). ([www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf](http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf))

## Activity in Federal Reserve Priced Services, 2003–2005

Thousands of items

Service	2005	2004	2003	Percent change	
				2004 to 2005	2003 to 2004
Commercial check .....	12,195,301	13,904,382	15,805,894	-12.3	-12.0
Funds transfer .....	135,227	128,270	125,936	5.4	1.9
Securities transfer .....	9,235	9,208	10,071	.3	-8.6
Commercial ACH .....	7,338,950	6,486,091	5,588,381	13.1	16.1
Noncash .....	117	211	280	-44.5	-24.7

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 off-

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

lected, an increase from 10.4 percent in 2004. In 2005 the Banks presented approximately 241.5 million substitute checks, or 2.0 percent of the total number of checks they collected. (For more information on substitute checks, see the box “The First Full Year of Check 21.”)

### Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled \$72.1 million in 2005. Revenue from ACH operations totaled \$79.3 million and other income totaled \$8.2 million, resulting in net income of \$15.2 million. The Banks processed 7.3 billion commercial ACH transactions (worth \$12.8 trillion), an increase of 13.1 percent from 2004. Overall, the price index for ACH services decreased 1.1 percent from 2004.

In 2005 the Reserve Banks conducted a pilot program of an ACH risk-management service that will be available to all depository institutions in 2006. The service will help originating institutions manage operational, credit, and third-party risk associated with originating ACH payments.

### Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled \$55.3 million in 2005. Revenue from these operations totaled \$61.0 million and other income amounted to \$6.3 million, resulting in net income of \$12.1 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 2005, the number of Fedwire funds transfers originated by depository institutions increased 5.4 percent from 2004, to approximately 135.2 million. The average daily value of Fedwire funds transfers in 2005 was \$2.1 trillion.

#### *National Settlement Service*

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks’ National Settle-

## The First Full Year of Check 21

The United States is in the midst of significant change in the way payments are made. At one time, most noncash payments were made by paper check. Evidence of major change was seen in the results of the Federal Reserve's most-recent payments research, which found that in 2003, for the first time ever, businesses and consumers made more payments electronically (by debit and credit card, for example) than by paper check. The declining use of checks is only a part of the ongoing change within the payments system, however. The way in which checks are collected is changing as well, as a result of the Check Clearing for the 21st Century Act (commonly referred to as Check 21). Before implementation of the act in 2004, laws governing check collection allowed a paying bank to require that the original check be physically presented for payment. Check 21 was designed to facilitate the electronic processing of checks, with the goal of making check collection faster, more efficient, and less costly.

Under Check 21, while a paying bank may demand that presentment be in the

form of a paper check, it may no longer require that the *original* check be presented. Instead, paying banks must accept a "substitute check," a special paper copy of an original check that can be processed in the same way as the original check. By authorizing this new, legally equivalent negotiable instrument, Check 21 facilitates, through the action of market forces, the adoption of check truncation and the electronic collection of checks.<sup>1</sup> As banks increasingly send and receive checks electronically, they will be able to reduce their

1. Check truncation is the removal of an original check from the check-collection system and the collection, instead, of a substitute check or, by agreement, information contained on the original check's magnetic ink character recognition (MICR) line, including the paying bank's routing number, the check writer's account number, the check serial number, and the amount of the check. Additional consumer information on Check 21 is available at [www.federalreserve.gov/consumers.htm](http://www.federalreserve.gov/consumers.htm). Banking industry educational and reference material on Check 21 is available at [www.ffiec.gov/exam/check21/default.htm](http://www.ffiec.gov/exam/check21/default.htm).

ment Service to settle their transactions. This service is provided to approximately fifty-five local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2005, the Reserve Banks processed slightly more than 440,000 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.<sup>4</sup> Reserve Bank operating expenses and imputed costs for providing this service totaled \$17.4 million in 2005. Revenue from the service totaled \$19.3 million, and other income totaled

4. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and certain international organizations. 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.

infrastructure for processing paper checks and the cost of physically transporting original paper checks from the bank where they were deposited to the banks that pay them.

The Federal Reserve Banks have been leaders within the payments industry in making use of the authority granted by Check 21. They began offering Check 21 services as soon as the law became effective in October 2004. The services allow for the deposit of digital check images with the Reserve Banks and the truncation of paper-check deposits by the Reserve Banks. The check images are transmitted to the Reserve Bank closest to the paying bank, thereby eliminating the need to physically transport paper checks between the Banks. The receiving Reserve Bank either prints substitute checks from the check images for presentment to the paying bank or, if the paying bank accepts electronic presentment, provides the check information electronically.

Across the industry, banks have begun to take advantage of the opportunities created

by Check 21. More than 500 depository institution customers were using Federal Reserve Check 21 services by year-end 2005. In December 2005, peak daily volume processed by the Reserve Banks exceeded 3 million substitute checks valued at more than \$19 billion.

As with many significant operational and technological changes, adoption of the new check-processing methods made possible by Check 21 has been gradual. To fully realize the benefits of a faster, more efficient, less costly, and more resilient check-collection system envisioned when Check 21 was enacted, the banking industry will need to make changes to its current systems to support the exchange of digital check images. As technology improves and scale economies are realized, the cost of collecting checks electronically will decrease relative to the cost of collecting paper checks, and this decrease should eventually spur greater adoption of Check 21 technologies across the banking industry.

\$2.0 million, resulting in net income of \$3.8 million. Approximately 9.2 million transfers of Treasury and other securities were processed by the service during the year, almost unchanged from 2004. In 2005, the surcharge for offline transfers increased from \$28 to \$33.

### Noncash Collection Service

At year-end 2005, the Reserve Banks withdrew from the noncash collection service, which collected and processed municipal bearer bonds and coupons issued by state and local governments (referred to as “noncash” items), because of a declining volume of coupons and bonds presented for collection. The service processed slightly fewer than 117,000 noncash transactions in

2005, representing a 44.5 percent decline in volume from 2004. Operating expenses and imputed costs for noncash operations totaled \$1.1 million in 2005, and revenue and other income totaled \$1.2 million, resulting in net income of approximately \$0.1 million.

### Float

The Federal Reserve had daily average debit float of \$133.4 million in 2005, compared with credit float of \$76.4 million in 2004.<sup>5</sup>

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

## **Developments in Currency and Coin**

The Federal Reserve Banks distribute the nation's currency (in the form of Federal Reserve notes) and coin through depository institutions and receive currency and coin from circulation. As currency flows into the Reserve Banks, the Banks inspect the notes and destroy those that are unfit for recirculation.

The Reserve Banks received 37.2 billion Federal Reserve notes from circulation in 2005, a 0.9 percent decrease from 2004, and made payments of 38.5 billion notes into circulation, a 1.6 percent increase from 2004. They received 56.1 billion coins from circulation in 2005, a 0.8 percent increase from 2004, and made payments of 72.1 billion coins into circulation, a 6.9 percent increase from 2004.<sup>6</sup>

Because many depository institutions overuse Reserve Bank cash-processing services, the Board in 2003 requested comment on a policy of providing incentives to encourage depository institutions to recirculate fit currency to their customers rather than return it to the Federal Reserve for processing. Under the policy, the Federal Reserve would establish a custodial inventory program that allows depository institutions to transfer a portion of their cash holdings to the books of a Reserve Bank. Reserve Banks would charge fees to institutions that, within a one-week period, deposited fit currency and reordered currency of the same denomination within the same Reserve Bank office's service area. The Reserve Banks conducted a custodial inventory proof-of-concept program in 2004 to test the effectiveness of a program that supports the proposed policy and evaluated the program in

2005. The Reserve Banks believe that a permanent custodial inventory program, together with recirculation fees, would provide incentives to depository institutions to recirculate currency.

Study of the proposed policy's potential effects on the quality of currency in circulation continues. In 2005, the Federal Reserve worked with vending industry representatives to determine the effect of quality variance on machines' ability to accept currency. The Federal Reserve is also developing a technical definition of currency that is "fit for commerce" and a Reserve Bank program to monitor and control the quality of currency in circulation. The Board is expected to consider approval of a final recirculation policy in early 2006.

The Reserve Banks also continue to study cost-effective alternatives to the existing infrastructure for providing cash services. Earlier studies resulted in the elimination of cash operations at the Little Rock, Louisville, Buffalo, and Portland (Oregon) offices and the replacement of these offices with cash depots. In a cash depot arrangement, armored carrier facilities serve as collection and distribution points for depository institutions' currency deposits and orders. The deposits and orders are transported to and from a nearby Reserve Bank by armored carrier.

## **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 federal government, process electronic and check payments for the Treasury, maintain the Treasury's bank account, and invest excess Treasury balances. The Reserve Banks

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6. Percentages reflect restatements of previously reported data.

## Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2003–2005

Thousands of dollars

Agency and service	2005	2004	2003
DEPARTMENT OF THE TREASURY			
<i>Bureau of the Public Debt</i>			
Treasury retail securities			
Savings bonds .....	59,624.0	72,385.1	66,403.7
TreasuryDirect and Treasury coupons .....	26,879.2	30,872.7	33,013.5
Treasury securities safekeeping and transfer .....	6,055.8	6,267.0	4,836.3
Treasury auction .....	17,553.5	17,159.5	16,802.6
Computer infrastructure development and support .....	2,575.5	5,935.1	7,836.7
Other services .....	1,806.5	1,709.8	1,460.7
Total .....	114,494.5	134,329.1	130,353.4
<i>Financial Management Service</i>			
Payment services			
Government check processing .....	20,988.0	24,245.4	25,624.7
Automated clearinghouse .....	5,709.5	5,352.9	6,253.9
Fedwire funds transfers .....	109.4	111.6	187.3
Other payment-related services .....	49,366.0	33,646.9	23,630.8
Collection services			
Tax and other revenue collections .....	39,736.0	34,248.4	29,782.9
Other collection-related services .....	14,354.2	12,922.8	12,532.6
Cash management services .....	40,496.7	21,835.8	18,227.8
Computer infrastructure development and support .....	67,703.3	52,673.3	24,575.3
Other services .....	2,332.2	6,931.6	6,666.2
Total .....	240,795.4	191,968.6	147,481.5
<i>Other Treasury</i>			
Total .....	15,726.7	15,106.1	13,913.5
Total, Treasury .....	371,016.6	341,403.7	291,748.5
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons .....	2,642.4	4,519.0	7,791.4
U.S. Postal Service			
Postal money orders .....	7,647.8	7,774.6	10,959.5
Other agencies			
Other services .....	14,870.2	16,104.0	16,508.2
Total, other agencies .....	25,160.4	28,397.5	35,259.2
Total reimbursable expenses .....	396,177.0	369,801.2	327,007.7

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 2005 amounted to \$396.2 million, compared with \$369.8 million in 2004 (table). Treasury-related costs were \$371 million in 2005, compared with \$341.4 million in 2004, an increase of 8.7 percent. The cost of providing services to other entities was \$25.2 million, compared with \$28.4 million in 2004. In 2005, as in 2004, the Treasury and other entities

reimbursed the Reserve Banks for the costs of providing these services.

The most-significant development in the provision of fiscal agency services in 2005 was the Reserve Banks' consolidation of customer service and back-office 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. The consolidation to two sites was completed in October 2005. The Banks expect that annual operating costs for retail securities operations will decline considerably in 2006 because of lower personnel costs.

### Debt Services

The Reserve Banks auction, provide safekeeping for, and transfer Treasury securities. Reserve Bank operating expenses for these activities totaled \$23.6 million in 2005, a slight increase from 2004. The Banks processed 245,000 tenders for Treasury securities, compared with 156,000 in 2004. They originated 12.6 million transfers of Treasury securities in 2005, an 18.6 percent increase from 2004.

The Reserve Banks also operate computer applications and provide customer service and back-office support for the Treasury's retail securities programs, including Treasury securities and savings bonds. Reserve Bank operating expenses for these activities were \$86.5 million in 2005, compared with \$103.3 million in 2004.

In addition, the Reserve Banks operate Treasury Direct, a program that allows investors to purchase and hold Treasury securities directly with the Treasury instead of through a broker. The program held \$68.1 billion (par value) of Treasury securities as of December 31, 2005. Because the program was designed for investors who plan to hold their securities to maturity, it does not provide transfer services. Investors may, however, sell their securities for a fee through Sell Direct, a program operated by one of the Reserve Banks. Approximately 14,000 securities worth \$874.8 million were sold through Sell Direct in 2005, compared with

15,000 securities worth \$673.3 million in 2004. Fees associated with the sale of securities through Sell Direct totaled \$566,000, an increase of 12.2 percent from the more than \$504,000 in fees collected in 2004.

The Banks printed and mailed more than 32 million savings bonds in 2005, a 9.6 percent decrease from 2004. They issued more than 3 million Series I (inflation indexed) bonds and 12.6 million Series EE bonds. Reissued or exchanged bonds accounted for the remaining bonds printed. The Banks processed about 3.5 million redemption, reissue, and exchange transactions, a 9.6 percent decrease from 2004.

### Payments Services

The Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments totaled \$76.2 million in 2005, compared with \$63.4 million in 2004. The Banks processed 981 million ACH payments for the Treasury, an increase of 4.4 percent from 2004, and more than 849,000 Fedwire funds transfers. They also processed 214.8 million paper government checks, a decline of 8.3 percent from 2004. In addition, the Banks issued more than 206,000 fiscal agency checks, a decrease of 25.9 percent from 2004.

In addition to processing payments, the Reserve Banks operate several programs to help the Treasury increase the use of electronic payments. One such program, the Automated Standard Application for Payment, enables recipients of federal grants to request payments using the Internet. This application processed \$423.8 billion in Fedwire funds transfers and ACH payments in 2005, compared with \$404.7 billion in

2004. Another such program, the stored-value card program, provides salary and benefit payments to military personnel, via a smart card, for use at military bases. In 2005, the Banks worked with the Treasury to plan a web-based application to allow federal agencies and vendors to exchange purchase orders and invoices and initiate ACH payments electronically. The operating costs for these three programs totaled \$19.7 million in 2005, compared with \$15.4 million in 2004.

### Collection Services

The Reserve Banks support several Treasury programs to collect funds owed the federal government. Reserve Bank operating expenses related to these programs totaled \$54.1 million in 2005, compared with \$47.2 million in 2004. 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. It uses the automated clearinghouse (ACH) to collect funds, so 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 allows these taxpayers to use EFTPS by providing a same-day electronic federal tax payment alternative. FR-ETA collected \$409.2 billion for the Treasury in 2005, compared with \$344.8 billion in 2004.

In addition, the Reserve Banks operate Pay.gov, a Treasury program that allows members of the public to pay for goods and services offered by 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 into ACH transactions at the point of sale or at lockbox locations. In 2005, the Reserve Banks originated more than 2.6 million ACH transactions through these programs, a 36 percent increase from the 1.9 million originated in 2004.

### Cash Management Services

The Treasury maintains its bank account at the Reserve Banks and invests the funds it does not need for 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 \$40.5 million in 2005, compared with \$21.8 million in 2004. The investments either are callable on demand or are for a set term. In 2005, the Reserve Banks placed a total of \$8.8 billion in immediately callable investments and \$574.1 billion in term investments. The rate for term investments is set at auction; the Reserve Banks held 104 such auctions in 2005, compared with 45 auctions in 2004. In 2005, the Treasury's income from the TT&L program was \$597.4 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.

## **The Federal Reserve System's Response to Hurricane Katrina**

The damage from Hurricane Katrina's strike along the Gulf Coast on August 29, 2005, and the subsequent flooding of much of New Orleans when levees were breached, seriously affected the banking system's ability to provide financial services at a time when individuals and businesses needed access to their funds. Some depository institutions were flooded and unable to open. Others in the Gulf Coast region that were not severely damaged and might have opened were unable to do so because of interruptions to utility services or a shortage of employees. The transportation of cash for distribution to the public was impeded, and the process of presenting and collecting checks was disrupted.

These conditions presented challenges to the Federal Reserve, which is charged with distributing the nation's currency and coin and provides check-collection services to depository institutions. In the Gulf Coast region, the Federal Reserve conducts these operations through the New Orleans Branch of the Atlanta Federal Reserve

Bank. The New Orleans Branch building was not flooded and sustained only minor damage from the hurricane. Only a few essential employees were able to remain in the building, however, so the Branch was unable to provide services as usual. Nonetheless, even before Hurricane Katrina struck, the Branch implemented its contingency operations plans by relocating certain essential employees from New Orleans to the Atlanta Bank's Birmingham, Alabama, Branch, and it quickly began providing services to depository institutions through other Federal Reserve offices. Recognizing that depository institutions faced gasoline shortages and could incur high costs to obtain cash from offices outside New Orleans, the Atlanta and Dallas Reserve Banks arranged for armored carriers to transport cash into the affected areas.

To further support recovery efforts, the Atlanta Reserve Bank also opened drop-off points for check deposits a few days after the hurricane. These deposits were then transported to the Bank's Atlanta office

## **Electronic Access to Reserve Bank Services**

The Federal Reserve Banks have been using a DOS-based platform, FedLine, to provide services and information to about seven thousand depository institution end points, mainly small and medium-sized institutions. A more-efficient replacement delivery channel, FedLine Advantage, which uses Internet web technologies to provide financial institutions with access to such critical payment systems as Fedwire Funds Service, Fedwire Securities Service, and FedACH Services, has been developed. Migration to FedLine Advantage began in 2005 and will be completed in 2006.

## **Information Technology**

In 2005, the Federal Reserve Banks completed projects to standardize local area network components and telephone private branch exchange systems and to implement reduced-cost wide area network telecommunications services. An initiative is now under way to strengthen information security controls across the System.

In partnership with the agencies that make up the Financial and Banking Information Infrastructure Committee, the Federal Reserve continued in 2005 to sponsor clearing and settlement utilities, key financial institutions, and key market participants in the national secu-

for processing. Staff from other Federal Reserve offices—and, subsequently, relocated New Orleans employees—have continued to process checks in Atlanta. The Atlanta Bank provided credit for deposited checks drawn on depository institutions in the New Orleans area even though it was initially unable to present checks to those institutions for collection, and it did not return the checks that it could not present. During the crisis, the number of checks drawn on New Orleans area institutions that cleared through the Federal Reserve rose significantly as checks that would normally have cleared through other channels were redirected through the Federal Reserve.

As depository institutions in the affected area began operating at contingency locations, the Atlanta Reserve Bank contacted those institutions to gather information on their situation, particularly on their liquidity and their ability to process payments. Reestablishing contact with depository institutions—an effort on which the Federal Reserve worked closely with other regulatory agencies—was critical, as some institutions had difficulty restoring their

operations and were unable to retrieve their ACH (automated clearinghouse) files, which contained information on payroll, Social Security, and other credit payments that their customers needed in this time of crisis.

The Board also worked with key government finance and banking regulatory agencies to devise a strategy for restoring vital telecommunications services to affected institutions. The Board served as the central point of contact for management of the overall restoration effort under the Telecommunications Service Priority (TSP) program—a federal program that identifies and prioritizes those telecommunications services essential to national security and emergency preparedness.<sup>1</sup> Most institutions that were assigned high TSP priority had some measure of telecommunications services available within a matter of days.

1. The TSP program is administered by the National Communications System (NCS), an interagency group of federal departments and agencies that plans for and coordinates national security and emergency preparedness telecommunications, especially during crises.

ity and emergency preparedness programs offered by the Department of Homeland Security's National Communications System, which coordinates activities to ensure that critical telecommunications services are prepared to meet natural disasters and national emergencies. The Board's role in implementing one of these programs—the Telecommunications Service Priority program—to help restore telecommunications services to financial institutions in Mississippi and Louisiana in the wake of Hurricane Katrina and the subsequent flooding in New Orleans is described in the accompanying box.

In response to recommendations in the 2004 report of the Financial Services

Task Force of the President's National Security Telecommunications Advisory Committee, the Federal Reserve in 2005 partnered with the Alliance for Telecommunications Industry Solutions (ATIS) on a collaborative project. The team assessed the ability to track changes in the way telecommunications circuits are routed to customer locations and determined that there is currently no commercially viable product that can be adopted to automate this process. The greater the number of carriers involved in providing services, the more difficult it becomes to track such changes. A diverse network provides more protection against disruption of service during contingencies, however, because diver-

sity lessens the risk of a single point of failure. A report on this initiative, the National Diversity Assurance Initiative, was released in February 2006.

### **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 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 2005, the Reserve Banks further 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 2005 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$4.6 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 2005, the Reserve Banks did not engage PwC for non-audit services.

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 2005 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 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 2004 and 2005.

Income in 2005 was \$30,729 million, compared with \$23,540 million in 2004. Expenses totaled \$3,633 million (\$2,677 million in operating expenses, \$213 million in earnings

Income, Expenses, and Distribution of Net Earnings  
of the Federal Reserve Banks, 2005 and 2004

Millions of dollars

Item	2005	2004
Current income .....	30,729	23,540
Current expenses .....	2,890	2,239
Operating expenses <sup>1</sup> .....	2,677	2,123
Earnings credits granted .....	213	116
Current net income .....	27,840	21,301
Net additions to (deductions from, - ) current net income .....	-3,577	918
Assessments by the Board of Governors .....	743	776
For expenditures of Board .....	266	272
For cost of currency .....	477	504
Net income before payments to Treasury .....	23,520	21,443
Dividends paid .....	781	582
Transferred to surplus .....	1,272	2,783
Payments to Treasury <sup>2</sup> .....	21,468	18,078

1. Includes net periodic pension credit of \$11 million in 2005 and \$37 million in 2004.

2. Interest on Federal Reserve notes.

credits granted to depository institutions, \$266 million in assessments for expenditures by the Board of Governors, and \$477 million for the cost of new currency). Revenue from priced services was \$901 million. The profit and loss account showed a net loss of \$3,577 million. The loss was due primarily to unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled \$781 million, \$199 million more than in 2004; 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 \$21,468 million in 2005, up from \$18,078 million in 2004; the payments equal net income after the deduction of dividends paid and of the amount necessary to equate the Reserve Banks' surplus to paid-in capital.

In the "Statistical Tables" section of this report, table 10 details the income

and expenses of each Reserve Bank for 2005 and table 11 shows a condensed statement for each Bank for the years 1914 through 2005; table 9 is a statement of condition for each Bank, and table 13 gives number and annual salaries of officers and employees for each. A detailed account of the assessments and expenditures of the Board of Governors appears in the section "Board of Governors Financial Statements."

### Holdings of Securities and Loans

The Federal Reserve Banks' average daily holdings of securities and loans during 2005 amounted to \$761,509 million, an increase of \$41,862 million from 2004 (table). Holdings of U.S. government securities increased \$41,801 million, and holdings of loans increased \$61 million. The average rate of interest earned on the Reserve Banks' holdings of government securities increased to 3.80 percent, from 3.11 percent in 2004, and the average rate of interest earned on loans increased to 3.49 percent, from 1.74 percent.

## Securities and Loans of the Federal Reserve Banks, 2003–2005

Millions of dollars except as noted

Item and year	Total	U.S. government securities <sup>1</sup>	Loans <sup>2</sup>
<i>Average daily holdings<sup>3</sup></i>			
2003 .....	683,438	683,294	144
2004 .....	719,647	719,494	153
2005 .....	761,509	761,295	214
<i>Earnings<sup>4</sup></i>			
2003 .....	22,598	22,597	1
2004 .....	22,347	22,344	3
2005 .....	28,966	28,959	7
<i>Average interest rate (percent)</i>			
2003 .....	3.31	3.31	1.00
2004 .....	3.11	3.11	1.74
2005 .....	3.80	3.80	3.49

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.

## Volume of Operations

Table 12 in the “Statistical Tables” section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 2002 through 2005.

## Federal Reserve Bank Premises

In 2005, construction was completed on new buildings for the Dallas Federal Reserve Bank’s Houston Branch and the Chicago Bank’s Detroit Branch, and construction began on the Kansas City Bank’s new headquarters building after the Board approved the project’s final design. Design work continued, and site preparation work began, for the San Francisco Bank’s new Seattle Branch building. The multiyear renovation program at the New York Bank’s headquarters building continued, as did facility renovation projects at several Reserve Bank offices to accommodate the consolidation of check activities.

Security enhancement programs continue at several facilities. One such

project is an ongoing external perimeter security improvement project at the Boston Bank. Another is taking place at the St. Louis Bank, where, as part of a long-term facility redevelopment program, construction of a new pedestrian entrance screening vestibule was completed and design work for an addition to the Bank’s headquarters building continued. The St. Louis Bank also completed the purchase and renovation of a building to be used as a business-continuity relocation facility. In addition, the Richmond Bank completed renovation of a building to be used as a relocation site for critical staff and initiated construction of additional security improvements to the building. The Dallas Bank completed the purchase of property behind its headquarters building for the construction of a remote vehicle screening and shipping/receiving facility.

Also during 2005, the Board approved the Richmond Bank’s purchase of property adjacent to its headquarters building for construction of a new parking garage, and the sales of the

New York Bank's Buffalo Branch and the Kansas City Bank's headquarters building were finalized. Efforts to sell the Chicago Bank's Detroit Branch building, the St. Louis Bank's Little Rock Branch building, and the San Francisco Bank's Seattle and Portland Branch buildings continued, as did efforts by the Dallas Bank to sell excess land at its Houston Branch and to lease excess space in the Branch building.

Administrative activities for the Buffalo, Louisville, and Little Rock Branches were moved to leased facilities. Check operations formerly conducted at the San Francisco Bank's Seattle and Portland Branches were con-

solidated and relocated to a leased facility near the Seattle airport. The Portland Branch cash operation was relocated to the current Seattle Branch building until the new building is completed.

Although utility services were interrupted, the Atlanta Bank maintained the security and building systems operations of its New Orleans Branch building during Hurricane Katrina. Because the building sits several feet above flood level, it was not damaged by flooding.

Table 14 in the "Statistical Tables" section of this report details the acquisition costs and net book value of the Federal Reserve Banks and Branches. ■

## Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2005 and 2004

Millions of dollars

Item	2005	2004	
<i>Short-term assets</i> (Note 1)			
Imputed reserve requirements on clearing balances .....	993.2	1,115.7	
Imputed investments .....	8,626.4	9,691.9	
Receivables .....	77.0	75.8	
Materials and supplies .....	1.3	1.9	
Prepaid expenses .....	25.6	31.8	
Items in process of collection .....	<u>5,934.4</u>	<u>6,107.1</u>	
Total short-term assets .....	15,657.7		17,024.1
<i>Long-term assets</i> (Note 2)			
Premises .....	424.5	471.8	
Furniture and equipment .....	156.1	152.8	
Leases, leasehold improvements, and long-term prepayments .....	88.5	107.9	
Prepaid pension costs .....	<u>796.8</u>	<u>795.4</u>	
Total long-term assets .....	<u>1,465.9</u>		<u>1,528.0</u>
Total assets .....	17,123.6		18,552.1
<i>Short-term liabilities</i>			
Clearing balances and balances arising from early credit of uncollected items .....	10,703.2	11,909.5	
Deferred-availability items .....	5,163.0	5,354.3	
Short-term debt .....	.0	.0	
Short-term payables .....	<u>126.2</u>	<u>92.2</u>	
Total short-term liabilities .....	15,992.4		17,355.9
<i>Long-term liabilities</i>			
Long-term debt .....	.0	.0	
Postretirement/postemployment benefits obligation .....	<u>275.0</u>	<u>268.6</u>	
Total long-term liabilities .....	<u>275.0</u>		<u>268.6</u>
Total liabilities .....	16,267.4		17,624.5
Equity .....	<u>856.2</u>		<u>927.6</u>
Total liabilities and equity (Note 3) ...	17,123.6		18,552.1

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

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

## Pro Forma Income Statement for Federal Reserve Priced Services, 2005 and 2004

Millions of dollars

Item	2005	2004
Revenue from services provided to depository institutions (Note 4) .....	901.0	865.9
Operating expenses (Note 5) .....	<u>750.0</u>	<u>800.6</u>
Income from operations .....	150.9	65.3
Imputed costs (Note 6)		
Interest on float .....	6.1	-1
Interest on debt .....	.0	.0
Sales taxes .....	11.3	11.6
FDIC insurance .....	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs .....	133.5	53.8
Other income and expenses (Note 7)		
Investment income .....	292.7	156.8
Earnings credits .....	<u>-199.0</u>	<u>-108.1</u>
Income before income taxes .....	227.2	102.5
Imputed income taxes (Note 6) .....	<u>67.3</u>	<u>30.6</u>
Net income .....	<u>160.0</u>	<u>72.0</u>
MEMO: Targeted return on equity (Note 6) ...	103.0	112.4

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, 2005

Millions of dollars

Item	Total	Com- mercial check collection	Fedwire funds	Fedwire securities	Com- mercial ACH	Noncash services
Revenue from services (Note 4) .....	901.0	740.3	61.0	19.3	79.3	1.1
Operating expenses (Note 5) .....	<u>750.0</u>	<u>619.0</u>	<u>49.3</u>	<u>15.5</u>	<u>65.1</u>	<u>1.1</u>
Income from operations .....	150.9	121.3	11.7	3.8	14.1	.0
Imputed costs (Note 6) .....	<u>17.4</u>	<u>15.5</u>	<u>.9</u>	<u>.3</u>	<u>.6</u>	<u>.0</u>
Income from operations after imputed costs .....	133.5	105.7	10.9	3.4	13.5	.0
Other income and expenses, net (Note 7) .....	<u>93.7</u>	<u>77.1</u>	<u>6.3</u>	<u>2.0</u>	<u>8.2</u>	<u>.1</u>
Income before income taxes .....	227.2	182.9	17.2	5.4	21.6	.1
Imputed income taxes (Note 6) .....	<u>67.3</u>	<u>54.1</u>	<u>5.1</u>	<u>1.6</u>	<u>6.4</u>	<u>.0</u>
Net income .....	<u>160.0</u>	<u>128.7</u>	<u>12.1</u>	<u>3.8</u>	<u>15.2</u>	<u>.1</u>
MEMO: Targeted return on equity (Note 6) .....	103.0	82.0	7.9	2.9	10.0	.2

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

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

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.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

(2) LONG-TERM ASSETS

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized a credit to expenses for the qualified pension plan of \$1.3 million in 2005 and a credit to expenses of \$7.5 million in 2004 with a corresponding increase 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, postretirement, and nonqualified pension 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 \$6.6 million in 2005 and \$7.6 million in 2004. The net credit to expenses under SFAS 87 (see note 2) that includes the nonqualified pension expense of \$1.0 million in 2005 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 2005 and 2004 as follows (in millions):

	<u>2005</u>	<u>2004</u>
Check .....	29.4	33.5
ACH .....	3.7	3.4
Fedwire funds .....	2.6	2.5
Fedwire securities .....	1.3	1.3
Noncash services .....	.1	.1
Total .....	<u>37.1</u>	<u>40.8</u>

(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 imputed in 2005 or 2004. The sales taxes and FDIC assessment that the Federal Reserve would have paid had

it 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 2005 in millions of dollars:

Total float	134.3
Unrecovered float	<u>11.9</u>
Float subject to recovery	122.5
Sources of recovery of float	
Income on clearing balances	12.3
As-of adjustments	-1.0
Direct charges	837.7
Per-item fees	-728.4

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

balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2005.

#### (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 and 2005 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. 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 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*

The Government Performance and Results Act of 1993 (GPRA) requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multi-year period and submit an annual performance plan and performance report. Although the Federal Reserve is not covered by the GPRA, the Board of Governors voluntarily complies with the spirit of the act.

### **Strategic Plan, Performance Plan, and Performance Report**

The Board's strategic plan in the GPRA format, which is prepared biennially and covers a four-year period, 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 most recent strategic plan, covering the period 2004–08, was made public in August 2004. (A strategic plan covering the period 2006–09 is scheduled for release in late spring 2006.)

The Board's performance plan, which is prepared biennially and covers a two-year period, sets forth specific targets for some of the performance measures identified in the strategic plan and describes the operational processes and resources needed to meet those targets; it also discusses data validation and verification of results. The most recent per-

formance plan, covering the period 2004–05, was made public in August 2004. The equivalent document for 2006–07, in the form of a performance budget, will be released in 2006.

The most recent performance report, covering the period 2002–03, was made public in August 2004. The report indicates that the Board generally met its goals for 2002–03. A performance report covering 2004–05 will be released in 2006.

These documents—the strategic and performance plans and the performance report—are available on the Board's web site, at [www.federalreserve.gov/boarddocs/rptcongress](http://www.federalreserve.gov/boarddocs/rptcongress). The Board's mission statement and a summary of the Federal Reserve's goals and objectives, as set forth in the most recently released strategic and performance plans, are given below.

### **Mission**

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

### **Goals and Objectives**

The Federal Reserve has six 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 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 identify emerging financial problems early so that crises can be averted.
- 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. At the same time, remain sensitive to the burden on supervised institutions.

- Provide a dynamic work environment that is challenging and rewarding. 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 compliance 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 effectively implement federal laws designed to inform and protect the consumer, to encourage community development, and to promote access to banking services in historically underserved markets

### *Objectives*

- Take a leadership role in shaping the national dialogue on consumer protection in financial services, addressing the rapidly emerging issues that affect today's consumers, strengthening consumer compliance supervision programs when required, and remaining sensitive to the burden on supervised institutions.
- Promote, develop, and strengthen effective communications and collaborations within the Board, the Federal Reserve Banks, and other agencies and organizations.
- Increase public understanding of consumer protection and community

development and the Board's role in these areas through increased outreach and by developing programs that address the information needs of consumers and the financial services industry.

- Develop a staff that is highly skilled, professional, innovative, and diverse, providing career development opportunities to ensure the retention of highly productive staff and recruiting highly qualified and skilled employees.
- Promote an efficient and effective work environment by aligning business functions with appropriate work processes and implementing solutions for work products and processes that can be handled more efficiently through automation.

### 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 by assessing their risks and risk-management approaches 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.

### Goal

To provide high-quality professional oversight of Reserve Banks

### Objective

- Produce high-quality assessments and oversight of Federal Reserve System strategies, projects, and operations, including adoption of technology to the business and operational needs of the Federal Reserve. The oversight process and outputs should help Federal Reserve management foster and strengthen sound internal control systems, efficient and reliable operations, effective performance, and sound project management and should assist the Board in the effective discharge of its oversight responsibilities.

### Goal

To foster the integrity, efficiency, and effectiveness of Board programs

### Objectives

- Oversee a planning and budget process that clearly identifies the Board's mission, results in concise plans for the effective accomplishment of operations, transmits to the staff the information needed to attain objectives efficiently, and allows the public to measure our accomplishments.
- Develop appropriate policies, oversight mechanisms, and measurement criteria to ensure that the recruiting, training, and retention of staff meet Board needs.
- Establish, encourage, and enforce a climate of fair and equitable treatment for all employees regardless of race, creed, color, national origin, age, or sex.
- Provide financial management support needed for sound business decisions.
- Provide cost-effective and secure information resource management services to Board divisions, support divi-

sional distributed-processing requirements, and provide analysis on information technology issues to the Board, Reserve Banks, other financial regulatory institutions, and central banks.

- Efficiently provide safe, modern, and secure facilities and necessary support for activities conducive to efficient and effective Board operations. ■

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## *Federal Legislative Developments*

### **Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**

On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Bankruptcy Act of 2005). Title IX of the act contains provisions designed to reduce systemic risk in the banking system and the financial markets when parties to certain types of financial transactions become bankrupt or insolvent, by allowing expeditious termination or netting of certain types of financial transactions. In addition, the Bankruptcy Act of 2005 makes several important amendments to the Truth in Lending Act.

#### Financial Contract Provisions

##### *Treatment of Swaps and QFCs*

The Bankruptcy Act of 2005 amends the definitions of several terms that appear in the Federal Deposit Insurance Act (FDI Act) and the Federal Credit Union Act (FCUA) to make them consistent with the definitions in the Bankruptcy Code and to reflect the enactment of the Commodity Futures Modernization Act of 2000 (CFMA). Of particular importance, the act updates the definition of “swap agreement” to include types of transactions that have recently entered the market. Under the FDI Act, the FCUA, and the Bankruptcy Code, swap agreements are eligible for termination, liquidation, acceleration, offset, and netting. The amended definition includes combinations of the listed agreements or transactions and permits contractual net-

ting across economically similar transactions that are the subject of recurring dealings in swap agreements.

In addition, the Bankruptcy Act of 2005 clarifies that the FDI Act and the FCUA expressly protect rights under securities agreements, arrangements, or other credit enhancements related to qualified financial contracts (QFCs). The act also clarifies that no provision of federal or state law relating to the avoidance of preferential or fraudulent transfers may be invoked to avoid a transfer made in connection with any QFC of an insured depository institution in conservatorship or receivership, absent actual fraudulent intent on the part of the transferee.

##### *Cross-Product Netting*

The Bankruptcy Act of 2005 also promotes cross-product netting through master agreements for QFCs. The act specifies that under the FDI Act and the FCUA, a master agreement for one or more securities contracts, commodity contracts, forward contracts, repurchase agreements, or swap agreements is to be treated as a single QFC, but only with respect to the underlying agreements that are themselves QFCs. This provision ensures that cross-product netting pursuant to a master agreement, or pursuant to an umbrella agreement for separate master agreements between the same parties, will be enforceable under the FDI Act and the FCUA. Cross-product netting permits the netting of a wide variety of financial transactions between two participants, thereby maximizing the present and potential future risk-reducing benefits

of the netting arrangement between the parties.

The Bankruptcy Act of 2005 similarly promotes cross-product netting through amendments to the Bankruptcy Code. The act adds definitions for “master netting agreement” and “master netting agreement participant” to the Bankruptcy Code in order to protect the termination and close-out netting provisions of cross-product master agreements between parties. These agreements may be used (1) to document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements or (2) as umbrella agreements for separate master agreements between the same parties, each of which is used to document a discrete type of transaction. The act also adds a new section 561 to the Bankruptcy Code designed to expressly protect the contractual rights of a master netting agreement participant to enforce any rights of termination, liquidation, acceleration, offset, or netting under a master netting agreement.

#### *“Financial Participants” under the Bankruptcy Code*

The Bankruptcy Act of 2005 adds a new definition for “financial participant” and allows such market participants to close out and net agreements with insolvent entities under the Bankruptcy Code. These changes are designed to limit the potential effect of insolvencies on major market participants. “Financial participant” is defined by the act to include entities having contracts of a total gross dollar value of not less than \$1 billion in notional or actual principal amount outstanding or having gross mark-to-market positions of not less than \$100 million (aggregated across counterparties). Clearing organizations

are also expressly included in the definition and may take advantage of these expanded protections. This amendment is intended to further the goal of promoting the clearing of derivatives and other transactions as a way of reducing systemic risk. The act also makes several amendments to the Bankruptcy Code to reflect current market practice and to conform certain definitions to the FDI Act.

#### *FDICIA Netting Protections*

The Bankruptcy Act of 2005 also extends the protections afforded to netting arrangements by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA provides that a netting arrangement will be enforced pursuant to its terms, notwithstanding the failure of a party to the agreement. The act extended FDICIA’s protections of netting arrangements to

- multilateral clearing organizations,
- uninsured national and state member banks,
- foreign banks and their branches and agencies,
- netting arrangements governed by the laws of a foreign country, and
- netting arrangements between clearing organizations.

#### *Authority of FDIC and NCUAB*

The Bankruptcy Act of 2005 provides that no provision of law may be construed to limit the power of the FDIC or the National Credit Union Administration Board (NCUAB) to transfer, or to disaffirm or repudiate, any QFC in accordance with its powers under the

FDI Act or the FCUA, respectively. Moreover, the act denies enforcement of “walkaway” clauses in QFCs. The act defines a walkaway clause as a provision that, after calculation of the value of a party’s position or an amount due to or from one of the parties upon termination, liquidation, or acceleration of the QFC, either (1) does not create a payment obligation for the party or (2) extinguishes a payment obligation of the party in whole or in part solely because of the party’s status as a non-defaulting party.

The Bankruptcy Act of 2005 also amends the FDIA and the FCUA to expand the receivership authority of the FDIC and the NCUAB, respectively, to permit transfers of QFCs to “financial institutions.” The amendment allows the FDIC and the NCUAB, when acting as receiver for an insolvent depository institution, to transfer QFCs to a non-depository financial institution, provided the transferee institution is not subject to bankruptcy or insolvency proceedings. In transferring QFCs, the receiver may not split the QFCs and related interests between the depository institution in default and a particular counterparty; rather, either the receiver must transfer all such QFCs to a single person or it may not transfer any of the QFCs for that particular counterparty. The act’s amendments also permit transfers to an eligible financial institution that is a non-U.S. person, or the branch or agency of a non-U.S. person, or a U.S. financial institution that is not an FDIC-insured institution if, following the transfer, the contractual rights of the parties would be enforceable substantially to the same extent as under the FDI Act and the FCUA. The act similarly limits the disaffirmance and repudiation authorities of the FDIC and NCUAB with respect to QFCs so as to make those authorities consistent with the agencies’ transfer

authority. The act requires that a conservator or receiver must either disaffirm or repudiate all QFCs between the depository institution in default and a particular counterparty or disaffirm or repudiate none of such QFCs. This requirement limits the ability of the FDIC and the NCUAB to “cherry pick” the QFCs between a depository institution in default and a particular counterparty. The amendment is consistent with the FDIC’s policy not to repudiate or disaffirm QFCs selectively. The unified treatment is fundamental to the reduction of systemic risk.

The Bankruptcy Act of 2005 also limits the enforcement of rights of termination, liquidation, or netting that arise solely because of the insolvency of a depository institution or that are based on the “financial condition” of the institution in receivership or conservatorship. However, any payment, delivery, or other performance-based default, or a breach of a representation or covenant putting in question the enforceability of the agreement, will not be deemed to be based solely on the financial condition of the institution. The amendment does not prevent counterparties from taking all actions permitted and recovering all damages authorized upon repudiation of any QFC by a conservator or receiver.

The Bankruptcy Act of 2005’s amendments also permit the FDIC and the NCUAB to transfer QFCs of a failed depository institution to a bridge bank or a depository institution organized by the FDIC or NCUAB for which a conservator is appointed either (1) immediately upon the organization of such institution or (2) at the time of a purchase and assumption transaction between the FDIC or NCUAB and the institution. These institutions are not to be considered financial institutions that are ineligible to receive transfers of QFCs under the FDI Act.

## TILA Amendments

The Bankruptcy Act of 2005 also includes several provisions that amend the Truth in Lending Act (TILA). These provisions deal principally with open-end (revolving) credit accounts and require new disclosures on periodic statements and on credit card applications and solicitations. The Board is required to issue regulations implementing most of the new provisions, and the new provisions generally will not become effective until twelve months after the regulations are finalized.

### *Minimum-Payment Warnings*

The Bankruptcy Act of 2005 requires creditors to provide, on each periodic statement for open-end credit, a clear and conspicuous disclosure that making only the minimum payment will increase the interest the consumer pays and the time it takes to repay the balance. The statute also requires that the disclosure include

- a hypothetical example of how long it would take to pay off a specified balance with a 17 percent annual percentage rate and
- a toll-free telephone number that consumers can call to obtain an estimate of how long it will take to pay off their own balance if only minimum payments are made.

The Bankruptcy Act of 2005 contains an exemption from these disclosure requirements for a creditor that maintains a toll-free telephone number for the purpose of providing customers with the actual number of months that it will take to repay the customer's outstanding balance. To standardize the information provided to consumers, the act directs

the Board to develop a "table" that creditors may use in responding to consumers. The Board and the FTC must establish their own toll-free telephone numbers for use by customers of small banks and non-depository institution creditors, respectively.<sup>1</sup>

### *Introductory Rate Offers*

Credit card issuers that offer discounted introductory interest rates are required, under the Bankruptcy Act of 2005, to disclose clearly and conspicuously on the application or solicitation for the credit card the expiration date of the offer, the rate that will apply after that date, and an explanation of how the introductory rate could be lost (for example, by making a late payment).

### *Internet Solicitations*

The act requires that credit card offers on the Internet must include the same disclosure table—commonly known as the "Schumer box"—that now is required to be included in applications or solicitations for credit cards that are sent by direct mail.

### *Late Fees*

For open-end credit, the Bankruptcy Act of 2005 requires creditors to disclose, on each periodic statement, the earliest date on which a late payment fee may be charged, as well as the amount of the fee.

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1. The Board is required to operate its toll-free telephone number for two years, while the FTC must operate its toll-free telephone number indefinitely.

### *High Loan-to-Value Mortgage Credit*

For home-secured credit that may exceed the home's fair market value, the act requires creditors to disclose in the application and in advertisements that the interest on the portion of the loan that exceeds the home's fair market value is not tax deductible.

### *Account Termination*

Creditors are prohibited under the Bankruptcy Act of 2005 from terminating an open-end credit account before its expiration date solely because the consumer has not incurred finance charges on the account.

### **Post-Employment Restrictions on Senior Examiners**

In December 2004, Congress imposed a new federal post-employment restriction applicable to senior examiners of the federal banking agencies, as part of the Intelligence Reform Act.<sup>2</sup> Under this provision, an officer or employee of a federal banking agency or a Federal Reserve Bank who acts as the "senior examiner" for a particular depository institution may not, within one year after terminating employment with the agency or Reserve Bank, knowingly accept compensation as an officer, director, employee, or consultant from that depository institution or any company (including a bank holding company) that controls the depository institution. A similar post-employment restriction is imposed on an officer or employee

who acts as the senior examiner of a particular bank holding company or savings and loan holding company; in these circumstances, the post-employment restrictions apply to relationships with the bank holding company or savings and loan holding company and any depository institution subsidiary of the holding company. These post-employment restrictions are in addition to any other conflict of interest and ethics rules and restrictions that may apply to examiners under applicable federal law or the internal codes of conduct established by the agency or Reserve Bank.

Under the statute, an officer or employee of an agency or a Reserve Bank is considered to be the "senior examiner" of a particular depository institution or depository institution holding company only if the examiner has "continuing, broad responsibility" for the examination or inspection of that depository institution or holding company. In addition, to be subject to these new post-employment restrictions, the officer or employee must have served as the senior examiner for the relevant institution or holding company for two or more months during the final twelve months of his or her employment with the agency or Reserve Bank. If a senior examiner violates the one-year post-employment restrictions, the appropriate agency must initiate proceedings to impose an order of removal and prohibition or a civil money penalty on the former senior examiner, and may seek both remedies.

In November 2005, the Board and the other federal banking agencies jointly adopted rules implementing these new post-employment restrictions. *See* 70 FR 69,633 (November 17, 2005). ■

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2. Codified at section 10(k) of the FDI Act.