Federal Reserve Operations
Banking Supervision and Regulation

The Federal Reserve has supervisory and regulatory authority over a variety of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of supervised financial institutions and the stability of U.S. financial markets as a whole.

In 2006, U.S. banking organizations reported record earnings despite tight net interest margins resulting from a persistently flat yield curve and heightened competition for deposits and loans. Credit quality indicators remained historically strong, although nonperforming assets increased, particularly in residential real estate portfolios. For a second consecutive year, there were no failures of insured banks. Banking supervisors focused on banking activities that could prove vulnerable in the event of an economic downturn. In particular, the federal banking agencies during the year issued guidance for supervised financial institutions on extensions of credit for nontraditional residential mortgages and for commercial real estate. Delinquencies among loans of these and most other types remained low.

Federal Reserve staff continued to work throughout the year with the other federal banking agencies to prepare for U.S. implementation of the Basel II capital accord.\(^1\) In September, the agencies issued a joint notice of proposed rulemaking (NPR) describing proposals for implementing the Basel II framework in the United States. In December, they issued an NPR proposing revisions to capital requirements for trading book positions subject to the market risk capital rule. The agencies are also developing Basel II supervisory guidance for examiners and the banking industry.

Under the NPR implementing Basel II, the new capital framework would be mandatory for large, internationally active banking organizations and optional for all others. Federal banking supervisors expect that the vast majority of banking organizations will remain subject to 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 agencies in December issued an NPR proposing changes to the Basel I framework that would be optional for banking organizations not subject to Basel II.

Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies, including financial holding companies formed under the authority of the 1999 Gramm-Leach-Bliley Act, and state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve seeks issued in November 2005 are available on the web site of the Bank for International Settlements (www.bis.org).

\(^1\) The Basel II capital accord, an international agreement formally 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 original document was issued in 2004; the original version and an updated version are available on the web site of the Bank for International Settlements (www.bis.org).
primarily to promote their safe and sound operation, including their compliance with laws and regulations.\(^2\)

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

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.

**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 takes enforcement and other supervisory actions as necessary.

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

Inspections of bank holding companies, including financial holding companies, are built around a rating system introduced in 2005 that reflects the recent shift in supervisory practices for these organizations away from the historical analysis of financial condition toward a more dynamic, forward looking assessment of risk-management practices and financial factors. Under the system, known as RFI but more fully termed RFI/C(D), holding companies are assigned a composite rating (C) that is based on assessments of three components: risk management (R), financial condition (F), and potential

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.” Supervision for compliance with other banking laws and regulations, which is described 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.
impact (I) of the parent company and its nondepository subsidiaries on the subsidiary depository institution. The fourth component, depository institution (D), is intended to mirror the primary regulator’s rating of the subsidiary depository institution.

In managing the supervisory process, the Federal Reserve takes a risk-focused approach that directs resources to (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 System’s central point of contact for the organization, has responsibility for only one LCBO, and is supported by specialists capable of evaluating the

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3. Each of the first two components has four subcomponents: Risk Management—Board and Senior Management Oversight; Policies, Procedures, and Limits; Risk Monitoring and Management Information Systems; and Internal Controls. Financial Condition—Capital; Asset Quality; Earnings; and Liquidity.

### State Member Banks and Holding Companies, 2002–2006

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<thead>
<tr>
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<tr>
<td><strong>State member banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total number</td>
<td>901</td>
<td>907</td>
<td>919</td>
<td>935</td>
<td>949</td>
</tr>
<tr>
<td>Total assets (billions of dollars)</td>
<td>1,405</td>
<td>1,318</td>
<td>1,275</td>
<td>1,912</td>
<td>1,863</td>
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<tr>
<td>Number of examinations</td>
<td>761</td>
<td>783</td>
<td>809</td>
<td>822</td>
<td>814</td>
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<tr>
<td>By Federal Reserve System</td>
<td>500</td>
<td>563</td>
<td>581</td>
<td>581</td>
<td>550</td>
</tr>
<tr>
<td>By state banking agency</td>
<td>261</td>
<td>220</td>
<td>228</td>
<td>241</td>
<td>264</td>
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<tr>
<td><strong>Top-tier bank holding companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large (assets of more than $1 billion)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total number</td>
<td>448</td>
<td>394</td>
<td>355</td>
<td>365</td>
<td>329</td>
</tr>
<tr>
<td>Total assets (billions of dollars)</td>
<td>12,179</td>
<td>10,261</td>
<td>8,429</td>
<td>8,295</td>
<td>7,483</td>
</tr>
<tr>
<td>Number of inspections</td>
<td>566</td>
<td>501</td>
<td>500</td>
<td>454</td>
<td>439</td>
</tr>
<tr>
<td>By Federal Reserve System</td>
<td>557</td>
<td>496</td>
<td>491</td>
<td>446</td>
<td>431</td>
</tr>
<tr>
<td>On site</td>
<td>500</td>
<td>457</td>
<td>440</td>
<td>399</td>
<td>385</td>
</tr>
<tr>
<td>Off site</td>
<td>57</td>
<td>39</td>
<td>51</td>
<td>47</td>
<td>46</td>
</tr>
<tr>
<td>By state banking agency</td>
<td>9</td>
<td>5</td>
<td>9</td>
<td>8</td>
<td>8</td>
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<tr>
<td><strong>Small (assets of $1 billion or less)</strong></td>
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<tr>
<td>Total number</td>
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<td>4,760</td>
<td>4,796</td>
<td>4,787</td>
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<tr>
<td>Total assets (billions of dollars)</td>
<td>947</td>
<td>890</td>
<td>852</td>
<td>847</td>
<td>821</td>
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<tr>
<td>Number of inspections</td>
<td>3,449</td>
<td>3,420</td>
<td>3,705</td>
<td>3,453</td>
<td>3,726</td>
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<tr>
<td>By Federal Reserve System</td>
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<td>3,233</td>
<td>3,526</td>
<td>3,324</td>
<td>3,625</td>
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<tr>
<td>On site</td>
<td>112</td>
<td>170</td>
<td>186</td>
<td>183</td>
<td>264</td>
</tr>
<tr>
<td>Off site</td>
<td>3,145</td>
<td>3,063</td>
<td>3,340</td>
<td>3,141</td>
<td>3,361</td>
</tr>
<tr>
<td>By state banking agency</td>
<td>192</td>
<td>187</td>
<td>177</td>
<td>129</td>
<td>101</td>
</tr>
<tr>
<td><strong>Financial holding companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic</td>
<td>599</td>
<td>591</td>
<td>600</td>
<td>612</td>
<td>602</td>
</tr>
<tr>
<td>Foreign</td>
<td>44</td>
<td>38</td>
<td>36</td>
<td>32</td>
<td>30</td>
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</table>

1. For large bank holding companies subject to continuous, risk-focused supervision, includes multiple targeted reviews.
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 are tailored to each banking organization’s size, complexity, and risk profile. As with the LCBOs, 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 2006, 901 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 14 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 total assets of less than $250 million may be examined once every eighteen months. In 2006, the Federal Reserve conducted 500 exams of state member banks in 2006.

**Bank Holding Companies**

At year-end 2006, a total of 5,825 U.S. bank holding companies were in operation, of which 5,102 were top-tier bank holding companies. These organizations controlled 6,106 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 complex smaller companies. 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 supervisory burden on banking organizations. Noncomplex bank holding companies with consolidated assets of $1 billion or less are subject to a special supervisory program that permits a more flexible approach.4 In 2006, the Federal Reserve conducted 557 inspections of large bank holding companies and 3,257 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 re-
uirements 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 supervisory 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 2006, 604 domestic bank holding companies and 44 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 38 had consolidated assets of $15 billion or more; 121, between $1 billion and $15 billion; 86, between $500 million and $1 billion; and 359, less than $500 million.

International Activities

The Federal Reserve supervises the foreign branches and overseas investments of 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 the 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; for national banks, the examinations are coordinated with the Office of the Comptroller of the Currency (OCC).

At the end of 2006, 53 member banks were operating 675 branches in foreign countries and overseas areas of the United States; 34 national banks were operating 625 of these branches, and 19 state member banks were operating the remaining 50. In addition, 17 nonmember banks were operating 21 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 corpo-
tions, 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 2006, 71 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, bank holding companies, and certain nonbanking companies. Foreign banks continue to be significant participants in the U.S. banking system.

As of year-end 2006, 178 foreign banks from 54 countries were operating 214 state-licensed branches and agencies, of which 8 were insured by the Federal Deposit Insurance Corporation (FDIC), and 45 OCC-licensed branches, of which 4 were insured by the FDIC. These foreign banks also owned 12 Edge Act and agreement corporations and 2 commercial lending companies; in addition, they held a controlling interest in 62 U.S. commercial banks. Altogether, the U.S. offices of these foreign banks at the end of 2006 controlled approximately 19 percent of U.S. commercial banking assets. These 178 foreign banks also operated 85 representative offices; an additional 59 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 involves examination of those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 339 examinations in 2006.

**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 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, 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 and terrorism financing are in place.

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 include a risk-focused review of information technology risk management activities. During 2006, the Federal Reserve was the lead agency in 1 cooperative, multiagency examination of a large, multiregional data processing servicer.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for state member commercial banks and depository trust companies that together reported, at the end of 2006, $36 trillion of assets in various fiduciary or custodial capacities. Additionally, state member nondepository trust companies supervised by the Federal Reserve reported $33 trillion of assets held in a fiduciary or custodial capacity. 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 2006, Federal Reserve examiners conducted 97 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 2006, the Federal Reserve conducted on-site examinations at 15 of the 78 state member banks and bank holding companies that were registered as transfer agents and 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-five state member banks and 8 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury’s regulations. During 2006, the Federal Reserve conducted 6 examinations of broker-dealer activities in government securities at these organizations. These examinations are generally conducted concurrently with the Federal Reserve’s examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring 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 20 entities that dealt in municipal securities during 2006, 9 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 (Credit by Banks and Persons other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock). 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 (NCUA), or the Office of Thrift Supervision (OTS).

At the end of 2006, 602 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 210 of these lenders, and the remaining 392 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 290 lenders from its on-site inspection program. The securities credit activities of the remaining 102 lenders were subject to either biennial or triennial inspection. Sixty inspections were conducted during the year.

**Business Continuity**

In 2006, 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 staff continued to work with financial institutions to assess implementation of 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 OCC and the Securities and Exchange Commission (SEC). During 2006, the agencies provided additional guidance to help institutions implement testing of their business continuity plans. The agencies continue to coordinate their efforts to ensure a consistent supervisory approach for business continuity practices.

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 2006, the Federal Reserve completed 37 formal enforcement actions. Civil money penalties totaling $212,050 were assessed. All civil money penalties, as directed by statute, are remitted to either the Department of the Treasury or 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 are posted on the Board’s website (www.federalreserve.gov/boarddocs/enforcement).

In addition to taking these formal enforcement actions, the Reserve Banks completed 70 informal enforcement actions in 2006. 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. Such monitoring and analysis helps direct examination resources to institutions that have higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

In January 2006, the Federal Reserve replaced its primary off-site monitoring tool, SEER (System to Estimate Examination Ratings), with the Supervision and Regulation Statistical Assessment of Bank Risk model (SR-SABR). Drawing primarily on the financial data that banks report on their Reports of Condition and Income (Call Reports), SR-SABR uses econometric techniques to identify banks that report financial characteristics weaker than those of other banks assigned similar supervisory ratings. To supplement the SR-SABR screening, 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. In addition, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised banking organizations. The reports, which are compiled from data provided by large bank holding companies in
quarterly regulatory reports (FR Y-9C and FR Y-9LP), contain, for individual companies, financial statistics and comparisons with peer companies. BHCPRs are made available to the public on the National Information Center web site, which can be accessed at www.ffiec.gov.

During the year, four major upgrades to the web-based Performance Report Information and Surveillance Monitoring (PRISM) application were completed. 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 surveillance screening for banks and bank holding companies. The upgrades made more regulatory data available for querying, added the results of surveillance screens (including SR-SABR), 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.5

Technical Assistance

In 2006, 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 2006 was concentrated in Latin America, Asia, and former Soviet bloc countries. The Federal Reserve, along with the OCC, the FDIC, and the Department of the Treasury, was also an active participant in the Middle East and North Africa 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 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 on Banking Supervision, 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 the region, 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. The Federal Reserve contributes significantly to ASBA’s organizational management and to its training and technical assistance activities.

5. The federal banking agencies that are members of the FFIEC are the Federal Reserve Board, the FDIC, the NCUA, the OCC, and the OTS.
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 supervisory and regulatory forums, provide support for the work of the FFIEC, and participate in international forums such as the Basel Committee on Banking Supervision, the Joint Forum, and the International Accounting Standards Board.

Capital Adequacy Standards

Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

On September 25, 2006, the Federal Reserve, OCC, FDIC, and OTS published a joint 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. Under the proposal, the basic minimum risk-based capital ratio format—regulatory capital divided by risk-weighted assets—would be maintained, with the minimum for tier 1 capital set at 4 percent and the minimum for total qualifying capital set at 8 percent. The primary differences between the current and proposed rules are the internal-ratings-based methodologies used to calculate risk-weighted assets and the advanced measurement approach for operational risk under Basel II. 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.

Revisions to Market Risk Capital Rule

On September 25, 2006, the agencies issued for public comment a notice of proposed rulemaking proposing revisions to the market risk capital rule used by the OCC, Board, and FDIC since 1997 for banking organizations having significant exposure to market risk. Under the market risk capital rule, certain banking organizations are required to calculate a capital requirement for the general market risk of their covered positions and the specific risk of their covered debt and equity positions. The proposed revisions would enhance the rule’s risk sensitivity, require the market risk capital charge to reflect any incremental default risk of traded positions, and require public disclosure of certain qualitative and quantitative market risk information. The comment period will end on January 23, 2007.

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

On December 26, 2006, the banking agencies issued for public comment an NPR proposing modifications to Basel I that would be optional for banking organizations not subject to Basel II. The proposals aim to enhance risk sensitivity without unduly increasing regulatory burden. They would expand the number of risk-weight categories, allow the use of external credit ratings to risk-weight certain exposures, expand the range of recognized collateral and eligible guarantors, use loan-to-value (LTV) ratios to risk-weight residential mortgages,
increase the credit conversion factor for certain commitments having an original maturity of one year or less, assess a capital charge for early amortizations in securitizations of revolving credit exposures, and remove the 50 percent limit on the risk weight for certain over-the-counter derivatives transactions. The comment period for the NPR will end on March 26, 2007.

### Other Capital Issues

Board staff conduct supervisory analyses of innovative capital instruments and novel transactions to determine whether such instruments qualify for inclusion in tier 1 capital. Much of this work in 2006 involved evaluating enhanced forms of trust preferred securities that bank holding companies developed in order to be granted more credit for equity by the rating agencies under the Board’s 2005 revisions to the rule on the qualifying components of tier 1 capital.

Staff members also identify and address supervisory concerns related to supervised banking organizations’ capital issuances and work with the Reserve Banks to evaluate the overall composition of banking organizations’ capital. In this work, the staff often must review the funding strategies proposed in applications for acquisitions and other transactions submitted to the Federal Reserve by banking organizations.

### Accounting Policy

The supervisory policy function is also responsible for monitoring major domestic and international proposals, standards, and other developments affecting the banking industry in the areas of accounting, auditing, internal controls, disclosure, and supervisory financial reporting. Federal Reserve staff members interact with key entities in the accounting and auditing professions, including standards-setters and accounting firms, the other banking agencies, and the banking industry, and issue supervisory guidance as appropriate.

During 2006, the Federal Reserve, together with the other banking agencies, issued a comment letter to the Financial Accounting Standards Board (FASB) on its then-proposed Statement of Financial Accounting Standards titled *The Fair Value Option for Financial Assets and Financial Liabilities.* The agencies also jointly issued guidance on loan and lease losses and on limitations on the liability of external auditors.

### Policy Statement on the Allowance for Loan and Lease Losses

In December the Federal Reserve, FDIC, NCUA, OCC, and OTS issued “Interagency Policy Statement on the Allowance for Loan and Lease Losses,” which updates and replaces earlier guidance on the methodology for calculating the allowance for loan and lease losses (ALLL). Revisions were made to ensure that policy is consistent with generally accepted accounting principles and with recent supervisory guidance related to the ALLL. Updated in the guidance are the responsibilities of boards of directors, management, and banking organization examiners; factors to be considered in estimating the ALLL; and the objectives and elements of an effective loan review system, including a sound credit-grading system. The guidance

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6. Tier 1 capital comprises common stockholders’ equity and qualifying forms of preferred stock, less required deductions such as goodwill and certain intangible assets.

also reiterates the points of agreement between the SEC and the banking agencies since 1999. To assist in application of the revised guidance, the agencies also issued a supplemental document anticipating frequently asked questions.

Advisory on Limitations on the Liability of External Auditors

The Federal Reserve, FDIC, NCUA, OCC, and OTS in May issued “Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagements.” The guidance addresses safety and soundness concerns that may arise when financial institutions enter into external audit contracts that limit the auditor’s liability for audit services. Specifically, the guidance informs financial institutions that the inclusion of certain auditor liability limitations in external audit contracts (typically referred to as engagement letters) for audits of financial statements, audits of internal control over financial reporting, or attestation on management’s assessment of internal control over financial reporting is generally unsafe and unsound.

Bank Secrecy Act and Anti–Money Laundering

In 2006, the FFIEC updated the Bank Secrecy Act/Anti–Money Laundering Examination Manual issued in 2005 by adding sections on risk assessment and automated clearinghouse transactions, updating the section on trade finance, and incorporating regulatory changes. The manual continues to contain an overview of Bank Secrecy Act (BSA) and anti-money-laundering requirements and supervisory expectations, resource materials, and examination procedures and to emphasize a banking organization’s responsibility to establish and implement a risk-based approach to complying with the BSA.

In January, the Federal Reserve, the Department of the Treasury’s Financial Crimes Enforcement Network, and the other federal banking agencies issued guidance on sharing Suspicious Activity Reports (SARs) with head offices or controlling companies. The guidance confirmed that a U.S. branch or agency of a foreign bank may disclose a SAR to its head office outside the United States. Similarly, a U.S. bank or savings association may disclose a SAR to its controlling company, whether domestic or foreign.

In March, the Federal Reserve issued a final rule amending Regulation K (International Banking Operations) to conform the Board’s regulations to BSA requirements and to clarify that Edge and agreement corporations and U.S. branches, agencies, and representative offices of foreign banks supervised by the Federal Reserve must establish and maintain procedures reasonably designed to ensure and monitor compliance with the BSA and its implementing regulations.

In April, the Federal Reserve and the other federal banking agencies entered into a memorandum of understanding with the Office of Foreign Assets Control within the Department of the Treasury to facilitate information-sharing and to further enhance interagency coordination in implementing U.S. sanctions rules.

International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision (Basel Committee), the Federal Reserve participates in efforts to advance sound supervisory policies for internationally active banking organizations and to improve the
stability of the international banking system. In 2006, the Federal Reserve continued to work cooperatively on Basel II, the 2004 accord to revise the international capital regime, and to develop international supervisory guidance. The Federal Reserve also continued to participate in Basel Committee working groups to address issues not fully resolved in the Basel II framework.

**Risk Management**

The Federal Reserve contributed to supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2006 that were generally aimed at improving the supervision of banking organizations’ risk-management practices.8

- “Enhancing Corporate Governance for Banking Organizations,” final paper issued in February, updating guidance published in 1999

**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. In 2006, the Federal Reserve participated in a Basel Committee effort to update the Core Principles in light of the significant changes in international banking regulation and experience gained since the principles were last revised in 1999. The revised guidance, “Core Principles for Effective Banking Supervision,” was issued in October.

**Joint Forum**

In 2006, the Federal Reserve also continued to participate in the Joint Forum—a group established under the aegis of the Basel Committee to address issues related to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. It is made up of representatives of the Basel Committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Federal Reserve contributed to the following supervisory policy papers, reports, and recommendations issued by the Joint Forum during 2006.9

- “Regulatory and Market Differences: Issues and Observations,” issued in May
- “The Management of Liquidity Risk in Financial Groups,” issued in May
- “High-Level Principles for Business Continuity,” issued in August

**International Accounting**

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. During 2006, Federal Reserve staff were involved in the development of two key Basel Committee documents issued to national supervisors and also of various comment letters related to accounting and auditing that were submitted to the International Accounting

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8. Papers issued by the Basel Committee can be accessed via the Bank for International Settlements web site at www.bis.org.

Standards Board and the International Auditing and Assurance Standards Board.

The Basel Committee document “Supervisory Guidance on the Use of the Fair Value Option for Financial Instruments by Banks,” issued in June, provides guidance on the prudential supervision of banks in their implementation of the fair value option included in the amended International Accounting Standard (IAS) 39, which became effective January 1, 2006. Under IAS 39, the fair value option allows an organization to irrevocably elect, at the date of purchase, a fair value measurement for certain financial instruments and to record in current earnings the gains and losses resulting from changes in fair value.

The Basel Committee document “Sound Credit Risk Assessment and Valuation for Loans,” issued in June, provides guidance on assessing credit risk and accounting for loan impairment. Specifically, the document addresses supervisory expectations for, and supervisory evaluations of, a banking organization’s establishment and support of its loan-loss-allowance accounts.

Response to Hurricane Katrina

Since Hurricane Katrina, the federal banking agencies—the Federal Reserve, FDIC, NCUA, OCC, and OTS—and the state banking agencies in Alabama, Louisiana, and Mississippi have worked together to monitor and support the recovery efforts of financial institutions and their customers in the U.S. Gulf Coast region. In 2006, the interagency efforts included:

- developing examiner guidance on the agencies’ expectations related to assessments of the financial condition of institutions affected by the hurricane;
- conducting a public service campaign encouraging individuals affected by Hurricane Katrina to contact their lenders (and also issuing a statement encouraging financial institutions to work with their borrowers to assist them in their financial recovery); and
- releasing “Lessons Learned from Hurricane Katrina: Preparing Your Institution for a Catastrophic Event,” a booklet describing financial institutions’ experiences with Hurricane Katrina and the lessons they learned that other institutions might find helpful in considering their readiness for a catastrophic event.

Credit Risk Management

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

Real Estate Appraisals

Under the federal banking agencies’ regulations on real estate appraisals, regulated institutions must ensure that the appraisals they use in connection with federally related transactions adhere to the Uniform Standards of Professional Appraisal Practice (USPAP). In June 2006, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued an interagency statement informing regulated institutions that the Appraisal Standards Board of the Appraisal Foundation had made significant revisions to USPAP, effective July 1, 2006; providing an overview of the revisions; and discussing the ramifications of the revisions for the institutions’ compliance with the regulations.

Home Equity Lending

In September, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued an
addendum to guidance issued in 2005—
“Interagency Credit Risk Management
Guidance for Home Equity Lending”—
that provided additional guidance on
managing the risks associated with
open-end home equity lines of credit
(HELOCs) that have interest-only or
negative amortization features. While
such HELOCs may give consumers
some flexibility, the agencies are con-
cerned that consumers may not fully
understand the product terms and asso-
ciated risks. The addendum addressed
the timing and content of communica-
tions with consumers that are obtaining
HELOCs having these features and
clarified the agencies’ expectations for
assessing borrower repayment capacity.

Nontraditional Mortgage Products

In September, the Federal Reserve,
FDIC, NCUA, OCC, and OTS issued
guidance, titled “Interagency Guidance
on Nontraditional Mortgage Product
Risks,” that addresses risk-management
and consumer disclosure practices that
institutions should employ to effectively
assess and manage the risks associated
with residential mortgage loans that
allow borrowers to defer repayment of
principal and, sometimes, interest (re-
ferred to as nontraditional mortgage
loans). Specifically, the guidance states
that regulated institutions should
• ensure that loan terms and underwrit-
ing standards are consistent with pru-
dent lending practices (including, for
example, that they evaluate the bor-
rower’s repayment capacity);
• recognize that many nontraditional
mortgage loans, particularly those that
have risk-layering features, are un-
tested in a stressed environment and
warrant strong risk-management stan-
dards, capital levels commensurate
with risk, and allowances for loan and
lease losses that reflect the collectibil-
ity of the portfolio; and
• ensure that consumers have sufficient
information to understand the loan
terms and the associated risks before
they choose a product or a payment
arrangement.

Commercial Real Estate
Concentrations

In December, the Federal Reserve,
FDIC, and OCC issued guidance titled
“Interagency Guidance on Concentra-
tions in Commercial Real Estate Lend-
ing, Sound Risk Management Practices”
to remind institutions that strong risk-
management practices and appropriate
levels of capital are important elements
of a sound lending program, particularly
if the institution has a concentration in
commercial real estate loans. The guid-
ance reinforced and enhanced existing
regulations and guidelines for safe and
sound real estate lending. (For more in-
formation, see the box “Guidance on
Concentrations in Commercial Real Es-
tate Lending.”)

Complex Structured Finance Activities

During the year, the Federal Reserve,
FDIC, OCC, OTS, and SEC prepared a
final statement on sound practices for
complex structured finance transactions
(CSFTs). The statement, to be issued in
early 2007, describes the types of inter-
nal controls and risk-management pro-
cedures that financial institutions should
use to identify, manage, and address the
heightened legal and reputational risks
that may arise from certain CSFTs.
(Excluded are most structured finance
transactions that are familiar to partici-
pants in the financial markets and have
well-established track records—such as
standard public mortgage-backed securi-
ties and hedging-type transactions in-
volving “plain vanilla” derivatives or collateralized debt obligations.) Financial institutions that engage in CSFTs should, as part of their process for approving transactions and new products, establish and maintain policies, procedures, and systems that are designed to identify elevated-risk CSFTs and should ensure that transactions and new products so identified are subject to greater review by appropriate levels of management. An institution should decline to participate in an elevated-risk CSFT if it determines that the transaction presents unacceptable risks or would result in a violation of applicable laws, regulations, or accounting principles.

Banks’ Securities Activities
In December, the Board and the SEC requested comments on joint proposed rules that would help define the scope of securities activities that a bank may conduct without registering with the SEC as a securities broker. The Gramm-Leach-Bliley Act eliminated the blanket “broker” exception for banks that had been contained in section 3(a)(4) of the Securities Exchange Act of 1934, but it granted exceptions designed to allow banks to continue to engage in securities transactions for customers in connection with their normal trust, fiduciary, custodial, and other banking operations. The proposed rules would implement the most important “broker” exceptions. Comments on the proposal are due by March 26, 2007.

Small Bank Holding Company Threshold
In February, the Board issued a final rule that raises, from $150 million to $500 million, 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 final rule also modifies 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. In addition, the final rule clarifies the treatment under the policy statement of subordinated debt associated with trust preferred securities.

Economic Growth and Regulatory Paperwork Reduction Act of 1996
The Economic Growth and Regulatory Paperwork Reduction Act of 1996 requires that the federal banking agencies review their regulations every ten years to identify and eliminate any unnecessary requirements imposed on insured depository institutions. (In addition, the Board periodically reviews each of its regulations.) During 2006, the Federal Reserve, OCC, FDIC, and OTS conducted the required review. Among other activities, they met with representatives of the banking industry and of consumer groups around the country to hear their concerns and their suggestions for reducing regulatory burden. The agencies expect to issue a final report in 2007.

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 companies and the formulation of regulations and supervisory policies. It is
Guidance on Concentrations in Commercial Real Estate Lending

As any banker worth his or her salt knows, lending concentrations must be carefully identified, monitored, and managed. It is one of the basics of banking to understand the consequences of placing all your eggs in one basket. Naturally, supervisors from time to time have concerns about growing credit risk concentrations at banks and bankers’ ability to manage them.

Susan Schmidt Bies, Member, Board of Governors
June 2006

In response to rising concentrations of commercial real estate (CRE) loans at many financial institutions, the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation on December 12, 2006, issued guidance promoting sound risk-management practices in this sector.1

The guidance, titled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,” the agencies recognize that financial institutions play a vital role in funding real estate development in their communities and can do so in a profitable way. However, as an institution’s concentration in CRE lending increases, management should understand its possible exposure to a downturn in the CRE market or to other adverse market and economic events.

Supervisors have observed over the past decade that CRE concentrations have been rising at many institutions, especially at small and medium-size banks. Between 1993 and 2005, CRE loans as a proportion of total equity plus reserves rose from 145 percent to 280 percent for commercial banks with assets between $100 million and $1 billion and from 120 percent to 230 percent for commercial banks with assets of $1 billion to $10 billion. Experience has shown that credit concentrations add a dimension of risk that compounds the simple risk inherent in individual loans.

1. As defined by the guidance, CRE loans include land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans; loans secured by multifamily property; and loans secured by nonfarm nonresidential property for which 50 percent or more of the source of repayment is third-party, nonaffiliated, rental income or the proceeds of the sale, refinancing, or permanent financing of the property. The guidance also applies to some loans to real estate investment trusts and unsecured loans to developers.

also used in responding to requests from Congress and the public for information on bank holding companies and their nonbank subsidiaries. Foreign banking organizations are also required to periodically submit reports to the Federal Reserve.

The FR Y-9 series of reports provides standardized financial statements for bank holding companies on both a consolidated basis and a 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 FRY-7N—help the Federal Reserve...
Further, supervisors are concerned that risk-management practices at some institutions may not have kept pace with the growth of CRE concentrations.

The agencies developed the 2006 CRE guidance to remind financial institutions that strong risk-management practices and appropriate capital levels are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans or has experienced rapid portfolio growth. The guidance provides the agencies’ examiners with two supervisory screening criteria designed to identify institutions whose CRE concentrations may require additional scrutiny:

- Total loans for construction, land development, and other land represent 100 percent or more of the institution’s total capital; or
- Total CRE loans represent 300 percent or more of the institution’s total capital, and the outstanding balance of the institution’s commercial real estate loan portfolio has increased 50 percent or more during the previous thirty-six months.

These screening criteria serve as a starting point for a dialogue between the agencies’ supervisory staff and an institution’s management about the level and nature of CRE concentration risk. The guidance focuses on CRE loans for which the risk of default is sensitive to CRE market demand, capitalization rates, vacancy rates, or rents.

The agencies recognize that different types of CRE lending present different levels of risk. For example, a well-structured loan for a multifamily housing project would generally have a lower risk profile than a loan for an office building to be built on speculation. The guidance acknowledges that institutions are in the best position to make such assessments about the level and nature of concentration risk in their CRE portfolios.

Building upon the agencies’ existing regulations and guidelines for real estate lending and loan portfolio management, the guidance describes the key elements that an institution should address in the areas of board and management oversight, portfolio management, management information systems, market analysis, credit-underwriting standards, portfolio stress-testing and sensitivity analysis, and the credit-risk review function.

The Federal Reserve recognizes that commercial real estate lending is a critically important activity that has become the “bread and butter” business of many small and medium-size banks. Supervisors emphasize that they did not intend the guidance to limit commercial real estate lending; rather, they expect that the guidance will encourage institutions to develop and maintain appropriate corporate-governance structures to address the risks posed by their lending strategies.

determine the condition of bank holding companies that are engaged in nonbank activities and also aid in monitoring the volume, nature, and condition of the companies’ nonbank subsidiaries.

In March, several revisions to the FR Y-9C, FR Y-9LP, and FR Y-9SP reports were approved for implementation during 2006. Effective March 31, the asset-size threshold for filing the FR Y-9C and FR Y-9LP reports was raised from $150 million to $500 million, reducing the number of respondents by approximately 60 percent. Other FR Y-9C revisions effective March 31 included the elimination of a number of data items; the addition of data items on loans for purchasing and carrying securities, regulatory capital, and credit derivatives; and the removal of the FR Y-9C filing requirement for lower-tier bank holding companies hav-
ing total assets of $1 billion or more. Revisions effective September 30 included new officer signature requirements and additional data items on mortgage banking activities and secured borrowings.

Effective June 30, the asset-size cap for the FR Y-9SP was raised from $150 million to $500 million, increasing the number of respondents by approximately 50 percent. Other FR Y-9SP revisions effective June 30 included the addition of two items identifying the total value of off-balance-sheet activities conducted directly or through a nonbank subsidiary and the total value of debt and equity securities registered with the SEC. Revised officer signature requirements for the FR Y-9SP were effective December 31.

In March, the Board also revised the asset-size threshold for the quarterly FR Y-11 and FR 2314 nonbank subsidiary reports, to make it consistent with the revised threshold for the FR Y-9C and to reduce reporting burden. Revising the threshold for the FR Y-11 reduced the number of quarterly respondents by approximately 30 percent; the revision had no immediate effect on the number of FR 2314 filers. Other FR Y-11 and FR 2314 revisions effective March 31 included the addition of a new equity capital component to the balance sheet for reporting partnership interest and, for the FR Y-11 only, the expansion of the scope of several loan items reported on the balance sheet memoranda.

Effective December 31, a new report was implemented: the Annual Report of Merchant Banking Investments Held for an Extended Period (FR Y-12A). The report collects data concerning merchant banking investments that are approaching the end of the holding period permissible under Regulation Y (Bank Holding Companies and Change in Bank Control).

Commercial Bank Regulatory Financial Reports

As the federal supervisor of state member banks, the Federal Reserve, along with the other banking agencies through the FFIEC, requires banks to submit quarterly Consolidated Reports of Condition and Income (Call Reports). Call Reports are the primary source of data for the supervision and regulation of banks and 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.

For the 2006 reporting period, the FFIEC implemented various revisions to the Call Report to streamline the reporting requirements and to add new items that focus on areas of increasing supervisory concern. The principal revisions included the collection of data related to the implementation of deposit insurance reform provisions, funding sources (Federal Home Loan Bank advances and other borrowings), and mortgage banking activities. The signature and attestation requirements were revised to add the chief financial officer, or equivalent, to the list of officials required to attest to and sign the Call Report.

In October, the FFIEC proposed revisions for the 2007 reporting period to address new safety and soundness considerations and to facilitate supervision. Among the proposed revisions are changes in data collection related to the deposit insurance assessment collection
process; changes in generally accepted accounting principles (including certain financial instruments measured at fair value and principles for accounting for defined benefit pension and other post-retirement plans); and nontraditional mortgage products.

Supervisory Information Technology

Information technology supporting Federal Reserve supervisory activities is managed within the System supervisory information technology (SSIT) function in the Board’s Division of Banking Supervision and Regulation. SSIT works through assigned staff at the Board and the Reserve Banks, as well as through System committees, to ensure that key staff members throughout the System participate in identifying requirements and setting priorities for IT initiatives.

In 2006, the SSIT function worked on the following strategic projects and initiatives: (1) align technology investments with business needs; (2) improve security of information-sharing technologies and provide for seamless collaboration in interagency efforts; (3) identify and implement improvements in the accessibility of technology to staff working in the field; (4) identify opportunities to converge and streamline IT applications, including key administrative systems, to provide consistent and seamless information; (5) evaluate and implement technologies (such as portals, search engines, and content management tools) to integrate supervisory and management information systems that support both office-based and field staff; and (6) enhance the information security framework for the supervisory function, improving both overall security and compliance with best-practices and regulatory requirements.

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 comprehensive data on banking structure throughout the United States; the National Examination Database (NED), which enables supervisory personnel and state banking authorities to access 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 (CDTR), which contains documents supporting the supervisory processes.

The structure and supervisory data systems are continually being updated to extend their useful lives and improve business workflow efficiency. During 2006, the NED system was modified to begin collecting Bank Secrecy Act information in an automated format, to support Federal Reserve enforcement activities. In 2006, the BOND and CDTR systems were modified to provide further integration with the Federal Reserve’s internal surveillance program, to provide additional support for the supervision of large financial institutions, and to allow integration of examinations of technology service providers. In addition, user authentication software was upgraded for external agency users, and use of the BOND and CDTR systems was extended to additional federal and state regulatory agencies.
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 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, anti-money laundering, capital markets, payment systems risk, and real estate appraisal. In addition, the System co-hosts the World Bank Seminar for supervisors from developing countries.

In 2006, the Federal Reserve trained 3,619 students in System schools, 952 in schools sponsored by the FFIEC, and 24 in other schools, for a total of 4,595, including 312 representatives of foreign central banks and supervisory agencies (see table). The number of training days in 2006 totaled 23,321.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 605 state examiners were trained—308 in Federal Reserve courses, 293 in FFIEC programs, and 4 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 two specialty areas: safety and soundness or consumer affairs. In 2006, 190 examiners passed the first proficiency examination, and 61 passed the second proficiency examination: 53 the safety and soundness exam, and 8 the consumer affairs exam.

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 concern bank holding company formations and acquisitions, bank mergers, and other transactions involving bank or nonbank firms. In 2006, the Federal Reserve acted on 1,378 proposals, which represented 3,171 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 company through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies 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

Training Programs for Banking Supervision and Regulation, 2006

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<tr>
<th>Program</th>
<th>Number of sessions conducted</th>
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<td>Schools or seminars conducted by the Federal Reserve</td>
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<tr>
<td>Core schools</td>
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<td>Financial analysis and risk management</td>
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<td>Bank management</td>
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</tr>
<tr>
<td>Report writing</td>
<td>15</td>
</tr>
<tr>
<td>Management skills</td>
<td>8</td>
</tr>
<tr>
<td>Conducting meetings with management</td>
<td>14</td>
</tr>
<tr>
<td>Other schools</td>
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</tr>
<tr>
<td>Credit risk analysis</td>
<td>5</td>
</tr>
<tr>
<td>Examination management</td>
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</tr>
<tr>
<td>Real estate lending seminar</td>
<td>3</td>
</tr>
<tr>
<td>Senior forum for current banking and regulatory issues</td>
<td>2</td>
</tr>
<tr>
<td>Basel II corporate activities</td>
<td>3</td>
</tr>
<tr>
<td>Basel II operational risk</td>
<td>2</td>
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<tr>
<td>Basel II retail activities</td>
<td>3</td>
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<tr>
<td>Principles of fiduciary supervision</td>
<td>2</td>
</tr>
<tr>
<td>Commercial lending essentials for consumer affairs</td>
<td>1</td>
</tr>
<tr>
<td>Consumer compliance examinations I</td>
<td>2</td>
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<tr>
<td>Consumer compliance examinations II</td>
<td>2</td>
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<tr>
<td>CRA examination techniques</td>
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</tr>
<tr>
<td>CA risk-focused examination techniques</td>
<td>2</td>
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<tr>
<td>Fair lending examination techniques</td>
<td>3</td>
</tr>
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<td>Asset liability management (ALM2)</td>
<td>2</td>
</tr>
<tr>
<td>Fundamentals of interest rate risk management</td>
<td>8</td>
</tr>
<tr>
<td>Trading and operations</td>
<td>1</td>
</tr>
<tr>
<td>Technology risk integration</td>
<td>3</td>
</tr>
<tr>
<td>Leadership dynamics</td>
<td>6</td>
</tr>
<tr>
<td>Fundamentals of fraud</td>
<td>16</td>
</tr>
<tr>
<td>Information technology seminar</td>
<td>11</td>
</tr>
<tr>
<td>Seminar for senior supervisors of foreign central banks</td>
<td>34</td>
</tr>
<tr>
<td>and 13 other international courses</td>
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<td>Self-study or online learning¹</td>
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<td>Orientation (core and specialty)</td>
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<tr>
<td>Self-study modules (26 modules)</td>
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<tr>
<td>Other agencies conducting courses²</td>
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<tr>
<td>Federal Financial Institutions Examination Council</td>
<td>78</td>
</tr>
<tr>
<td>The Options Institute</td>
<td>1</td>
</tr>
</tbody>
</table>

1. Held at the IT Lab at the Chicago Reserve Bank.
2. Conducted jointly with the World Bank.
3. Self-study programs do not involve group sessions.
4. Open to Federal Reserve employees.
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 2006, the Federal Reserve acted on 638 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 permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company’s debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board’s capital adequacy guidelines. In 2006, the Federal Reserve reviewed 7 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 2006, 48 domestic financial holding company declarations and 7 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 community(ies) to be served, and the competitive effects of the proposed merger. In 2006, the Federal Reserve approved 65 merger applications under the act.

As a result of enactment of the Financial Services Regulatory Relief Act of 2006, the Federal Reserve is no longer required for each proposed bank merger to either request competitive factors reports from the other federal banking and thrift regulatory agencies or provide reports on competitive factors to those other agencies. The Federal Reserve now must consider only the views of the U.S. Department of Justice regarding the competitive aspects of a proposed bank merger. In addition, the views of the Department of Justice need not be solicited for bank mergers involving affiliated insured depository institutions. Before these statutory changes occurred in the third quarter of 2006, the Federal Reserve had submitted 451 reports on competitive factors to the other agencies.
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. In addition, with enactment of the Financial Services Regulatory Relief Act of 2006, the Federal Reserve must also consider the future prospects of the institution to be acquired: a proposed transaction should not jeopardize the stability of the institution or the interests of depositors. During its review of a proposed transaction, the Federal Reserve may contact other regulatory or law enforcement agencies for information about relevant individuals.

In 2006, the Federal Reserve approved 98 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 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 2006, the Federal Reserve acted on new and merger-related branch proposals for 2,033 domestic branches and granted prior approval for the establishment of 7 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 2006, 1 application for a financial subsidiary was 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 2006, the Federal Reserve approved 29 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 16 applications to make additional investments through an Edge
Act or agreement corporation, 1 application to establish an Edge Act 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 2006, the Federal Reserve approved 19 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 immediately; they are subsequently reported in the Board’s weekly H.2 statistical release. The H.2 release also contains announcements of applications and notices received by the Federal Reserve upon which action has not yet been taken. For each pending application and notice, the related H.2A contains the deadline for comments. The Board’s web site (www.federalreserve.gov) provides information on orders and announcements as well as a guide for U.S. and foreign banking organizations that wish to submit applications or notices to the Federal Reserve.

Enforcement of Other Laws and Regulations

The Federal Reserve’s enforcement responsibilities also extend to the disclosure of financial information by state member banks and the use of credit to purchase and carry securities.
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 2006, 17 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.

Federal Reserve Membership

At the end of 2006, 2,593 banks were members of the Federal Reserve System and were operating 53,938 branches. These banks accounted for 35 percent of all commercial banks in the United States and for 71 percent of all commercial banking offices.
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 compliance with the regulations;
- investigating complaints from the public about state member banks’ 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 issue commentaries and other guidance.

During 2006, the Board published final amendments to its Regulation E, which implements the Electronic Fund Transfer Act, and the associated commentary to make the regulation applicable to payroll card accounts established through an employer to provide a consumer with electronic fund transfers of salary, wages, or other employee compensation on a recurring basis. The Board also amended Regulation E to clarify that a person, such as a merchant, must obtain a consumer’s authorization to collect returned-item fees electronically from the consumer’s account. The Board engaged in several rulemaking and other activities with the other federal banking agencies and the Federal Trade Commission (FTC). The Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued final guidance on the most recent amendments to the agencies’ Community Reinvestment Act (CRA) regulations. The Board also issued joint final guidance with the OCC, the FDIC, the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) to address the risks associated with nontraditional mortgage products. In addition, the Board and the FTC jointly issued a report to Congress on the consumer dispute provisions of the Fair Credit Reporting Act.

Furthermore, the Board raised the dollar threshold that triggers additional requirements under the Home Ownership and Equity Protection Act and raised the exemption threshold for depository institutions required to collect data under the Home Mortgage Disclosure Act.
Amendments to Regulation E (Electronic Fund Transfers)

Payroll Cards
In August, the Board published final amendments to Regulation E that address payroll card accounts established through an employer on behalf of a consumer and to which recurring electronic fund transfers of salary, wages, or other employee compensation are made. Under the final rule, payroll card accounts are subject to the same requirements that apply to traditional transaction accounts under Regulation E; these requirements include a financial institution’s duty to provide payroll-card account holders with initial disclosures, periodic statements, and error-resolution and liability provisions. For periodic statements, however, the final rule allows financial institutions to provide the specified account information electronically, and in writing upon the consumer’s request, rather than through paper statements.

Regulation E applies to financial institutions that (1) hold an account belonging to a consumer or (2) both issue an access device (such as a debit card) to a consumer and agree with the consumer to provide electronic fund transfer (EFT) services. The final rule clarifies that the depository institution holding the consumer’s funds in a payroll card account is a financial institution under the regulation. The final rule does not generally cover employers or third-party service providers. The mandatory compliance date for the final rule is July 1, 2007.

Returned-Item Fees
In December, the Board published a final rule amending Regulation E and its official staff commentary. These amendments clarify the consumer-authorization requirements for the electronic collection of returned-item fees. The final rule states that a person seeking to collect a fee for a returned check or any other item must obtain a consumer’s authorization to initiate an EFT to collect this fee. This requirement applies to the person initiating the EFT, not to the consumer’s account-holding financial institution. Consumer authorization is obtained when (1) a notice stating the specific amount of the fee (or explaining how the fee is calculated, if the fee may vary) and a statement that the fee will be collected via an EFT is provided to the consumer and (2) the consumer goes forward with the transaction. For point-of-sale transactions, the notice must be posted in a prominent and conspicuous location, and a copy of the notice must be given to the consumer to retain. The required copy of the notice may be given to the consumer at the time of the transaction or mailed to the consumer’s address as soon as reasonably practicable after the EFT has been initiated.

Joint Guidance on the Community Reinvestment Act Regulations
In March, the Board, along with the FDIC and the OCC, issued joint final guidance to implement changes to the agencies’ CRA regulations, which were effective in September 2005. The guidance answers frequently asked questions about the new CRA rules, including a new rule that provides CRA “community development” consideration for bank activities that revitalize or stabilize designated disaster areas. The guidance states that banks will receive consideration for activities they conduct within 36 months of an area’s designation as a disaster area when such activities help to attract new, or to retain existing, busi-
nesses or residents to the area and are related to disaster recovery.

The guidance also implements a new rule that provides “community development” consideration for bank activities that revitalize or stabilize underserved or distressed middle-income rural areas. The guidance describes the types of activities that will receive consideration as well as how such activities will be evaluated. In addition, the guidance discusses the new community development test for intermediate small banks (banks that have assets of between $250 million and $1 billion).

Interagency Guidance on the Risks of Nontraditional Mortgage Products

In September, the Board, along with the OCC, the FDIC, the OTS, and the NCUA, issued final guidance to address the risks associated with the growing use of so-called nontraditional mortgage products, such as interest-only mortgages and payment-option adjustable-rate mortgages. These products, which allow borrowers to defer repayment of the loan’s principal and sometimes interest, are being offered to a wide spectrum of borrowers. Among other issues, the interagency guidance addresses concerns that some borrowers may not fully understand the risks of these products, including their potential for negative amortization.

Specifically, the agencies provided guidance in three primary areas: loan terms and underwriting standards, portfolio and risk-management practices, and consumer protection issues. The first section of the guidance advises financial institutions to ensure that their loan terms and underwriting standards for nontraditional mortgage products are consistent with prudent lending practices, which include considering whether a borrower has the capacity to repay a loan. The second section outlines the need for financial institutions to have strong risk-management standards, capital levels commensurate with the risk of their products and activities, and an allowance for loan and lease losses that reflects the collectibility of their loan portfolio. The third section describes recommended practices to ensure that financial institutions are providing consumers with clear and balanced information that allows them to understand the terms and associated risks of a loan before they choose a specific product or payment option. (See related box “Nontraditional Mortgages—Balancing Innovation, Regulation, and Education.”)

Report on Compliance with Consumer Dispute Provisions of the Fair Credit Reporting Act

In August, the Board and the FTC issued a joint report to Congress pursuant to section 313(b) of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act). In addition to other changes, the FACT Act amended the Fair Credit Reporting Act (FCRA) to enhance the FCRA’s consumer dispute provisions. The joint report describes the extent to which consumer reporting agencies (CRAs) and furnishers of information to CRAs comply with the consumer dispute provisions of the FCRA. Before writing the report, the Board and the FTC conducted a study that examined several sources of information: public comments from consumers, CRAs, and consumer and industry groups; consumer complaints sent to the federal financial institution regulatory agencies; bank examination data on FCRA compliance; and other studies.

Nontraditional Mortgages—Balancing Innovation, Regulation, and Education

Homeownership has long been viewed as a fundamental step to furthering personal and financial well-being. A home is often the largest and most important asset individuals and families acquire, and the equity earned on a home can, over time, provide homeowners with financial flexibility and security. Consumers have benefited from public policies to encourage and facilitate homeownership, as well as from innovations in the financial services industry that have increased both the number of lenders and types of home loans available. While increased competition and product choice provide consumers with new opportunities, they also present many challenges for both borrowers, who must be prepared to evaluate their options, and for regulators, who seek to ensure consumer protections without hindering market innovation through overly restrictive regulation.

In recent years, so-called nontraditional mortgages, including interest-only and payment-option adjustable-rate mortgages, have become increasingly popular. Originally designed as niche products to meet the needs of certain borrowers, such as wealthy customers or customers who have seasonal or other fluctuations in their incomes, nontraditional mortgages are now commonplace among more-typical borrowers. In 2006, nontraditional mortgages accounted for one-third of all mortgage originations, compared with only one-tenth of mortgage originations in 2003. Nontraditional mortgages can provide borrowers with greater flexibility by allowing them to repay only interest for a period of time or to choose among other repayment options, in contrast to a fully amortizing loan that requires fixed payments throughout the loan term. The interest rate and payments are adjusted later in the term of a nontraditional mortgage in order to recapture repayment of principal. Because nontraditional mortgages typically allow a borrower to make lower payments early in the loan, these loans have become increasingly popular in high-cost housing markets.

But nontraditional mortgages can also carry significant risk, including negative amortization, which occurs when the amount of the loan increases over time, and “payment shock,” which occurs when interest rate adjustments result in a much higher payment later in the loan term. Further, reports of aggressive marketing practices for these loans, as well as reported incidents of consumers receiving inadequate or misleading loan disclosures, have raised concerns among consumer groups, financial institution regulatory agencies, and some lawmakers that nontraditional mortgages are inappropriately marketed to and used by some borrowers. However, the need to ensure that consumer protections are in place for nontraditional mortgages must be balanced with the desire to encourage innovation and flexibility in the mortgage industry.

In 2006, the Federal Reserve Board took a multifaceted approach to responding to consumer-related issues in today’s mortgage market, including the risks presented by the growing use of nontraditional mortgage products. During the summer, the Board convened a series of public hearings to discuss home equity lending markets and practices. After conducting initial outreach to an array of interested groups, Federal Reserve regulatory and research staff structured the hearings to include discussion panels on the impact of the 2002 changes to the Home Ownership and Equity Protection Act (HOEPA) regu-
lations, as well as panels on key issues in the mortgage market. Topics included trends and issues associated with complex products, such as nontraditional mortgages and reverse mortgages, as well as efforts to provide consumers with pre- and post-purchase counseling and intervention, lender “best practices” and the role of mortgage brokers, and the results of research on state predatory lending laws. The hearings also explored consumer behavior in shopping for mortgage loans and discussed the challenges of designing more effective and informative consumer disclosures. Both lenders and consumer advocates participated in the hearings, which enabled diverse viewpoints on both the benefits and pitfalls of nontraditional mortgages to be presented.

Lenders testified that nontraditional mortgage loans are appropriately underwritten and have historically shown strong performance. Consumer advocates and state officials, on the other hand, testified that aggressive marketing and the complexity of these products increase the risk that a borrower will obtain a mortgage he or she does not understand and might not be able to afford. They also questioned whether additional loan disclosures would only overwhelm consumers, because the products are so complex. Board staff are considering the comments from these hearings, as well as insights gained from consumer focus groups and other sources of information, as they evaluate potential revisions to the mortgage disclosure requirements in Regulation Z.

Recognizing the important role of education in understanding mortgage transactions, the Board partnered with other federal supervisory agencies to improve the resources available to both consumers and lenders on nontraditional mortgages. For consumers, the Federal Reserve, in partnership with the Office of Thrift Supervision, updated the “Consumer Handbook on Adjustable-Rate Mortgages,” which includes an in-depth discussion of nontraditional mortgages and illustrations of how loan payments may result in negative amortization.1 The Board also published a consumer information brochure, “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?,” which includes a glossary of lending terms, a mortgage shopping worksheet, and a list of additional information sources to help consumers evaluate whether these types of loans are right for them.2 This publication stresses the importance of understanding key mortgage loan terms, warns of the risks consumers may face, and urges borrowers to be realistic about whether they can handle future payment increases. In addition, interagency guidance on nontraditional mortgages, issued in September, highlights the increased risk for lenders and borrowers that nontraditional mortgages can present.3 The guidance discusses the importance of (1) carefully managing the potential heightened risk levels, for the benefit of both lenders and borrowers; (2) using prudent loan-structuring and underwriting standards; (3) considering a borrower’s repayment capacity; and (4) ensuring that consumers have sufficient information to understand the terms and risks before making a loan or payment choice.

The mortgage industry has proven to be innovative in developing a wide range of mortgage credit products. Through its supervisory responsibilities, research, consumer education, and outreach to communities and lenders, the Federal Reserve will continue to strive to balance such innovation in the financial services industry with responsive oversight and consumer protection.

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2. www.federalreserve.gov/pubs/mortgage_interestonly/default.htm
reports, and data conducted or maintained by the federal financial institution regulatory agencies. The report found that most CRAs appear to be processing consumer disputes within the statutory time frame; however, there was disagreement as to the adequacy of the dispute investigations conducted by CRAs and furnishers of information to CRAs.

To ensure that the FACT Act provisions enhancing the consumer dispute process are given enough time to be effective, the Board and the FTC did not recommend any additional administrative or legislative actions at this time. However, as discussed in the report, the FTC and the Board will continue to monitor the performance of the dispute process, explore possible enhancements, and recommend actions, if appropriate.

Other Regulatory Actions
The Board also took the following regulatory actions during 2006:

- In August, the Board amended the official staff commentary to Regulation Z to raise from $528 to $547 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act. As prescribed by that statute, the increased threshold (effective January 1, 2007) reflects changes in the consumer price index. As a result, depository institutions that have assets of $36 million or less as of December 31, 2006, are exempt from data collection, effective January 1, 2007.

- In December, the Board amended the official staff commentary to Regulation C to raise from $35 million to $36 million the asset-size exemption threshold for depository institutions required to collect data under the Home Mortgage Disclosure Act. As prescribed by that statute, the increased threshold reflects changes in the consumer price index. As a result, depository institutions that have assets of $36 million or less as of December 31, 2006, are exempt from data collection, effective January 1, 2007.

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 Federal Reserve 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 operations. 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 2006 reporting period, the Reserve Banks conducted CRA examinations of 276 banks: 27 were rated Outstanding, 248 were rated Satisfactory, none was rated Needs to
Improve, and one was rated Substantial Noncompliance.2

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

During 2006, the Board considered applications for several significant banking mergers. The Board approved the application by Capital One Financial Corporation, McLean, Virginia, to acquire North Fork Bancorporation, Inc., Melville, New York, in November; this acquisition was a major expansion of Capital One Corporation’s relatively new retail banking operations. In addition, three large bank holding companies, National City Corporation, in Cleveland, Ohio; BB&T Corporation, in Winston-Salem, North Carolina; and Marshall & Ilsley Corporation, in Milwaukee, Wisconsin, each acquired two large banking organizations in 2006.

Several other significant applications are listed below.

• An application by Trustmark Corporation, Jackson, Mississippi, to acquire Republic Bancshares of Texas, Inc., Houston, Texas, was approved in August.

• An application by Wachovia Corporation, Charlotte, North Carolina, to acquire Golden West Financial Corporation, Oakland, California, was approved in September.

• An application by Regions Financial Corporation, Birmingham, Alabama, to acquire AmSouth Bancorporation, also of Birmingham, was approved in October.

The public submitted comments on each of these applications. Commenters expressed concerns that minority applicants were being denied mortgage loans more frequently than nonminority applicants; other concerns described included potentially predatory lending practices of subprime and payday lenders; potential adverse effects of branch closings; and lenders’ failure to address the convenience and needs of low- and moderate-income communities. Many of the comments referenced pricing information on residential mortgage loans that was required to be reported beginning with the 2004 Home Mortgage Disclosure Act (HMDA) data. Commenters’ concerns that minority applicants were more likely than nonminority applicants to receive higher-priced mortgages were largely based on observations of the 2004 and 2005 HMDA pricing data.3

In total, the Board acted on twenty-four 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 thirty-six applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.4

Other Consumer Compliance Activities

The Division of Consumer and Community Affairs supports and oversees the supervisory efforts of the Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly en-

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2. The 2006 reporting period for examination data was July 1, 2005, through June 30, 2006.

3. HMDA requires lenders to collect price information on loans they originated in the higher-priced segment of the home-loan market. “Higher-priced mortgages” refers to mortgage loans whose annual percentage rates are 3 percentage points or more over the yield on comparable Treasury securities on first-lien loans, and 5 percentage points or more over that yield on junior-lien loans.

4. In addition, four applications involving consumer compliance issues were withdrawn.
Division staff provide guidance and expertise to the Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. 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 2006 reporting period, the Reserve Banks conducted 321 consumer compliance examinations—303 of state member banks and 18 of foreign banking organizations.5

The Board periodically issues guidance for Reserve Bank examiners on consumer protection laws and regulations. In addition to updating examination procedures and guidance in concert with the other federal financial institution regulatory agencies, the Board issued guidance on state member banks’ activities in disaster areas affected by the 2005 hurricanes in the Gulf Coast region.6 As put forth in the guidance, state member banks located outside of the hurricane disaster areas will receive CRA consideration for their activities that revitalize or stabilize the disaster areas, if the banks have otherwise adequately met the needs of their assessment areas. (See “Response to the 2005 Hurricanes” later in this chapter.)

**Fair Lending**

The Federal Reserve is committed to ensuring that every institution it supervises complies fully with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. Fair lending reviews are conducted regularly within the supervisory cycle. Additionally, examiners may conduct fair lending reviews outside of the usual supervisory cycle, if warranted. To promote rigorous and consistent fair lending enforcement, the Division of Consumer and Community Affairs staff coordinate investigations of potential fair lending violations with Reserve Bank staff.

The Federal Reserve enforces the ECOA and the provisions of the Fair Housing Act that apply to lending institutions. The ECOA prohibits 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. The Fair Housing Act prohibits discrimination in residential real estate–related transactions, including the making and purchasing of mortgage loans, on the basis of race, color, religion, national origin, handicap, familial status, or sex.

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.

6. The guidance was released in a letter (CA 06-5) to the Reserve Banks on February 24, 2006 (www.federalreserve.gov/boarddocs/caletters).
ment of Justice. If a violation of the ECOA also constitutes a violation of the Fair Housing Act and a referral is not made to the Department of Justice, the matter will be referred to the Department of Housing and Urban Development.

During 2006, the Board referred the following matters to the Department of Justice, on the basis of these findings:

- The Board determined that a mortgage company owned by a state member bank had engaged in redlining—that is, discrimination against potential borrowers on the basis of the racial composition of their neighborhoods—in violation of the ECOA and the Fair Housing Act. The mortgage company had adopted a marketing strategy that was based on negative racial stereotypes and, as a result, excluded a cluster of minority neighborhoods from its lending activity.

- The Board found that a state member bank had violated the ECOA and the Fair Housing Act by discriminating against several mortgage applicants on the basis of race and national origin. The bank rejected several minority applicants on the basis of “insufficient collateral” without ordering an appraisal, even though, in contrast, the bank did not deny any white applicants for insufficient collateral without ordering an appraisal.

- Two state member banks were found to have engaged in discrimination on the basis of marital status in their pricing of auto loans, in violation of the ECOA. The banks used rate sheets that expressly provided that non-spousal co-applicants (applicants who were not married to each other) should be charged higher interest rates.

- The Board determined that a state member bank discriminated on the basis of age, in violation of the ECOA, by offering customers over 50 years of age a special account with preferential credit features. The “over 50” account provided for an interest rate reduction on consumer loans if payment was made through automatic debit. This interest rate reduction was not offered to borrowers who did not have an “over 50” account. The ECOA generally prohibits creditors from considering age when evaluating creditworthiness, except that a creditor may consider the age of an applicant 62 years or older in the applicant’s favor.

Since the addition of pricing information to the data reported under HMDA, the Federal Reserve has used the pricing data to facilitate its fair lending enforcement efforts. (See “Reporting on Home Mortgage Disclosure Act Data” later in this chapter.) The Federal Reserve does not rely on HMDA data alone in its enforcement efforts, however, because HMDA data do not include many potential determinants of loan pricing, such as the borrower’s credit history and the loan-to-value ratio. Instead, the Federal Reserve analyzes the HMDA pricing data in conjunction with other fair lending risk factors—such as discretionary pricing and incentives for loan officers to charge higher prices—to identify lenders that are at risk for pric-

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7. The Board referred this case to the Department of Justice in December 2005. It was not included in the 2005 Annual Report because the referral occurred outside the reporting period for the 2005 report (July 1, 2004, through June 30, 2005). It is included in the 2006 Annual Report, which otherwise reports referrals occurring during the 2006 calendar year.
ing discrimination. These lenders will receive a targeted pricing review. During a targeted pricing review, examiners collect additional information (including factors that are not available in the HMDA data) to determine whether a pricing disparity by race or ethnicity is fully attributable to legitimate factors, or whether any portion of the pricing disparity is attributable to discrimination.

**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 are generally 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 Board and other federal financial institution regulatory agencies to impose civil money penalties when it finds a pattern or practice of violations of the regulation. The agencies have issued regulations creating exceptions to the statute’s general prohibition; therefore, the FCRA examination procedures have been revised to reflect these new regulations. In addition, the FFIEC revised the CRA examination procedures for large banks, small banks, wholesale or limited-purpose banks, and banks operating under strategic plans. The revisions incorporate the CRA regulatory changes that were approved in 2005.

During 2006, the Board imposed civil money penalties against four state member banks. The penalties, which were assessed via consent orders, totaled $32,050.

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9. The FFIEC member agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA).
affairs conferences; the next conference
is scheduled for October 2007.

Finally, the Board, the OCC, and the
FDIC updated the host-state loan-to-
deposit ratios used to determine compli-
ance with section 109 of the Riegle-
Neal Interstate Banking and Branching
Efficiency Act of 1994.10

Response to 2005 Hurricanes

In 2006, the Federal Reserve and the
other banking agencies continued initia-
tives to help financial institutions af-
fected by the 2005 hurricanes in the
Gulf Coast. The Board, the FDIC, the
OCC, and the OTS sponsored an inter-
agency forum, “The Future of Banking
in the Gulf Coast: Helping Banks and
Thrifts Rebuild Communities,” that fo-
cused on the short-term and long-term
challenges facing these financial institu-
tions, including how they can help meet
the needs of their local communities. In
addition to officials from the sponsoring
agencies, senior executives from both
large and small financial institutions and
representatives from community devel-
opment corporations and a number of
other federal agencies participated in the
forum.

The FFIEC member agencies and the
Conference of State Bank Supervisors
released a booklet, “Lessons Learned
from Hurricane Katrina: Preparing Your
Institution for a Catastrophic Event.”11
Using financial institutions’ experiences
and lessons learned during Hurricane
Katrina and its aftermath, the booklet is
intended to help other institutions plan
for an emergency or a catastrophic
event.

Training for Bank Examiners

Ensuring that financial institutions com-
ply with laws that protect consumers
and encourage community reinvestment
is an important part of the bank exami-
nation and supervision process. As the
number and complexity of consumer
financial transactions grow, training for
examiners of the organizations under
the Federal Reserve’s supervisory re-
sponsibility becomes even more impor-
tant. The consumer compliance exami-
ner training curriculum consists of six
courses focused on various consumer
protection laws, regulations, and exam-
ining concepts. In 2006, these courses
were offered in ten sessions to more
than 195 consumer compliance examin-
ers and System staff members.

Board and Reserve Bank staff regu-
larly review the core curriculum for ex-
aminer training, updating subject matter
and adding new elements as appropriate.
During 2006, staff conducted curricu-
num reviews of the following two
courses in order to incorporate technical
changes in policy and laws, along with

10. See the June 13, 2006, press release
(www.federalreserve.gov/boarddocs/press/bcreg/
2006/).
11. The booklet is available on the FFIEC’s
web site (www.ffiec.gov/Katrina_lessons.htm).
changes in instructional delivery techniques:

- **Community Reinvestment Act Examination Techniques Course.** Equips assistant examiners to participate in all aspects of a CRA examination, including the evaluation of a bank’s CRA program and the determination of its CRA rating.

- **Fair Lending Examination Techniques Course.** Provides assistant examiners with the skills and knowledge to plan and conduct the risk-focused fair lending portion of a consumer compliance examination.

When appropriate, courses are delivered via alternative methods, such as the Internet or other distance-learning technologies. The CRA course discussed above uses a combination of instructional methods: (1) classroom instruction focused on case studies and (2) specially developed computer-based instruction that includes interactive self-check exercises. The computer-based instruction is reinforced through daily conference calls and discussions on electronic bulletin boards. The Fair Lending course discussed above also uses computer-based training.

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

**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.

In response to the growth of the subprime-loan market, the Federal Reserve updated Regulation C in 2002. The revisions, which became effective in 2004, require lenders to collect price information for loans they originated in the higher-priced segment of the home-loan market. When applicable, lenders report the number of percentage points by which a loan’s annual percentage rate exceeds the threshold that defines “higher-priced loans.” The threshold is 3 percentage points or more above the yield on comparable Treasury securities for first-lien loans, and 5 percentage points or more above that yield for junior-lien loans. The HMDA data collected in 2004 and released to the public in 2005 provided the first publicly available loan-level data about loan prices. The FFIEC released the 2005 HMDA data to the public in September 2006.

A September 2006 article published by Federal Reserve staff in the Federal Reserve Bulletin uses the 2005 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.12

As in 2004, relatively few lenders accounted for most of the higher-priced

loan originations in 2005. Of the 8,850 home lenders reporting HMDA data, 1,120 of them made 100 or more higher-priced loans. The 10 home lenders that had the largest volume of higher-priced loans accounted for about 59 percent of all such loans. Higher-priced lending is also concentrated by price: in 2005, the vast majority of higher-priced loans had annual percentage rates within 3 percentage points of the reporting thresholds. As in 2004, the majority of all loan originations were not higher priced in 2005, however, the incidence of higher-priced lending did increase substantially—26.2 percent in 2005, compared with 15.5 percent in 2004.

Some of the increase in the incidence of higher-priced lending is attributed to changes in the interest rate environment from 2004 to 2005, as well as to changes in borrower profiles and lender practices.

Loan pricing is a complex process that may reflect a wide variety of factors about the level of risk a particular loan or borrower presents to the lender. As a result, the prevalence of higher-priced lending varies widely. First, the incidence of higher-priced lending varies by product type. For example, manufactured-home loans show the greatest incidence of higher-priced lending, because these loans are considered higher risk. In addition, first-lien mortgages are generally less risky than comparable junior-lien loans, and the pricing for these loans reflects their risk profiles: 25.7 percent of first-lien refinance loans were reported as higher-priced in 2005, compared with 30.2 percent of comparable junior-lien loans.

Second, higher-priced lending varies widely by geography. As in 2004, many of the metropolitan areas that reported the greatest incidence of higher-priced lending were in the southern region of the country. Several metropolitan areas on the West Coast also had an elevated incidence of higher-priced lending in 2005. For example, in many metropolitan areas in the South, Southwest, and West, 30 percent to 40 percent of the homebuyers who obtained conventional loans in 2005 received higher-priced loans.

Third, the incidence of higher-priced lending varies greatly among borrowers of different races and ethnicities. In 2005, as in 2004, blacks and Hispanics were much more likely than non-Hispanic whites and Asians to receive higher-priced loans. For example, in 2005, 55 percent of black borrowers, and 46 percent of Hispanic borrowers, received higher-priced home-purchase loans, compared with only 17 percent of non-Hispanic white or Asian borrowers.

To a large extent, these differences reflect a segmentation of the home-loan market, that is, black and Hispanic borrowers were much more likely to obtain mortgage loans from institutions that specialize in higher-priced lending.

Because HMDA data lack information about credit risk and other legitimate pricing factors, it is not possible to determine from HMDA data alone whether the observed pricing disparities and market segmentation reflect discrimination. When analyzed in conjunction with other fair lending risk factors and supervisory information, however, the HMDA data can facilitate fair lending supervision and enforcement. (See “Fair Lending” earlier in this chapter.)

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.\textsuperscript{13}

\textbf{Regulation B} \\
\textit{(Equal Credit Opportunity)}

The FFIEC agencies reported that 87 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation B, compared with 85 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- abstain from inquiring about the race, color, religion, national origin, or sex of an applicant in connection with a credit transaction unless permitted by regulation
- collect information for monitoring purposes about the race, ethnicity, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- note on the application form monitoring information regarding ethnicity, race, and sex when an applicant chooses not to provide the information
- 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 one supervisory agreement to a savings association for its alleged violations of the Equal Credit Opportunity Act (ECOA) and Regulation B, as well as other consumer regulations. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation B during the reporting period.

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, an examination conducted by the National Association of Securities Dealers, Inc., found one violation of Regulation B at a member firm. The firm’s written supervisory procedures did not contain information regarding the denial of credit to customers. However, none of these other agencies initiated any formal enforcement actions relating to Regulation B during 2006.

\textbf{Regulation E} \\
\textit{(Electronic Fund Transfers)}

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation E, which is comparable to the level of compliance for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

\textsuperscript{13} Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2006 reporting period was July 1, 2005, through June 30, 2006.
• determine whether an error occurred, within ten business days of receiving a notice of error from a consumer
• give the consumer provisional credit for the amount of an alleged error when an investigation into the alleged error cannot be completed within ten business days
• provide initial disclosures that contain required information, including limitations on the types of transfers permitted and error-resolution procedures, at the time a consumer contracts for an electronic fund transfer service
• when a determination is made that no error has occurred, provide a written explanation and note the consumer’s right to request documentation supporting the institution’s findings

The Federal Trade Commission (FTC) filed two complaints in federal district court for alleged violations of Regulation E and federal statutes. Among other allegations, one complaint alleged that the defendants charged consumers’ credit cards or debited their bank accounts, both on a recurring basis, to pay for a discount health plan, without obtaining the consumers’ authorization for preauthorized electronic fund transfers. The other complaint alleged that defendants enrolled consumers in a mail-order program for dietary supplements and then automatically billed consumers on a recurring basis, without obtaining their authorizations for the recurring debits. The 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 2006 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2005 reporting period. 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 98 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation P, compared with 97 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:
• provide a clear and conspicuous annual privacy notice to customers
• disclose the institution’s information-sharing practices in initial, annual, and revised privacy notices
• provide customers with a clear and conspicuous initial privacy notice that accurately reflects the institution’s privacy policies and practices, not later than when the customer relationship is established

The 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 85 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation Z, compared with 80 percent for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:
• in closed-end credit transactions, accurately disclose the finance charge and the security interest that the creditor has or will acquire in the property identified

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

• 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

In addition, 106 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 $1.5 million to consumers for understating the annual percentage rate or the finance charge in their consumer loan disclosures.

The OTS issued three supervisory agreements for violations of a number of consumer regulations, including Regulation Z, during the reporting period. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation Z during the reporting period.

The Department of Transportation investigated one air carrier for its improper handling of credit card and cash refunds for unused refundable tickets. As a result of this investigation, the air carrier made the required refunds and entered into a consent order under which it was directed to cease and desist from further violations of the credit refund requirements of Regulation Z. The air carrier was assessed a civil penalty of $50,000.

The FTC continued litigation against a mortgage broker and its principals for their alleged violations of Regulation Z and federal statutes, in connection with advertisements for extremely low mortgage rates. In 2004, the court entered a stipulated preliminary injunction against the defendants. In 2006, the defendant’s chief executive filed for bankruptcy, following his 2005 agreement to—among other terms—pay the FTC $400,000 under a stipulated order releasing him from confinement for civil contempt of the 2004 stipulated preliminary injunction. The FTC filed a proof of claim for amounts it is owed in the underlying federal district court action and the contempt action. Litigation is ongoing in this case.

In 2006, the FTC settled charges in a case alleging that a defendant violated Regulation Z and federal statutes. The defendant allegedly engaged in misrepresentation about refunds for tax information products. After accepting product returns from consumers, or otherwise acknowledging that the consumers were owed refunds, the defendant failed to credit the consumers’ credit card accounts in a timely fashion.

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

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2006 reporting period were in compliance with Regulation AA, which is comparable to the level of compliance for the 2005 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 92 percent of institutions examined dur-
The 2006 reporting period were in compliance with Regulation CC, compared with 93 percent for the 2005 reporting period. 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 procedures when invoking the exception for large-dollar deposits
- provide required information when placing an exception hold on an account
- make funds from local and certain other checks available for withdrawal within the times prescribed by regulation

The OTS issued one supervisory agreement 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 during the 2006 reporting period were in compliance with Regulation DD, which is comparable to the level of compliance for the 2005 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- use the phrase “annual percentage yield” in an advertisement disclosing required additional terms and conditions for customer accounts
- provide account disclosures containing all required information
- provide account disclosures clearly and conspicuously, in writing, and in a form that the consumer may keep

The 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 any complaints that it receives that involved other creditors and businesses. Each Reserve Bank investigates complaints against state member banks in its District. In 2006, the Federal Reserve received 641 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 641 complaints about regulated practices, 70 percent involved consumer loans: 2 percent alleged discrimination on a basis prohibited by law (race, color, religion, national origin, sex, marital status, handicap, 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 the remainder concerned other credit-related practices, such as fair credit reporting; billing-error resolution; and credit card rates, terms, and fees. Twenty-eight percent of the complaints involved disputes about insufficient-funds charges and procedures, amounts withdrawn from a consumer’s account, funds availability, and other deposit account practices, including electronic
Consumer Complaints against State Member Banks, by Classification, 2006

<table>
<thead>
<tr>
<th>Classification</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulation B (Equal Credit Opportunity)</td>
<td>53</td>
</tr>
<tr>
<td>Regulation C (Home Mortgage Disclosure)</td>
<td>0</td>
</tr>
<tr>
<td>Regulation E (Electronic Fund Transfers)</td>
<td>73</td>
</tr>
<tr>
<td>Regulation H (Bank Sales of Insurance)</td>
<td>1</td>
</tr>
<tr>
<td>Regulation H (Flood Insurance)</td>
<td>3</td>
</tr>
<tr>
<td>Regulation M (Consumer Leasing)</td>
<td>1</td>
</tr>
<tr>
<td>Regulation P (Privacy of Consumer Financial Information)</td>
<td>17</td>
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<tr>
<td>Regulation Q (Payment of Interest)</td>
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<tr>
<td>Regulation Z (Truth in Lending)</td>
<td>243</td>
</tr>
<tr>
<td>Regulation BB (Community Reinvestment)</td>
<td>1</td>
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<tr>
<td>Regulation CC (Expeditied Funds Availability)</td>
<td>39</td>
</tr>
<tr>
<td>Regulation DD (Truth in Savings)</td>
<td>60</td>
</tr>
<tr>
<td>Fair Credit Reporting Act</td>
<td>117</td>
</tr>
<tr>
<td>Fair Debt Collection Practices Act</td>
<td>20</td>
</tr>
<tr>
<td>Fair Housing Act</td>
<td>3</td>
</tr>
<tr>
<td>Regulations T, U, and X</td>
<td>0</td>
</tr>
<tr>
<td>Real Estate Settlement Procedures Act</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>641</td>
</tr>
</tbody>
</table>

In 97.5 percent of the 641 complaints against state member banks regarding regulated practices that were investigated in 2006, the banks had correctly handled the customer’s account. The remaining 2.5 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 2006, the Federal Reserve received more than 1,300 complaints against state member banks that involved unregulated practices. The most common complaints involved checking accounts and credit cards. Consumers most frequently complained about problems with either opening or closing an account (113 complaints), issues involving fraud (104), insufficient-funds charges and procedures (77), and concerns over specific interest rates, terms, and fees on credit cards (70). The remainder of the com-

Complaints against State Member Banks That Involve Regulated Practices, 2006

<table>
<thead>
<tr>
<th>Subject of complaint</th>
<th>All complaints</th>
<th>Complaints involving violations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Percent</td>
</tr>
<tr>
<td>Total</td>
<td>641</td>
<td>100</td>
</tr>
<tr>
<td>Loans</td>
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<tr>
<td>Discrimination alleged</td>
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<td></td>
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<tr>
<td>Real estate loans</td>
<td>3</td>
<td>0.47</td>
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<tr>
<td>Credit cards</td>
<td>4</td>
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<tr>
<td>Other loans</td>
<td>3</td>
<td>0.47</td>
</tr>
<tr>
<td>Other types of complaints</td>
<td>57</td>
<td>8.89</td>
</tr>
<tr>
<td>Real estate loans</td>
<td>342</td>
<td>53.35</td>
</tr>
<tr>
<td>Credit cards</td>
<td>41</td>
<td>6.40</td>
</tr>
<tr>
<td>Deposits</td>
<td>108</td>
<td>16.85</td>
</tr>
<tr>
<td>Electronic fund transfers</td>
<td>73</td>
<td>11.39</td>
</tr>
<tr>
<td>Trust services</td>
<td>1</td>
<td>0.16</td>
</tr>
<tr>
<td>Other</td>
<td>9</td>
<td>1.40</td>
</tr>
</tbody>
</table>
plaints concerned a wide range of unregulated practices involving credit cards, including errors or delays in processing consumers’ payments, the amounts banks charged for late payments, and overlimit fees and procedures.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies that requires that a complaint alleging a violation of the Fair Housing Act be forwarded to HUD, in 2006 the Federal Reserve referred three complaints to HUD that alleged state member bank violations of the Fair Housing Act. In two of the three cases, the Federal Reserve’s investigations revealed no evidence of illegal discrimination. The remaining case was pending at year-end.

Advice from the Consumer Advisory Council

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

During their March meeting, council members discussed proposed changes to Regulation E, which implements the Electronic Fund Transfer Act (EFTA). The proposed changes addressed payroll card accounts, specifically the disclosure and notification requirements of financial institutions that provide payroll card account services to consumers. Under the interim final rule, financial institutions are granted relief from the requirement to provide consumers with paper periodic statements—if they provide the information in periodic statements to consumers through alternative means (such as electronically or by telephone). Both industry and consumer representatives generally supported the proposed changes and agreed that their scope and approach effectively addressed consumer protection issues. Several industry representatives noted that substituting alternative methods for the delivery of account information appropriately balances consumers’ rights and their need to access their accounts, on the one hand, with financial institutions’ potential compliance costs, on the other. Some consumer representatives, however, suggested that the periodic statements are an important educational tool for consumers and, therefore, consumers would benefit from receiving paper periodic statements.

Council members also discussed proposed changes to Regulation Z, which implements the Truth in Lending Act (TILA), at their March meeting. Members shared their views on whether the Board should establish a standard cutoff time for the crediting of payments on open-end credit accounts. The council did not reach a consensus on a specific cutoff time; however, members noted that such a cutoff would have important consequences, including high fees and increased interest rates, for consumers who make late payments. Several members suggested that the need to provide consumers with more transparency about the costs and fees imposed as a result of late payments may be greater than the need to establish cutoff times for the crediting of payments. Council
members also discussed a TILA amend-
ment that requires creditors that offer
open-end credit accounts to provide con-
sumers with disclosures, on each peri-
odic statement, about the effects of mak-
ing only minimum payments on their
accounts. Members expressed a wide
range of views on whether such disclo-
sures would be meaningful and useful to
consumers; members also shared con-
cerns about ensuring the accuracy of the
disclosures.

During its March and June meetings,
the council discussed issues related to
the Board’s public hearings on the home
equity lending market, as well as the
adequacy of existing consumer disclo-
sures and protections. Members dis-
cussed the Board’s 2002 revisions to the
Home Ownership and Equity Protection
Act (HOEPA) rules and their effect on
consumer protections and the availabil-
ity of credit in the high-cost and
subprime-lending markets. The council
also discussed several issues related to
how consumers shop for credit and how
that process may affect the loan terms
they ultimately receive. Members dis-
cussed the increased role that mortgage
brokers play in the loan-making process—
and whether this role high-
lights a need for additional regulation of
brokers, specifically regulation on the
broker practice of directing potential
borrowers to certain mortgage products.
Members addressed the need to
strengthen consumer disclosures to en-
sure that borrowers understand key
credit terms and costs, particularly for
mortgage products that feature interest-
only periods, prepayment penalties, and
adjustable or “teaser rates.” Several
members also expressed a need for addi-
tional research on consumer behavior in
the home mortgage market.

In June, the council discussed several
issues related to financial literacy, in-
cluding goals for financial education
programs, methods for educating con-
sumers, and how to measure and evalu-
ate the effectiveness of financial educa-
tion programs. Members identified
financial education as a fundamental
tool for helping consumers build and
preserve assets. Because financial lit-
eracy not only enhances the well-being
of individuals or households but also
strengthens neighborhoods and commu-
nities, council members support (1)
making financial literacy a national pub-
lic policy priority and (2) creating na-
tional education initiatives and more-
formalized methods to train and educate
consumers.

At the October meeting, members
also discussed proposed regulations and
guidelines to implement provisions of
the Fair and Accurate Credit Transac-
tions Act (FACT Act) that require finan-
cial institutions to identify “red flags”
for detecting possible cases of identity
theft. Most industry representatives ex-
pressed the need for more-flexible
guidelines that would allow financial
institutions to use a risk-based approach
to address identity-theft risks, which
change rapidly. Consumer representa-
tives were concerned that the proposed
guidelines give covered institutions and
creditors too much discretion over their
identity-theft prevention and detection
policies. Council members also shared
their views on the implementation of the
proposed regulations, including the staff
training requirement and requirements
for covered institutions to develop and
implement a written identity-theft pre-
vention program.

At their October meeting, members
discussed the importance of creating
greater incentives to encourage invest-
ment in affordable housing. Homeown-
ership is a fundamental part of a con-
sumer’s asset-building strategy; the
availability of affordable housing in a
neighborhood can create economic op-
opportunities that, in turn, support future investments in entrepreneurship and education. Members noted that financial institutions play a critical role by providing mortgage credit to consumers and by financing the development of affordable housing. They highlighted the need for federal bank regulators to play a larger role by providing institutions with greater incentives for (1) meeting affordable housing needs and (2) expanding their outreach to local community organizations, as part of their community reinvestment strategies.

During each of their meetings this past year, council members discussed interagency guidance on managing the potential heightened risk of new and emerging residential mortgage products, often referred to as “nontraditional,” “alternative,” or “exotic” mortgage loans. Members generally supported the guidance, noting its importance in light of the recent proliferation and use of nontraditional mortgage products, especially by consumers whose household incomes are not keeping up with home-price appreciation. Members generally agreed that these products do not present problems for some borrowers. But the loans are risky for consumers whose cash flows or income projections may limit their ability to repay, who may not have the capacity or discipline to manage the loan, or who are not fully informed about the terms and conditions such loans carry.

Several members expressed concern that the guidance has given certain mortgage originators a competitive advantage, since the key principles of the guidance apply only to banking and thrift organizations and federal credit unions. Others reiterated this concern by emphasizing that the agencies are only providing guidance rather than creating requirements that could be enforced by consumers or law enforcement agencies. Members also commented on the proposed illustrations of consumer information, which were part of the guidance. The illustrations are designed to help borrowers better understand the features of nontraditional mortgages. The council was generally supportive of the illustrations. Members stated that the illustrations highlight important information, such as the costs, terms, features, and risks of a loan, for borrowers. However, members expressed a need to include additional loan information, such as information on the risk of payment shock to the consumer, the costs of reduced-documentation loans, prepayment penalties, and the potential for negative amortization of the loan.

Consumer Education and Research

The Consumer Education and Research section produces the Board’s consumer education materials and supports the Board’s consumer outreach initiatives. Section staff also conduct research in support of the division’s policy development and community development functions. For example, research staff analyze the annual HMDA data, which are then used in the monitoring and enforcement of the fair lending laws.

The Federal Reserve maintains a consumer information web site (www.federalreserve.gov/consumer.htm) that contains publications and educational materials related to the Board’s consumer regulations. In 2006, staff produced or updated the following publications on nontraditional mortgages:

- “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?” (a new publication, issued jointly with the FFIEC agencies, that includes a glossary of lending terms, a mortgage-shopping work-
sheet, and a list of additional information sources)

- “Consumer Handbook on Adjustable-Rate Mortgages” (substantially revised and updated in conjunction with the OTS to incorporate descriptions and illustrations of how changes in interest rates affect a consumer’s loan payments, including an example of how an increase in interest rates may actually increase the total loan amount)

In addition, the Board’s brochure “How to File a Consumer Complaint about a Bank,” was updated. (The brochure is available in both English and Spanish.) Print and web-based versions of these publications are available on the web site.

Throughout the year, Board staff participated in a number of financial education events, including events for community members, federal employees, and congressional staff. The Board continued to work with the interagency Financial Literacy and Education Commission (FLEC); last year, staff helped update and expand the FLEC’s MyMoney.gov web site to incorporate links to Reserve Bank consumer education resources. In their speeches and other appearances, Board members underscored the importance of financial education to an individual’s economic well-being. Former Governor Mark Olson spoke at the press conference for the announcement of FLEC’s National Strategy for Financial Education in April. Chairman Ben Bernanke testified on the Federal Reserve’s role in financial education before the U.S. Senate Committee on Banking, Housing, and Urban Affairs in May.14

In cooperation with the Department of Defense, the U.S. Army, and Army Emergency Relief (a private nonprofit organization), staff are studying whether a two-day financial education program had an impact on how the participating soldiers manage their finances. At this stage, baseline data have been collected, and staff will be working to gather follow-up data.

Research on Financial Information and Disclosures

A financial institution is required to provide consumers with disclosures about its products and services, including disclosures about its privacy policy or the terms of a loan. The Federal Reserve is one of seven agencies working to develop more “consumer-friendly” disclosures, that is, disclosures written in clear, understandable language that provide information a consumer can use to compare financial services providers. In the spring, the agencies released a report that summarized their research on developing a comprehensible financial privacy notice for consumers.15 The Financial Services Regulatory Relief Act of 2006, which was signed in October, subsequently required the federal financial regulatory agencies to develop a model privacy notice. The design, format, and language of the model notice must be easily understood and allow consumers to compare the privacy policies of different financial institutions.

As part of its overall effort to improve consumer disclosures, the Board studied how consumers use different types of information sources—both the quantity and quality of the sources—and whether this information affected their credit and investment decisions. This study, in addition to the research on privacy notices, will be used in the upcoming

review of the Board’s open-end credit regulations. The Board has contracted with a market research firm to conduct formative and usability testing on credit card disclosures, including the disclosures used in solicitation letters, applications, periodic statements, and change-in-terms notices. Consumer testing will continue in early 2007; the Board will consider data collected in these sessions as it develops new proposed rules under Regulation Z.

Promotion of Community Economic Development and Access to Financial Services in Historically Underserved Markets

In 2006, 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 improving the sustainability and financial capacity of community development organizations, creating asset-building opportunities for low-income individuals, and promoting initiatives to help homeowners preserve this important asset and avoid foreclosure. Activities included publishing newsletters and articles, sponsoring conferences and seminars, conducting research, and supporting the dissemination of information to both general and targeted audiences.

As a decentralized function, the Community Affairs Offices (CAOs) at each of the twelve Reserve Banks design activities in response to the needs of communities in the Districts they serve in conjunction with staff from the Board. The 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. Similarly, the Board’s CAO promotes and coordinates Systemwide efforts, in addition to engaging in activities and exploring issues that have public policy implications. In 2006, the Board and the Reserve Banks collaborated on a number of activities that focused on asset-building for individuals and strengthening community development organizations, while continuing their efforts to expand public understanding of the need to enhance access to affordable credit in underserved markets.

Collaborative Efforts

The Reserve Banks and the Board continued their work on two substantial collaborative efforts over the past year. The System resumed its asset-building and wealth-creation partnership with the CFED, a nonprofit organization dedicated to expanding access to economic opportunity by bringing together community development practitioners, public policy analysts, and private-sector representatives. In 2006, the Federal Reserve System and the CFED held the last three in a series of five forums convening leaders in economic policy, community development, philanthropy, and the financial industry. Starting with the initial forum in June 2005, the forums were convened to encourage more individuals to engage in asset-building activities, such as homeownership, entrepreneurship, savings, and investment. One session, held in Kansas City, focused on the unique challenges to developing asset-building programs in rural communities; the forum was cosponsored by the Reserve Banks of Kansas City, Dallas, Minneapolis, and St. Louis. A second meeting, hosted by the Reserve Bank of Atlanta, explored asset-
building for low- and moderate-income savers, but from the perspective of financial institutions. The discussions focused on developing products to help this population begin or expand its saving efforts. The final forum, hosted by the Board of Governors, gathered a roundtable of leaders in the asset-building field. The leaders reflected on the results of the regional forums and identified next steps to help the industry progress.16

A related initiative, led by the San Francisco Reserve Bank, was a call for papers on asset-building issues and strategies. Twenty-eight of the more than 100 papers received were presented at a research forum during CFED’s 2006 Assets Learning Conference, “A Lifetime of Assets: Building Families, Communities and Economies.” More than 1,000 participants attended; staff from each Reserve Bank and the Board were actively involved in planning the conference, including developing the agenda, presenting research, and serving as moderators and participants in formal discussion groups. The Board’s Community Affairs officer delivered a keynote address during the conference. Board staff presented research on the asset portfolios of low-income households and how these assets have changed over the past fifteen years (from 1989 to 2004). Staff also explored homeownership and foreclosure patterns that affect the asset-building capabilities of low-income households.17

Beyond the CFED partnership, Reserve Banks have been active in the promotion and development of regional asset-building coalitions. Staff from the Richmond Reserve Bank chaired the planning committee for the South Carolina Asset Development Collaborative, and staff from the San Francisco Reserve Bank facilitated both the Oregon Asset Building Convergence and the Washington State Asset Building Summit. Other Reserve Banks continued to provide advisory services for more than a dozen other state and regional asset-building coalitions throughout the country, such as the Houston Asset Building Coalition, Minnesota Saves, and the Nashville Wealth Building Alliance.

Another Systemwide collaboration was a partnership with the Aspen Institute, a national research and leadership development organization. The goal of this collaboration was to identify sustainable and scalable business models that community development organizations can use to more effectively advance their goals. In 2006, the Federal Reserve System and the Aspen Institute cosponsored four conferences around the country that explored a variety of business models that have led to successful community development finance programs. A forum at the San Francisco Reserve Bank highlighted funding efforts for community development financial institutions (CDFIs), individual development account programs, charter schools, and child care facilities. A forum at the Chicago Reserve Bank focused on collaborative efforts to promote the earned-income tax credit by helping low- to moderate-income families prepare their taxes. Participants at a forum at the New York Reserve Bank examined several collaborative efforts undertaken by development organizations, including efforts to share infrastructure resources (facilities, equipment, etc.), collaborate on fundraising, and pool other resources and strategies to increase their organizational capacity.

16. Summaries of the forum sessions are available on the CFED web site (www.cfed.org/focus.m).
17. The research papers presented at this conference are available at www.frbsf.org/community/research/assets.html.
Finally, a forum at the Dallas Reserve Bank focused on the formation of potential new sources of capital for CDFIs and community development corporations. These forums generated ongoing Systemwide research on various aspects of public and private subsidies for community development. Staff from several of the Reserve Banks and the Board are currently involved in a research project to measure the magnitude of the need for public and private groups to subsidize community development, measure how effectively these subsidies are utilized, and identify emerging strategies for optimizing the leverage of subsidy dollars.

Access to Financial Services
Staff from around the System have continued working on several initiatives to enhance access to affordable credit in currently underserved markets. In 2006, the San Francisco Reserve Bank and the Board partnered to study issues related to the creation of a secondary market for community development loans. The San Francisco Reserve Bank devoted an issue of its Community Development Investment Review to an overview of the community development finance industry, which included advice on best practices from industry practitioners. The Board and the San Francisco Reserve Bank followed up by hosting a conference in Washington, D.C., for lenders, investors, and financial intermediaries, in addition to policymakers and academics. The conference sought to (1) assess the status of the industry and (2) discuss ways to innovate and collaborate to increase liquidity for community development lending. The next edition of the Review included the conference proceedings and essays by conference participants laying out a possible road map for the creation of a secondary market for community development loans, and included remarks by Governor Kroszner, who keynoted the conference.

The Minneapolis Reserve Bank has taken the lead in another initiative to expand access to financial services through its work with Native American communities. On many reservations, access to affordable credit is often limited by ambiguities and inconsistencies in the various tribal laws that govern secured transactions. In response, Minneapolis Reserve Bank staff have worked to help investors and lenders better understand the property rights of Native Americans. For the past few years, the Reserve Bank staff have worked to create an improved legal structure that tribes can use to facilitate their efforts to borrow from off-reservation partners or other tribes. In 2005, staff were part of a team that completed a draft Model Tribal Secured Transactions Act (MTA) for the National Conference of Commissioners on Uniform State Laws (NCCUSL). Throughout 2006, staff supported education and dissemination efforts for the MTA by providing technical assistance and making numerous presentations, including one to tribal judges, on the benefits of tribal adoption of the MTA. During the year, the Crow tribe adopted the MTA, three additional tribes in Montana passed resolutions to adopt it, and approximately fifteen tribes were in various stages of considering adoption of the MTA.

Resources, Advisory Services, and Outreach
In 2006, the Board released an update of the Federal Reserve Fiscal Impact Tool (FIT). First released in 2003, the FIT software helps users analyze the fiscal impacts of economic development in small- and mid-sized communities. FIT supports economic development plan-
ning by producing a cost-benefit analysis of proposed development projects; FIT estimates a project’s impact on local sales and property tax revenues and on costs to local government. To supplement this analysis, FIT integrates a wide array of data, at the city, county, and state levels, on incorporated locations in the United States. The 2006 update contains more and newer data, along with a module that allows for time discounting and the calculation of a net present value. The Board distributed more than 1,000 copies of the updated software in 2006. Users include state and local economic development organizations, academics, and consultants. A recent survey of users identified two communities—El Paso, Texas, and Lincoln, Nebraska—that have employed FIT to assist in setting limits on incentives for development projects.

During the past year, the foreclosure rate has risen for certain housing markets. Low- and moderate-income families and communities may be especially at risk for foreclosure. Consequently, the Board and the Reserve Banks have enhanced their efforts to preserve homeownership among these populations. The Board continued its involvement with NeighborWorksAmerica (NeighborWorks), a national network of more than 240 community-based organizations providing financial support, technical assistance, and training for community rehabilitation efforts. A member of the Board of Governors serves on the NeighborWorks board of directors, and members of the Board’s staff serve on the organization’s Center for Homeownership Education and Counseling. Staff from the Reserve Banks have led regional collaborative efforts with NeighborWorks through their participation in foreclosure-prevention training workshops for homeownership counselors. The Banks have also provided support to and endorsement of state-level activities, for example, the Minneapolis Reserve Bank’s participation in Minnesota’s Emerging Market Homeownership Initiative and the Cleveland Reserve Bank’s promotion (through the Pittsburgh Branch) of the foreclosure-mitigation efforts of the Pennsylvania secretary of banking.

Over the past year, the Board continued its outreach activities to provide the public with information about the Board’s responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consumers, to promote community development and consumer education, and to foster discussion of policy issues. Board staff periodically met with financial institutions, community groups, and other members of the public in formal and informal settings. For example, the Board expanded its prior work with Operation HOPE, a national nonprofit organization dedicated to developing and implementing programs focused on connecting minority communities with mainstream, private-sector resources and to empowering underserved communities. The System has collaborated with Operation HOPE in prior years, and the director of the Board’s Division of Consumer and Community Affairs serves on the Operation HOPE Mid-Atlantic Advisory Board. In 2006, Chairman Bernanke delivered a keynote address at the “Anacostia Economic Summit,” a conference sponsored by Operation HOPE and the District of Columbia. (Anacostia is an underdeveloped neighborhood in southeast Washington, D.C.) The summit focused on ways to encourage revitalization in this area and highlighted the importance of obtaining both targeted public and private investment to jump-start the development efforts in this and other underserved neighborhoods. In preparation for the
conference, Chairman Bernanke toured the Anacostia community with lenders, community development leaders, and local property developers to gain first-hand insight into the community's redevelopment.

...
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 provide payment services to depository and certain other institutions, distribute the nation’s currency and coin, and serve as fiscal agents and depositories for the United States.

Developments in Federal Reserve Priced Services

The Federal Reserve Banks provide a range of payment and related services to depository institutions, including collecting checks, operating an automated clearinghouse service, transferring funds and securities, and providing a multilateral settlement service. 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). Over the past ten years, the Reserve Banks have recovered 99.0 percent of their priced services costs, including the PSAF (table). In 2006, the Board implemented changes to the method for calculating the target return on equity measure in the PSAF. Overall, the price index for priced services increased 2.4 percent from 2005 to 2006. Revenue from priced services amounted to $908.4 million, other income was $122.8 million, and costs were $875.5 million, resulting in net income from priced services of $155.7 million. In 2006, the Reserve Banks recovered 108.8 percent of total costs of $947.5 million, including the PSAF.

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

2. Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standards Board’s Statement of Financial Accounting Standards No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans (FAS 158), which resulted in the recognition of a $343.9 million reduction in equity related to the priced services’ benefit plans. Including this reduction in equity, which represents a decline in economic value, results in cost recovery of 95.5 percent for the ten-year period. For details on how implementing FAS 158 affected the pro forma financial statements, refer to notes 2, 3, and 5 at the end of this chapter.

3. In 2005, the Board approved changing the method from using the average of the results of three analytical methods—the comparable accounting earnings model, the discounted cashflow model, and the capital asset pricing model (CAPM)—to using only the CAPM.

4. Financial data reported throughout this chapter—revenue, other income, cost, net revenue, and income before taxes—can be linked to the pro forma financial statements at the end of this chapter. Other income is revenue from invest-
Priced Services Cost Recovery, 1997–2006

Millions of dollars except as noted

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue from services 1</th>
<th>Operating expenses and imputed costs 2</th>
<th>Targeted return on equity</th>
<th>Total costs</th>
<th>Cost recovery (percent) 3, 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>818.8</td>
<td>752.8</td>
<td>54.3</td>
<td>807.1</td>
<td>101.5</td>
</tr>
<tr>
<td>1998</td>
<td>839.8</td>
<td>743.2</td>
<td>66.8</td>
<td>809.9</td>
<td>103.7</td>
</tr>
<tr>
<td>1999</td>
<td>867.6</td>
<td>775.7</td>
<td>57.2</td>
<td>832.9</td>
<td>104.2</td>
</tr>
<tr>
<td>2000</td>
<td>922.8</td>
<td>818.2</td>
<td>98.4</td>
<td>916.6</td>
<td>100.7</td>
</tr>
<tr>
<td>2001</td>
<td>960.4</td>
<td>901.9</td>
<td>109.2</td>
<td>1,011.1</td>
<td>95.0</td>
</tr>
<tr>
<td>2002</td>
<td>918.3</td>
<td>891.7</td>
<td>92.5</td>
<td>984.3</td>
<td>93.3</td>
</tr>
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<td>2003</td>
<td>881.7</td>
<td>931.3</td>
<td>104.7</td>
<td>1,036.1</td>
<td>85.1</td>
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<tr>
<td>2004</td>
<td>914.6</td>
<td>842.6</td>
<td>112.4</td>
<td>955.0</td>
<td>95.8</td>
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<tr>
<td>2005</td>
<td>994.7</td>
<td>834.7</td>
<td>103.0</td>
<td>937.7</td>
<td>106.1</td>
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<tr>
<td>2006</td>
<td>1,031.2</td>
<td>875.5</td>
<td>72.0</td>
<td>947.5</td>
<td>108.8</td>
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<tr>
<td>1997–2006</td>
<td>9,149.9</td>
<td>8,367.5</td>
<td>870.5</td>
<td>9,238.1</td>
<td>99.0</td>
</tr>
</tbody>
</table>

Note: Here and elsewhere in this chapter, totals and percentages may not reflect components shown because of rounding.

1. For the ten-year period, includes revenue from services of $8,727.4 million and other income and expense (net) of $422.5 million.
2. For the ten-year period, includes operating expenses of $7,722.6 million, imputed costs of $296.4 million, and imputed income taxes of $348.5 million.
3. Revenue from services divided by total costs.
4. For the ten-year period, cost recovery is 95.3 percent, including the reduction in equity related to FAS 158 reported by the priced services in 2006.

Commercial Check Collection Service

In 2006, operating expenses and imputed costs for the Reserve Banks’ commercial check collection service totaled $716.9 million, of which $35.4 million was attributable to the transportation of commercial checks between Reserve Bank check-processing centers. Revenue amounted to $745.0 million, of which $34.2 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was $100.7 million. The resulting net income was $128.7 million. Check service revenue in 2006 increased $4.7 million from 2005, largely because of price increases and faster-than-anticipated adoption of check-processing services associated with the Check Clearing for the 21st Century Act (Check 21).5

The Reserve Banks handled 11.0 billion checks in 2006, a decrease of 9.9 percent from 2005 (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.6 Of all the checks presented by the Reserve Banks to paying banks in 2006, 14.0 percent of the checks were deposited and 4.3 percent were presented using Check 21 products, compared with 1.8 percent and 0.0 percent, respec-

5. The Reserve Banks’ Check 21 product suite includes electronic alternatives to paper-check collection, return, and presentment.
Overall, the price index for commercial checks collected, including processed and fine-sort items; in commercial ACH, the total number of commercial checks processed; in funds transfer and securities transfer, the number of transactions originated online and offline; and in multilateral settlement, the number of settlement entries processed.

Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled $80.1 million in 2006. Revenue from ACH operations totaled $80.5 million and other income totaled $10.9 million, resulting in net income of $11.3 million. The Banks processed 8.2 billion commercial ACH transactions (worth $13.1 trillion), an increase of 12.2 percent from 2005. Overall, the price index for ACH services decreased 9.1 percent from 2005.

In 2006, the Reserve Banks began offering ACH risk-management services to all depository institutions. These services help originating institutions manage the operational and credit risk associated with originating ACH payments. By the end of 2006, 76 financial institutions subscribed to these services.

Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled $59.3 million in 2006. Revenue from these operations totaled $63.6 million and other income amounted to $8.6 million, resulting in net income of $13.0 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 2006, the number of Fedwire funds transfers originated by depository insti-
tutions increased 0.9 percent from 2005, to approximately 136.4 million. The average daily value of Fedwire funds transfers in 2006 was $2.3 trillion. Overall, the price index for the Fedwire Funds and National Settlement Services increased 3.4 percent from 2005.

Last year, the Reserve Banks collaborated with The Clearing House Payments Company to study the use of funds transfers for business-to-business payments. The study examined why businesses select one payment type over another and what changes are needed to make funds transfers a more attractive payment alternative. Key findings from the study suggested that businesses wanted a more streamlined process for making funds transfers and favored the inclusion of remittance information in funds transfer orders.

National Settlement Service

The National Settlement Service is a multilateral settlement system that allows participants in private-sector clearing arrangements to exchange and settle transactions on a net basis using reserve or clearing balances. In 2006, the service processed settlement files for approximately fifty-four local and national private arrangements, primarily check clearinghouse associations. The Reserve Banks processed slightly more than 17,300 files that contained more than 470,000 settlement entries for these arrangements in 2006.

Fedwire Securities Service

The Fedwire Securities Service allows participants in the service to transfer electronically securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations to other participants in the service. Reserve Bank operating expenses and imputed costs for providing this service totaled $19.1 million in 2006. Revenue from the service totaled $19.2 million, and other income totaled $2.6 million, resulting in net income of $2.7 million. Overall, the price index for the service increased 2.8 percent from 2005.

In 2006, approximately 9.1 million non-Treasury securities transfers were processed by the service, slightly lower than in 2005. Last year, the Reserve Banks also implemented technical changes to the Fedwire Securities Service applications to support changes to the Federal Reserve Policy on Payments System Risk (PSR). The PSR policy changes require that government-sponsored enterprises and certain international organizations fund principal and interest payments before the Reserve Banks distribute those payments in order to limit the credit exposure of the Reserve Banks.

Float

The Federal Reserve had daily average credit float of $85.9 million in 2006, compared with debit float of $133.4 million in 2005.

8. The expenses, revenues, volumes, and fees reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and certain international organizations. The Reserve Banks provide Treasury securities services in their role as the U.S. Treasury’s fiscal agent. These services are not considered priced services. For details, see the section “Debt Services” later in this chapter.

9. Credit float occurs when the Reserve Banks present items for collection to the paying bank prior to providing credit to the depositing bank, and debit float occurs when the Reserve Banks credit the depositing bank prior to presenting items for collection to the paying bank.
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 also receive currency and coin from circulation through these institutions. As currency flows into the Reserve Banks, the Banks inspect the notes and destroy those that are unfit for recirculation.

The Reserve Banks received 38.5 billion Federal Reserve notes from circulation in 2006, a 3.5 percent increase from 2005, and made payments of 39.1 billion notes into circulation in 2006, a 1.5 percent increase from 2005. They received 59.7 billion coins from circulation in 2006, a 6.5 percent increase from 2005, and made payments of 73.9 billion coins into circulation, a 2.7 percent increase from 2005.

In March, the Board approved a policy that provides 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 implemented a custodial inventory program that allows depository institutions to transfer a portion of the currency holdings in their vaults to the books of a Reserve Bank. As of December 31, the Reserve Banks had established twenty-nine custodial inventory sites with depository institutions. Beginning in July 2007, the Reserve Banks will charge fees to institutions that, within a one-week period, deposit fit $10 or $20 notes and reorder currency of the same denomination, above a de minimis amount, within the same Reserve Bank office’s service area.

In March, the Reserve Banks began issuing the redesigned $10 Federal Reserve note that includes enhanced security features and subtle background colors.

The Presidential $1 Coin Act requires, among other things, that the Federal Reserve and the Mint take steps to ensure that an adequate supply of $1 coins is available for commerce. To that end, the Federal Reserve worked with the United States Mint to develop an effective distribution strategy for Presidential $1 coins, the first of which was issued by the Mint in February 2007.

In March, the Reserve Banks began issuing the redesigned $10 Federal Reserve note that includes enhanced security features and subtle background colors.

The Reserve Banks conducted extensive testing of a prototype upgrade to the high-speed currency-processing machines. The Reserve Banks will begin implementing the upgrades on their machines in 2007; the upgrades are scheduled to be completed in 2009.

The Federal Reserve developed the requirements for an automation system to replace the current platform used to support and facilitate the System’s provision of cash services. The Reserve Banks issued a preview request for proposal for development of the new automation system and held an orientation with potential vendors in December.

The Reserve Banks completed a comprehensive study of cost-effective alternatives to the existing infrastructure for providing cash services. The study resulted in the elimination of cash processing at the Oklahoma City and Birmingham offices in March and May, respectively, and the replacement of these offices with outsourced cash depots. In these cash depot arrangements, armored carrier facilities serve as collection and distribution points for deposi-
tory institutions’ currency deposits and orders. The deposits and orders are transported to and from the nearest Reserve Bank by armored carrier for processing.

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 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 2006 amounted to $426.1 million, compared with $396.2 million in 2005 (table). Treasury-related costs were $397.8 million in 2006, compared with $371.0 million in 2005, an increase of 7.2 percent. The cost of providing services to other

### Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2004–2006

Thousands of dollars

<table>
<thead>
<tr>
<th>Agency and service</th>
<th>2006</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Department of the Treasury</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bureau of the Public Debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treasury retail securities</td>
<td>73,931.4</td>
<td>86,503.2</td>
<td>103,257.7</td>
</tr>
<tr>
<td>Treasury securities safekeeping and transfer</td>
<td>7,535.2</td>
<td>6,055.8</td>
<td>6,267.0</td>
</tr>
<tr>
<td>Treasury auction</td>
<td>23,594.9</td>
<td>17,553.5</td>
<td>17,159.5</td>
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<tr>
<td>Computer infrastructure development and support</td>
<td>3,853.1</td>
<td>2,575.5</td>
<td>5,935.1</td>
</tr>
<tr>
<td>Other services</td>
<td>1,578.7</td>
<td>1,806.5</td>
<td>1,709.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>110,493.2</td>
<td>114,494.5</td>
<td>134,329.1</td>
</tr>
<tr>
<td><strong>Financial Management Service</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government check processing</td>
<td>20,918.6</td>
<td>20,988.0</td>
<td>24,245.4</td>
</tr>
<tr>
<td>Automated clearinghouse</td>
<td>5,823.1</td>
<td>5,709.5</td>
<td>5,352.9</td>
</tr>
<tr>
<td>Fedwire funds transfers</td>
<td>123.1</td>
<td>109.4</td>
<td>111.6</td>
</tr>
<tr>
<td>Other payment programs</td>
<td>69,696.8</td>
<td>49,366.0</td>
<td>33,646.9</td>
</tr>
<tr>
<td>Collection services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax and other revenue collections</td>
<td>37,095.5</td>
<td>39,736.0</td>
<td>34,248.4</td>
</tr>
<tr>
<td>Other collection programs</td>
<td>14,122.6</td>
<td>14,354.2</td>
<td>12,922.8</td>
</tr>
<tr>
<td>Cash-management services</td>
<td>48,320.2</td>
<td>40,496.7</td>
<td>21,835.8</td>
</tr>
<tr>
<td>Computer infrastructure development and support</td>
<td>67,046.4</td>
<td>67,703.3</td>
<td>52,673.3</td>
</tr>
<tr>
<td>Other services</td>
<td>7,414.8</td>
<td>2,332.2</td>
<td>6,931.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>270,561.2</td>
<td>240,795.4</td>
<td>191,968.6</td>
</tr>
<tr>
<td><strong>Other Treasury</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>16,786.3</td>
<td>15,726.7</td>
<td>15,106.1</td>
</tr>
<tr>
<td>Total, Treasury</td>
<td>397,840.7</td>
<td>371,016.6</td>
<td>341,403.7</td>
</tr>
<tr>
<td><strong>Other Federal Agencies</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Department of Agriculture</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food coupons</td>
<td>2,929.8</td>
<td>2,642.4</td>
<td>4,519.0</td>
</tr>
<tr>
<td>United States Postal Service</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Postal money orders</td>
<td>9,334.4</td>
<td>7,647.8</td>
<td>7,774.6</td>
</tr>
<tr>
<td>Other agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total, other agencies</td>
<td>15,977.1</td>
<td>14,870.2</td>
<td>16,104.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>28,241.4</td>
<td>25,160.4</td>
<td>28,397.5</td>
</tr>
<tr>
<td><strong>Total reimbursable expenses</strong></td>
<td>426,082.1</td>
<td>396,177.0</td>
<td>369,801.2</td>
</tr>
</tbody>
</table>
entities was $28.2 million, compared with $25.2 million in 2005. In 2006, as in 2005, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing these services.

Debt Services
The Reserve Banks auction, provide safekeeping for, and transfer Treasury securities. Reserve Bank operating expenses for these activities totaled $31.1 million in 2006, compared with $23.6 million in 2005. The Banks processed 148,000 commercial tenders for Treasury securities, compared with 169,000 in 2005. They originated 12.9 million transfers of Treasury securities in 2006, a 1.8 percent increase from 2005. The Reserve Banks are developing a new Treasury auction application and infrastructure that will provide increased functionality and security. The application will be operational in late 2007.

The Reserve Banks also operate computer applications and provide customer service and back-office support for the Treasury’s retail securities programs. Reserve Bank operating expenses for these activities were $73.9 million in 2006, compared with $86.5 million in 2005. The Reserve Banks operate Legacy Treasury Direct, a program that allows investors to purchase and hold Treasury securities directly with the Treasury through the Reserve Banks instead of through a broker. The program held $72 billion (par value) of Treasury securities as of December 31. 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 13,000 securities worth $678.9 million were sold through Sell Direct in 2006, compared with 14,000 securities worth $874.8 million in 2005. The Banks printed and mailed more than 28.9 million savings bonds in 2006, a 10 percent decrease from 2005. They issued more than 5.3 million Series I (inflation-indexed) bonds and 23.1 million Series EE bonds.

Payments Services
The Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments and for payments-related programs totaled $96.6 million in 2006, compared with $76.2 million in 2005. The Banks processed 991.6 million ACH payments for the Treasury, an increase of 2.8 percent from 2005, and more than 855,000 Fedwire funds transfers. They also processed 192 million paper government checks, a decline of 11 percent from 2005. In addition, the Banks issued more than 170,000 fiscal agency checks, a decrease of 17.4 percent from 2005.

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 $51.2 million in 2006, compared with $54.1 million in 2005. 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 clearing-house (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 $456.3 billion for the Treasury in 2006, compared with $409.2 billion in 2005.

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 2006, the Reserve Banks originated more than 2.6 million ACH transactions through these programs, roughly the same number of transactions as in 2005.

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 and other cash-management initiatives totaled $48.3 million in 2006, compared with $40.5 million in 2005. The investments either are callable on demand or are for a set term. In 2006, the Reserve Banks placed a total of $309.2 billion in immediately callable investments, which includes funds invested through retained tax deposits and direct, special direct, and dynamic investments, and $508 billion in term investments. The rate for term investments is set by auction; the Reserve Banks held 104 such auctions in 2006, roughly the same number of auctions as in 2005. In 2006, the Treasury’s income from the TT&L program was $1.04 billion. In March, Treasury launched the Repurchase Agreement Program, a pilot program that allows Treasury to place a portion of its excess operating funds directly with TT&L depositories through a repurchase transaction for a set period at an agreed-on interest rate. In 2006, the Reserve Banks placed a total of $478.9 billion of investments through repurchase agreements.

Services Provided to Other Entities
The Reserve Banks provide fiscal agency and depository services to other domestic and international entities when required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute. The majority of the work is securities-related.

Electronic Access to Reserve Bank Services
In 2006, the Federal Reserve Banks completed the migration of their FedLine DOS customers to FedLine Advantage. About 6,200 customers were converted to FedLine Advantage, a web-based access delivery channel typically used by small and medium-sized depository institutions to access critical payment services, such as the Fedwire Funds, Fedwire Securities, National Settlement, and FedACH Services. In addition, the Reserve Banks began migrating their high-volume computer-interface customers, which are typically large depository institutions, to FedLine Direct, an internet-protocol-based computer-to-computer access delivery channel for critical payment services. Also in 2006, the Reserve Banks announced a new option, FedLine Command, a lower-cost computer-to-computer access delivery channel for FedACH customers. The Reserve Banks will continue to migrate customers to

**Information Technology**

In early 2006, the Federal Reserve Banks initiated the first phase of the Information Security Architecture Framework (ISAF), a program that will cost $30.5 million by the end of 2008, when this phase of the program will be completed. The ISAF program is intended to respond to the continuing and increasingly sophisticated threats facing information technology systems and to improve information security at all points in the Federal Reserve System’s networks. ISAF is a portfolio of initiatives to improve (1) targeted security services by ensuring that overall risks are reduced and the residual risks of these services are acceptable and (2) the overall efficiency and coherence of the provisioning of these services.

The System established a National Information Security Assurance (NISA) function in 2006 to enhance information security governance. By managing and coordinating information security at the enterprise level, NISA will have an integrated view of information security compliance across the Reserve Banks. NISA will implement a business-oriented model of information security responsibility and accountability and will establish comprehensive information security standards and processes for all the Reserve Banks.

In mid-2006, the Federal Reserve System adopted the Technology Project Standards (TPS), a set of standards for managing information technology projects. The standards are based on the Project Management Book of Knowledge (PMBOK), a recognized industry best practice. All Reserve Banks are expected to train their staff members who are involved in information technology projects and to fully transition to the TPS by January 1, 2008.

Also in 2006, the Federal Reserve Bank of New York migrated its primary dealers (banks and securities brokers-dealers) to the FedTrade application, which provides increased functionality and security. The FedTrade application is used to execute various forms of open market operations using electronic auctions with the primary dealers as bidders.

Throughout 2006, the Reserve Banks continued to focus on initiatives to reduce IT costs over the long term by standardizing processes, increasing productivity, and strengthening the Federal Reserve’s ability to respond to cyber security threats.

**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 performs its own reviews and engages a public accounting firm. The public accounting firm performs an annual audit of the combined financial statements of the Reserve Banks (see the section “Federal Reserve Banks Combined Financial Statements”) and 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. The Reserve Banks have further enhanced their assessments under the COSO framework to strengthen the key control assertion process and in 2006 met 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 confirms 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 2006 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $4.2 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 2006, the Reserve Banks did not engage PwC for nonaudit 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 examinations also include 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 2005 and 2006.

Income in 2006 was $38,410 million, compared with $30,729 million in 2005. Expenses totaled $4,056 million ($2,987 million in operating expenses, $276 million in earnings credits granted to depository institutions, $301 million in assessments for expenditures by the Board of Governors, and $492 million for the cost of new currency). Revenue from priced services was $908 million. Net additions to and deductions from current net income showed a net loss of $159 million. The loss was due primarily to interest expense on securities sold under agreements to repurchase offset, in part, by unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled $871 million, $90 million more than in 2005; 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 $29,052 million in 2006, up from $21,468 million in 2005; 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. The implementation of FAS 158 required a reduction to surplus of $1,849 million and increased the amount necessary to equate surplus to paid-in capital in 2006.
In the “Statistical Tables” section of this report, table 10 details the income and expenses of each Reserve Bank for 2006 and table 11 shows a condensed statement for each Bank for the years 1914 through 2006; table 9 is a statement of condition for each Bank, and table 13 gives the number and annual salaries of officers and employees for each Bank. 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 2006 amounted to $794,395 million, an increase of $32,886 million from 2005 (table). Holdings of U.S. government securities increased $32,879 million, and holdings of loans increased $7 million. The average rate of interest earned on the Reserve Banks’ holdings of government securities increased to 4.59 percent, from 3.80 percent in 2005, and the average rate of interest earned on loans increased to 5.44 percent, from 3.49 percent.

### 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 2003 through 2006.

### Federal Reserve Bank Premises

In 2006, construction continued on the Kansas City Bank’s new headquarters building and construction began on the San Francisco Bank’s new Seattle Branch building after the Board approved the project’s final design. 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. A long-term facility re-
development program at the St. Louis Bank continued. Construction of a new pedestrian-screening vestibule was completed, and construction of an addition to the Board’s headquarters building began.

Security enhancement programs continue at several facilities. One such project is the recently completed external perimeter security improvement project at the Boston Bank. In addition, the Richmond Bank continued construction of additional security improvements to its headquarters 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. Planning continues for a similar screening facility at the Philadelphia Bank.

Also during 2006, the Board approved the Richmond Bank’s purchase of property adjacent to its headquarters building for construction of a new parking garage. The sales of the Chicago Bank’s former Detroit Branch building, the Kansas City Bank’s Oklahoma City Branch building, and the San Francisco Bank’s Portland Branch building were finalized. Efforts to sell the St. Louis Bank’s Little Rock Branch building continued, as did efforts by the Dallas Bank to sell excess land at its Houston Branch.

Activities for the Portland Branch were moved to leased facilities. The Kansas City Bank sold its Oklahoma City Branch building and is leasing space in the building for the Branch’s administrative activity. The Birmingham Branch check and cash operations were relocated to the head office in Atlanta. The Birmingham building will house the remaining Branch activities, and available space will be leased.

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.

### Securities and Loans of the Federal Reserve Banks, 2004–2006

Millions of dollars except as noted

<table>
<thead>
<tr>
<th>Item and year</th>
<th>Total</th>
<th>U.S. government securities</th>
<th>Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Average daily holdings</strong>&lt;sup&gt;3&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>719,647</td>
<td>719,494</td>
<td>153</td>
</tr>
<tr>
<td>2005</td>
<td>761,509</td>
<td>761,295</td>
<td>214</td>
</tr>
<tr>
<td>2006</td>
<td>794,395</td>
<td>794,174</td>
<td>221</td>
</tr>
<tr>
<td><strong>Earnings</strong>&lt;sup&gt;4&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>22,347</td>
<td>22,344</td>
<td>3</td>
</tr>
<tr>
<td>2005</td>
<td>28,966</td>
<td>28,959</td>
<td>7</td>
</tr>
<tr>
<td>2006</td>
<td>36,464</td>
<td>36,452</td>
<td>12</td>
</tr>
<tr>
<td><strong>Average interest rate (percent)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>3.11</td>
<td>3.11</td>
<td>1.74</td>
</tr>
<tr>
<td>2005</td>
<td>3.80</td>
<td>3.80</td>
<td>3.49</td>
</tr>
<tr>
<td>2006</td>
<td>4.59</td>
<td>4.59</td>
<td>5.44</td>
</tr>
</tbody>
</table>

1. Includes federal agency obligations.
2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.
3. Based on holdings at opening of business.
4. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.
## Pro Forma Financial Statements for Federal Reserve Priced Services

### Pro Forma Balance Sheet for Priced Services, December 31, 2006 and 2005

**Millions of dollars**

<table>
<thead>
<tr>
<th>Item</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Short-term assets (Note 1)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imputed reserve requirements on clearing balances</td>
<td>821.7</td>
<td>993.2</td>
</tr>
<tr>
<td>Imputed investments</td>
<td>7,245.7</td>
<td>8,626.4</td>
</tr>
<tr>
<td>Receivables</td>
<td>73.6</td>
<td>77.0</td>
</tr>
<tr>
<td>Materials and supplies</td>
<td>0.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>24.2</td>
<td>25.6</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>3,391.0</td>
<td>5,934.4</td>
</tr>
<tr>
<td><strong>Total short-term assets</strong></td>
<td>11,557.1</td>
<td>15,657.7</td>
</tr>
<tr>
<td><strong>Long-term assets (Note 2)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Premises</td>
<td>424.9</td>
<td>424.5</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>127.9</td>
<td>156.1</td>
</tr>
<tr>
<td>Leases, leasehold improvements, and long-term prepayments</td>
<td>83.3</td>
<td>88.5</td>
</tr>
<tr>
<td>Prepaid pension costs</td>
<td>399.0</td>
<td>796.8</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>146.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Total long-term assets</strong></td>
<td>1,181.0</td>
<td>1,465.9</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>12,738.1</td>
<td>17,123.6</td>
</tr>
</tbody>
</table>

| **Short-term liabilities** | | |
| of uncollected items | 8,015.6 | 10,703.2 |
| Deferred-availability items | 3,592.5 | 5,163.0 |
| Short-term debt | 0.0 | 0.0 |
| Short-term payables | 100.4 | 126.2 |
| **Total short-term liabilities** | 11,708.4 | 15,992.4 |

| **Long-term liabilities** | | |
| Long-term debt | 0.0 | 0.0 |
| Postretirement/postemployment benefits obligation | 392.8 | 275.0 |
| **Total long-term liabilities** | 392.8 | 275.0 |
| **Total liabilities** | 12,101.2 | 16,267.4 |
| Equity (including accumulated other comprehensive loss of $343.9 million at December 31, 2006) | | |
| **Total liabilities and equity (Note 3)** | 12,738.1 | 17,123.6 |

**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, 2006 and 2005

Millions of dollars

<table>
<thead>
<tr>
<th>Item</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from services provided to depository institutions (Note 4)</td>
<td>908.4</td>
<td>901.0</td>
</tr>
<tr>
<td>Operating expenses (Note 5)</td>
<td>803.5</td>
<td>750.0</td>
</tr>
<tr>
<td>Income from operations</td>
<td>104.8</td>
<td>150.9</td>
</tr>
<tr>
<td>Imputed costs (Note 6)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on float (Note 6)</td>
<td>−4.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Interest on debt</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Sales taxes</td>
<td>10.8</td>
<td>11.3</td>
</tr>
<tr>
<td>FDIC insurance</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Income from operations after imputed costs</td>
<td>98.9</td>
<td>133.5</td>
</tr>
<tr>
<td>Other income and expenses, net (Note 7)</td>
<td>383.6</td>
<td>292.7</td>
</tr>
<tr>
<td>Earnings credits</td>
<td>−260.8</td>
<td>−199.0</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>221.8</td>
<td>227.2</td>
</tr>
<tr>
<td>Imputed income taxes (Note 6)</td>
<td>66.1</td>
<td>67.3</td>
</tr>
<tr>
<td>Net income</td>
<td>155.7</td>
<td>160.0</td>
</tr>
<tr>
<td>MEMO: Targeted return on equity (Note 6)</td>
<td>72.0</td>
<td>103.0</td>
</tr>
</tbody>
</table>

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

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

### Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2006

Millions of dollars

<table>
<thead>
<tr>
<th>Item</th>
<th>Total</th>
<th>Commercial check collection</th>
<th>Commercial ACH</th>
<th>Fedwire funds</th>
<th>Fedwire securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue from services (Note 4)</td>
<td>908.4</td>
<td>745.0</td>
<td>80.5</td>
<td>63.6</td>
<td>19.2</td>
</tr>
<tr>
<td>Operating expenses (Note 5)</td>
<td>803.5</td>
<td>658.2</td>
<td>74.7</td>
<td>52.9</td>
<td>17.7</td>
</tr>
<tr>
<td>Income from operations</td>
<td>104.8</td>
<td>86.8</td>
<td>5.8</td>
<td>10.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Imputed costs (Note 6)</td>
<td>5.9</td>
<td>4.1</td>
<td>0.6</td>
<td>0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Income from operations after imputed costs</td>
<td>98.9</td>
<td>82.7</td>
<td>5.2</td>
<td>9.9</td>
<td>1.3</td>
</tr>
<tr>
<td>Other income and expenses, net (Note 7)</td>
<td>122.8</td>
<td>100.7</td>
<td>10.9</td>
<td>8.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>221.8</td>
<td>183.3</td>
<td>16.1</td>
<td>18.5</td>
<td>3.9</td>
</tr>
<tr>
<td>Imputed income taxes (Note 6)</td>
<td>66.1</td>
<td>54.6</td>
<td>4.8</td>
<td>5.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Net income</td>
<td>155.7</td>
<td>128.7</td>
<td>11.3</td>
<td>13.0</td>
<td>2.7</td>
</tr>
<tr>
<td>MEMO: Targeted return on equity (Note 6)</td>
<td>72.0</td>
<td>57.1</td>
<td>7.5</td>
<td>5.6</td>
<td>1.8</td>
</tr>
</tbody>
</table>

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

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

NOTES TO PRO FORMA FINANCIAL STATEMENTS FOR PRICED SERVICES

(1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in a portfolio of investments, shown as imputed investments.

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-service 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 December 31, 2006, the Reserve Banks implemented FAS 158, which requires an employer to record the funded status of its benefit plans on its balance sheet, resulting in a reduction to the prepaid pension asset related to priced services and the recognition of an associated deferred tax asset with an offsetting adjustment, net of tax, to accumulated other comprehensive income (AOCI) (see note 3).

(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.

In order to reflect the funded status of its benefit plans as required by FAS 158, the Reserve Banks recognized the deferred items related to these plans, which include prior service costs and actuarial gains or losses, on the balance sheet. This resulted in an increase to the benefits obligation related to the priced services and an offsetting adjustment, net of tax, to AOCI, which is included in equity.

Equity is imputed at 5 percent of total assets.

(4) REVENUE

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution’s account or charges against its accumulated earnings credits.

(5) OPERATING EXPENSES

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $7.5 million in 2006 and $6.6 million in 2005.

Effective January 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board’s Statement of Financial Accounting Standards No. 87, Employers’ Accounting for Pensions (FAS 87). Accordingly, the Reserve Banks recognized operating expenses for the qualified pension plan of $11.5 million in 2006 and a credit to expenses of $1.3 million in 2005. Operating expenses also include the nonqualified pension expense of $3.2 million in 2006 and $1.0 million in 2005. The implementation of FAS 158 does not change the systematic approach required by generally accepted accounting principles to recognize the expenses associated with the Reserve Banks’ benefit plans in the income statement.

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 based on an expense-ratio method. Corporate overhead was allocated among the priced services during 2006 and 2005 as follows (in millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check</td>
<td>30.6</td>
<td>29.4</td>
</tr>
<tr>
<td>ACH</td>
<td>4.1</td>
<td>3.7</td>
</tr>
<tr>
<td>Fedwire funds</td>
<td>2.8</td>
<td>2.6</td>
</tr>
<tr>
<td>Fedwire securities</td>
<td>1.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Total</td>
<td>39.0</td>
<td>37.0</td>
</tr>
</tbody>
</table>
(6) **Imputed Costs**

Imputed costs consist of income taxes, return on equity, interest on debt, sales taxes, the FDIC assessment, and interest on float. Many imputed costs are derived from the private-sector adjustment factor (PSAF) model. The cost of debt and the effective tax rate, which reflect bank holding company data as the proxy for a private-sector firm, are used to impute debt and income taxes in the PSAF model. The after-tax rate of return on equity is based on the returns of the equity market as a whole and 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 2006 or 2005. 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, 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 2006 in millions of dollars:

| Total float  | –84.7 |
| Unrecovered float | 15.6 |
| Float subject to recovery | –100.3 |

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 2006.

(7) **Other Income and Expenses**

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2006 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 (GPRA) of 1993 requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multiyear 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 articulates the Board’s mission, sets forth major goals, 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 performance measures, and discusses performance evaluation. The most recent strategic plan covers the period 2006–09.

Both the performance plan and the performance report are prepared biennially. The performance plan 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 results verification. The most recent performance plan covers the period 2006–07.

The performance report discusses the Board’s performance in relation to its goals. The most recent performance report indicates that the Board generally met its goals for 2004–05.

All of the aforementioned documents are available on the Board’s web site, at 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 listed 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 divisional 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.
Federal Legislative Developments

The following federal laws enacted during 2006 affect the Federal Reserve System and the institutions it regulates: the Financial Services Regulatory Relief Act of 2006; the Unlawful Internet Gambling Enforcement Act of 2006; the Military Personnel Financial Services Protection Act; and the Financial Netting Improvements Act of 2006.

**Financial Services Regulatory Relief Act of 2006**

On October 13, 2006, President Bush signed into law the Financial Services Regulatory Relief Act of 2006 (Regulatory Relief Act), culminating more than four years of work by Congress, the Board, and other interested parties. The act incorporates a number of significant monetary policy, supervisory, and regulatory provisions that were proposed or supported by the Board. These provisions should reduce unnecessary burden on banking organizations and improve operation of the financial system. The most important provisions of the Regulatory Relief Act affecting the Federal Reserve System and banking organizations supervised by the Federal Reserve are discussed below. Except as noted below, the act became effective on October 13, 2006.

**Monetary Policy Provisions**

*Authority to Pay Interest on Balances Held at Reserve Banks and Greater Flexibility in Setting Reserve Requirements*

For monetary policy purposes, federal law obliges the Board to establish reserve requirements on certain deposits held at depository institutions and mandates that the Board set the ratio of required reserves on transaction accounts above a certain percentage (8 percent for amounts above the so-called low reserve tranche, and 3 percent for amounts within the low reserve tranche). Because the Federal Reserve does not pay interest on balances held at Reserve Banks to meet reserve requirements, depositories have an incentive to reduce their reserve balances to a minimum. To do so, they engage in a variety of reserve-avoidance activities, including using “sweep” arrangements that move funds from accounts subject to reserve requirements to accounts and money market investments that are not. These sweep programs and similar activities absorb resources and therefore diminish banking system efficiency. Depository institutions also may voluntarily hold contractual clearing balances and excess reserve balances at a Reserve Bank. These balances also do not explicitly earn interest, although contractual clearing balances implicitly earn interest in the form of credits that may be used to pay for Federal Reserve services, such as check clearing.

The Regulatory Relief Act gives the Federal Reserve the authority, effective as of October 1, 2011, to pay explicit interest on all types of balances (including required reserves, excess reserves, and contractual clearing balances) held by or for depository institutions at a Reserve Bank. Paying interest on required reserve balances, once authorized, will remove a substantial portion of the incentive for depositories to...
engage in reserve-avoidance measures, and the resulting improvements in efficiency should eventually be passed through to bank borrowers and depositors.

Moreover, if the Board were to determine to pay explicit interest on contractual clearing balances, once authorized to do so, the action could provide a stable enough supply of voluntary balances to allow the Federal Reserve to effectively implement monetary policy using existing procedures without the need for required reserves.

Importantly, the Regulatory Relief Act gives the Board the discretion, effective as of October 1, 2011, to lower the ratio of reserves that a depository institution must maintain against its transaction accounts below the ranges currently established by law, including potentially establishing a zero reserve ratio. Thus, once these authorities become effective, the Board could reduce or even eliminate reserve requirements if it determined that such action was consistent with the effective implementation of monetary policy. Such action, if taken, would reduce a significant regulatory burden for all depository institutions.

Having the authority to pay interest on excess reserves also will enhance the Federal Reserve’s monetary policy toolkit. If the Board were to determine to pay interest on such balances at some point in the future, the rate paid would act as a minimum for overnight interest rates and, thus, could help mitigate potential volatility in overnight interest rates.

**Authority for Member Banks to Use Pass-Through Reserves**

The Regulatory Relief Act also eliminated the statutory provisions that prohibited banks that are members of the Federal Reserve from counting as reserves their deposits in other banks that are “passed through” by those banks to the Federal Reserve as required reserve balances. These amendments, once implemented, will enable national and state member banks to take advantage of the same type of pass-through reserve arrangements previously available only to state nonmember banks.

**Supervisory and Regulatory Provisions**

**Rules Implementing the “Broker” Exceptions for Banks Adopted as Part of the Gramm-Leach-Bliley Act**

Before the Gramm-Leach-Bliley Act (GLB Act) of 1999, banks had a blanket exception from the definition of “broker” in the Securities Exchange Act of 1934. This meant that banks could engage in any type of securities activity permissible under federal and state banking laws without registering with the Securities and Exchange Commission (SEC) as a broker and without complying with the SEC’s rules applicable to registered brokers. In the GLB Act, Congress eliminated this blanket exception for banks from the definition of “broker” and replaced it with eleven exceptions for broad types of securities activities conducted by banks. These new activity-focused exceptions were designed and intended to allow banks to continue to provide their customers with securities services as part of their usual trust, fiduciary, custodial, and other banking functions. The SEC requested comment on rules that would implement these “broker” exceptions for banks in 2001 and 2004.

The Regulatory Relief Act requires that the SEC and the Board, within 180 days of enactment, jointly request comment on a new “single set” of rules to implement the “broker” exceptions for banks that were adopted as part of the GLB Act. The Regulatory Relief Act
also requires that the SEC and the Board jointly adopt a “single set” of final rules to implement these exceptions after consulting with, and seeking the concurrence of, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS).

In addition, the act provides that the single set of final rules adopted jointly by the Board and the SEC shall supersede the rules previously issued by the SEC to implement these exceptions.

On December 18, 2006—well before the end of the 180-day period established by the Regulatory Relief Act—the Board and the SEC issued and requested comment on joint proposed rules to implement the “broker” exceptions for banks. See 71 FR 77,522 (Dec. 26, 2006). These joint proposed rules—designated Regulation R—are designed to accommodate the securities activities that banks conduct as part of their normal banking functions, consistent with the purposes of the GLB Act.

Expanded Eligibility for Eighteen-Month Examination Schedule for Small Banks

The Regulatory Relief Act expands the number of well-capitalized and well-managed small insured depository institutions that may qualify for an eighteen-month (rather than a twelve-month) on-site safety and soundness examination schedule. Before the act, an insured depository institution could qualify for an extended eighteen-month safety and soundness examination schedule only if the institution had less than $250 million in total assets, was well capitalized and well managed, and met certain other supervisory criteria. See 12 USC 1820(d)(4). The act raised this $250 million asset threshold for an eighteen-month exam cycle to $500 million, thereby allowing additional small, well-run institutions to potentially qualify for an extended examination schedule. On January 11, 2007, President Bush also signed into law a complementary bill, Pub. L. 109-473, that allows an insured depository institution that meets the new $500 million total assets threshold to potentially qualify for an eighteen-month on-site exam cycle if the institution received a composite rating of either a 1 or a 2 at its most recent safety and soundness examination.

Nonwaiver of Privileges

The Regulatory Relief Act includes an important provision that should facilitate the sharing of information between banking organizations and federal, state, and foreign banking authorities. Specifically, the act provides that any privilege (for example, attorney-client or work-product privilege) a person may have with respect to information is not waived or destroyed if the person provides that information to “any federal banking agency, state bank supervisor, or foreign banking authority for any purpose in the course of the supervisory or regulatory process of such agency, supervisor, or authority.”

Voting State Representative Added to the Federal Financial Institutions Examination Council

Another provision of the Regulatory Relief Act adds a state representative as a voting member of the Federal Financial Institutions Examination Council (FFIEC). Specifically, the act provides for the current State Liaison Committee of the FFIEC (which is composed of five representatives of state supervisory agencies for depository institutions) to elect a chairperson, and adds this chairperson as a full voting member of the FFIEC.
Elimination of Certain Reporting Requirements Relating to Insider Lending

The Regulatory Relief Act eliminated certain reporting requirements previously imposed on banks and their executive officers and principal shareholders that the federal banking agencies did not find particularly useful in monitoring insider lending or preventing insider abuse. Specifically, the act eliminated the statutory provisions that previously required:

- an executive officer of a bank to file a report with the bank’s board of directors whenever the executive officer obtained a loan from another bank in an amount that exceeded the amount the executive officer could obtain from his or her own bank (12 USC 375a(g)(6)),
- a bank to file a separate report with its quarterly Call Report concerning any loans the bank made to its executive officers since its previous Call Report (12 USC 375a(g)(9)), and
- an executive officer or principal shareholder of a bank to file an annual report with the bank’s board of directors if the officer or shareholder had a loan outstanding from a correspondent bank of the bank (12 USC 1972(2)(G)).

Although the act eliminated these reporting requirements, it did not alter the statutory and regulatory limits and restrictions on lending to insiders or the ability of the federal banking agencies to examine for potential insider lending abuses as part of the supervisory process. On December 6, 2006, the Board adopted, on an interim basis, and requested public comment on amendments to the Board’s Regulation O (12 CFR 215) that implement the elimination of these reporting requirements. See 71 FR 71,472 (December 11, 2006).

Streamlining the Supervisory Process for Bank Merger Transactions

The Regulatory Relief Act streamlines the supervisory process for Bank Merger Act (12 USC 1828(c)) transactions in two respects. First, it eliminates the need for the responsible agency in a Bank Merger Act transaction to request a report on the competitive effects of the transaction from each of the other federal banking agencies, as well as the Attorney General. Instead, the act requires that the responsible agency request a competitive factors report only from the Attorney General and provide a copy of the request to the FDIC (if it is not the responsible agency). Second, the Regulatory Relief Act allows the reviewing agency for a Bank Merger Act transaction to avoid requesting a competitive factors report from the other federal banking agencies and the Attorney General if the transaction involves affiliated institutions. The act also eliminates the post-approval waiting period for bank mergers involving affiliated institutions, as these transactions typically do not present any competitive issues. The act does not, however, alter in any way the reviewing agency’s obligation to conduct a competitive analysis of a proposed Merger Act transaction.

Amendment Allowing the Board to Grant Exceptions from the Attribution Rule in Section 2(g)(2) of the Bank Holding Company Act

Section 2(g)(2) of the Bank Holding Company Act (BHC Act) (12 USC 1841(g)(2)) provides that in all circumstances, a company is deemed to control any shares that are held by a trust for the benefit of the company or its sharehold-
ers, members, or employees. This attribution rule was intended to prevent a bank holding company from using a trust established for the benefit of its management, shareholders, or employees to evade the BHC Act’s restrictions on the acquisition of shares of banks and nonbanking companies. However, the rule can create inappropriate results in situations in which the bank holding company does not have the ability to control, directly or indirectly, the shares acquired by the trust. Accordingly, the Regulatory Relief Act allows the Board to waive application of this attribution rule if the Board determines that the exception is appropriate in light of the facts and circumstances of the case and the purposes of the BHC Act. Such an exception might be appropriate, for example, if the shares are held by the trust as part of a participant-directed and widely held 401(k) plan and the plan’s investment options are selected by an independent fiduciary (and not by the bank holding company or its officers, directors, or employees).

Streamlining Reports of Condition

The Regulatory Relief Act requires the Board and the other federal banking agencies to conduct a review of the Call Report forms within one year of enactment, and at least once every five years thereafter, and to eliminate any information or schedule that the agencies determine is no longer necessary or appropriate.

Increase in Asset Threshold for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act

The Depository Institution Management Interlocks Act, among other things, generally prohibits a management official of one depository organization from serving as a management official of any other nonaffiliated depository organization if the organizations have offices located in the same metropolitan statistical area. The act provides an exception from this restriction if each of the depository organizations involved has less than a specified amount of total assets. The Regulatory Relief Act raised this specified amount from $20 million to $50 million, thus allowing a greater number of small depository organizations to qualify for the exception.

Protection of Confidential Information Received by Federal Banking Agencies from Foreign Banking Supervisors

The Regulatory Relief Act clarifies the authority of the Board and the other federal banking agencies to maintain the confidentiality of information obtained from a foreign regulatory or supervisory authority. Specifically, the act provides that a federal banking agency may not be compelled to disclose information received from a foreign regulatory or supervisory authority if public disclosure of the information would violate the law of the foreign country and the federal banking agency obtained the information in connection with the administration and enforcement of the federal banking laws or under a memorandum of understanding between the foreign authority and the agency. The act, however, would not authorize the agencies to withhold such information from Congress or if the information was sought under a court order in an action initiated by the United States or the agency.

Modification to Cross-Marketing Restrictions Applicable to Merchant Banking Investments

Another provision of the Regulatory Relief Act allows the depository institution subsidiaries of a financial holding com-
pany, with prior Board approval, to engage in cross-marketing activities through “statement stuffers” and Internet web sites with nonfinancial portfolio companies held by the financial holding company under the GLB Act’s merchant banking authority. Previously, the depository institution subsidiaries of a financial holding company were permitted to engage, with Board approval, in these limited types of cross-marketing activities only with portfolio companies held by the financial holding company under the GLB Act’s insurance company investment authority.

**Change in Bank Control Act Amendments**

The Regulatory Relief Act expands the factors that the Board and the other federal banking agencies may consider in determining whether to disapprove, or extend the time period for processing, a notice filed under the Change in Bank Control Act (CIBC Act). In particular, the act allows the appropriate federal banking agency to disapprove a CIBC Act notice if the agency determines that the future prospects of the institution to be acquired might jeopardize the stability of the institution or the interests of depositors. (Currently, the financial and managerial factors in the CIBC Act focus on the resources of the acquiring person, not the institution to be acquired.) In addition, the act allows an agency to extend the time for processing a CIBC Act notice for up to an additional two 45-day periods (beyond the initial 60-day review period and discretionary 30-day extension) if the agency determines that additional time is needed to analyze (1) the future prospects of the institution to be acquired or (2) the safety and soundness of any plans by the acquiring person to make major changes in the business, corporate structure, or management of the institution.

**Amendments to Allow D.C.-Chartered Banks to Become State Member Banks**

The Regulatory Relief Act makes several technical changes to the Federal Reserve Act to allow banks chartered in the District of Columbia to become state member banks.

**Enforcement-Related Provisions**

**Amendments Expanding the Agencies’ Suspension Authority**

The Federal Deposit Insurance Act (FDI Act) currently allows the appropriate federal banking agency to suspend, remove, or prohibit an institution-affiliated party (IAP) from participating in the affairs of the depository institution with which he or she is affiliated if the IAP is charged with or convicted of certain crimes involving dishonesty, breach of trust, or money laundering. See 12 USC 1818(g)(1). The Regulatory Relief Act expands this authority by allowing the appropriate federal banking agency to suspend an IAP that has been charged with such a crime from participating in the affairs of any depository institution (not just the institution at which the IAP then serves). In addition, the act clarifies that the appropriate agency may suspend, remove, or prohibit an IAP even if the IAP is no longer associated with any depository institution at the time the action is taken.

**Restricting the Ability of Convicted Individuals to Participate in the Affairs of a Bank Holding Company or Edge Act or Agreement Corporation**

Section 19 of the Federal Deposit Insurance Act (12 USC 1829) automatically prohibits a person that has been convicted of a crime involving dishonesty, a breach of trust, or money laundering from participating in the affairs of an
insured depository institution without the consent of the FDIC. The Regulatory Relief Act extends this prohibition so that persons convicted of such crimes also may not participate in the affairs of a bank holding company (other than a foreign bank), an Edge or agreement corporation, or a savings and loan holding company unless the individual receives the prior consent of the Board or the OTS, as appropriate. The Regulatory Relief Act also gives the Board and the OTS additional discretionary authority to remove a person convicted of such a crime from, respectively, a nonbank subsidiary of a bank holding company or a savings and loan holding company.

Authority to Enforce Deposit Insurance Conditions

Section 8 of the Federal Deposit Insurance Act currently permits the appropriate federal banking agency for an insured depository institution to enforce a written condition imposed by that agency on the institution or an IAP of the institution. The Regulatory Relief Act amended section 8 of the FDI Act to allow the appropriate federal banking agency for an institution to enforce a condition imposed on an insured depository institution by another federal banking agency. This will allow, for example, the Board (as the appropriate agency for a state member bank) to enforce a condition imposed on a state member bank by the FDIC in connection with the bank’s application for deposit insurance.

Standards for Enforcing Written Conditions and Written Agreements

The Regulatory Relief Act also amended section 8 of the Federal Deposit Insurance Act to allow the appropriate federal banking agency for an insured depository institution to enforce a written condition imposed on the institution or an IAP, or a written agreement entered into by the agency with the institution or IAP, without demonstrating that the institution or IAP was unjustly enriched or acted in reckless disregard of the law or a prior agency order. Similarly, the act allows the appropriate federal banking agency for an undercapitalized institution to enforce a written condition imposed on, or a written agreement entered into with, the institution or an IAP without regard to the limit in the FDI Act (12 USC 1831o(e)(2)(E)) that normally caps the liability of a controlling shareholder under a capital restoration plan.

Clarifying the Ability of the Banking Agencies to Enforce Conditions Imposed in Connection with CIBC Act Notices

The Regulatory Relief Act amends section 8(b) of the Federal Deposit Insurance Act to provide that the appropriate federal banking agency for an insured depository institution may enforce written conditions imposed in connection with “any action on any application, notice, or other request” by the depository institution or IAP. These changes are designed to clarify and confirm the agencies’ ability to enforce conditions imposed in connection with a notice filed under the Change in Bank Control Act.

Board Approval of OCC Removal Actions

The Regulatory Relief Act strikes the provision in the FDI Act (see 12 USC 1818(e)(4)) that required the Board to issue a final decision in any contested administrative action by the OCC to remove or prohibit an IAP of a national bank. Thus, the OCC now has the same authority as the Board, the FDIC, and the OTS to independently remove or
prohibit an IAP of an institution under the agency’s jurisdiction.

Consumer-Related Provisions

Public Welfare Investments by National and State Banks

The Regulatory Relief Act makes several important modifications to the statutes that authorize national and state member banks to make “public welfare” investments. See 12 USC 24 (eleventh) and 338a. First, it raises, from 10 percent of capital and surplus to 15 percent of capital and surplus, the aggregate amount of “public welfare” investments that a national or state member bank may make under these authorities.\(^1\) In addition, the act refocuses these investments on low- and moderate-income (LMI) families and communities by providing that to be considered a “public welfare” investment, an investment must primarily benefit LMI families or communities (such as by providing housing, services, or jobs). The act also clarifies that each “public welfare” investment made by a national or state member bank, either directly or through a subsidiary, must benefit primarily LMI communities or families.

Development of Model Privacy Disclosure Forms

The Regulatory Relief Act requires the Board, the other federal banking agencies, the National Credit Union Administration, the Secretary of the Treasury, the Securities and Exchange Commission, and the Federal Trade Commission to jointly develop a model form that may be used by financial institutions, at their option, to fulfill the initial and annual privacy policy disclosure requirements imposed by section 503 of the Gramm-Leach-Bliley Act (12 USC 6803). The model form must be issued in proposed form for public comment within 180 days of enactment. The Board has been working extensively with the other relevant agencies and conducting consumer testing to develop potential model privacy forms that may be used by financial institutions.

Studies and Reports

GAO Study of Currency Transaction Reports

The Regulatory Relief Act directs the Government Accountability Office (GAO) to conduct a study of the volume of currency transaction reports (CTRs) filed with the Secretary of the Treasury under the Bank Secrecy Act. The study must evaluate, among other things, (1) the extent to which depository institutions avail themselves of the current exemption system for CTRs, (2) ways to improve the current exemption system for CTRs, and (3) the usefulness of CTRs to law enforcement agencies. The Regulatory Relief Act also provides that the study should include recommendations for changes to the CTR exemption system that would reduce burden without adversely affecting the reporting system’s effectiveness. The GAO must submit a report on its findings to Congress by January 13, 2007.

Unlawful Internet Gambling Enforcement Act of 2006

The Unlawful Internet Gambling Enforcement Act of 2006, Pub. L. 109-347, (codified at 31 USC 5361 et seq.) prohibits a person engaged in the busi-

\(^1\) As under current law, a national or state member bank would have to obtain the approval of the OCC or the Board, respectively, to make “public welfare” investments that, in the aggregate, exceed 5 percent of the bank’s capital and surplus.
ness of betting or wagering from knowingly accepting credit, electronic fund transfers, checks, drafts, or similar instruments drawn on or payable through any financial institution in connection with the participation of another person in unlawful Internet gambling ("restricted transactions"). The act generally defines “unlawful Internet gambling” as transmitting a bet by any means that involves the use, at least in part, of the Internet and where such bet or wager is unlawful under any applicable federal or state law in the state or tribal lands in which the bet or wager is initiated, received, or otherwise made.

The act charges the Secretary of the Treasury and the Board, in consultation with the Attorney General, with developing regulations to require each payment system that the agencies determine could be used to process restricted payments (as well as financial transaction providers participating in such payment systems) to establish "policies and procedures reasonably designed to identify and block or otherwise prevent or prohibit the acceptance of restricted transactions." In prescribing the regulations, the Secretary and the Board must identify the types of policies and procedures, including nonexclusive examples, deemed by the agencies to be reasonably designed to identify and block restricted transactions. To the extent practical, any participant in a designated payment system must be permitted to choose among alternative means of complying, including by relying on and complying with the policies and procedures of the designated payment system, so long as these policies and procedures comply with the regulation. The act also requires the Secretary and the Board to grant exemptions from any requirement imposed under the regulations to particular types of transactions or designated payment systems if the agencies jointly find that it is not reasonably practical to identify and block, or otherwise prevent or prohibit, such restricted transactions. The regulations must be published by July 10, 2007.

Military Personnel Financial Services Protection Act

The National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, enacted on September 30, 2006, imposes restrictions on and disclosure requirements for consumer credit provided to members of the military and their families. The act charges the Department of Defense (DOD) with defining "consumer credit" in its regulations and permits the DOD to include all consumer credit apart from residential mortgages, loans to fund the purchase of a motor vehicle, and other personal property loans when the property purchased from the proceeds of the loan serves as collateral for the loan. Requirements for creditors include a 36 percent annual percentage rate (APR) cap, which includes all fees, along with APR calculations and disclosures that differ from the APR used in disclosures under the Truth in Lending Act (TILA). The act mandates that all credit disclosures, including TILA disclosures, be provided both orally and in writing prior to the extension of credit.

Moreover, the act imposes limitations on lending to members of the military and their dependents, such as prohibiting rollovers and refinancings of consumer credit by the same creditor, and prohibiting loans with prepayment penalties and mandatory arbitration clauses. The act imposes criminal and monetary penalties for knowing violations and voids contracts that are prohibited under the statute. The legislation was intended, at least in part, to address concerns about payday loans, installment loans.
that are secured by a motor vehicle (other than loans for the purchase of a motor vehicle), and other forms of short-term credit to military members and their dependents. In prescribing regulations for this legislation, the DOD must consult with the Board, among other federal agencies. The effective date of the act is October 1, 2007, regardless of whether the DOD adopts regulations. This statute would become effective earlier if interim regulations are issued by the DOD.

Financial Netting Improvements Act of 2006

In 2005, Congress passed comprehensive legislation to revise the federal bankruptcy laws (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8). Title IX of that act contained amendments to banking laws and the Bankruptcy Code to provide increased certainty that netting and close-out of financial market contracts would be enforceable, even in the event of a counterparty insolvency. Title IX also clarified certain duties and obligations of the FDIC as receiver or conservator of an insured depository institution.

The Financial Netting Improvements Act of 2006 (Pub. L. 109-390), enacted on December 12, 2006, makes technical changes to the netting and financial contract provisions that were added or revised by title IX of the 2005 act. The 2006 act updates the descriptions of various financial contracts (“securities contract,” “forward contract,” and “swap agreement”) in the Federal Deposit Insurance Act, the Federal Credit Union Act (FCUA), and the Bankruptcy Code to reflect current market and regulatory practice. The 2006 act also revises provisions in the Bankruptcy Code to clarify the rights of certain counterparties to exercise self-help foreclosure-on-collateral rights, setoff rights, and netting rights with respect to financial contracts with a debtor. These provisions conform the Bankruptcy Code with parallel provisions in the FDI Act and the FCUA. In addition, the 2006 act amends the FDI Act and the FCUA to clarify the conditions under which a receiver of an insolvent depository institution can enforce a financial contract that contains a “walkaway” clause (a clause that would otherwise allow a contract participant to suspend, condition, or extinguish a payment obligation when the other party becomes insolvent). The 2006 act also makes other technical and conforming revisions to the FDI Act, FCUA, Bankruptcy Code, Federal Deposit Insurance Corporation Improvement Act of 1991, and Securities Investor Protection Act of 1970.