Federal Reserve Operations

Banking Supervision and Regulation

The Federal Reserve has supervisory and regulatory authority over a variety of financial institutions and activities. It plays an important role as umbrella supervisor of bank holding companies, including financial holding companies. And it is the primary federal supervisor of state banks that are members of the Federal Reserve System.

Two thousand seven was a challenging year for bank holding companies (BHCs) and state member banks. BHC asset quality and earnings deteriorated over the second half of the year, mainly because of the effects of developments in the residential housing market. Nonperforming assets increased notably as the quality of mortgages, home equity lines of credit, and loans to real estate developers weakened. Nevertheless, BHCs reported net income exceeding $90 billion for the full year. A sharp increase in subprime mortgage delinquencies adversely affected the securitization market. Liquidity and capital were strained as some BHCs brought certain off-balance-sheet exposures onto their books. Several institutions also recognized significant valuation write-downs on assets affected by market conditions. Despite these pressures, BHCs continued to maintain regulatory capital ratios in excess of minimum regulatory requirements.

Most state member banks entered 2007 after a sustained period of strong earnings performance, partly mitigating developments in the market. Although net income and return on assets fell late in the year, reflecting asset write-downs and higher loan-loss provisions, these measures of profitability have been at historically high levels since the mid-1990s, helping to provide banks with a substantial base of capital. Risk-based capital ratios declined modestly over the year, but at year-end more than 99 percent of all commercial banks continued to report capital ratios consistent with a "well capitalized" designation under prompt corrective action standards. Although credit quality indicators also worsened during the year, overall loan quality measures remained relatively sound by historical standards.

In 2007 the banking industry saw bank failures for the first time in three years as three insured institutions—two state nonmember banks and one thrift institution with assets totaling approximately $2.6 billion—were closed.

Banking supervisors focused in 2007 on credit risk issues related to subprime lending activities. During the course of the year the federal financial regulatory agencies—the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS)—issued guidance encouraging supervised institutions to work constructively with homeowners unable to continue meeting their mortgage payments. The agencies also released a statement emphasizing the need to maintain prudent underwriting standards and to provide clear and balanced information to consumers so that institutions and consumers can assess the risks arising from certain adjustable-rate mortgage (ARM) products that offer discounted or low introductory rates. The Federal Reserve also joined with the FDIC, NCUA, OCC, OTS, and the Conference of State Bank Supervisors to issue a statement encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review their authority under pooling and servicing agreements so as to identify borrowers at risk of default and pursue appropriate loss-mitigation strategies designed to preserve sustainable home ownership.

Federal Reserve staff continued to work with the other federal banking agencies in 2007 to prepare for U.S. implementation of the Basel II capital accord.[1] In November the Board of Governors approved final rules implementing new risk-based capital requirements for large, internationally active banking organizations (the Basel II advanced approaches framework) and joined the OCC, FDIC, and OTS in publishing those rules in December.

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 primarily to promote their safe and sound operation, including their compliance with laws and regulations.

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 organizations.

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,

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 issued in November 2005 are available on the website of the Bank for International Settlements (www.bis.org).

State Member Banks and Bank Holding Companies, 2003–2007

Entity/Item	2007	2006	2005	2004	2003
State member banks					
Total number	878	901	907	919	935
Total assets (billions of dollars)	1,519	1,405	1,318	1,275	1,912
Number of examinations	694	761	783	809	822
By Federal Reserve System	479	500	563	581	581
By state banking agency	215	261	220	228	241
Top-tier bank holding companies					
Large (assets of more than $1 billion)					
Total number	459	448	394	355	365
Total assets (billions of dollars)	13,281	12,179	10,261	8,429	8,295
Number of inspections	492	566	501	500	454
By Federal Reserve System[1]	476	557	496	491	446
On site	438	500	457	440	399
Off site	38	57	39	51	47
By state banking agency	16	9	5	9	8
Small (assets of $1 billion or less)					
Total number	4,611	4,654	4,760	4,796	4,787
Total assets (billions of dollars)	974	947	890	852	847
Number of inspections	3,186	3,449	3,420	3,703	3,453
By Federal Reserve System	3,007	3,257	3,233	3,526	3,324
On site	120	112	170	186	183
Off site	2,887	3,145	3,063	3,340	3,141
By state banking agency	179	192	187	177	129
Financial holding companies					
Domestic	597	599	591	600	612
Foreign	43	44	38	36	32

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

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, asset quality, earnings, and liquidity; and (5) a review for compliance with applicable laws and regulations. The table provides information on 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 a 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 the potential Impact (I) of the parent company and its nondepository subsidiaries on the subsidiary depository institution.[2] 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; (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 Federal Reserve System's central point of contact for the organization, has responsibility for only one LCBO, and is supported by specialists capable of evaluating the risks of LCBO business activities and functions); and (4) promoting Systemwide 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.

2. 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

At the end of 2007, 878 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 $500 million may be examined once every eighteen months.[3] The Federal Reserve conducted 479 exams of state member banks in 2007.

3. The total assets threshold for this group of well-capitalized, well-managed organizations was increased during the year. The Financial Services Regulatory Relief Act of 2006, which became effective in October 2006, authorized the federal banking agencies to raise the threshold from $250 million to $500 million, and final rules incorporating the change into existing regulations were issued on September 21, 2007.

Bank Holding Companies

At year-end 2007, a total of 5,793 U.S. bank holding companies were in operation, of which 5,070 were top-tier bank holding companies. These organizations controlled 6,038 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 and 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 2007, the Federal Reserve conducted 476 inspections of large bank holding companies and 3,007 inspections of small, noncomplex bank holding companies.

Financial Holding Companies

Under the Gramm-Leach-Bliley Act, bank holding companies that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in a wider range of financial activities, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales. The statute streamlines the Federal Reserve's supervision of all bank holding companies, including financial holding companies, and sets forth parameters for the 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 2007, 597 domestic bank holding companies and 43 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 33 had consolidated assets of $15 billion or more; 136, between $1 billion and $15 billion; 93, between $500 million and $1 billion; and 335, 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 and also the investments by bank holding companies in export trading companies. In addition, it supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

Foreign Operations of U.S. Banking Organizations

In supervising the international operations of state member banks, Edge Act and agreement corporations, and bank holding companies, the Federal Reserve generally conducts its examinations or inspections at the U.S. head offices of these organizations where the ultimate responsibility for the foreign offices lies.

4. The special supervisory program was implemented in 1997 and modified in 2002. See SR letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex (www.federalreserve.gov/boarddocs/srletters/).

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 OCC.

At the end of 2007, 55 member banks were operating 619 branches in foreign countries and overseas areas of the United States; 33 national banks were operating 567 of these branches, and 22 state member banks were operating the remaining 52. In addition, 17 nonmember banks were operating 23 branches in foreign countries and overseas areas of the United States.

Edge Act and Agreement Corporations

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

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

At year-end 2007, 67 banking organizations, operating 12 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 2007, 172 foreign banks from 53 countries were operating 211 state-licensed branches and agencies, of which 8 were insured by the FDIC, and 47 OCC-licensed branches and agencies, of which 4 were insured by the FDIC. These foreign banks also owned 9 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 2007 controlled approximately 18 percent of U.S. commercial banking assets. These 172 foreign banks also operated 91 representative offices; an additional 49 foreign banks operated in the United States 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 357 examinations in 2007.

Compliance with Regulatory Requirements

The Federal Reserve examines supervised institutions for compliance with a broad range of legal requirements, including anti-money-laundering and consumer protection laws and regulations, and other laws pertaining to certain banking and financial activities. Most compliance supervision is conducted under the oversight of the Division of Banking Supervision and Regulation, but consumer compliance supervision is conducted under the oversight of the Division of Community and Consumer Affairs. The two divisions coordinate their efforts with each other and also with the Board's Legal Division to ensure consistent and comprehensive Federal Reserve supervision for compliance with legal requirements.

Anti-Money-Laundering Examinations

With regard to anti-money-laundering requirements, 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, terrorism 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 2007, the Federal Reserve was the lead agency in 2 cooperative, interagency examinations of large, multiregional data processing servicers.

Fiduciary Activities

The Federal Reserve has supervisory responsibility for state member commercial banks and depository trust companies that together reported, at the end of 2007, $39 trillion of assets in various fiduciary or custodial capacities. Additionally, state member nondepository trust companies supervised by the Federal Reserve reported $40 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 its 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 2007, Federal Reserve examiners conducted 98 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 2007, the Federal Reserve conducted on-site examinations at 18 of the 68 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 Treasury regulations governing dealing and brokering in government securities. Thirty state member banks and 6 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2007, the Federal Reserve conducted 7 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 state member banks and bank holding companies that act as municipal securities dealers comply with the Securities Act Amendments of 1975. Municipal securities dealers are examined pursuant to the Municipal Securities Rulemaking Board's rule G-16 at least once every two calendar years. Of the 22 entities that dealt in municipal securities during 2007, 7 were examined during the year.

Securities Credit Lenders

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. As part of its general examination program, the Federal Reserve examines the banks under its jurisdiction for compliance with the Board's Regulation U (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 (FCA), the NCUA, or the OTS.

At the end of 2007, 621 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 200 of these lenders, and the remaining 421 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 246 lenders from its on-site inspection program. Nonexempt lenders are subject to either biennial or triennial inspection. Sixty-eight inspections were conducted during the year.

Business Continuity

In 2007, the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions. The Federal Reserve, the OCC, and the Securities and Exchange Commission (SEC) continued joint supervisory assessments of the activities of core clearing and settlement firms and significant market participants in implementing and maintaining sound business resiliency and continuity practices as outlined in "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System." The Federal Reserve and the other Federal Financial Institutions Examination Council (FFIEC) agencies continued to coordinate their efforts to ensure a consistent supervisory approach for business continuity practices.[5]

Enforcement Actions

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 2007, the Federal Reserve completed 34 formal enforcement actions. Civil money penalties totaling $20,255,290 were assessed.

5. The FFIEC member agencies are the Federal Reserve Board, the FDIC, the NCUA, the OCC, and the OTS.

As directed by statute, all civil money penalties are remitted to either 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 67 informal enforcement actions in 2007. 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.

The primary off-site monitoring tool used by the Federal Reserve is 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 BHCPRs, 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 (NIC) website, which can be accessed at www.ffiec.gov.

During 2007, three 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, gave users the ability to display commercial real estate guidance data, and provided a way to access structure information for all institutions in NIC.

The Federal Reserve works through the FFIEC Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.

International Training and Technical Assistance

In 2007, 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 2007 was concentrated in Latin America, Asia, and former Soviet bloc countries. The Federal Reserve, along with the OCC, the FDIC, and 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, both in the United States and in a number of foreign jurisdictions. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, the Basel Committee on Banking Supervision (Basel Committee), and the Financial Stability Institute.

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

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, the Joint Forum, and the International Accounting Standards Board.

Capital Adequacy Standards

Risk-Based Capital Standards for Certain Internationally Active Banking Organizations

On December 7, 2007, the Federal Reserve, OCC, FDIC, and OTS published final rules implementing new risk-based capital requirements for large, internationally active banking organizations (the Basel II advanced approaches framework). The advanced approaches framework is broadly consistent with international approaches to implementation of Basel II and includes a number of prudential safeguards, such as the requirement that banking organizations satisfactorily complete a four-quarter parallel run period before operating under the Basel II framework, and the use of transitional capital floors. It retains the long-standing minimum risk-based capital requirement of 4 percent tier 1 capital and 8 percent total qualifying capital and the tier 1 leverage ratio.

New Capital Adequacy Framework for U.S. Banking Organizations

Aligning regulatory capital requirements with risk and fostering good risk measurement and management practices for our largest and most complex banking organizations will, I believe, contribute to safer and sounder banks and a more resilient financial system.

Randall S. Kroszner, *Member*, Board of Governors
November 2007

On December 7, 2007, the U.S. banking agencies published a new risk-based capital adequacy framework.[1] The new framework—known as the advanced approaches framework—is designed to align more closely the amount of capital U.S. banking organizations are required to hold as a cushion against potential losses with the risks to which they are exposed. Effective April 2008, large, internationally active U.S. banking organizations will be required to transition to the advanced approaches framework to calculate the amount of capital they must hold relative to their risk profile; other banking organizations may choose to use the new framework.[2] The advanced approaches framework for U.S. banking organizations is based on the revised international capital accord known as Basel II, which was adopted in 2006 by international banking authorities working through the Basel Committee on Banking Supervision.

The need for a new capital adequacy framework arose from continuing rapid and extensive evolution and innovation in the financial marketplace, which has substantially reduced the effectiveness of the existing risk-based capital rules (the Basel I-based rules) for large, internationally active banking organizations. The Basel II-based rules are more sensitive to risk and are tailored to the different kinds of risk to which banking organizations are exposed. Basel II regulatory capital requirements will vary from organization to organization in line with the organization's actual risk profile, so that a banking organization exposed to greater risk will have higher requirements than one exposed to less risk.

Both the international and the U.S. frameworks encompass three elements, or pillars: minimum risk-based capital requirements (pillar 1); supervisory review of capital adequacy (pillar 2); and market discipline through enhanced public disclosure (pillar 3).

Pillar 1 addresses calculation of regulatory capital requirements in relation to certain risk exposures. To calculate their minimum requirements in relation to the credit risk arising from wholesale and retail

1. The U.S. banking agencies are the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

2. Banking organizations with at least $250 billion of consolidated total assets or at least $10 billion of foreign exposure are required to use the advanced approaches and to meet the rule's rigorous qualification requirements; other banking organizations may opt into the advanced approaches framework, provided they also meet its requirements.

Banking organizations subject to the framework are expected to meet certain public disclosure requirements designed to foster transparency and market discipline. In addition, the prompt corrective action rules for banks that are not adequately capitalized remain in effect. (For more information, see the box "New Capital Adequacy Framework for U.S. Banking Organizations.")

exposures, U.S. banking organizations will use an internal ratings-based approach, inserting their own internal estimates of key credit risk parameters into formulas provided by supervisors. They will calculate their minimum requirements in relation to operational risk using advanced measurement approaches, which rely on the institutions' internal risk-measurement and capital calculation processes. The advanced approaches framework also specifies separate methodologies for calculating capital requirements in relation to securitization and equity exposures.

Compared with the Basel I-based rules, banking organizations under Basel II-based rules will be required to take greater account of their off-balance-sheet activities in calculating their capital requirements. The new framework also provides a more-risk-sensitive regulatory capital approach to capital markets activities and transactions, such as repurchase agreements, securities borrowing and lending, margin loans, and over-the-counter derivatives. The enhanced risk sensitivity of the advanced approaches framework should provide incentives for lending to creditworthy counterparties and using effective credit-risk mitigation techniques, such as requiring collateral.

The advanced approaches build on the risk-measurement and risk-management approaches already being used by sophisticated banking organizations and are designed to evolve over time as these organizations refine and enhance their internal practices. As a result, these approaches are better able than the Basel I-based rules to be adapted to innovations in banking and financial markets and to capture the risks arising from new products and activities. This increased adaptability and flexibility suggests that the relationship between the risk-based regulatory measure of capital adequacy and a banking organization's actual risk exposures and its day-to-day risk management will be stronger and more consistent.

Pillars 2 and 3 are also essential elements of the advanced approaches framework. Under pillar 2, banking organizations are required to have an internal process for ensuring that they are holding enough capital to support their overall risk profile (including those risks not captured or not fully addressed under pillar 1), particularly during economic downturns and periods of financial stress. These internal processes will be subject to rigorous supervisory review.

Pillar 3 addresses banking organizations' communication with market participants about their risks, the associated levels of capital, and the manner in which they are meeting the requirements of the advanced approaches framework. The public disclosures called for under pillar 3 are expected to increase the transparency of banking organizations' activities and exposures, giving market participants useful information about banking organizations' risk profiles and their ability to manage risk.

Adoption of the advanced approaches framework is an important milestone for the U.S. banking agencies, but effective implementation in the coming years will be just as important. Implementation of the Basel II-based rules, and the associated improvements in risk management, will not be a one-time event, but rather an ongoing process. The agencies will observe carefully how the advanced approaches work in practice, assessing their advantages and limitations, to ensure that they are operating as intended.

Revisions to the Market Risk Capital Rule

During 2007, the Federal Reserve, OCC, FDIC, and OTS considered public comments on a September 2006 notice of proposed rulemaking that presented revisions to the market risk capital rule used by the Federal Reserve, OCC, and

FDIC since 1997 for banking organizations having significant exposure to market risk. Under the existing 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 banking organizations that model specific risk to reflect any incremental default risk of traded positions, and require public disclosure of certain qualitative and quantitative market risk information. The agencies expect to finalize this rule in the first half of 2008.

In July 2007, the Federal Reserve issued a letter reminding supervised banking organizations that the application of the fair value option to securities may subject the organization to the market risk capital rule. The letter directed those organizations to contact their Reserve Bank to discuss their plans to address the rule's requirements.

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

During 2007, the Federal Reserve, OCC, FDIC, and OTS considered public comments on a notice of proposed rulemaking (NPR) issued in December 2006 proposing modifications to the current Basel I-based capital rules. The proposed rules would provide an option to those banking organizations that are not required to adopt Basel II and do not wish to voluntarily follow the advanced approaches. This option is known as the Basel I-A proposal.

In response to comments calling for an option to adopt the standardized approach under Basel II, the agencies revised the Basel I-A proposal and intend to issue a new NPR setting forth a proposed standardized Basel II capital rule in the first half of 2008.

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.[6] Much of this work in 2007 involved evaluating enhanced forms of trust preferred securities and mandatory convertible securities.

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 over financial reporting, financial disclosure, and supervisory financial reporting. Federal Reserve staff members interact with key constituents in the accounting and auditing professions, including regulators, standard-setters, accounting firms, accounting and banking industry trade groups, and the banking industry, and issue supervisory guidance as appropriate.

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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.

Domestic Accounting

The Federal Reserve continues to closely monitor domestic and international accounting standard-setting related to the use of fair value accounting. In previous comment letters to the Financial Accounting Standards Board (FASB), the Federal Reserve has raised concerns about the reliability of reported financial results based on fair value measurements, especially when financial instruments are illiquid. In May 2007, Federal Reserve staff issued a comment letter to the FASB regarding its “Invitation to Comment on Valuation Guidance for Financial Reporting” that strongly supported efforts to consider the need for additional valuation guidance.

The FASB’s Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, issued in February 2007, allows most financial assets and financial liabilities to be reported at fair value. As part of its continued focus on the use of fair value accounting at banking organizations, and in light of the potential increased use of fair value accounting for loans, the Federal Reserve staff conducted a study of fair value measurements of commercial loan values. The study was intended to provide additional insight into valuation methodologies used and related control frameworks for loans at a number of large, internationally active banking organizations. The study report, issued in June 2007, summarizes commercial loan fair value measurement practices at these organizations.

Federal Reserve staff participated in a number of SEC and FASB efforts to address current accounting issues. A senior Federal Reserve representative is an official observer on the SEC Advisory Committee on Improvements to Financial Reporting, which was established to examine the U.S. financial reporting system with the goals of reducing unnecessary complexity and making information more useful and understandable for investors. Federal Reserve staff also participated in FASB efforts to improve financial reporting, including roundtable discussions on modifications of securitized subprime mortgage loans and the joint FASB−International Accounting Standards Board (IASB) project on Financial Statement Presentation.

Bank Secrecy Act and Anti–Money Laundering

In 2007, the FFIEC again updated the *Bank Secrecy Act/Anti–Money Laundering Examination Manual* (originally issued in 2005) to further clarify supervisory expectations, incorporate new regulatory issuances, and respond to industry requests for additional guidance. Significant revisions included updates to the chapters on customer due diligence, suspicious activity reporting, foreign correspondent accounts, electronic banking, and trade finance. The manual provides current and consistent risk-based guidance to help banking organizations comply with the BSA and safeguard operations from money laundering and terrorism financing.

Also during the year, the FFIEC agencies issued “Interagency Statement on Enforcement of Bank Secrecy Act/Anti−Money Laundering Requirements” setting forth their interpretation of the requirement in the Federal Deposit Insurance Act relating to supervisory actions to address certain BSA compliance issues. The statement provides greater consistency among the agencies on certain BSA enforcement decisions and describes considerations that affect those decisions.

The Federal Reserve and other federal banking agencies continued during 2007 to share information with the Financial Crimes Enforcement Network (FinCEN) under the interagency memorandum of understanding (MOU) that was finalized in 2004, and with the Treasury's Office of Foreign Assets Control (OFAC) under the interagency MOU that was finalized in 2006.

The Federal Reserve continues to participate in efforts to promote transparency and address risks faced by financial institutions that act as intermediaries in international funds transfers. The Federal Reserve, other U.S. banking agencies, and the Treasury have supported private-sector efforts to address the anti-money-laundering and sanctions concerns of banks that have international operations. In addition, the Federal Reserve participates in the Anti–Money Laundering and Countering the Financing of Terrorism Expert Group, a subcommittee of the Basel Committee's International Liaison Group.

International Guidance on Supervisory Policies

As a member of the 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 2007, the Federal Reserve participated in ongoing cooperative work on implementation of Basel II and on development of international supervisory guidance, particularly in the area of funding liquidity risk management.

The Federal Reserve also continued to participate in Basel Committee working groups addressing issues not fully resolved in the Basel II framework. One effort is a look at eligible capital instruments across jurisdictions with the goal of developing a definition of *capital*. The Federal Reserve also participated in a workshop addressing supervisory and industry expectations with regard to implementation of pillar 2 of Basel II (supervisory review).

Risk Management

The Federal Reserve contributed to supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2007 that were generally aimed at improving the supervision of banking organizations' risk-management practices.[7] Two of these were

- "Principles for Home-Host Supervisory Cooperation and Allocation Mechanisms in the Context of Advanced Measurement Approaches," consultative document published in February and final document published in November
- "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book," consultative document published in October

The Federal Reserve contributed to efforts begun in January 2007 to look at liquidity regulation across jurisdictions and to review the 2000 Basel Committee paper "Sound Practices for Managing Liquidity in Banking Organisations" with a view toward updating the paper.

Joint Forum

In 2007, the Federal Reserve 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

7. Papers issued by the Basel Committee can be accessed via the Bank for International Settlements website at www.bis.org.

of financial conglomerates. The Joint Forum 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 development of supervisory policy papers, reports, and recommendations issued by the Joint Forum during 2007, including work on risk concentrations, credit risk transfer, customer suitability, and implementation of principles for the supervision of financial conglomerates.[8] The Federal Reserve also participated in Joint Forum-sponsored information-sharing on pandemic planning and other business continuity initiatives.

International Accounting

The Federal Reserve participates in the Basel Committee's Accounting Task Force (ATF), which represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. During 2007, Federal Reserve staff contributed to the development of numerous Basel Committee comment letters related to accounting and auditing matters that were submitted to the IASB and the International Auditing and Assurance Standards Board (IAASB).

The Basel Committee in May 2007 issued a comment letter to the IASB on its discussion paper "Fair Value Measurements." The paper was prepared by the IASB as part of its efforts to develop a standard for fair value measurements similar to the FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, issued in September 2006. In its letter, the Basel Committee emphasized the importance of sound guidance on fair value measurement, particularly as part of the joint FASB-IASB program on convergence between International Financial Reporting Standards and U.S. generally accepted accounting principles (GAAP).

In 2007 the Basel Committee also issued a series of comment letters to the IAASB related to the international standards on auditing (ISAs) that are being revised as part of the IAASB's Clarity Project. The Clarity Project is part of an effort by the IAASB to increase consistency in the application of auditing standards around the world and to improve the clarity of the ISAs. The revised ISAs cover such audit areas as planning the audit, auditing different types of financial statements, audit evidence, related parties, going concern, fair value measurements, internal audit, and the auditor's report.

Credit Risk Management

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

Working with Mortgage Borrowers

In April 2007 the Federal Reserve, FDIC, NCUA, OCC, and OTS issued staff guidance to encourage supervised institutions to work constructively with homeowners who are financially unable to continue meeting their mortgage payments. The agencies reminded institutions that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Subprime Mortgage Lending

In June the Federal Reserve, FDIC, NCUA, OCC, and OTS issued "State-

8. Papers issued by the Joint Forum can be accessed via the Bank for International Settlements website at www.bis.org.

ment on Subprime Mortgage Lending" to address issues and questions related to certain adjustable-rate mortgage (ARM) products marketed to subprime borrowers. The statement emphasizes the need for prudent underwriting standards and clear and balanced consumer information, so that institutions and consumers can assess the risks arising from certain ARM products that have discounted or low introductory rates. It describes the prudent safety and soundness and consumer protection standards that institutions should follow to ensure that borrowers obtain loans they can afford to repay. These standards include qualifying borrowers on a fully indexed, fully amortized basis and guidelines on the use of risk-layering features, including an expectation that stated income and reduced documentation would be accepted only if there are documented factors that clearly minimize the need for verification of the borrower's repayment capacity. Consumer protection standards include clear and balanced product disclosures for customers and limits on prepayment penalties so that customers have a reasonable period to refinance without penalty, typically at least sixty days before expiration of the initial fixed interest rate period.

Statement on Loss-Mitigation Strategies

In September the Federal Reserve, FDIC, NCUA, OCC, OTS, and Conference of State Bank Supervisors issued a statement encouraging federally regulated financial institutions and state-supervised entities that service securitized residential mortgages to review their authority under pooling and servicing agreements to identify borrowers at risk of default and to pursue appropriate loss-mitigation strategies designed to preserve sustainable home ownership. The statement outlines the steps a servicer may take when there is an increased risk of default, including identifying borrowers at heightened risk of delinquency or default, contacting borrowers to assess their ability to repay, and determining whether default is reasonably foreseeable. The statement goes on to explain possible loss-mitigation techniques that a servicer may pursue with a borrower, recognizing that the servicer must consider the documents governing the securitization trust to determine its authority to restructure loans that are delinquent or are at risk of imminent default.

Pandemic Planning

In December, the FFIEC agencies published guidance on planning for the purpose of minimizing the potential adverse effects of an influenza pandemic. The guidance emphasizes the importance of (1) a preventive program to reduce the likelihood that the institution's operations will be significantly affected by a pandemic, (2) a documented strategy that scales the response to the particular stages of an outbreak, (3) a comprehensive framework of facilities, systems, or procedures needed to continue critical operations, (4) a testing program, and (5) an oversight program. In September and October, the Federal Reserve participated with the other FFIEC agencies in a Treasury-sponsored, industrywide business continuity exercise to test the financial sector's ability to respond to a pandemic crisis. The Federal Reserve helped develop the after-exercise report, which was published in January 2008.

Banks' Securities Activities

In September, the Federal Reserve and the SEC adopted joint final rules defining the scope of securities activities 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 rules implement the most important "broker" exceptions for trust and fiduciary activities, custodial and deposit "sweep" functions, and third-party networking arrangements.

Economic Growth and Regulatory Paperwork Reduction Act of 1996

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) 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 2007, the Federal Reserve, OCC, FDIC, and OTS completed the required review and issued a joint report to Congress, which is available on the EGRPRA website at www.egrpra.gov.

Regulatory Reports

The supervisory policy function is responsible for developing, coordinating, and implementing regulatory reporting requirements for various financial reporting forms filed by domestic and foreign financial institutions subject to Federal Reserve supervision. Federal Reserve staff members interact with appropriate federal and state supervisors, including foreign bank supervisors as needed, to recommend and implement appropriate and timely revisions to the reporting forms and the attendant instructions.

Bank Holding Company Regulatory Reports

The Federal Reserve requires that U.S. bank holding companies periodically submit reports providing financial and structure information. The information is essential in supervising the companies and in formulating regulations and supervisory policies. It is also used in responding to requests from Congress and the public for information about bank holding companies and their nonbank subsidiaries. Foreign banking organizations also are required to periodically submit reports to the Federal Reserve.

Reports in the FR Y-9 series—FR Y-9C, FR Y-9LP, and FR Y-9SP—provide standardized financial statements for bank holding companies on both a consolidated 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. Nonbank subsidiary reports—FR Y-11, FR 2314, and FR Y-7N—help the Federal Reserve determine the condition of bank holding companies that are engaged in nonbank activities and also aid in monitoring the number, nature, and condition of the companies' nonbank subsidiaries.

In March, several revisions to the FR Y-9C report were approved for implementation during 2007: (1) collection of certain data on the sources of fair value measurements from all institutions that choose, under GAAP, to apply a fair value option to one or more financial instruments and one or more classes of servicing assets and liabilities, and from certain institutions that report trading assets and liabilities; (2) collection of information on the cumulative change in the fair value of liabilities accounted for under the fair value option that is attributable to changes in the bank holding company's own creditworthiness, for purposes of determining regulatory capital; (3) collection of certain data on one- to four-family residential mortgage loans that have terms allowing for negative amortization; and (4) revision of instructions for reporting time deposits and brokered deposits.

Effective March 2007, four new items were added to the quarterly FR Y-11 and FR 2314 reporting forms to facilitate monitoring of the extension of negatively amortizing residential mortgage loans. Also, a new section concerning notes to the financial statements was added to the FR 2314.

Effective June 2007, reporting forms used to collect information on changes in organizational structure and the status of a foreign branch (FR Y-10, FR Y-10F, FR Y-10S, and FR 2058) were combined into one event-generated form called the FR Y-10. Also, a supplemental form was created (FR Y-10E) to collect additional structure information that the Federal Reserve deems to be critical and is needed in an expedited manner in order to meet new legislative requirements, answer congressional inquiries, or respond to market events. Effective December 2007, a requirement that an institution verify its list of domestic branches was added to the FR Y-6.

In November, the Federal Reserve proposed a number of revisions to the FR Y-9 for the 2008 reporting period comparable to those proposed for the bank Consolidated Reports of Condition and Income (Call Report) as described in the next section. In addition, the Federal Reserve proposed to collect certain data on the FR Y-9LP, FR Y-9SP, FR Y-11, FR 2314, FR Y-7, and FR 2886b forms from all institutions that choose to apply a fair value option to financial instruments and servicing assets and liabilities, and also proposed to collect other information on sources of income for supervisory purposes.

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 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 2007 reporting period, the FFIEC implemented various revisions to the Call Report to address new safety and soundness considerations and to facilitate supervision. Among these revisions were changes related to the reporting of data for deposit insurance assessments; changes to provide for the reporting of data on nontraditional mortgage products; and changes to provide for the reporting of data related to certain financial instruments measured at fair value.

In September, the FFIEC proposed a number of revisions to the Call Report for the 2008 reporting period. The proposed revisions include collecting additional information related to one- to four-family residential mortgage loans; modifying the definition of *trading account* in response to the creation of a fair value option in generally accepted accounting principles; revising certain schedules to enhance the reporting of information available under the fair value option; revising the instructions for reporting daily average deposit data by newly insured institutions to conform with the FDIC's assessment regulations; and clarifying the instructions for reporting credit derivatives data in the risk-based capital schedule.

In 2007, Federal Reserve staff led a review of the Call Report by the federal banking agencies to determine which data requirements are no longer necessary or appropriate. The review, required by the Financial Regulatory Relief Act of 2006 to be conducted every five years, documented the safety and soundness and other public policy uses of each Call Report item and will serve as a reference for future changes to the Call Report.

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 information technology initiatives.

In 2007, the SSIT function worked on several strategic projects and initiatives: (1) alignment of technology investments with business needs; (2) identification and implementation of improvements to make technology more accessible to staff working in the field; (3) strengthening of compliance with data-privacy regulations; (4) identification of opportunities to converge and streamline IT applications, including key administrative systems, to provide consistent and seamless information; (5) evaluation and implementation of collaboration and analysis technologies (such as communities of practice and business intelligence tools) to integrate supervisory and management information systems that support both office-based and field staff; (6) with the other federal regulatory agencies, modernization of the Shared National Credit system; and (7) enhancement of the information security framework for the supervisory function, improving both overall security and compliance with best-practices and regulatory requirements (security enhancements included the encryption of data on all laptop computers and distribution of encrypted portable drives). In addition, new, advanced security measures were pilot-tested prior to expected implementation in 2008.

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 data on banking structure throughout the United States; the National Examination Database (NED), which enables supervisory personnel as well as federal 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.

Within the NIC, the supporting systems have been modified over time to extend their useful lives and improve business workflow efficiency. During 2007 work continued on upgrading the entire NIC infrastructure in order to provide easier access to information, a consistent Federal Reserve enterprise information layer, a comprehensive metadata repository, and uniform security across the Federal Reserve. Implementation is expected to be phased in beginning midyear 2008, with a completion target of 2010. Also in 2007, the NED system was modified to enhance the collection and reporting of Bank Secrecy Act information. In addition, the BOND and CDTR systems were enhanced to provide the document storage facility for the new national Federal Reserve Consumer Help call center. Key summary documentation regarding consumer complaints and inquiries is posted into the CDTR and made available to System staff and staff at the other federal banking agencies via the BOND system. The BOND and CDTR systems were also enhanced to provide an automated, electronic means for passing examination and inspection reports to the records management system of the Board's Office of the Secretary. This new electronic process has allowed the Reserve Banks to discontinue the long-standing practice of sending hard-copy reports to the Board for records management purposes.

Finally, during 2007 the Federal Reserve continued to work closely with other federal and state banking agencies—including federal agency chief information officers, FFIEC task forces and subgroups, and the Conference of State Bank Supervisors—on a variety of technology-related initiatives and projects supporting the supervision business function.

Staff Development

The System Staff Development Program trains staff members at the Board, the Reserve Banks, and state banking departments. Training is offered at the basic, intermediate, and advanced levels in several disciplines within bank supervision: safety and soundness, information technology, foreign banking organizations, and consumer affairs. Classes are conducted in Washington, D.C., as well as at Reserve Banks and other locations. The Federal Reserve 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 (see table).

In 2007, the Federal Reserve trained 2,588 students in Federal Reserve System schools, 894 in schools sponsored by the FFIEC, and 26 in other schools, for a total of 3,508. The number of training days in 2007 totaled 16,791.

The System provides scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 659 state examiners were trained—347 in Federal Reserve courses, 309 in FFIEC programs, and 3 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination as well as a second proficiency examination in one of two specialty areas, safety and sound-

Training Programs for Banking Supervision and Regulation, 2007

Program	Number of sessions conducted	
	Total	Regional
Schools or seminars conducted by the Federal Reserve		
Core schools		
Banking and supervision elements	9	8
Financial analysis and risk management	9	8
Bank management	3	1
Report writing	17	17
Team dynamics and negotiation	9	9
Conducting meetings with management	15	15
Other schools		
Credit risk analysis	7	7
Examination management	6	5
Real estate lending seminar	2	1
Senior forum for current banking and regulatory issues	1	1
Basel II corporate activities	1	1
Basel II operational risk	2	1
Basel II retail activities	2	2
Principles of fiduciary supervision	1	1
Commercial lending essentials for consumer affairs	1	1
Consumer compliance examinations I	2	0
Consumer compliance examinations II	2	2
CRA examination techniques	2	2
CA risk-focused examination techniques	2	2
Fair lending examination techniques	2	2
Foreign banking organizations seminar	1	1
Information systems continuing education	8	8
Asset liability management (ALM1)	2	2
Fundamentals of interest rate risk management	6	6
Technology risk integration	4	4
Trading risk management	2	2
Leadership and influence	4	4
Fundamentals of fraud	7	7
Information technology seminars[1]	21	21
Self-study or online learning[2]		
Orientation (core and specialty)	0	0
Self-study programs 1, 2, and 3	3	0
Self-study modules	0	0
Other agencies conducting courses[3]		
Federal Financial Institutions Examination Council	71	1
The Options Institute	1	1

1. Held at the IT Lab at the Chicago Federal Reserve Bank.
2. Self-study programs do not involve group sessions.
3. Open to Federal Reserve employees.

ness or consumer affairs. In 2007, 161 examiners passed the first proficiency examination and 73 passed the second proficiency examination, 53 examiners in safety and soundness and 20 in consumer affairs. An information technology specialty is also offered; it requires passing a proficiency examination and an examination administered by an information technology industry association.

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 2007, the Federal Reserve acted on 1,365 proposals, which represented 2,661 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 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 2007, the Federal Reserve acted on 603 applications and notices 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 2007, the Federal Reserve reviewed 11 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 2007, 37 domestic financial holding company declarations and 2 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. The Federal Reserve also must consider the views of the U.S. Department of Justice regarding the competitive aspects of any proposed bank merger involving unaffiliated insured depository institutions. In 2007, the Federal Reserve approved 68 merger applications under the act.

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 future prospects of the institution to be 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 fund. 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 2007, the Federal Reserve approved 106 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 2007, the Federal Reserve acted on new and merger-related branch proposals for 1,520 domestic branches and granted prior approval for the establishment of 20 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 2007, no financial subsidiary applications were filed.

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 2007, the Federal Reserve approved 69 proposals for overseas investments by U.S. banking organizations, many of which represented investments through an Edge Act or agreement 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 2007, the Federal Reserve approved 18 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.2 contains the deadline for comments. The Board's website (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 2007, 12 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 purchase 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 Financial Industry Regulatory Authority (formed through the combination of the National Association of Securities Dealers and the regulation, enforcement, and arbitration functions of the New York Stock Exchange), and the Chicago Board Options Exchange 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 FCA, 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 2007, 2,489 banks were members of the Federal Reserve System and were operating 55,603 branches. These banks accounted for 36 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;
- promoting community development in historically underserved markets; and
- conducting research and promoting consumer education.

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.

The Federal Reserve System's various consumer protection and community development roles were the subject of great interest in 2007. Consumer protection concerns moved to the forefront of public dialogue as lawmakers, regulators, the media, and consumers scrutinized various practices being used in the financial services marketplace, particularly in the markets for subprime mortgages and credit cards. Intense examination of the policies and practices at issue has revealed the complexity of the current financial services marketplace. Deregulation and technological and financial innovation over the last two decades fueled the growth of this market, increasing competition and consumer choice. However, the number and types of consumer financing products and providers now available means consumers have to become more vigilant and well-informed as they shop for financial products and manage their personal finances. The Federal Reserve has strategically used its regulatory and supervisory authorities to address consumer protection issues in today's complex consumer financial services marketplace and to promote consumer education and community development.

Mortgage Credit

Homeownership has long been a highly valued goal of both policymakers and consumers. In response to the demand for home loans, the mortgage industry has introduced innovative and creative loan products into the consumer financial services market. As a result, consumers' access to home mortgage credit has expanded considerably over the last decade. Market opportunities and technological advancements have contributed to the growth of the mortgage industry. As the mortgage market grew, some lenders employed nontraditional underwriting and risk-layering strategies in order to capture new market segments, particularly consumers who may not have been able to qualify for credit under more-traditional mortgage-underwriting criteria. Although innovation in the mortgage market has made access to mortgage credit possible for increasing numbers of households, loan products have become increasingly complex—and underwriting standards

An Overview of the Subprime Mortgage Market

At $11 trillion, the depth and breadth of the U.S. home mortgage market is unique. Its sheer capacity has enabled many families to become homeowners, facilitating a long-standing goal of consumers and policymakers. Over the past two decades, the mortgage industry has expanded as a result of financial innovation, technological advancements, and deregulation. Lenders have been able to provide more consumers with access to mortgage credit. In particular, advances in credit scoring technology and risk-based pricing strategies opened up the mortgage market to consumers considered to be higher-risk because of their limited or negative credit histories, income limitations, or other financial issues. Lenders charged these borrowers, known as subprime borrowers, higher rates to reflect the higher level of risk they presented. The subprime mortgage market began to expand markedly in the mid-1990s and peaked in 2006.

The growth of the subprime mortgage market was fueled by expansive developments across the financial industry that significantly changed every aspect of the mortgage industry, from how mortgages were marketed and underwritten to how they were funded. The use of credit scoring models to price for risk enabled lenders to more efficiently evaluate a consumer's creditworthiness, reducing transaction costs for lenders. In addition, changes to and the ongoing growth of the secondary mortgage market increased the ability of lenders to sell many mortgages to "securitizers" that pooled large numbers of mortgages and sold the rights to the resulting cash flows to investors. Previously, lenders tended to hold mortgages on their books until the loans were repaid. The increasingly popular "originate-to-distribute" lending model gave lenders (and mortgage borrowers) greater access to capital markets and allowed risk to be shared more widely. Increased access to mortgage credit was further fueled by the rise of both mortgage brokers who expanded the sales and distribution channels of mortgage lending and independent mortgage originators not directly affiliated with a federally supervised depository institution.

The expanding field of nonbank mortgage lenders was particularly notable in the subprime mortgage market. Data from 2006 reported under the Home Mortgage Disclosure Act indicate that 45 percent of high-cost first mortgages were originated by independent mortgage companies, institutions that are not regulated by the federal banking agencies and that typically sell nearly all of the mortgages they originate. These nondepository institutions fund mortgage lending through the capital markets rather than customer deposits, the traditional source of loan funding for banks.

All of these mortgage market developments increased the supply of mortgage credit, which in turn likely contributed to

have loosened in recent years, particularly in the subprime market. (See related box "An Overview of the Subprime Mortgage Market.")

Aware of the changing conditions in the mortgage market, the Federal Reserve Board has responded to the consumer protection and supervisory concerns of nontraditional and subprime mortgage loans.[1] In recent years and throughout 2007, Federal Reserve staff have undertaken various initiatives to (1) scrutinize potentially risky practices within the mortgage industry and (2) ad-

1. See the testimony of Chairman Ben S. Bernanke, September 20, 2007 (www.federalreserve.gov/newsevents/testimony/bernanke20070920a.htm).

the rise in the national homeownership rate from 64 percent in 1994 to about 68 percent in 2007. But the broadening of access to mortgage credit also had negative aspects. Given their weaker credit histories and financial conditions, subprime borrowers tend to default on their loans more frequently than prime borrowers. A higher incidence of weaker underwriting standards and risk-layering practices, such as failing to document income and lending nearly to the full value of the home, further increased a subprime borrower's vulnerability for default.

In 2007, the problems in the subprime market, deceleration of the housing market, decreased house-price appreciation, and the weakening of the overall economy contributed to a significant number of subprime mortgage defaults. As a result, the subprime mortgage market experienced significant setbacks: several independent mortgage lenders declared bankruptcy, and some large financial organizations experienced multimillion dollar losses in their portfolios. For consumers, the consequences of defaulting on a mortgage can be severe, such as the loss of accumulated home equity, reduced access to credit, and foreclosure. And the negative effects can spread beyond subprime customers. Clusters of foreclosures in one community can cause the value of nearby properties to decline and lead to an increase in vacant and abandoned properties, thereby inflicting economic harm on entire neighborhoods.

As the subprime mortgage crisis expanded throughout the last quarter of 2007, the Federal Reserve actively used its policy, supervisory, and regulatory tools to respond to the needs of markets, lenders, consumers, and communities. These activities were discussed in detail by Federal Reserve Board governors and other officials who testified before Congress throughout the year, offering lawmakers and the public an in-depth discussion about the issues and actions undertaken by the Federal Reserve in response to concerns about the subprime market.[1] In addition, staff at Federal Reserve Banks across the country worked with regulators, government officials, lenders, servicers, consumer advocates, and community leaders to improve their understanding of the complex issues that contribute to, as well as the effects of, widespread mortgage delinquencies and foreclosures. (For a detailed discussion of the Federal Reserve's efforts, see the "Mortgage Credit" section of this chapter.) The Federal Reserve has a strong interest in supporting consumers and communities. Its activities during 2007 have laid the foundation for continued efforts to help stabilize the mortgage industry and assist consumers to make sound financial decisions.

1. See www.federalreserve.gov/newsevents/testimony/2007testimony.htm)

dress issues through regulatory, supervisory, or community engagement activities.

Regulatory Actions

In June, the Board held a public hearing under the Home Ownership and Equity Protection Act (HOEPA). The purpose of the hearing was to gather information on how the Board might use its rulemaking authority to curb abusive lending practices in the home mortgage market, particularly the subprime sector.[2] The

2. In 1994, HOEPA was enacted in response to reports of predatory home equity lending practices in underserved markets. HOEPA amended the

meeting, moderated by Governor Randall Kroszner, was the last in a series of five hearings held under HOEPA; the other four hearings were held throughout the nation during the summer of 2006.[3] Representatives from the financial services industry, consumer and community groups, and state agencies participated in the June hearing and shared their perspectives on certain lending practices, such as prepayment penalties, the underwriting of "stated income" loans, and the failure to provide escrow accounts for taxes and insurance.[4] Representatives from the financial services industry acknowledged that some recent lending practices merited concern, but these participants urged the Board to address most of the concerns by issuing supervisory guidance rather than regulations under HOEPA. They suggested that recent supervisory guidance on nontraditional mortgages and subprime lending, as well as corrective measures initiated within the mortgage market, had reduced the need for new regulations. Industry participants said that if the Board issues regulations, they must be clear enough to eliminate uncertainty and avoid unduly restricting credit. To help consumers avoid abusive lending practices, industry representatives supported improving the disclosures provided to consumers during the mortgage process.

Conversely, consumer advocates and state and local officials urged the Board to adopt robust regulations under HOEPA. They acknowledged a useful role for supervisory guidance but contended that recent problems in the mortgage market indicated a need for stronger requirements that can be enforced through civil actions—actions that would only be possible under regulations, not supervisory guidance. Consumer advocates and others welcomed efforts to improve mortgage disclosures but insisted that disclosures alone would not prevent abusive loans. They argued that independent mortgage lenders are not subject to the federal regulators' guidance, and enforcement of the existing laws governing these entities is limited.

In addition to the series of hearings, the Board received information and advice from its Consumer Advisory Council (see "Advice from the Consumer Advisory Council") and from outreach meetings to gain insight into industry practices. These efforts informed the Board's release of proposed amendments to Regulation Z (Truth in Lending) at a public meeting in December.[5] The goals of these proposed amendments are to

- protect consumers in the mortgage market from unfair, abusive, or deceptive lending and servicing practices, while preserving responsible lending and sustainable homeownership;
- ensure that advertisements for mortgage loans provide accurate and balanced information and do not contain misleading or deceptive representations; and

Truth in Lending Act by imposing additional disclosure requirements and other limits on certain high-cost, home-secured loans. Under HOEPA, the Board is authorized to issue rules that prohibit certain acts or practices in connection with home mortgage loans. HOEPA also directs the Board to periodically hold public hearings to examine the home equity lending market and the adequacy of existing regulatory and legislative provisions for protecting the interests of consumers, particularly low-income consumers.

3. For Governor Kroszner's opening comments, see www.federalreserve.gov/newsevents/speech/kroszner20070614a.htm.

4. For a list of panelists and the agenda, see www.federalreserve.gov/newsevents/press/bcreg/20070612a.htm.

5. See www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm.

- provide additional consumer protections on "higher-priced mortgages," mortgages whose annual percentage rate (APR) exceeds the yield on comparable Treasury securities by at least three percentage points for first-lien loans, or five percentage points for subordinate-lien loans.

The proposed rules are comprehensive both in their reach and aim: they would apply to all mortgage lenders, not just depository institutions, and they seek to improve transparency and enhance consumer protection in mortgage lending.

The proposal directly addresses those practices raising the most significant concerns. For higher-priced loans, the proposed rule would prohibit lenders from engaging in a pattern or practice of making mortgage loans on the basis of collateral alone, without considering a borrower's ability to repay the loan; require lenders to verify the income or assets they rely upon in making the loan; and require lenders to establish escrow accounts for taxes and insurance. Prepayment penalties would be permitted on higher-cost loans only under certain conditions. For higher-cost loans and most other mortgage loans secured by a principal dwelling, the proposed rules would prohibit lenders from paying yield-spread premiums to brokers, unless a written agreement between the consumer and broker disclosed the broker's total compensation and other important information; prohibit lenders and brokers from coercing appraisers to misstate a home's value; and require that servicers credit loan payments on the date of receipt and refrain from charging consumers multiple late fees.

With respect to the marketing of home loans, the proposed rules would require lenders to disclose applicable rates or payments in advertisements as prominently as advertised teaser rates. For closed-end loans, the proposed rules would prohibit seven misleading or deceptive advertising practices, for example, using the term "fixed" to describe a rate that is not fixed. The public comment period ends in early April 2008.

Supervisory Activities

Throughout 2007, concerns about the mortgage industry continued to grow. The Board undertook various supervisory activities in collaboration with other agencies to provide guidance to lenders and support to consumers. A comprehensive overview of the Federal Reserve Board's ongoing efforts to address supervisory concerns in the subprime mortgage market was outlined in congressional testimony delivered in March by the director of the Division of Consumer and Community Affairs.[6] In April, the federal financial regulatory agencies jointly issued the "Statement on Working with Mortgage Borrowers" that encouraged institutions to work constructively with residential borrowers who are, or who are reasonably expected to be, unable to make payments on their home loans.[7] The statement emphasizes that loan-workout arrangements are generally in the long-term best interest of both financial institutions and borrowers, provided the arrangement is consistent with safe and sound lending practices. The statement cites examples of constructive workout arrangements; for instance, an institution might modify a borrower's loan terms or move a borrower from a variable-rate to a fixed-

6. See the testimony of Sandra F. Braunstein, March 27, 2007 (www.federalreserve.gov/newsevents/testimony/braunstein20070327a.htm).

7. See www.federalreserve.gov/newsevents/press/bcreg/20070417a.htm (press release) and www.federalreserve.gov/boarddocs/srletters/2007/sr0706.htm (Consumer Affairs letter).

rate loan. In addition, bank and thrift programs that transition low- or moderate-income homeowners from higher-cost loans to lower-cost loans in a safe and sound manner may receive favorable consideration under the Community Reinvestment Act.[8]

In May, the federal bank, thrift, and credit union regulatory agencies issued final illustrations of the information on nontraditional mortgage products that lenders should provide to consumers. The sample illustrations are intended to help institutions implement consumer protections in the "Interagency Guidance on Nontraditional Mortgage Product Risks" that the agencies adopted in October 2006.[9] The consumer protections described in the guidance aim to ensure that consumers receive clear and balanced information about nontraditional mortgages—before they choose a mortgage product or select a payment option for an existing mortgage. Accordingly, the illustrations consist of a narrative explanation of nontraditional mortgage products, a chart comparing interest-only and payment-option adjustable-rate mortgages (ARMs) with a traditional fixed-rate loan, and a table showing the impact of various payment options on the loan balance of a payment-option ARM (such a table could be included in monthly loan statements). Institutions are not required to use the sample illustrations, but the guidance sets forth information that lenders should provide to consumers to allow them to evaluate a nontraditional mortgage loan.

The federal financial regulatory agencies jointly issued additional guidance titled the "Statement on Subprime Mortgage Lending" in June.[10] This guidance describes prudent safety-and-soundness and consumer protection standards that institutions should follow when originating certain ARMs that are typically offered to subprime borrowers. These ARMs offer low initial payments that are based on a short-term fixed introductory rate that is significantly discounted from the fully indexed rate (the sum of the current index and the margin). The statement emphasizes the importance of evaluating a borrower's repayment capacity and ability to make payments under the fully indexed rate, assuming a fully amortizing repayment schedule. The guidance also stresses the need for institutions to consider a borrower's total monthly housing-related payments (that is, principal, interest, taxes, and insurance) when assessing the borrower's repayment capacity, using the borrower's debt-to-income ratio. Finally, the guidance instructs lenders to provide consumers with clear and balanced information on the benefits and risks of this type of ARM.

In September, the federal financial regulatory agencies and the Conference of State Banking Supervisors issued the "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages."[11] The guidance encourages servicers of residential mortgages to pursue strategies to mitigate their losses and seek to preserve homeownership among their borrowers. The statement outlines steps that servicers may pursue to determine if a borrower is at an increased risk

8. For more information, see Q&A §__.22(a)-1 (Interagency Questions and Answers Regarding Community Reinvestment, July 11, 2001).

9. See www.federalreserve.gov/newsevents/press/bcreg/20070531b.htm.

10. See www.federalreserve.gov/newsevents/press/bcreg/20070629a.htm (press release) and www.federalreserve.gov/boarddocs/srletters/2007/sr0712.htm (Consumer Affairs letter).

11. See www.federalreserve.gov/newsevents/press/bcreg/20070904a.htm (press release) and www.federalreserve.gov/boarddocs/srletters/2007/sr0716.htm (Consumer Affairs letter).

of mortgage default. Steps include identifying borrowers who have a heightened risk of delinquency, contacting those borrowers to assess their ability to repay, and determining whether default is reasonably foreseeable. The guidance also presents many possible loss-mitigation techniques that a servicer may initiate with a troubled borrower.

In addition to issuing industry guidance, the Board entered a multiagency partnership to conduct targeted consumer compliance reviews of selected nondepository lenders that have significant subprime mortgage operations.[12] The joint effort, announced in July, is the first time multiple agencies have collaborated to plan and conduct consumer compliance reviews of independent mortgage lenders and nondepository subsidiaries of bank and thrift holding companies, as well as mortgage brokers doing business with, or working for, these entities.

The agencies involved—the Federal Reserve, the Office of Thrift Supervision (OTS), the Federal Trade Commission (FTC), state agencies represented by the Conference of State Bank Supervisors, and the American Association of Residential Mortgage Regulators—have begun developing plans for the targeted consumer compliance reviews. Federal Reserve System examiners, assisted by representatives from the FTC and the states, will lead reviews of entities supervised by the Federal Reserve System. At the same time, state regulators will conduct a coordinated review of an independent state-licensed subprime lender and associated mortgage brokers, and the OTS will conduct a review of a selected mortgage subsidiary of a thrift holding company. These reviews will evaluate the companies' underwriting standards, as well as senior management's oversight of the risk-management practices the companies used to ensure compliance with state and federal consumer protection regulations and laws, including the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Federal Trade Commission Act, and the Home Ownership and Equity Protection Act. The agencies will share information about the reviews and investigations; take supervisory action, as appropriate; collaborate on lessons learned; and seek ways to better cooperate in ensuring effective and consistent reviews of these institutions. By jointly developing and applying a coordinated review program, the regulatory agencies will be better positioned to evaluate and more consistently assess subprime mortgage practices across a broad range of mortgage lenders and other participants within the industry. On-site reviews are scheduled to begin in February 2008.

Community Outreach Efforts

To augment the Board's regulatory and supervisory activities, System community affairs staff engaged in numerous efforts to address the personal, economic, and social distress of homeowners and communities that have been negatively affected by the sharp increases in subprime mortgage loan delinquencies and foreclosures. Community affairs analysts and outreach specialists used their long-standing networks of industry and community relationships to convene local community and business leaders, investors, lenders, servicers, rating agency representatives, government officials, consumer and community groups, and others across the country. To complement these discussions, System research staff collected

12. See www.federalreserve.gov/newsevents/press/bcreg/20070717a.htm.

and analyzed data on real estate and subprime mortgage conditions and on the impact of homeowner counseling programs. The Federal Reserve Bank of Philadelphia began collecting data for a longitudinal study of the effectiveness of homeownership counseling. In a similar but smaller-scale study, the Dallas Reserve Bank began measuring the impact of a local mortgage assistance program. The New York Reserve Bank collected zip code−level data on the incidence of Alt-A and subprime mortgage products in its District. Several other researchers focused on loan workouts and modifications throughout the country. Other key initiatives for the research functions included providing regional foreclosure projections and in-depth analyses of the incidence of defaults within a particular region.

The Board and the Reserve Banks hosted a number of events, conferences, and meetings on foreclosure-related matters in 2007. Many events focused on encouraging lenders and servicers to develop systematic loss-mitigation techniques and to promote coordinated outreach to distressed borrowers. In the twelfth District, the San Francisco Reserve Bank and its partners conducted a series of six forums to explore foreclosure issues and identify strategies for preserving homeownership among minorities and low-income borrowers.[13] The Federal Reserve Bank of Chicago sponsored symposiums in Chicago, Indianapolis, and Detroit that featured discussions on the regional impact of foreclosures. The Cleveland Reserve Bank cosponsored a conference on vacant and abandoned properties, and the Federal Reserve Bank of Minneapolis hosted several events in the Twin Cities area focused on mortgage broker licensing, the need to modernize the foreclosure system, and the differences in state foreclosure laws. The Reserve Banks also organized several public workshops and participated in outreach events to highlight innovative intervention programs. For example, the San Francisco and Dallas Reserve Banks cosponsored a series of mortgage-streamlining workshops to leverage participants' broader knowledge of community development subjects and apply this knowledge to homeownership initiatives for Native Americans.

During the past year, Board and System staff strengthened partnerships with two prominent national homeownership preservation organizations, NeighborWorks America and the Hope Now Alliance. Both groups have mobilized their national networks of affiliates and partners in order to advance efforts to streamline the mortgage-refinancing process and modify subprime mortgages. In 2007, Governor Kroszner continued to serve on the NeighborWorks America board of directors. Members of the Board's staff remain involved with that organization's Center for Homeownership Education and Counseling, which establishes education standards for counseling intermediaries. System community affairs staff collaborated with NeighborWorks America by participating in several foreclosure-prevention training workshops for homeownership counselors; staff also helped promote the 1-888-995-HOPE hotline that links borrowers in financial distress with mortgage counseling. The Atlanta Reserve Bank produced an educational DVD in partnership with NeighborWorks America that addressed the growing foreclosure challenges in its region.

Several Reserve Banks also supported the Hope Now Alliance, a collaboration of counselors, servicers, investors, and other mortgage market participants. Sys-

13. See www.sf.frb.org/community/issues/assets/preservation/index.html.

tem community affairs staff worked with local Hope Now partners and community stakeholders to identify cross-industry technology solutions that would enable servicers and counselors to contact at-risk borrowers and better serve homeowners.

Substantial consumer protection and community development concerns continue to be raised about mortgage lending practices. The Federal Reserve will continue its regulatory, supervisory, and community development efforts to seek ways to protect and support consumers' interests in mortgage credit. The Federal Reserve will also work collaboratively with a broad spectrum of partners to develop strategies and programs that will help troubled homeowners address their mortgage credit difficulties.[14]

Credit Cards

The credit card market is another area of consumer finance that has grown rapidly, spurred by technological advances, new products, and other innovations. Increasingly, electronic payments are accepted for a wide range of transactions, and consumers now use credit cards to facilitate everyday purchases, such as groceries, gasoline, and even a cup of coffee. In 2007, the total level of revolving debt held by consumers increased by nearly 8 percent from 2006, to nearly $944 billion.

Competition in the credit card market has intensified over the last decade. As a result, lenders have undertaken aggressive marketing and product development campaigns and also pursued strategies to rely more on fee-based income. (Previously, lenders had relied almost solely on interest from their customers' account balances for revenue.) These industry developments have significantly elevated concerns about consumer protection; the transparency of credit card pricing; and the adequacy of consumer disclosures in credit card marketing materials, contracts, and periodic statements.[15]

Credit card disclosures are intended to provide consumers with the information they need to shop for the product that best meets their needs and to enable them to make well-informed decisions regarding usage of their cards. However, as credit products became more complex, the Board recognized the need to evaluate its existing regulations governing the content and presentation of information on credit card disclosures. This undertaking required an in-depth understanding of the credit card industry, consumers' information needs, and the way consumers shop for credit cards. Before engaging in rule-writing, the Board undertook extensive consumer testing. Working with a consultant, the Board developed a testing methodology that involved several stages. First, two sets of focus-group meetings were held with credit card customers. The focus groups offered insight on

- what credit terms consumers usually consider when shopping for a credit card,
- what information consumers find useful when they receive a new card in the mail, and
- what information consumers find useful on periodic statements.

14. See the testimony of Governor Randall S. Kroszner, December 6, 2007 (www.federalreserve.gov/newsevents/testimony/kroszner20071206a.htm), and October 24, 2007 (www.federalreserve.gov/newsevents/testimony/kroszner20071024a.htm).

15. See the testimony of Governor Frederic S. Mishkin, June 7, 2007 (www.federalreserve.gov/newsevents/testimony/mishkin20070607a.htm).

The second stage of the consumer testing focused on current credit card disclosures. In one-on-one interviews, credit card customers were presented with mock disclosures. Participants were asked to evaluate the information presented, and an interviewer asked them follow-up questions in order to evaluate the usability of the disclosures and consumers' understanding of them.

Feedback from the second stage was used to develop revised sample disclosures for the third phase of testing. These sample disclosures were tested and refined during multiple interviews with consumers. This process allowed staff to learn more about what information consumers read on current credit card disclosures; to observe how easily consumers can find various pieces of information in these disclosures; and to test consumers' understanding of the terminology used in the disclosures.

The consumer testing process provided important insights into the way consumers shop for credit cards and the information they need to make informed decisions. In particular, staff found that consumers tend to notice numbers rather than narrative text. Consumers frequently reviewed the summary table of rates and terms that they receive with credit card solicitations but paid little attention to densely worded account-opening disclosures and change-in-terms notifications. Likewise, on periodic statements, consumers generally focused on numbers, such as fee and interest charge information. The Board took these findings into account as it began drafting proposed amendments to Regulation Z.

Proposed Amendments to Regulation Z

In May, the Board issued for public comment proposed Regulation Z amendments. The proposal is intended to improve the effectiveness of the disclosures consumers receive in connection with credit card accounts and other revolving credit plans; specifically, the proposal seeks to ensure that such information is provided in a timely manner and in a form that is readily understandable. The proposed amendments would require changes to the format, timing, and content requirements of the five main types of open-end credit disclosures: (1) credit and charge card application and solicitation disclosures; (2) account-opening disclosures; (3) periodic-statement disclosures; (4) change-in-terms notices; and (5) advertising provisions. The proposed amendments largely reflect the results of the consumer testing described above.

The proposal generated a great deal of interest, yielding more than 2,500 comments during the comment period that ended in October. A large number of these comments were submitted by individual consumers. Additional insights were provided by consumer advocates and industry representatives serving on the Board's Consumer Advisory Council. (See "Advice from the Consumer Advisory Council.")

Applications and Solicitations

The proposal contains changes to make the disclosures provided with credit and charge card applications and solicitations more meaningful and easier for consumers to use. Proposed changes include adopting new format requirements for the summary table, including rules regarding type size and the use of boldface type for certain key terms; placement of information; and use of cross-references. The proposed rules address a number of issues regarding the penalties credit and charge card companies may charge customers. For example, applications and solicitations would have to state how long penalty rates may be in effect, provide a modified disclosure about variable rates, describe the effect of creditors' payment-allocation practices, and reference consumer education materials on the Board's website.

Account-Opening Disclosures

The proposal contains revisions to make the cost disclosures provided to consumers at account opening more conspicuous and easier to read. The proposed changes would require that certain key terms be disclosed in a summary table at account opening; this table would summarize the key information consumers need to make informed decisions about how they use credit cards. The proposed changes would also adopt a different approach to disclosing fees, in order to make it easier for consumers to identify the costs associated with using the card.

Periodic-Statement Disclosures

The proposal contains revisions to make the disclosures on periodic statements more understandable, primarily by changing the format requirements for these disclosures—for example, by grouping fees, interest charges, and transactions together by type. Other format changes include itemizing the interest charges for different types of transactions, such as purchases and cash advances, and providing aggregate totals of fees and interest for the month and year-to-date. In addition, creditors would have to disclose to consumers the effect of making only the minimum required payments on their account balances.

Change in Consumer's Interest Rate and Other Account Terms

The proposal expands the circumstances under which consumers will receive written notice of changes in the terms (for example, an increase in the interest rate) applicable to their accounts, and it increases the amount of time these notices must be sent before the change becomes effective. Generally, the proposed rules would increase advance notice before a changed term can be imposed from 15 to 45 days, to better allow consumers to obtain alternative financing or change their account usage. The proposed rules would also require a creditor to provide 45 days' prior notice before increasing a rate as a result of a consumer's delinquency or default.

Advertising Provisions

The proposal revises the rules governing the advertising of open-end credit, to help consumers better understand the credit terms being offered. Under the proposed revisions, advertisements that state a minimum monthly payment on a plan offered to finance the purchase of goods or services would be required to disclose, in equal prominence to the minimum payment, the time period required to pay off the balance and the total of payments if only minimum payments were made. Furthermore, advertisements would be able to refer to a rate as "fixed" only if the advertisement specified the time period for which the rate was fixed and that the rate would not increase for any reason during that time. If a time period is not specified, the term "fixed" may be used only if the rate will not increase for any reason while the plan is open.

Other Regulatory Actions

In addition to proposed rules related to mortgages and credit cards, the Board issued regulatory amendments in 2007 related to the electronic delivery of consumer disclosures, electronic fund transfers, and the privacy of financial information.

Electronic Disclosures

In November, the Board published amendments to five consumer financial services and fair lending regulations (Regulations B, E, M, Z, and DD). The amendments clarify the requirements for providing consumer disclosures in electronic form under the Electronic Signatures in Global and National Commerce Act (the E-Sign Act). Enacted in 2000, the E-Sign Act provides that electronic documents and electronic signatures have the same validity as paper documents and handwritten signatures. The E-Sign Act also contains special rules for the use of electronic disclosures in consumer transactions. Under the act, consumer disclosures that are required by other laws or regulations to be provided in writing may be provided in electronic form if the consumer affirmatively consents after receiving the notice specified in the statute and if certain other conditions are met.

In March 2001, the Board published interim final rules under Regulations B, E, M, Z, and DD that established uniform standards for the timing and delivery of electronic disclosures, consistent with the requirements of the E-Sign Act. The Board later lifted the mandatory compliance date for these rules. As a result, institutions could provide disclosures electronically pursuant to the E-Sign Act but were not required to comply with the 2001 interim rules.

In November, the Board withdrew certain portions of the 2001 interim rules from the Code of Federal Regulations in order to reduce confusion about their status and simplify the regulations. The Board also withdrew other provisions of the 2001 interim rules that might have imposed undue burdens on electronic banking and commerce and that were unnecessary for consumer protection. The November final rules also included guidance on the use of electronic disclosures, including provisions to clarify the circumstances under which consumers conducting transactions online may obtain electronic disclosures without regard to the consent requirements of the E-Sign Act. The mandatory compliance date for the final rules is October 1, 2008.[16]

Regulation E

The Electronic Fund Transfer Act (EFTA) provides a basic framework of rights, liabilities, and responsibilities for participants in electronic fund transfer systems. The EFTA is implemented by the Board's Regulation E (12 CFR 205). In July, the Board published a final rule that exempts transactions of $15 or less from Regulation E's requirement that receipts be made available to consumers for transactions initiated at an electronic terminal. For this purpose, electronic terminals include automated teller machines and point-of-sale terminals. This exception is intended to facilitate the ability of consumers to use debit cards in retail settings where it may not be practical or cost-effective to provide receipts. The rule was effective August 6, 2007.[17]

Fair Credit Reporting Act

In November, the Board published two final rules under Regulation V to implement provisions of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act), which amended the

16. See www.federalreserve.gov/newsevents/press/bcreg/20071101a.htm.

17. See www.federalreserve.gov/newsevents/press/bcreg/20070628a.htm.

Fair Credit Reporting Act (FCRA). First, the Board published final rules to implement the affiliate-marketing-notice and opt-out requirements of section 214 of the FACT Act. The final rules give consumers the ability to limit the use of certain information for marketing purposes by affiliates of companies with which consumers have done business. The final rules also incorporate certain statutory exceptions to the notice and opt-out requirement, including exceptions for when an affiliate has a preexisting business relationship with a consumer or when the marketing is in response to a consumer-initiated communication. The mandatory compliance date for the final rule is October 1, 2008. The affiliate-marketing rules were developed on an interagency basis with the other federal banking agencies, the Federal Trade Commission (FTC), and the Securities and Exchange Commission.[18]

Second, the Board published final rules to implement the identity theft "red flag" provisions of section 114 of the FACT Act and the address-discrepancy provisions of section 315 of the act. The final rules require financial institutions and creditors to develop and implement an identity theft protection program that is designed to detect, prevent, and mitigate identity theft. The final rules also require users of consumer reports to (1) adopt reasonable policies and procedures for verifying the identity of a consumer upon receipt of a notice of address discrepancy from a consumer reporting agency and (2) reconcile the discrepancy when the user opens an account despite the discrepancy and regularly furnishes information to the consumer reporting agency. The mandatory compliance date for the final rule is November 1, 2008. The rules for identity theft red flags and address discrepancies were developed on an interagency basis with the other federal banking agencies and the FTC.[19]

In December, the Board published proposed rules to implement the provisions of section 312 of the FACT Act, which apply to those who furnish information to consumer reporting agencies (furnishers). That section requires the Board to issue guidelines to ensure the accuracy and integrity of information being furnished to consumer reporting agencies. Section 312 also requires the Board to issue rules identifying the circumstances under which furnishers must investigate disputes about the accuracy of information contained in consumer reports based on a direct request from a consumer. The comment period for the proposal will close in February 2008. The furnisher accuracy-and-integrity guidelines and the direct-dispute rules were developed on an interagency basis with the other federal banking agencies and the FTC.[20]

Other Supervisory Activities Related to Compliance with Consumer Protection and Community Reinvestment Laws

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 enforced. (See "Mortgage Credit" earlier in this chapter for a description of the division's supervisory activities related to mortgage lending.) Division staff members provide guidance and expertise to the Reserve Banks on consumer

18. See www.federalreserve.gov/newsevents/press/bcreg/20071025a.htm.

19. See www.federalreserve.gov/newsevents/press/bcreg/20071031a.htm.

20. See www.federalreserve.gov/newsevents/press/bcreg/20071129a.htm.

protection regulations, examination and enforcement techniques, examiner training, and emerging issues. Routinely, staff members develop and update examination policies, procedures, and guidelines; review Reserve Bank supervisory reports and work products; and participate in interagency activities that promote uniformity in examination principles and standards.

Examinations are the System's primary means of enforcing compliance with consumer protection laws. During the 2007 reporting period,[21] the Reserve Banks conducted 324 consumer compliance examinations—312 of state member banks and 12 of foreign banking organizations.[22]

Fair Lending

The Federal Reserve is committed to ensuring that the institutions it supervises comply 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. When examiners find evidence of potential discrimination, they work closely with the division's Fair Lending Enforcement Section, which brings additional legal and statistical expertise to the examination and ensures that fair lending laws are enforced consistently and rigorously throughout the Federal Reserve System.[23]

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.

Pursuant to the ECOA, if the Board has reason to believe that a creditor has engaged in a pattern or practice of discrimination in violation of the ECOA, the matter will be referred to the Department of Justice (DOJ) The DOJ reviews the referral and decides if further investigation is warranted. A DOJ investigation may result in a public civil enforcement action or settlement. The DOJ may decide instead to return the matter to the Federal Reserve for administrative enforcement. When a matter is returned to the Federal Reserve, staff ensures that the institution corrects the problems and makes amends to the victims.

During 2007, the Board referred the following eight matters to the DOJ:

21. The 2007 reporting period for examination data was July 1, 2006, through June 30, 2007.

22. 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.

23. See the testimony of Sandra F. Braunstein, director, Division of Consumer and Community Affairs, July 25, 2007 (www.federalreserve.gov/newsevents/testimony/braunstein20070725a.htm).

- Two referrals involved ethnic and racial discrimination in mortgage pricing by nationwide lenders. These referrals are discussed in more detail below. (See “Evaluating Pricing-Discrimination Risk by Analyzing HMDA Data and Other Information.”)
- One referral involved racial discrimination in the pricing of automobile loans. The institution purchased loans in which auto dealers had charged higher interest rates, through the use of markups, that were based on the race of the borrowers. This pricing was permitted by the lender, who received a share of the markups.
- One referral involved an institution with two loan policies that were found to be discriminatory. One policy prohibited lending on Native American lands. The other policy restricted lending on row houses, which resulted in discrimination against African Americans.
- Four referrals involved discrimination against unmarried people. In one matter, an institution combined incomes for married applicants, but not for co-applicants who were unmarried, when underwriting consumer loans. In another matter, an institution only permitted spousal co-applicants for consumer loans. The institution also improperly required non-applicant spouses to sign mortgage notes. The remaining two referrals involved improper spousal guarantees.

If a fair lending violation does not constitute a pattern or practice that is referred to the DOJ, the Federal Reserve acts on its own to ensure that the bank remedies it. Most lenders readily agree to correct fair lending violations. In fact, lenders often take corrective steps as soon as they become aware of a problem. Thus, the Federal Reserve generally uses informal supervisory tools (such as memoranda of understanding between the bank’s board of directors and the Reserve Bank) or board resolutions to ensure that violations are corrected. If necessary to protect consumers, however, the Board can and does bring public enforcement actions.

Evaluating Pricing-Discrimination Risk by Analyzing HMDA Data and Other Information

The two previously mentioned referrals involving mortgage-pricing discrimination resulted from a process of targeted pricing reviews that the Federal Reserve initiated when Home Mortgage Disclosure Act (HMDA) pricing data first became available in 2005. (See “Reporting on Home Mortgage Disclosure Act Data.”) Board staff developed, and continue to refine, HMDA screens that identify institutions that may warrant further review on the basis of an analysis of HMDA pricing data. Because HMDA data lack many factors that lenders routinely use to make credit decisions and set loan prices, such as information about a borrower’s creditworthiness and loan-to-value ratios, HMDA data alone cannot be used to determine whether a lender discriminates. Thus, the Federal Reserve staff analyzes HMDA data in conjunction with other supervisory information to evaluate a lender’s risk for engaging in discrimination.

For the 2006 HMDA pricing data—the most recent year for which the data are publicly available—Federal Reserve examiners performed a pricing-discrimination risk assessment for each institution that was identified through the HMDA screening process. These risk assessments incorporated not just the institution's HMDA data but also the strength of the institution's fair lending compliance program; past supervisory experience with the institution; consumer complaints against the institution; and the presence of fair lending risk factors, such as discretionary pricing. On the basis of these comprehensive assessments, Federal Reserve staff determined which institutions would receive a targeted pricing review. Depending on the examination schedule, the targeted pricing review could occur as part of the institution's next examination or outside the usual supervisory cycle.

Even if an institution is not identified through HMDA screening, examiners may still conclude that the institution is at risk for engaging in pricing discrimination and may perform a pricing review. The Federal Reserve supervises many institutions that are not required to report data under HMDA. Also, many of the HMDA-reporting institutions supervised by the Federal Reserve originate few higher-priced loans and, therefore, report very little pricing data. For these institutions, examiners analyze other available information to assess pricing-discrimination risk and, when appropriate, perform a pricing review.

During a targeted pricing review, staff analyze additional information, including potential pricing factors that are not available in the HMDA data, to determine whether any pricing disparity by race or ethnicity is fully attributable to legitimate factors, or whether any portion of the pricing disparity may be attributable to illegal discrimination. To perform these reviews, staff use analytical techniques that account for the increasing complexity of the mortgage market. Two industry changes in particular—the proliferation of product offerings and the increased use of risk-based pricing—have increased the complexity of fair lending reviews. It is not uncommon for a lender to offer many different products, each with its own pricing based on the borrower's credit risk.

To effectively detect discrimination in the expanding range of products and credit-risk categories, the Federal Reserve increasingly uses statistical techniques. When performing a pricing review, staff typically obtain extensive proprietary loan-level data on all mortgage loans originated by the lender, including prime loans (that is, not just the higher-priced loans reported under HMDA). To determine how to analyze these data, the Federal Reserve studies the lender's specific business model, pricing policies, and product offerings. On the basis of the review of the lender's policies, staff determine which factors from the lender's data should be considered. A statistical model is then developed that takes those factors into account and is then tailored to that specific lender. Typically, a test for discrimination in particular geographic markets, such as metropolitan statistical areas (MSAs), is performed. Looking at specific markets is important, as relatively small unexplained pricing disparities at the national level can mask much larger disparities in individual markets.

On the basis of the results of pricing reviews conducted, Federal Reserve staff had reason to believe that two nationwide lenders had engaged in a pattern or practice of discrimination and referred these cases to the DOJ. After accounting for legitimate factors reflected in the lenders' specific pricing policies, staff found that minorities still paid more for their mortgages than non-Hispanic white borrowers in multiple MSAs. The first referral involved two of the fair lending risk factors that the agencies have identified and used for some time: (1) broad discretion in pricing by loan officers or brokers and (2) financial incentives for loan officers or brokers to charge borrowers higher prices. The lending institution gave its loan officers discretion to charge overages and underages, that is, to set loan prices higher or lower than its standard rates. The institution also paid loan officers more if they charged overages. The Federal Reserve found evidence that, in multiple MSAs, African American and Hispanic borrowers paid higher overages than comparable non-Hispanic whites.

The second referral involved loans originated through mortgage brokers at which the institution also permitted pricing discretion. In multiple MSAs, African Americans and Hispanics paid higher annual percentage rates than comparable non-Hispanic whites. Pricing discretion and financial incentives to charge borrowers more do not always result in fair lending violations; however, these referrals underscore that it is critical for lenders that permit these practices to have clear policies about their use and to monitor their use effectively.

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 (HMDA's implementing regulation) 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 2006 HMDA data to the public in September 2007.

A December 2007 article published by Federal Reserve staff in the *Federal Reserve Bulletin* uses the 2006 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.[24] The article also analyzed several of the items included in the HMDA data in order to determine their usefulness in predicting mortgage-loan delinquency across metropolitan-area counties. The analysis resulted in several findings, including that the incidence of higher-priced lending and the share of non-owner-occupied loans in a county were both related to higher levels of default in the future.

As in 2004 and 2005, most reporting institutions reported extending few if any higher-priced loans in 2006; 61 percent of the lenders originated less than

24. Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "The 2006 HMDA Data," *Federal Reserve Bulletin*, December 2007 (www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf).

10 higher-priced loans that year. The data also indicate that relatively few lenders accounted for most of the higher-priced loan originations in 2006. Of the nearly 8,900 home lenders reporting HMDA data, 928 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 38 percent of all such loans in 2006. Also as in 2004 and 2005, the majority of all loan originations were not higher priced in 2006; however, the incidence of higher-priced lending did increase from 26.2 percent in 2005 to 28.7 percent in 2006. Some of the increase in the incidence of higher-priced lending is attributed to changes in the interest rate environment from 2005 to 2006, 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 (more than half of these loans are higher priced), 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: 25.3 percent of first-lien conventional home purchase loans were reported as higher-priced in 2006, compared with 45.7 percent of comparable junior-lien loans.

Second, higher-priced lending varies widely by geography. As in 2004 and 2005, 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 2006. In many metropolitan areas in the South, Southwest, and West, 30 percent to 40 percent of the homebuyers who obtained conventional loans in 2006 received higher-priced loans.

Third, the incidence of higher-priced lending varies greatly among borrowers of different races and ethnicities. In 2006, as in 2004 and 2005, African Americans and Hispanics were much more likely than non-Hispanic whites and Asians to receive higher-priced loans. For example, in 2006, 54 percent of African American borrowers, and 47 percent of Hispanic borrowers, received higher-priced conventional home purchase loans, compared with 18 percent of non-Hispanic white and 17 percent of Asian borrowers. 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.”)

Examinations and 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,[25]
- analyzes applications for mergers and acquisitions by state member banks and bank holding companies in relation to CRA performance, and[26]
- disseminates information on community development techniques to bankers and the public through community affairs offices at the Reserve Banks.

The Federal Reserve assesses and rates the performance of state member banks under the CRA in the course of examinations conducted by staff at the twelve Reserve Banks. During the 2007 reporting period, the Reserve Banks conducted 271 CRA examinations of banks: 33 were rated Outstanding, 237 were rated Satisfactory, none was rated Needs to Improve, and one was rated Substantial Noncompliance.[27]

Consumer Alert on Solicitations for CRA Programs

In February, the Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision jointly released a consumer alert about CRA-related solicitations from lenders.[28] This alert cautioned the public about loan solicitations or other offers from lenders or mortgage brokers that offer consumers cash as part of a "Community Reinvestment Act (CRA) Program." The agencies had received numerous consumer complaints and inquiries about this type of solicitation, and the alert warned that the solicitation appears to be a deceptive effort to encourage consumers to apply for a mortgage loan secured by their home. A statement that the agencies do not sponsor or endorse such programs and that the CRA does not require such programs was also included in the alert, along with a warning for consumers to be suspicious about conducting business with lenders who make deceptive claims.

Proposed Interagency Questions and Answers on the CRA

In July, the federal bank and thrift regulatory agencies released for comment a series of new and revised interagency questions and answers on CRA. The agencies are proposing new questions and answers, as well as making substantive and technical revisions to the existing material. Some of the proposed revisions are intended to encourage institutions to work with homeowners who are unable to make their mortgage payments; the questions and answers emphasize that institutions can receive CRA consideration for foreclosure-prevention programs for low- and moderate-income homeowners, consistent with the April 2007 interagency "Statement on Working with Mortgage Borrowers."[29] In addition, several technical changes are being proposed to clarify, update, and improve the readability of existing guidance. A few of the more substantive changes include

- allowing CRA consideration for investments made by banks to minority- or women-owned financial institutions when that investment benefits

25. See the testimony of Sandra F. Braunstein, director, Division of Consumer and Community Affairs, October 24, 2007 (www.federalreserve.gov/newsevents/testimony/braunstein20071024a.htm).

26. See the testimony of Sandra F. Braunstein, director, Division of Consumer and Community Affairs, May 21, 2007 (www.federalreserve.gov/newsevents/testimony/braunstein20070521a.htm).

27. The 2007 reporting period for examination data was July 1, 2006, through June 30, 2007.

28. See www.federalreserve.gov/newsevents/press/other/20070216a.htm.

29. See www.federalreserve.gov/newsevents/press/bcreg/20070417a.htm.

the minority or women-owned financial institution's local community, even if the investment does not benefit the bank's own assessment area;

- providing flexibility to certain intermediate small banks in the evaluation of their home mortgage, small business, and small farm loans; and
- clarifying that an institution that makes a loan or investment in a national or regional community development fund should be able to demonstrate that the fund will benefit the institution's assessment area(s) or the broader statewide or regional area that includes the bank's assessment area(s) as contemplated by the regulation, provided the fund meets certain definition and geographic requirements.

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

During 2007, the Board considered applications for several significant banking mergers. The Board approved two applications by Bank of America Corporation, Charlotte, North Carolina, the second largest depository institution in the United States. The company's acquisition of U.S. Trust Corporation, New York, New York, was approved by the Board in March and its application to acquire ABN AMRO North America Holding Company, Chicago, Illinois, was approved in September. The merger of two historic bank holding companies, The Bank of New York, New York, New York, and Mellon Financial Corporation, Pittsburgh, Pennsylvania, was approved by the Board in June. Several other significant applications are listed below.

- An application by PNC Financial Services Group, Inc., Pittsburgh, Pennsylvania, to acquire Mercantile Bankshares Corporation, Baltimore, Maryland, was approved in February.
- An application by Huntington Bancshares, Inc., Columbus, Ohio, to acquire Sky Financial Group, Inc., Bowling Green, Ohio, was approved in June.
- An application by Wells Fargo & Company, San Francisco, California, to acquire Greater Bay Bancorp, East Palo Alto, California, was approved in August.

The public submitted comments on nine applications, including those mentioned above. Many of the commenters referenced pricing information on residential mortgage loans and concerns that minority applicants were more likely than nonminority applicants to receive higher-priced mortgages. These concerns were largely based on observations of lenders' 2005 and 2006 HMDA pricing data. Other issues raised by commenters involved minority applicants being denied mortgage loans more frequently than nonminority applicants; potentially predatory lending practices by subprime and payday lenders; the potential adverse effects of branch closings; and lenders' failure to address the convenience and needs of low- and moderate-income communities. In addition, the Board also received comments about the adverse effects of increased foreclosures, especially in low- and moderate-income communities.

The Board considered forty-two applications with outstanding issues involving compliance with consumer protection statutes and regulations, including fair lending laws, and the CRA.[30] Thirty-seven of those applications were approved and five were withdrawn, including one with an adverse CRA rating.

30. The forty-two applications do not include the nine protested applications.

Initiatives for Minority-Owned Financial Institutions

The Federal Reserve is committed to ensuring the provision of financial services to all consumers and communities. One of the many ways the Board achieves this goal is by promoting the safety and soundness of all the institutions subject to System supervision, including those that are minority owned. Through its regulatory, supervisory, and community development functions, the Board consistently addresses the unique challenges and needs of minority-owned banks. At the same time, the Board holds these institutions to the supervisory standards that are applied to all state member banks. The Board views this strategy as integral to its efforts to promote a safe, sound, and competitive banking system that also protects consumer interests.

To enhance its support of minority-owned institutions, the Federal Reserve has been developing an innovative and comprehensive training and technical assistance program for minority-owned depository institutions. Designed to address issues that might inhibit or limit the financial and operating performance of minority-owned institutions, the program includes outreach and technical assistance for institution directors. It also fosters relationship-building between institutions and supervisory staff, and raises supervisory awareness of the unique challenges faced by minority-owned institutions. The program is scheduled to be fully operational in 2008.[31]

31. See the speech by Governor Randall S. Kroszner, August 1, 2007 (www.federalreserve.gov/newsevents/speech/kroszner20070801a.htm). See also the testimony of Sandra F. Braunstein, director, Division of Consumer and Community Affairs, October 30, 2007 (www.federalreserve.gov/newsevents/testimony/braunstein20071030a.htm).

Bank Examiner Guidance and Training

Examiner Guidance on Unfair and Deceptive Acts and Practices

Periodically, the Board issues guidance on consumer protection laws and regulations to Reserve Bank examiners. Some guidance is developed and updated in concert with the other federal financial institution regulatory agencies, and some is issued solely by the Board. In 2007, the Board issued examination procedures designed to help examiners determine whether specific acts or practices conducted by state-chartered banks are unfair or deceptive. These procedures incorporate general guidance provided in the March 11, 2004, “Statement on Unfair or Deceptive Acts or Practices (UDAP) by State-Chartered Banks” issued jointly by the Board and the Federal Deposit Insurance Corporation. The Board’s guidance helps examiners analyze potential UDAP issues during a consumer compliance examination or a complaint investigation.

Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervision process. As the number and complexity of consumer financial transactions grow, training for staff that review and examine the organizations under the Federal Reserve’s supervisory responsibility becomes even more important. The consumer compliance examiner training curriculum consists of six courses focused on various consumer protection laws, regulations, and examination concepts. In 2007, these courses were offered in eleven sessions to more than 193 consumer compliance examiners and System staff members.

Board and Reserve Bank staff regularly review the core curriculum for examiner training, updating subject matter and adding new elements as appropriate. During 2007, staff conducted a curriculum review of the Introduction to Consumer Compliance Examinations I (CA I) course to incorporate technical changes in policy and laws, along with changes in instructional delivery techniques. This course, designed for assistant examiners, focuses on the (1) consumer laws and regulations that govern operations and non−real estate lending and (2) regulations affecting deposit and non−real estate lending operations. The course emphasizes examination techniques and procedures that demonstrate the practical application of these laws and regulations.

When appropriate, courses are delivered via alternative methods, such as the Internet or other distance-learning technologies. The CA I course 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.

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.

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. Moreover, 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 civil money penalties are payable to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2007, the Board imposed civil money penalties against eight state member banks. The penalties, which were assessed via consent orders, totaled $246,050.

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 and the FFIEC member agencies (collectively, the FFIEC agencies), as well as other federal enforcement agencies.[32]

Regulation B (Equal Credit Opportunity)

The FFIEC agencies reported that 85 percent of the institutions examined during the 2007 reporting period were in compliance with Regulation B, com-

32. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2007 reporting period was July 1, 2006, through June 30, 2007.

pared with 87 percent for the 2006 reporting period. The most frequently cited violations involved

- the failure to properly collect information for monitoring purposes, including the race, ethnicity, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- the improper collection of information on an applicant's race, color, religion, national origin, or sex when not permitted by regulation
- the improper requirement of the signature of an applicant's spouse or other person, other than a joint applicant, when the applicant qualified under the creditor's standards of creditworthiness for the amount and terms of the credit requested
- the failure to provide a written notice of denial or other adverse action to a credit applicant that contains the specific reason for the adverse action, along with other required information

During this reporting period, the OTS issued two supervisory agreements and one cease-and-desist order to a savings association for 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 specific 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 Regulation B violations involving the improper collection of government monitoring information.

Regulation E
(Electronic Fund Transfers)

The FFIEC agencies reported that approximately 94 percent of the institutions examined during the 2007 reporting period were in compliance with Regulation E, compared with 95 percent in the 2006 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

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

The Federal Trade Commission (FTC) settled charges against one corporation that falsely marketed products and debited consumer accounts without obtaining consumers' authorization for preauthorized electronic fund transfers, in violation of Regulation E. The FTC also continued litigation against a group of defendants for allegedly enrolling consumers in a program and automatically billing them for charges without obtaining authorization for the recurring debits.

Regulation M (Consumer Leasing)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2007 reporting period were in compliance with Regulation M, which equals the level of compliance for the 2006 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 97 percent of the institutions examined during the 2007 reporting period were in compliance with Regulation P, compared with 98 percent for the 2006 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 82 percent of the institutions examined during the 2007 reporting period were in compliance with Regulation Z, compared with 85 percent for the 2006 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- accurately disclose the finance charge in closed-end credit transactions
- accurately disclose the amount financed, by subtracting any prepaid finance charge from the amount financed
- accurately disclose the payment schedule, including the number, amounts, and timing of payments scheduled to repay the obligation
- ensure that disclosures reflect the terms of the legal obligation between the parties

In addition, 185 banks supervised by the Federal Reserve, FDIC, OCC, and OTS were required, under the Interagency Enforcement Policy on Regulation Z, to reimburse a total of approximately $2.75 million to consumers for understating the annual percentage rate or the finance charge in their consumer loan disclosures.

The OTS issued two supervisory agreements and two cease-and-desist orders 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 specific to

Regulation Z during the reporting period.

The Department of Transportation continued to prosecute one air carrier for its improper handling of credit card refund requests and other Federal Aviation Act violations.

The FCA identified creditors that were using incorrect templates, resulting in violations of Regulation Z. While all required disclosures were made, the format of the disclosures was not consistent with regulatory requirements.

The FTC continued litigation in federal district court against a mortgage broker for alleged violations of Regulation Z; the alleged violations involved the broker's advertisements and finance-charge disclosures.

Regulation AA (Unfair or Deceptive Acts or Practices)

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2007 reporting period were in compliance with Regulation AA, which equals the level of compliance for the 2006 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 90 percent of institutions examined during the 2007 reporting period were in compliance with Regulation CC, compared with 92 percent for the 2006 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, which included Regulation CC. The other FFIEC agencies did not issue any formal enforcement actions specific to Regulation CC during the reporting period.

Regulation DD (Truth in Savings)

The FFIEC agencies reported that 88 percent of institutions examined during the 2007 reporting period were in compliance with Regulation DD, compared with 91 percent for the 2006 reporting period. The most frequently cited violations involved the failure to take one or more of the following actions:

- provide a statement that fees could reduce the earnings on an account, when the term "annual percentage yield" is used in an advertisement
- use the term "annual percentage yield" if an advertisement states a rate of return
- provide initial account disclosures containing all required information
- provide adequate subsequent account disclosures for time accounts that have maturities greater than one year

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

Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards those that involve other creditors and businesses to the appropriate enforcement agency. Each Reserve Bank investigates complaints against state member banks in its District. In 2007, the Federal Reserve received 1,540 consumer complaints concerning regulated practices by state member banks.

In November, the Federal Reserve System launched Federal Reserve Consumer Help (FRCH), an initiative that consolidates and streamlines the Federal Reserve's process for handling consumer complaints and inquiries. FRCH improves consumers' access to the Federal Reserve by providing a convenient, one-stop website and a toll-free number where consumers can get assistance with their banking problems or questions. (See related box "The Federal Reserve Consumer Help Center.")

Under the direction of the Federal Financial Institutions Examination Council (FFIEC), an interagency working group was formed in late 2007 to explore ways to improve consumers' experiences with contacting a banking agency and with submitting a complaint or inquiry to the appropriate regulator. A third-party contractor may be used to examine best practices and recommend improvements to the process consumers use to file a complaint or inquiry with one of the FFIEC agencies.[33]

Complaints Against State Member Banks

The majority (61 percent) of complaints about regulated practices involved credit cards. The most common credit card problem fell into the complaint category called "other rates/terms/fees" (35 percent), followed by problems with billing-error resolution (19 percent) and banks' providing inaccurate account information (8 percent).[34]

Complaints about checking accounts were the next largest category (19 percent) of complaints about regulated practices. The most common checking account concerns were insufficient-funds or overdraft charges and procedures (30 percent), funds availability (14 percent), and disputed withdrawals of funds by banks (13 percent).

Real estate–related complaints made up 5 percent of complaints involving regulated practices.[35] Of those, only 4 percent (or three complaints) concerned adjustable-rate mortgages. The most common real estate–related loan problems concerned escrow accounts (15 percent); other rates, terms, or fees (11 percent); and errors or delays in crediting loan payments (10 percent). Of all complaints involving regulated practices, 13 (0.8 percent) alleged discrimination on a basis prohibited by law (race, color, religion, national origin,

33. FFIEC agencies represented on the working group are the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. Representatives from the Conference of State Bank Supervisors are also participating.

34. Includes complaints about interest rates, terms, or fees other than late fees, overlimit fees, prepayment fees, fees related to credit insurance, or the calculation of the finance charge.

35. Includes adjustable-rate mortgages; residential construction loans, open-end home equity lines of credit, home improvement loans, home purchase loans, home refinance or closed-end loans; and reverse mortgages.

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).

Complaint investigations determined that banks had handled customers' accounts in accordance with Federal Reserve regulations in the majority (96 percent) of the complaints reviewed. Investigations for the remaining 4 percent determined that the bank had violated a consumer protection regulation. The most common violations involved credit cards and checking accounts. (See tables.)

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 2007, the Board received more than 2,000 complaints against state member banks that involved unregulated practices. The product categories that contained the most complaints were credit cards and checking accounts. In those categories, consumers most frequently complained about fraud, forgery, or theft (216 complaints); problems with opening or closing an account (196 complaints); issues involving insufficient-funds or overdraft charges and procedures (190 complaints); and certain credit card interest rates, terms, and fees (129 complaints).

Consumer Complaints against State Member Banks That Involve Regulated Practices, by Classification, 2007

Classification	Number
Regulation AA (Unfair or Deceptive Acts or Practices)	85
Regulation B (Equal Credit Opportunity)	62
Regulation C (Home Mortgage Disclosure)	1
Regulation E (Electronic Fund Transfers)	98
Regulation H (Bank Sales of Insurance)	2
Regulation M (Consumer Leasing)	3
Regulation P (Privacy of Consumer Financial Information)	35
Regulation Q (Payment of Interest)	3
Regulation Z (Truth in Lending)	761
Regulation BB (Community Reinvestment)	6
Regulation CC (Expedited Funds Availability)	123
Regulation DD (Truth in Savings)	124
Regulations T, U, and X	0
Regulation V (Fair and Accurate Credit Transactions)	13
Fair Credit Reporting Act	138
Fair Debt Collection Practices Act	64
Fair Housing Act	1
Flood Insurance	1
Homeownership Counseling	2
HOPA (Homeowners Protection Act)	1
Real Estate Settlement Procedures Act	15
Right to Financial Privacy Act	2
Total	**1,540**

Complaints against State Member Banks That Involve Regulated Practices, 2007

Subject of complaint	All complaints		Complaints involving violations	
	Number	Percent	Number	Percent
Total	**1,540**	**100**	**53**	**3**
Discrimination alleged	13			
Real estate loans	1	.1	0	0
Credit cards	8	.5	0	0
Other loans	4	.3	0	0
Nondiscrimination complaints, total[1]	1,527[1]			
Credit cards	939	61	39	3
Checking accounts	295	19	13	.8
Real estate loans	80	5	0	0

1. Only the top three product categories of nondiscrimination complaints are listed here.

The Federal Reserve Consumer Help Center: A New Resource for Expert, Immediate Help

Credit cards, mortgages, and electronic funds transfers are just a few of the services and products consumers use to conduct their financial business. The use of these products and services has become widespread, and it can be easy to lose sight of their complexity—until a consumer has a question or something goes wrong. Consumers often need help navigating the maze of terminology, regulations, and policies that governs financial products, services, and institutions. For more than 30 years, the Federal Reserve System has provided professional help to consumers who have complaints against a financial institution. In 2007, the Federal Reserve launched the Federal Reserve Consumer Help (FRCH) center, a centralized consumer complaint center that improves consumers' access to information and services. The FRCH website (www.federalreserveconsumerhelp.gov) provides comprehensive information on consumer financial issues, as well as contact information. Consumers can use the site to research their issue, or they may contact the Federal Reserve to ask a question or file a complaint via e-mail, a toll-free number, fax, or mail.

Consumer complaints are an important source of information for the Federal Reserve Board. Regardless of their outcome, complaints often identify areas of concern that the Board considers when writing regulations or guidance for bank examiners. Complaints can also reveal emerging consumer-protection issues and trends in banking practices. The Federal Reserve established its program for receiving consumer complaints and inquiries in 1976. Drawing on the resources of the Federal Reserve System's twelve Reserve Bank Districts, the program answers consumers' questions, investigates complaints against state member banks (those institutions under the Federal Reserve's supervisory authority), or refers consumers to the appropriate agency for a response. In addition, the Board responds to issues raised by congressional representatives on behalf of their constituents. Over the last decade, the consumer financial services marketplace has dramatically changed. Technological developments and increased access to technology have also changed both the way institutions operate and how consumers want to communicate with financial

Complaint Referrals to HUD

In 2007, the Federal Reserve received one housing-related discrimination complaint and forwarded it to HUD in accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies regarding complaints alleging a violation of the Fair Housing Act. The Federal Reserve's investigation of this complaint revealed no evidence of illegal credit discrimination.

Responding to Community Economic Development Needs in Historically Underserved Markets

The mission of the community affairs function within the Federal Reserve System is to promote community economic development and fair access to credit for low- and moderate-income communities and populations. As a decentralized function, the Community Affairs Offices (CAOs) at each of the twelve Reserve institutions and others. In 2007, the Federal Reserve responded to these forces by launching FRCH, while continuing to tap staff expertise and knowledge of regional banking markets.

The Federal Reserve is committed to providing superior service to consumers. The call center is staffed by highly trained professionals; 80 percent of incoming calls or e-mail inquiries are answered by a representative within 60 seconds or less. Complaints against banking institutions supervised by the Federal Reserve continue to be investigated by the Reserve Bank responsible for examining the institution in question. This approach ensures that complaints are investigated by examiners who are knowledgeable about an institution and its regional banking market—and who can leverage the bank-supervisor relationship to resolve an issue. If a consumer has a complaint against an institution not supervised by the Federal Reserve, FRCH can seamlessly connect him or her with the appropriate agency.

FRCH tracks all incoming questions and requests for assistance, by issue and volume. Data will be shared with the other federal banking regulatory agencies. The Federal Reserve and other agencies analyze the data so that they can identify shared issues, develop best practices for customer service and complaint investigation, and develop consumer education materials. Such collaboration is critical to addressing consumer protection issues in the broader financial services marketplace and developing consumer information materials to educate consumers about trends in banking products and their rights. In addition, FRCH is establishing a mechanism for tracking customer satisfaction, that is, whether consumers feel the center helped them with their financial services issues.

Early reviews of available data on FRCH call volume and website visits indicate that consumers are contacting the the Federal Reserve in record numbers. The Federal Reserve is dedicated to providing superior access to consumers who need assistance and will continue to monitor the performance of FRCH, with the goal of identifying further opportunities to help consumers exercise their rights and work through their financial services challenges. The Federal Reserve plans to launch a Spanish-language version of the website in the first quarter of 2008.

Banks design activities in response to the needs of communities in the Districts they serve, with oversight from Board staff. 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 high-priority efforts; in particular, Board community affairs staff focus on issues that have public policy implications.[36]

In 2007, disruptions in the housing market made collaboration among the financial services community, the Board, and the Reserve Banks impera-

36. See www.federalreserve.gov/communitydev/default.htm.

tive. The CAOs worked diligently to identify solutions that would help mitigate the adverse consequences of the increasing numbers of mortgage defaults and foreclosures in many Districts. (See "Mortgage Credit.") System staff also continued work on a number of important topics: improving the sustainability and financial capacity of community development organizations, creating asset-building opportunities for low- and moderate-income populations, and developing programs to promote community development and consumer education. Activities included conducting research, sponsoring conferences and seminars, publishing newsletters and articles, and supporting the dissemination of information to both general and targeted audiences.

System Collaborative Efforts

The Reserve Banks and the Board continued their work on two substantial collaborative efforts over the past year. The first effort, an initiative undertaken by System Community Affairs staff and the Brookings Institution, analyzes and compares communities that have high concentrations of poverty. Using sixteen case studies from selected communities, the project employs both quantitative and qualitative analyses to explore the dynamics of the communities, their residents, their economies, and programs that are helping or hindering a community's integration into the economic mainstream. The data generated by this ongoing initiative help Reserve Banks, local financial institutions, business leaders, service providers, and philanthropic organizations better understand their regional economies and the capital and credit needs of the communities they serve.

The second major collaborative effort in 2007 was the Community Affairs System Research Conference, "Financing Community Development: Learning from the Past, Looking to the Future," cosponsored by the Board and the Federal Reserve Bank of Philadelphia. The conference brought together a diverse audience from academia, financial institutions, community organizations, foundations, and the government. Approximately 400 participants learned about and discussed original studies on the opportunities and obstacles to helping low- and moderate-income communities and people build wealth by using home loans, small business loans, or other financial services. System community affairs staff were actively involved in the planning and execution of the conference: staff reviewed papers, developed the agenda, presented research, and served as moderators and participants in formal discussion groups. The Board's Community Affairs officer delivered a keynote address during the conference, and Chairman Ben Bernanke provided remarks on the history, evolution, and new challenges of the Community Reinvestment Act.[37]

Identifying Strategies to Enhance Access to Community Development Financing and Asset-Building

In 2007, Community Affairs staff from around the System continued working on several initiatives to not only enhance access to affordable credit in currently underserved markets but also to provide information and promote awareness of investment opportunities to financial institutions, government agencies, and organizations. The St. Louis Reserve Bank hosted "Exploring Innovation: A Conference on Community

37. See www.federalreserve.gov/newsevents/speech/bernanke20070330a.htm.

Development Finance" to explore how organizational creativity, learning, and innovation can improve community development projects, increase their access to capital, and help projects achieve scale and sustainability. The San Francisco Reserve Bank's Center for Community Investments hosted two conferences focused on community development investment. One conference, which was cosponsored with the Board, focused on the availability of rural venture capital; the other, cosponsored with the New York Reserve Bank, discussed issues related to the creation of a secondary market for community development loans. Other Reserve Banks hosted symposiums on this topic as well, such as the Federal Reserve Bank of Richmond's Community Development Financial Institution (CDFI) workshops that gathered community development lenders, local bankers, and representatives from the CDFI Fund to discuss capitalizing and certifying potential CDFIs. The Federal Reserve Bank of Boston and the Aspen Institute, a national research and leadership development organization, cohosted a conference on socially responsible investment and the role of subsidy dollars in public investment. In a related initiative, the Boston Reserve Bank collaborated with the Massachusetts Small Business Assistance Advisory Council on the launch of a loan program for small businesses.

Asset-building and financial education remained major areas of focus for the Community Affairs Offices in 2007. System staff continued to collaborate with constituent organizations on efforts to provide advisory services and conduct outreach to low- and moderate-income communities. The Federal Reserve Bank of Atlanta worked with the Federal Deposit Insurance Corporation to create MoneySmart curriculum modules on low-income investment. The Kansas City Reserve Bank cosponsored a major conference on entrepreneurship with the Association for Enterprise Opportunity. Together with the San Francisco and Minneapolis Reserve Banks, the Kansas City Reserve Bank also continued work on several Indian country initiatives focused on improving the financial literacy and housing options of Native Americans. The three Banks continued to promote the adoption of uniform commercial codes to facilitate tribes' efforts to borrow from off-reservation partners or other tribes. The Federal Reserve Bank of Dallas engaged in efforts to promote financial education in the workplace, including sponsorship of a highly successful seminar for human resource professionals attended by approximately 80 employers, who in turn represented 380,000 employees. The Richmond Reserve Bank released two issues of its journal *MarketWise*, one which featured an article on the earned-income tax credit (EITC). The New York Reserve Bank cosponsored a conference with the New York City Office of Financial Empowerment that promoted the EITC. As a result of the conference, a statewide coalition of EITC practitioners was created, and several statewide asset-building strategies for low- and moderate-income communities were adopted.

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.”) Among other issues, council discussions in 2007 focused on two significant topics:

- various issues related to mortgage lending, specifically the Board’s rulemaking authority under the Home Ownership and Equity Protection Act (HOEPA) to address concerns about abusive lending practices in the home mortgage market, and concerns about foreclosures and the subprime lending market
- proposed amendments to Regulation Z that would revise the disclosure requirements for credit card accounts and other open-end (revolving) credit plans that are not secured by a borrower’s home

Mortgage Lending Issues

HOEPA

In its June and October meetings, the council addressed several issues related to the Board’s rulemaking authority under HOEPA: whether the Board should issue rules or guidance, the possibility of prohibiting or restricting certain loan terms or practices in subprime loans, the definition of “subprime,” and the role and timing of the disclosures provided to consumers during the loan-making process.

Several consumer representatives strongly supported issuing rules under HOEPA rather than guidance. Consumer representatives expressed the view that guidance puts supervised institutions at a competitive disadvantage to other mortgage lenders that do not have to comply with guidance. Rules, however, would apply to all mortgage lenders, not just federally supervised institutions. Consumer representatives noted that rules would also provide consumers with a private right of action. Several members stated that rulemaking may be appropriate for areas in which the Board can establish clear, bright lines for regulatory supervision but that guidance is the best way to ensure that institutions have appropriate flexibility to meet consumers’ needs.

In considering whether proposed rules on mortgage lending should apply to the subprime mortgage market, council members generally urged the Board to define “subprime” not by borrower characteristics but according to the type of loan or its terms, such as a loan’s annual percentage rate. An industry member endorsed the definition of “subprime” that the Board used in earlier guidance and cautioned against using Home Mortgage Disclosure Act (HMDA) standards as a pricing criterion for subprime loans, because the HMDA standards may not capture all subprime loans.

Several members urged the Board to ban prepayment penalties, particularly for subprime loans. They expressed concerns that, for subprime borrowers, prepayment penalties are not balanced by lower interest rates and often prevent borrowers from graduating into prime loans. Other members acknowledged problems with using prepayment penalties in the subprime market but said the penalties can be a useful tool and yield lower interest rates for consumers. These members urged the Board to regulate prepayment penalties to ensure that borrowers receive a choice about whether to have a prepayment penalty, which may result in a lower interest rate for them. A consumer representative suggested that prepayment penalties for adjustable-rate mortgages should expire 60 days before the first interest-rate reset on such a loan.

Council members generally agreed that it is a sound underwriting practice to require borrowers to make monthly payments to escrow accounts for taxes and insurance, as loans that include escrow payments generally perform better. There was also consensus on the importance of clearly disclosing whether an advertised payment amount includes a borrower's taxes and insurance. Recognizing the financial vulnerability of subprime borrowers, members generally agreed that the Board should mandate that escrow accounts be established for subprime loans. Some members suggested that escrow accounts should not be required for borrowers who take out prime loans. Members had a variety of views about initially mandated escrow accounts that borrowers could later opt out of. Both consumer and industry representatives generally agreed that any opt-out decision should not be made at loan closing and that clear disclosure of any escrow requirement and opt-out provision is paramount.

Several council members commented on the need for stated-income loans, especially in immigrant communities and for borrowers who engage in cash transactions or are otherwise not connected with mainstream financial institutions. The members emphasized the importance of sound, responsible underwriting for stated-income loans and urged that lenders be given flexibility to use nontraditional, third-party forms of income documentation. Some members highlighted the importance of providing borrowers with clear disclosures for stated-income loans to ensure that these borrowers are aware they may not be receiving the lowest rate for which they qualify.

Council members generally agreed that the Board should require lenders to ensure borrowers' ability to repay a loan for a reasonable term by underwriting the loan to the fully indexed rate. Some members commented that such a standard would also benefit investors by giving them greater assurance about the quality of the loans they are purchasing. Members disagreed about the length of time for which ability to repay should be considered. Some industry representatives cautioned that setting too strict a standard could inappropriately restrict access to credit.

Members agreed on the importance of providing consumers with simplified, plain-language disclosures for mortgage products. Several members identified key terms that should be clearly and concisely disclosed. Some members expressed concern, however, that simplified disclosures may not sufficiently inform borrowers about the more complex or exotic mortgage products being offered; they suggested such products may require a different type of disclosure. Some members supported a requirement that Truth in Lending Act (TILA) disclosures be provided earlier in the loanmaking process for nonpurchase mortgage loans. They also emphasized that TILA disclosures should accurately reflect the terms of the transaction.

In a discussion of yield-spread premiums (YSPs), several members stated that many consumers do not know about YSPs or understand how they work. Members agreed on the importance of providing borrowers with transparent YSP disclosures. Several consumer representatives expressed concern about abusive practices related to YSPs; for example, a consumer may receive a higher interest rate because his or her mortgage broker has an agreement to receive a YSP from a certain lender, or some lenders may combine YSPs and discount points, resulting in higher fees for borrowers. An industry member expressed the view that banning YSPs would hurt small broker businesses by eliminating a key source of their compensation and would put small loan originators at a competitive disadvantage to large lenders, thereby leaving consumers with fewer choices in the marketplace.

Foreclosures and Subprime Lending Issues

At its March meeting, the council discussed the recent increase in home foreclosures in a number of markets across the country. Several members described the impact of defaults and foreclosures on their communities: large concentrations of abandoned and vacant properties and the associated need to enhance policing efforts and other city services, a rise in homelessness, decreasing property values, and declining tax revenues for local governments. Some members noted a disproportionate concentration of foreclosures in communities that are predominately Latino or African American; members also shared concerns about foreclosure "rescue" scams and the "flipping" of previously foreclosed homes, and they stressed the importance of having community-based organizations coordinate and manage rescue funds for homeowners facing foreclosure. Members discussed possible ways to assist households facing default or foreclosure. Several consumer representatives described the difficulty credit counselors face when they try to contact servicers on behalf of borrowers. Members also noted the challenges associated with restructuring mortgages that have been securitized.

Members commented on the proposed statement on subprime mortgage lending issued by the federal financial regulatory agencies in March. The proposal addressed concerns that (1) subprime borrowers may not fully understand the risks and consequences of products like adjustable-rate mortgage loans and (2) these products may pose an elevated risk to financial institutions. Most members supported the guidance. Several members voiced approval for the provision recommending that lenders underwrite a loan at its fully indexed rate. They were also supportive of the recommendation that a loan's underwriting include an escrow component for taxes and insurance. Some members supported extending the principles of the guidance to prime mortgage lending, but others noted possible difficulties to segmenting the mortgage market in this way. Several members shared concerns that applying the guidance to prime loans might reduce the variety of loan products available to consumers. Members representing the financial services industry questioned whether the guidance might lead to the creation of a loan-suitability standard, that is, a requirement that lenders gauge the suitability of a loan product for certain borrowers. Industry members generally thought such a standard could limit the array of loan products available to consumers. Several members emphasized the need for a new Federal Housing Administration loan product that could meet the needs of subprime borrowers.

Credit Cards

In May, the Board issued proposed amendments to Regulation Z, which implements the Truth in Lending Act, that would affect the content, format, and timing of credit card disclosures. The council's discussions in June and October focused on several dimensions of the proposal: the summary table, or "Schumer box," for application and solicitation disclosures; account-opening disclosures; periodic statements; and change-in-terms notices.

Several members commended the Board for proposed revisions to the Schumer box. By highlighting key information on credit card terms, the revisions would facilitate consumers' ability to compare different credit cards, members said. Several consumer representatives urged the Board to include a "typical APR" in the Schumer box. This APR would include the fees that consumers typically pay during a billing cycle and could alert them to the potential costs of using the credit card. A typical APR would also allow consumers to compare the fees different cards charge. Several industry members objected to the idea of a typical APR, however, expressing concerns that such a rate would be misleading and unhelpful, as many fees are not necessarily incurred by every consumer. Industry representatives supported the disclosure of fees in dollar amounts rather than as a percentage of the balance, noting that the Board's consumer testing found that consumers more readily understand dollar amounts than percentages. Several consumer representatives commended the Board for proposing a disclosure to inform consumers about the amount of available credit if the account-opening fees are 25 percent or more of the credit limit, as is sometimes the case with subprime credit cards.

For account-opening disclosures, members generally supported the Board's proposal to require a summary table similar to the Schumer box. They noted that a summary would make it easy for consumers to compare the actual account terms with those they were originally offered. Some industry and consumer representatives disagreed about the proposal to allow the verbal disclosure of some fees at the time a consumer incurs a charge, instead of relying on account-opening disclosures to disclose all fees.

Members generally approved of the new format for periodic statements, particularly the clear grouping of fees and the year-to-date totals for interest charges and fees. They noted the importance of highlighting the late-payment notice by requiring its placement on the front of the statement and emphasized the importance of clearly disclosing day and time deadlines for payments (that is, the cutoff before late-payment charges apply). Several consumer representatives stated that the effective APR disclosure should be retained because it more accurately accounts for the total cost of credit. Industry representatives, however, expressed their preference for eliminating the effective APR disclosure on the basis that, even with the change in labeling, the figure is confusing to consumers. The industry members stated that the proposed year-to-date totals for interest and fees represent the most meaningful disclosure to consumers of the total cost. Several members commended the Board on its use of consumer testing to develop the credit card disclosures and urged the Board to continue using both qualitative and quantitative testing as it determines how best to communicate complicated financial terms to consumers.

For change-in-terms notices, several consumer representatives expressed support for requiring 45 days' advance notice for rate increases triggered by a consumer's default or delinquency. They emphasized that advance notice will give consumers the opportunity to pursue other credit options. Industry representatives disagreed with providing a 45-day advance notice of increased rates when the increase is prompted by consumer default. They noted that default pricing is properly disclosed to consumers at account opening and that the triggering of a default rate by a consumer's action does not constitute a change in terms. Industry representatives expressed support for 45 days' advance notice of charges or changes in terms that have not been previously disclosed. Several industry representatives opposed having an opt-out when a rate increase is prompted by default or delinquency, but they supported a consumer's right to opt out in other cases.

The council also discussed credit card issuers' practice of offering a 0 percent APR for consumers' balance transfers from other credit cards and a higher APR for purchases. Typically, issuers then typically allocate consumers' payments to balances that have the lowest APR—allowing high-APR balances to remain high. Several consumer representatives urged the Board to prohibit policies that apply all payments to the lowest-rate balance first, noting that many consumers do not understand how such low-APR products work. Several industry representatives expressed the view that such payment-allocation methods are appropriate business practices and that consumers benefit from low-APR cards because they receive an interest-free loan for a certain period of time. Industry representatives did acknowledge the need for better disclosures.

There was consensus among council members on what they consider to be best practices for due dates on credit card payments: if creditors do not receive mail or post payments on weekends or holidays, then payments that arrive on those days should be posted on the next business day and should be credited as on time if the due date fell on that weekend or holiday. Similarly, a payment that has a weekend or holiday due date should be credited as on time if it is received on the next business day.

Other Issues

At their March meeting, council members discussed additional topics, including model privacy notices, proposed amendments to Regulation E, and several aspects of Regulation CC.

To comply with their disclosure obligations on the sharing of consumer information under the Gramm-Leach-Bliley Act, financial institutions may use the model privacy form developed jointly by the federal financial regulatory agencies and the Federal Trade Commission. Members generally commended the agencies for the proposed form, noting that the prototype was a marked improvement over current privacy notices because it is clearer and easier to navigate—and thus makes it easier for consumers to compare different privacy policies. Some industry representatives expressed concerns that the form did not sufficiently address additional notice and opt-out requirements that may exist under state laws; they urged the agencies to preempt state privacy law requirements. Institutions may not use the form if they lack confidence that doing so would satisfy their obligations under state laws, industry representatives said.

The council provided feedback on proposed amendments to Regulation E, which implements the Electronic Fund Transfer Act, that would eliminate the receipt requirement at point-of-sale and other electronic terminals for debit card transactions of $15 or less. Members acknowledged that consumers increasingly use credit and debit cards for small-dollar transactions but disagreed about whether receiving a receipt helps consumers manage their finances. Industry members generally expressed the view that consumers receive minimal benefit from receipts for small-dollar transactions. They noted that consumers would continue to receive information about each of their transactions on periodic statements. Several consumer representatives opposed the Board's proposal, stating that receipts are an important tool to help consumers accurately track their transactions, obtain reimbursements, and provide documentation in a dispute. Several industry representatives expressed concern that the costs associated with providing terminal receipts for debit card transactions are burdensome and impede industry efforts to create cashless payment options in certain retail settings. Consumer representatives generally regarded the proposed $15 threshold as too high. Industry representatives, however, suggested that the threshold should be increased to $25, consistent with current credit card rules that waive requirements for authorization by signature or personal identification number for transactions less than this amount.

Members discussed several aspects of Regulation CC, which governs the availability of funds deposited in checking accounts and the collection and return of checks. They focused particularly on scams involving fraudulent checks and on the exception-hold practices that financial institutions can use to protect themselves and their customers from these scams. Members expressed concern that the brief hold periods permitted under Regulation CC for certain checks may impede financial institutions' ability to conduct appropriate due diligence. Several industry representatives emphasized the importance of cooperation and information-sharing among financial institutions when an institution has concerns that a check may be fraudulent. Some members suggested that enhanced enforcement to require a paying institution to return a check item promptly could be helpful in this process. Others recommended that the federal financial regulatory agencies standardize and coordinate fraudulent-check alerts rather than issue separate alerts. Members highlighted the importance of education to increase awareness of fraudulent-check issues among both financial institution employees and consumers. ■

Federal Reserve Banks

In addition to contributing to setting 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.[1] The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).[2] Over the past ten years, the Reserve Banks have recovered 99.1 percent of their priced services costs, including the PSAF (table).[3]

In 2007, the Reserve Banks recovered 101.9 percent of total costs of $993.7 million, including the PSAF.[4] Revenue from priced services amounted to $878.4 million, other income was $133.8 million, and costs were $913.3 million, resulting in net income from priced services of $98.9 million.

1. Financial data reported throughout this chapter—revenue, other income, cost, income before taxes, and net income—can be linked to the pro forma financial statements at the end of this chapter.

2. 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 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.

3. Effective December 31, 2006, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, which has resulted in the recognition of a $237.9 million reduction in equity related to the priced services' benefit plans through 2007. Including this reduction in equity, which represents a decline in economic value, results in cost recovery of 96.7 percent for the ten-year period. For details on how implementing SFAS No. 158 affected the pro forma financial statements, refer to notes 2, 3, and 5 at the end of this chapter.

4. *Other income* is revenue from investment of clearing balances net of earnings credits, an amount termed net income on clearing balances. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the FDIC assessment), imputed income taxes, and the targeted return on equity.

Priced Services Cost Recovery, 1998–2007

Millions of dollars except as noted

Year	Revenue from services[1]	Operating expenses and imputed costs[2]	Targeted return on equity	Total costs	Cost recovery (percent)[3, 4]
1998	839.8	743.2	66.8	809.9	103.7
1999	867.6	775.7	57.2	832.9	104.2
2000	922.8	818.2	98.4	916.6	100.7
2001	960.4	901.9	109.2	1,011.1	95.0
2002	918.3	891.7	92.5	984.3	93.3
2003	881.7	931.3	104.7	1,036.1	85.1
2004	914.6	842.6	112.4	955.0	95.8
2005	994.7	834.7	103.0	937.7	106.1
2006	1,031.2	875.5	72.0	947.5	108.8
2007	1,012.3	913.3	80.4	993.7	101.9
1998–2007	9,343.4	8,528.0	896.6	9,424.8	99.1

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 $8,816.8 million and other income and expense (net) of $526.6 million.

2. For the ten-year period, includes operating expenses of $7,938.1 million, imputed costs of $227.2 million, and imputed income taxes of $362.8 million.

3. Revenue from services divided by total costs.

4. For the ten-year period, cost recovery is 96.7 percent, including the net reduction in equity related to FAS 158 reported by the priced services in 2007.

Commercial Check-Collection Service

In 2007, the Reserve Banks recovered 100.7 percent of the total costs of their commercial check-collection service, including the PSAF. The Reserve Banks' operating expenses and imputed costs totaled $743.3 million, of which $26.1 million was attributable to the transportation of commercial checks between Reserve Bank check-processing centers. Revenue amounted to $705.0 million, of which $23.1 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was $106.9 million. The resulting net income was $68.6 million. Check-service revenue in 2007 decreased $40.0 million from 2006, largely because of a drop in paper-check fee revenue; this drop was partially offset by an increase in Check 21 fee revenue.

The Reserve Banks handled 10.0 billion checks in 2007, a decrease of 9.8 percent from 2006 (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.[5] Of all the checks presented by the Reserve Banks to paying banks in 2007, 42.2 percent were deposited and 24.6 percent were presented using Check 21 products, compared with 14.0 percent and 4.3 percent, respectively, in 2006.[6] By the end of 2007, this growth resulted in 57.5 percent of the Reserve Bank

5. The Federal Reserve System's retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. For details, see Federal Reserve System, "The 2007 Federal Reserve Payments Study: Noncash Payment Trends in the United States, 2003-2006" (December 2007). (www.frbservices.org/files/communications/pdf/research/2007_payments_study.pdf).

6. The Reserve Banks also offer non−Check 21 electronic-presentment products. In 2007, 19.2 percent of the Reserve Banks' deposit volume was presented to paying banks using these products.

Activity in Federal Reserve Priced Services, 2005–2007
Thousands of items

Service	2007	2006	2005	Percent change	
				2006 to 2007	2005 to 2006
Commercial check	10,001,289	11,083,122	12,227,718	–9.8	–9.4
Commercial ACH	9,363,429	8,230,782	7,338,950	13.8	12.2
Funds transfer	137,555	136,399	135,227	0.9	0.9
Multilateral settlement	505	470	440	7.4	6.8
Securities transfer	10,110	9,053	9,235	11.7	–2.0

NOTE: Activity in *commercial check* is the total number of commercial checks collected, including processed and fine-sort items; in *commercial ACH*, the total number of commercial items 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.

check deposits and 39.0 percent of Reserve Bank check presentments being made through Check 21 products.

In 2007, the Reserve Banks continued efforts to reduce check-service operating costs in response to the ongoing decline in check volume. These efforts included the consolidation of some check-processing sites. Check processing at Nashville has now been consolidated to Atlanta; San Francisco operations to Los Angeles; and Helena (Montana) operations to Denver. As part of a longer-range strategy, the Reserve Banks have selected Philadelphia, Cleveland, Atlanta, and Dallas as regional check-processing sites, which will provide a full range of check-processing services. The transition to this new structure is expected to begin in 2008. The Reserve Banks will continue to review their check infrastructure regularly to respond to further changes within the nation's payments system and to meet statutory requirements for long-term cost recovery.

Commercial Automated Clearinghouse Services

In 2007, the Reserve Banks recovered 107.6 percent of the total costs of their commercial automated clearinghouse (ACH) services, including the PSAF. The Reserve Banks' operating expenses and imputed costs totaled $85.9 million. Revenue from ACH operations totaled $88.3 million and other income totaled $13.7 million, resulting in net income of $16.0 million. The Banks processed 9.4 billion commercial ACH transactions, an increase of 13.8 percent from 2006.

In 2007, nationwide ACH volumes continued to grow at double-digit rates. This growth is largely attributable to volume increases associated with electronic check conversion applications—including checks converted at lockbox locations or at the point of purchase. ACH rule changes that took effect in early 2007 permitted checks to be converted in processing centers or back offices, spurring further growth in the volume of ACH check conversions.

Fedwire Funds and National Settlement Services

In 2007, the Reserve Banks recovered 107.3 percent of the costs of their Fedwire Funds and National Settlement Services, including the PSAF. The Reserve Banks' operating expenses and imputed costs totaled $63.1 million in 2007. Revenue from these operations totaled $64.4 million and other income amounted to $10.1 million, resulting in net income of $11.4 million.

Fedwire Funds Service

The Fedwire Funds Service allows participants to use their reserve or clearing balances at the Reserve Banks to transfer funds to other participants. In 2007, the number of Fedwire funds transfers originated by depository institutions increased 0.9 percent from 2006, to approximately 137.6 million. The average daily value of Fedwire funds transfers in 2007 was $2.7 trillion.

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 2007, 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 17,000 files that contained almost 505,000 settlement entries for these arrangements in 2007.

Fedwire Securities Service

In 2007, the Reserve Banks recovered 103.7 percent of the total costs of their Fedwire Securities Service, including the PSAF. The Reserve Banks' operating expenses and imputed costs for providing this service totaled $21.0 million in 2007. Revenue from the service totaled $20.6 million, and other income totaled $3.2 million, resulting in net income of $2.9 million.

The Fedwire Securities Service allows participants to electronically transfer securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations to other participants in the service.[7] In 2007, the number of non-Treasury securities transfers processed by the service increased 11.7 percent from 2006, to approximately 10.1 million.

In 2007, the Board published an assessment of the compliance of the Fedwire Securities Service with the Recommendations for Securities Settlement Systems that are included in the Federal Reserve Policy on Payments System Risk.[8] The Fedwire Securities Service mostly complied with the recommendations' applicable standards.[9] Both the Fedwire Funds Service and the Fedwire Securities Service assessments will be reviewed periodically to ensure that they remain accurate.

Float

The Federal Reserve had daily average credit float of $604.9 million in 2007,

7. 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.

8. The Recommendations are a set of nineteen minimum standards, developed by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO), to address legal, presettlement, settlement, operational, and custody risks, among other issues, in securities settlement systems. See www.federalreserve.gov/paymentsystems/fedwiresecsvs/fedwiresecsvs.pdf.

9. In 2006, the Board published an assessment of the compliance of the Fedwire Funds Service with the Core Principles for Systemically Important Payment Systems. See www.federalreserve.gov/paymentsystems/coreprinciples/coreprinciples.pdf.

compared with credit float of $85.9 million in 2006.[10]

Developments in Currency and Coin

The Federal Reserve Banks issue the nation's currency (in the form of Federal Reserve notes) and distribute coin through depository institutions. The Reserve Banks also receive currency and coin from circulation through these institutions. The Reserve Banks received 38.0 billion Federal Reserve notes from circulation in 2007, a 0.8 percent decrease from 2006, and made payments of 38.5 billion notes into circulation in 2007, a 1.5 percent decrease from 2006. They received 63.3 billion coins from circulation in 2007, a 5.9 percent increase from 2006, and made payments of 75.7 billion coins into circulation, a 2.2 percent increase from 2006.

In July, the Reserve Banks implemented the fee component of the Federal Reserve currency recirculation policy. The intent of the policy is to reduce the overuse of Federal Reserve currency-processing services by depository institutions. Under the policy, the Reserve Banks assess 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. At the end of the first two billing quarters, the Reserve Banks had collected $5.5 million in recirculation fees from institutions.

Board staff worked with the Treasury Department, the U.S. Secret Service, and the Reserve Banks' Currency Technology Office to develop more-secure designs for the $5 Federal Reserve note. The Reserve Banks issued the redesigned $5 note in March 2008.

Board staff worked with the Reserve Banks and the United States Mint to implement the distribution strategy for the Presidential $1 Coin Program. Consistent with the requirements of the Presidential $1 Coin Act, the Federal Reserve and the Mint conducted additional outreach to depository institutions and coin users to gauge demand for the coins and to anticipate and eliminate obstacles to the efficient circulation of $1 coins.

The Reserve Banks began implementing a program to extend to 2017 the useful life of the System's BPS 3000 high-speed currency-processing machines. The program will replace the operating systems of the current equipment but retain the machines' frames, note-transport mechanisms, and large mechanical parts. Software problems and development delays have extended the schedule for completion of the program to the fourth quarter of 2009.

The Reserve Banks selected a vendor to design software to replace the current standard cash application. The multiyear project will begin in 2008; the target implementation date for the new automation system is 2010.

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

10. 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.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2005–2007

Thousands of dollars

Agency and service	2007	2006	2005
DEPARTMENT OF THE TREASURY			
Bureau of the Public Debt			
Treasury retail securities	74,149.2	73,931.4	86,503.2
Treasury securities safekeeping and transfer	8,687.7	7,535.2	6,055.8
Treasury auction	41,372.0	23,594.9	17,553.5
Computer infrastructure development and support	3,558.7	3,853.1	2,575.5
Other services	724.5	1,578.7	1,806.5
Total	128,492.1	110,493.2	114,494.5
Financial Management Service			
Payment services			
Government check processing	17,522.7	20,918.6	20,988.0
Automated clearinghouse	6,050.3	5,823.1	5,709.5
Fedwire funds transfers	116.8	123.1	109.4
Other payment programs	81,636.9	69,696.8	49,366.0
Collection services			
Tax and other revenue collections	38,254.5	37,095.5	39,736.0
Other collection programs	12,483.6	14,122.6	14,354.2
Cash-management services	46,093.6	48,320.2	40,496.7
Computer infrastructure development and support	70,999.9	67,046.4	67,703.3
Other services	7,507.2	7,414.8	2,332.2
Total	280,665.7	270,561.2	240,795.4
Other Treasury			
Total	17,997.1	16,786.3	15,726.7
Total, Treasury	427,154.9	397,840.7	371,016.6
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons	2,706.0	2,929.8	2,642.4
United States Postal Service			
Postal money orders	8,913.2	9,334.4	7,647.8
Other agencies			
Other services	19,412.0	15,977.1	14,870.2
Total, other agencies	31,031.1	28,241.4	25,160.4
Total reimbursable expenses	458,186.0	426,082.1	396,177.0

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 2007 amounted to $458.2 million, compared with $426.1 million in 2006 (table). Treasury-related costs were $427.2 million in 2007, compared with $397.8 million in 2006, an increase of 7.4 percent. The cost of providing services to other entities was $31.0 million, compared with $28.2 million in 2006. In 2007, as in 2006, 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 $50.1 million in 2007, compared with $31.1 million in 2006. The Banks processed 104,000 commercial tenders for Treasury securities in 2007 through the Fedwire Securities Service, compared with 148,000 in 2006. They originated

13.7 million transfers of Treasury securities in 2007, a 6.4 percent increase from 2006. 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 early 2008.

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 $74.1 million in 2007, compared with $73.9 million in 2006. 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 $70.3 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 $642.4 million were sold through Sell Direct in 2007, compared with 13,000 securities worth $678.9 million in 2006. The Banks printed and mailed more than 25.1 million savings bonds in 2007, a 13.2 percent decrease from 2006. They issued more than 4.2 million Series I (inflation-indexed) bonds and 20.6 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 $105.3 million in 2007, compared with $96.6 million in 2006. The Banks processed 1,027 million ACH payments for the Treasury, an increase of 3.6 percent from 2007, and more than 618,000 Fedwire funds transfers. They also processed 214 million government checks, a decline of 3.6 percent from 2006. The proportion of government checks being processed as paper checks has been declining as an increasing number of checks are being presented by depository institutions in image form. Of all the government checks processed by the Banks in 2007, 54 percent of the checks were presented as paper and 46 percent were presented as images, compared with 87 percent and 13 percent, respectively, in 2006. In addition, the Banks issued more than 131,000 fiscal agency checks, a decrease of 22.6 percent from 2006.

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 $50.7 million in 2007, compared with $51.2 million in 2006. The Banks operate the Federal Reserve Electronic Tax Application (FR-ETA) as an adjunct to the Treasury's Electronic Federal Tax Payment System (EFTPS). EFTPS allows businesses and individual taxpayers to pay their taxes electronically. It uses the automated clearinghouse (ACH) to collect funds, so tax payments must be scheduled at least one day in advance. Some business taxpayers, however, do not know their tax liability until the tax due date. FR-ETA allows these taxpayers to use EFTPS by providing a same-day electronic federal tax payment alternative. FR-ETA collected $519.8 billion for the Treasury in

2007, compared with $456.3 billion in 2006.

In addition, the Reserve Banks operate Pay.gov, a Treasury program that allows members of the public to use the Internet to pay for goods and services offered by the federal government. 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 2007, the Reserve Banks originated more than 10.1 million ACH transactions through these programs, a significant increase from 2006 due to growth in the electronic check processing program.

Treasury 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 $46.1 million in 2007, compared with $48.3 million in 2006. The investments either are callable on demand or are for a set term. In 2007, the Reserve Banks placed a total of $308.4 billion in immediately callable investments, which includes funds invested through retained tax deposits and direct, special direct, and dynamic investments, and $687 billion in term investments. The rate for term investments is set by auction; the Reserve Banks held 126 such auctions in 2007, roughly the same number of auctions as in 2006. In 2007, the Treasury's income from the TT&L program was $1.15 billion. The Treasury provides the Repurchase Agreement Program on a limited basis, which allows the Treasury to place a portion of its excess operating funds directly with TT&L depositaries through a repurchase transaction for a set period at an agreed-on interest rate. In 2007, the Reserve Banks placed a total of $499 billion of investments through repurchase agreements.

In 2007, the Treasury announced the Collections and Cash Management Modernization (CCMM) initiative, which is a multiyear effort to streamline, modernize, and improve the process and systems supporting the Treasury's collections and cash-management programs. Several Federal Reserve Banks have been selected to work on the CCMM initiative.

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 2007, the Federal Reserve Banks continued to migrate their computer interface customers to FedLine Direct and FedLine Command. This migration, typically for high-volume depository institutions, comes after the Reserve Banks completed the FedLine Advantage migration, typically for low- to moderate-volume depository institutions, in 2006. FedLine Direct is an internet-protocol-based computer-to-computer electronic access channel used to access critical payment services, such as Fedwire Funds, Fedwire Securities, National Settlement, and FedACH Services. FedLine Command is a lower-cost internet-protocol-based computer-to-computer electronic access channel for file delivery services, including the FedACH Service. The Reserve Banks began the migration to FedLine Direct and FedLine Command in 2006 and expect to complete the conversion in 2008.

Information Technology

In 2007, the Federal Reserve Banks enhanced their information technology (IT) governance framework to better align IT management authority and accountability with the business models used in the System. A System chief information officer (CIO) position and two advisory councils were established. The Business Technology Council represents the technology needs of the Federal Reserve's business lines, and the Technology Services Council represents the Federal Reserve's IT providers. The CIO leads System efforts to develop and implement the Federal Reserve's overall IT strategy at the Reserve Banks, manages national information-security risk, and analyzes and coordinates the System's IT investments.

The System continued to develop the National Information Security Assurance function as a central point of governance for enterprise-level information security. Associated roles and responsibilities within the function were clarified. Efforts to improve the function will continue as the Federal Reserve's information security environment continues to evolve.

To address the business implications of reduced demand for mainframe services, Federal Reserve Information Technology in mid-2007 implemented a multiyear strategic plan for mainframe technologies. These technologies are no longer considered strategic, and the System has decided not to make any further significant investments in the mainframe platform. System business owners are looking at alternative platforms for web-based access to applications and data, partly because of concerns about the continued availability of technical resources to support mainframe platforms.

In 2007, the Federal Reserve continued to implement the Information Security Architecture Framework (ISAF), a large program scheduled to be completed in 2008. ISAF is intended to respond to the continuing and increasingly sophisticated security threats facing information technology systems and to improve information security at all points in the Federal Reserve by raising the level of enterprise-wide assurance. Major accomplishments in 2007 include improving the separation of sensitive infrastructure, limiting access to sensitive desktop functions, and strengthening desktop-access protections.

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) to assess 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 2007 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 each Bank's board of directors and to the Board of Governors.

In 2007, the Board engaged Deloitte & Touche LLP (D&T) for the audits of the individual and combined financial statements of the Reserve Banks. Previously, PricewaterhouseCoopers LLP performed the audits. Fees for D&T's services totaled $4.7 million. To ensure auditor independence, the Board requires that D&T be independent in all matters relating to the audit. Specifically, D&T 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 Reserve Banks, or in any other way impairing its audit independence. In 2007, the Reserve Banks did not engage D&T 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 primarily 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, D&T 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 2006 and 2007. Income in 2007 was $42,576 million, compared with $38,410 million in 2006.

Expenses totaled $4,382 million ($3,270 million in operating expenses, $240 million in earnings credits granted to depository institutions, $296 million in assessments for expenditures by the Board of Governors, and $576 million for the cost of new currency). Revenue from priced services was $878.4 million. Net additions to and deductions from current net income showed a net profit of $198 million. The profit was due primarily to unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates offset, in part, by interest expense on reverse repurchase agreements. Statutory dividends paid to member banks totaled $992 million, $121 million more than in 2006; 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 $34,598 million in 2007, up from $29,052 million in 2006; the payments equal net income after the de-

Income, Expenses, and Distribution of Net Earnings
of the Federal Reserve Banks, 2007 and 2006

Millions of dollars

Item	2007	2006
Current income	42,576	38,410
Current expenses	3,510	3,264
Operating expenses[1]	3,270	2,987
Earnings credits granted	240	276
Current net income	39,066	35,147
Net additions to (deductions from, –) current net income	198	–159
Assessments by the Board of Governors	872	793
For expenditures of Board	296	301
For cost of currency	576	492
Change in funded status of benefit plans[2]	324	. . .
Net income before payments to Treasury	38,716	34,195
Dividends paid	992	871
Transferred to (from) surplus and change in accumulated other comprehensive income	3,126	4,272
Payments to Treasury[3]	34,598	29,052

1. Includes a net periodic pension expense of $110 million in 2007 and $53 million in 2006.

2. Subsequent to the adoption of SFAS 158 in 2006, the Reserve Banks began to recognize the change in funded status of benefit plans as an element of other comprehensive income.

3. Interest on Federal Reserve notes.

. . . Not applicable.

duction of dividends paid and of the amount necessary to equate the Reserve Banks' surplus to paid-in capital.

In the "Statistical Tables" section of this report, table 10 details the income and expenses of each Reserve Bank for 2007 and table 11 shows a condensed statement for each Bank for the years 1914 through 2007; 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 2007 amounted to $816,115 million, an increase of $28,243 million from 2006 (table). U.S. government securities holdings increased $26,124 million, and loans increased $1,297 million. In December 2007, the Federal Reserve established a Term Auction Facility (TAF) under which the Reserve Banks conduct auctions for a fixed amount of funds for a fixed term, with the interest rate determined by the auction process, subject to a minimum bid rate. All advances under the TAF must be fully collateralized. In 2007, average daily holdings of Term Auction Credit (TAC) under the TAF amounted to $822 million.

The average rate of interest earned on the Reserve Banks' holdings of government securities increased to 4.95 percent, from 4.63 percent in 2006, and the average rate of interest earned on loans decreased to 2.18 percent, from 5.36 percent. The average interest rate on TAC was 4.66 percent.

Securities and Loans of the Federal Reserve Banks, 2005–2007

Millions of dollars except as noted

Item and year	Total	U.S. government securities[1]	Loans[2]	Term Auction Credit[3]
Average daily holdings[4]				
2005[5]	**753,748**	**753,549**	**199**	. . .
2006[5]	**787,872**	**787,648**	**224**	. . .
2007	816,115	813,772	1,521	822
Earnings[6]				
2005	28,966	28,959	7	. . .
2006	36,464	36,452	12	. . .
2007	40,369	40,298	33	38
Average interest rate (percent)				
2005[5]	**3.84**	**3.84**	**3.52**	. . .
2006[5]	**4.63**	**4.63**	**5.36**	. . .
2007	4.95	4.95	2.18	4.66

1. Includes federal agency obligations.
2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.
3. Reflects temporary Term Auction Facility activity beginning in 2007.
4. Based on holdings at opening of business.
5. Amounts in bold are restatements due to changes in previously reported data.
6. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.

. . . Not applicable.

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 2004 through 2007.

Federal Reserve Law Enforcement

In November, the Federal Reserve System became the eleventh federal law enforcement agency to be awarded accreditation from the Federal Law Enforcement Training Accreditation board of directors for its Basic Law Enforcement Course (BLEC). The primary benefit of accreditation is increased public confidence in the integrity, professionalism, and accountability of the law enforcement agencies. Accreditation is considered a “best practice” for federal law enforcement agencies and signifies compliance with 63 stringent standards. All law enforcement candidates complete the Federal Reserve’s BLEC prior to their designation as Federal Reserve law enforcement officers (FRLEOs). The 240-hour program covers a variety of topics related to the mission of an FRLEO. The Federal Reserve was granted federal law enforcement authority by the USA Patriot Act to protect and safeguard Board and Federal Reserve Bank premises, grounds, property, personnel, and operations.

Federal Reserve Bank Premises

In 2007, construction was largely completed on the Kansas City Bank’s new headquarters building and the San Francisco Bank’s new Seattle Branch building. The multiyear renovation program at the New York Bank’s headquarters building continued. The St. Louis Bank continued a long-term facility redevelopment program that includes the ongoing construction of an addition to the Bank’s headquarters building.

Security enhancement programs continued at several facilities. Construction of security improvements to the Richmond Bank’s headquarters building is ongoing. The Philadelphia Bank completed the purchase of property behind its headquarters building for the construction of a remote vehicle-screening facility and is developing the facility's design. Design development of a similar screening facility for the Dallas Bank also continued.

During 2007, the Board approved the final design of a new parking garage to be constructed adjacent to the Richmond Bank's headquarters building. Efforts to sell the St. Louis Bank's Little Rock Branch building continued.

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

Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2007 and 2006

Millions of dollars

Item	2007		2006	
Short-term assets (Note 1)				
Imputed reserve requirements on clearing balances	755.7		821.7	
Imputed investments	6,465.7		**7,207.5**	
Receivables	66.7		73.6	
Materials and supplies	1.8		0.9	
Prepaid expenses	28.5		24.2	
Items in process of collection	1,769.6		3,391.0	
Total short-term assets		9,088.0		**11,518.9**
Long-term assets (Note 2)				
Premises	453.5		424.9	
Furniture and equipment	130.2		127.9	
Leases, leasehold improvements, and long-term prepayments	64.2		83.3	
Prepaid pension costs	484.6		**453.0**	
Deferred tax asset	109.4		**130.0**	
Total long-term assets		1,242.0		**1,219.0**
Total assets		10,330.0		**12,737.9**
Short-term liabilities				
Clearing balances and balances arising from early credit of uncollected items	7,641.1		8,015.6	
Deferred-availability items	1,685.1		3,592.5	
Short-term debt	0.0		0.0	
Short-term payables	102.4		100.4	
Total short-term liabilities		9,428.5		11,708.4
Long-term liabilities				
Long-term debt	0.0		0.0	
Postretirement/postemployment benefits obligation	385.0		**392.6**	
Total long-term liabilities		385.0		**392.6**
Total liabilities		9,813.5		**12,101.0**
Equity (including accumulated other comprehensive loss of $237.9 million and **$306.1** million at December 31, 2007 and 2006, respectively)		516.5		636.9
Total liabilities and equity (Note 3)		10,330.0		**12,737.9**

NOTE: Components may not sum to totals because of rounding. Amounts in bold are restated due to changes in previously reported data.

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

Pro Forma Income Statement for Federal Reserve Priced Services, 2007 and 2006

Millions of dollars

Item	2007		2006	
Revenue from services provided to depository institutions (Note 4)		878.4		908.4
Operating expenses (Note 5)		888.2		803.5
Income from operations		−9.8		104.8
Imputed costs (Note 6)				
Interest on float	−32.0		–4.9	
Interest on debt	0.0		0.0	
Sales taxes	11.6		10.8	
FDIC insurance	0.0	−20.4	0.0	5.9
Income from operations after imputed costs		10.6		98.9
Other income and expenses (Note 7)				
Investment income	362.3		383.6	
Earnings credits	−228.5	133.8	–260.8	122.8
Income before income taxes		144.5		221.8
Imputed income taxes (Note 6)		45.5		66.1
Net income		98.9		155.7
MEMO: Targeted return on equity (Note 6)		80.4		72.0

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, 2007

Millions of dollars

Item	Total	Commercial check collection	Commercial ACH	Fedwire funds	Fedwire securities
Revenue from services (Note 4)	878.4	705.0	88.3	64.4	20.6
Operating expenses (Note 5)	888.2	733.6	78.3	56.9	19.3
Income from operations	−9.8	−28.6	10.0	7.5	1.3
Imputed costs (Note 6)	−20.4	−21.8	0.2	0.9	0.3
Income from operations after imputed costs	10.6	−6.7	9.7	6.6	1.0
Other income and expenses, net (Note 7)	133.8	106.9	13.7	10.1	3.2
Income before income taxes	144.5	100.2	23.4	16.6	4.2
Imputed income taxes (Note 6)	45.5	31.6	7.4	5.2	1.3
Net income	98.9	68.6	16.0	11.4	2.9
MEMO: Targeted return on equity (Note 6)	80.4	63.2	8.8	6.3	2.0
MEMO: Cost recovery (percent) (Note 8)	101.9	100.7	107.6	107.3	103.7

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

Long-term assets consist 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 the Financial Accounting Standard Board's Statement of Financial Accounting Standards (SFAS) No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* which requires an employer to record the funded status of its benefit plans on its balance sheet. This resulted 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 core 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 post-employment, 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 SFAS No. 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. In 2007, this resulted in a decrease to the benefits obligation related to the priced services with 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 (see Note 7).

(5) Operating Expenses

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $6.7 million in 2007 and $7.5 million in 2006.

Effective January 1, 1987, the Reserve Banks implemented SFAS No. 87, *Employers' Accounting for Pensions.* Accordingly, the Reserve Banks recognized operating expenses for the qualified pension plan of $21.3 million in 2007 and $11.5 million in 2006. Operating expenses also include the nonqualified pension expense of $3.1 million in 2007 and $3.2 million in 2006. The implementation of SFAS No. 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, imputed costs, and cost recovery. 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 2007 and 2006 as follows (in millions):

	2007	2006
Check	34.7	30.6
ACH	4.3	4.1
Fedwire funds	3.0	2.8
Fedwire securities	1.7	1.5
Total	43.7	39.0

(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 are derived from bank holding company data, which serves as the proxy for the financial data of a representative private-sector firm, and 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 2007 or 2006.

Effective in 2007, the Reserve Bank priced services imputed a one-time FDIC assessment credit of $16.6 million. In 2007, the credit fully offset the imputed $4.0 million assessment, resulting in a remaining credit of $12.6 million. The remaining credit can be used to offset up to 90 percent of the assessment in the future.

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 the Check, Fedwire Funds, National Settlement Service, ACH, and Fedwire Securities services.

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, less the total shipping expenses, for all services.

The following shows the daily average recovery of actual float by the Reserve Banks for 2007 in millions of dollars:

Total float	–603.3
Unrecovered float	24.1
Float subject to recovery	–627.4
Sources of recovery of float	
Income on clearing balances	–62.7
As-of adjustments	–1.6
Direct charges	267.3
Per-item fees	–833.6

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 CIPC, 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 2007.

(7) Other Income and Expenses

Other income and expenses consist of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2007 and 2006 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. 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.

(8) Cost Recovery

Annual cost recovery is the ratio of revenue to the sum of operating expenses, imputed costs, imputed income taxes, and targeted return on equity.

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 every two years. The performance plan includes 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 report covering the period 2006–07 will be completed in 2008. Preliminary analysis indicates that the Board generally met its goals for 2006–07.

All of these 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. Updated documents will be posted on the website as they are completed.

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, address the rapidly emerging issues that affect today's consumers, strengthen consumer compliance supervision programs when required, and remain 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; provide career development opportunities to improve retention; and recruit highly qualified and skilled employees.
- Promote an efficient and effective work environment by aligning busi-

ness 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 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 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 the Board's 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 and analyze information technology issues for the Board, Reserve Banks, other financial regulatory institutions, and other nations' central banks.
- Efficiently provide safe, modern, and secure facilities and necessary support for activities conducive to efficient and effective Board operations. ■