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SUMMER 2005

Central Banker

News and Views for Eighth District Bankers

Federal Banking Agencies Issue Expanded FAQs on Customer Identification Programs

Federal banking agencies have released an expanded frequently asked questions document (FAQs) that provides additional guidance on the customer identification program (CIP) rules issued under Section 326 of the Patriot Act. The expanded interpretive guidance addresses how banks, savings associations, credit unions and certain non-federally regulated banks must apply customer identification rules when opening and maintaining customer accounts, processing customer data and engaging in other record-keeping activities. The FAQs also provide additional guidance on the definitions of "account," "bank" and "customer."

The agencies recognize that these expanded FAQs will not answer every question financial institutions may have, and the agencies encourage institutions to use the basic principles set forth in the CIP rule. Additionally, financial institutions must create risk-based procedures in their CIPs, which verify each customer's identity to a reasonable and practical extent.

The expanded FAQs can be found on the Board of Governors' web site, www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0509.htm. For more information about the FAQs, contact Jeff Bock at (314) 444-8835 or toll free at 1-800-333-0810, ext. 44-8835. To understand how banks can help combat identity theft and fraud, read Julie Stackhouse's *Feditorial*, found on Page 2. ■

Enhancements to FR Y-10 Online To Arrive This July

The Federal Reserve has offered respondents to the "Report of Organizational Structure" (FR Y-10) the ability to submit their reports via the Internet since 2001. A new release of the electronic application "FR Y-10 Online"—scheduled for July—will include:

- new data-entry options organized by specific business events, which guide and assist respondents through the completion of their appropriate reporting schedules. This new business event feature replaces the previous wizard functionality and offers enhanced ease and flexibility to FR Y-10 Online structure reporting.
- the ability to duplicate FR Y-10 Online draft reports, which will make the application more flexible and help respondents avoid entering unnecessary data.
- a link to each user's FR Y-10 Online account profile, where respondents can update names and telephone numbers, and modify passwords. This link will be available on the application home page.

Electronic reporting is easier and helps to ensure that respondents are reporting accurate structure information. If your institution is currently not utilizing FR Y-10 Online, we encourage you to do so.

FR Y-10 Online can be found on a secure web site, https://y10online.federalreserve.gov. For more information, contact Joan Boelter at (314) 444-8627 or toll-free at 1-800-333-0810, ext. 44-8627. ■

Feditorial

Proper Disposal of Consumer Information Protects All of Us

By Julie Stackhouse, senior vice president, Banking Supervision and Regulation

It's alarming to know that consumer-fraud and identify-theft complaints have soared for the third year in a row. More than 635,000 complaints were received by the Federal Trade Commission during 2004, up from 500,000 in 2003 and 400,000 in 2002. Recent losses totaled more than $547 million, and in almost a quarter of these instances the victim's consumer information was misused to perpetrate either loan or bank fraud.

So what is being done to solve this problem? Congress enacted the Fair and Accurate Credit Transactions Act (FACT Act) in December 2003 as a comprehensive statute aimed at combating identity theft. Effective this July 1, regulations implementing the FACT Act will officially start requiring "any person that maintains or otherwise possesses consumer information, or any compilation of consumer information, derived from consumer reports for business purposes to properly dispose of any such information or compilation."

What does this mean for bankers? First and foremost, the new rules apply to information placed and/or found in a consumer report–even if the consumer is not a customer of your organization. Also, regulatory guidelines now explicitly require a financial institution to have information-security programs that safeguard consumer information when it is disposed. This includes using a risk-assessment framework.

Fortunately, these new requirements should have minimal impact on financial institutions that have information-security programs meeting past regulatory guidelines. The change may be more significant, however, for many nonbank entities because the new rules cover "any person" having consumer information derived from a consumer report for a business purpose. This means that many new individuals and groups–e.g., landlords, utility companies, telecommunications companies and any business that obtains consumer reports for employment screening purposes–now will be required to abide by consumer-oriented, information-security practices and other requirements of the FACT Act.

A strong consumer information disposal program is important because it protects your customers and it protects you. And in this time of increased fear about fraud and identity theft, financial institutions that have a strong reputation for protecting customer and consumer information are recognized as organizations that are truly committed to customer and consumer satisfaction. ■

Regulatory Agencies Issue Joint Guidance on Overdraft Protection Programs

The Federal Financial Institutions Examination Council (FFIEC) on Feb. 18, 2005, released final guidance on overdraft protection programs to assist insured financial institutions in the responsible disclosure and administration of all types of overdraft services. (Office of Thrift Supervision guidance was issued separately.) Unlike traditional overdraft programs, some new programs are marketed essentially as short-term credit facilities; consumer groups and others have raised issues about the marketing, disclosure and implementation of some of these new programs. The principal elements of the FFIEC's final guidance are centered on three primary areas: safety and soundness considerations, legal risks and best practices.

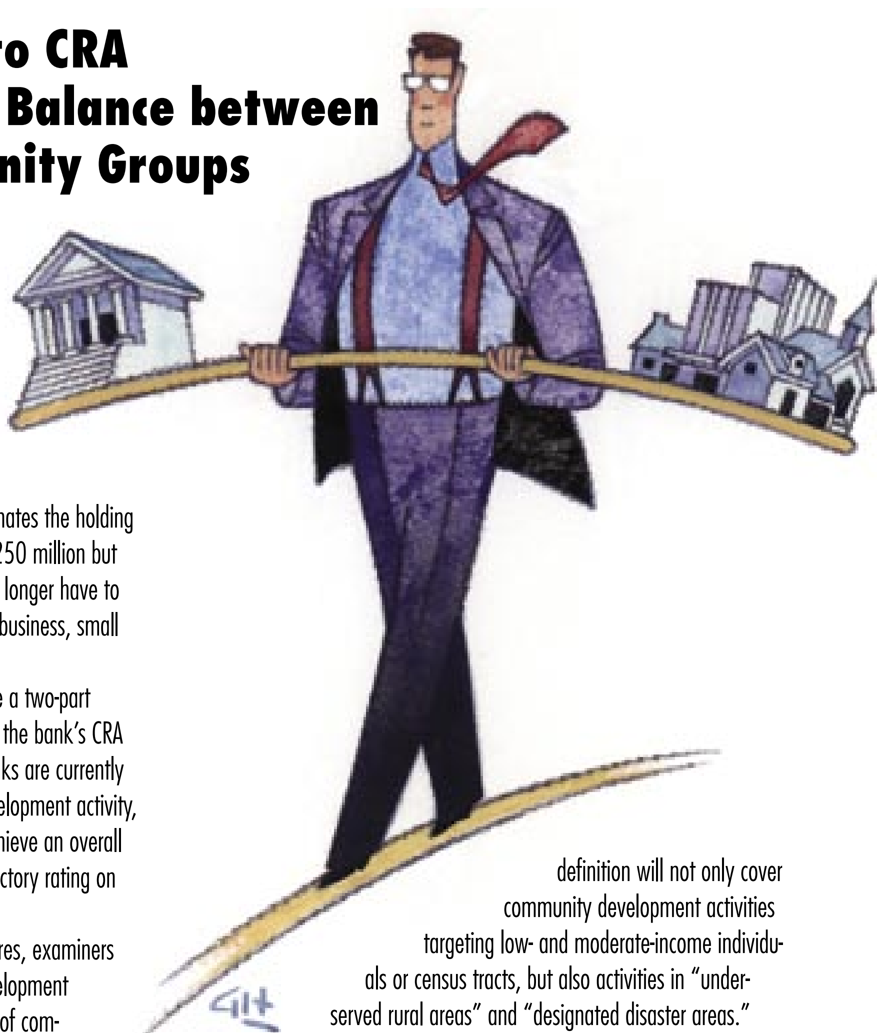
Safety and Soundness Considerations: The final guidance reaffirms that overdrafts are credit; therefore, institutions must adopt policies and procedures to address credit risks. Banks should also establish account eligibility standards/dollar limits, monitor accounts and identify customers who are undue credit risks, develop management reports to manage program performance and adopt prudent risk management practices. One important distinction exists between the proposed and final guidance, however. The agencies have extended the charge-off period from 45 to 60 days.

Legal Risks: Overdraft programs must comply with all applicable federal/state laws and regulations, and institutions should have their programs reviewed by legal counsel. Converting an overdraft line to a closed-end loan triggers the Truth in Lending Act (TILA) consumer disclosure requirements; the Board will make decisions about TILA disclosure coverage of future overdraft programs on a case-by-case basis.

Best Practices: Most practices relate to customer marketing, communication and account management; however, a new best practice was included, recommending that institutions provide ATM customers a specific notice that they are triggering an overdraft protection program.

More information can be found on the Board's web site, www.federalreserve.gov/boarddocs/SRLETTERS/2005/sr0503.htm. ■

Proposed Revisions to CRA Regulations Strike a Balance between Bankers and Community Groups



Federal banking agencies released a joint notice on March 11, 2005, with proposed rulemaking designed to improve the effectiveness of the Community Reinvestment Act (CRA) and reduce the compliance burden for financial institutions. A number of changes are proposed.

The first change raises the asset threshold for "small banks" from $250 million to $1 billion and eliminates the holding company asset test. In addition, banks with assets of $250 million but less than $1 billion ("intermediate small banks") will no longer have to collect data and submit aggregate lending data on small business, small farm and community development loan activity.

Under the proposal, intermediate small banks will face a two-part test. The first test focuses on retail lending and assesses the bank's CRA performance using the five criteria under which small banks are currently evaluated. The second test will focus on community development activity, including loans, investments and services. In order to achieve an overall satisfactory rating, a bank must achieve at least a satisfactory rating on both tests.

Similar to the current large-bank examination procedures, examiners will evaluate the number and amount of community development loans and qualified investments, as well as the provision of community development services, against the:

- bank's capacities and business strategy,
- needs of the local community, and
- number and types of opportunities for community development activities.

The proposed community development test is intended to provide greater flexibility than the current large-bank tests for intermediate small banks. Small banks will be able to allocate their resources among community development loans, investments or services based on the needs of their communities.

This increased flexibility should increase the effectiveness of the CRA by encouraging only meaningful loans, investments and services. For example, intermediate small banks often face intense competition in some markets for the limited supply of qualified investments that are safe and sound, yielding an acceptable return. In order to fulfill their responsibilities under the current investment test, intermediate small banks will often purchase and sell the same pool of investments among themselves, failing to increase the net amount of investments in a market.

Another important aspect of the proposed revision to CRA is a new definition of "community development" for all banks—regardless of asset size—to include activities targeted in rural areas. One significant criticism from both community banks and community organizations is that the current definition of community development fails to recognize the unique community development needs of rural communities because they often are not designated as low- or moderate-income. Consequently, the proposed definition will not only cover community development activities targeting low- and moderate-income individuals or census tracts, but also activities in "underserved rural areas" and "designated disaster areas."

Finally, the proposal outlines instances when a bank's CRA rating may be adversely affected when examiners find evidence of discrimination or other illegal credit practices. Specifically, these practices will include:

- credit discrimination, in violation of the Equal Credit Opportunity or Fair Housing Acts;
- illegal referral practices, in violation of Section 8 of the Real Estate Settlement Procedures Act;
- violations of the Truth in Lending Act, concerning a consumer's right to rescind a credit transaction secured by a principal residence;
- violations of the Home Ownership and Equity Protection Act; and
- any evidence of unfair or deceptive acts or practices in violation of Section 5 of the Federal Trade Commission Act.

A bank's CRA evaluation also can be adversely affected by illegal practices of any affiliate, if affiliate loans are considered in the bank's CRA evaluation.

The proposed changes to CRA are designed to strike a balance between the concerns of bankers and community groups. The public comment period closed May 10, and the federal agencies are reviewing the comments they have received. For a complete copy of the joint notice of proposed rulemaking, visit www.federalreserve.gov/boarddocs/press/bcreg/2005/20050311/default.htm. ■

Regional Roundup

St. Louis Fed's Annual Report Focuses on Fed/Treasury Relationship

The U.S. Treasury has a mission to encourage electronic forms of payments. In producing and promoting these types of payments, the Treasury works in tandem with the Federal Reserve. The St. Louis Fed's 2004 annual report covers the historic relationship between the two organizations and discusses the key role played by the St. Louis Bank, which has served as the Treasury's main liaison within the Reserve System since 2001.

The report, *Common Bonds: Why the partnership between the U.S. Treasury and the Federal Reserve is good for government, and for you*, is available on the St. Louis Fed's public web site, www.stlouisfed.org, under the Publications link. To order additional print copies, call (314) 444-8809. ■

Federal Reserve Publishes Information on Managing Electronic Risk

Effective risk management is vital for maintaining the U.S. financial system. With more institutions converting to electronic payments, the risks are changing, and financial institutions need newer tools to control losses. The April issue of *Fedfocus*SM, a customer magazine published by Fed's Customer Relationship and Support Office, has devoted an entire section to exploring the new tools that have been developed to mitigate electronic payments risk. A special section features different perspectives on risk, product solutions from the Fed, and practical tips financial institutions can apply to protect themselves and their customers. *Fedfocus* can be found on www.frbservices.org/Home Page/PubsPress.html#FF. ■

Regulatory Agencies Publish FAQs about New HMDA Data

The federal bank, credit union and thrift agencies, along with the Department of Housing and Urban Development (HUD), have released a set of answers to frequently asked questions (FAQs) that address the new home loan price data that were disclosed this year under the Home Mortgage Disclosure Act (HMDA). The agencies will also engage in educational outreach to state and local agencies, trade associations, and consumer- and community-based organizations. For more information about the FAQs, see the Bank's web site, www.stlouisfed.org/banking, or you may contact Bob Dowling at (314) 444-8532 or toll free at 1-800-333-0810, ext. 44-8532. ■

Fed Publishes Small Business Resource Guides for Little Rock and Memphis

The Federal Reserve Bank of St. Louis has released two new resource guides for small and micro businesses in the Little Rock and Memphis metropolitan regions. The guides were produced by the Bank's Community Affairs staff at the Bank's branch offices in Little Rock and Memphis.

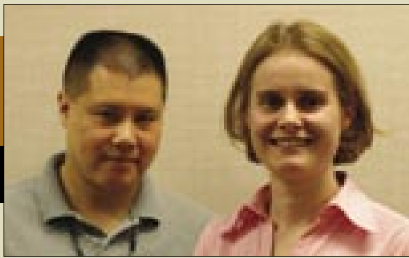
The resources listed in these guides are a starting point for new businesses or existing businesses that wish to expand. The guides are divided into two main sections. "Business Assistance Resources" lists the agencies that offer technical expertise to businesses, and "Alternative Financial Resources" contains nontraditional lending sources.

The guides also contain a list of local chambers of commerce; the booklets do not include traditional lending sources because business owners already are probably familiar with commercial lenders in their regions.

The featured resources for the Little Rock region fall into a geographic area that includes 11 counties: Conway, Faulkner, Garland, Grant, Hot Spring, Lonoke, Jefferson, Perry, Pulaski, Saline and White. Resources for the Memphis guide are located primarily in Memphis and Shelby County.

Commercial lenders or organizations wishing to distribute these guides may order multiple copies at no cost.

The Resource Guide for Small Businesses in the Little Rock Area is available by calling (501) 324-8296. *The Resource Guide for Small Businesses in the Memphis and Shelby County Region* is available by calling (901) 579-4101. ■



Down to the Core

By Kristie M. Engemann and Michael T. Owyang

Michael T. Owyang is a senior economist and Kristie M. Engemann is a senior research associate at the Federal Reserve Bank of St. Louis. This piece is based on their article "Hard 'Core' Inflation," *which appeared in the February 2005 issue of* Monetary Trends.

Turn on the news and you might hear the term "core inflation," as it is considered to be a better predictor of future price movements than all-inclusive inflation. Core inflation removes items that have frequent price fluctuations, such as food and energy.

In this article, we discuss two measures of core inflation using the Consumer Price Index: inflation excluding food and energy, and weighted median inflation.

The Consumer Price Index measures what consumers pay for a given basket of goods relative to a base year. For example, the same basket of market goods costing $100 in 2000 would have cost almost $110 during 2004. The inflation rate is the percentage change in the index from the same period of the previous year. Thus, an inflation rate of 3.0 percent for May 2004 implies that the index was 3.0 percent higher for May 2004 than for May 2003.

Inflation excluding food and energy is the measure of core inflation most often cited in the media. This measure is calculated similarly to overall inflation; however, food and energy are eliminated from the basket of goods.

Calculating weighted median inflation involves three steps. First, one calculates the percentage change in price from the previous month for each component–not the entire basket. Next, the components are ordered by their inflation rate for that month and weighted by the percentage of the total amount spent on that component. Finally, one determines the inflation rate where the median exists–half of the components have price changes higher (or equal) and half are lower (or equal).

The following example shows a market basket ordered by monthly inflation rates. Component A has an inflation rate of 0.3 percent and a weight of 10 percent. Component B has an inflation rate of 0.6 percent and a weight of 18 percent. When you add the weights of components A and B, the cumulative weight is 28 percent. Thus, 28 percent of the goods in this basket have an inflation rate of 0.6 percent or lower. Here, a cumulative weight of 50 percent is associated with Component D, and the weighted median inflation rate is 1.2 percent.

Component	Infl. Rate (%)	Weight	Cumulative
A	0.3	0.10	0.10
B	0.6	0.18	0.28
C	0.7	0.17	0.45
D	1.2	0.11	0.56
E	1.5	0.25	0.81
F	1.9	0.19	1.00

As our first example illustrates, the weighted median does a good job of measuring core inflation because it eliminates components that have large and small price changes, which are not likely to reflect a trend.

Consider a second example where one component has an abnormally large spike in price. In this second basket, Component Z is computer supplies, and two of the other components are food and energy. Suppose the factory that makes the majority of computer chips has a fire that temporarily disrupts production, causing a price spike. We include Component Z when calculating inflation excluding food and energy, but eliminate it when calculating weighted median inflation rate. Thus, the weighted median inflation rate seems a truer reflection of price trends.

Component	Infl. Rate (%)	Weight	Cumulative
V	0.2	0.15	0.15
W	0.4	0.17	0.32
X	0.5	0.19	0.51
Y	0.8	0.33	0.84
Z	3.0	0.16	1.00

Inflation excluding food and energy eliminates only food and energy every month, regardless of the price changes for each good. In contrast, the weighted median inflation rate may exclude different components from one month to the next based on price fluctuations. Our second example shows that inflation excluding food and energy may not reflect price trends, as it may include components that have short-lived, extreme price changes. Weighted median inflation ignores those components, making it a better measure of core inflation. ■

FedFacts

New End-of-Day Accounting Statements Are Available

A new comma delimited end-of-day statement file became available in April. This new statement file is available via the Account Management Information (AMI) system and allows financial institutions to download end-of-day statements in spreadsheet software such as Microsoft Excel. In addition, statement activity is available for five business days and includes detailed information on posted transactions, including Fedwire® Funds and Fedwire Securities.

Also referred to as FIRD Plus, the new spreadsheet file is useful during balancing and posting activities and may be especially helpful for small to mid-size institutions that do not have automated reconcilement processes in place. For more information on the new end-of-day statement file or other online accounting services, please contact your local account executive. ■

U.S. Mint Announces Its First 24-Karat Gold Coin

The U.S. Mint has announced that it will begin manufacturing 24-karat (99.99% fineness) gold bullion coins. The new coins won't enter into general circulation, but will be sold to investors and collectors.

The U.S. Treasury has not announced any specific designs, denominations or quantities. After a public comment period, the Treasury will release those details later this year. ■

Federal Reserve Offers Free Online Seminars for FedLine Advantage

FedLine Advantage® is the Federal Reserve's newest access method. Your financial institution can prepare for its upcoming conversion to FedLine Advantage by taking one of the Fed's free online seminars. Two seminars are available 24 hours a day, seven days a week:

- Full: a 50-minute interactive web-based seminar; and
- Basic: a condensed 15-minute version of the full online seminar.

The online seminars will be available through the end of the FedLine Advantage conversion process. More information and a link to the online registration forms can be found on the Bank's web site, www.stlouisfed.org/financial. ■

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Out *for* Comment

The following is a Federal Reserve System proposal currently out for comment:

The federal bank and thrift regulatory agencies are requesting comment on proposed changes to the supervisory framework for the classification of commercial credit exposures. The proposed guidance would replace the current commercial loan classification system categories—"special mention," "substandard" and "doubtful"—with a two-dimensional framework: borrower rating and facility rating. Borrower rating measures the risk of the borrower defaulting, while facility rating focuses on the loss an institution would likely incur if a borrower defaulted on a loan.

Direct all comments to: Jennifer Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th St. and Constitution Ave., N.W., Washington, D.C. 20551. Comments are due by June 30, 2005.

For more information about this proposal, visit www.federalreserve.gov/boarddocs/press/bcreg/2005/20050328/default.htm. ■

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