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SUMMER 2007

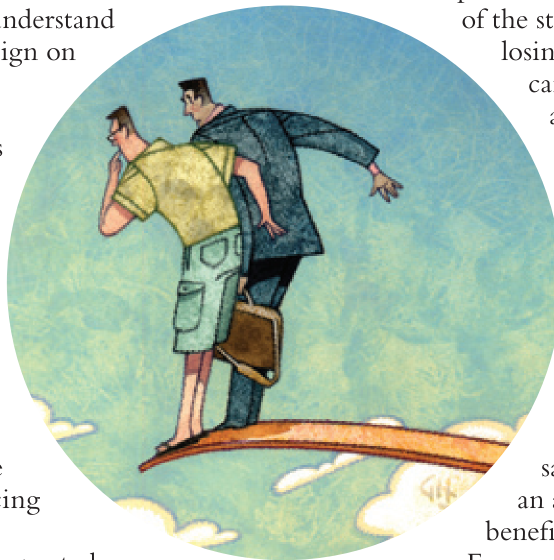
Central Banker

News and Views for Eighth District Bankers

Banks Should Help Customers Look before They Leap into a Subprime Mortgage

Subprime mortgages are causing headaches for some homeowners across the nation, and federal regulatory agencies want to make sure borrowers fully understand the major risks before they sign on the dotted line.

Regulators already had guidance in place that urges banks to help customers know the risks and the repercussions of subprime mortgages. Recently, the agencies, including the Federal Reserve, proposed further guidance on subprime adjustable rate mortgage (ARM) products and borrowers' ability to service their loans without refinancing or selling their property.



"Regulators have always expected banks to properly underwrite their loans and ensure that their customers are fully aware of what they're getting into—and most banks do," says Tim Bosch, Banking Supervision & Regulation vice president at the St. Louis Fed. "Many of the stories we hear about people losing their homes because they can't service their ARM usually, but not always, concern uninsured and unregulated financial institutions."

Regulators urge banks to make prudent arrangements with borrowers who can no longer meet the obligations of a subprime mortgage. "Banks really don't want homes and don't want to foreclose," says Bosch. "So, working out an arrangement is much more beneficial to both parties."

For more information on the proposed guidance, visit www.federalreserve.gov/boarddocs/press/bcreg/2007/20070417/. ■

FedCash® Pricing Changes Coming this Summer

The Federal Reserve System will introduce in July a new service fee for cross-shipping activity and a necessary pricing change to the Uniform Cash Access Policy (UCAP) fee. The changes will come via FedCash,® the Fed's service that ensures institutions have sufficient supplies of currency and coin.

First, a $5 fee will be charged to depository institutions that cross-ship $10 and $20 notes (deposit and order fit notes within the same business week). The fee will be billed quarterly and applied to each bundle ordered or deposited above the 875-bundle *de minimis* exemption. To learn more, visit www.frbservices.org/Cash/Currency RecirculationPolicy.html.

Second, the UCAP fee will be standardized. Starting July 2, all depository institutions will be charged a uniform fee of $35 per deposit or order above the basic level of free access. This pricing change represents a $15 increase for Eighth District customers. For more information, visit www.frbservices.org/Cash/pdf/UcapBrochure.pdf.

For further assistance, visit the respective web sites or contact your local FedCash Services representative: Rich Harper (St. Louis) at 314-444-8323 or Ranada Williams (Memphis and Little Rock) at 901-579-2412. ■

* *FedCash is a registered trademark of the Federal Reserve banks.*

Feditorial

Why Subprime Lending Is News—and Will Continue To Be

Julie Stackhouse, senior vice president, Banking Supervision & Regulation

Subprime mortgage lending has been in the news for several months. Just recently, the federal financial regulatory agencies issued a statement on subprime mortgage lending. The statement calls for lending institutions to analyze a subprime borrower's ability to repay an adjustable rate mortgage at the fully indexed rate, assuming a fully amortizing repayment schedule. The statement also calls for clear communications with consumers.

What is the reason for the statement and why is subprime lending in the news recently?

First, subprime mortgages make up a larger share of outstanding mortgages than ever before. In 1998, fewer than 600,000 subprime mortgages were outstanding, representing less than 2.5 percent of all mortgages. Just eight years later, 5.8 million subprime mortgages were outstanding, representing more than 13.5 percent of all mortgages. The peak year for subprime mortgage originations was 2004.

These subprime mortgages are now showing a significant increase in delinquencies and foreclosures. The amount of all subprime mortgages nationwide that were at least 30 days delinquent reached 13.3 percent during the fourth quarter of 2006. All indications are that foreclosure rates will move higher in 2007.

A major reason for the rapid deterioration of average subprime mortgage quality is that the majority of these loans had either adjustable rates when originated or low initial rates (called "teaser" rates) that are now converting to adjustable rates after two or three years. The combination of rising short-term interest rates during 2004, 2005 and 2006—and the contractual switch from initial low teaser rates to fully indexed rates—means that many mortgage holders are now facing significant payment shock.

The payment shock has been further complicated by a slowdown in housing price appreciation in many parts of the country and weak economic conditions in areas such as the upper Midwest, with its concentration of auto-related and other manufacturing industries.

The years 2007 and 2008 promise to be challenging both for lenders and borrowers who chose adjustable rate subprime mortgages. Some borrowers will be capable of refinancing into other mortgage products. Other borrowers will not and will need to work with their lenders to avoid foreclosure wherever possible. Congress has also promised legislative action. In the end, the lesson learned will likely be one that bankers have learned many times over: Strong underwriting practices and careful consumer disclosure are the best tools to avoid long-term issues. ■

Keep Track of All Payments Info at Check Image Central

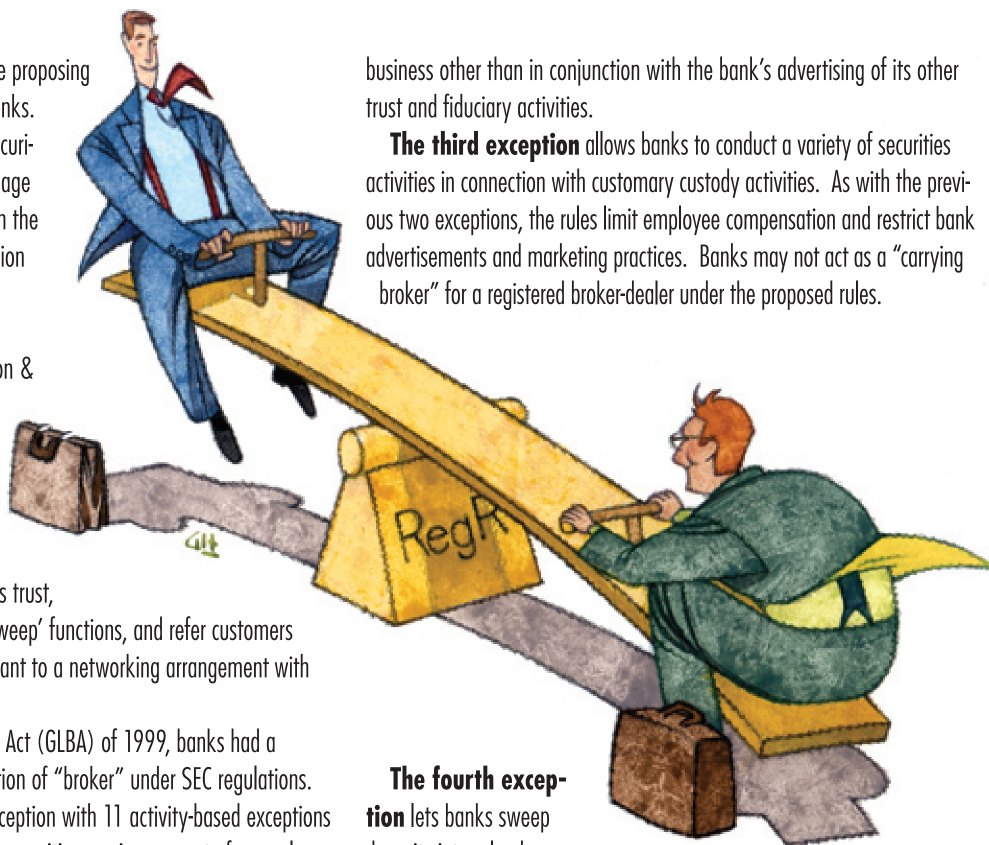
As the nation's payments system continues to move away from paper-based check processing to more efficient forms of payments, you can keep track of all the latest electronic alternatives and Check 21 information in one place.

The new Check Image Central web site contains the latest Check 21 industry adoption updates, industry and operational practices, rules and regulations, consumer information, related links, and more. The Electronic Check Clearing House Organization and the Fed's Retail Payments Office designed the site to be applicable to a wide audience.

Check Image Central is a one-stop resource created to raise awareness, provide industry-driven education, and promote the benefits of and encourage best practices for image exchange and Check 21. Representatives of trade and financial organizations from across the country worked the past two years to identify and share information on check image clearing that will help financial institutions understand and successfully implement image exchange.

Visit Check Image Central at www.checkimagecentral.org. ■

Proposed Exceptions Would Keep Balance Between Bankers and Securities Brokers



Federal regulatory agencies are proposing broker exemption rules for banks. The rules would define the securities activities that banks may engage in without needing to register with the Securities and Exchange Commission (SEC) as a securities broker.

Explains Tim Koellner of the St. Louis Fed's Banking Supervision & Regulation department: "In short, the rules would let a bank, subject to certain conditions, continue to conduct securities transactions for its customers as part of the bank's trust, fiduciary, custodial and deposit 'sweep' functions, and refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer."

Before the Gramm-Leach-Bliley Act (GLBA) of 1999, banks had a blanket exception from the definition of "broker" under SEC regulations. The GLBA replaced the blanket exception with 11 activity-based exceptions that let banks continue to provide securities services as part of normal banking functions while also preventing firms from moving a broker-dealer into a bank to avoid SEC regulations. To implement the four most important exceptions, the SEC and Federal Reserve Board jointly issued the proposed Regulation R, which is summarized below.

The first exception lets banks and their employees refer customers to a broker-dealer, subject to certain conditions. Those employees may receive a referral fee that is nominal, non-contingent and paid only in cash. There are special rules on fees for referrals of high net worth and institutional customers. The proposal is not intended to disrupt traditional bonus plans that are: 1) unrelated to securities transactions conducted at a broker-dealer and referrals to a broker-dealer or 2) based on any measure of overall profitability of the bank or any of its affiliates or operating units (other than a broker or dealer). The proposed rules also specify acceptable bonus payment practices.

The second exception lets a bank continue to make securities transactions for its trust and fiduciary customers if the bank receives predominantly "relationship compensation," including administration fees, annual fees, processing fees that do not exceed the bank's cost for executing the transactions and fees based on a percentage of assets under management. The proposed rule prohibits public solicitation of brokerage business other than in conjunction with the bank's advertising of its other trust and fiduciary activities.

The third exception allows banks to conduct a variety of securities activities in connection with customary custody activities. As with the previous two exceptions, the rules limit employee compensation and restrict bank advertisements and marketing practices. Banks may not act as a "carrying broker" for a registered broker-dealer under the proposed rules.

The fourth exception lets banks sweep deposits into a load money market mutual fund if the bank does not characterize the fund as being no-load and provides the fund's prospectus to the customer before sweep transactions are authorized. A bank may transfer any type of customer money into a money market fund if the bank provides the customer with some other banking product or service that does not require broker-dealer registration, such as loan or escrow services.

In sum, the proposed exceptions basically let a bank continue to offer certain security services without registering as a broker. However, if a bank's activities don't qualify for the GLBA's statutory exceptions, including those exceptions outlined above, the bank will be required to either register as a broker with the SEC or transfer the activities to a registered affiliate or third-party brokerage firm.

The comment period ended before this issue of *Central Banker* went to print; the final rules have not yet been adopted. Once they are, banks will not have to comply with the new broker exceptions until at least June 30, 2008. For more information, see www.sec.gov/rules/proposed/2006/34-54946fr.pdf. ■

Regional Roundup

St. Louis Fed's Web Site Offers Audiocasts on Research Topics

Now you can listen to current Fed research on topics that may affect your bank. The St. Louis Fed is offering audiocasts with economists on selected topics that appeal to a wide audience, including bankers.

Audiocasts are based on published research. The audiocasts are available at www.stlouisfed.org/news and usually last no more than 15 minutes. The files are in .mp3 format and can be played with most media players and saved to your computer.

Current audiocasts include:

- **Payday lending.** New York Fed economist Don Morgan speaks on payday lending (interviewed by St. Louis Fed economist Bill Emmons) at www.stlouisfed.org/news/audiocast/paydaylending.html.
- **Tracking livestock.** St. Louis Fed economist Michael Pakko discusses the controversial National Animal Identification System at www.stlouisfed.org/news/audiocast/NAIS.html. ■

St. Louis Fed's Annual Report To Focus on Fed's Role in Bank Consolidations

The number of independent banking organizations is about half of what it was in the 1980s as the pace of banking mergers and acquisitions has increased. Nevertheless, banking competition remains healthy on the local level, and the stability of the banking system is as solid as ever. Learn how the Federal Reserve acts to produce these positive outcomes in the St. Louis Fed's 2006 annual report, titled: *Checkpoint: The Federal Reserve's Role in Ensuring Safety, Soundness and Competitiveness in a Consolidating Banking Industry.* The report will be released in June and will also be available online at www.stlouisfed.org. ■

Fed Tells Its Story In Plain English

Just what *does* the Federal Reserve Bank do? Is it just the "bank for banks"? Or is there more to the story?

The Federal Reserve offers a free DVD, *In Plain English,* which takes you through the three main entities and three main responsibilities of the Federal Reserve. You can use this resource as part of your bank's orientation and training programs for new tellers, employees and directors. The DVD could also serve as a tool to aid bankers engaged in public discussions or to help teach students about banking as a profession. To order *In Plain English* DVDs, go to www.stlouisfed.org/publications/pleng/OrderForm.cfm ■

FFIEC Tells of Lessons Learned from Hurricane Katrina

The FFIEC (Federal Financial Institutions Examination Council) and the Conference of State Bank Supervisors have released *Lessons Learned From Hurricane Katrina: Preparing Your Institution for a Catastrophic Event.*

The resource is filled with bankers' experiences dealing with widespread communications and power outages and a lack of transportation.

The resource is intended to help others with disaster recovery and business continuity planning and is available at www.ffiec.gov/katrina_lessons.htm. ■

Fed's AMI Now Includes Account Information

In today's fast-paced environment, having immediate access to account information can give you an edge. FedLine® Customer Access Services now includes accounting information with the Account Management Information (AMI) tool. This online inquiry tool gives real-time access to account information, statements and cash management reports.

Even if you don't reconcile directly with the Fed, you can benefit from AMI's notification service, which produces electronic advices each time a specified item is processed to your routing transit number.

Visit www.frbservices.org for detailed information on all that's available through AMI. Whether you're just giving AMI a try or you're a seasoned expert, check out the AMI eLearning tool, a tutorial showing screens and explaining where specific information is found on AMI.

You can also call 1-800-333-0869 or e-mail accountingservices@stls.frb.org and ask for your institution profile to make sure you're taking advantage of all the tools available to you. ■

* *FedLine is a registered trademark of the Federal Reserve banks.*

Recalling Ben Bernanke's First Year as Fed Chairman

By Justin P. Hauke and Edward Nelson

Edward Nelson (left) is an economist and assistant vice president and Justin P. Hauke is a senior research associate in the Research division at the Federal Reserve Bank of St. Louis.

When Ben Bernanke was sworn in as Chairman of the Federal Reserve on Feb. 6, 2006, he inherited a low inflation economy of unmatched stability. After nearly two decades of Alan Greenspan as chairman, the appointment of a successor was a major watershed—signifying the end of a very successful, if sometimes opaque, period of monetary policy.

Prior to Bernanke's appointment, several analysts expressed concern about preserving continuity with the "Greenspan Fed." Under Greenspan, monetary policy had become perceived as amounting to a one-man show, focused primarily on the chairman's judgment and high reputation. Some economists, while acknowledging Greenspan's success, stressed the need for more depersonalized monetary policy, with one arguing, "It is reasonable to be concerned about the extent to which favorable monetary policy has arisen because of the idiosyncratic traits of particular central bankers."[1]

Once Bernanke's nomination was announced, observers looked for differences in his perspective from Greenspan's. It had frequently been noted that, while Greenspan defined the optimal rate of inflation as "zero, if inflation is properly measured," he had been less specific about how actual, measured inflation should behave.[2]

Bernanke, by contrast, expressed his preferred level of inflation as around 2 percent in the measured rate. In addition, while Greenspan preferred a relatively unstructured approach to monetary policy that maximized his own room to move, Bernanke was on record as favoring an announced "inflation objective," which would help inform the public about the Fed's future policy actions.[3]

The past year's record suggests that fears surrounding post-Greenspan economic prospects have not been realized. Throughout 2006, Chairman Bernanke and the Federal Open Market Committee have carried out monetary policy in a manner consistent with the aims Bernanke expressed in his 2005 confirmation hearings. In those hearings, Bernanke had said he would make "continuity with the policies and policy strategies of the Greenspan Fed a top priority."[4] In addition, Bernanke has emphasized his agreement with Greenspan that low and stable inflation is necessary for sustained economic growth.

Chairman Bernanke has also stressed the importance of structural changes in the real economy, particularly in the area of labor productivity. Over the past decade, productivity growth increased nearly twice as fast on average as it did from the early 1970s until 1995.[5] This shift has allowed the economy to absorb greater growth rates of aggregate demand without generating inflationary pressure.

The economic results of the Bernanke regime must be interpreted tentatively, both because little more than a year's worth of data is available and because it takes time for monetary policy actions to affect the economy. But outcomes so far are encouraging. Inflation has generally been low, aside from energy-driven spikes that did not spill over into higher inflation expectations. In addition, the economy has grown at a healthy pace.

These outcomes suggest that the new leadership at the Fed has been successful in preserving continuity with the Greenspan era. ■

ENDNOTES:

1. Jeffrey C. Fuhrer, "Optimal Monetary Policy in a Model with Habit Formation and Explicit Tax Distortions," Federal Reserve Bank of Boston working paper No. 16, Dec. 2001; quotation from page 1.
2. Alan Greenspan, as quoted in transcript of the FOMC meeting of July 23, 1996, p. 51.
3. Ben S. Bernanke, "Panel Discussion: Inflation Targeting," Federal Reserve Bank of St. Louis *Review*, July/Aug. 2004, 86(4), pp. 165-168; quotation from page 165.
4. Ben S. Bernanke, testimony at Senate confirmation hearings, Nov. 15, 2005.
5. Ben S. Bernanke, "Productivity," speech before Leadership South Carolina, Greenville, S.C., Aug. 31, 2006.

FedFacts

Public Welfare Investments Redefined, Cap Raised

One of the significant changes in the Financial Services Regulatory Relief (FSRR) Act of 2006 was to the authority that banks have to make public welfare investments. The act raised the cap on the maximum aggregate public welfare investments that state member and national banks can make, from 10 percent to 15 percent of the bank's unimpaired capital and surplus.

FSRR also redefines a permissible "public welfare" investment as one that primarily benefits low- and moderate-income (LMI) communities or families. State member and national banks had been permitted to make investments that primarily promote the public welfare, with LMI-focused investments included as the principal example of a permissible investment. For more information, see www.occ.gov/ftp/bulletin/2006-44.html. ■

Directo a México Sends Money to Mexico

Banks can help customers send funds from the United States to Mexico for less than $5 per transaction with *Directo a México* (Direct to Mexico), a product introduced by Federal Reserve banks and *Banco de México,* the central bank of Mexico.

FedACH International Mexico Service, the service that supports *Directo a México,* is priced so that banks can offer it at competitive rates. ACH is a low-cost payments channel and is already in place in almost every financial institution in the United States. For this reason, there are no setup costs for most banks.

Financial institutions can receive a *Directo a México* tool kit that includes Spanish-language promotional materials. More information on *Directo a México* is available at www.frbservices.org/Retail/intfedach.html. ■

CalendarEvents

UPCOMING FED-SPONSORED EVENTS FOR EIGHTH DISTRICT DEPOSITORY INSTITUTIONS

Reaching the Unbanked and Underbanked

LITTLE ROCK, ARK.—JULY 19

This ongoing series provides financial institutions with the tools they need to create products and programs targeted to the unbanked and underbanked in their communities. This particular session will focus on acquiring new customers with free tax preparation services and using community partnerships to reach the unbanked. The fee is $15. Register by July 12. Contact Julie Kerr of the St. Louis Fed's Little Rock Branch at 501-324-8296 or julie.a.kerr@stls.frb.org.

Trends in Neighborhood Unemployment

ST. LOUIS—JULY 24

Fed economist Christopher Wheeler will present his new study on the rising concentration of unemployed residents in America's urban neighborhoods. Wheeler studied neighborhood-level unemployment in more than 360 U.S. cities. The presentation will include information on Little Rock, Louisville, Memphis and St. Louis. A panel discussion will follow. To register, contact Cindy Davis of the St. Louis Fed to 314-444-8761 or communityaffairs@stls.frb.org.

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