Fourth Quarter 2001

SRC Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.

Volume 6 Issue 2

IN THIS ISSUE

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SVP Commentary on...

Consumer Debt and Credit Risk

by Michael E. Collins

On September 11, people in America and worldwide watched in horror as terrorism came to America's shores. We all were affected by these events, whether directly or indirectly, and we had to use business crisis management and human relationship skills in ways that we could not have foreseen. I would like to commend our Third District institutions for recognizing the importance of continuing to meet their business objectives while coping with the human aspects of this tragedy.

September's shocks altered the economic landscape and heightened an already growing concern about credit risk. Although the U.S. financial system remains stable, the recent disaster has caused a shift in fortunes among U.S. corporations and industries and post-September 11 banking challenges will be greater. Some industries will suffer, including tourism, restaurants, hotels, airlines, and insurance. Other industries will benefit, including defense, telecommunications, construction, and capital goods.

David Bowers/Scott Hull Associates

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Financial Subsidiaries – Another Option in Financial Modernization

by James D. DePowell, Regulatory Applications Manager

The Gramm-Leach-Bliley Act (GLB) ushered in a new era for financial modernization, even though many new activities were already well under way at banking institutions through a variety of legal precedents and regulatory interpretations. Nevertheless, the new law provides opportunities to engage in a wider variety of nonbanking activities and more options for the legal entities that may conduct them. While financial holding companies have emerged as the most common vehicle for engaging in securities, insurance, and other financial in nature activities, the new law also creates opportunities for banks to conduct new activities in financial subsidiaries. Because these activities are housed directly under the insured depository institutions, Congress imposed additional restrictions on financial subsidiaries that do not apply to financial holding companies.

> A financial subsidiary may engage in activities that are financial in nature or incidental to financial activities and any activity that the bank may conduct directly.

In view of the recent issuance of the Federal Reserve's final rule on financial subsidiaries for state member banks (SMBs) (§208.71 et. seq. of Regulation H)[1], this is a good opportunity to provide a brief overview of financial subsidiaries and the highlights of the final rule. Although the OCC and the FDIC have issued similar rules for national and state nonmember banks, respectively, this article primarily addresses financial subsidiaries at SMBs.

Activities at Financial Subsidiaries

GLB authorizes qualified SMBs to own or control a new type of subsidiary, referred to as a financial subsidiary. A financial subsidiary may engage in activities that have been determined to be financial in nature or incidental to financial activities under GLB, including general insurance agency activities in any location and travel agency activities. In addition, a financial subsidiary may engage in underwriting, dealing in, and making a market in all types of securities – activities previously prohibited for subsidiaries of SMBs by the Glass-Steagall Act. A financial subsidiary of an SMB also may conduct any activity that the bank is permitted to conduct directly.

GLB prohibits financial subsidiaries from engaging in certain types of activities. As a general matter, a financial subsidiary may not engage as principal in underwriting insurance, providing or issuing annuities, real estate development or real estate investment, and merchant banking and insurance company investment activities. In addition, a financial subsidiary may not engage in activities that the Board of Governors of the Federal Reserve System (the Board) deem to be "complementary" to financial in nature activities.

Qualifying Criteria

The following criteria must be met before a state member bank may control or hold an interest in a financial subsidiary:

- The SMB and each of its depository institution affiliates must be well capitalized and well managed. An insured depository affiliate is "well capitalized" if it meets or exceeds the capital levels designated as "well capitalized" by its appropriate Federal banking

[1] See the Board of Governor's press release and the final rule at <www.federalreserve.gov/boarddocs/press/boardacts/2001/20010813/default.htm>.

agency under section 38 of the Federal Deposit Insurance Act. Generally, “well managed” refers to the achievement of at least a satisfactory overall rating at the bank’s most recent examination and must include at least a satisfactory assessment of management.

- The SMB and all its insured depository institution affiliates must maintain at least a satisfactory CRA assessment.

- The size of the financial subsidiary may not exceed the lesser of 45 percent of the SMB’s consolidated total assets or $50 billion.

- In the event the SMB is one of the 100 largest insured banks and desires to engage in a newly authorized activity as principal, it must have at least one issue of outstanding eligible debt that is currently rated in one of the three highest investment grade categories by a nationally recognized rating agency. The second 50 largest banks can meet this requirement if they obtain a current long-term issuer credit rating that is within the three highest investment grade categories from at least one nationally recognized rating organization.

Prudential Safeguards

GLB established several prudential safeguards to ensure that the SMB’s banking assets and the FDIC insurance fund are not exposed to imprudent risks related to nonbanking activities at financial subsidiaries.

- An SMB with a financial subsidiary must de-consolidate the assets and liabilities of its financial subsidiary from those of the bank for regulatory accounting purposes and then deduct the aggregate amount of its equity investment in all financial subsidiaries from the bank’s capital and assets. Specific procedures for making the deductions for each regulatory capital measure are contained in the final rule. The resultant capital ratios must meet all regulatory requirements, and regulators will continue to review the operations and the financial and managerial resources of the bank on a consolidated basis as part of the supervisory process.

- An SMB with a financial subsidiary must establish and maintain policies and procedures to manage the financial and operational risks arising from its ownership of the financial subsidiary and preserve the bank’s separate corporate identity.

- For purposes of the anti-tying prohibitions of the Bank Holding Company Act Amendments of 1970, a financial subsidiary is considered a subsidiary of the bank holding company and not a subsidiary of the bank.

- A financial subsidiary of an SMB is considered an affiliate (and not a subsidiary) of the bank for purposes of sections 23A and 23B of the Federal Reserve Act, and is subject to the GLB special provisions governing the application of section 23A to investments in and extensions of credit to a financial subsidiary. The requirement that the SMB’s investment in its financial subsidiary(s) count against the 20 percent statutory limit on transactions between the bank and all of its affiliates is potentially onerous, as it can limit the ability of the combined organization to engage in additional intercompany transactions that may be desirable from a financial standpoint.

Failure to Comply with Qualifying Criteria or Prudential Standards

An SMB controlling a financial subsidiary will be notified if (i) it or any of its affiliated depository institutions fails to continue to be well capitalized and well managed, (ii) the assets of the bank’s financial subsidiary exceed the asset limitation imposed on financial subsidiaries, or (iii) the SMB has failed to comply with the operational safeguards required by the rule. In addition, the final rule also provides that an SMB must submit notice to its Reserve Bank within 15 calendar days of becoming aware of a change in an affiliate’s capital or managerial status, identifying the relevant depository institution affiliate and the area(s) of noncompliance.

Upon receipt of a noncompliance notice from its Reserve Bank, the bank must execute an agreement with the Board or its appropriate Federal banking agency to bring itself back into compliance with the requirements of the rule. This may result in conditions being imposed by the Board or other agency. Failure to correct the deficiencies within 180 days may result in the Board or other agency requiring the divestiture of the financial subsidiary.

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A Brief Q & A

E-Banking in the Third District

At the September Bankers' Forums in the Field, we had the opportunity to meet with approximately 60 officials from Third District banks and bank holding companies. One area of discussion was the impact of e-banking on the financial institutions in the District. We would like to share with you some of the e-banking issues that were discussed at these Forums.

What is the most recent guidance on internet banking released by the Federal Reserve?

The Board of Governors of the Federal Reserve System has recently developed examination procedures for electronic banking. This guidance includes an overview of electronic banking products and services and the required oversight of management and the board of directors. In addition, the guidance discusses internal controls related to e-banking and briefly reviews information security techniques. The guidance will be incorporated into the next update of the Commercial Bank Examination Manual. However, the procedures are available today on SRC's public website at <www.phil.frb.org/src/examinations/internetbanking.html>.

Is there any current guidance on authentication tools and procedures?

The Board of Governors of the Federal Reserve System released SR 01-20, *FFIEC Guidance on Authentication*, on August 15, 2001. The letter discusses the three current methodologies of authentication and how to perform a proper risk assessment to determine appropriate authentication tools. On-line account originations and customer verification is briefly discussed, as well as monitoring and reporting. Information on current authentication methods is described in the appendix attached to the SR Letter.

Has there been an increase in the use of authentication services in the Third District?

Aside from the traditional authentication tools such as passwords and PINs, there has been an increase in use of outsourced products. One product used by Third District banks allows visitors to their web site to confirm the address of the site and the operator.

Another product allows visitors to the web site to click on an icon to verify the legitimacy of the site. This product uses public key infrastructure technology (PKI). PKI involves the creation of digital certificates, which can be created for both individuals and businesses. Digital certificates are issued and maintained by a third party who verifies the identity of the digital certificate user via some form of reliable data (e.g., birth certificate, driver's license, etc.).

What are the current e-banking trends in the Third District?

The percentage of Third District state member banks operating web sites has grown dramatically in 2001 and is rapidly approaching 100 percent. This number includes both information and transaction based web sites. The majority of transaction based web sites offer a bill payment feature. There has also been an increase in the number of state member banks offering on-line credit applications. In addition, many sites now have the bank's privacy policy posted.

A growing trend is the use of links to various other web sites. Used as a customer service feature, links to the Federal Reserve, news, weather, and entertainment sites have been increasing. Institutions should be careful when providing links to local businesses that offer credit-related products to ensure that they do not inadvertently violate any consumer regulations.

Are the prospects for the future of electronic banking as strong as originally predicted?

The prospects for electronic banking are still strong but the model continues to change. Pure internet banks have not achieved the overwhelming success they once anticipated. Some of this is due to the downturn in the dot-com arena and some is due to the slower than expected acceptance of on-line banking. Many internet banks have found they need to develop some form of physical presence to complement their on-line banking services, thus the rise of the brick and click institution.

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[1] See SR 01-20, *Guidance on Authentication*, at <www.federalreserve.gov/boarddocs/SRLETTERS/2001/sr0120.htm>.

On the other hand, the number of banks with a web presence is quickly increasing as institutions strive to offer all delivery channels. There is customer demand for e-banking; it is just less than what was originally predicted. The outlook for e-banking is still positive, it is just the form that will continue to develop and change.

Will wireless technology permanently change the face of electronic banking?

At this stage in the game it is too early to tell. What is important about wireless technology is that, through the use of cell phones, the delivery channel may be even more wide spread and user friendly than on-line banking was when it was introduced. In addition, on-line banking and wireless technologies are exciting delivery channels because of convenience, and wireless technologies represent the next step in the evolution of online banking.

Although it is somewhat premature to make projections regarding the speed at which this technology will be adopted, there have been studies regarding customer interest in this delivery channel. According to a 2001 survey published in the *American Banker*, eight percent of survey respondents stated they were very interested in wireless banking services and another fourteen percent stated that they were somewhat interested. This interest by the consumer, coupled with the proliferation of cell phone use throughout the country, will provide an environment in which financial institutions will have to at least evaluate this delivery channel in the not-to-distant future.

What is the number one complaint of e-banking customers?

According to a 2001 survey published in the *American Banker*, the number one complaint of e-banking customers is service interruptions, closely followed by slow log-in results. Other significant complaints were security concerns, which tied for third place with difficulty in using the web site; slow processing; price; and impersonal web sites.

If you have questions about e-banking in the Third District, please contact Frank Doto, Manager (frank.doto@phil.frb.org) at (215) 574-4304 or Joanne Branigan, Assistant Examiner III (joanne.branigan@phil.frb.org) at (215) 574-3769. ■

Internet Banking on the Web

Visit SRC's Internet Banking web page for links to guidance disseminated by the Federal Reserve and other banking agencies. As your institution moves along the electronic banking continuum, papers and guidance such as these might prove to be helpful.

- Federal Reserve Electronic Banking Examination Procedures
- Checkers Bank: An Interactive Learning Tool for Consumer Regulation Issues in Internet Banking
- Electronic Signatures in Global and National Commerce Act
- Guidance on the Risk Management of Outsourced Technology Services (SR 00-17)
- Tips for Safe Banking Over the Internet
- Basel Committee Risk Management Principles for Electronic Banking
- Basel Committee Electronic Banking Group Initiatives and White Papers

"Consumer Debt" *continued from page 1*

At banking organizations, we have already begun to see a large number of covenant waiver requests, a shift toward less leveraged structures, and a renewed focus on pricing commercial paper back-up lines. Along with a requirement for more equity in capital structures, we see an increased emphasis on hard asset collateral. A sharpened focus on operational risk is also evident.

The probable negative effects from these events have both contributed to and are reflected in the decline in consumer confidence measures. All of these dramatic shifts will make our future, even here in the Third District, more challenging than our past.

Without question, our near-term future has been dramatically altered, and industry performance during the first half of 2001 might no longer be an accurate predictor for performance over the coming months. However, I concur with Chairman Greenspan's testimony in late September when he stated that the economy's longer-run prospects have not been significantly diminished by these events. In addition, I take comfort in the fact that the industry has entered this period of change in rather strong health, and I am expecting this to be an earnings event and not a solvency event.

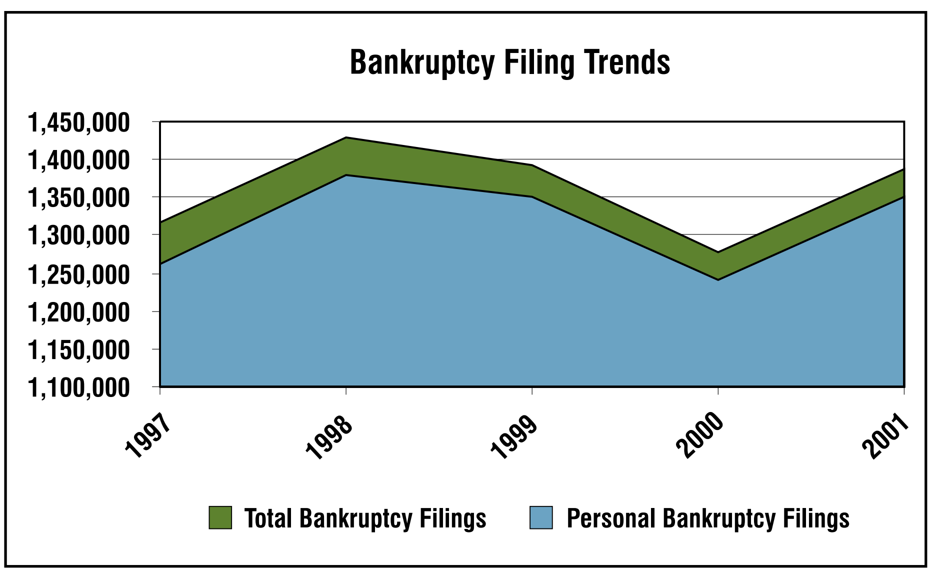
Nevertheless, the days of rapidly rising earnings and share prices have been curtailed, replaced by prospects for slow global and domestic economic growth in the near-term. Accordingly, today's banking strategies will center on reducing costs, managing credit exposure, and investing in critical businesses.

Insomuch as the consumer has driven the economy and, notwithstanding recent events, will continue to play a significant role in the nation's future growth, I would like to comment on consumer debt and credit risk. A lot has been written in recent months on the emerging consumer debt burden. While much of the data is indisputable, how the trends in consumer spending and debt might affect financial institutions is subject to debate and interpretation. First, let's look at the data.

Bankruptcy Filings

In August, the Administrative Office of the U.S. Courts[1] released statistics indicating that the number of personal bankruptcies rose 8.8 percent to 1,349,471 filings during the twelve-month period ending June 30, 2001. While this is not as high as the peak reached at June 30, 1998, the sharp increase from just a year ago is disturbing. In addition, the quarter-to-quarter increase is even more dramatic. Personal bankruptcy filings increased 24.8 percent from the three months ended June 30, 2000 to 390,064 filings during the quarter ended June 30, 2001.

The states comprising the Third Federal Reserve District were not immune from the increase in bankruptcy filings. Personal bankruptcies in Pennsylvania, New Jersey, and Delaware also rose 8.8 percent to 90,013 filings during the twelve-month period ending June 30, 2001. From the second calendar quarter 2000 to the same quarter in 2001, personal bankruptcy filings in the tri-state area increased 21.6 percent to 26,081.



[1] See the Administrative Office of the U.S. Courts' website at <www.uscourts.gov>.

The increase in filings is due in large part to the economic slowdown in 2001, coupled with rising consumer debt. However, tighter bankruptcy legislation pending in Congress, which would make it more difficult for personal credit card debt to be extinguished in bankruptcy, probably contributed to the increase.

> Consumer spending was largely responsible for the scope and duration of the recent economic expansion.

Consumer Debt and Spending

Consumer spending, which makes up approximately two-thirds of the U.S. economy, was largely responsible for the scope and duration of the recent economic expansion. The increase in consumer spending has fed, or arguably been caused by, similar increases in consumer debt. Since the last recession in 1991, the level of consumer debt, excluding real estate debt, more than doubled, increasing from $781 billion to $1.6 trillion at the end of the second quarter of 2001. During the same period, the level of revolving debt, which is primarily credit card debt, nearly tripled, rising from $248 billion in May 1991 to $694 billion at June 30, 2001.[2]

At the end of the second quarter 2001, consumers' total debt burden, the estimated ratio of debt payments to disposable personal income, was 14.04 percent, its highest level since the second quarter 1987. The consumer debt burden, which excludes mortgage payments, was 7.79 percent, virtually unchanged from the first quarter 2001, which was the highest level since 1988. The consumer mortgage debt burden was 6.25 percent, the highest level since 1991.[3] These debt burden statistics reflect not only the increasing propensity for consumers to borrow, but also their propensity to borrow against the equity in their homes. While home equity borrowing might have certain tax advantages, consumers are taking on the additional risk of foreclosure should they be unable to make the payments as scheduled.

Consumer Credit Quality

The increased level of consumer credit card debt, coupled with a slowing economy and rising layoffs, has somewhat predictably lead to an increase in credit card delinquency and charge-off rates. Moody's Investors Service[4] tracks the credit quality of the roughly $335 billion of U.S. bank credit card loans backing approximately 225 securities that it rates. The late-payment rate for these loans rose for the eighth consecutive month in July 2001, reaching 5.06 percent, up from 4.41 percent in July 2000. The loan charge-off rate increased for the sixth consecutive month, reaching 6.47 percent in July, up from 5.16 percent a year earlier. Despite the trends in delinquencies and charge-offs and the falling interest rate environment, Moody's reported that yields have remained relatively stable. The yield on credit card portfolios tracked by Moody's was 19.39 percent in July 2001, up marginally from 19.34 percent in July 2000.

What Does This Mean for Banks?

Of the $1.6 trillion in non-real estate consumer debt outstanding at August 31, 2001, commercial banks held approximately one-third, or $540 billion, on their books, including $213 billion in revolving debt and $327 billion in nonrevolving debt. An additional $375 billion in revolving debt and $155 billion in nonrevolving debt was held in pools of securitized assets.[5] While these are large numbers, they represent only 14 percent of the approximately $3.9 trillion in loans in commercial bank portfolios.

With the concentration of credit card banks in Delaware, one would expect Third District banks collectively to have broad exposure to consumer borrowings. This is the case, as Third

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[2] See the Federal Reserve's Statistical Release G.19 *Consumer Credit* at <www.federalreserve.gov/releases/G19/> and at <www.federalreserve.gov/releases/G19/hist/cc_hist_mt.html>.

[3] See the Federal Reserve's *Household Debt-Service Burden* at <www.federalreserve.gov/releases/housedebt/default.htm>.

[4] See Moody's Investors Service's website at <www.moodys.com>.

[5] See the Federal Reserve's Statistical Release G.19 *Consumer Credit* at <www.federalreserve.gov/releases/G19/>.

District banks held $64 billion in non-real estate revolving debt and $8 billion in nonrevolving debt at June 30, 2001. This represents over 51 percent of the $142 billion in total loans at District banks. However, excluding credit card banks, Third District exposure to consumer debt is significantly less. Non-credit card banks held only $400 million in non-real estate revolving debt and $4.4 billion in nonrevolving debt at June 30, 2001, representing less than 6 percent of the approximately $87.2 billion in loans in Third District commercial bank portfolios.

Due to the relatively small concentration of consumer loans in relation to total loans at commercial banks both nationwide and in the Third District, even a significant deterioration in consumer loan portfolios should not have a critical effect on overall bank performance. However, a continued economic slowdown or an increase in bankruptcy filings would be expected to affect more strongly those banks with a concentration in consumer lending, such as monoline credit card banks. Moreover, given that consumer spending is a key economic driver, a deep or protracted slowdown might have a significant spillover effect on business credit quality and investment, which could adversely impact bank and financial services performance.

America as a nation and Americans as individuals are remarkably resilient. Therefore, as you go about the business of banking over the coming months, I urge you not to lose sight of the financial well being of one of the important market segments in the Third District – our consumers. ■

"Financial Subsidiaries"

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In the event that an SMB or any of its insured depository institution affiliates receives a less than satisfactory CRA rating, the SMB would be prohibited from controlling any additional financial subsidiaries or engaging in additional financial in nature activities through existing financial subsidiaries. These prohibitions would continue in effect until the SMB and all of its affiliates again achieve at least a satisfactory CRA rating.

Notice Requirements

Before an SMB may acquire control of or an interest in a financial subsidiary, it must file a notice with its appropriate Reserve Bank. The notice must include certifications that it meets the qualifying criteria and a description of the current and proposed activities of the financial subsidiary and the specific authority permitting each activity. In the case of the initial affiliation of the bank with a company engaged in insurance activities, the notice must identify each state where the company holds an insurance license and the state insurance regulatory authority that issued the license. A notice will be deemed approved on the fifteenth day after receipt of a complete notice by the appropriate Reserve Bank, unless the Board or Reserve Bank advises otherwise.

Forming a Financial Subsidiary

There are various reasons why a bank may chose to conduct activities through a financial subsidiary. The primary reason that an SMB might form a financial subsidiary is that it does not have or does not desire to form a bank holding company. Depending on the unique circumstances of the bank, there might also be other strategic issues or financial considerations that make the financial subsidiary alternative attractive.

The decision to form a financial subsidiary should be weighed with the support of legal counsel possessing an appropriate level of expertise in banking legislation. However, the first critical step for the SMB is to determine whether a financial subsidiary is necessary for the activity it desires to conduct. For example, the financial subsidiary rule does not apply to a subsidiary that engages only in activities that the parent bank may conduct directly and that are conducted on the same terms and conditions that govern the conduct of the activity by the SMB. These activities may continue to be conducted through new or existing operations subsidiaries permitted under state law and Board interpretations, without complying with the requirements of the financial subsidiary rule.

If you have any questions on financial subsidiary notifications, formation, or permissible activities, visit the Regulatory Applications section of the Reserve Bank's web site at <www.phil.frb.org/src/applications/index.html>. Alternatively, you can contact Jim DePowell, Regulatory Applications Manager (jim.depowell@phil.frb.org) at (215) 574-4153. ■

A Behind the Scenes Look at How the Fed Values Collateral

by Kimberly R. O'Grady, Credit Risk Management Specialist

Asset Type	Collateral Value (in billions)	Dollar Percentage
Priceable		
US Treasuries	$ 14.81	8.03%
Agencies	32.84	17.82%
International Agencies	13.10	7.11%
Mortgage-Backed Securities	44.85	24.33%
Asset-Backed Securities	16.74	9.08%
Collateralized Mortgage Obligations	21.04	11.42%
Corporate Bonds	31.70	17.20%
Municipal Securities	9.23	5.01%
Total Priceable	**$184.31**	**32.12%**
Non-Priced		
Agricultural Loans	$ .99	0.03%
Commercial Loans	246.48	63.28%
Commercial Real Estate Loans	42.69	10.96%
Consumer Loans	50.70	13.01%
Residential Real Estate Loans	49.56	12.72%
Total Non-Priced	**$390.42**	**67.88%**

Depositary institutions pledge assets to Reserve Banks to serve as collateral for discount window advances, daylight and overnight overdrafts on reserve accounts, and Treasury programs. Over the past several years, the Federal Reserve System (the "System") has significantly expanded the types of collateral that it accepts for these purposes. As would be expected, acceptance of additional forms of collateral has brought about review of the valuation process.

Recently, a task force made up of collateral specialists from around the System completed a major effort to evaluate the System's collateral valuation practices. More specifically, the task force analyzed alternative market pricing practices in an effort to determine and implement the pricing practice that optimizes risk management of collateral pledged to the System.

To appreciate the relevance of this project some general background on collateral is needed. The Federal Reserve System maintains collateral in two systems, the National Book Entry System (NBES) and the Collateral Management System (CMS). NBES is the system of record for all US Treasury and Government Agency securities, as well as some Government Sponsored Enterprise securities. To date, NBES holds approximately 698,000 unique securities. On average, during the first half of 2001, approximately 10,600 of those securities were pledged as collateral to the System. CMS records all non-Treasury and Agency assets pledged as collateral to the System, including priced securities such as municipals and non-priced assets such as commercial loans. The table above provides some perspective on System collateral levels by illustrating the general categories of assets acceptable to be pledged as collateral and the amount currently pledged to the System.

The System currently values its marketable securities, or "priceable" collateral, by soliciting market prices from a vendor on a weekly basis. To determine the collateral value of the securities, a margin is applied to the market price to account for the interest rate and credit volatility of the asset until it is re-priced. For those assets types where a reliable pricing source is not available (e.g., loans) a margin is applied to the outstanding balance to account for the theoretical market price and the interest rate and credit spread volatility.

The collateral task force's effort to review the valuation of marketable securities included analyzing the current weekly pricing practice and numerous other pricing alternatives, including daily pricing of collateral, ad-hoc pricing of collateral, and using multiple pricing vendors. To obtain information on the pricing services available in the market place and the associated costs, a request for proposal was distributed to eight prospective securities pricing vendors. Seven vendors responded to the request for proposal. Each vendor's response was evaluated against a variety of criteria, including completeness of coverage, accuracy of prices, breadth of supplementary information (maturity, coupon rate, duration, etc.), contingency capabilities, and financial strength.

The task force considered the cost of each pricing option in relation to the benefits and the direction of the System with regard to collateral management to determine the best pricing approach. Based on these considerations, the current practice of pricing collateral on a weekly basis with the optional capability of repricing on an ad-hoc basis proved to be the best option. This option allows the System to continue its current valuation practices while also reducing its exposure to market risks when those risks are deemed unacceptable. In addition to adding the ability to price collateral on an ad-hoc basis, this effort also precipitated a change in the System's pricing vendor. The new vendor will streamline the collateral valuation process and ensure the highest quality prices and service level to the System. The other pricing options researched did not optimize the System's risk management of collateral and the associated costs generally outweighed the benefits.

The System plans to implement the ad-hoc pricing capabilities and utilize its new pricing vendor by year-end 2001. However, these changes should be transparent to depository institutions.

If you would like additional information on the System's collateral acceptability or valuation criteria, please contact Kimberly R. O'Grady, Credit Risk Management Specialist (kimberly.ogrady@phil.frb.org) at 215-574-6527. ■

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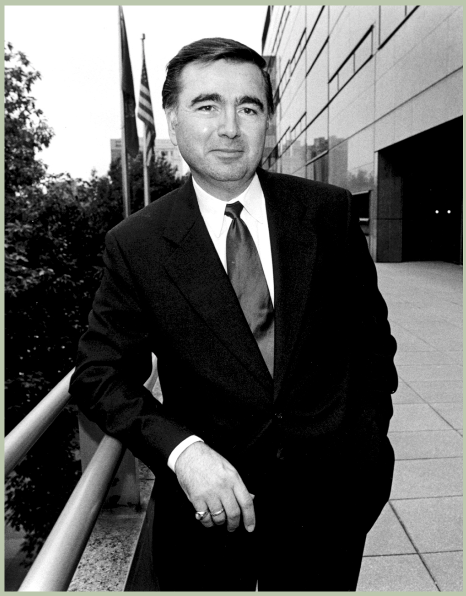
Does Bank Regulation Help Bank Customers?

On October 26, 2001, Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, spoke before the Frontiers in Services Conference on whether bank regulation helps bank customers. The full text of President Santomero's remarks is available on the Bank's web site at <www.phil.frb.org/publicaffairs/speeches/santomero15.html>. Reprinted here are his concluding remarks.

Let me conclude by returning to the question with which I began: Does bank regulation help bank customers?

In some cases, my answer is a clear "yes," though perhaps not in the way one might at first think. As I said early on, in order for the nation to have a sound and stable banking system, the government must absorb some of the risks inherent in the system. In the United States, government does so by serving as deposit insurer, payment guarantor, and lender of last resort. Having absorbed these risks, the government must regulate and supervise banks to ensure they do not introduce new ones. So bank regulation is part and parcel of having the sound and stable banking system that bank customers in the U.S. enjoy.



In other cases, my answer is a clear "no." Regulations that do not take into account the self-interested reactions of market participants - both bankers and bank customers - will not serve bank customers or achieve any other regulatory goal. At best they will have no effect; at worst they will produce unintended and deleterious consequences.

And finally, in some cases, my answer is a clear "maybe." In principle, bank regulation can help bank customers if they increase the degree of competition or the flow of information in the marketplace and thus drive suppliers to do a better job of meeting their customers' demands. But in practice, regulations designed to improve the quality of information, such as Truth-in-Lending or Truth-in-Saving, have met with mixed success at best.

Recent developments in the subprime lending market, particularly the egregious episodes of predatory lending, deserve regulators' serious attention. My personal belief is that the most effective and lasting solution to this problem lies not in regulation, but in education.

I'll conclude today by making a bold point to you. Given today's fast-growing, complex, and sophisticated financial marketplace, raising the general level of financial literacy among consumers may be a more productive use of public resources than any new regulatory initiative. ■

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Editor.................Cynthia L. Course

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