SRC Insights

Second Quarter 2012 / Volume 16 Issue 4

Federal Reserve Bank of Philadelphia

Pg. 5

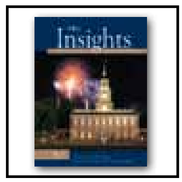
A Farewell to *SRC Insights*: New Connections with Community Banks

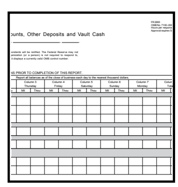
SRC Insights is published quarterly and is distributed to institutions supervised by the Federal Reserve Bank of Philadelphia. The current and prior issues of *SRC Insights* are available at the Federal Reserve Bank of Philadelphia's website at www.philadelphiafed.org. Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-6633), or by e-mail (katrina.johnston@phil.frb.org). Please address all correspondence to: Katrina Johnston, Federal Reserve Bank of Philadelphia, SRC - 7th Floor, Ten Independence Mall, Philadelphia, PA 19106-1574.

Editor...........Julie D'Aversa
Editor...........Katrina Johnston
Designer......Roberta Nicholson

FEDERAL RESERVE BANK OF PHILADELPHIA

In this Issue...





ON THE COVER:

Fireworks display over Independance Hall, Philadelphia, PA

Letter from the Editors

Katrina Johnston and Julie D'Aversa, Editors

The End of an Era: *SRC Insights* Closes Its Pages

Although it's been a long journey, covering nearly 17 years of banking supervision matters, *SRC Insights* is closing its pages with this issue. This publication has provided insight into so many varied topics over the years, and it has received a great response from its esteemed readers. The Federal Reserve System recognizes the importance of outreach initiatives like this one, so you will soon receive a new publication in place of *SRC Insights*. *Community Banking Connections* is a new quarterly Systemwide publication focused on community banks that will be published in the third quarter of 2012. An expanded website will also be available soon. Although it won't be dedicated specifically to Philadelphia's Third District, it will provide robust information and perspectives on supervision and regulation matters that affect community banking institutions across the country. We are certain that you will find it to be a valuable addition to your reading, and we encourage you to provide the editors with any feedback you may have on the publication or content.

Before we close this chapter, though, we wanted to take a look back on where we've been in our journey of *Insights*.

Before it all began, in the fall of 1995, interviews were held with bankers as part of a Systemwide effort to enhance the Federal Reserve's supervisory processes for the 21st century. Feedback from these interviews included a desire to enhance the communication and outreach efforts from the regulators to the banks. Therefore, in the third quarter of 1996, *SRC Insights* was created to provide new perspectives on current events affecting the financial services industry.

The first few volumes were purposefully lighter on content, encouraging ideas from bankers on what they wanted to hear from the Federal Reserve Bank of Philadelphia and the Supervision, Regulation, and Credit Department (SRC). However, each issue did, and still does, contain a "Supervision Spotlight" article from our senior leader, originally Senior/Executive Vice President Michael Collins and now Senior Vice President Bill Lang. This has been the perfect venue for the SRC senior leader to provide insight to bankers on some of the things they've seen, heard, or just wanted to discuss in greater detail. In addition to this recurring feature, authors have continually written about topics they found, not just in the news or community, but in discussions with bankers regarding issues they face during their day-to-day activities.

In 2001, we introduced *Compliance Corner*, a section of *SRC Insights* dedicated to consumer compliance and CRA issues at state member banks and bank holding companies. *Com-*

pliance Corner addressed all things compliance, including regulations, consumer complaints, payday lending issues, fair lending, and much more. Like *SRC Insights*, *Compliance Corner* evolved into a new Systemwide publication in 2008. *Consumer Compliance Outlook* is now your source for compliance information (www.consumercomplianceoutlook.org).

It's hard to remember a time when you couldn't just go to the Internet to search for information on any topic. When *SRC Insights* began, the Internet was just picking up speed, but we've since printed many articles related to technology, including online banking, Internet fraud prevention, and more. One of our first issues, the fourth quarter of 1996, discussed how the Internet is a rapidly-growing network and what its effects might be on banking. During the second quarter issue of 1997, a special feature was included to reveal the results of a survey conducted by the Third District on institutions' interest and participation in emerging technologies. At the time, only 50 percent of state member banks surveyed had a home page on the Internet, while 17 percent planned to implement a home page. While we can only assume that the remaining 33 percent have implemented full websites by now, it's interesting to note how quickly things change and how important emerging technologies are to the way we do business. Technology will always be a pertinent subject with big impact, and the article, "Technology and the Competitive Edge for Community Banks" in this issue discusses it as well.

Authors have continually written about topics they found, not just in the news or community, but in discussions with bankers regarding issues they face during their day-to-day activities.

Other timely and interesting articles throughout the years included contingency planning for Y2K, subprime lending in 2001 and again in 2008, and preparing for the avian influenza (bird flu) pandemic in 2006. Additionally, new regulations have provided great subject matter for our authors. Many new regulations were highlighted and explained in articles, such as Regulation W in 2002, Sarbanes-Oxley in 2003, Basel II in 2004, and Dodd-Frank in 2011. Many of these subjects seem far away in the annals of history, but at the time they brought very current concerns to light, and our articles attempted to clarify and inform our readers to limit any concerns.

While some of our topics have changed in accordance with the times, many have remained relevant throughout the years. From 1996 through today and beyond, certain themes will always be important. Some of these repeat topics include the following: interest rate risk, applications, commercial real estate lending, subprime lending, credit risk, Bank Secrecy Act, balancing risk and innovation, trust-preferred securities, allowance for loan and leases losses, and more. Explaining new guidance, especially, has been a key goal in many issues of *SRC Insights*.

We have also tried to keep the look and feel of the publication current and appealing by including more graphs and illustrations over the years, even providing a crossword puzzle in some of our 2001 editions. To keep up with changing graphics and layout styles, we've redesigned the covers and added color and illustrations to various articles over the years.

So although this is the end of an era for *Insights*, we hope we've provided value to our audience as we've all navigated this ever-changing environment. We're thankful to our bankers for the interest and questions you have provided throughout the years. And we are very thankful to our authors and contributors—the past 17 years would not have been possible without your contributions and hard work. We consider this a great success and hope you enjoy the Federal Reserve System's new publication, *Community Banking Connections*.

Supervision Spotlight

A Farewell to *SRC Insights*: New Connections with Community Banks

by William W. Lang, Executive Vice President and Lending Officer

William W. Lang, Executive Vice President and Lending Officer

Community banks are often defined as institutions having less than $1 billion in total assets. Using this benchmark, over 84% of Third District commercial banks are considered community banks. The Federal Reserve Bank of Philadelphia has recognized the important role of community banks for many years and remains deeply committed to understanding the current risks and issues facing this segment and to providing resources to assist community banks in the Third District.

Through the years, a series of well-established local programs and publications has been developed to facilitate greater interaction and to promote information sharing between bankers and regulators. One cornerstone of our outreach effort, this *SRC Insights* newsletter, will end a 16-year publication run with this issue. *SRC Insights* is not being retired because it has become obsolete, as its goals and purpose are particularly relevant in today's environment. Rather, SRC's outreach efforts are evolving and being focused on developing a new national Federal Reserve publication directed at addressing issues facing community banks. The first issue of the new publication, *Community Banking Connections*, will debut in the third quarter of 2012, with a joint website that will provide extensive resources to community banks.

We truly appreciate your readership over the years. Banking is a dynamic industry, and we hope that you found the *SRC Insights* topics and articles to be timely and useful; the letter from the editors in this issue takes a look back on pertinent topics discussed through the years. Of course, we remain committed to our other outreach efforts and will continue to convey regulatory developments, as well as Third District regional and local information, through other in-person communication channels, such as field meetings, bankers' forums, directors' workshops, and other events.

In my final *Insights* article, I will look at today's community banking business environment and highlight some recent Federal Reserve enhancements and initiatives designed to improve the effectiveness of communications with community banks and, to the extent possible, reduce unnecessary regulatory burden.

Community Banks by the Numbers

Third District community banks have been challenged during the financial crisis, and they now face a new set of challenges in its aftermath. For the most part, Third District institutions did not originate material amounts of subprime or nontraditional residential mortgage products, nor did they invest heavily in complex hybrid securities. However, many community banks did take on high concentrations of commercial real estate (CRE). The CRE exposures, particularly exposures to construction and land development lending (C&LD), became problematic as the housing market collapsed and the economy entered into a deep and prolonged recession.

While the recession has technically ended, and the housing market is no longer in free fall, growth remains sluggish, and the housing market remains troubled. In addition, community bankers are also facing an extremely low interest rate environment, rising compliance costs, slack loan demand, and intense competition for creditworthy customers. It is, therefore, not surprising that community bankers cite the difficulty of finding sources of top line revenue growth as one of their biggest challenges.

The Federal Reserve is responding to the current challenges facing community banks in multiple ways, including emphasizing improved communications with the industry.

As a result of these challenges, the number of community banks has been falling due to a combination of consolidation and failures. At the start of 2007, there were 144 commercial banks headquartered in the Third District, but by year-end 2011, that number declined to 116, a decrease of over 19%. For the nation, there were 6,900 commercial banks in 2007, but that number declined to 5,759 by the end of 2011, a loss of 1,141 banks, or 16 percent. While overall conditions have seen notable improvement and the number of problem banks has been falling slowly, over 800 banks nationwide still remain on the problem bank list, the majority of which are under $1b.

Furthermore, market share has shifted significantly through the decades. The total assets are more heavily concentrated in the nation's largest institutions. The Federal Reserve Bank of Dallas's 2011 annual report notes that, "Since the early 1970s, the share of banking industry assets controlled by the five largest U.S. institutions has more than tripled to 52 percent from 17 percent."[1]

Amid growing trepidation, some critics even began questioning the relevance of the community banking model in today's environment. The Federal Reserve, however, has always recognized the important role community banks serve. As Chairman Bernanke emphasized in a recent speech, "Community banks remain a critical component of our financial system and our economy. They help keep their local economies vibrant and growing by taking on and managing the risks of local lending, which larger banks may be unwilling or unable to do. They often respond with greater agility to lending requests than their national competitors because of their detailed knowledge of the needs of their customers and their close ties to the communities they serve."[2]

Federal Reserve's Enhanced Focus on Community Banks

The Federal Reserve is responding to the current challenges facing community banks in multiple ways, including emphasizing improved communications with the industry. Listening to and understanding bankers' perspectives are integral to this process. Regulators and bankers benefit greatly from ongoing and open dialogue that leads to meaningful solutions. A series of enhancements and initiatives has been designed to improve the effectiveness of communications and to find ways of reducing regulatory burden, where possible.

The importance of constructive two-way communication between industry representatives and regulators cannot be underestimated. Formal frameworks that call for periodic discussions can help facilitate the overall feedback gathering

---

[1] "Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now," 2011 Annual Report, Federal Reserve Bank of Dallas, dallasfed.org/assets/documents/fed/annual/2011/ar11.pdf.

[2] Bernanke, B., "Community Banking," speech at the Independent Community Bankers of America National Convention and Techworld, Nashville, Tennessee, March 14, 2012, www.federalreserve.gov/newsevents/speech/bernanke20120314a.htm.

process. One example is the Community Depository Institutions Advisory Council (CDIAC), which was established by the Board of Governors in 2010 and gathers representatives from commercial banks, thrift institutions, and credit unions. During its biannual meetings, the council provides information and advice and offers recommendations from the community depository institution perspective. A current listing of the members of Philadelphia's CDIAC is available at www.philadelphiafed.org/about-the-fed/directors-and-councils/councils/community-depository-advisory-council.cfm.

The Fed has embarked on an effort to more clearly communicate distinctions in how regulations and guidance apply to community banks relative to larger institutions.

In addition, bankers are typically given an opportunity to offer their insights on proposed rulemaking or guidance during set commentary periods open prior to enactment. A diverse array of viewpoints helps to make the overall decisionmaking process more robust and productive. Having spent time at the Board of Governors, I can assure you that your comments are given careful consideration, so I encourage all bankers to actively participate.

Examiners must also communicate clearly with bank management about supervisory concerns and expectations in order to help bankers make appropriate improvements. Banking Supervision and Regulation management is committed to ensuring that examination results are thoroughly vetted, that examiners take a fair and balanced approach, and that examiners provide clear and direct feedback to institutions. Finally, in the event of irreconcilable differences between examiners and bank management, there is a formal procedure in place to appeal supervisory ratings.

Providing greater transparency around the expectations and criteria used in the decisionmaking process helps bankers understand the reasoning behind decisions and allows them to better assess their current status independently. For example, on March 2, 2012, the Federal Reserve issued guidance titled *Upgrades of Supervisory Ratings for Banking Organizations with $10 Billion or Less in Total Consolidated Assets*.[3] This guidance was issued to "clarify application of the interagency ratings guidelines when in a period of stabilized or generally improving economic conditions."

Major banking reforms were needed to curb excessive risk in the banking industry and mitigate the risk or impact of future crisis. The expectations and costs associated with the implementation of Dodd-Frank rulemaking have remained a prominent concern among community bankers. While regulatory reform impacts the entire financial industry, the majority of the reforms were aimed at addressing issues related to large and systemically important financial institutions. Clearly identifying supervisory policies that exempt smaller banks could save time and effort and reduce regulatory burden. The Fed has embarked on an effort to more clearly communicate distinctions in how regulations and guidance apply to community banks relative to larger institutions. For example, where applicable, newly released guidance and regulations contain a clear and concise statement upfront that allows a reader to quickly determine whether specific regulations pertain to banks below a certain size threshold.

Economic research focused on community banking is mutually beneficial, and more needs to be conducted. Research studies can help regulators gain a better understanding of community bank operations, performance, comparative advantages, and contribution to the broader economy. Analytical studies and surveys may lead to new techniques for improving bank profitability, identifying and assessing emerging risks trends earlier, and better gauging the potential influence of regulatory responses.

---

[3] SR Letter 12-4, *Upgrades of Supervisory Ratings for Banking Organizations with $10 Billion or Less in Total Consolidated Assets*, March 1, 2012, www.federalreserve.gov/bankinforeg/srletters/sr1204.htm.

Finally, new approaches to conducting outreach are underway. As noted earlier, a new national quarterly publication devoted specifically to community banking is in development and is targeted for release early in the third quarter. The publication's website will also host a variety of resources of interest to community banks. Targeting the narrower audience allows us to highlight nuances and focus attention on the particular issues that are most relevant to the sector. The technology available in today's world has also ushered in new media channels and new expectations around how information is conveyed. The Federal Reserve will continue to expand into new avenues of communication.

Conclusion

The relationship lending and financial services that community banks provide to creditworthy individuals and small businesses help keep local communities vibrant and growing. Both challenges and opportunities are prevalent in today's environment.

The Federal Reserve System is committed to solidifying relationships with community bankers by enhancing our understanding of needs, improving modes of communication, listening to concerns, and pursuing mutually beneficial solutions. The development of this new System publication, *Community Banking Connections*, is an important new step toward attaining that goal. We at the Federal Reserve Bank of Philadelphia are proud and excited to be playing a prominent role in launching this new publication, and though we close *SRC Insights* today, we remain dedicated to fostering a constructive dialogue with community banks in the Third District.

FEDERAL RESERVE SYSTEM

COMMUNITY BANKING

CONNECTIONS

A SUPERVISION AND REGULATION PUBLICATION

The Federal Reserve System (System) recognizes the important role that community banks play in the larger economy. To provide stronger support and guidance to community banks, the System is launching a new publication focusing specifically on community bank matters. The first issue of the new publication, *Community Banking Connections*, will be released in the third quarter of 2012. Its website, www.communitybankingconnections.org, will also be available in the third quarter of 2012.

Community Banking Connections will include articles on current, common issues that community banks are facing; resources that provide further details on key supervisory guidance; highlights of new regulations; perspectives from bank examiners and other Federal Reserve staff; and much more.

The Federal Reserve Bank of Philadelphia remains committed to the specific needs of Third District institutions. We are certain that you will find *Community Banking Connections* to be a very helpful resource, in addition to our other outreach programs.

As always, your ideas and suggestions for articles and outreach efforts are welcome. Please email us at Editor@communitybankingconnections.org with any comments you may have.

From the **Examiner's Desk**

Becky Goodwin,
Team Manager

Technology and the Competitive Edge for Community Banks

by Becky Goodwin, Team Manager

Change is inevitable, and with each generation, there are shifts in technology that compel everyone to move forward. Today, it seems that expectations, coupled with cutting edge technology, produce some phenomenal results. In community banking, banks are expected to manage the expectations of the ever-changing technological landscape, meet the needs of their increasingly technically-advanced customer base, and satisfy their regulators, all while improving the bottom line. It can be quite a balancing act, but advanced technology may assist community banks with meeting these expectations, while helping them to maintain a competitive edge.

A 2010 technology survey conducted by the Independent Community Bankers of America (ICBA) revealed some interesting results regarding technology at community banks across the country.[1] The survey indicated that 82 percent of community bankers were primarily concerned with complying with regulations, 57 percent with detecting and mitigating fraud, and 44 percent with adding value to the organization. Of the 7,583 community banks surveyed and 895 responses, 54 percent of the respondents indicated that their banks' technology was on schedule, while 31 percent considered their technology to be less than desired. This article will highlight some potential technological solutions that might help community banks meet the many challenges they face.

[1] 2010 ICBA Community Bank Technology Survey, www.icba.org/files/ICBASites/PDFs/2010TechnologySurveyResults.pdf.

Consumer Appeal

Advances in cell phone technology affect nearly everyone. The trend in the use of smartphones is skyrocketing, as is the accessibility to numerous applications. Deloitte estimated that the combined sales of smartphones, tablets, and non-PC netbooks would be well over 400 million units, or more than half of all the computing devices sold throughout 2011.[2] In March 2012, Nielsen studies showed that nearly half of mobile subscribers in the U.S. own a smartphone.[3] More than ever, industries are preparing to gain a competitive edge by offering their customers convenience, easily accessible information, and transactional capabilities through various applications, including those applicable to smartphones.

The volume of smartphone usage and other technologies currently on the rise could provide banks with a way to diversify and improve revenue streams. Check-imaging systems that some banks offer to large business customers can cultivate strong relationships with volume-driven customers, designed to replenish the cost of technology investments. Moreover, mobile and online banking tools, such as electronic banking, paperless statements, and bill pay can

[2] Boulton, Clint, "Desktops and Notebooks: Tablets, Smartphones Fuel 10 Technology Trends for 2011: Deloitte," January 20, 2011, www.eweek.com/c/a/Desktops-and-Notebooks/Tablets-Smartphones-Fuel-10-Technology-Trends-for-2011-Deloitte-113531/.

[3] Hing, David, "US Smartphone Adoption on the Rise," March 30, 2012, mandmglobal.com/news/30-03-12/us-smartphone-adoption-on-the-rise.aspx.

serve to offer convenience to the tech-savvy consumer and broaden an institution's customer base and virtual accessibility.[4] These conveniences are becoming standard, even expected, in today's industry.

On the other hand, in the current economic environment, lost revenue is a viable concern. So, to make up for lost revenue, market research experts at Mintel Comperemedia suggest that banks consider adding fees for products such as mobile banking or mobile/online payments, rather than charging for the use of debit cards.[5] Diversifying fee income streams has the potential to offset the cost of new technologies.

Improving the Bottom Line

Aside from meeting the customers' needs, banks are concerned with adhering to regulatory requirements, while still achieving overall profitability. For example, the Dodd-Frank Act is changing the landscape of reporting requirements and expectations. Not all provisions of the legislation are applicable to community banks (considered to be those with less than $1 billion in assets); however, the potential impact to the competitive landscape may be concerning to some community bankers. The legislation is comprehensive, requiring some additional paperwork, and, according to author Richard Longo, community banks have some work to do in preparing for the Dodd-Frank Act and its associated regulations. The Community Depository Institutions Advisory Council, or the CDIAC, estimates that, despite exemptions made for small institutions, adhering to Dodd-Frank will require community banks to hire and train staff and increase transaction times. Longo estimates that successfully meeting these challenges with standard processes and procedures will cost community banks a quarter of their technology budgets. As such, a shift in a bank's core fundamental processes, coupled with an enterprise risk approach, will be necessary. [6]

In the current economic environment, traditional revenue streams continue to be challenged. Community banks are grappling with ways to control cost and diversify income sources to remain profitable and conserve capital. It is anticipated that throughout 2012 more financial institutions will look internally for nontraditional revenue sources, with a focus on improving operational efficiencies and increasing revenue.[7] Much of this will be driven by shifts in innovative technology. Lee Wetherington, director of strategic insight,

[4] "Technology Can Help Community Banks Compete Beyond Traditional Borders," McGladrey, mcgladrey.com/Strategy/Technology-can-help-community-banks-compete-beyond-traditional-borders.

[5] Brankin, Andrea McKenna, "Mintel: Banks Should Tap Mobile and PFM Products, Not Debit, for New Revenues," December 9, 2011, www.paymentssource.com/news/mintel-banks-tap-pfm-mobile-fee-revenue-not-debit-3008803-1.html.

[6] Longo, Richard, "What Community Banks Need to Survive the Dodd Frank Act," February 28, 2012, www.coretrac.com/what-community-banks-need-to-survive-the-dodd-frank-act.

[7] Messier, John, "5 Community Banking Predictions for 2012," January 11, 2012, www.banktech.com/management-strategies/232400205.

ProfitStars, stresses that new data visualization technology has empowered banks to better understand and capitalize on payment data that historically have been hidden away in inscrutable databases and spreadsheets.

Banks may find some resource and technology savings within existing systems. According to McGladrey, even though many banks fully use their in-house system, most banking systems are equipped with built-in reporting functions. Experts advise banks to conduct an information audit to examine the data they collect, determine why and what data they should collect, and then determine how to best use the existing systems to obtain and analyze that information. Ultimately, a broader understanding of a bank's core system and its abilities is essential for ensuring the highest and best use of the system and for controlling costs.[8]

Technology expansion brings with it increased and more complex forms of fraud and the need for more robust risk management systems.

Fraud Detection and Risk Identification

Technology expansion brings with it increased and more complex forms of fraud and the need for more robust risk management systems. However, newer technologies are also recommended for both early fraud detection and robust risk management. According to Tom Leuchtner, director of Financial Crime Control Solutions for Wolters Kluwer Financial Services, a technology solution can help increase the efficiency and effectiveness of monitoring efforts, avoiding the time and labor-intensive processes associated with manual fraud detection. By capturing and recording data across a network, an automated approach can alert an institution to threats and create an audit trail of flagged activity to streamline investigation and loss mitigation.[9]

Risk identification can also be enhanced through newer technology, which enables bank management to assess risk more holistically. An Oracle Financial Services Thought Leadership paper from December 2011 highlights the need for today's banks to quantify and measure all types of risk across an enterprise in an integrated manner to ensure close operational synergy between the risk and finance functions.[10] Enterprise risk management solutions can enable a bank to achieve compliance through a transparent and complete audit trail, while eliminating the need for expensive customized programming and time-consuming application maintenance based upon more sophisticated risk management applications.[11] These are just a few methods by which an institution can maximize technology to limit the strain on human resources.

Additional Guidance

To address the growth of electronic banking and the accompanying increase in sophistication of threats, the Federal Financial Institutions Examination Council (FFIEC) released updated guidance on Internet banking authentication for institutions.[12] Some of the guidelines include the following:

- Require annual risk assessments.
- Keep authentication consistent with the level of risk.

---

[8] Wetherington, Lee, "Visualizing Payments Data for Customer Analytics," April 11, 2012, www.bai.org/BANKINGSTRATEGIES/payments/transaction-processing/visualizing-payments-data-for-customer-analytics.

[9] Leuchtner, Tom, "4 Internal Frauds and How to Spot Them," *ABA Banking Journal*, May 26, 2011, www.ababj.com/briefing/4-internal-frauds-and-how-to-spot-them-1965.html.

[10] Imeson, Michael and Pugh, Gary, "Modernize or Fail: The Modernization Challenges Facing Banks, and the Technology Implications," *An Oracle Financial Services Thought Leadership Paper*, December 2011.

[11] Silva, Jerry, "Holistic Fraud Reduction Through Customer Security Management," searchfinancialsecurity.techtarget.com/tip/Holistic-fraud-reduction-through-customer-security-management.

[12] "FFIEC Releases Supplemental Guidance on Internet Banking Authentication," press release, June 28, 2011, www.ffiec.gov/press/pr062811.htm.

- Consider and implement layered security, where appropriate.
- Establish practices to detect and respond to suspicious activity.
- Implement a customer education and awareness program.

Conclusion

While community banks can readily employ new technology in efforts to meet strategic objectives and streamline operations, board and management decisions must be prudent, well researched, and openly discussed. Product offerings should be preceded by research, testing, and a review of regulatory compliance, prior to customer roll-out. Proper controls, monitoring and reporting processes, staffing requirements, compliance, and audit expertise should also be factored into the decisionmaking process.

Whether an institution is able to integrate new technologies into its framework or to simply find more comprehensive and efficient uses for its existing technology, there is great potential in examining the value and potential of evolving technology in meeting the expectations of customers, regulators, and shareholders.

Who to Call

Your institution may need to contact an officer, manager, or staff member in the Supervision, Regulation, and Credit Department, but you may not know whom to contact. The following list should help you find the correct contact person to call. Financial institutions that have an appointed central point of contact should generally contact that individual directly.

Contact names appearing in **bold** are the primary contacts for their areas.

Community Regional Supervision

William W. Lang, SVP	215-574-7225
Constance H. Wallgren, VP	215-574-6217
Joanne Branigan, Examining Officer	215-574-3769
John Munera, AVP	215-574-6056
Eric A. Sonnheim, AVP	215-574-4116
William T. Wisser, AVP	215-574-7267
Glen Davis, Manager	**215-574-6379**
Jacqueline Fenton, Manager	**215-574-6234**
Becky Goodwin, Manager	**215-574-4324**
Stephen J. Harter, Manager	**215-574-4385**
Adina A. Himes, Manager	**215-574-6443**
Lorraine Lopez, Manager	**215-574-6596**

Consumer Compliance & CRA Examinations

William W. Lang, SVP	215-574-7225
Robin P. Myers, AVP	215-574-4182
Carole Foley, Manager	**215-574-6494**
Robert Snarr, Manager	**215-574-3918**

Consumer Complaints

Federal Reserve Consumer Help Center	**888-851-1920**

Regulations Assistance

Regulations Assistance Line	**215-574-6568**

Enforcement

Constance H. Wallgren, VP	215-574-6217
Christopher C. Henderson, AVP	**215-574-4139**
Susan Gonzalo, Manager	**215-574-6211**

Regulatory Applications

A. Reed Raymond, VP	215-574-6483
H. Robert Tillman, AVP	215-574-4155
James D. DePowell, Manager	**215-574-4153**

Retail Risk Analysis

Paul Calem, AVP	**215-574-4132**

Discount Window and Reserve Analysis

Vish P. Viswanathan, VP	215-574-6403
Gail L. Todd, Credit Officer	**215-574-3886**

Simplified Reserve Requirements

by Donna Wilson, Credit and Risk Management Specialist

Donna Wilson, Credit and Risk Management Specialist

The current set of rules governing the administration of reserve requirements for depository institutions and Federal Reserve Banks is quite complex. These complexities have developed over time; for example, there are the rules governing as-of adjustments for check errors and FR2900 data revisions, as well as using an excess or deficient reserve balance in a future maintenance period. In addition, some depository institutions are on a 7-day maintenance period, but only report FR2900 data quarterly, while some depository institutions are on a 14-day maintenance period, but report FR2900 data weekly.

Given the various complexities that have developed over time, the Federal Reserve has recognized the need to simplify them and has identified four changes to the rules that will do so. These changes, or simplifications, will significantly reduce the complexity, administrative burden, and operational costs associated with reserve requirements. They will coincide with changes being made to Regulation D, which governs reserve requirements, and Regulation J, which relates to check collections, including references to as-of adjustments. Not only will these changes reduce the administration of reserve requirements, but they will also maintain the integrity of reserve requirements in implementing monetary policy.

The Simplifications

The four simplifications are:

1. The contractual clearing balance program will end.
2. Direct compensation will replace as-of adjustments.
3. All depository institutions will have a common maintenance period.
4. A reserve balance requirement band will replace carryover and routine waivers.

These four simplifications will be implemented in a phased-in approach. In April 2012, depository institutions received written communications about the first two changes to be implemented on July 12, 2012: the termination of contractual clearing balances and the elimination of the as-of adjustments. Additional communications will be sent out later this year on the common maintenance periods for all depository institutions and the reserve balance requirement band to replace carryover and routine waivers for deficiencies.

The Termination of Contractual Clearing Balances

Federal Reserve Banks will be ending the contractual clearing balance program on July 12, 2012. A contractual clearing balance is the amount a depository institution agrees to maintain in its Federal Reserve master account, which is in addition to its reserve requirement balance. Balances held under a contractual clearing balance generate earnings credits. The earnings credits are used to offset Federal Reserve Bank service charges. *Operating Circular 1, Account Relationships*, will be amended with the clearing balance legal agreement termination authority.

Since the implementation in 2008 of the Federal Reserve paying interest on required and excess reserve balances, clearing balances have declined. Unlike earnings credits, there are no restrictions on how institutions use the interest on reserves. Although the clearing balance program will be ending, any unused earnings credits will expire 12 months from issuance and will continue to be applied on a first-in, first-out basis.

Elimination of As-of Adjustments

As-of adjustments are memorandum items that are used to correct the reserve balance position of a depository institution. These adjustments are caused primarily by errors in processing check cash letters and incorrect FR2900 data reporting. The amount of the as-of adjustment is usually determined by the impact back to the day the error occurred, and it is applied in the calculation of the reserve/clearing position of a depository institution. Historically, the Federal Reserve Bank was in the best position to correct reporting and transaction-based errors and to process the as-of adjustment associated with the correction.

Starting with the maintenance period on July 12, 2012, the Federal Reserve will no longer issue as-of adjustments for FR2900 deposit revisions to correct for data reporting errors by the depository institution. However, in order to maintain the integrity and accuracy of monetary aggregate calculations, depository institutions will still be required to submit FR2900 deposit revisions. As-of adjustments to correct for transaction and Reserve Bank errors will be replaced with direct compensation. Compensation will be calculated using the daily average federal funds rate and will result in either a direct debit or credit entry to an institution's Federal Reserve account. All operating circulars are being revised to remove references to as-of adjustments and, where appropriate, add terms and conditions of direct compensation.

Common Maintenance Period

Today, institutions are required to manage their required reserves over either a one- or two-week maintenance period. In early 2013, all institutions will use a two-week maintenance period. The common maintenance period simplifies the existing maintenance period structure and reduces administrative and operational costs for institutions by eliminating the need to change maintenance periods in association with changes in deposit reporting frequency. The two-week maintenance gives institutions that previously had a one-week maintenance period greater flexibility to meet their reserve requirement. It should be noted that the common maintenance period only affects how the institution meets its reserve requirement and will not affect an institution's FR2900 deposit reporting frequency.

Reserve Balance Requirement Band

The final simplification is the creation of a reserve balance requirement band to replace a specific dollar amount to satisfy the reserve requirement and eliminate carryover and routine waivers for deficiencies. The current rules for carryover recognize the challenges with managing required reserves to a specific dollar amount. Carryover is the amount of excess (credit) or deficient (debit) balances that depository institutions are allowed to move to the next maintenance period. Institutions can use that carryover amount in meeting their reserve requirement in the next maintenance period by either holding additional balances or decreasing the amount held.

Routine waivers are waivers for deficiencies under $25.00. Other routine waivers include waivers that were given once every two years if a depository institution met certain criteria. At this time, the details regarding how the band will be determined have not been finalized; however, it is envisioned that the band will be applied in a similar manner as it is today for contractual clearing balances. If an institution's average balance falls below the band, a penalty would be assessed for reserve deficiency; balances above the band will be treated as excess balance and subject to interest on excess reserves. More information will be provided as it becomes available.

Summary

These four changes will help to simplify the rules for reserve requirements: eliminating as-of adjustments and replacing them with direct compensation, ending the contractual clearing balance program, introducing a common maintenance period for all depository institutions, and implementing a reserve balance requirement band to replace carryover and routine waivers.

In early April 2012, written notice was sent out regarding the elimination of as-of adjustments and the termination of the contractual clearing balances. Information on the last two simplifications, the common maintenance periods for all depository institutions and the reserve balance requirement band, will be provided later in 2012.

Information will also be available on the Reserves Central Resource Center, located at www.frbservices.org/centralbank/reservescentral/. For more information on the simplifications, see the Federal Reserve notice at www.federalreserve.gov/newsevents/press/other/20120405a.htm.

DFA Today

The Dodd-Frank Act: Progress, Priorities, and Challenges

Bob Rell,
Senior Specialist

by Bob Rell, Senior Specialist

As the Dodd-Frank Act (DFA or the act) rapidly approaches its second anniversary, it's a time to reflect back on the numerous accomplishments to date, the sizable tasks that remain, and the impact that continues to unfold. The act represents a sea of change in bank regulation. It aims to strengthen the resilience of the financial system, without unduly constraining credit or deterring financial innovation. Spirited arguments between critics and proponents are still heard daily. History will be the ultimate judge of the effectiveness of the DFA.

This recurring feature of *SRC Insights* highlights key events associated with the DFA that have transpired since the last issue. Reference links to more detailed information on the subject matter are also provided. If you have any questions regarding this periodic section, please contact Senior Specialist Bob Rell at bob.rell@phil.frb.org.

RULE PROPOSALS AND REQUESTS FOR COMMENT

April 20, 2012
Federal Reserve Board Announces the Formation of the Model Validation Council
The Federal Reserve Board announced the formation of the Model Validation Council, which will provide the Federal Reserve with expert and independent advice on its process to rigorously assess the models used in stress tests of banking institutions. In addition, the Federal Reserve announced it will host a two-day symposium to discuss best practices in stress testing.
www.federalreserve.gov/newsevents/press/bcreg/20120420a.htm

April 19, 2012
Volcker Rule Conformance Period Clarified
The Federal Reserve Board (the Board) announced its approval of a statement clarifying that an entity covered by section 619 of the DFA, or the so-called Volcker Rule, has the full two-year period provided by the statute to fully conform its activities and investments, unless the Board extends the conformance period.
www.federalreserve.gov/newsevents/press/bcreg/20120419a.htm

April 2, 2012
Federal Reserve Seeks Comment on Proposed Rulemaking to Establish Requirements for Determining Whether a Company Is Predominantly Engaged in Financial Activities
The Board requested comment on a proposed amendment to its Notice of Proposed Rulemaking (NPR) issued February 11, 2011, to establish requirements for determining whether a company is "predominantly engaged in financial activities."
www.federalreserve.gov/newsevents/press/bcreg/20120402a.htm

March 30, 2012
Agencies Clarify Effective Date for Section 716 of the DFA
Three federal financial regulatory agencies issued guidance clarifying that the effective date of section 716, the so-called Swaps Pushout provision, of the DFA is July 16, 2013. Section 716 prohibits certain types of federal assistance, such as discount window lending and deposit insurance, for certain uses to a swaps entity, subject to specified exceptions, with respect to its swap, security-based swap, or other activity.
www.federalreserve.gov/newsevents/press/bcreg/20120330a.htm

March 27, 2012
Federal Deposit Insurance Corporation (FDIC)—Proposed Rule Amending the Definitions Used to Determine Assessment Rates for Large, Complex Institutions
The FDIC proposes to amend its regulations to revise some of the definitions used to determine assessment rates for large and highly complex insured depository institutions. The FDIC believes that the proposed amendments would result in more consistent reporting, better reflect risk to the FDIC, significantly reduce reporting burden, and satisfy many of the concerns voiced by the industry after adoption of the final rule published in the Federal Register on February 25, 2011 (76 FR 10672).
www.stlouisfed.org/regreformrules/Pdfs/2012-3-27_FDIC_Proposed_definitions_for_assessment_rates.pdf

LEGISLATIVE ACTIONS, HEARINGS, AND LEGAL PROCEEDINGS

April 19, 2012
Budget Hearing—the Office of Financial Research
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=289792

March 29, 2012
The Semiannual Report of the Consumer Financial Protection Bureau (CFPB)
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=286519

March 28, 2012
Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=286181

March 22, 2012
International Harmonization of Wall Street Reform: Orderly Liquidation, Derivatives, and the Volcker Rule
U.S. Senate Committee on Banking, Housing, and Urban Affairs Hearing
banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=28e89835-8053-4928-b948-582b1f0c310b

March 1, 2012
Understanding the Effects of the Repeal of Regulation Q on Financial Institutions and Small Businesses
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=281653

February 15, 2012
Budget Hearing—CFPB
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=278359

February 15, 2012
Pay for Performance: Incentive Compensation at Large Financial Institutions
U.S. Senate Committee on Banking, Housing, and Urban Affairs Hearing
banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=16a388c2-c4c7-41ec-9974-98137d75ce41

February 8, 2012
Legislative Proposals to Promote Accountability and Transparency at the CFPB
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=277386

February 8, 2012
Limiting the Extraterritorial Impact of Title VII of the DFA
Committee on Financial Services Hearing
financialservices.house.gov/Calendar/EventSingle.aspx?EventID=277472

January 31, 2012
Holding the CFPB Accountable: Review of First Semiannual Report
U.S. Senate Committee on Banking, Housing, and Urban Affairs Hearing
banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=fdc6713a-a47c-4872-ac2d-f201e60cd26b

GAO AND OTHER NOTABLE REPORT RELEASES SPEECHES, TESTIMONY, AND EVENTS OF INTEREST

GAO Reports

Mar 8, 2012
Capital Purchase Program: Revenues Have Exceeded Investments, but Concerns About Outstanding Investments Remain (GAO-12-301)
www.gao.gov/products/GAO-12-301

Speeches

April 10, 2012
Developing Tools for Dynamic Capital Supervision
Governor Daniel K. Tarullo at the Federal Reserve Bank of Chicago Annual Risk Conference, Chicago, Illinois (via videoconference)
www.federalreserve.gov/newsevents/speech/tarullo20120410a.htm

February 16, 2012
Community Banking
Chairman Ben S. Bernanke at the Future of Community Banking Conference, sponsored by the FDIC, Arlington, Virginia
www.federalreserve.gov/newsevents/speech/

OTHER REPORTS

bernanke20120216a.htm
March 7, 2012
Committee on Capital Markets Regulation (CCMR) Research
The CCMR expressed "deep concern about the inadequacy of cost-benefit analysis" that its research has identified in proposed rulemaking under the act.
capmktsreg.org/2012/03/lack-of-cost-benefit-analysis-in-dodd-frank-rulemaking/

April 2012
Davis Polk DFA Progress Report
www.davispolk.com/files/Publication/fe8b8c74-f613-46dd-b1f3-919ef3d485b6/Presentation/PublicationAttachment/62510afd-1bb8-4e4f-

a2c5-93cc69270fbf/Apr2012_Dodd.Frank.Progress.Report.pdf

March 6, 2012
Dodd-Frank: Implementation as of January 31, 2012
Morrison & Foerster
With just over a year and a half of DFA behind us, it is time to take a breath and review how far we have come with regulatory reform. The short answer is, not as far as regulators had intended by this point, yet, given the scope of the undertaking, the regulators and the industry may be on a reasonable course.
www.mofo.com/files/Uploads/Images/120306-Dodd-Frank-Implementation.pdf

March 1, 2012
Revisions to the Consolidated Reports of Condition and Income for March and June 2012
The Federal Financial Institutions Examination Council (FFIEC) has approved several revisions to the reporting requirements for the Consolidated Reports of Condition and Income (Call Reports). These revisions will take effect in the first two quarters of 2012.
www.fdic.gov/news/news/financial/2012/fil12010.html

March 2012
Federal Reserve Bank of Dallas 2011 Annual Report—*Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now*
The too-big-to-fail institutions that amplified and prolonged the recent financial crisis remain a hindrance to full economic recovery and to the very ideal of American capitalism. It is imperative that we break up the big banks.
dallasfed.org/fed/annual/index.cfm

March 2012
Report to the Congress on the Office of Minority and Women Inclusion
Pursuant to section 342(e) of the DFA, Sheila Clark, director of the Board's Office of Diversity and Inclusion, submits this first annual report to the Congress outlining the activities, successes, and challenges of the office.
federalreserve.gov/publications/other-reports/files/omwi-report-20120402.pdf

UPDATES ON NEW AGENCIES

Consumer Financial Protection Bureau (CFPB)

CFPB—Public Input Sought to Set Priorities for Updating Regulations that the CFPB Inherited from Other Agencies
Under the DFA, rulemaking authority and existing regulations under federal consumer financial laws transferred from seven agencies to the CFPB on July 21, 2011. On December 5, 2011, the CFPB requested comment on which provisions of existing regulations should have the highest priority for being updated, modified, or eliminated (76 FR 75825). Due to the number and complexity of the comments submitted in the first round, the CFPB is extending the comment reply period until June 4, 2012 (77 FR 14700).
www.stlouisfed.org/regreformrules/Pdfs/2012-3-13_CFPB_Streamlining_inherited_regulations_extension.pdf

March 20, 2012
Fair Debt Collection Practices Act (FDCPA)
This is the first annual report summarizing CFPB activities to administer the FDCPA during the past year. These activities represent the CFPB's inaugural effort to curtail deceptive, unfair, and abusive debt collection practices in the marketplace prohibited by the FDCPA.
www.consumerfinance.gov/reports/fair-debt-collection-practices-act/

Federal Insurance Office (FIO)

March 30, 2012
Open Meeting of the Federal Advisory Committee on Insurance
www.federalregister.gov/articles/2012/03/12/2012-5935/open-meeting-of-the-federal-advisory-committee-on-insurance

March 30, 2012
Brian Duperreault Named Chairman of the Federal Advisory Committee on Insurance
irnews.mmc.com/phoenix.zhtml?c=113872&p=irol-newsArticle&ID=1678643&highlight=

Financial Stability Oversight Council (FSOC)

April 3, 2012
Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies
This final rule and the interpretive guidance attached as an appendix thereto describe the manner in which the FSOC intends to apply the statutory standards and considerations and the processes and procedures that the FSOC intends to follow in making determinations under section 113 of the DFA.
www.treasury.gov/press-center/press-releases/Pages/tg1521.aspx

February 1, 2012
Minutes of the FSOC
www.treasury.gov/initiatives/fsoc/Documents/Tab%209a%20-%20Minutes%20of%20FSOC%20Meeting%202-1-2012%20DRAFT%20(3).pdf

Office of Financial Research (OFR)

March 22, 2012
Notice Establishing the Federal Research Advisory Committee and Seeking Applications for Committee Members
The Federal Research Advisory Committee (FRAC) will present advice and recommendations to assist the OFR in carrying out its functions in support of the FSOC.
www.stlouisfed.org/regreformrules/Pdfs/2012-3-22_TREAS_Federal_research_advisory_cte.pdf

March 2012
Strategic Framework for OFR
www.treasury.gov/initiatives/wsr/ofr/Documents/OFRStrategicFramework.pdf

March 20, 2012
Written Testimony of Richard Berner before the Senate Banking Committee for Nomination to be the Director of the OFR
www.treasury.gov/press-center/press-releases/Pages/tg1457.aspx

FEDERAL RESERVE BANK
OF PHILADELPHIA

Supervision, Regulation and Credit Department
Ten Independence Mall
Philadelphia, PA 19106

www.philadelphiafed.org

Scan with your smartphone to access *SRC Insights* online

E-Mail Notification Service

Would you like to read *SRC Insights* on our website up to three weeks before it is mailed? Sign up for our e-mail notification service today at <http://www.srcinsights.org/>.