RECORD OF CONFERENCE OF THE FEDERAL ADVISORY COUNCIL

DATE: December 6, 2002

TIME: 10:00 a.m.

LOCATION: Board Room

ATTENDANCE:

Mr. Greenspan, Chairman
Mr. Ferguson, Vice Chairman
Mr. Gramlich
Ms. Bies
Mr. Olson
Mr. Bernanke
Mr. Kohn

Federal Advisory Council
Mr. Daberko, National City Corporation, President of the Council
Mr. Baker, Wachovia Corporation, Vice President of the Council
Mr. Spina, State Street Corporation
Mr. Coulter, J.P. Morgan Chase & Co.
Mr. Smith, Fulton Financial Corporation
Mr. Humann, SunTrust Banks
Mr. McNally, Harris Bankcorp
Mr. Kemper, Commerce Bancshares
Mr. Jones, Signal Financial Corporation
Mr. Fine, Midwest Independent Bank
Mr. Evans, Frost National Bank
Mr. O'Neill, Bank of Hawaii
Mr. Annable, Co-Secretary
Mr. Korsvik, Co-Secretary

Office of the Secretary
Ms. Johnson, Secretary
Ms. Putman-Hunter, Administrator
Ms. Foltz, Manager, Secretarial Section

Office of Board Members
Ms. Smith, Assistant to the Board
Mr. Skidmore, Special Assistant to the Board

Division of Research and Statistics
Mr. Ettin, Deputy Director
Mr. Parkinson, Associate Director
Mr. Passmore, Assistant Director

Ms. West, Assistant Director
Mr. Simpson, Senior Adviser

Division of Monetary Affairs
Mr. Reinhart, Director
Mr. Lindsey, Deputy Director
Mr. Madigan, Deputy Director
Mr. Whitesell, Deputy Associate Director
Mr. Clouse, Assistant Director

Division of Banking Supervision and Regulation
Mr. Spillenkothen, Director
Mr. Cole, Senior Associate Director
Mr. Houpt, Associate Director
Mr. Martinson, Associate Director
Ms. Bouchard, Assistant Director
Mr. Wright, Assistant Director

Division of Consumer and Community Affairs
Ms. Smith, Director

Division of Reserve Bank Operations and Payment Systems
Ms. Roseman, Director

Other supporting staff

BASEL CAPITAL ACCORD -- Banks that are participating in the Quantitative Impact Study are two-thirds through the survey process. Are you finding the capital calibrations to be risk-sensitive? Is your overall capital charge likely to change very much from the current level? How does your estimate for capital charges under Basel II compare to your economic capital charge? Are you comfortable, roughly speaking, with the relative capital charges? In what areas are you finding problems? What specific suggestions do you have at this preliminary point?

Discussed.
December 6, 2002.

Messrs. Spina and Coulter presented the views of the Council.

Since only 20 U.S. banks are currently participating in the QIS 3 process, specific estimates of the impact of the current Basel Accord proposal are somewhat limited. In addition, a number of banks participating in QIS 3 have not yet completed sufficient analysis to provide a complete estimate of the effects of the proposed Accord.

Are you finding the capital calibrations to be risk-sensitive?

Most banks consider the more advanced approaches to credit risk to be fairly risk-sensitive, especially compared to the current Accord. One Council member, however, indicated concern that the Accord "typically relies on excessively conservative estimates."

The Basic and Standardized Approaches to operational risk are viewed as non-risk-sensitive. The Advanced Measurement Approach (AMA), while receiving limited comment, appears to be potentially more risk-sensitive --- although the conceptual nature and associated lack of specificity of the current proposal makes a full evaluation difficult.

Is your overall capital charge likely to change very much from the current level?

While most banks note that specific regulatory capital estimates are still premature, banks generally expect that the use of the Internal Ratings Based (IRB) approaches to credit risk will result in material reductions in regulatory capital.

Some specialized institutions, such as those without significant loan books, expect an increase in required credit risk capital due to the new Accord. These increases may result from higher capital assessments in areas such as indemnified securities lending and short-term unused loan commitments.

However, banks remain unable to make an overall comparison between capital charges under the current and new Accords due to uncertainty over the magnitude of the new charge for operational risk. Many banks are concerned that an operational risk capital charge may be sizable and onerous.

How does your estimate for capital charges under Basel II compare to your economic capital charge?

Banks providing comparisons between the expected regulatory capital charge and internal economic capital assessments provided divergent views of the consistency between the two.

Several Council members reported that their initial estimates suggest the proposed regulatory capital levels for credit risk are relatively consistent with their current internal measure of economic capital.

Another Council member predicted regulatory capital under the new Accord will be higher than internal economic capital charges, due to differing allocation methodologies for retail and corporate SME credit exposures, operational risk exposures, and portfolio diversification factors.

The general view was that for the Advanced Internal Ratings Approach the proposed Basel II charges would tend to be below internal capital charges and that this would be an appropriate result. Some banks observed that even if their regulatory capital charges declined under Basel II it is questionable whether they would reduce capital levels because of the market demands at existing ratings from other constituents such as rating agencies and capital market participants.

Are you comfortable, roughly speaking, with the relative capital charges?

Several significant divisions among Council members exist. [ ]

Of the banks participating in the survey, those who are uncomfortable remain concerned about the theoretical basis for creating an allocation for operational risk, the application to cover external data, scenarios and expected losses. And this group is concerned about making banks noncompetitive with nonbank providers of operations-based services. These [ ] banks are optimistic about the prospect of housing credit and market risk under Pillar 1, and believe Pillar 2 treatment for operational risk is the best solution.

One bank [ ] believes that credit, market and operational risk should all be under Pillar 1, with continuing refinements of the rules.

The typically smaller banks [ ] are not comfortable about the proposal. Even if the smaller banks are excluded from the terms of the new Accord, they worry about a developing competitive disadvantage, rooted in their use of old rules or basic applications. The specific concern is that larger banks will eventually price products to reflect lower capital allocations. A second concern is that U.S. bank regulators will expect costly changes in risk management systems to match those of the internationally active banks.

In what areas are you finding problems?

Banks cited problems in several areas, including the following:

- Community bankers remain concerned that regulators may require smaller banks to adopt expensive, inappropriate capital risk models.
- Lack of flexibility in the retail and corporate SME areas, despite recent changes and preliminary indication that the capital charges for credit cards had come down significantly.
- Undue conservatism in the calibration of the Basic Indicator and Standardized Approaches for operational risk.
- Lack of data that would impede effective implementation of the operational risk charge.

- Excessive capital charges for investment real estate.
- Poor recognition of credit hedging (i.e. no recognition of joint default risk).
- Lack of conceptual and empirical analysis justifying capital charges for securitization tranches that are lower than for similarly rated corporates at higher credit grades and higher at lower credit grades.
- No recognition of portfolio diversification across risk types (market, credit and operational).
- Inclusion in the capital calibration charges for expected losses, particularly for retail exposures.
- Artificial breakdown between Tier 1 and Tier 2 capital (i.e. Tier 1 capital must be 50 percent of total capital) which is difficult to justify conceptually and to track.
- Counterparty credit exposure and collateral methodologies that are out of step with evolving methodologies.
- Implementation
  Data – capturing historical information to meet validation requirements;
  Cost, resource allocation and displacement of other systems initiatives;
  Accessing deal-specific information to calculate securitization charges.

What specific suggestions do you have at this preliminary point?

Banks made a number of suggestions, including the following:

- Adopt an internal models approach at least for retail exposures.
- Require capital for unexpected losses only. Failing that, eliminate the expected loss portion of the retail charge by allowing banks to deduct the risk-weighted asset equivalent of loan loss reserves.
- Recognize the lower risk of joint default when hedging with credit derivatives by requiring a counterparty credit risk charge for the hedge only or by substantially haircutting the substitution approach.
- Allow banks to use their internal ratings for securitization exposures if they are based on or similar to rating agency models.

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

CORPORATE GOVERNANCE -- (A) Research and Investment Banking: Should investment banking research units (that produce publicly available research) be separated from other investment banking operations? Can an internal research department be structured in a manner that makes it independent within the firm and, if so, how? Is creating a source of independent stock research for investors or an independent panel which oversees investment bank research, funded by brokerage firms, a good way to provide untainted analysis to investors? What

else needs to be done to enhance investor confidence in investment bank research activities?

Approved.
December 6, 2002.

Mr. Baker presented the views of the Council.

Recent events provide cause for investors to be cynical of research reports issued by firms with investment banking capabilities. We believe, however, that investment banking departments and research departments can exist within the same firm as an appropriate part of an integrated client service model and can be structured in a manner that preserves analyst objectivity.

Recent and current regulatory requirements, including the NASD and NYSE rules adopted in response to conflict-of-interest concerns raised by New York's Attorney General and others, address major structural and incentive issues that have been the prime source of the analyst conflict-of-interest issues at major investment banks.

These rules, among other things: prohibit firms from promising favorable research in exchange for investment banking business; limit communication between the investment banking department and research unit concerning research reports; prohibit the compensation of analysts based on specific investment banking transactions; and prohibit supervision and control of analysts by the investment banking department. In addition, rules require comprehensive disclosure of potential conflicts of interest of the analyst and the firm, including disclosure of equity ownership in, and actual and potential investment banking relationships with, companies covered by research analysts.

These controls and disclosures address the potential for abuse by curtailing major sources of influence on an analyst's objectivity and additionally providing the investor with information on which to evaluate the objectivity of the analyst.

The potential for abuse will not be completely gone until corporate cultures, values, and leadership change and improper conduct is discouraged and eliminated. Rules, without provisions addressing appropriate alignment of incentives, will not result in the kind of cultural shift required. This may mean that some in the industry would need to redesign incentive plans to reward desired behavior and discourage improper conduct. In all cases, however, incentive plans need to recognize contribution and then reward objective financial performance. While recognizing the logic underlying a prohibition against compensating research analysts for specific investment banking transactions, we also note that an incentive system that does not allow firms to compensate analysts based on the firm's overall financial performance (of which investment banking is a part) raises difficult questions as to how firms would pay for very expensive research and, perhaps more importantly, implement effective client coverage.

Equity research provides useful information to institutional and individual investors. It is critical for lawmakers and regulators to continue to focus on addressing the problem at hand (i.e. the manipulation of recommendations in exchange for investment-banking business) and not "throw out the baby with the bath water" or strangle a useful service into extinction. Recent regulatory changes, in large part, are consistent with existing practices of many companies. The regulatory response, so long as it is measured and thoughtful, should restrict abusive practices. This in turn will eliminate what has been an unfortunate and unfair advantage for some competitors while still allowing for provision of a valuable service to investors. An appropriate regulatory response also will clarify permissible practices in an area in which there is a need for strong guidance. This clarity can only be a good thing.

We have followed with great interest reports suggesting the creation of an independent research group and/or an independent panel to oversee research. We are concerned that this step may produce little in the way of benefit to investors beyond what can be achieved through existing and pending regulatory response and oversight of firms producing research. Questions include, will this independent group be positioned to attract the best and the brightest when it is competing against other research providers, including buy-side providers, with greater resources. We are also concerned that there remains a potential for actual or perceived conflicts of interest arising from the yet-to-be determined method to fund the group.

Because the NASD and the NYSE have oversight and supervisory responsibility for broker-dealer research practices, we believe that an independent research panel would be redundant. In our view, an independent panel would add an unnecessary, and expensive, layer of regulatory oversight, particularly in light of recent rulemaking initiatives. The current reconsideration of existing practices and the implementation of new business practices consistent with recent regulatory initiatives should improve and restore investor confidence. Obviously, regulating oversight will be crucial to the issue.

(B) Board Relationships between a Commercial Bank and its Customers or Suppliers: Under what conditions should a banker be on a customer's or supplier's board of directors? What degree of separation is needed between banks and their customers to avoid the appearance of impropriety?

Bankers should be permitted to serve on customer or supplier boards whenever the bank's relationship is insufficiently material to create an inherent conflict of interest. Since banks have relationships across a broad spectrum of corporations, it would be overly restrictive to bar board membership given that the banking relationship is relatively small, is in the ordinary course of the bank's business, is not on a preferential basis, or any extension of credit is in compliance with the Federal Reserve Regulation O.

A banker's service on a customer or supplier board can be a significant benefit to both. The banker, by supplying financial or industry-related experience may improve the prospects of the customer or supplier. Indeed experience suggests that customers and suppliers have gained helpful, valuable advice from banker directors and may have averted serious difficulties through this counsel. Professional relationships with other directors also may benefit the banker.

From a bank's perspective, a banker's service on customer or supplier boards should be subject to protecting the banker and the bank from liability arising from potential conflicts of interest. A bank may mitigate the risk of a banker's service on a customer's or supplier's board by requiring that its banker take one of more of the following measures.

- The company may provide an indemnity for directors against any liability arising from service.
- The company may provide directors and officers liability insurance coverage.
- Potential conflicts of interest may be fully disclosed at the time a banker is considered for election and agreements may be entered to the effect that a banker may, when conflicted, abstain from votes.
- A banker, by agreement with the company, may choose to be excluded from information given to other members of the board, which, if known by the banker, could cause the bank to become conflicted.

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

CONSOLIDATION OF FINANCIAL SERVICES REGULATION -- Should the responsibility for writing regulations for banking and other financial services industries be separated from supervising financial institutions, as recently suggested by Treasury Under Secretary Peter Fisher? Does the current environment encourage regulatory arbitrage, as suggested by Fisher and, if so, is such arbitrage bad? Are banking agencies too focused on protecting the entities they currently regulate through their rule-making process?

Discussed.
December 6, 2002.

Mr. McNally presented the views of the Council.

Mr. Fisher's thesis can be summarized as follows:

- Financial services regulation (rulemaking) should be separated from supervision:

  - with a more coherent, unified rulemaking process, perhaps with a super-regulator
  - but supervision remaining divided among agencies where "real (specialized) knowledge and expertise" are needed to supervise.

- Regulators should promote competition, "best practices" and "positive tail" outcomes:
  - focusing less on protecting financial institutions and preventing "negative tail" outcomes
  - and not protecting chartered entities from additional competition from new entrants.

- Regulatory arbitrage is bad:
  - rather, we need a common set of rules
  - with "like rules for like products."

  In short, there is little support for Mr. Fisher's proposals among Council members.

Should the responsibility for writing regulations for banking and other financial services industries be separated from supervising financial institutions, as recently suggested by Treasury Under Secretary Peter Fisher?

- The financial services industry today is extremely complex. Regulators, whether rulemakers or supervisors, cannot be expected to meet the challenge of understanding the issues facing the industry without direct and frequent contact with regulated institutions.

- Separating the rulemaking and supervisory functions would create the very high risk of an "ivory tower" of rulemaking, detached from the realities of the financial services industry. A supervisory agency is best positioned to write regulations for the financial institutions that it supervises, and can gauge the impact that any regulation will have on those entities.

- With respect to the idea of a consolidated financial services "super-regulator," the Council strongly disagrees on both philosophic and practical grounds.

- Given the enormous power of regulators and the crucial roles that financial institutions play in the health and vitality of the national economy, it is imperative that the regulatory system preserves real choice (including the dual banking system) and maintains regulatory checks and balances.

- In fact, multiple agencies strengthen our regulatory system by creating a healthy tension among agencies, which encourages "best practices" and innovation.

- Within this context of regulatory "competition" and innovation, harmonizing new

"best practices" in consistent regulation among financial services companies is, in turn, an important element in providing a "level playing field," encouraging vigorous competition among firms, and reducing the cost and complexity of compliance (particularly at the state level for regional and national firms).

- In addition to the statutory framework provided by Gramm-Leach-Bliley, there are many ways by which regulatory harmonization can and does occur – e.g., proposed regulations are published for comment (including comments by other regulators and the Treasury Department); regulators work closely together on important matters (e.g. shared national credits, and the inter-agency agreement on loan loss reserves); the FFIEC; the President's Working Group on Financial Markets; and congressionally mandated joint studies.

- These are all better forms of harmonization than a federal "super-regulator." Moreover, the greatest single opportunity for regulatory harmonization lies in the area of federal preemption of proliferating state and local requirements with respect to important matters such as privacy, predatory lending, and insurance.

Does the current environment encourage regulatory arbitrage, as suggested by Fisher and, if so, is such arbitrage bad?

- The current regulatory system does create some opportunity for "regulatory arbitrage" – which is good in that it puts some practical limits on the power of any one regulator and fosters innovation for the industry.

- The existence of competition in the public sector and the ability for financial institutions to choose their primary regulator provide incentives for regulators to excel.

- It helps safeguard the financial system against over-zealous regulation that dominance by a single agency could engender.

- Adoption of concurrent rules by several agencies may take more time and effort, but can yield a superior product with greater acceptability and legitimacy.

Are banking agencies too focused on protecting the entities they currently regulate through their rulemaking process?

- The Council does not believe that regulators are too focused on protecting the institutions they regulate.

- The role and responsibility of regulators is to serve the public interest (depositors, investors, consumers and the national economy), and this can only be realized when the financial system operates in a safe, sound, competitive and profitable manner. However, the role and responsibility of regulators is not to protect *individual* financial institutions from competitive forces and risk of failure.

- Is there at times over-zealous regulation? From time-to-time, particularly at the field supervision level – as regulators focus on actual or potential negative outcomes, and remedial actions to mitigate them. Hence, to help keep this in check, the value of "regulatory arbitrage."

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

PAYMENTS SYSTEM -- (A) An article in the Federal Reserve Bulletin in August 2002 suggested that, overall, the use of checks may be declining. Does this decline reflect the experience at your institution? If demand is declining at your institution, does it reflect efforts by your institution to move customers to other methods of payment? How is your institution responding to a decline in the use of checks (that is, how are prices changing, how are costs in check processing being altered, and what is the effect on profits?) Are there other initiatives in electronic payments that might influence the use of checks?

Discussed.
December 6, 2002.

Mr. Kemper presented the views of the Council.

If demand is declining at your institution, does it reflect efforts by your institution to move customers to other methods of payment?

The payment system through service charges and interest spread on DDA checking deposits has contributed about 50 percent of commercial banks' profitability. The recent significant shifts away from paper to electronic payments which all member banks agree will continue and probably accelerate in the future is a major challenge as well as opportunity for the banking industry. Bank customer relationships are centered around the payment system and banks are at significant risk in losing their preeminent position with their customers as new patterns of payment emerge. Nonbanks are aggressively moving into and challenging banks traditional payment position and could significantly affect industry profitability.

All Federal Advisory Council banks report declines in check usage per individual account ranging from 1.5 to 7 percent over the last measurable year. Consistent with the Federal Reserve article, banks on the coasts or in more urban settings tended to show larger reductions. Decline in check volume seems to have accelerated over the last couple of years with the popularity of alternative payment systems. All member banks responded that shifts in customer usage of payment type

is driven by customer preference. Customers (both retail and commercial) are actively choosing the most convenient and cost effective form of payment type which tends to substitute electronic for paper. At the same time, banks have recognized the convenience and cost advantages of electronic payments with several banks giving monetary incentives for direct deposit, direct debits for loan and mortgage payments, and promotion of ACH for periodic payments such as utility bills. Commercial customers such as utility and phone companies are also much more actively promoting ACH payments to their customers. Member banks are actively promoting electronic alternatives to both retail and commercial customers who are embracing these more convenient and cost-effective electronic payment solutions.

How is your institution responding to a decline in the use of checks (that is, how are prices changing, how are costs in check processing being altered, and what is the effect on profits?)

The overall decline in check volume has not yet significantly affected pricing on check processing. Member banks report continued rationalization and investment in image technology to become more efficient in paper processing. Higher productivity and efficiency so far seems to have offset volume decline in check processing unit costs. Several banks, however, mentioned exploring working with other banks or other alliances to manage costs in a declining volume environment. No banks commented on any relationship between declining check volume and decline in service charges such as NSF/OD charges or sale of checks to customers.

Are there other initiatives in electronic payments that might influence the use of checks?

Debit usage is experiencing explosive growth as will be discussed. POS electronic truncation and the proposed Check Truncation Act should significantly accelerate elimination of clearing paper checks. Image capture at the bank branch and ATM could significantly reduce handling costs and servicing costs at ATMs.

Other alternative systems such as PAYPAL are gaining wide acceptance with college students. One member bank pointed out the risk of low pricing on ACH settlement mentioning a "wholesale" vs. "retail" mentality which allows nonbanks access to the settlement process without having to pay for any of the infrastructure. As nonbanks drive volume away from more profitable bank payments products, the industry has significant risk to its profit structure. Lower pricing in areas such as ACH will encourage movement away from other payment mechanisms.

(B) How are financial institutions marketing the use of debit cards? Do the institutions encourage their customers to use the cards in signature-initiated transactions or in PIN-number-initiated transactions? What are the advantages and disadvantages of using one method over another?

How are financial institutions marketing the use of debit cards?

All banks reported strong marketing and acceptance of debit cards by both commercial and retail customers. Examples of marketing programs for debit cards are myriad including heavy advertising and direct mail, as well as specific incentive programs such as reward or points programs, rebates, cobranding cards, sweepstakes, and reduced fees for more frequent card usage.

On-line and off-line debit usage by the consumer has increased dramatically over the last five years. For example, at[ ]while all annual transactions per account over the last 5 years have remained steady at about 500 a year, debit card usage (excluding ATM transactions) has increased from 4 percent to 17 percent of all transactions. During this 5-year period, active use of debit cards has increased from 29 percent to 64 percent of all individual accounts. Member banks report customers understand the convenience and acceptance of debit cards by merchants while banks obviously have lower processing costs and better fee income for debit transactions vs. paper processing.

Do the institutions encourage their customers to use the card in signature-initiated transactions or in PIN-number-initiated transactions?

Most member banks report a strong preference for signature vs. PIN debit transactions because of the (current) significantly better economics for the signature transactions (average revenue 50¢ vs. 15¢ for bank) with much higher profit margins.

Promotions such as sweepstakes, points and rewards programs, and cobranding all are based on signature-based transactions. Merchants at the same time have rapidly invested in PIN- enabled POS equipment to encourage PIN usage and to allow the merchant to avoid the signature associated costs. Although no member bank reported charging specific PIN-based purchase fees to customers on merchant transactions, such fees are appearing in the industry. Although all debit transactions continue to rapidly grow, PIN based activity is increasing the quickest because of merchant infrastructure build out. Current litigation as well as increase in PIN usage will probably force the pricing of PIN and signature transactions closer together.

What are the advantages and disadvantages of using one method over another?

The consumer receives the same protection on a signature transaction as he would with his credit card (no liability on unauthorized purchases, extended warranties, loss or damage coverage, extensive purchase dispute right). PIN transactions give the consumer another layer of security with his password protection. Signature debit is accepted more widely although some major retailers (COSTCO, Sam's) will not accept signature or credit cards.

The merchant has lower costs and can accept both debit and ATM cards with

PIN technology as well as having the transaction settle more quickly. In accepting signature debit the merchant does not have to install PIN pads.

Banks receive higher interchange and also are dealing with credit card companies. PIN-based transactions have less financial risk to the bank as they settle more quickly.

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

STATE AND LOCAL CONSUMER REGULATION -- Many states and localities have considered or have adopted laws regulating financial institutions, including laws that regulate subprime lending or tighten privacy regulation. How substantial a problem is the fragmentation of regulation across states and localities for the banking industry? What is the banking industry doing to encourage federal laws or standards? What common elements exist among the state and local regulations concerning subprime lending or privacy that might be adopted at the federal level in order to encourage preemption of state and local laws? Has your institution restricted or altered credit availability in response to new state or local laws?

Discussed.
December 6, 2002.

Mr. O'Neill presented the views of the Council.

How substantial a problem is the fragmentation of regulation across states and localities for the banking industry?

The fragmentation of regulation across states and localities is a substantial problem for the banking industry, particularly for multi-state financial institutions. In both privacy and anti-predatory lending, the financial services industry (and ultimately the consumer) is paying increasingly higher costs because of the need to comply with the growing number of different state and municipal laws. Recent movement towards state and local regulation of financial services threatens to reduce the efficiency of the banking system, increase confusion among customers, and potentially, reduce the level of service, number of product offerings, and protection available to customers.

For example, nationwide there are more than 1,200 state and federal laws affecting the confidentiality of personal information. These laws cover categories such as criminal records, computer crimes, credit reporting, employment, mailing lists, etc. California ranks the highest as having the most laws protecting privacy. Not only do financial institutions in this state have to comply with the federal Graham-Leach-Bliley

Act (GLBA) and its regulations, but also with the State Constitution, which gives each citizen the right to pursue and obtain "privacy." Consequently, municipalities have begun to take action similar to that of San Mateo County this past August, which now requires banks to get customer permission before sharing their data with third parties.

In addition, telemarketing restrictions are growing, with 30 different state laws regulating telemarketing in addition to FCC and FTC rules. These laws have inconsistent provisions, which present a variety of challenges (e.g. whether telemarketing lists have to be scrubbed against state "do not call" lists or telemarketer maintained "do not call" lists; how often these lists have to be scrubbed; and whether these laws apply to telemarketing to existing customers).

Further, [ ] noted that the lack of a uniform, federal standard for privacy of customer information hampers the U.S.'s ability to reach an understanding with the European Union (EU) in relation to its Data Protection Directive. In the interest of maintaining international data flows, it should be a U.S. government priority to reach agreement with the EU – an agreement which is made increasingly difficult by the current patchwork of competing and inconsistent privacy regulations.

What is the banking industry doing to encourage federal laws or standards?

With regard to predatory lending, the banking industry, through both its trade associations and individual institutions, has met with state and federal elected officials and regulators to educate them on the difficulties financial institutions face in responding to the patchwork of state and local regulations. Specifically, industry representatives worked closely with former Assistant Treasury Sheila Bair to forge a national set of "best practices" for responsible lending. Similar efforts have been undertaken in the privacy arena with the credit bureaus and with the Direct Marketing Association.

The banking industry, through both its trade associations and individual institutions, strongly supports the federal preemption of state and local authority to impose additional financial services regulations, particularly in the area of privacy. One of the primary concerns is renewing the preemption provisions of the Fair Credit Reporting Act (FCRA), which are due to expire at the end of the year. Discussion of the FCRA will inevitably open up discussion of other privacy issues. For example, the industry will urge Congress to enact legislation strengthening the GLBA statute by preempting the state's current authority to go beyond the federal privacy regulations. There is, however, a general recognition within the industry that Congress will not act to preempt the states without imposing additional federal privacy restrictions -- if it acts at all. So far, there does not appear to be an industry consensus on what the industry can "give up" in exchange for federal preemption.

What common elements exist among the state and local regulations concerning subprime lending or privacy that might be adopted at the federal level in order to encourage preemption of state and local laws?

To encourage preemption of state and local laws, federal adoption of some or all of the following elements might be considered, and banks need to give careful thought to acceptable ways in which these elements might be incorporated into federal law:

- Restrictions against the sale of single premium insurance
- Prohibitions on loan flipping and default interest rates
- Prohibition of extending credit without regard to the borrower's ability to pay
- Home ownership counseling requirements on high cost loans
- Limits on demand features on high cost loans
- Restrictions on prepayment penalties, balloon payments, and late fee payments
- Improved licensing and oversight of appraisers, brokers, mortgage brokers, and telemarketers

Has your institution restricted or altered credit availability in response to new state or local laws?

Five respondents stated that they have restricted or altered credit availability in response to new state or local laws because of the various risks and operational realities presented by local and state laws. For example, [ ] shut down all non-prime lending operations in Cleveland as a result of recently enacted "fair lending legislation" that imposes stringent pricing controls and severe penalties. Similarly, [ ] has had to either eliminate features of certain credit products or alter the availability of various credit products in response to local laws.

Five respondents stated that they have not found it necessary to restrict or alter credit availability because they do not engage in subprime lending or they have no serious conflicts with the state and local laws enacted in their jurisdictions.

The remaining respondents continue to examine their markets for possible impact.

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

CORPORATE LOAN CREDIT QUALITY AND CORPORATE PROFITS -- Is corporate loan credit quality continuing to deteriorate? What particular sectors of industry or types of borrowers look weak now? Are there any industries in which economic conditions seem to be improving? Are lending standards and terms tightening overall or just for certain borrowers? What is your outlook for corporate profits? Given the recent efforts to improve the accounting for profits,

to what degree do you now discount corporate earnings statements? Does your bank now undertake a more in-depth review of its corporate customers' financial statements?

Discussed.
December 6, 2002.

Mr. Evans presented the views of the Council.

Is corporate loan credit quality continuing to deteriorate?

- The consensus we heard from all districts is that credit quality has stabilized, both on a year-over-year and quarter-over-quarter basis.
- Several regions mentioned that decelerating deterioration might continue through the fourth quarter of this year and possibly into the first quarter of next year.
- None of the regions felt that the loan credit quality experienced to this point was above manageable levels.
- Most regions expected to see an improvement in credit quality at some point during 2003.

What particular sectors of industry or types of borrowers look weak now?

- Virtually every region mentioned weakness in the telecommunications, manufacturing, energy, and insurance sectors.
- Sectors of increasing concern as we approach 2003 are retail sales, auto manufacturing, and construction for both commercial and residential purposes.
- Several regions with strong reliance on agriculture mentioned the pervasively depressed performance of that sector with farmers finding difficulty repaying loans.
- District 2 mentioned that the sectors dependent on consumer spending and those requiring ongoing access to levels of financing/liquidity also present heightened risk.
- Multiple regions mentioned the continued poor performance of the hotel and entertainment sector. It was noted that this sector has not recovered as profoundly from the events of 9/11 as they had expected.
- Districts 6, 9, 12 and 5 mentioned weakness in the airline industry.
- District 4 indicated that electrical utilities are weak due to heavy expenditures in non-regulated businesses, coupled with weak demand and over capacity brought on by new construction.

Are there any industries in which economic conditions seem to be improving?

- Defense and some components of health care seem to be the only sectors showing discernable improvement.
- Consumer auto sales and residential real estate have been the two strongest sectors, but both appear to be slowing. There is a growing sense that these two sectors will underperform in 2003.
- Commercial real estate is generally weak, with vacancy rates high and rents falling.

However, changes in the capital structures on such properties, relying more on equity investment, has sharply limited bank exposure here relative to previous periods of weakness.

- Regions without defense or health-care concentrations reported that there don't appear to be any particular industries that are improving.
- District 5 pointed out that although there are stresses in the retail industry, the low-end "big box" retailers and self-service discount stores seem to be doing reasonably well.

Are lending standards and terms tightening overall or just for certain borrowers?

- Overall, lending standards have not tightened over the last quarter. Several regions mentioned, however, that credit standards were ratcheted higher at some point over the last year.
- Also, virtually every region noted that standards have tightened to the above-mentioned sectors of weakness and that credit for speculative purposes has diminished appreciably.
- Several districts mentioned a heightened focus on relationship-driven banking and movement away from shared national credits (SNCs).
- The absence of venture capital and capital market-based funding has given the appearance that banks are not as readily lending money. The responses from every district, however, indicated more than adequate availability of credit for qualified borrowers.
- As District 3 said, "Because there is just too much available credit chasing too few quality deals, we continue to see very aggressive pricing and more creativity in loan structure."
- Several regions mentioned overall relationship profitability and more stringent focus on corresponding reward to risk in pricing as being potential contributors to the misconception that credit is not as readily available from financial institutions.

What is your outlook for corporate profits?

- Top line earnings are expected to be down for the near future with several regions mentioning the hope of a recovery in the second half of 2003.
- Bottom line profitability has been firming over the last few months, with expense control, layoffs, leaner inventories, and cheaper input costs being the primary drivers.
- Several districts noted that meeting the expectation of industry equity analyst purely through expense control without an appreciable increase in top line revenue cannot continue much longer.
- According to District 7, costs got out of control in the final stages of the boom, causing profits to plunge. It was not a massive revenue decline that caused profits to plunge. It was too much hiring and too much capital spending.
- District 6 pointed out that pensions and stock options may hurt the corporate profit outlook.

- District 5 communicated a concern about the sustainability of consumer spending. Mortgage refinancing likely has peaked and put some money into the retail markets, but consumers have not moved these dollars to durable goods.
- Consumer spending, a war with Iraq, and the cheapening dollar were all mentioned as externally controlled variables that might materially impact corporate profitability in 2003.

Given the recent efforts to improve the accounting for profits, to what degree do you now discount corporate earnings statements?

- None of the regions have been discounting corporate earnings statements.
- Several mentioned, however, that they believed that the increased scrutiny on financial statements would produce further beneficial financial transparency.
- Greater emphasis on core earnings, cash generation, and understanding of off-balance sheet activities were all mentioned.

Does your bank now undertake a more in-depth review of its corporate customers' financial statements?

- Most regions indicated that they have always performed very in-depth reviews of all available financial information.
- Areas that have received scrutiny from regulators or where there may be potential for overstatement of earnings are receiving a little more focus.
- Several districts mentioned that the accounting and earnings scrutiny has brought about better disclosure, although earnings statements can be overly complicated, requiring closer attention to details.

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

CONSUMER LENDING AND SAVING -- What is the Council's sense of consumer sentiment and the willingness of households to borrow? Have Council members seen any notable changes in the use or composition of consumer loans that might suggest that consumers are more or less worried about their economic prospects? What has happened to the pace of mortgage refinancing (adjusting for seasonal variations) and mortgage demand recently? Are cash-out refinancings still an important part of mortgage refinancings? What is happening with home equity lending? What additional concerns, if any, lie on the horizon with regard to the quality of consumer loans and households' debt service burdens?

Discussed.
December 6, 2002.

Mr. Jones presented the views of the Council.

What is the Council's sense of consumer sentiment and the willingness of households to borrow?

Although certain districts report weaker consumer loan demand, on balance, the consumer seems willing to continue to borrow. This relatively strong consumer loan demand seems counterintuitive when viewed against four consecutive months of decline in consumer confidence as reported by The Conference Board. Newly released economic data suggests that the consumer outlook may have brightened somewhat in recent weeks and the 2002 American Express Retail Index, a national poll on holiday shopping, shows that consumers are anticipating spending 5 percent more on holiday shopping than they did in the previous year. The Council believes that this continued willingness to borrow is being primarily driven by low interest rates and increases in household wealth coming from real estate valuations and very recent increases in valuations of stock market portfolios.

Have Council members seen any notable changes in the use or composition of consumer loans that might suggest that consumers are more or less worried about their economic prospects?

Most districts are reporting little change in the use or composition of consumer loans over the past few months. What has been consistent, however, throughout 2002 is that mortgage lending, mortgage refinancings, and home equity lending have been the drivers of consumer credit. The most often listed uses for these consumer real estate related loans continues to be debt consolidation, home improvement, and automobile purchases. The Council does not believe that this fundamental shift is a result of a change in consumer expectations about their future circumstances. Once again, the lower interest rate environment is allowing the consumer to consolidate debts at lower rates and strengthen their balance sheets as real estate values continue to rise.

What has happened to the pace of mortgage refinancing (adjusting for seasonal variations) and mortgage demand recently?

Council members use words such as "boom," "frenzied," "soaring" or simply "strong" when describing the pace of mortgage refinancing. By any account, mortgage-related products have been the consumers' debt of choice over the past two years. The pace of growth has accelerated dramatically during 2002. Of note, [ ] uses an average of Freddie Mac, Fannie Mae, and Mortgage Bankers Association (MBA) to forecast production levels. The industry average of quarterly production dipped in Q1 2002 to $554 billion from $620 billion in Q4 2001.

The industry showed a slow Q2 2002 at $500 billion, but bounced back strongly to $612 billion in Q3 of 2002. The forecast shows an incredibly strong Q4 at almost $700 billion. Not surprisingly, several districts anticipate slowing of this activity in coming months. Through October 31, 2002, the Mortgage Bankers Association is showing that 56 percent of these volumes are in refinancing activity.

While the growth in mortgage-related loans has been substantial, it is uncertain as to whether this "boom" will continue indefinitely. Interest rates will inevitably start to rise. The number of consumers with high interest rate mortgage loans will have been substantially decreased. Many customers are on their second or even third refinancing for purposes of obtaining a lower rate. It is unlikely that rates could fall much further to a level that would create an additional wave of refinancings.

Are cash-out refinancings still an important part of mortgage refinancings?

Yes. Cash-outs continue to be a significant portion of mortgage refinancings. Several districts are reporting cash-out refinancings averaging about 40 percent of total refinancing business but less than in previous months. Most report that the additional credit is being used to pay off other kinds of debt such as credit cards, car loans, and educational expenses. Over the past six months, several districts are reporting a decrease in the amount of cash-out refinancings but from extremely high levels in the previous six months. Once again, the primary driver of these increased levels of cash-out refinancings is the extraordinarily low interest rate environment.

What is happening with home equity lending?

Home equity lending products have experienced record volumes in 2002. Customer demand for both home equity lines and home equity loans is very strong and is the leading consumer loan product in many markets. Most home equity lines of credit originations are being made on a variable rate basis. The average loan-to-value ratio on refinanced homes remains close to 70 percent, showing that the home maintains a significant amount of equity after refinancing. Total home equity grew by $600 billion in 2001 and by another $300 billion in the first half of 2002. This means rising home values are simultaneously increasing the wealth of homeowners even as they turn some of this equity into cash. The sense of the Council is that line usage, the percentage of balance outstanding compared to line commitments has been increasing over the past year.

What additional concerns, if any, lie on the horizon with regard to the quality of consumer loans and households' debt service burdens?

The predominant themes coming from Council members are the potential for a drop in housing prices and the increased levels of debt being shouldered by the consumer.

Whereas evidence of a "housing bubble" is anecdotal and regionalized, the

Council does express concern that housing prices will not be able to rise at this pace forever. Levels of home equity have been supported by these increased housing values but should those values begin to fall, lenders will be faced with higher loan to value ratios and with little room for the problems created by a potential downturn in the economy.

Increasing levels of consumer debt burden are also a concern to the Council. Federal Reserve data indicate that household debt service payments were more than 14 percent of disposable income in the third quarter of this year, near the highest level in 22 years. Although consumers are still relatively "wealthy" because of increases in home values, there still remains concern should the economy turn downward. In addition, unemployment remains a concern amongst Council members. As of October, the number of unemployed persons was 8.2 million. Correspondingly, the unemployment rate stood at 5.7 percent unchanged from the previous reporting period. The unemployment situation is expected to remain uncertain as a large number of companies have recently announced plans for a fresh round of job cuts. Several Council members also expressed concern over the high rate of personal bankruptcy filings and whether prospects for fresh bankruptcy legislation would trigger additional filings. These issues will likely affect consumer credit quality in the future.

Participating in this discussion: The Federal Advisory Council, Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

ECONOMIC DISCUSSION -- (A) Inflation: Are the prices of products and services rising more or less quickly (or declining more) than in the recent past? Are the prices for the products and services you purchase rising more or less quickly?

Discussed.
December 6, 2002.

Mr. Fine presented the views of the Council.

Nearly all districts report that inflation pressures have remained largely subdued. However, several districts report that in recent weeks, prices have edged higher in several key areas compared to the first two quarters of 2002. Education, housing, health services, energy, and more recently, paper costs continue to rise faster than the overall CPI.

Several districts highlighted significant cost increases in insurance premiums and legal and audit services. Mitigating these increases and contributing to the general price stability is unusually strong productivity growth in recent quarters.

Two districts highlighted the dichotomy between service and commodity

pricing, pointing out that most commodity prices have barely budged (and have actually fallen in some regions), while core service costs are up sharply in recent months.

Wage pressures across all districts continue to be subdued with notable exceptions in health care and among highly specialized professionals.

(B) Housing Markets: Is housing activity increasing or decreasing in your region, taking into account the usual seasonal factors? Are house prices rising more or less rapidly than they were three months ago? Are house prices at sustainable levels or does the current level raise concerns about a possible decline in prices in the future? Are banks well positioned to handle a possible decline in house prices?

Nearly all districts reported that housing activity slowed in recent weeks, but is still considered strong by historical standards. Home price inflation appears to be moderating across most districts, with the most noticeable declines reported in the First, Fifth, Sixth, Tenth, and Eleventh Districts. With the exception of the First District, all districts report that starter to middle-level housing sales remain strong to very strong, while several districts report that luxury and "trophy" home sales are slack, and in some areas prices are declining for "up-scale" homes.

Mitigating these concerns are reports that developers/builders are anticipating slower demand in 2003 and are adjusting their plans accordingly. There does not appear to be a significant over-supply of homes on the market as yet. However, concerns persist about downward pressures emerging and many districts warn that an overhang could develop in 2003 should mortgage rates trend higher, or if the strong pace of home sales continues to cool as in recent weeks.

Most banks appear to be anticipating weaker housing markets by approving fewer construction loans. The decline may be a response to softer demand, however. While several districts reported a slight increase in mortgage delinquencies, all districts reported that banks are generally well positioned to withstand any significant weakness in the housing markets.

(C) Labor Markets: Have there been any changes in the degree of slack in labor markets in recent months? Is the pace of wage and compensation increases rising or declining? Are there areas where banks or their business customers still have trouble attracting and keeping employees? Have layoffs in your market areas had much impact on the availability of workers and compensation? Are workers who have been laid off having difficulties finding new employment?

Overall, there has been little change in labor markets over the past two quarters. All districts report that labor markets are generally soft. Most banks and other businesses report lower turnover. Only the Twelfth District reported any significant improvement in employment trends.

Wage pressures were reported as stable or continuing to moderate with notable exceptions among higher education, health care and technology professionals. The Twelfth District reported that certain sector pressures in several markets within the District have caused a moderate upward movement on wages.

Layoffs are widespread throughout nearly all districts. Districts report that laid off workers are having more difficulty finding a position with similar job skills. There are clearly more candidates available for open positions. They continue to maintain high expectations of starting salaries and are content to wait for better positions rather than just obtain employment. Layoffs and a stagnant job market have stabilized labor costs, with the exceptions noted above.

Despite soft labor markets, many commercial businesses and banks report that highly specialized professionals and experienced skilled workers remain difficult to hire. People on layoff appear to be waiting until severance runs out before aggressively seeking new employment or are waiting for salaries that match skills.

(D) Economic Activity: Has activity in your region increased or diminished? In particular, what sectors or regions are growing and what sectors are slowing?

All districts reported either sluggish or stabilizing economies with no significant upward or downward trends, with the Eleventh and Twelfth Districts notable exceptions. The Eleventh District reported that weak state output, unimproved employment and negative coincidental indicators suggest that Texas is still in recession. The Twelfth District reported that its economy is back on track, growing, and outpacing the rest of the country.

Retail sales in October and early November were generally weak nationwide, including notable declines in motor vehicle sales from previous high levels. Consumer spending has slowed somewhat from record levels in most districts in recent weeks, although retailers are encouraged by the Thanksgiving weekend retail traffic. Manufacturing activity, which seemed to rebound during the summer, fell back in recent months and may not have bottomed out. Capital spending continues to be held back by a large overhang of capital. Commercial real estate has softened significantly in recent weeks with several districts reporting that commercial real estate markets are overbuilt. Technology-related industries still feel they have not seen the bottom of the cycle and expect challenges well into 2003.

The agriculture sector is mixed; many areas were hit hard by drought, but other regions reported ideal growing conditions and record harvests. Land values in most regions are holding steady. Energy and mining activities have been uneven. Labor markets in all districts are lackluster.

Residential housing and housing-related businesses continue to do well, and

together with steady consumer spending and a relatively strong services sector are the primary drivers of the economy.

Most districts noted that both consumer and commercial lending demand has slowed in recent weeks, with the exception of residential related lending. Many banks report slight to modest deterioration in both consumer and commercial credit quality, but generally not outside anticipated levels.

Most Council members regard next year as a transition year from the sluggish activity of the past two years to more "normalcy."

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