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News and Views for Eighth District Bankers

Check 21 Encourages Efficiency in Check Processing

The Check Truncation Act of 2003, also known as The Check Clearing for the 21st Century Act, or Check 21, was signed into law Oct. 28, 2003. The law will go into effect Oct. 28, 2004. Under Check 21, financial institutions will be able to create substitute checks from digital images and electronic check information, allowing them to collect and return checks more quickly. These substitute checks—not the check images themselves—will serve as the legal equivalent of the original check.

In order to be legal, the substitute checks must:

- meet industry standards,
- accurately and legibly include all of the information from both the front and back sides of the original check.
- be MICR-encoded and machine readable, and
- bear a legend that states, "This is a legal copy of your check. You can use it the same way you would



use the original check."

The Act does *not* mandate that checks be imaged. Furthermore, it does not determine what constitutes presentment or provide legal coverage for the image exchange. And, as is the case today, banks can collect and return checks electronically only through individual agreements with other financial institutions.

Fed Chairman Alan Greenspan, speaking at a recent Fed System conference, praised Check 21 as "an important event for the financial industry." Said Greenspan, "From a broad perspective, the Check 21 Act continues the work of our society to ensure that the marketplace can respond flexibly to fundamental shifts in our technologies." In the Feditorial on page 2,

First Vice President LeGrande Rives offers his thoughts about why check processing will never be the same. ■

Fed Releases 2003 CRA/HMDA Reporter

The Federal Reserve Board and the St. Louis Fed recently published the fourth edition of the *CRA/HMDA Reporter*. This annual publication provides Community Reinvestment Act (CRA) and Home Mortgage Disclosure Act (HMDA) reporters with valuable updates, tips and resources for data submission.

- This year's publication focuses on:
- changes to the FFIEC's HMDA Data Entry Software,
 - improving CRA data quality,

- redefined Metropolitan Statistical Areas,
- submitting data via the Internet and
- CRA and HMDA quick tips.

Recently, all CRA and HMDA reporters, as well as third-party software vendors, received hard copies of the *CRA/HMDA Reporter*, which also is available online at www.ffiec.gov/hmda/newsletter.htm. Additional information about Reg C changes, compliance tips and resources can

be found on the national HMDA Regulation C Amendments web site, www.stlouisfed.org/hmdaregcamendments. CRA and HMDA reporters may also find helpful information on the FFIEC's web sites, (CRA) www.ffiec.gov/cra and (HMDA) www.ffiec.gov/hmda.

If you have any questions about any of these CRA/HMDA resources, contact Bob Dowling at (314) 444-8532, or 1-800-333-0810, ext. 44-8532. ■



Feditorial

Check 21 Signals a Major Change in Check Processing

By W. LeGrande Rives, first vice president of the Federal Reserve Bank of St. Louis

Now that the Check Truncation Act of 2003 (Check 21) has been signed into law, check processing may never be the same. As you are well aware, our current method of check processing is both labor intensive and expensive because original checks must be repeatedly sorted before being transported to their final destination. Beginning Oct. 28, 2004, however, a “substitute check” will have the same legal status as the original and must be accepted in place of the original.

The public may not change their check-writing habits quickly. This small change in law, however, will have a significant impact on the way checks are collected and returned in the United States—replacing the sorting and transportation processes with quicker and cheaper electronic transmission of check images. If Check 21 leads to increased usage of image processing in check collection—and I have every reason to believe it will—everyone will win. Banks will reduce their costs and collect checks more quickly, and consumers will receive more

conveniences such as faster availability of funds and statement deliveries.

One of the barriers that has kept this from happening under existing law is that collecting banks do not always know if the drawer of a check has agreed not to receive the original check back. Likewise, some community banks also have had difficulty obtaining the required bank-to-bank agreements for exchanging electronic information or images.

With the enactment of Check 21, more banks, I believe, will agree to exchange images because they will know that these images can be converted to paper substitute checks at any time. Banks will still need to agree on image-exchange standards and allocation of liability, but broad multilateral agreements will be far more likely to develop and greater numbers of banks will likely be willing to join such agreements.

In addition, customers who don't receive their original checks might then take the next step and accept images or the information from the MICR line in their statements. None of this will happen overnight, but the end of paper-check processing just got one step closer. ■

Banking Supervision Division Conducts Banker Visits

The St. Louis Fed's Banking Supervision Division recently began a banker visitation initiative focusing on nonregulatory issues. Its goal is to:

- assess the effectiveness of communications between the division and financial institutions, and
- obtain suggestions for improvement.

Harry Slingerland, the division's communications officer, began visiting financial institutions in early September. During the visits, Slingerland asks bank management how the institution currently receives information from the Fed. To date, Slingerland has

found that most institutions use the St. Louis Fed's electronic distribution service (ED) to receive regulations, circulars and press releases. They also use the public web site, www.stlouisfed.org, to view a variety of other banking information.

Slingerland also assesses whether institutions are taking full advantage of new software and Internet tools. For example, institutions can:

- send and receive many regulatory and statistical files and reports electronically using Internet submission;
- manage their Federal Reserve accounts in real time and more easily comply with payments system

risk policies by using FedLine® for the Web and Account Management Information; and

- view, manage and accurately estimate their reserve balances with ReserveCalc Internet software.

Finally, Slingerland checks to see if the institution is aware of and taking advantage of the Bank's credit programs, such as the seasonal credit program or the Fed's primary and secondary credit programs. For more information about the Bank's new visitation program, contact Harry Slingerland at (314) 444-8752, or 1-800-333-0810, ext. 44-8752. ■

Community Banks Tap into “Cedars” to Grow Deposits

CDARS debuted in January 2003 and is the newest funding tool community banks can use to attract local—and otherwise uninsured—funds.¹ With CDARS, large deposits can be spread across other institutions in chunks under the \$100,000 threshold, thereby securing complete FDIC coverage. The ability to offer 100 percent coverage could benefit community banks by helping them attract and retain funds from customers who demand complete insulation from losses, such as retirees and local governments.

CDARS is the sole service of Promontory Interfinancial Network, a bank consulting firm based in Washington, D.C. The network is led by Eugene Ludwig, former comptroller of the currency, and Alan Blinder, former vice chairman of the Federal Reserve System’s Board of Governors. About 350 banks currently belong to the Promontory network, and about half of them actively use CDARS.

At first glance, CDARS might raise some regulatory eyebrows. Funds placed in the Promontory network are immediately classified as brokered deposits on the reports banks must file quarterly with their supervisory agency. Traditionally, the term “brokered deposits” has been applied to blocks of funds pooled by securities broker/dealers and then placed in depository institutions offering the highest yield. During the thrift crisis of the 1980s, many failing institutions used brokered deposits to “gamble on resurrection.” As a result, supervisors now closely monitor institutions that rely heavily on this type of funding.

But CDARS are not likely to cause the problems that brokered deposits did during the thrift crisis. As noted, bank supervisors have procedures in place to monitor brokered deposits and prevent their misuse. Even more important, the CDARS deposit swap generally is initiated by a desire to retain local deposits, not to cover potentially unsafe-and-unsound loan growth. Moreover, any bank bent on acquiring funds to cover imprudent growth would find it much easier to tap the wholesale-funding market directly rather than using CDARS.

In theory, CDARS also could exacerbate the moral hazard in deposit insurance because it allows otherwise uninsured depositors to get full insurance coverage. Fully insured depositors are less likely to withdraw funding or demand higher interest rates as bank risk increases; so, CDARS could implicitly encourage risk-taking.

Recent research, however, suggests that jumbo-CD holders are not particularly sensitive to bank risk. Because of deposit-preference laws—which give domestic jumbo-CD holders priority over foreign depositors in failure resolutions—and high bank-capital levels, expected losses on jumbo CDs are small. Therefore, little monitoring or disciplining by uninsured depositors is going on. Put simply, weakening already weak deposi-



tor discipline by transforming jumbo CDs into fully insured CDs should not encourage risk taking—at least in the current institutional and economic environment.

However, CDARS could cause short-run problems in off-site surveillance. As previously noted, heavy dependence on brokered deposits traditionally has been a supervisory red flag, and funds placed in the Promontory network are reclassified automatically as brokered deposits on bank financial statements. Therefore, CDARS users could end up looking suspicious—on paper, at least—to examiners who monitor bank condition between exams. These examiners will have to stay in close contact with their bank to make sure that “blips” in brokered-deposit-dependence ratios are not misinterpreted.

Of course, the full supervisory implications of CDARS will not be clear until we have evidence about how banks have reshaped their balance sheets in response to the product. Also, community-bank depositors may not respond as enthusiastically as expected to the deposit protection afforded by CDARS—so this may be much ado about nothing. Regardless, community bankers face a continuing challenge to secure the funding they need to compete effectively, and CDARS could become an important new tool for meeting this challenge.² ■

¹ CDARS—pronounced “cedars”—stands for “Certificate of Deposit Account Registry Service.”

² An earlier version of this article by Mark D. Vaughan and Timothy J. Yeager was published in the October 2003 edition of *The Regional Economist*. To view the complete article, go to www.stlouisfed.org/publications/re/2003/d/pages/cedars_deposits.html.

Regional Roundup

St. Louis Fed Publishes 2004 Holiday Calendar

The St. Louis Fed recently published its 2004 holiday calendar. Christmas Day was not included in the schedule because it falls on a Saturday. For holidays falling on a Saturday, Federal Reserve banks and branches will be open the preceding Friday; however, the Board of Governors will be closed. You may access the St. Louis Fed's 2004 legal holiday schedule and the Board of Governors' holiday schedule through 2008 at www.stlouisfed.org/about/holidays.html. ■

St. Louis Fed Announces 2004 Prices for Financial Services

In response to great change within the market and the passage of Check 21,

the prices for the Federal Reserve's financial services have evolved. The Fed's sustained focus on efficiency has allowed us to either maintain or reduce electronic access and electronic payments processing fees for 2004. Paper check prices, however, will increase by an average of 5 percent, and electronic check prices will rise by less than 1 percent.

To view the letter from Vice President Edward E. Richardson, go to www.stlouisfed.org/financial/assets/pdf/cust_comm/2003/COA1024.pdf. More information about the Eighth District's 2004 prices can be found on our public web site, www.stlouisfed.org/financial/priced_service_fees_2004.htm. For a complete list of the 2004 national priced service fees, please visit the national financial services web site, www.frb services.org. ■

BHC Reports Require Electronic Filing

Beginning this year, the Federal Reserve no longer accepts paper copies of reports from bank holding companies. Therefore, the FR Y-9SP (Parent Company Only Financial Statements for Small Bank Holding Companies) and FR Y-9ES (Financial Statements for Employee Stock Ownership Plan Bank Holding Companies) reports, as of Dec. 31, must be submitted electronically. If you have never submitted a report electronically, you may view the information on electronic reporting at www.reportingandreserves.org or contact Matt Horenkamp at (314) 444-4640, or 1-800-333-0810, ext. 44-4640. ■

St. Louis Fed Announces Facilities Renovation

The St. Louis Fed has announced that it will renovate its downtown St. Louis facilities to enhance security and increase its physical space. This is the first significant expansion the Bank has undertaken in about 60 years—since the Bank bought the northern building, a former department store located on St. Charles Street, and refurbished it.

After the terrorist attacks of Sept. 11, 2001, the Bank made substantial upgrades and improvements to its current buildings; however, more improvements were required and several departments had outgrown their work areas. The Bank examined several alternatives—including moving out of downtown St. Louis. After a thorough analysis, however, the decision was made to renovate the downtown facilities.

Many improvements are planned over the next few years. The Bank will demolish its current garage, creating a new and improved secure area for employees, visitors and customers. On top of this new area, the Bank will also add another 54,000 square feet of office space.



The first step of the renovation includes acquiring the Marquette Garage, located on the corners of Broadway and Locust streets. This new garage will provide parking around the clock for most of the 900 employees who work in St. Louis. The renovations will begin in 2004 and are scheduled for completion in 2008. ■

Retail Deposit Sweep Programs Turn 10

By Richard G. Anderson, vice president and economist, and Michelle T. Meisch, analyst, Research



(Richard G. Anderson is a vice president and economist and Michelle T. Meisch is a research associate at the Federal Reserve Bank of St. Louis. This article is based on a working paper written by Anderson and can be found at www.research.stlouisfed.org/wp/2003/2003-026.pdf.)

January 2004 marks the 10th anniversary of retail deposit sweep programs at U.S. banks. Some regulators initially were skeptical about the effects of retail sweep programs. This anniversary seems an appropriate time to re-examine their effects.

Retail deposit sweep programs increase bank earnings by reducing the amount of noninterest bearing deposits that banks hold at Federal Reserve banks. A bank's transaction deposits beyond approximately the first \$50 million are subject to a 10 percent reserve requirement ratio, which is satisfied by holding vault cash or non-interest-bearing deposits at Federal Reserve banks. In contrast, savings deposits are subject to a zero percent ratio.

Retail deposit sweep programs take advantage of this difference by "sweeping" transaction deposits into savings deposits—that is, relabeling transaction deposits as savings deposits for reserve-requirement purposes. Currently, banks are limited by law to no more than six transfers per month between a customer's transaction deposit account and this type of savings account. (Withdrawals, including checks, are paid from the transaction deposit. When the transaction deposit is depleted,

the computer must move funds from the savings deposit back to the original transaction account.)

Sweep programs allow banks to increase their earnings by redeploying excess Federal Reserve deposits into earning assets. In many cases, the bank is able to reduce its reservable transaction deposits by 70 percent or more. Some analysts have regarded the increase of retail deposit sweep programs as the end of binding statutory reserve requirements, because many banks find they are able to reduce their required reserves below the amount of vault cash necessary for day-to-day business.

During the early years of retail deposit sweep programs, some analysts were concerned that federal funds rate volatility would increase as banks held fewer deposits at the Federal Reserve. Some recalled the winter of 1991, when higher volatility followed the December 1990 cut in reserve requirements. The spread of retail sweep programs among banks, however, has not increased the volatility of the federal funds rates. This experience demonstrates that—at least for the United States—banks and the clearing system can operate effectively with low levels of deposits at Federal Reserve banks.

This "win-win" experience with retail deposit sweep programs—higher bank earnings without increased federal funds rate volatility—has led some members of Congress to propose relaxing regulatory constraints on retail deposit sweeping. Proposed legislation would increase that limit to 24 transfers per month, more than one for each business day. Such a change would be economically equivalent to reducing the reserve-requirement ratio to zero for banks with sweep programs—effectively, the end of binding statutory reserve requirements in the United States.

For financial market analysts, retail deposit sweep programs have distorted available data. Larger banks report to the Federal Reserve their daily close-of-business amounts of transaction and saving deposits; however, they do not report the amounts of deposits involved in retail deposit sweeps. Hence, the amount of transaction deposits swept into savings is excluded from published figures on M1.

Today, this amount is approximately *half* of all transaction deposits held by households and firms, compared with 10 years ago. For example, the Federal Reserve's Flow of Funds accounts showed households held currency and transaction deposits of \$615 billion in 1994; in 2003, those deposits were down to \$322 billion. The reason for the drop is clear: The household sector is calculated as a residual from the deposit figures reported by depository institutions to the Board for reserve-requirement purposes, and half of all transaction deposits are being swept into savings deposits.

The widespread availability of retail deposit sweep software now makes binding statutory reserve requirements a voluntary constraint for most banks. Fears of an increase in federal funds rate volatility have proven unfounded. Perhaps the most serious remaining issue is distortion to published M1 and other aggregate measures of financial intermediation, a small issue at best. ■

Fed Offers New Products in Response to Check 21

Now that Check 21 has passed, the Federal Reserve has announced that it will continue to offer existing check services along with developing new products and services. Some of these new products include: forward and return image cash letters, image cash letter conversion and image cash letter delivery. For more information about these new products, contact your local account executive or visit www.frb.services.org.

Fed Announces Changes to Regulation D

The Federal Reserve has amended Regulation D, Reserve Requirements by Depository Institutions, by:

- increasing the amount of transaction accounts to which the lowest reserve requirements (3 percent) will apply, from \$42.1 million to \$45.4 million, and
- increasing the amount of reservable liabilities subject to a zero percentage, from \$6.0 million to \$6.6 million.

These changes are effective with the maintenance periods beginning Dec. 25, 2003, for weekly reporters of FR 2900 data, and Jan. 15, 2004, for quarterly reporters. For further information, please contact Hillary Debenport at (314) 444-8488, or 1-866-666-8316.

New York Fed Creates New Online Publications Catalog

The New York Fed recently unveiled its new web site, www.newyorkfed.org, which includes a redesigned publications catalog. Students, teachers, bankers and the general public may view, order and/or subscribe to a variety of publications and videos produced throughout the Federal Reserve System by visiting www.newyorkfed.org/publications/frame1.cfm.

Federal Agencies Release New Consumer Protection Brochure

A collection of federal agencies, including the Federal Reserve Board of Governors, has released a new consumer-protection publication, "Putting Your Home on the Line Is Risky Business." Information inside this publication includes:

- guidance on avoiding potential borrowing pitfalls, including high-cost predatory home loans,
- tips for getting the best financing deal possible and
- a worksheet to help consumers shop for a home loan.

A link to the online version of this publication can be found at www.stlouisfed.org/consumer.

CRA Investment Funds EVANSVILLE, IND.

Dec. 11, 2003

11:30 a.m. to 1 p.m.

For more information, contact Faith Weekly at (502) 568-9216.

OUT FOR COMMENT

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

On Oct. 8, the Federal Reserve Board of Governors requested public comment on a proposal to change its cash services policy. The public comment period will conclude on Jan. 15, 2004. The Board wishes to add two elements:

1. A custodial inventory program that provides an incentive to depository institutions (DIs) to hold currency in their vaults to meet their customers' demands, and
2. A fee charged to DIs that deposit currency to and order currency from Federal Reserve banks within the same week — instead of recirculating deposited currency among their customers.

More information can be found at www.stlouisfed.org/email_alerts/fs/cash.html and www.federalreserve.gov/boarddocs/press/Other/2003/20031008/default.htm.

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



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