FEDERAL RESERVE BANK
OF DALLAS

HELEN E. HOLCOMB
FIRST VICE PRESIDENT AND
CHIEF OPERATING OFFICER

DALLAS, TEXAS
75265-5906

May 5, 1997

Notice 97-44

TO: The Chief Operating Officer of each financial institution and others concerned in the Eleventh Federal Reserve District

SUBJECT

Collateral Valuation of Structured Notes[1]

DETAILS

Effective May 15, 1997, the Federal Reserve System and the U.S. Treasury will implement a change to the acceptance standards for structured notes issued by United States agencies, private corporations, and municipalities that are deposited with Federal Reserve Banks to secure discount window borrowings, Treasury Tax and Loan balances, or overdrafts[2] at Reserve Banks. The valuation methodology for acceptable securities will not change, but acceptable securities must meet the minimum price floors listed below.

The acceptance and valuation criteria are as follows:

1. Reject all structured notes that place principal at risk (redemption amount of bond tied to price of gold, S&P 500, etc.)

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[1] As defined in the Call Report instructions, with the exception of asset-backed and agency inflation-indexed securities (see attached). Treasury inflation-indexed issues are not deemed structured under either Call Report definitions or our policy.

[2] In-transit securities collateral is not covered under this policy.

2. To be acceptable, structured notes, regardless of structure, must have a market price at or above the following price floors:

Term-to-Maturity

Less than:	3-mo	6-mo	1-yr	2-yr	3-yr	5-yr	7-yr	10-yr	30-yr
Floor (A)[3] [90% Valuation]	90-14	90-27	91-19	92-24	93-24	95-24	97-12	100-00	122-25
Floor (B) [80% Valuation]	80-12	80-24	81-13	82-14	83-11	85-04	86-18	88-29	109-05

3. The valuation standards have not changed. The collateral values assigned to eligible structured notes will remain at the existing levels: 90% of remaining principal balance for agency-issued and investment-grade state and Puerto Rico-issued general obligations and 80% of remaining principal balance for investment-grade corporate issues and all other investment-grade municipal issues.

4. Prices will be reviewed monthly to ensure that they continue to meet the eligibility requirements.

If prices are not available through routine Federal Reserve sources, the pledging institution may be required to provide prices from acceptable sources upon deposit and monthly thereafter. Please review your current collateral portfolio and, if necessary, adjust your collateral pledges according to the new acceptance standard.

ATTACHMENT

Attached is a copy of the reporting requirements.

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[3]. Floor (A) pertains to United States agency-issued securities and state and Puerto Rico-issued general obligations. Floor (B) pertains to corporate-issued securities and all other structured municipal securities.

MORE INFORMATION

For more information, please contact Bob Cushman at (214) 922-5331. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely,

Helen E. Holcomb

9 Structured notes. Report in this item all structured notes included in the held-to-maturity and available-for-sale accounts and reported in Schedule RC-B, items 2, 3, and 5. In general, structured notes are debt securities whose cash flow characteristics (coupon rate, redemption amount, or stated maturity) depend upon one or more indices and/or that have embedded forwards or options or are otherwise commonly known as "structured notes." Include as structured notes any asset-backed securities (other than mortgage-backed securities) which possess the aforementioned characteristics.

Structured notes include, but are not limited to, the following common structures:

(1) Floating rate debt securities whose payment of interest is based upon a single index of a Constant Maturity Treasury (CMT) rate or a Cost of Funds Index (COFI).

(2) **Step-up Bonds.** Step-up securities initially pay the investor an above-market yield for a short noncall period and then, if not called, "step up" to a higher coupon rate (which will be below current market rates). The investor initially receives a higher yield because of having implicitly sold one or more call options. A step-up bond may continue to contain call options even after the bond has stepped up to the higher coupon rate. A **multistep** bond has a series of fixed and successively higher coupons over its life. At each call date, if the bond is not called, the coupon rate increases.

(3) **Index Amortizing Notes (IANs).** IANs repay principal according to a predetermined amortization schedule that is linked to the level of a specific index (usually the London Interbank Offered Rate - LIBOR - or a specified prepayment rate). As market interest rates increase (or prepayment rates decrease), the maturity of an IAN extends, similar to that of a collateralized mortgage obligation.

(4) **Dual Index Notes.** These bonds have coupon rates that are determined by the difference between two market indices, typically the CMT rate and LIBOR. These bonds often have a fixed coupon rate for a brief period, followed by a longer period of variable rates, e.g., 8 percent fixed for two years, then the 10-year CMT rate plus 300 basis points minus three-month LIBOR.

(5) **De-leveraged Bonds.** These bonds pay investors according to a formula that is based upon a fraction of the increase or decrease in a specified index, such as the CMT rate or the prime rate. For example, the coupon might be the 10-year CMT rate multiplied by 0.5, plus 150 basis points. The de-leveraging multiplier (0.5) causes the coupon to lag overall movements in market yields. A **leveraged** bond would involve a multiplier greater than 1.

(6) **Range Bonds.** Range bonds (or accrual bonds) pay the investor an above-market coupon rate as long as the reference rate is between levels established at issue. For each day that the reference rate is outside this range, the bonds earn no interest. For example, if LIBOR is the reference rate, a bond might pay LIBOR plus 75 basis points for each day that LIBOR is between 3.5 and 5.0 percent. When LIBOR is less than 3.5 percent or more than 5 percent, the bond would accrue no interest.

(7) **Inverse Floaters.** These bonds have coupons that increase as rates decline and decrease as rates rise. The coupon is based upon a formula, such as 12 percent minus three-month LIBOR.

Exclude from structured notes floating rate debt securities denominated in U.S. dollars whose payment of interest is based upon a single index of a Treasury bill rate, the prime rate, or LIBOR and which do not contain adjusting caps, adjusting floors, leverage, or variable principal redemption. Furthermore, debt securities that do not possess the aforementioned characteristics of a structured note need not be reported as structured notes solely because they are callable as of a specified date at a specified price. In addition, debt securities that in the past possessed the characteristics of a structured note, but which have "fallen through" their structures (e.g., all of the issuer's call options have expired and there are no more adjustments to the interest rate on the security), need not be reported as structured notes.

Generally, municipal and corporate securities that have periodic call options should **not** be reported as structured notes. Although many of these securities have features similar to those found in some structured notes (e.g., step-ups, which generally remain callable after a step-up date), they are **not commonly known** as structured notes. Examples of such callable securities that should **not** be reported as structured notes include:

(1) Callable municipal and corporate bonds which have single (or multiple) explicit call dates and then can be called on any interest payment date after the last explicit call date (i.e., they are continuously callable).

(2) Callable federal agency securities that have continuous call features after an explicit call date, except step-up bonds (which are structured notes).

The mere existence of simple caps and floors does not necessarily make a security a structured note. Securities with **adjusting** caps or floors (i.e., caps or floors that change over time), however, are structured notes. Therefore, the following types of securities should **not** be reported as structured notes:

(1) Variable rate securities, including Small Business Administration "Guaranteed Loan Pool Certificates," **unless** they have features of securities which are commonly known as structured notes (i.e., they are inverse, range, or de-leveraged floaters, index amortizing notes, dual index or variable principal redemption or step-up bonds), or have adjusting caps or floors.

(2) Mortgage-backed securities.

9(a) Amortized cost (of structured notes). Report the amortized cost of all structured notes included in the held-to-maturity and available-for-sale accounts. The amortized cost of these securities will have been reported in columns A and C of the body of Schedule RC-B.

9(b) Fair value (of structured notes). Report the fair (market) value of structured notes reported in Memorandum item 9(a) above. The fair value of these securities will have been reported in columns B and D of the body of Schedule RC-B. Do not combine or otherwise net the fair value of any structured note with the fair or book value of any related asset, liability, or off-balance sheet derivative instrument.