FEDERAL RESERVE BANK OF NEW YORK
NEW YORK, N.Y. 10045-0001
AREA CODE 212-720-5000

AT. 10732 (b)

August 29, 1994

To the Chief Executive Officer of Each State
Member Bank, Bank Holding Company and Branch
or Agency of a Foreign Bank in the Second
Federal Reserve District:

SUBJECT: Supervisory Policies Relating To Structured Notes

The Federal Reserve has recently issued the enclosed letter in response to the growing volume of structured notes held by banks and bank holding companies. The letter recognizes that these instruments may be appropriate investments for banking organizations, but also cites their potential risks and advises that investors evaluate the price sensitivity of these instruments under a broad range of market conditions.

The Federal Reserve expects bankers to understand the risks inherent in all of their trading and investment products. Accordingly, examiners will carefully evaluate the implications of any investments in structured notes as part of their normal review of a banking organization's portfolio investments and management of market risk. If you have any questions about this statement, please call me at 212-720-1830.

(Enclosure)

Yours truly,

Christine M. Cumming

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Senior Vice President

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

SR 94-45 (FIS)

DIVISION OF BANKING
SUPERVISION AND REGULATION

August 5, 1994

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Supervisory Policies Relating To Structured Notes

The following guidance is being issued to highlight the growing use of structured notes by banking organizations and the need for examiners to ensure that banks, bank holding companies, and U.S. branches and agencies of foreign banks that hold these instruments do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions. Some of these instruments can expose investors to significant losses as interest rates, foreign exchange rates, and other market indices change. Accordingly, examiners should be mindful of these securities, whether they are used in an institution's trading, investment, or trust activities.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cashflows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium term maturities and reflect a wide variety of cashflow characteristics that can be tailored to the needs of individual investors.

As such, these notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and address more specifically an institution's risk exposures. Risk to principal is typically small. Accordingly, when they are analyzed and managed properly, structured notes can be acceptable investments and trading products for banks.

Structured notes can also, however, have characteristics that cause them to be inappropriate holdings for many depository institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed income instruments with comparable face values. Their customized

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features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, institutions considering the purchase of structured notes should determine whether these factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cashflows, which can involve both principal and interest payments. Some notes employ "trigger levels", at which cashflows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to manage the market risks of their institution in a satisfactory manner. Therefore, examiners should evaluate the appropriateness of these securities bank-by-bank, with a knowledge of management's expertise in evaluating such instruments, the quality of the institution's relevant information systems, and the nature of it's overall exposure to market risk. This evaluation may include a review of the institution's ability to conduct stress tests. Failure of management to understand adequately the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banks.

When making investment decisions, some institutions may focus only on the low credit risk and favorable yields of these notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the institution's risk management process and assess management's recognition of their potential volatility.

The risks inherent in such complex instruments and relevant risk management standards have been addressed in a variety of previous SR letters and supervisory manuals. They include SR 90-16, which provides standards for investing in asset-backed securities; SR 93-69, which advises examiners when reviewing trading activities; and the recently issued Trading Activities Manual. Although these documents do not specifically cite structured notes, they all help to highlight the following important supervisory and risk management practices that are relevant to these instruments:

- the importance of board approved policies that address the goals and objectives expected to be achieved with such

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products and that set limits on the amount of funds that may be committed to them;

- the need for management to understand fully the risks these instruments can present, including their potentially reduced liquidity in secondary markets and the price volatility that any embedded options, leveraging, or other characteristics can create;

- the need for adequate information systems and internal controls for managing the risks under changing market conditions; and,

- the importance of clear lines of authority for making investment decisions and for evaluating and managing the institution's securities activities that involve such instruments.

Trust examiners should review the use of structured notes and other complex instruments by trust departments to ensure that their use conforms with the institution's policies and fiduciary responsibilities. They should also consult the Trust Examination Manual and SR 91-4 for any relevant guidance.

Richard Spillenkothen
Director