THE FEDERAL RESERVE BANK of ST. LOUIS

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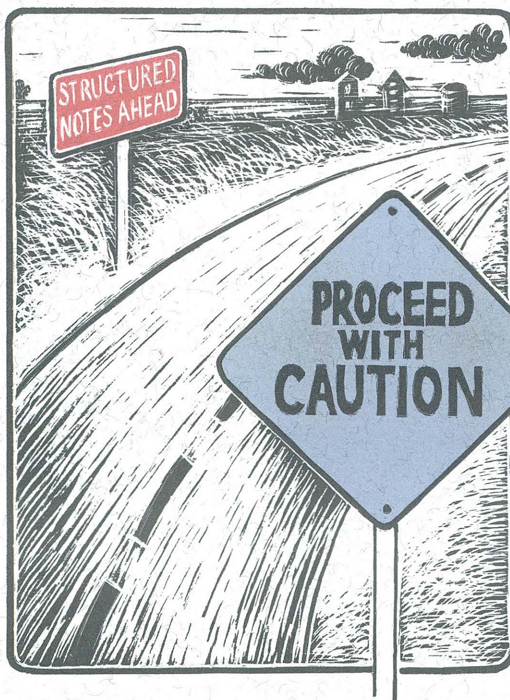
SUPERVISORY ISSUES

Supervisory News and Views for the Eighth District

Risk Management Is Essential When Purchasing Structured Notes

The Federal Reserve recently advised banking organizations of the risks associated with debt securities known as structured notes. The Fed reiterated that risk management policies and practices must be in place to assure that use of these securities is consistent with safe and sound banking practices.



Characteristics of Structured Notes

Structured notes are typically medium-term debt securities, most of which are issued by U.S. government agencies and other government-sponsored entities. These notes are "structured" in that a form of embedded swap and/or option is incorporated into the debt instrument. Coupon and principal payment levels are tied to one or more indices either directly or by formulas which may change during the term of the note. These formulas may have various reset periods and either periodic or lifetime caps and floors.

Among the primary issuers of structured notes are the Federal Home Loan Banks. Most notes issued by the banks have either callable structures or floating rate structures. A callable structured note includes an index amortizing note with a principal payment level that is tied to an index such as LIBOR. A floating rate structured note will carry a coupon rate tied to an index. If the coupon rate moves as the index moves, the instrument is called a "floater." If the rate resets based on a formula that includes a multiple or variation of the index, it is a "leveraged floater." If the rate resets based on the difference between a set rate and the index, it is an "inverse floater." There are many other structured note types, and new products are continuing to be developed.

Because interest rate and cash-flow characteristics vary widely, these notes may offer advantages over other 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

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Structured Notes

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risk exposures. Risk to principal is typically small, and yields are generally high to compensate the investor for the embedded option risk. Accordingly, when analyzed and managed properly, structured notes can be acceptable investments for banks.

Price Volatility and Liquidity Risk

Despite potential benefits, the customized features and embedded option characteristics of structured notes make them hard to price, increase their price volatility and may result in difficulties for an institution that elects to liquidate its position in the secondary market. The notes also reflect high amounts of leverage when compared with fixed income instruments with comparable face values. Accordingly, institutions considering the purchase of such instruments must look beyond the low credit risk and initially favorable yields, and evaluate the market and liquidity risks associated with the note structures under a broad range of possible market conditions.

Appropriate Risk Management Practices

Institutions must demonstrate the following risk management practices to assure that the purchase of structured notes is consistent with safe and sound banking practices:

- Policies must be approved by the board of directors, and address the goals and objectives for these products, as well as set limits on the amount of funds that may be committed to them.
- Management must demonstrate that it understands fully the risks these instruments present, including the potentially reduced liquidity in secondary markets and the price volatility that any embedded options, leveraging or other characteristics can create.
- Adequate information systems and internal controls must exist for regularly evaluating compliance with policies and managing risks under changing market conditions.
- There must be clear lines of authority for making investment decisions, and for evaluating and managing the institution's securities activities.

Examiners will evaluate whether these instruments are appropriate investments for each institution. In that evaluation, they will consider the ability of management to understand and manage in a safe and sound manner the risks inherent in these instruments. In addition, they may review management's ability to conduct appropriate stress tests.

Supervisory risk management standards for these instruments reflect standards already articulated for asset-backed securities and standards in the trading activities examination manual issued by the Federal Reserve System earlier this year.

Mortgage Origination Practices Must Be Consistent With Fair Lending

The Federal Reserve, in consultation with the Departments of Justice and Housing and Urban Development, is advising lenders that certain mortgage origination practices may result in examiner review for compliance with the Equal Credit Opportunity and Fair Housing acts.

The mortgage origination practice which permits lenders to charge different interest rates, origination fees and higher points or other fees to different borrowers during the same period is called overages. This practice gives the broker or loan originator an incentive to bring in more business, and permits the broker to receive additional compensation for originating small balance loans compared with large balance loans. Overages also increase the value of loan servicing rights.

This practice is not inherently discriminatory but may result in apparent disparate treatment or have a disparate impact. A lender who provides loan officers with discretion in setting the price of a loan should review its lending performance to ensure that discretion is exercised fairly and without regard to prohibited factors such as race or gender. If a lender finds, for example, that overages were charged more often to minorities than to nonminorities—regardless of loan type or amount—the lender must demonstrate a nondiscriminatory business reason for this apparently disparate treatment.

Even if the overage policy is limited to loans under certain amounts, it may have a disparate impact because it results in a disproportionate number of minority borrowers who receive loans under that threshold and pay overages. In that case, the lender must demonstrate that the policy has been applied impartially, serves a necessary business objective and that no other, less discriminatory, method is available.

The interagency fair lending task force is currently considering more formal guidance on the use of overages. Lenders who permit overages are urged to review carefully their policies and practices to ensure that they are applied in a nondiscriminatory manner and without a discriminatory effect.

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Examiners Find Common Exceptions to Regulation DD

Just over a year has passed since the implementation of Regulation DD (Truth in Savings), and examiners report that overall compliance with the regulation is good. There have been a few common exceptions, however, noted during examinations.

New Accounts

Though new account disclosures generally meet regulatory requirements, the following disclosures are often omitted:

For *fixed rate* accounts—the period that the interest rate will be in effect.

For *variable rate* accounts—

- the fact that the rate and annual percentage yield may change, how the rate is determined, the frequency with which it may change and any limitation on the amount rates may change;
- the frequency with which interest is *compounded and credited*, and whether consumers will forfeit interest if the account is closed before accrued interest is credited; and
- the *minimum balance* required to open and maintain the account to avoid being charged a fee.

For *time accounts*—the maturity date and early withdrawal penalties; and how withdrawing interest before maturity will affect the annual percentage yield.

Periodic Statements

Regulation DD does not require banks to provide periodic statements. If, however, a bank does send statements to consumers regularly and at least four times a year, certain disclosures must be made. Examples of information frequently missing from periodic statements include the annual percentage yield *earned*, the number of days in the statement cycle, and the beginning and ending dates of the statement period.

Automatically Renewable Time Accounts

An automatically renewable time account's maturity determines the timing and content of disclosures.

Regarding timing, notices must be mailed within the periods specified in the regulation even if the interest rate and annual percentage yield have not yet been determined. If this is the case, the disclosure should explain that the information is not yet available. It should also provide the date that the information will be available and include a telephone number consumers may call to obtain interest rate and annual percentage yield information.

Disclosures for accounts which require *advance* notice must be sent either 30 calendar days before the scheduled maturity date or 20 calendar days before the end of a grace period, as long as the grace period is at least five days. If the account has a maturity of one month or less, disclosures must be sent within a reasonable time after maturity.

In terms of content, disclosures will vary as follows:

- *Longer than one year*—Notices must include the maturity date for the existing account as well as all disclosures required for a new account.
- *Longer than one month, but one year or less*—Notices must provide *either* the disclosures required for accounts with maturities longer than one year *or* the maturity dates for both the new and maturing accounts combined with a description of any differences in the terms between the new and maturing accounts.
- *One month or less*—Notices must describe any term that has changed for the new account, other than the annual percentage yield and interest rate.

Rates and Yields

Examiners frequently noted that banks are not disclosing the annual percentage yield (used for account disclosures and advertising) and the annual percentage yield earned (used in periodic statements) within the allowed tolerances described in the appendix to the regulation. Both must be shown to two decimal places and rounded to the nearest one-hundredth of 1 percent. In addition, neither percentage is considered accurate if it is more than 0.05 of 1 percent above or below the actual yield.

The interagency procedures, objectives and checklist used by Fed examiners are found in the Federal Reserve System's *Consumer Compliance Handbook*. To order a copy, send $20 to: Publications Services, Mail Stop 138, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

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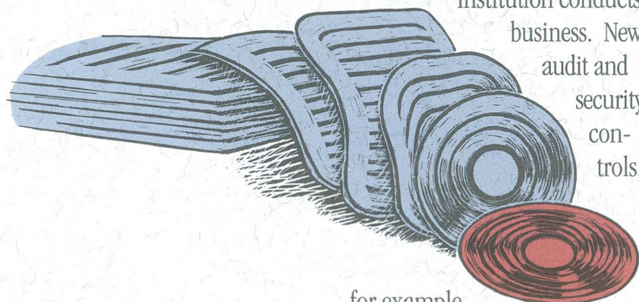
How to Prepare for an Electronic Imaging Environment

The term *electronic imaging*—the technology used to capture, store and retrieve electronic images of paper documents—is becoming commonplace in financial institutions.

For most, the technology of storing images electronically is a welcome substitute for handling, distributing and storing paper documents. Launching a new imaging system, however, will significantly affect how an institution conducts business. New audit and security controls, for example, must be developed and designed into the automated process to ensure that information in image files cannot be altered, erased or stolen. Some potential areas for risk include:



Planning – Careful planning is essential when launching an imaging system. The lack of planning in selecting and converting paper systems to document imaging systems, for example, can result in excessive installation costs, the destruction of original documents, and the failure to achieve expected benefits. Critical issues such as converting existing paper storage files, integrating the imaging system into the organization's workflow, and establishing processes for equipment backup and recovery should be addressed to avoid reduced customer service and business interruptions.

Auditing – Imaging systems change the traditional controls inherent in paper-based systems. Redesign of audit procedures and implementation of new controls is essential.

Workflow Redesign – When introducing imaging systems, institutions generally redesign workflow to benefit from the new technology. New jobs are often identified and others are eliminated. Traditional control functions such as time stamps, control numbers and review signatures must be addressed in the automated system to prevent any increased risk to the institution.

Scanning Devices – These are the entry points for image documents and introduce significant risk in imaging systems. Factors that should be considered are quality control over the scanning and indexing process, the scanning rate of the equipment, the storage of images, equipment backup and repair times, and the experience of the personnel performing the scanning function.

Indexing – The organization and integrity of the indexing system ensures access to documents and protects them from unauthorized modification. Institutions should keep automated journals and audit trails of the access and modification to customer records.

Software Security – The integrity and reliability of the imaging system is directly related to the control quality over access to the system. Software and administrative security functions are essential to protect information from unauthorized access and modification.

Contingency Planning – Because a large number of documents—more than 100,000—can be stored on a single optical disk, contingency planning is crucial. The loss of electronic image files or storage media can, in fact, severely affect business operations if back-up electronic or paper files are not readily available. Contingency planning and back-up storage procedures for imaging system documents should follow generally accepted practices for data processing and management information systems.

Training – Personnel must be adequately trained not only to ensure quality control over the scanning and storage of imaged documents, but also to maximize the benefits of converting to an imaging system. Inadequate training of personnel can result in poor quality document images and indexes as well as a premature destruction of original documents.

Legal Issues – Although a precedent has been established on electronically captured documents such as facsimile, microfilm and photocopies, courts have not yet addressed the authenticity of imaged documents. Institutions with imaging systems should consider the legal implications of converting original documents to images as well as the subsequent destruction of the original documents.

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Bank Performance

Reporting Inconsistencies Complicate Interpretation of Mutual Funds Sales

According to data collected from the June 1994 call report, 16 percent of the 1,150 District banks reported mutual fund sales and annuities, an increase of 17 percent from the previous quarter.

As the chart below indicates, money market sales account for 56 percent of mutual fund sales—due largely to daily sweep account activity. Banks report that fee income from the sale of mutual funds and annuities accounts for 2.4 percent of total noninterest income.

Although this data may provide some long-awaited insight into mutual fund activity, reporting inconsistencies make it premature to begin a comprehensive analysis of bank mutual fund sales and related fee income.

Instructions provided for the March 1994 call report, for example, resulted in differing interpretations of reportable data by banks. Some institutions reported *gross* sales—which included transfers between funds—while others reported *net* sales. In addition, the instructions do not exempt fiduciary sales; current data appears to include a substantial number of sales to trust funds.

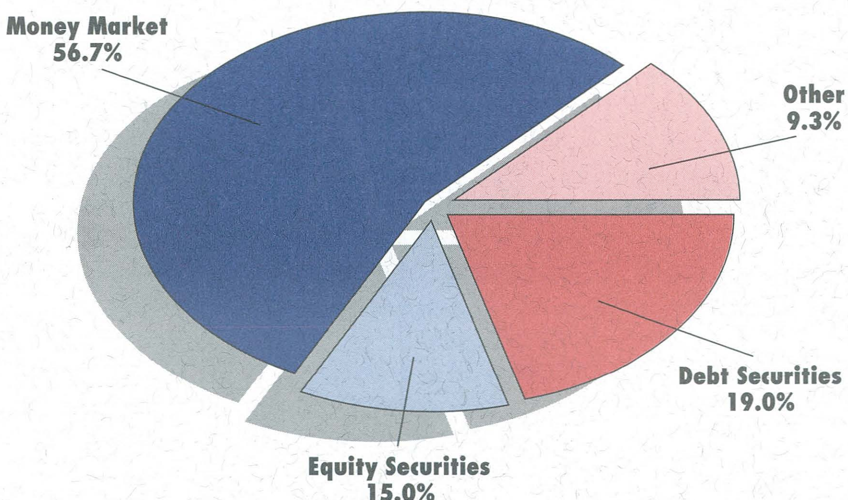
On the other hand, retail sales may be understated because sales by nonbank subsidiaries and affiliates are not included if there is no contractual relationship with the reporting bank.

Interpretation of mutual fund activity is further complicated because we were unable to fully analyze the data since fee income is lumped into one total and is not segregated by type of mutual fund or annuity.

Revised instructions which address many of these shortcomings will be issued to banks next year; a similar data collection effort will begin for bank holding companies. In the meantime, banks can help improve the quality of information several ways:

- When sales are made by an off-site entity, the sales should be reported if a contractual arrangement exists, and if the entity's activity is dependent on customer referrals.
- For sweep account activity, report the *average* amount of depositors' funds swept into money market funds each day during the quarter.

For more information about mutual fund reporting, contact Frank Bufe at (314) 444-8750 or Jim Mack at (314) 444-8599.



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Rieker Retires, Fed Makes Reassignments

After 38 years with the St. Louis Fed—26 years of those with the Banking Supervision and Regulation Division—Assistant Vice President Harold Rieker has retired.

Effective Sept. 19, Assistant Vice President Lynn Barry assumed responsibility for consumer affairs supervision. She continues to oversee bank and holding company regulatory reporting and data collection: call reports, the Y-9 (Bank Holding Company) series and HMDA. Lynn can be reached at (314) 444-8565.

Ed Hopkins, assistant vice president, has assumed responsibility for all remaining reports, including FR2900 (Report of Transaction Accounts, Other Deposits and Vault Cash). Ed's telephone number is (314) 444-8432.

Also effective Sept. 19, Tim Bosch, assistant vice president, assumed responsibility for EDP, trust and related specialty supervision. Tim retains his current responsibilities for safety and soundness supervision in the Eighth District's western region. Tim's phone number remains the same—(314) 444-8440.

Supervisory Bulletin To Be Released

Watch your mailbox later this month for your copy of *Supervisory Bulletin*, a new service for communicating policy statements and other supervisory information to state member banks and bank holding companies.

Oct. 23 through 29 is National Consumers Week. The 1994 theme, "Know Your Consumer Rights," is designed to increase consumer awareness and promote positive action in the marketplace. Your institution should receive more information soon.

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