FEDERAL RESERVE BANK OF PHILADELPHIA

# SRC INSIGHTS

**A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.**

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## IN THIS ISSUE



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### SVP Commentary on …

# Privacy Policies and Banking

*by Michael E. Collins*

Perhaps the single most valuable asset of financial institutions is the trust that their customers place in them. Consequently, if public trust falters, the value of a banking franchise may decline significantly. The elements comprising this trust are broad, and include customer's trust that their deposits will be safeguarded, that their safe deposit assets will be secure, and that their personal information will be held in the highest confidence.

Consumers are becoming increasingly concerned about their personal privacy. This was readily apparent in the outpouring of comments protesting the agencies' proposed "Know Your Customer" rules earlier this year. This increased concern about privacy has primarily been spurred by the recent growth in information technology and information-sharing technology. Banks have always collected personal information from their customers, information that is necessary for banks to properly identify their customers when opening deposit accounts, applying for loans, or conducting day-to-day transactions. However, information technology developments have enabled banks to retain, analyze, and transfer this information to a greater extent and at a faster speed than ever before. This capability, coupled with the inherent value that the information may have to marketers, has lead to the inevitable conflict between the value of customer information to a financial institution and the value of privacy to the customer. This dilemma was highlighted earlier this year when U.S. Bancorp was sued by the Minnesota attorney general for allegedly selling private information about its customers. The suit alleged violations of the Fair Credit Reporting Act, as well as violations of state laws related to consumer fraud and deceptive advertising.

As Federal Reserve Board Governor Gramlich stated in his testimony to Congress on July 21, 1999, the expansion of information-sharing technology has heightened some important public policy issues that must be quickly addressed by the Congress. Congress did in fact address this issue in Title V of the Gramm-Leach-Bliley Act of 1999, which was signed into law by President Clinton on November 12, 1999. The Act states that "[i]t is the policy of the

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# So, You Want to File an Application?

*by Cynthia L. Course, Senior Financial Specialist*

So, you recently read in the newspaper that President Clinton signed the Gramm-Leach-Bliley Act into law in November. This Act promises a new array of financial activities for banks and bank holding companies, and you want to stake your claim early in the process. Perhaps instead you have decided to expand your traditional bank operations into a new market area by opening a branch. Maybe you have a large shareholder who would like to acquire additional stock.

These activities, along with many others, would bring you into contact with the Applications Unit, headed by Bill Gaunt, Assistant Vice President, and Jim DePowell, Applications Manager. Under their direction, a team of four analysts and two support staff process applications and respond to questions related to bank holding company and state member bank activities in the Third Federal Reserve District.

The responsibilities of the Applications Unit have changed significantly since the Board of Governors approved a comprehensive revision of Regulation Y in 1997, making banks and bank holding companies more competitive with other financial service providers. With these revisions, the applications process was significantly modified, in most cases shortening the timeframes for processing applications and notices, and, in some cases, eliminating the need for a formal application. Since the processing and review process was shortened, it became more important than ever that financial institutions, or their legal representative, file a complete application package up front. This minimizes the need for additional correspondence that could potentially delay processing.

To assist you in filing applications with the Federal Reserve Bank of Philadelphia, our analysts have developed the following helpful hints. As you review these suggestions, please remember that each application is unique, and that no matter how much preplanning occurs, additional correspondence will probably be needed.

### Can I call the Federal Reserve with questions before filing an application?

As you are deciding whether you want to engage in a particular activity, or open a particular branch, questions will inevitably come up regarding the applications process. We certainly welcome and encourage questions before you file an application, since this will help you file a complete and accurate application or notice under the appropriate statutory authority. However, there are many, many nuances to the regulations and statutes governing the activities of financial institutions. Therefore, your questions should be as specific as possible, and you should avoid questions about hypothetical institutions or situations, as any guidance that we provide on a hypothetical basis may not be applicable to the actual transaction proposed by your institution.

### How many copies of an application must I file?

Applications are reviewed by a wide variety of regulatory stakeholders. Consequently, depending on the type of application or notice filed, we may send copies to our Legal and Research Departments, the Board of Governors, the primary federal regulator of the lead banking subsidiary of the bank holding company, the department of banking for the chartering state, or to the Department of Justice. If the application or notice requires action by the Board of Governors, we need multiple copies for the Board. If the application is related to Internet banking activities, an additional copy will be needed. Also, if the application is for an institution with a less than satisfactory CRA rating, additional copies will be needed.

As a rule of thumb, you can refer to the following table to determine the minimum number of copies that you should file. However, if your application has issues that may require Board action or if your institution has issues related to CRA, you should contact the Applications Unit staff to determine if additional copies should be provided.

### My application is confidential, isn't it?

Unless we are advised to the contrary, all information in an application or notice will be deemed public information. If you want any portion of the application to be confidential, you must specifically request confidential treatment, clearly identify the elements of the application that are confidential, clearly explain why the information should be afforded confidential treatment, and clearly separate the confidential information from the public information. We will review your request for confidential treatment, and will contact you if we have questions, need additional justification for confidential treatment, or do not concur with your request.

### Do I need to hire an attorney or consultant?

Institutions are not required to retain legal counsel during the applications process. However, as you are certainly aware, banking is a highly regulated industry. Similarly, filing a bank application requires a detailed knowledge of banking regulations and their underlying statutory authority. Qualified legal counsel, accountants, or consultants may be able to provide assistance in structuring the transaction to comply with regulatory, statutory, and taxation requirements, and may be able to lend knowledge and expertise that will expedite the transaction.

Applicants should remember, however, that attorneys in the Legal Department at the Reserve Bank review and comment on every application or notice (with the exception of branching applications and section 24A notices). Additionally, Board attorneys will almost certainly review an application that requires Board Action, or consultation with the Board. Having an attorney available who is familiar with the application and who can respond to Reserve Bank and Board attorneys may expedite the processing of the application.

| Type of Application/Notice | Number of Copies |
| --- | --- |
| Section 3 of the Bank Holding Company Act | 8 |
| Section 4 of the Bank Holding Company Act | 7 |
| Change in Bank Control Act of 1978 | 10 |
| Section 18c of the Federal Deposit Insurance Act | 16 |
| Membership (Section 9 of the Federal Reserve Act) | 8 |
| Branch formation | 3 |

### What does the Federal Reserve need to determine that we have published the required public notice?

You need to send to the Reserve Bank the original proof of publication from the newspaper, complete with the seal. We can start processing your application based on the receipt of a newspaper clipping, with the exception of branch applications, where we must have the original proof of publication to even accept the application for processing.

### When should we publish in the newspaper?

Generally, public notice of the following applications must be published in a newspaper of general circulation in the banking markets affected:

- Bank holding company formations – 3(a)(1) (except expedited Riegle notifications)
- Bank holding company expansions – 3(a)(3) or 3(a)(5)
- Insured depository acquisition under 4(c)(8)
- Change in Bank Control
- Branch opening

With the exception of branch applications, the public notice may be published up to fifteen calendar days before, but no later than seven calendar days after, the date that the application or notice is filed with the Reserve Bank. Since the public comment period runs for 30 calendar days, and the Federal Reserve cannot approve an application until at least three days have passed since the end of the public comment period, many institutions take advantage of the early publication option.

For branch applications, the public notice may be published up to seven calendar days before, but no later than the date that the application is filed with the Reserve Bank. The public comment period for branch applications runs for 15 days.

### What about publication in the *Federal Register*?

Public notice may also have to be published in the *Federal Register*. *Federal Register* publication is handled by the Board of Governors, upon receipt of an application or notice, or upon receipt of a request for early publication. Generally, *Federal Register* notice is required for the following applications:

- Bank holding company formations – 3(a)(1) (except expedited Riegle notifications)

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# Ready or Not, New PMI Rules Are Here

*by Elizabeth Rozsa, Compliance-CRA Writer/Editor*

The Homeowner's Protection Act went into effect on July 29, 1999.[1] This law, passed by Congress in July 1998, affects originators and servicers of single family residential loans by requiring them to inform borrowers about their rights regarding the termination of private mortgage insurance (PMI). Prior to the enactment of the Act, PMI was not required after a loan reached 80% loan-to-value (LTV), but many mortgage servicers were not terminating the insurance, resulting in many borrowers paying unnecessary premiums.

The Act requires that borrowers be given disclosures informing them about their rights regarding PMI cancellation and termination upon loan consummation, annually, and upon cancellation or termination of insurance. Briefly, the Act requires that the borrower's request for cancellation upon reaching 80% LTV be granted as long as the loan is in good standing, and that PMI be automatically terminated when the loan is scheduled to reach a LTV of 78%.

### Disclosures…At Closing

For loans closed after July 29, 1999, the lender is required to provide the borrower with an initial amortization schedule at closing, as well as notify the borrower in writing about their PMI cancellation and termination rights.

**Cancellation.** For *fixed rate* mortgages, the disclosure must state that the borrower may request cancellation of PMI when, according to the loan's amortization schedule, the LTV is scheduled to reach 80%, or, if the loan reaches 80% before the scheduled date, at the time that it actually reaches 80%. The closing disclosures must also state that exemptions to cancellation exist, and whether or not the loan falls into an exempt category.

For *adjustable rate* mortgages, the disclosure must state that the borrower may submit a written request to cancel PMI when the amortization schedule or pay-

[1] The Act, Pub. L. 105-216, can be found through the GPO's website at <www.access.gpo.gov/nara/publaw/105publ.html>. This website, which is not affiliated with or authorized by the Federal Reserve System, contains information that may be helpful to you. The Federal Reserve, however, has no control over the information contained therein and cannot guarantee its accuracy.

| Is this loan affected by the Act? | |
|---|---|
| Is it a single-family residential loan closed on or after July 29, 1999? | The loan may be covered by the Act. |
| Does it have borrower or lender paid PMI? | Yes, the loan is covered, but the provisions are different for lender paid PMI. |
| Is it conforming or nonconforming (jumbo)? | Yes, the loan is covered by the Act, but the provisions are different for nonconforming loans. |
| Is it "high-risk"? | "High-risk" loans are covered, but with special provisions. |
| Is the rate fixed or adjustable? | Both fixed rate and adjustable rate loans are covered, with slightly different provisions. |

ments show the balance to be at 80% LTV. The loan servicer must also notify the borrower when 80% LTV has been reached. As with fixed rate loans, the closing disclosures must also state that exemptions to cancellation exist, and whether or not the loan falls into an exempt category.

**Termination.** Closing disclosures must also include PMI termination provisions. The disclosures for both fixed and adjustable rate loans must state that PMI will be terminated when the loan is scheduled to reach 78% LTV if the borrower is current on payments at that time. If the borrower is not current, PMI will be terminated at the time the borrower becomes current. For fixed rate loans, the disclosure must also state the actual termination date, and, for adjustable rate loans, that the borrower will be notified at the time of automatic termination.

**High-risk loans.** In the case of a "high-risk" loan, the notice to the borrower at closing must state that PMI is not required beyond the midpoint of the amortization schedule as long as the loan payments are current. Fannie Mae and Freddie Mac will be determining the definition of "high-risk" for conforming loans. Individual lenders will define the criteria for "high-risk" nonconforming loans.

### Disclosures… Annually

Loan servicers are required to make annual PMI disclosures to borrowers. These disclosures must inform borrowers of their right to cancel PMI, and provide them with an address and telephone number at which the servicer can be contacted. If a loan currently carrying PMI was closed before July 29, 1999, servicers must disclose to borrowers that PMI may be cancelable, as well as provide the servicer's address and telephone number.

### Disclosures… At Termination, Cancellation, or Determination of Disqualification

If PMI is cancelled at the borrower's request or automatically terminated as provided in the Act, the servicer must notify the borrower that the PMI has been cancelled or terminated, and that the borrower will not be liable for any further premiums or fees, within 30 days. If a borrower does not qualify for cancellation or termination at the appropriate time, the servicer must provide the borrower written notice of the reasons for disqualification within 30 days, and, if an appraisal contributed to the decision, the results of the appraisal.

### Conditions for Cancellation

There are certain conditions that a borrower must meet in order to be eligible for PMI cancellation upon request at 80% LTV. These conditions include:

- the cancellation request is in writing;
- the borrower can provide evidence that the property value has not decreased to below the original value;
- the borrower can demonstrate that there are no subordinate liens on the property; and
- the borrower has a good payment history.

The lender must provide the borrower with the requirements for demonstrating property value "promptly" after the request for cancellation. The property's current value will be compared against the original value, which is defined as the lesser of the sale price or appraised value of the property at loan origination. For purposes of these provisions, a good payment history is defined as no past due payments of 30 days or more in the past 12 months and no past due payments of 60 days or more in the past 24 months. Written notice of cancellation or disqualification of the borrower for cancellation must be made within 30 days of the borrower's request.

### Conditions for Automatic Termination

Servicers are required to terminate PMI on the date the loan is scheduled to reach 78% LTV, without regard to the existence of subordinated liens or the value of the property. This date is determined by the initial amortization schedule. The borrower must be current on the loan at this time; however, if not current, PMI will be terminated at such time as the loan becomes current. If PMI is still carried on the loan at the midpoint of the amortization period, it must be terminated at that time, providing the loan is paid up to date.

If a *nonconforming* loan is defined by the lender as "high-risk," PMI will terminate when the LTV is scheduled to reach 77%, regardless of the actual balance, as long as payments are current.

If a *conforming* loan is determined by Fannie Mae or Freddie Mac to be "high-risk," then PMI must be terminated no later than the first day of the month following the month during which the midpoint of the amortization schedule is reached, as long as payments are current.

### Exceptions to the Law

The new law does not pertain to loans insured by the Federal Housing Administration, or loans on which the lender pays PMI. However, for lender paid PMI (LPPMI), certain written disclosures are required within 30 days of the date of commitment. These disclosures must inform the borrower that a loan with LPPMI usually results in higher interest rates than with borrower paid PMI, and may not be cancelled by the borrower nor will be terminated by the lender unless the loan is terminated. The notice must also disclose the advantages and disadvantages of both LPPMI and PMI, including a 10 year comparison of the costs and benefits of both, and a statement that LPPMI may be tax deductible.

Within 30 days after the termination date that would apply if the borrower had PMI, the servicer must provide written notice to the borrower stating that the borrower may want to change their financing in such a way that would eliminate the necessity of LPPMI.

> PMI payments should be included in the finance charge until the date on which PMI must automatically terminate.

### Form of Disclosure

There are no specific forms required for use under the Act; standardized forms are permitted, but no one form is mandated. In addition, the Act allows the annual disclosures to be provided with certain other disclosures made annually to borrowers.

### Enforcement and Penalties for Noncompliance

The Homeowner's Protection Act will not be enforced by any single governmental agency. The Act does give enforcement authority to the federal banking agencies with regulatory authority over lending institutions. This authority allows them to correct violations by requiring the banks to adjust loan accounts that had been subject to improper disclosures or improper application of the Act. Enforcement actions may be brought for a maximum of two years after the discovery of the violation, and federally regulated entities are liable for up to $2,000 statutory damages in an individual case.

### Unresolved Issues

Many questions have arisen regarding the Act, due in part to the lack of specific authority for the federal banking regulatory authorities to write rules and regulations to implement the Act. However, the Board of Governors of the Federal Reserve System did address one of these issues in the revision to the official staff commentary of Regulation Z. The March 31, 1999 commentary stated that the borrower's PMI payments should be included in the finance charge until the date on which the servicer must automatically terminate coverage under the law. The question of the impact of rounding on the date at which insurance must be terminated (must it be terminated when the LTV is 78.4%, for example, or only at exactly 78%) will be addressed in the Commentary for Regulation Z in the coming months. It is also possible that the precise method to be used in calculating the appropriate dates for cancellation and termination for adjustable rate mortgages will be addressed by Congress.

Other issues which need to be addressed include: whether "current" means the date of the payment or when funds from a payment are collected; how Fannie Mae and Freddie Mac will define "high-risk" conforming loans; how lenders should define "high-risk" nonconforming loans; and how borrowers will certify the existence or absence of subordinate liens.

The Federal Financial Institutions Examination Council is developing interagency examination procedures to examine banks' compliance with the Act, and many of the open questions may be answered by these procedures. In the interim, however, the regulatory agencies, including the Federal Reserve Board, have made it clear that banks are expected to develop forms and procedures to ensure their compliance with the Act.

In light of these expectations, it is very important that bankers are aware of the new law and its affect on their capacity as loan originators and servicers, and implement procedures and forms to ensure compliance with the law as it stands. If questions or concerns arise regarding compliance in general or with respect to a specific situation, banks should contact their primary regulator for assistance. Look for more details soon. ■

# Hedging Interest Rate Risk at Community Banks

*by Perry D. Mehta, Capital Markets Specialist*

Interest rate risk, or IRR, is a measure of the potential deterioration in the financial condition or performance of an institution, as a result of changes in interest rates. Since IRR typically is a significant component of market risk, regulators carefully assess it in their determination of the S (Sensitivity to Market Risk) component of the supervisory CAMELS ratings[1]. Prudential Asset-Liability Management requires the institution to identify, measure, monitor, and control IRR, using techniques appropriate for the nature and extent of the risk. In articles in the first and third quarter 1999 editions of *SRC Insights*, David Fomunyam and Perry Mehta discussed the models available to community banks and Federal Reserve regulators to identify, measure, and monitor IRR. This article suggests an approach to mitigating IRR at a community bank, once it is identified and measured. Specifically, it outlines some financial derivative products that can serve to hedge against IRR.

### The "D" Word

Derivatives are financial instruments whose value is derived from another asset, referred to as the "underlying asset," or "underlying." Derivatives can have commodities, foreign currencies, interest-rate instruments, equities (stocks and stock indices), or other derivatives as underlyings. They can be stand-alone instruments, designed and traded expressly for the purpose of financial management, or they can be embedded in financial instruments. Stand-alone derivatives may be standardized products traded on an exchange, or individualized transactions negotiated between buyer and seller, referred to as "over-the-counter" or OTC products.

Derivatives are often complex financial instruments, which, if inappropriately used, can add significant amounts of risk to an institution's profile. Hence, many bank managers have traditionally resisted their use in financial management. Some institutions have explicitly ruled out their use as a matter of policy. The recent, high profile, derivatives-related losses associated with Orange County, CA, Barings PLC, and Long Term Capital Management have heightened the aversion to derivative instruments.[2] However, it is important to note that, in practice, their use of some derivatives positions involved speculation or arbitrage, and not hedging. Additionally, many of those positions were in unduly complex instruments.

> A prudential derivatives strategy can offer considerable risk management benefits to an institution.

The reaction against derivatives is understandable; however, what may be lost in the backlash is that a prudential derivatives strategy can offer considerable risk management benefits to an institution. Relatively simple products exist that can serve to reduce risk. Furthermore, notwithstanding the prohibition of derivative instruments at some institutions, even the least complex banks have options embedded in their assets and liabilities,[3] exposing the institution to risks which they can hedge quite effectively with relatively simple derivative products. Such use

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[1] See guidance in the Federal Reserve's SR Letters 96-38: *Uniform Financial Institutions Rating System (Joint Statement on Revised CAMELS)* and 97-4: *Interagency Guidance on Common Questions About the Application of the Revised CAMELS Rating System* at <www.federalreserve.gov/boarddocs/SRLETTERS/>.

[2] In 1994, Orange County, California declared bankruptcy after losing $1.7 billion in complex securities on a highly leveraged balance sheet. Barings, a 233-year old British bank, declared bankruptcy in 1995 after $1.4 billion in losses by a single trader were uncovered. In 1998, LTCM incurred massive derivatives losses on an extremely leveraged balance sheet, and was acquired by a consortium of financial institutions for $3.6 billion.

[3] For example, borrowers can prepay mortgage loans at any time. Commercial loans also often carry these prepayment options. Demand depositors can withdraw their monies at will. In all these cases, the bank has effectively sold an option to the lender or depositor, and is exposed to the risk of prepayment or withdrawal.

refutes the myth that only large, complex financial institutions can gainfully employ derivatives.

In addition, strategic and competitive considerations often restrict even a small bank's flexibility in making asset and funding changes to manage IRR, leaving specialized financial products, such as derivatives, as the only alternative. Fortunately, technological advances have made available an array of computer hardware and software products to satisfy the analytical needs of an effective derivatives program. Private vendors of derivative analytics have proliferated. Business schools now routinely are teaching derivative products as part of their finance curriculum, so that newer generations of bank managers will be more familiar with derivatives.

### The "Pound of Flesh"

For those community banks contemplating the use of financial derivatives for the management of IRR, the foregoing does not imply that implementing a derivatives strategy is an effortless exercise. The bank's managers must understand thoroughly the behavior of these instruments, and develop a solid control structure to manage them. Additionally, the bank will be required to hold capital against its derivatives positions.[4] These demands represent a nontrivial investment in resources. However, a growing number of institutions is finding that a prudentially managed derivatives strategy can have significant risk-management benefits.

### Show Me the Money!

The following examples briefly introduce, using simplified scenarios, how non-complex institutions can employ derivatives to mitigate risk. We will apply three product types—futures, caps, and swaps—to two institutions, Alpha Bank and Trust Co. and Beta Community Bank. The products are outlined in the boxes on the following page.

Alpha has, among other assets, a portfolio of five-year loans paying a fixed rate of 8%. It funds these with six-month CDs, with rates equal to six-month LIBOR.[5] This portion of the institution's balance sheet is exposed to rising rates, which would lead to compression in earnings and a decline in economic value.

Beta has, among other assets, a portfolio of adjustable-rate mortgages (ARMs), repriced annually, with a coupon equal to one-year CMT + 3%. The ARMs have a lifetime cap of 9% (an example of an embedded derivative), and are funded by one-year CDs with rates tied to one-year CMT. Beta will see an earnings squeeze if rates rise sufficiently to "cap out" the ARMs.

**Futures.** Alpha could purchase a T-bill futures contract in the appropriate $1 million multiples. If interest rates were to rise as feared, the contract would appreciate, helping the bank compensate for balance sheet losses. Similarly, an institution exposed to falling rates could sell T-bill futures to hedge IRR.

Alpha is hedging its *six-month* CD rate with *three-month* T-bill futures. Since the two maturities are less than perfectly correlated, Alpha's hedge is subject to **term mismatch risk**. Additionally, Alpha ties its CD rate to the LIBOR, while its futures hedge is based on the T-bill rate. When an institution attempts to hedge exposure to one variable with an instrument whose value depends on another, it is exposed to **basis risk**. Futures contracts are traded on a number of other underlying rates, including the thirty-day Fed Funds rate, the one-month LIBOR, and the three-month Eurodollar rate.[6] Futures contracts are also available on longer-term fixed-income securities, including two-, five- and ten-year treasury notes, and treasury bonds with maturities in excess of fifteen years.[7]

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[4] See SR Letter 95-51: *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies* at <www.federalreserve.gov/boarddocs/SRLETTERS/1995/sr9551.htm> for elements of the control structure, and the Federal Reserve's *Trading and Capital Markets Activities Manual* §2110.1 <www.federalreserve.gov/boarddocs/supmanual/default.htm#trading> for capital requirements.

[5] LIBOR, or London Interbank Offer Rate for a specified maturity, is an average of the interest rates that large, international banks in London charge each other for dollar deposits of that maturity. It is a publicly-reported and widely-available rate, for maturities of up to one year.

[6] The 3-month Eurodollar rate is the same as the 3-month LIBOR.

[7] See the web pages of the Chicago Mercantile Exchange <www.cme.com/market/interest/howto/> and the Chicago Board of Trade <www.cbot.com/ourproducts/financial/index.html> for examples of traded interest-rate futures and options. These websites, which are not affiliated with or authorized by the Federal Reserve System, contain information that may be helpful to you. The Federal Reserve, however, has no control over the information contained therein and cannot guarantee its accuracy.

# FUTURES

Under the terms of a futures contract, the seller delivers to the buyer the underlying asset for a contracted price at a specified time in the future. Both the buyer and the seller can thereby lock in the price of the contract, irrespective of the later behavior of the underlying. A Treasury bill futures contract, for example, delivers $1 million in face value of thirteen-week T-bills to the buyer at maturity. In practice, most futures contracts are offset with buyers and sellers engaging in the opposite transaction just prior to maturity, a practice also referred to as "closing out" the transaction. Since futures contracts are traded on major exchanges, they are available only in standardized contract sizes and maturities. The exchange serves as counterparty to each buyer and seller, so that the contracts are virtually free of counterparty credit risk. The bank can take a futures position by investing an initial margin, which is a fraction of the contract size.

# OPTIONS

A financial option confers upon its owner the right, but not the obligation, to buy or sell an asset at a specified price and during a specified period in the future. The right to buy is referred to as a call option or call, and the right to sell, a put option or put. The contracted price is referred to as the strike price or exercise price. The buyer of a put or call pays the seller (also known as the writer) of the option an up-front price, called the option premium. If the option expires unexercised, the buyer would incur his maximum loss, the amount of the premium.

If, however, the price of the underlying moves favorably, the buyer could exercise the option to recoup a part of, or even a multiple of, the premium, to curb losses, or possibly make a profit. The option buyer's downside risk is thus limited to the premium paid, but the upside profit potential is unlimited. Thus options have asymmetrical upside and downside risks. The option seller or writer, on the other hand, faces potentially unlimited losses. Hence, short options positions, unless they offset other long positions, are viewed as extremely speculative and risky. As the key purpose of hedging is to mitigate risk, a bank is exceedingly unlikely to find options hedges that entail short positions.

**Traded options:** Exchange-traded options are available on a variety of interest rate futures, including two-, five-, and ten-year Treasury note futures, and Treasury bond futures. For example, the buyer of a T-bond futures call option would gain from exercising the option when the futures price exceeds the strike price. Active exchange-traded, fixed-income options are typically on futures contracts, rather than on underlying cash instruments to provide the product standardization necessary to maintain liquid markets.

**OTC options:** A popular over-the-counter option is the cap. On periodic reset dates (usually a quarter apart), the prevailing interest rate (typically an index like three-month LIBOR, or a short-term CMT rate) is compared with the strike rate of the cap. If the index rate exceeds the strike rate, the cap seller pays the buyer a cash amount proportional to the difference. If the index rate is no greater than the strike rate, no cash is exchanged.

# SWAPS

A (plain-) vanilla interest rate swap exchanges floating-rate payments on a specified notional principal for fixed-rate payments over a predetermined period, known as the swap's "tenor." In practice, the payments are netted out, and only one cash flow occurs in each period. Also, there is no exchange of principal. The floating rate is typically a widely reported index, such as a LIBOR or a CMT rate. The swaps dealer determines the fixed rate referred to as the swap's price, from the yield curve at the time, and the creditworthiness of its client. Most swaps are priced so that the client does not have to pay an up-front cash amount.

It is important to note that while a futures hedge will offset losses from an unfavorable rate change (a rate increase in the example above), it will also offset gains from a favorable rate move. In other words, futures hedges have symmetrical upside and downside risks. While it is hard to sacrifice a portion of gains for hedging purposes, it may help to remember that futures hedges serve to desensitize the bank's earnings from the volatility in interest rates, thereby reducing IRR overall, and making returns look more attractive on a risk-adjusted basis.

**Options.** Beta Community Bank would be relatively free of IRR if its ARMs were not capped. It can hedge the short cap embedded in the loans with a long, standalone cap. If rates were to rise to a level that caps the ARMs out, and provides no further increase in coupon, the standalone structure could provide compensating cash flows.

**Swaps.** Alpha Bank and Trust could also hedge its exposure using a vanilla interest-rate swap. The swaps dealer would offer Alpha a fixed rate of 6.5% against a variable leg based on the six-month LIBOR. Coupled with the 8% loan yield and CDs priced at six-month LIBOR, the swap effectively locks in a margin of 1.5% (barring the credit risk of Alpha's loan obligors), irrespective of the behavior of interest rates.[8] This structure is a very effective hedge, executable without an up-front cash cost.

**Other Derivatives.** The products outlined herein represent a small subset of available interest rate derivatives, a universe that is growing continually with innovation in the marketplace. Additional products available for bank risk management include forward rate agreements, amortizing swaps, basis swaps, and swaptions. These products will be discussed in more detail on the Capital Markets page of SRC's website, <www.phil.frb.org>.

### Some Final Thoughts

To summarize, derivative instruments are risky financial products. However, they can actually mitigate risk, even at a non-complex bank, if prudently managed. Understanding their performance, implementing a control structure to manage them, and allocating regulatory capital to them, all require a nontrivial investment of resources. On the other hand, competitive and strategic considerations can limit a bank's balance sheet flexibility, making derivatives a viable risk management alternative. The growth in computer hardware and software, as well as in the finance skills of professionals make a derivatives strategy more viable than in the past. ■

[8] In practice, Alpha, a community bank, will have to post collateral against the credit risk faced by the dealer, typically a major money-center bank or large securities firm. This will reduce the margin.

## SVP Commentary On…

# Privacy Policies and Banking

*continued from page 1*

Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information."

Some of the major provisions of the Act are:

- In general, a financial institution may not disclose any nonpublic personal financial information to a nonaffiliate unless they disclose that fact to the consumer and the consumer is given an opportunity to direct that the information not be disclosed.
- Certain exceptions to this general prohibition are created, including, among others, the disclosure of nonpublic personal information in connection with servicing or processing a financial product or service requested or authorized by the consumer, or maintaining or servicing the consumer's account.

- Financial institutions must disclose their policies and practices with respect to disclosing nonpublic personal information to both affiliates and nonaffiliated third parties when establishing a customer relationship with a consumer and annually thereafter.

- The Federal banking agencies must consult and coordinate with each other (and with the NCUA, the Treasury, the SEC, and the FTC) to develop and issue regulations to carry out the provisions in the Act within six months of the enactment of the Act.

The Act also allows States to enact privacy provisions that provide greater consumer protection than that provided by the Act. However, the provisions in the Act will supercede any State statutes, regulations, orders, or interpretations that are "inconsistent," e.g., provide less consumer protection, with the Act.

While Congress has grappled with the issue, the judicial system has also searched for the appropriate balance between privacy interests and economic value. Although the Supreme Court has clearly identified documents relating to a customer's account as "the business records of the banks," courts have found that there is an unspoken duty on the part of the banks to maintain the confidentiality of this information.

Until the Gramm-Leach-Bliley Act of 1999, there were no legal requirements that financial institutions develop or maintain privacy policies. Unwilling to await congressional action, some bank regulators and banking associations issued guidance to their constituents on the importance of privacy policies. On August 17, 1998, the FDIC issued Financial Institution Letter 86-98, *Electronic Commerce and Consumer Privacy.* This was followed by the OTS November 3, 1998 *Policy Statement on Privacy and Accuracy of Personal Customer Information.* On May 4, 1999, the OCC issued Advisory Letter 99-6, *Guidance to National Banks on Web Site Privacy Statements.* The Bankers Roundtable, the Independent Community Bankers of America (ICBA), the American Bankers Association, and the Consumer Bankers Association worked together to provide the industry with a uniform set of privacy principles.

The Board of Governors of the Federal Reserve System has continued to study the matter and will issue guidance that is consistent with the requirements of the Gramm-Leach-Bliley Act. The Board does, however, have its own privacy policy posted on its web site, <www.federalreserve.gov>, as does the Federal Reserve Bank of Philadelphia, at <www.phil.frb.org>.

The privacy policy provisions in the Act do not apply just to institutions on the Internet; they apply to all financial institutions. However, the privacy policy disclosures of institutions offering on-line banking or advertising on the Internet are relatively easy to study. Earlier this year, the Board of Governors, the FDIC, the OCC, and the OTS examined 314 randomly selected Internet sites, plus the Internet sites of the 50 largest banks and thrifts with Internet sites. Based on the results of the study, it is apparent that many financial institutions developed privacy policies even before they were legislatively mandated. Overall, 48 percent of the 364 web sites surveyed posted a privacy disclosure, whether a full privacy policy or an information disclosure statement. Of the web sites that collected personal information, 62 percent posted a privacy policy disclosure. The full report of the results of this survey is available on the Board of Governors web site at <www.federalreserve.gov/boarddocs/press/General/1999/19991109>.

Additional legislation related to privacy may be forthcoming. At least three anti-laundering bills have recently been introduced in the House or Senate. While many of the provisions in these bills are related to foreign money laundering, they may result in banks collecting additional information from all or most customers to ensure compliance with the Bank Secrecy Act.

All banks, with or without public Internet sites and with or without foreign customers, would be well served by staying attuned to their customers' concerns about the privacy of personal information, as well as legislative and regulatory requirements at both the state and federal level. Ignoring this issue will place your most valuable asset at risk – the trust placed in you by your customers. ■

# So, You Want to File an Application?

*continued from page 3*

- Bank holding company expansions – 3(a)(3) or 3(a)(5)
- Insured depository acquisition under 4(c)(8)
- Nonbanking activities under 4(c)(8) that are not listed or approved
- Change in Bank Control

During the 15-calendar day pre-filing period, you can ask the Reserve Bank for advance publication in the *Federal Register.* This request must be in writing, and must contain all of the necessary identifying information. It takes approximately one week from the date we receive your request or your application until the notice is actually published in the *Federal Register*. Since the *Federal Register* comment period can run for up to 30 days, the *Federal Register* comment period may still end after the newspaper public comment period.

### What other hints do you have on filing an application?

**Cite Regulatory Section.** If a picture is worth a thousand words, a regulatory cite is certainly worth at least a hundred words. There are numerous sections and subsections of regulations and statutes under which you could be filing an application. The application should clearly state which section of which regulation the application is being filed under. Without this information, the acceptance and processing of your application could be delayed.

**Signatures Required.** Although we request multiple copies of most applications and notices, they do not all need to be "original" copies. However, the application must be signed, and at least one copy must contain an original signature.

**Visit Us on the Web.** We have just begun to populate the Applications section of the Reserve Bank's web site at <www.phil.frb.org>. You can find us by clicking on the "Supervision, Regulation & Credit" button on the button bar, and clicking on the "Applications" text link on SRC's homepage. On the Applications page, we currently have links to:

- The Board's H.2 and H.2A release, summaries of applications received and weekly actions taken by the Board, its staff, and the Federal Reserve Banks
- Application forms and instructions, as indexed on the Board's web site
- A discussion of how to become a state member bank.

Through our "Contacts" link on "Who We Are," you can also contact Bill Gaunt or Jim DePowell directly by telephone or e-mail. ■

## NEXT ISSUE

*Consumer Compliance Update*

*Bank Lending Standards*

*Contingency Planning*

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