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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SVP Commentary on…

Financial Modernization

by Michael E. Collins

The forces of globalization, advances in technology and telecommunications, and deregulation have now been joined by Congressional action to change significantly the competitive landscape of financial institutions and markets. On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act (the "Act"), updating U.S. financial services laws and removing the remaining walls that fragmented the financial marketplace. This legislation, which represents the most significant change in the U.S. financial services industry in 66 years, repealed the core provisions of the Glass-Steagall Act and the Bank Holding Company Act that restricted bank holding companies from affiliating with securities firms and insurance companies.

It can be debated whether this legislation was revolutionary or evolutionary. The Federal Reserve System has long sought repeal of the Glass-Steagall Act, and market forces, court rulings, and regulatory actions had already watered down many of the barriers between banking, securities, and insurance activities. However, with the passage of the Act, a single organization may now offer an array of financial services, including banking, securities, and insurance products. The legislation also expanded the range of permitted nonbanking activities for certain entities beyond the traditional scope of activities that are "financial in nature" to include those that are "incidental to" or "complementary to" financial activities. What the legislation does not do is allow for the mixing of banking and commerce, and it limits the chartering and transfer of unitary thrift holding companies, the current tool used by business corporations to enter the banking industry.

Companies that wish to offer banking services in conjunction with securities and/or insurance activities must do so through financial holding companies or, in some instances, in a financial subsidiary of the bank. The Act and the federal banking regulators have established extensive qualification and performance criteria for both of these new corporate vehicles. These criteria are de-

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Managing Credit Risk with Synthetic Collateralized Loan Obligations

by Randolph D. Brown, Senior Examiner

Synthetic collateralized loan obligations ("synthetic CLOs") are a relatively recent addition to the asset management toolbox. Several large banking organizations have created synthetic CLOs over the last year. While the current list of institutions using synthetic securitizations is small, it is likely to grow significantly as synthetic CLOs gain broader acceptance. Therefore, the purpose of this article is to create a broader understanding of the purpose and use of synthetic CLOs by reviewing the evolution of synthetic CLOs and discussing supervisory guidance on the risk-based capital requirements for these transactions. However, before one can hope to understand the structure, risks, and benefits inherent in synthetic CLOs, it is necessary to have an understanding of traditional CLOs.

> By creating a synthetic CLO, a bank avoids sensitive client relationship issues.

Collateralized Loan Obligations

Collateralized loan obligations are securitizations of large loans and commitments to commercial and industrial borrowers. In a traditional CLO transaction, the sponsoring bank[1] transfers a variety of credit-related products—commercial loans and commitments, revolving credit facilities, letters of credit, or bankers' acceptances—to a trust or bankruptcy-remote special purpose vehicle (SPV). In turn, the SPV packages the interests in the assets into securities and sells them to investors. Bank-sponsored CLOs transfer assets off the balance sheet, freeing capital previously held against the assets for future loan originations.

Commercial banks began using CLOs in 1997, and large banking organizations have been using CLOs with increasing regularity ever since. The significant increase in volume has been driven by the array of benefits inherent in CLOs, including:

- efficient capital allocation;
- reduced leverage;
- diversification of financing sources;
- cost-effective funding;
- credit risk exposure management; and
- liquidity.

The success and acceptance of CLOs spawned the development of new, innovative structures. Banks are now able to synthetically replicate CLOs by using securitization technology and credit derivatives. A synthetic CLO allows the loans comprising the reference loan portfolio to remain on the institution's balance sheet, while the associated credit risk is transferred to the SPV through credit derivatives such as credit-linked notes or credit default swaps.[2]

Benefits and Risks of Synthetic Securitizations

One of the benefits of traditional CLOs is that assets are removed from the balance sheet, freeing capital for future growth. Why then would a bank synthetically replicate a CLO if the underlying assets will remain on its books? In contrast to traditional CLOs, synthetic CLOs are privately negotiated confidential transactions that use credit derivatives to transfer economic risk without transferring legal ownership of the underlying assets. By creating a synthetic CLO, a sponsoring bank avoids sensitive client relationship issues that arise when a loan is sold. Synthetic CLOs also overcome the legal prohibitions in some jurisdictions against transferring assets into an SPV. Finally, synthetic CLOs allow a bank to minimize credit exposure from pools of assets that may not lend themselves to

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[1] A variety of institutions holding large commercial and industrial loans may elect to issue CLOs or create synthetic CLOs. For purposes of this article, these institutions will be collectively referred to as "banks."

[2] For additional information on credit derivatives, refer to Joanna Frodin's article, "Credit Derivatives: A New Toy or a New Tool," in the Fourth Quarter 1996 edition of *SRC Insights*.

securitization, including unfunded off-balance sheet obligations and loans that are not intrinsically transferable.

Synthetic CLOs often have credit risk reduction capabilities embedded in their structure. For example, a sponsoring bank may replace matured or partially amortized loans and commitments in the underlying loan pool with other loans. A loan substitution based on any other criteria, such as poor performance, is generally not permissible. However, a reduction in loans and commitments may trigger the prepayment of notes issued by the SPV. Despite the fact that synthetic CLOs use credit derivatives to manage and transfer credit risk, banks still face the risk of borrower default in the underlying loan collateral. Consequently, banks must continue to engage in ongoing, independent credit scrutiny of the loan portfolio.

The transfer of assets in a traditional CLO generally results in improvements to risk-based capital levels, as investment-grade commercial loans are removed from the balance sheet and the 100% risk-weighting category. Frequently, the market's capital requirements for such loans, implicitly included in the pricing of the CLO, are more favorable than regulatory capital requirements. The regulatory capital relief available to banks engaging in synthetic CLOs has been somewhat unclear, since assets remain on the books of the sponsoring banks. Recently issued regulatory guidance provides some clarification of the issue. The following example of a synthetic CLO transaction illustrates the structure of the transaction and the potential capital benefits, as outlined in the regulatory guidance.

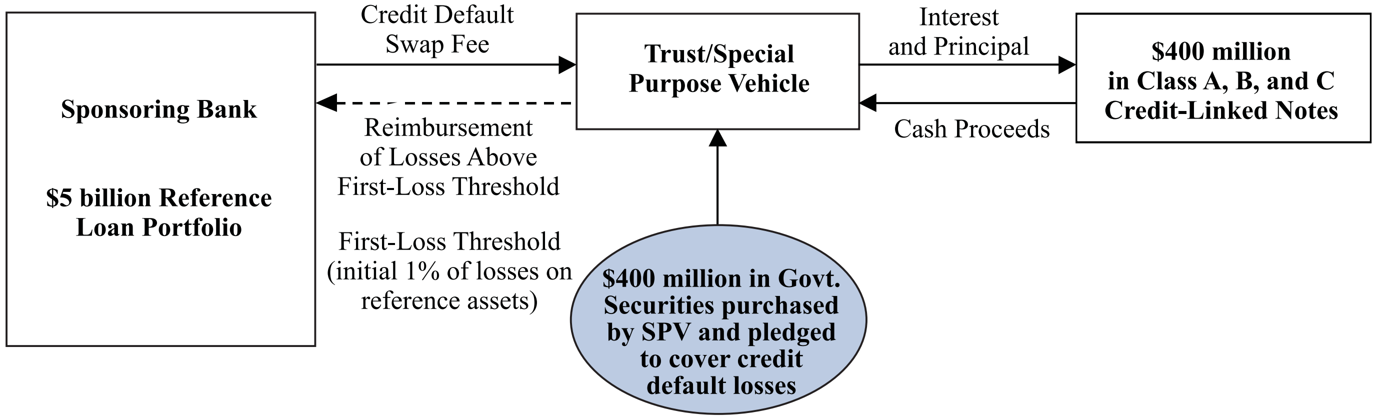
Mechanics of Synthetic Securitizations

The transaction depicted below begins with a reference loan portfolio of $5 billion in fully and partially funded loans. To minimize its credit risk, the sponsoring bank purchases credit default protection from a SPV, and pays the SPV an annual fee in exchange for the protection. In this example, a credit default swap transfers the credit risk on the reference portfolio to the SPV. Since this is a synthetic CLO, the reference loans are not transferred to the SPV, even if a loan loss has occurred. According to the terms of the swap agreement, the SPV will reimburse the bank for loan losses above a first-loss threshold caused by a "credit default event." A credit default event could include certain bankruptcy events, or payment default by the loan obligor(s).

The default swaps on each of the obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers. When a loan in the reference portfolio has a credit default event, the then-current market price of the loan is used to determine the amount of the loss. In this example, if cumulative losses exceed $50 million (1% of the covered loan amount), the SPV will reimburse the sponsoring bank for the losses above $50 million.

In order to support the guarantee in the credit default swap, the SPV sells credit linked notes (CLNs) to investors, using the cash proceeds to purchase government securities (e.g., U.S. Treasury notes or bonds). The SPV then pledges the government securities to the sponsoring bank to cover default losses. The amount of CLNs is set at a level sufficient to cover some multiple of ex-

Synthetic CLO Securitization
Retention of a First-Loss Position



pected losses, but well below the notional amount of the reference portfolio being protected. In the example, the SPV issues CLNs totaling $400 million, or 8% of the reference portfolio, in a senior/subordinated structure. Thus, the structure of this synthetic securitization provides for multiple loss levels, which affects the regulatory risk-based capital requirement for the transaction.

Capital Treatment for Retention of First-Loss Position

Through the use of credit default swaps, the sponsor bank transferred all of the reference portfolio's credit risk in excess of the first-loss position to the SPV. Consequently, since the sponsoring bank retains a first-loss position equaling one percent of the reference portfolio, the SPV would only reimburse the bank for cumulative losses in excess of $50 million. Investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior credit classes of CLNs. Since the CLNs are issued into the capital markets, government securities are purchased to cover some multiple of expected losses on the underlying exposures.

On November 17, 1999, the Federal Reserve Board issued SR 99-32 (SUP), *Capital Treatment for Synthetic Collateralized Loan Obligations*. SR 99-32 provides guidance on the capital requirements for synthetic CLOs, and sets forth two approaches that a bank may use to determine how the overall transaction should be treated for risk-based capital purposes.[3]

The first approach is similar to the low-level recourse rules governing traditional CLO securitizations. Using this approach, the sponsor bank's capital charge equals the maximum amount of possible loss. If this rule were applied to the above example, the sponsor bank would be required to hold dollar-for-dollar capital against its retained one percent first-loss position, or $50 million. There would be no capital charge against the second and senior credit risk positions. Alternatively, if the underlying reference portfolio were not treated as being sold to an SPV, then the sponsor bank would have to maintain $320 million in capital against the assets, or 8% of $5 billion.

The second approach requires two steps, applying capital to both the first-loss position and the uncollateralized reference portfolio. First, the one-percent first loss position retained by the sponsor bank is treated as a guarantee (i.e., a direct credit substitute). Assuming that the obligors of the reference portfolio are

[3] A sponsor bank will not realize any reduction in its leverage ratio since the reference loans remain on the balance sheet.

Minimum Requirements to Receive Preferential Capital Treatment on Retained Senior Credit Loss Positions

- Probability of loss on the retained senior position is extremely low due to:
  - High credit quality of the reference portfolio *and/or*
  - Amount of prior credit protection
- Market discipline
  - Sale of CLNs into the market *and*
  - Most senior CLN rated AAA by national recognized credit rating agency
- Stress testing
  - Bank performs rigorous and robust stress testing *and*
  - Bank demonstrates that credit enhancements are sufficient to protect it from losses under various scenarios
- Bank meets other requirements as deemed necessary by the Federal Reserve or the OCC ("the Agencies")
- Sufficiency of bank's efforts in meeting criteria determined on a case-by-case basis by the Agencies

in the 100% risk-based capital category, the sponsor bank is assessed an initial 8% capital charge against the $50 million first loss position, or $4 million. However, since investors in the SPV's credit linked notes assume the second loss position, the sponsor bank is entitled to a deductible (i.e., a zero percent capital charge) for that portion of the reference portfolio collateralized by government securities. Finally, in this example, the sponsoring bank retains the senior credit loss position. This position must be included in the bank's risk-weighted assets according to the characteristics of the portfolio and the obligor, unless the bank meets certain conditions. If the bank has virtually eliminated its credit risk exposure through the issuance of CLNs and meets other stringent requirements, the bank may be allowed to assign the retained senior credit loss position to the 20% risk-based capital category. Highlighted in the box on page 4 are examples of minimum stringent conditions that a bank must meet to receive preferential capital treatment. SR 99-32 provides additional information on these conditions.

Assuming that the minimum conditions are met, in this example, the sponsor bank would be required to hold additional capital to cover 20% of $4.55 billion ($5 billion reference portfolio, less the $400 million deductible and $50 million first-loss position), or $910 million in risk-weighted assets.[4] The sponsor bank would need to hold $72.8 million in capital (8% of $910 million) against the retained senior credit loss position. Combined with the capital held against the first loss position, the sponsor bank would hold $76.8 million in capital against the entire reference portfolio.

Under the guidance in SR 99-32, a sponsoring bank would be required to hold capital against the retained first-loss position equal to the higher of the capital requirements calculated under the two approaches. Additionally, the sponsoring bank must continue to monitor not only the credit risk associated with its first-loss position, but also the credit risk profile of its counterparties.

> A bank must ensure that it maintains proper credit underwriting standards, hedging strategies, performance monitoring, and liquidity management.

Risk Management Practices

As a matter of normal operations, a bank must ensure that it maintains proper credit underwriting standards, hedging strategies, performance monitoring, and liquidity management. This becomes even more important if the bank is involved in synthetic securitization activity. The Federal Reserve Board's SR 99-37 (SUP), *Risk Management and Valuation of Retained Interests Arising from Securitization Activities,* provides additional guidance in this area. SR 99-37 indicates that a sponsoring banking organization should (1) implement risk management systems and controls that are adequate in relation to the nature and volume of risk, and (2) write off asset values that cannot be supported.

Supervisory Concerns

Fitch ICBA, a securities rating company, believes that banks will take whatever measures are available to keep a securitization from being downgraded and/or defaulting in order to protect their reputation in the marketplace. Because of this implicit, if not explicit, support for securitizations, regulators are concerned that even assigned capital levels by banks may be insufficient, as banks may be pressured to support their SPVs in times of economic crises.

Consequently, examiners will evaluate whether a bank involved in synthetic securitization activity is capable of accurately assessing the credit risk that it retains in its portfolio, and whether the bank is adequately capitalized after considering retained residual risks. In making this

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[4] If the reference portfolio contains undrawn long-term commitments, which have a risk-based capital requirement one-half of the requirement of loans, the capital requirement could be considerably less than illustrated.

Compliance Implications of Electronic Delivery Systems: Guidance is Coming

by Eddie L. Valentine, Supervising Examiner

On February 13, 2000, the Federal Reserve System released draft guidance for examiner use in reviewing a bank's electronic delivery systems. In addition to the written examination guidance, the System developed a training web site to aid examiners in assessing a bank's website for compliance with consumer protection laws and regulations. Federal Reserve examiners are now using the new procedures and the training web site. The draft guidance and the training web site, which are for internal Federal Reserve System use only, will be revised and issued in final form later this year. The final procedures and the web site will eventually be available to the public.

Written Examination Guidance

The written examination guidance serves as a tool to ensure that examiners consider compliance issues in an electronic environment. The draft guidance is divided into four functional examination areas—Advertisements, Lending, Deposits, and Stored Value Products. The guidance addresses applicable laws and regulations affecting each of the four functional areas, providing general information and specific examination objectives for each law.

> Many requirements in the current regulatory environment apply to electronic delivery systems.

The overall examination objective is to ensure that the consumer protections currently provided under the regulations for paper-based delivery systems are also applied to transactions occurring through electronic delivery systems. Many of the general principles, requirements, and controls within the current consumer protection regulatory environment apply to financial services conducted electronically.

Advertising. The federal banking regulators consider a bank's website to be an advertisement. This means that a bank website is subject to the advertising provisions in laws and regulations such as the Fair Housing Act, Truth in Savings (Regulation DD), Truth in Lending (Regulation Z), Consumer Leasing (Regulation M), and the Equal Credit Opportunity Act (Regulation B), among others. Examples of the advertising provisions in these existing regulations that also apply to websites appears in the box to the right.

The same analysis can be applied to two other functional examination areas—Lending and Deposits.

Lending. Institutions that solicit loan applications or provide lending disclosures over the Internet or through another electronic delivery system must ensure that the activities conducted are consistent with the regulations. Where a regulation expressly authorizes electronic communication, institutions may comply with the regulation via electronic communication of disclosures. Absent express authority, however, regulatory compliance should be accomplished through traditional, paper-based methods.

Seven consumer laws and regulations address lending and leasing activities by banks:

- Consumer Leasing (Regulation M)
- Truth in Lending (Regulation Z)
- Real Estate Settlement Procedures Act (RESPA) (Regulation X)
- Equal Credit Opportunity Act (Regulation B)
- Home Mortgage Disclosure Act (Regulation C)
- Fair Credit Reporting Act
- Flood Insurance (Regulation H)

Advertising Regulations and Electronic Delivery Systems

Fair Housing Act

- Equal Housing Lender logotype, slogan, or statement is properly displayed on web pages that promote loans to purchase, construct, improve, or repair a dwelling
- No advertisement expresses, implies, or suggests a discriminatory preference or policy by words, symbols, or models

Truth in Savings (Reg. DD)

- Advertisements contain all of the prescribed information (§230.8)

Truth in Lending (Reg. Z)

- Advertisements state available terms and express loan rates properly (§226.16 and §226.24)
- Additional credit terms are disclosed when triggering terms are advertised (§226.16(b))

Consumer Leasing (Reg. M)

- Advertisements contain all of the required disclosures (§213.7)
- Additional credit terms are disclosed when triggering terms are advertised (§213.7(d))

Equal Credit Opportunity Act (Reg. B)

- No advertisement expresses, implies, or suggests a discriminatory preference or policy of exclusion by words, symbols, or models (§202.5(a))

Deposits. Institutions that solicit deposits or provide deposit-related disclosures over the Internet must do so consistent with existing regulations. Four consumer laws and regulations address the deposit functions:

- Truth in Savings (Regulation DD)
- Availability of Funds and Collection of Checks (Regulation CC)
- Reserve Requirements of Depository Institutions (Regulation D)
- Electronic Fund Transfers (Regulation E)

Stored Value Products. Electronic stored value products go by many names, including stored value cards, smart cards, and electronic cash. Currently, there are no consumer protection laws or regulations that specifically address electronic stored value products; therefore, there are no specific examination guidelines for stored value products. However, to the extent that a stored value product is also a credit card or a debit card, then the appropriate lending or deposit regulations would apply.

What will the examiners review to determine compliance?

The examiners' review of electronic delivery systems will encompass those areas that pose the greatest risk to the bank and its customers. Examiners will assess the compliance management processes that are designed to identify, monitor, and manage these risks. In so doing, examiners will evaluate the degree of board and management oversight. The institution's board and management should recognize the consequences associated with noncompliance, and devote sufficient resources to ensure that the compliance program covers electronic banking systems. Management is also responsible for instilling a compliance culture throughout the organization, including the administration of electronic banking systems.

Examiners will also determine the compliance officer's involvement in the development, implementation, and review of disclosures for the bank's electronic delivery systems. The compliance officer's participation in all aspects of website development is critical to ensure compliance with the myriad of laws and regulations.

Finally, examiners will assess the institution's policies, procedures, training, audits, and internal controls to ensure compliance with all the provisions of the regulations in an electronic environment.

Examiners will base the scope of their review on the degree of complexity of the institution's electronic delivery systems and the effectiveness of the compliance management program. For example, a complex website in a large bank with inadequate management oversight will require a broad examination scope. On the other hand, an examiner may determine that a less complex website at a small bank with adequate management controls will require less regulatory review.

Training Web Site (The Checkers Bank)

The second section of the draft guidance consists of a training web site. The Checkers Bank is an online, simulated bank with a variety of compliance violations. The content on The Checkers Bank web pages simulates data that examiners will encounter during an examination, and provides tutorial guidance assisting the examiners with their review.

Compliance Violations at The Checkers Bank

- Violation: This page promotes deposit products, but lacks the official FDIC membership statement (Part 328).

  Corrective action: Add membership statement to all pages that promote deposit accounts.

- The term "free" is used to describe a checking account that requires $1.00 per item retrieval charge.

  Corrective action: Discontinue use of the term "free," or eliminate fee.

The Checkers Bank is currently not available to the public. However, the Federal Reserve System plans to make this website publicly available in the near future. Above is an illustrative screen from The Checkers Bank, which may contain violations of existing regulations. Test your compliance knowledge and see if you can find the violations.

Conclusion

The rapid pace of change in electronic banking presents potential risks to banks and consumers alike. Therefore, it is important that senior bank management and compliance professionals implement effective internal policies and compliance risk management procedures for the electronic delivery of deposits and loans. Although legislators and bank supervisors wrote the current regulations for a paper-based banking system, they still apply in the electronic world. Consequently, although the draft procedures have not been released publicly, I encourage you to carefully review your institution's website to ensure that it complies with both the letter and the spirit of the existing laws and regulations.

If you have any questions regarding compliance and electronic banking, please contact Connie Wallgren, Consumer Compliance Examinations Manager at (215) 574-6217 or Supervising Examiner Eddie L. Valentine at (215) 574-3436. ■

A Closer Look at phil.frb.org

by Theresa A. Willgruber, Quality Coordinator

The Federal Reserve Bank of Philadelphia's website, <www.phil.frb.org>, contains a wealth of information about the Reserve Bank, the economy, financial services, and bank supervision and regulation. While the site map provides a broad overview of the content, I would like to take a closer look at some of the highlights of "phil.frb.org."

As with most quality websites, we regularly review and update the content on our site. We recently added three new sections to our website, which you should find of interest – Frequently Asked Questions, The Gramm-Leach-Bliley Act, and Consumer Finance. We've also expanded the information in our Applications section to help banks, bank advisers, and the general public understand the Applications process.

Frequently Asked Questions

Did you ever want to know the answers to these questions?

- *Who owns the Fed?*
- *Are the employees of the Federal Reserve Bank government employees?*
- *How do I determine if a note is counterfeit?*
- *Where can I obtain newly minted coins, the new state quarters, or commemorative coin sets?*
- *Where can I find economic information?*

You can find the answers to these and other questions by visiting our website. Once you are on our home page, just click on *Frequently Asked Questions* under *Quick Picks.* You can also access this information through General Information on the button bar.

Financial Modernization – The Gramm-Leach-Bliley Act

A new section of the website covers one of the hottest topics in banking today—financial modernization, or the Gramm-Leach-Bliley Act (the "Act"). The Act is perhaps the most significant change in the U.S. financial services industry in several decades. The Act will enhance competition in the financial services industry by permitting banks, securities firms, insurance companies, and other financial service providers to affiliate under common ownership and offer their customers a complete range of financial services.

You can find a broad overview and a discussion of issues related to the Act on our home page by clicking on *Financial Modernization*. You can also find this information in the Supervision, Regulation, and Credit section of the website, which you can select from the button bar, or you can access the page directly at <www.phil.frb.org/src/glba.html>. Once there, you will find:

- Text of the Act
- A list of approved Financial Holding Companies
- Final Rules and Regulations
- Interim and Proposed Rules and Regulations
- SR Letters
- Speeches, Testimony, and Presentations
- Publications

We provide much of the information on the Act through links to other established websites, including the Board of Governors, the Government Printing Office, the FDIC, and the OCC. However, a recent addition to the website is a brochure published by the Federal Reserve Bank of Philadelphia. This brochure, *The Gramm-Leach-Bliley Act: A New Frontier in Financial Services*, discusses many of the provisions of the Act, and provides guidance in a question and answer format.

Consumer Finance

The staff in Supervision, Regulation and Credit (SRC) does more than just examine banks. For example, we also monitor nationwide trends of credit conditions and all components of consumer finance. The Special Studies unit of SRC provides our staff with information on macro financial and banking conditions that are relevant to Third District institutions, and tracks the overall financial performance of these institutions. We make some of this information available to the public in the Special Studies section of our website. You can access this section by clicking on the *Supervision, Regulation and Credit* button on our home page, or you can view it directly at <www.phil.frb.org/src/specialstudies/consumer finance.html>.

On this web page, the Special Studies unit provides extensive coverage of information related to consumer finances, including consumption, savings, wealth, debt, categories of loans, sources of data, and so forth. An annotated bibliography contains summaries of articles on related topics published by researchers around the Federal Reserve System.

Every quarter, the unit provides an executive summary on emerging trends or commentary on Consumer Finance and related issues. A recent summary covered *Recent Trends in Consumer Finances and a Look at Consumer Debt*. In this article, Joanna Frodin, a vice president in SRC, reviews economic activity and consumer borrowing behavior through the end of 1999. Past articles have addressed topics such as *Trends in Commercial Bank Loans,* and *Commentary: Is the Savings Rate Really Negative?*.

This web page also includes PowerPoint charts and supporting data for over 50 measures of consumer borrowing activity. Some of the data is available for periods as long as 50 years. Visit the Consumer Finances *Charts, Definitions, and Data* page for current charts and data on:

- Income, Savings, and Wealth
- Consumer Debt
- Commercial Bank Lending
- Consumer Debt Growth at Commercial Banks
- Commercial Bank Loan Performance
- Consumers' Aggregate Balance Sheet
- Subprime Lending
- Securitizations and Commitments

Applications

You can access the Applications section of our website through the *Supervision, Regulation and Credit* button, or you can bookmark it and access it directly at <www.phil.frb.org/src/applications/index.html>. The Applications section provides information on the processes through which individuals, banks, bank holding companies, and financial holding companies apply for or notify the Federal Reserve of formations, changes in control, and new activities. This section of our website also includes links to the Board of Governors' publication, *The Federal Reserve System Purposes & Functions*; websites posting information on actions and orders; notices of applications filed; and websites containing the forms necessary to file applications. The application forms can be printed, completed, and mailed directly to the Reserve Bank. Although these forms are not currently accepted on-line, the Board of Governors is considering this as an option in the future.

One area of this website I would like to highlight is the section on becoming a state member bank, which you can access from the Applications page. This web page includes detailed information, including:

- A definition of a state member bank
- Services available to a state member bank
- Requirements for becoming a state member bank
- Who may become a state member bank
- Factors considered for membership
- Contact names and numbers to assist in membership process

Before submitting an application for membership, applicants are encouraged to contact Reserve Bank staff so they can determine whether a pre-membership examination is necessary. We may waive the pre-membership examination, depending on the date of the institution's latest examination, the rating assigned, and the size of the institution. If the applying institution is a de novo bank, it should obtain the state banking department's preliminary charter approval before filing a final application with the Reserve Bank.

There's More…

The Federal Reserve Bank of Philadelphia's website contains much more information in an easy to search format. If you cannot find the information you are looking for on our website, let us know. The nature of the Internet makes it very easy for us to maintain a living website that meets the needs of all of our constituents.

By the way, the citizens of the United States could be considered to "own" the Federal Reserve, and Federal Reserve employees are not "government employees." To find out why, visit our website! ■

SVP Commentary on…

Financial Modernization

continued from page 1

signed to protect the assets of the banking subsidiaries from abuse or loss, and consequently to protect the safety net—the FDIC insurance funds. Additional safeguards of banking assets were provided by extending many of the provisions of sections 23A and 23B of the Federal Reserve Act, which limit credit extensions and require arms-length activity, to transactions between a bank and its own financial subsidiaries, as well as to transactions between a bank and the financial holding company affiliates.

The passage of the Act does not, by any means, end the work of banking and other financial service regulators on financial modernization. The Federal Reserve and the other agencies are working together under tight time frames to write a wide range of rules to implement the legislation, while also conducting studies and preparing reports required by the Act. Over the coming months, you should expect to see both new regulations and modifications to existing regulations. For example, the Act established the concept of functional regulation of subsidiaries of financial holding companies, and established the Federal Reserve as the umbrella supervisor. Regulations governing the formation, operations, and supervision of financial holding companies and functional subsidaries have been proposed, and public comments are being considered.

There will be no pre-eminent model for the successful banking organization of the future.

The changes in the rules of affiliation in the Act will create new opportunities and risks for all financial institutions and accelerate the trends toward financial convergence. Opportunities to expand product offerings, provide one-stop shopping to consumers, develop a diversified income stream, and use a flexible corporate structure offer the promise of synergy, efficiency, and increased market share. Risks include exposure to new or potentially higher-risk products, decisions to enter strategic alliances in unfamiliar business lines, increased competition, and the potential to lose strategic focus.

Due to the wide array of opportunities and risks, there will be no pre-eminent model for the successful banking organization of the future. Rather, several models will thrive and survive, as the forces of competition compel institutions to find opportunities and create value for their stakeholders.

The application of the Act by financial service regulators will be a critical factor in fulfilling the promise of the legislation. The Federal Reserve faces the challenge of overseeing the expanded powers of banking organizations, while maintaining an adequate supervisory framework to prevent excessive risk taking. Incentive-based supervision and the expanded use of market discipline will complement supervision.

To help you keep abreast of the regulatory changes related to the Act, the Federal Reserve Bank of Philadelphia created a website dedicated to the Gramm-Leach-Bliley Act. This website, which you can access at <www.phil.frb.org/src/glba.html>, contains links to numerous regulatory and supervisory releases related to the Act. The Reserve Bank has also prepared a brochure, *The Gramm-Leach-Bliley Act: A New Frontier in Financial Services.* This brochure summarizes many of the provisions of the Act; provides tables containing the effective dates and target dates for new regulations, reports, and studies; and includes answers to commonly-asked questions. We have also updated the Applications section of our website to include new information related to the Act. I encourage you to use our website and this brochure to focus your strategic discussions with your Board of Directors and management, allowing you to respond effectively to the opportunities and challenges presented by financial modernization. ■

Managing Credit Risk with Synthetic Collateralized Loan Obligations

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determination, examiners will consider whether the sponsoring bank has used the appropriate approach to capital allocation as set forth in SR 99-32. Examiners will assess whether the sponsoring bank has sufficiently isolated itself from the credit risk exposure through the following minimum requirements: (1) virtually all the risk is transferred to third parties; (2) the ability to evaluate remaining banking book risk exposure is maintained and adequate capital provided; and (3) adequate public disclosures of such transactions regarding their risk profile and capital adequacy are provided. Examiners will also evaluate the scope of both internal and external independent audits of securitization activities to determine whether the level of review is appropriate for the level of risk.

Caveat

This article discusses the credit risk implications of synthetic CLOs. However, an organization should not use synthetic CLOs until it considers all of the risks and benefits of such a program. Funding issues, liquidity management, revenue and cost recognition, profitability measures, and management expertise are among the issues that management must address before implementing a synthetic CLO strategy.

For additional information on credit risk and synthetic CLOs, contact Randolph D. Brown, Senior Examiner, at (215) 574-4125, or refer to the Federal Reserve Board's SR letters, which can be accessed through the Federal Reserve Bank of Philadelphia's website at <www.phil.frb.org>. ■

FEDERAL RESERVE BANK OF PHILADELPHIA

NEXT ISSUE

Consumer Compliance Update

Integrating Safety and Soundness and Information Technology Examinations

Electronic Banking Examinations

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