



Bureau of Banks and Trust Companies

August 5, 2002

Mr. Kevin P. Murray  
Institutional Products Manager  
Bankers Financial Services Corp.  
8800 N.W. 62nd Avenue  
P.O. Box 6240  
Johnston, Iowa 50131-6240

Re: Dow Jones Indexed CDs

Dear Mr. Murray:

This letter is in response to your recent letter in which you asked the Office of Banks and Real Estate (the "Agency") to determine whether Illinois state-chartered banks may participate in the Dow Jones Industrial Average Indexed Certificate of Deposit Program (the "BFS Program") developed and administered by Bankers Financial Services Corp. ("BFS"). The Agency does not object to state banks selling and investing in certificates of deposit offered through the BFS Program, subject to the conditions noted below.

Based on the materials you supplied, the Agency's understanding of the BFS Program is as follows. Banks participating in the BFS Program will offer their customers a five-year certificate of deposit with a variable rate of return tied to the performance of the Dow Jones Industrial Average (the "CD"). The actual rate of return will equal the "participation rate" multiplied by the rate of appreciation in the Dow Jones Industrial Average over the term of the CD. The comparison points for determining the rate of appreciation will be the Dow Jones Industrial Average on the date the CD is issued and the average of the Dow Jones Industrial Average over the last 12 quarters preceding maturity. The participation rate will be a fixed rate that will vary depending on the particular product issue, but it is anticipated to be between 80% and 90%. In all instances, a bank and its customer will know the participation rate prior to the sale of the CD. In addition, a rate of return floor is established to guarantee the return of a customer's principal investment if the CD is held to maturity.

A bank that participates in the BFS Program will engage in hedging activities administered by BFS and its escrow agent, The Bank of New York, as a means of reducing exposure to the volatility of the Dow Jones Industrial Average. BFS will purchase an over-the-counter option contract (the "OTC Option") from an option seller based on the notional value of the CDs sold during a specified selling period by banks participating in the BFS Program. BFS will then assign each bank a pro rata interest in the OTC Option based on the notional value of the CDs each bank sold. The OTC Option term will match the term of the CDs, and it will provide for payment of the same appreciation in value of the Dow Jones Industrial Average that banks participating in the Program are obligated to pay the CD purchasers. Each bank will pay a one-time premium for its interest in the OTC Option. Option sellers may vary from time to time, but BFS will enter into the Multicurrency-Cross Border Master Agreement developed by the International Swap Dealers Association, Inc. with each of them. Potential option sellers include Societe General and Credit Lyonnais.

There are several other key attributes of the CD from the perspective of a bank and its customer. The principal of the CD is insured by the Federal Deposit Insurance Corporation ("FDIC") up to established limits.<sup>1</sup> A customer does not earn interest on the CD until maturity because the rate of return cannot be computed until then. Thus, the FDIC does not insure interest on the CD prior to maturity. In spite of the contingent nature of interest on the CD, the Internal Revenue Service will require a bank customer to make an annual tax payment based on an imputed rate of return. Further, a substantial charge will likely result if a customer exercises an early withdrawal option because the underlying hedge a bank will employ after selling the CD is designed for CDs held to maturity. A customer who obtains an early withdrawal may not receive a full return of principal.

The Agency recently addressed a similar equity-linked CD program in Interpretive Letter 02-01 (January 16, 2002) ("IL 02-01"). In IL 02-01, the Agency determined that Illinois state-chartered banks are permitted to engage in the sale of equity-linked CDs and related hedging activities under Section 3 of the Illinois Banking Act (the "Act") as part of their general banking business.<sup>2</sup> The Agency found additional support for banks to engage in the related hedging activities under Section 5(11) of the Act, which permits state banks to perform activities or own assets authorized or permitted to national banks.<sup>3</sup> The Agency further determined that state banks could purchase equity-linked CDs subject to the limitations prescribed by Section 32 of the Act.<sup>4</sup> These sections of the Act have equal application to the BFS Program and would allow state-chartered banks to participate in the BFS Program.

However, this authorization does not mean that participation in equity-linked CDs programs in general, and the BFS Program in particular, is suitable for all state-chartered banks, nor should this authorization be construed as an endorsement of the BFS Program for those banks for which the BFS Program may be suitable. As noted in IL 02-01, a bank must have the expertise to understand the risks and accounting issues associated with equity derivatives, and it must fully understand its funding costs in order to determine whether the BFS Program is preferable to other funding options.<sup>5</sup> In particular, it will be

---

<sup>1</sup> See, February 27, 2002 letter from FDIC Senior Regional Attorney Joseph A. Genova, Jr. to BFS.

<sup>2</sup> 205 ILCS 5/3.

<sup>3</sup> 205 ILCS 5/5(11).

<sup>4</sup> 205 ILCS 5/32.

<sup>5</sup> For a detailed summary of the various risks associated with financial derivatives, see the Office of the Comptroller of the Currency's ("OCC") Banking Circular 277, *Risk Management of Financial Derivatives* (October 27, 1993).

incumbent on participating banks to evaluate the credit risk associated with the option seller and the performance capacity and reliability of BFS and its escrow agent.

Please note that the Agency's opinion is premised on and applies only to the BFS Program set forth in the materials you supplied.<sup>6</sup> Modifications to any aspect of the BFS Program could lead to a reversal of the Agency's position.

In your letter, you also asked if OTC Options are a permissible investment for state-chartered banks under the Act, and you expressed your thought that such contracts could be purchased pursuant to Sections 33, 34, and 35 of the Act.<sup>7</sup> Section 33 states the general rule that a bank only can purchase "marketable investment securities" for its own account. In addition, such securities must be rated in the top four rating categories, and holdings of any one security are limited to 20% of unimpaired capital and surplus. Sections 34 and 35 state the exceptions to the general rule. The materials BFS supplied indicate that a bank's pro rata interest in the OTC Option will not be marketable. Further, such an interest would not fall within any of the exceptions of Sections 34 and 35. However, the Agency does not regard Section 33 of the Act and its related exceptions as determinative of the ability of a bank to conduct hedging activities under the BFS Program. A participating bank will hold its interest in the OTC Option as a specific hedge against the interest rate risk of a particular deposit product rather than for investment purposes for its own account. As such, Section 33 does not apply. As previously stated, in IL 02-01, the Agency concluded that a bank's ability to engage in hedging activities to limit exposure to fluctuations in equity markets derives from Section 3 of the Act as incidental and germane to the power of a bank to accept deposits.

A similar analysis applied in Interpretive Letter 97-02 (March 11, 1997) in which the Agency addressed the ability of a bank to hold a borrower's stock as part of an effort to work out a troubled loan. No section of the Act expressly permitted the bank to hold its borrower's stock. Nonetheless, the bank was allowed to hold the stock:

OBRE recognizes that while a bank may not be authorized to invest in a particular stock, it may nevertheless accept and hold the stock, not as an investment *per se*, but rather as an incident to a permitted activity, or in this instance in an attempt to work out a problem loan and maximize the bank's recovery. We conclude, as you suggested in your inquiry, that as part of the general banking business a bank may accept assets in which the bank could not invest in the first instance and that the Bank may accept the preferred stock as described in your letter provided that the conditions described, including the maximum holding period, are observed.

Further, as noted above, IL 02-01 recognized additional support for an Illinois state chartered bank to engage in deposit hedging of equity-linked CDs pursuant to Section 5(11) of the Act.<sup>8</sup> A national bank is

---

<sup>6</sup> The primary materials supplied consist of a Disclosure Statement (Product Issue 1.1), Indexed Certificate of Deposit Program Master Agreement, International Swap Dealers, Inc. Multicurrency-Cross Border Master Agreement, Escrow Agreement between BFS and The Bank of New York, and correspondence between BFS and the FDIC.

<sup>7</sup> 205 ILCS 5/33, 205 ILCS 5/34, and 205 ILCS 5/35.

<sup>8</sup> 205 ILCS 5/5(11).

permitted to engage in equity derivatives hedging activities,<sup>9</sup> so a state bank may do so as well, subject to the same limits imposed on national banks. In the particular context of equity index swaps, such as those contemplated under the BFS Program, the OCC has imposed no limits on matched option-based hedging practices beyond general safety and soundness limits, nor has it characterized the holding of matched options for hedging purposes as investments in marketable securities.<sup>10</sup>

The Agency addressed financial derivatives activities of state-chartered banks on two other occasions. In Interpretive Letter 94-19 (September 15, 1994), the Agency concluded that state banks and foreign banks under Illinois jurisdiction could trade energy derivatives to the same extent as national banks pursuant to the "wildcard" provision of Section 5(11) of the Act.<sup>11</sup> However, the Agency required a bank to obtain Agency approval before engaging in energy derivatives trading. Subsequently, in Interpretive Letter 95-15 (December 20, 1995), the Agency concluded that Section 5(11) allowed state banks to enter into any financial derivatives contracts permitted to national banks. Further, the Agency signified that it would require a state bank to obtain prior Agency approval any time it sought to own, hold, or trade financial derivatives. Given our understanding of the BFS Program and the limited nature of a one-time purchase of an interest in the OTC Option, the Agency will waive the prior approval requirement set forth in Interpretive Letter 95-15 for banks participating in the BFS Program. However, banks that fail to demonstrate the proper management and controls to participate in the BFS Program in a safe and sound manner will be subject to appropriate regulatory action.

You also asked if there would be a limit to the total value of OTC Options that would support a notional volume of CDs. As noted above, the investment limits of Section 33 of the Act do not apply, but a bank participating in the BFS Program must comply with general safety and soundness requirements, including the avoidance of excessive concentrations.

Next, you asked if the limitations set forth in IL 02-01 would be applicable to the BFS Program. One set of limits the Agency discussed in IL 02-01 related to bank-to-bank sales and purchases of CDs. These limits apply with equal effect to the BFS Program. The Agency also indicated that the Prudent Investor Rule<sup>12</sup> limits a trustee's investment of trust assets in the equity-linked CDs discussed in IL 02-01. The Prudent Investor Rule would likewise apply to any trustee seeking to purchase the CDs offered through the BFS Program. Further, the Agency concluded that the investment rules for wards set forth in the Probate Act of 1975<sup>13</sup> did not permit the investment of a ward's assets in the equity-linked CDs discussed in IL 02-01 because of the absence of deposit insurance prior to maturity for the contingent interest component. Similarly, the CDs banks will offer under the BFS Program do not provide for deposit insurance of the interest component until maturity, so the same prohibition applies.

In addition, you asked us to provide the key concerns or issues the Agency's examiners will consider when reviewing the BFS Program with regard to safety and soundness standards. It is difficult to predict all

---

<sup>9</sup> See, e.g., OCC Interpretive Letter No. 892 (September 13, 2000) in which the OCC summarized its prior conclusions that hedging of equity-linked deposits by national banks is an integral part of the authority to receive deposits (12 USC 24(Seventh)) and enter into contracts (12 USC 24(Third)).

<sup>10</sup> OCC Interpretive Letter No. 652 (September 13, 1994) and OCC Interpretive Letter No. 892 (September 13, 2000).

<sup>11</sup> 205 ILCS 5/5(11).

<sup>12</sup> 760 ILCS 5/5.

<sup>13</sup> 755 ILCS 5/21-2 through 755 ILCS 5/21-2.15.

Mr. Kevin P. Murray

August 5, 2002

Page 5

of the Agency's key concerns given that we have not had the opportunity to observe the BFS Program in operation. A bank participating in the BFS Program will offer a deposit product for sale that contains an embedded financial derivative. It will hedge the deposit product with an option contract. The bank will rely on various third parties, including BFS, to perform as contracted. The Agency's examiners will look at any issue that could arise relating to deposit products, financial derivatives, options, and outside service providers. One concern that is apparent is that the purchasers of the CDs will be exposed to unique risks not normally associated with bank depository products. The examiners will look for documentation that these risks were adequately explained. Further, as noted above, the BFS Program might not be suitable for every state bank. As with any new product or service, the Agency will evaluate each bank's decision to participate in the BFS Program, as well as its level of participation, in light of the bank's particular circumstances.

Finally, an unresolved issue remains regarding the early withdrawal feature of the CD. In a letter to BFS dated February 27, 2002, the FDIC concluded that the Disclosure Statement a participating bank will give to potential CD purchasers did not comply with Regulation DD of the Board of Governors of the Federal Reserve System ("Regulation DD").<sup>14</sup> The FDIC determined that any amount received upon early withdrawal that is less than the original amount deposited would constitute a fee or an early withdrawal penalty. Because the fee or early withdrawal penalty is not quantified in the Disclosure Statement, the FDIC concluded that the Disclosure Statement failed to meet the requirements of either Section 230.4(b)(4) or Section 230.4(b)(6)(i) of Regulation DD, which govern fees and penalties, respectively.<sup>15</sup> BFS subsequently modified the Disclosure Statement, but in a letter dated May 3, 2002, the FDIC still found compliance with Regulation DD lacking for the reasons it previously stated. The FDIC suggested that BFS should seek a determination from the Board of Governors of the Federal Reserve System (the "Federal Reserve") that the Disclosure Statement does not violate Regulation DD, and the FDIC further indicated that it would likely defer to the Federal Reserve's decision. BFS has sought such a determination, and its request is pending.

You and I discussed Regulation DD compliance as well. BFS asserts that the early withdrawal provisions of the Disclosure Statement comply with Regulation DD because the difference between the amount received by a customer upon early withdrawal and the original amount deposited is neither a fee nor a penalty. Further, you indicate that BFS is not capable of quantifying the early withdrawal amount because the OTC Option seller determines this amount at the time of the early withdrawal based on financial models that, in essence, re-price the OTC Option by incorporating then-existing market conditions. In addition, you provided sample calculations to further illustrate the early withdrawal feature.

The Agency is appreciative of BFS' efforts to keep us fully informed of the Regulation DD issues. Obviously, it is important for banks participating in the BFS Program to comply with Regulation DD as well as all other applicable laws and regulations. Therefore, the Agency will condition its approval for Illinois state-chartered banks to participate in the BFS Program on a favorable resolution of the Regulation DD issues raised by the FDIC. A determination by the Federal Reserve that the Disclosure Statement does not violate Regulation DD would appear to be the best resolution from BFS' standpoint. Further modification of the Disclosure Statement may be another option. Please continue to keep the Agency informed of your efforts with the Federal Reserve and the FDIC and provide us with copies of any correspondence from these agencies.

---

<sup>14</sup> 12 C.F.R. 230.1 *et seq.*

<sup>15</sup> 12 C.F.R. 230.4(b)(4) and 12 C.F.R. 230.4(b)(6)(i).

Mr. Kevin P. Murray  
August 5, 2002  
Page 6

We trust this letter is responsive to your inquiries. Should you have any questions related to this letter, please do not hesitate to contact the Agency.

Sincerely,

A handwritten signature in cursive script that reads "Douglas S. Slayton". The signature is written in black ink and is positioned above the printed name and title.

Douglas S. Slayton  
Legal Counsel