

DATE: April 8, 2002

SUBJECT: Derivative Contracts Hedging Trust Preferred Stock (SR 02-10)

HIGHLIGHTS: Federal Reserve staff has become aware that in recent weeks bank holding companies (BHCs) seeking to hedge the interest rate risk on their issues of trust preferred stock have been offered derivative contracts with terms that have the effect of contravening the strict conditions for the inclusion of the trust preferred stock in tier 1 capital. The terms in question take effect when the BHC defers dividend payments on the trust preferred stock subject to the hedge. When such a deferral event occurs, the contracts provide that the derivative counterparty will defer on a cumulative basis its swap payments due to the banking organization while the BHC continues to make payments to the derivative counterparty.

The Federal Reserve has supervisory concerns where the contract terms for deferral on swap payments are not symmetrical and require the banking organization to make payments to the swap counterparty without receiving payments from the counterparty. Contracts structured in this manner undermine the loss-absorbing capacity of the hedged trust preferred stock and, consequently, its eligibility for tier 1 capital.

Any banking organization that has hedged trust preferred stock with an interest rate derivative contract that is asymmetrical with regard to deferral terms should immediately contact its Reserve Bank.

Additional information regarding this matter is included in the Federal Reserve System's Supervision and Regulation policy letter, SR 02-10 (SUP), dated March 28, 2002.

DOCUMENT LOCATION: The SR letter is available under the "SR Letters" section of the Board of Governors' web site, as follows:

<http://www.federalreserve.gov/boarddocs/SRLETTERS/2002>

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