Bank Asset/Liability Management

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Attracting Deposits

By

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A relatively new bank funding mechanism that has been gaining popularity is a "structured deposit" that pays something *other than* traditional interest to the depositors. This product is designed to allow banks to attract funds from non-traditional depositors. For example, these deposits could be constructed to appeal to equity oriented investors or other investors who seek to earn returns that relate to other performance measures besides interest rates..

Such structured deposits should be understood to be hybrid instruments composed of a traditional debt host (either fixed or floating rate debt), coupled with an embedded derivative that serves to generate the payoff desired by the depositor. The precise nature of the returns can be of a myriad of possibilities, with the only caveat that it must mirror the critical terms of a derivative that can be traded in the over-the-counter (OTC) derivatives market place.

As an example, the deposit might promise a guaranteed return of principal after some stated term, plus the prospect of enjoying some proportion of the appreciation of, say, the S&P500 index over and above some defined threshold level. This structure would be satisfied by issuing a zero coupon deposit that matures to a value equal to the original deposit value, and using the difference between the starting and maturing balances to purchase a call option on the S&P500 index. At maturity, if the stock market fails to breach the predefined level, the call will expire worthless, but the zero coupon instrument returns the original deposit amount. Alternately, if the stock market does rise above that threshold, the depositor gets not only the return of principal (from the zero coupon host contract) but also the ending intrinsic value of the call.

Any deposit with a guaranteed minimum end value would similarly be constructed by pairing a zero-coupon deposit with a purchased option, and that option could be a call (a right to buy) or a put (a right to sell) literally any underlying good or security. Thus, the payoff could allow participation to price increases (with embedded calls) or price decreases (embedded puts). Either or both could be constructed.

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Accounting Considerations

Returning to the above example, the debt host relates to interest rates while the embedded derivative relates to equities. Thus, these two components of the hybrid are said to be "*not* clearly and closely related." This language is very specific to the accounting literature pertaining to derivative contracts. Given this determination, the embedded derivative must be *bifurcated.* In other words, although the deposit will be carried on the balance sheet as a unified contract, its value would reflect (a) the historical cost of the host debt (i.e., the starting value plus any interest accruals), plus (b) the market value of the embedded derivative. Changes in this resulting value would be recognized in earnings, most likely as interest expense.

Critically, the starting value of the deposit will be the amount received by the bank, but the host value must be determined residually. That is, the embedded derivative must be valued at the start, and the host value would be the starting deposit amount less the starting value of the embedded derivative.

Coincidently with issuing the deposit, the bank would likely want to enter into an over-the-counter derivative that mirrors all of the critical terms of the embedded derivative. In this way, the bank would offer depositors return characteristics that they find attractive (at least prospectively), while at the same time, the bank would still bear traditional interest rate exposure. They might be able to approximate this result with an over-the-counter derivative, but using something other than the perfect offset would introduce some incremental, unintended earnings -- possibly beneficial, possibly not.

The accounting for this new, stand-alone derivative is straight forward: it's carried on the balance sheet at fair market value, with changes in value posted to earnings. Assuming the use of an OTC mirror image derivative, its earnings impact would be equal and opposite to the earnings impact of the embedded derivative – save for some possible discrepancy that might arise as a function of different credit qualities of the counterparty pairs for the deposit and the OTC derivative, respectively. The possibility of significant credit deterioration notwithstanding, these credit-related valuation variances would typically be expected to be immaterial. Using an exchange-traded derivative (i.e., not the perfect mirror image) would approximate this result.

It should be understood that the accounting treatment described above is the standard accounting for derivative. More specifically, *special hedge accounting* is neither necessary nor appropriate. Thus, the prescribed accounting requires no special hedge documentation or effectiveness testing. There are, however, disclosures that are required relating to both the embedded derivatives and the OTC contracts, detailing the fact that the bank is principal to these derivative contracts and describing the bank's objectives in entering into these positions.