Tackling Step-Ups

No longer “red-lined” as structured notes, but are they suitable?

Step-ups were classified as structured notes prior to 1998 and, as such, carried the added regulatory burden of stress testing and special reporting. The FFIEC 1998 Supervisory Statement on Investment Activities lifted the requirement that certain, specified securities (including step-ups) be tested, but added the requirement that bankers develop their own testing procedures, including pass/fail limits.

In reality, this added post-purchase stress testing of all securities. The 1998 change, then, raises two questions:

• Are step-ups suitable for community bank portfolios?
• If so, what tests and pass/fail limits should be established?

Step-Up Suitability

A callable step-up is simply a callable bond with a coupon that increases if the bond is not called. Chart I compares a five-year agency callable with two five-year agency callable step-ups. The straight callable carries a 4.22 percent coupon from date of issue until called or matured. The agency step-ups A and B carry beginning coupons of 3.5 percent and 2.625 percent, respectively. If not called, A’s coupon steps up 0.50 percent annually to a final rate of 6.00 percent. Agency B coupon steps up 0.50 percent semi-annually to a final rate of 7.125 percent.

As a practical matter, a step-up is more desirable than a callable when considering price volatility and extension risk. The step-up is really a callable bond with an added benefit; that is, a higher coupon if not called. That is why, in general, the higher and the faster the coupons step-up, the lower the initial yields (the less risk, the less yield).

It should also be noted that bonds with higher and faster steps are likely to be called sooner than straight callables or bonds with lower and slower steps. For example, in Chart I, rates would have to go up dramatically for Step-up B to go to maturity with a 7.125 percent coupon.

Testing Step-Ups

Actually, the testing of callable step-ups need be no more strenuous than the testing of comparable straight callables since it has been shown that a straight callable has more price volatility and extension risk than does a comparable step-up.

With that thought in mind, the following general questions will help meet the FFIEC’s regulatory requirements for most securities, including straight or step-up callables. The bank’s directors must approve a list of those securities suitable for purchase, which require testing and specific test pass/fail limits.

• Is this security on the directors’ approved list of suitable securities?
• Is the security being purchased a “standardized, noncomplex security”? If so, pre-purchase testing is not required.

Standardized, noncomplex securities are defined by the FFIEC as instruments with risks which are “well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.” A good rule of thumb is that a standardized, noncomplex security is any investment grade security with a final maturity of no greater than five years. Tax-frees and other easily understood securities could be longer, depending of the directors’ comfort level.

• How much does the market price of a security fluctuate when rates rise or fall? Pre- and post-purchase testing are required.
• How much does the average life or cash flow of a security fluctuate when rates rise or fall? Pre- and post-purchase testing are required.

<table>
<thead>
<tr>
<th>Chart I</th>
<th>STRAIGHT CALLABLE</th>
<th>STEP-UP A</th>
<th>STEP-UP B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Coupon</td>
<td>4.22%</td>
<td>3.50%</td>
<td>2.625%</td>
</tr>
<tr>
<td>Step-Up Interval</td>
<td>N/A</td>
<td>Annual</td>
<td>Semi-Annual</td>
</tr>
<tr>
<td>Final Coupon</td>
<td>4.22%</td>
<td>6.00%</td>
<td>7.125%</td>
</tr>
<tr>
<td>Price Volatility (rates up 300 basis points)</td>
<td>&lt;11.8%&gt;</td>
<td>&lt;10.8%&gt;</td>
<td>&lt;9.7%&gt;</td>
</tr>
</tbody>
</table>

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• How much do the bank’s earnings fluctuate when rates rise or fall? Post-purchase testing is required—normally included in a bank’s interest rate risk measurements.

All this sounds more difficult than it is. The well-known Bloomberg stress test can be used to perform all pre-purchase testing to determine a security’s price volatility and average life fluctuations. Post-purchase tests can be performed periodically to retest the bank’s individual securities, as well as to test the overall price volatility and cash flow characteristics of the bank’s investment portfolio.

This month’s column started out to be a simple explanation of why callable step-up securities are actually less risky than comparable straight callables. However, it expanded to offer an explanation on testing requirements. In fact, the testing requirement explanations it covers just scratch the surface and should be further explored to adequately address building bank policies and procedures.

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• Sample policies for investment activities and interest rate risk management;

• March 1999 *Independent Banker* reprint on investment activity requirements and director responsibilities;

• Pre- and post-purchase stress testing; and

• Customized Performance Profile showing actual post-purchase test results for your bank.