

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

May 30, 2002

**BANKING SUPERVISION AND REGULATION:
CREDIT CARD SECURITIZATIONS AND
FINANCIAL INSTRUMENT FRAUDS**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

**Regulatory Capital Treatment of Accrued Interest Receivables Related to Credit Card
Securitizations (SR 02-12)**

The federal banking agencies have identified inconsistencies across financial institutions in the regulatory capital treatment of accrued interest receivables (AIRs) related to credit card securitizations. The agencies have worked together and developed guidance that clarifies the appropriate risk-based capital treatment for banking organizations that securitize credit card receivables and record on-balance sheet assets commonly referred to as AIRs. The interagency guidance is located on the Federal Reserve Board's web site at <http://www.federalreserve.gov/boarddocs/SRLETTERS/2002/SR0212a1.pdf>.

When a banking organization transfers a pool of credit card receivables to a trust, it typically also transfers to the trust the right to receive interest and fee income from those receivables. Some institutions continue to accrue interest and fee income on the investors' portion of the transferred credit card receivables on their balance sheets, reporting the right to these future cash flows as an AIR asset. Any accrued amounts the banking organization collects, however, generally must be transferred to the trust upon collection. Because the banking organization passes all cash flows related to the AIR to the trust, where they are available to satisfy more senior obligations before excess amounts are returned to the seller, the AIR constitutes a residual interest in the securitized assets. The AIR serves as a credit enhancement to protect third party investors in the securitization from credit losses and meets the definition of a "residual interest" under the banking agencies' rules on the capital treatment of recourse arrangements issued in November 2001, which are specifically referenced in footnote 3 of the guidance. Under those rules, an institution must hold "dollar-for-dollar" capital against residual interests even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.

The banking agencies expect banking organizations to reflect the aforementioned treatment in their regulatory reports by no later than December 31, 2002. Institutions that have been properly reflecting the AIR asset as a credit enhancement for risk-based capital purposes are expected to continue to do so. Notwithstanding these expectations, the banking agencies highlight in their guidance that there may be circumstances where a banking organization may have to treat the AIR asset in the way described by the guidance at an earlier date due to supervisory concerns or other factors.

“Prime Bank” and Other Financial Instrument Fraud Schemes (SR 02-13)

In 1993 and 1996, the Federal Reserve issued advisories concerning illegal schemes purporting to involve “prime bank” financial instruments.¹ In its alerts, the Federal Reserve advised banking organizations and the public that it does not know of any legitimate use of any financial instrument called a “prime bank” note, guarantee, letter of credit, or debenture. The Federal Reserve also advised that it does not guarantee or enter into transactions with individuals and does not license anyone to trade “prime bank” financial instruments or act as the Federal Reserve’s agent to sell or redeem such instruments.

Since 1996, fraudulent schemes involving financial instruments have proliferated in the United States and abroad, and investors have lost significant sums of money. Federal and state law enforcement agencies, as well as the U.S. Securities and Exchange Commission, have investigated and prosecuted numerous individuals associated with supposed investment opportunities involving “prime bank” instruments or other financial instruments.

The Federal Reserve wants to again highlight the dangers associated with investing or participating in questionable transactions that promise unrealistically high rates of return and involve other dubious characteristics. Over the past several years, Federal Reserve staff has reviewed numerous illicit transactions and provided assistance to U.S. and foreign law enforcement and securities regulators and, based on this experience, has identified the following hallmarks or “red flags” associated with many fraudulent financial instrument scams that can be used to avoid them:

- References to financial instruments issued by “prime banks,” “top 100 world banks,” “top 25 European banks,” and similar references to categories or groups of banks that are not used in the banking industry.
- Promises of extremely high, unrealistic rates of return with little or no risk.
- Participation in an investment program often referred to as a “roll program (or programme),” “high yield investment program,” or “bank debenture trading program.”
- High rates of return are generated by repeatedly trading (or buying and selling) financial instruments (often over a 40-week period).
- Legitimate financial instruments, such as letters of credit, guarantees, and medium term notes, are bought and sold or traded in manners that are not realistic—for example, standby letters of credit are bought and sold.²
- Transactions are overly complex and nonsensical.
- Terms that have no meaning in legitimate financial transactions are used repeatedly—for example, “conditional SWIFT,” “key tested telex,” “pay order,” “funds of good, clean, clear and non-criminal origin,” “master commitment,” “one year and one day,” and “commitment holder.”
- High degree of secrecy—for example, the trading of financial instruments takes place on a secret market, your banker or investment adviser will not know about the investment opportunity because only a few special people around the world are aware of it or participate in the secret trading, or the investor is being allowed to participate in a secret trading program and, if he or she reveals any information about the program, the investor’s participation will be terminated.

¹ Copies of the Federal Reserve’s alerts are available at http://www.newyorkfed.org/bankinfo/circular/10858.html#Investment_Scheme_Advisory. Over the past several years, advisories concerning illegal “prime bank” and other financial instrument schemes have also been issued by the U.S. Securities and Exchange Commission, the World Bank, the International Monetary Fund, the International Chamber of Commerce, the Law Society of Britain and Wales, and other U.S. and foreign law enforcement and regulatory authorities.

² In August 1993, an article entitled “Anatomy of the Medium-Term Note Market” was published in the *Federal Reserve Bulletin*. The article was written by Federal Reserve economists and describes the use of this type of legitimate debt instrument by corporations and banking organizations and how they are underwritten and priced by the market. Since the publication of this article and the issuance of the Federal Reserve’s 1993 “prime bank” advisory, which alerted the public to the non-existence of “prime bank” instruments, many illicit scams purport to involve the trading of “medium term notes” (often referred to as “MTNs”) rather than “prime bank” financial instruments. Apparently, wrongdoers involved with illegal financial instrument scams try to convince their victims that the Federal Reserve Bulletin article proves the existence of a market where MTNs can be traded for enormous profits. No such market exists.

- The investor's funds are absolutely safe and cannot be lost—for example, a bank has issued a guarantee or an attorney is holding the funds in a special escrow fund.
- Involvement of a well known governmental authority, such as the Federal Reserve, World Bank, or IMF.
- Inaccurate references to the International Chamber of Commerce and its publications.
- Investor's funds will be used for "humanitarian" projects.

Federal law enforcement authorities have asked the Federal Reserve to advise individuals, banking organizations, and other entities who have been approached to invest in a "prime bank" financial instrument or participate in some manner in any transaction containing the characteristics listed above to contact the local offices of the agencies. This includes the field offices of the Federal Bureau of Investigation, U.S. Secret Service, U.S. Customs Service, or Internal Revenue Service's Criminal Investigation Division. The U.S. Securities and Exchange Commission is also actively involved with investigating securities frauds associated with these types of transactions, and asks that companies and individuals alert a local office of that agency.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>. Paper copies of the Board's notice **(SR 02-12 and SR 02-13)** are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information about SR 02-12, please contact our Banking Supervision and Regulation Department at (415) 974-3177.

For additional information about SR 02-13, please contact our Banking Supervision and Regulation Department at (415) 974-2911.

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