

**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket No. 95-17]

**FEDERAL RESERVE SYSTEM****12 CFR Part 208**

[Docket No. R-0802]

**FEDERAL DEPOSIT INSURANCE CORPORATION****12 CFR Part 325**

RIN 3064-AB22

**Risk-Based Capital Standards: Interest Rate Risk**

**AGENCIES:** Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); and Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Final rule.

**SUMMARY:** The OCC, the Board, and the FDIC (collectively referred to as the banking agencies) are issuing this final rule to implement the portion of Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that requires the banking agencies to revise their risk-based capital standards to ensure that those standards take adequate account of interest rate risk. This final rule amends the capital standards to specify that the banking agencies will include, in their evaluations of a bank's capital adequacy, an assessment of the exposure to declines in the economic value of the bank's capital due to changes in interest rates.

Concurrent with the publication of this final rule, the banking agencies are issuing for comment, a joint policy statement that describes the process the banking agencies will use to measure and assess the exposure of a bank's net economic value to changes in interest rates. After the banking agencies and banking industry gain sufficient experience with the proposed measurement process, the banking agencies intend, through a subsequent rulemaking process, to issue a proposed rule that would establish an explicit capital charge for interest rate risk that will be based upon the level of a bank's measured interest rate risk exposure.

**EFFECTIVE DATE:** September 1, 1995.

**FOR FURTHER INFORMATION CONTACT:**

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National Bank Examiner (202/874-5070), Office of the Chief National Bank Examiner; Michael Carhill, Financial Economist, Risk Analysis Division (202/874-5700); and Ronald Shimabukuro, Senior Attorney, Legislative and Regulatory Activities Division (202/874-5090), Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

*Board of Governors:* James Houpt, Assistant Director (202/452-3358), William F. Treacy, Supervisory Financial Analyst (202/452-3859), Division of Banking Supervision and Regulation; Gregory Baer, Managing Senior Counsel (202/452-3236), Legal Division, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

*FDIC:* William A. Stark, Assistant Director (202/898-6972) or Phillip J. Bond, Senior Capital Markets Specialist (202/898-3519), Division of Supervision, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:****I. Background**

Interest rate risk is the exposure of a bank's current and future earnings and equity capital arising from adverse movements in interest rates. This risk results from the possibility that changes in interest rates may have an adverse impact on a bank's earnings and its underlying economic value. Changes in interest rates affect a bank's earnings by changing its net interest income and the level of other interest-sensitive income and operating expenses. The underlying economic value of the bank's assets, liabilities, and off-balance sheet items also are affected by changes in interest rates. These changes occur because the present value of future cash flows, and in some cases the cash flows themselves, change when interest rates change. The combined effects of the changes in these present values reflect the change in the underlying economic value of the bank's capital as well as provide an indicator of the expected change in the bank's future earnings arising from the change in interest rates.

Interest rate risk is inherent in the role of banks as financial intermediaries. Interest rate risk, however, introduces volatility to bank earnings and to the economic value of the bank. A bank that has an excessive level of interest rate risk can face diminished future

earnings, impaired liquidity and capital positions, and, ultimately, may jeopardize its solvency.

Section 305 of FDICIA, Pub. L. 102-242 (12 U.S.C. 1828 note), requires the banking agencies to revise their risk-based capital guidelines to take adequate account of interest rate risk. Section 305 of FDICIA also requires the banking agencies to publish final implementing regulations by June 19, 1993, and to establish transition rules to facilitate compliance with those regulations.

The banking agencies have not met the June 19, 1993, statutory date for publishing a final rule for this section of FDICIA. This delay reflects the difficult tradeoffs the banking agencies have faced in developing and implementing a rule that provides a sufficiently accurate basis for estimating banks' interest rate risk exposures and their need for capital, yet maintains enough transparency and simplicity to allow bank management to readily determine their regulatory capital requirements. The banking agencies also are mindful of the need to avoid unnecessary regulatory burdens associated with this rule, consistent with Section 335 of the Reigle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325 (12 U.S.C. 1828 note).

**II. September 1993 Proposal****A. Proposal**

In September 1993, the banking agencies issued a proposed rule that solicited comments on a framework for measuring banks' interest rate risk exposures and determining the amount of capital needed by a bank to account for interest rate risk. See 58 FR 48206 (September 14, 1993).

The framework outlined by the banking agencies in the September 1993 proposed rule incorporated the use of a three-level measurement process to evaluate banks' interest rate risk exposures. The first measure was a quantitative screen, based on existing Consolidated Report of Condition and Income (Call Report) information, that would exempt potential low risk banks from additional reporting requirements. The exemption screen was based on two criteria: (1) the amount of a bank's off-balance sheet interest rate contracts in relation to its total assets, and (2) the relation between a bank's fixed- and floating-rate loans and securities that mature or reprice beyond five years and its total capital.

Banks not meeting the proposed exemption test would have been required to calculate their economic exposure by either: (1) a supervisory

model that measured the change in the economic value of the bank for a specified change in interest rates; or (2) the bank's own interest rate risk model, provided that the model was deemed adequate by examiners for the nature and scope of the bank's activities and that it measured the bank's economic exposure using the interest rate scenarios specified by the banking agencies.

The September 1993 proposed rule also sought comment on two alternative methods for determining the amount of capital a bank may need for interest rate risk. Both approaches proposed to focus supervisory attention and need for capital on those banks whose measured exposure exceeded a proposed supervisory threshold level.<sup>1</sup> One method (Minimum Capital Standard) proposed to establish an explicit minimum capital standard for interest rate risk. This approach would have relied on the results of either the supervisory model or banks' own models and would have required banks to have capital sufficient to cover the amount by which their measured exposure exceeded a supervisory threshold level. The second approach (Risk Assessment) proposed to use model results as one of several factors that examiners would consider when determining a bank's capital needs for interest rate risk. Under this approach, a bank's need for capital would be determined on a case-by-case basis as part of each banking agency's examination process. In determining the need for capital, examiners would consider the quality of the bank's interest rate risk management, internal controls and the overall financial condition of the bank. Banks that had measured exposures in excess of the supervisory threshold and weak interest rate risk management systems would generally be required to hold additional capital for interest rate risk.

#### B. Comments

The banking agencies collectively received a total of 133 comments on the September 1993 proposed rule. The majority of commenters were banks. Thrifts, trade associations, bank consultants, other government-sponsored agencies and other regulators also commented. The majority of commenters responded favorably to modifications that the banking agencies made from the earlier advance notice of proposed rulemaking published in the *Federal Register* on August 10, 1992.

See 57 FR 35507 (August 10, 1992). In particular, most commenters expressed strong support for using the results of banks' own interest rate risk models to determine their levels of exposure and corresponding need for capital. Commenters noted the potential inaccuracies of standardized regulatory models, such as the proposed supervisory model, as one reason for allowing the use of internal models. Internal models, they believed, would better capture the unique characteristics of individual bank portfolios. Many commenters also stated that permitting the use of internal models would provide banks with incentives to improve their internal risk measurement systems.

The vast majority of commenters also urged the banking agencies to adopt a "Risk Assessment" approach for determining capital adequacy. Among the reasons cited for this approach were concerns about the accuracy of the proposed supervisory model and the need to consider qualitative factors, such as the quality of a bank's risk management process and its ability to respond to changing market conditions, in evaluating capital. Many commenters believed that by considering such factors, the banking agencies would reward banks that have superior risk management capabilities.

Some commenters believed that the banking agencies' primary focus when evaluating the level of a bank's interest rate risk exposure should be on the exposure of the bank's near-term (one-to two-year) reported earnings, rather than on its exposure to economic value. While recognizing the importance of understanding the degree to which a bank's reported earnings are vulnerable to changing interest rates, the banking agencies have concluded that the economic value perspective more effectively identifies the risks that the bank's current business activities pose to its financial condition, its longer-term earnings and solvency, and hence the adequacy of its capital levels. Economic value measures the effect of a change in interest rates on the value of *all* future cash flows generated by a bank's current financial instruments, not just those that affect earnings over the next few months or quarters. Indeed, an earnings analysis provides information only on positions repricing within the forecast horizon, and thus would not take account of the full magnitude of risk. As a result, the effect of embedded and explicit options can be significantly understated by such an analysis. In contrast, an economic value perspective captures the effect of changing interest rates for all time periods, and offers a superior vehicle for

assessing the effect of those rate changes on positions that have option characteristics. In addition, an economic value perspective offers important insights into the effect of changing interest rates on the liquidity of a bank's assets.

Many commenters also raised common concerns about various elements of the measurement process outlined in the September 1993 proposed rule. Most commenters believe that the proposed treatment of non-maturity deposits understate their effective maturity. Others raised concerns about the accuracy of the proposed supervisory model and the appropriateness of the proposed exemption test criteria. The measurement system, proposed in today's joint policy statement, includes a discussion of these comments and incorporates a number of changes to the September 1993 proposed rule in response to commenters' concerns.

#### III. Final Rule and Two-Step Process for Establishing Minimum Capital Standards

After careful consideration of all the comments, the banking agencies have decided to implement minimum capital standards for interest rate risk exposures in a two-step process.

This final rule implements the first step of that process by revising the capital standards of the banking agencies to explicitly include a bank's exposure to declines in the economic value of its capital due to changes in interest rates as a factor that the banking agencies will consider in evaluating a bank's capital adequacy.<sup>2</sup> This final rule does not codify a measurement framework for assessing the level of a bank's interest rate risk exposure. The information and exposure estimates collected through a new proposed supervisory measurement process, described in the banking agencies' joint policy statement on interest rate risk, would be one quantitative factor used by examiners to determine the adequacy of an individual bank's capital for interest rate risk. The focus of that proposed process is on a bank's economic value exposure. Other quantitative factors that examiners will consider include the bank's historical financial performance and its earnings exposure to interest rate movements. Examiners also will consider qualitative

<sup>1</sup> A threshold level representing a decline in economic value equal to 1.0 percent of assets was proposed by the banking agencies.

<sup>2</sup> The exposure of a bank's economic value is generally the change in the present value of its assets, less the change in the present value of its liabilities, plus the change in the value of its interest rate off-balance-sheet contracts. It represents the change in the underlying economic value of the bank's capital.

factors, including the adequacy of the bank's internal interest rate risk management. Consistent with each banking agency's safety and soundness guidelines, the banking agencies expect a bank to properly manage all of its risks, including its interest rate risk, in a manner commensurate with its risk profile. Nothing in this rule is intended to diminish the importance or need for a bank to have an effective risk management system.

This final rule represents the banking agencies' adoption of the Risk Assessment approach described in the September 1993 proposed rule with the exception that, unlike that proposed rule, this final rule does not establish an explicit supervisory threshold that defines whether a bank had an above "normal" level of interest rate risk exposure. The banking agencies have concluded that it is appropriate to first collect industry data and to evaluate the level of interest rate risk exposure in the banking industry before establishing an explicit supervisory threshold above which capital would be required. It is important to note, however, that the banking agencies intend for this case-by-case approach for assessing a bank's capital adequacy for interest rate risk to be a transitional arrangement.

The second step of the banking agencies' process will be to issue a proposed rule that would establish an explicit minimum capital charge for interest rate risk, based on the level of bank's measured interest rate risk exposure. The banking agencies anticipate that the proposed policy statement on the supervisory assessment of interest rate risk will provide the foundation for the proposed rule that would propose the establishment of an explicit minimum capital requirement. The banking agencies will implement this second step at some future date, through a subsequent and separate proposed rule after the banking agencies and the banking industry have gained more experience with the proposed supervisory measurement and assessment process.

During the transitional period before the second rulemaking process is initiated, the banking agencies will work with the industry to determine what, if any, further modifications to the proposed measurement process are warranted. Such modifications may include further refinements to the supervisory model and to other criteria used by examiners to evaluate the adequacy of banks' internal models. The transition period also allows the banking agencies to collect and monitor more rigorous and consistent information on the level of banks'

interest rate risk exposures. This experience and information will assist the banking agencies in formulating a proposed rule for explicit minimum capital standards for interest rate risk.

Second 305(b)(2) of FDICIA requires the banking agencies to discuss the development of comparable standards with members of the supervisory committee of the Bank for International Settlements (BIS). The Basle Committee on Banking Supervision, under the auspices of the BIS, has been working on ways to incorporate interest rate risk into the Basle Accord on risk-based capital standards. See International Convergence of Capital Measurement and Capital Standards (July 1988). The banking agencies are participating actively in that international effort. However, the timing of any international standard for monitoring and assessing capital for interest rate risk is uncertain. Given the importance of interest rate risk to the safety and soundness of the banking industry and the mandate of section 305 of FDICIA, the banking agencies have concluded that they should not delay the implementation of this rule and measurement process until an international standard is achieved. The banking agencies will continue to work with international organizations to develop consistent international capital standards. At the time that an international agreement emerges on either a measurement system or explicit minimum capital standard, the banking agencies will revisit their rules in light of the international standard.

#### **IV. Regulatory Flexibility Act Statement**

Each banking agency has concluded after reviewing the final regulations that the regulations, if adopted, will not impose a significant economic hardship on small institutions. The final rules do not necessitate the development of sophisticated recordkeeping or reporting systems by small institutions nor will small institutions need to seek out the expertise of specialized accountants, lawyers, or managers in order to comply with the regulation. Each banking agency therefore hereby certifies pursuant to section 605b of the Regulatory Flexibility Act (5 U.S.C. 605b) that the final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.).

#### **V. Executive Order 12866**

The Comptroller of the Currency has determined that this final rule is not a significant regulatory action under Executive Order 12866.

#### **VI. OCC Response to Unfunded Mandates Act of 1995**

Section 202 of the Unfunded Mandates Act of 1995 (Unfunded Mandates Act) (signed into law on March 22, 1995) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. Because the OCC has determined that this final rule will not result in expenditures by state, local and tribal governments, or by the private sector, of more than \$100 million in any one year, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. As discussed in the preamble, this final rule will clarify the authority of the OCC to require additional capital for any significant exposure to declines in the economic value due to changes in interest rates. Under the proposed joint policy statement, the supervisory model and internal bank models will serve as supervisory tools to assist examiners in assessing capital adequacy. Any decision to require additional capital will be made on a case-by-case basis as prescribed under the current capital procedures.

#### **List of Subjects**

##### *OCC*

##### *12 CFR Part 3*

Administrative practice and procedure, Capital risk, National banks, Reporting and recordkeeping requirements.

##### *Board*

##### *12 CFR Part 208*

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

##### *FDIC*

##### *12 CFR Part 325*

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

**Comptroller of the Currency****12 CFR Chapter I****Authority and Issuance**

For the reasons set forth in the joint preamble, part 3 of chapter I of title 12 of the Code of Federal Regulations is amended as set forth below.

**PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES**

1. The authority citation for part 3 continues to read as follows:

**Authority:** 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

2. Section 3.10 is revised to read as follows:

**§ 3.10 Applicability.**

The OCC may require higher minimum capital ratios for an individual bank in view of its circumstances. For example, higher capital ratios may be appropriate for:

- (a) A newly chartered bank;
- (b) A bank receiving special supervisory attention;
- (c) A bank that has, or is expected to have, losses resulting in capital inadequacy;
- (d) A bank with significant exposure due to the risks from concentrations of credit, certain risks arising from nontraditional activities, or management's overall inability to monitor and control financial and operating risks presented by concentrations of credit and nontraditional activities;
- (e) A bank with significant exposure to declines in the economic value of its capital due to changes in interest rates;
- (f) A bank with significant exposure due to fiduciary or operational risk;
- (g) A bank exposed to a high degree of asset depreciation, or a low level of liquid assets in relation to short term liabilities;
- (h) A bank exposed to a high volume or, or particularly severe, problem loans;
- (i) A bank that is growing rapidly, either internally or through acquisitions; or
- (j) A bank that may be adversely affected by the activities or condition of its holding company, affiliate(s), or other persons or institutions including chain banking organizations, with which it has significant business relationships.

3. In appendix A to part 3, section 1, paragraph (b)(1) is revised to read as follows:

**Appendix A to Part 3—Risk-Based Capital Guidelines**

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*Section 1 \* \* \* (b) \* \* \* (1) The risk-based capital ratio derived from these guidelines is an important factor in the OCC's evaluation of a bank's capital adequacy. However, since this measure addresses only credit risk, the 8% minimum ratio should not be viewed as the level to be targeted, but rather as a floor. The final supervisory judgment on a bank's capital adequacy is based on an individualized assessment of numerous factors, including those listed in 12 CFR 3.10. With respect to the consideration of these factors, the OCC will give particular attention to any bank with significant exposure to declines in the economic value of its capital due to changes in interest rates. As a result, it may differ from the conclusion drawn from an isolated comparison of a bank's risk-based capital ratio to the 8% minimum specified in these guidelines. In addition to the standards established by these risk-based capital guidelines, all national banks must maintain a minimum capital-to-total assets ratio in accordance with the provisions of 12 CFR part 3.*

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**Office of the Comptroller of the Currency**

Dated: June 29, 1995.

**Eugene A. Ludwig,**

*Comptroller of the Currency.*

**Federal Reserve System****12 CFR Chapter II****Authority and Issuance**

For the reasons set forth in the preamble, part 208 of chapter II of title 12 of the Code of Federal Regulations is amended as set forth below:

**PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)**

1. The authority citation for Part 208 revised to read as follows:

**Authority:** 12 U.S.C. 36, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p–1, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318.

2. Appendix A to part 208 is amended by revising the fifth and sixth paragraphs under “I. Overview” to read as follows:

**Appendix A to Part 1208—Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure****I. Overview**

\* \* \* \* \*

The risk-based capital ratio focuses principally on broad categories of credit risk, although the framework for assigning assets and off-balance-sheet items to risk categories does incorporate elements of transfer risk, as

well as limited instances of interest rate and market risk. The framework incorporates risks arising from traditional banking activities as well as risks arising from nontraditional activities. The risk-based ratio does not, however, incorporate other factors that can affect an institution's financial condition. These factors include overall interest-rate exposure; liquidity, funding and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit; certain risks arising from nontraditional activities; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities.

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of those factors, including, in particular, the level and severity of problem and classified assets as well as a bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio.

\* \* \* \* \*

By Order of the Board of Governors of the Federal Reserve System.

Dated: July 7, 1995.

**William W. Wiles,**

*Secretary of Board.*

**Federal Deposit Insurance Corporation****12 CFR Chapter III****Authority and Issuance**

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is amended as set forth below:

**PART 325—CAPITAL MAINTENANCE**

1. The authority citation for part 325 continues to read as follows:

**Authority:** 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 3907, 3909, 4808; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102–242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. In appendix A to part 325, the fifth undesignated paragraph of the introductory text is revised to read as follows:

**Appendix A to Part 325—Statement of Policy on Risk-Based Capital**

\* \* \* \* \*

The risk-based capital ratio focuses principally on broad categories of credit risk, however, the ratio does not take account of many other factors that can affect a bank's financial condition. These factors include

overall interest rate risk exposure, liquidity, funding and market risks; the quality and level of earnings; investment, loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities; the quality of loans and investments; the effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risk presented by concentrations of credit and nontraditional activities. In addition to

evaluating capital ratios, an overall assessment of capital adequacy must take account of each of these other factors, including, in particular, the level and severity of problem and adversely classified assets as well as a bank's interest rate risk as measured by the bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from the conclusions that might be drawn

solely from the absolute level of the bank's risk-based capital ratio.

By order of the Board of Directors.

Dated at Washington, D.C. this 27th day of June, 1995.

Federal Deposit Insurance Corporation.

Jerry L. Langley,

*Executive Secretary.*

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