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Statement No. 68

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Statement of the Shadow Financial Regulatory Committee

on

OTS Proposal for Capital Requirement for Interest Rate Risk

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The Office of Thrift Supervision (OTS) has recently proposed changing its risk-based capital regulation to require thrift institutions to hold capital against the risk of loss from changes in interest rates. The OTS proposal would require thrift institutions to hold capital equal to 50 percent of the estimated decline in the market value of the firm's equity that would result from a 200 basis point adverse change in interest rates. The OTS requests comments on whether such a requirement should be in addition to, or should replace, components of the existing credit-risk based system.

In the view of the Shadow Financial Regulatory Committee, the lack of such a requirement has been a major shortcoming of the risk-based capital standards promulgated by the regulatory agencies. The thrift industry suffered huge losses from the extremely sharp interest rate increases of the early 1980s. We attribute much of the movement of thrift institutions into high-risk real estate investment as a direct response to their weakened financial condition brought about by the losses from adverse interest-rate movements.

The Committee welcomes the proposal as a serious attempt to deal with the very difficult problem of capital adequacy in the presence of interest-rate risk and urges the banking agencies to accelerate their efforts at developing such a requirement for commercial banks. The recent Treasury Report on "Modernizing the Financial System" also endorses adoption of such a requirement by OTS and the banking agencies.

Besides its concern about the lack of an interest-rate risk component, the Committee has two significant reservations about the existing system of capital requirements. First, the Committee believes that capital requirements should be higher than they are now (Statement No. 41, February 13, 1989). Second, the Committee believes that capital requirements should be based on market values (Statement No. 18, May 18, 1987). We support the use of market values as the base for the OTS capital calculation and we urge that this requirement be framed as an addition to existing risk-based capital requirements.

Reservations expressed about the proposed regulation relate to the details of implementation rather than the concept of requiring capital against interest-rate risk. The OTS proposal tempers conceptual aptness with considerations of practicability. One limiting factor is the availability of data with which to make the market value calculations that are essential to the proposal. It may be appropriate to increase the level of detail on the Maturity and Rate section of the Thrift Financial Report, and to experiment with other types of interest rate change.

Other criticisms of the OTS proposal have focused on the complexity of the methodology. The approach taken in the proposal makes the OTS responsible for calculating the capital requirement for each institution, using a standardized approach. While the Committee is aware of implementation problems, we urge that the proposal be adopted. Practical difficulties can be resolved over time.