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Statement of the Shadow Financial Regulatory Committee on the Need To Regulate Interest Rate Risk

February 17, 1992

The Shadow Financial Regulatory Committee is concerned that current interest rate conditions are luring some banks and thrift institutions into gambling once again on the future course of interest rates. Short-term rates have declined very substantially over the past year, while long-term rates have declined only modestly. The result has been a sharply upward-sloping yield curve. Rates on 30-year government bonds are close to 8 percent, while Treasury bills yield less than 4 percent. This situation increases reported profits of many banks and thrift institutions whose interest costs on deposits have thus far declined much more than their earnings on loans. It also offers banks an apparent opportunity to gain by borrowing short and lending long, thereby substantially increasing their vulnerability to losses from future increases in rates.

The Committee's concern is based on sound banking principles, past experience and current developments. Many banks have been hurt by adverse interest rate movements in the past. The collapse of the thrift industry is due to the industry's long-standing exposure to interest rate risk. The high interest rates that developed in the early 1980s resulted in large operating losses as deposit interest costs soared, and in a huge decline in the value of fixed-rate mortgages. Many of these institutions, responding to the perverse incentives of the deposit insurance system, moved into high-risk lending and adopted aggressive growth policies. These strategies compounded the industry's losses when real estate markets crashed. Press reports indicate that a large number of banks are now again taking on increased interest rate risk.

The Committee deplores the failure of the federal regulatory agencies to implement a capital requirement that disciplines interest rate risks. A year ago the Office of Thrift Supervision (OTS) proposed such a regulation, and that proposal was strongly endorsed by the Committee (Statement No. 68, February 11, 1991). The OTS failed to implement its proposed regulation because of opposition from the industry.

The inaction of the regulators has not escaped notice by the Congress. The FDIC Improvement Act now requires (§ 305) that the agencies include an interest rate risk measure in the risk-based capital requirement, although this requirement does not become effective for 18 months. It is unfortunate that it takes an act of Congress to get the agencies to do what historical experience and economic logic have long demanded. The regulatory agencies must accept responsibility for the consequences of their inaction if future increases in interest rates cause bank and thrift institution failures that impose additional losses on the taxpayer.

The Committee urges the regulators to lessen the risk of another deposit insurance debacle. As the OTS proposed more than a year ago, insured depository institutions should be required to hold sufficient capital to cover the effect of interest rate risk to which they expose themselves.