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**Statement of the Shadow Financial Regulatory Committee
on**

**Rule Proposed by Bank Regulators
to Control Interest Rate Risk**

September 14, 1992

In August, the federal bank regulatory agencies each proposed rules to implement an important part of Section 305 of the FDIC Improvement Act of 1991. The proposed rule responds to the requirement that risk-based capital standards be revised to account for interest rate risk. The Shadow Financial Regulatory Committee has long argued that interest rate risk should be incorporated into risk-based capital requirements and that its longstanding omission has constituted a serious and undesirable defect (e.g., Statement Nos. 68, February 11, 1991 and 82, February 17, 1992). Thus, the Committee supports actions to correct this failing.

Unfortunately, the proposed rule fails to develop either an effective measure of bank exposure to interest rate risk or an effective framework for managing supervisory responses to limit the risk exposure of the Bank Insurance Fund. The proposed framework needs to be reworked completely before it can be said to control the exposure of the Bank Insurance Fund to interest rate risk.

The proposal notes that the "measurement system is designed to minimize reporting burdens." In its pursuit of simplicity, the model advanced employs too little relevant information and makes insufficient use of

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financial theory. As a result, the model fails to fashion a truly meaningful measure of a bank's exposure to interest rate risk. It is also inferior to the model developed by the Office of Thrift Supervision for measuring interest rate risk for savings and loan associations. Indeed, the bank regulators admit that they "do not intend for it to replace other, more sophisticated procedures that banks may use in their asset and liability management process."

The proposed system collects data on the dollar amounts of some 20 major asset and liability categories on and off the balance sheet, classified into six maturity or repricing categories. Dollar amounts in each cell are multiplied by corresponding interest-sensitivity weights which represent measures of the time to repricing for each category. Values in each cell are summed to obtain an aggregate difference between risk-weighted assets and liabilities. This difference is divided by total assets to obtain a measure of the bank's overall interest rate risk (IRR). A deduction, set at 1 percent, from this IRR is then used to generate a percentage of additional tier 1 capital to be required in all cases where the IRR proves greater than one (roughly 20 percent of all banks).

The model is primitive and its assumptions are arbitrary. It focuses on the hypothetical effect of a single 100 basis-point shift upward or downward in interest rates to reserve for a bank's exposure to interest-rate risk. The single number generated as output by the bank agencies' model provides banks with little useful information with which to evaluate their exposure to the true range of possible interest-rate changes. In contrast, the OTS model measures the present value of changes in a bank's capital position for a 100 basis-point change in interest rates, covering a range of 400 basis-point movements in each direction.

The Committee urges that for each bank regulators establish a reserve for interest-induced losses and gains, to absorb whatever changes in the value of bank capital result from changes in interest rates that actually take place. It is crucial for each bank's assets and liabilities to be properly revalued as interest rates change through time and for each bank's capital position to be recalculated to take account of interest-induced gains and losses. Accurately assessing the incremental IRR capital sensitivity to future interest rate movements is of secondary significance to calculating the effect of actual movements on the

adequacy of the overall capital ratio, deficiencies in which trigger FDICIA's tripwire system of regulatory discipline. If the cumulative effect of actual interest rate movements is neglected, the trigger ratio for a bank will fail to reflect the interest-induced losses it has actually experienced.

The Committee believes that, as proposed, the new interest-rate risk standard would fail to trigger prompt regulatory response to interest-induced losses. By providing taxpayers and regulators a false sense of security, the proposed framework could do more harm than good. The model should be revised to capture the cumulative past effects, as well as the future incremental effects, of interest rate movements. Unless calculations of current capital are tied to market reality, the tripwire system can not provide taxpayers the protections they have been led to expect.