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Statement of Shadow Financial Regulatory Committee

on

The Banking Agencies' Proposed Interest Rate Risk Capital Standards

September 18, 1995

On August 2, the federal bank regulatory agencies proposed another joint policy statement on how to measure a bank's interest rate risk profile for the purpose of assessing its capital adequacy. Section 305 of the FDIC Improvement Act of 1991 (FDICIA) requires incorporating interest rate risk into a bank's capital requirements. In several past policy statements (No. 87, September 14, 1992 and No. 96, May 24, 1993), the Shadow Financial Regulatory Committee has criticized the regulatory agencies on several grounds. The Committee has deplored their failure to make the 1993 rule-making deadline specified in FDICIA, their failure to require additional capital for excessive risk exposure, their reliance on grossly inaccurate measurements of interest rate risk exposure, and their exemption of banks on the basis of size rather than risk exposure. The new proposal continues to show the low priority given by the agencies to this important assignment under FDICIA.

The Committee is disappointed that the agencies appear to have learned so little from the lessons of the past. Interest rate risk lay at the core of the S&L crisis of the 1980s that cost U.S. taxpayers some $150 billion. Although losses from interest rate risk are not a major problem in a stable interest rate environment, evidence suggests that institutions are on average exposed to losses when interest rates are volatile. Last year many banks suffered large unrealized losses in their bond portfolios when interest rates rose sharply for a brief period of time. Indeed, many of the banks that

typically assume high interest rate risk are smaller banks, which are largely exempt from the proposed regulations.

The Committee urges the agencies to move rapidly to complete the task of defining an objective capital standard for interest rate risk. Meanwhile, continuing to use the case by case approach leaves us in the same position as in the 1980s. The agencies should assign higher priority and devote additional resources to the developing of an appropriate interest rate risk model and an explicit capital standard, as the Office of Thrift Supervision has already done. The Committee believes that the banking agencies ought to complete this task by the end of this year.