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## OTS 98-32 - OTS Announces New Risk Management Guidance

Office of Thrift Supervision

# NEWS

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| FOR RELEASE at noon EDT | For further information |
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### OTS Announces New Risk Management Guidance

WASHINGTON, D.C., April 22, 1998 - The Office of Thrift Supervision (OTS) today proposed comprehensive guidance to improve risk management practices at savings associations. The guidance, covering three major risk management areas - interest rate risk, investment securities, and use of financial derivatives -- would be consolidated into a single comprehensive bulletin under a common conceptual framework. The proposed Thrift Bulletin 13a would replace seven existing OTS thrift bulletins.

OTS is also planning to replace three outmoded regulations on forward commitments, futures transactions, and financial options transactions that have remained virtually unchanged since they were first adopted during the period of 1979 to 1982. In their place, OTS would adopt a single regulation establishing general requirements applicable to all derivative instruments. The proposed regulation and bulletin are designed to work together, with the bulletin providing the kind of specific guidance that previously had been contained in the regulations.

OTS previewed its regulation and bulletin at a press briefing today.

The proposed Thrift Bulletin 13a, "Management of Interest Rate Risk, Investment Securities, and Derivatives Activities," and the accompanying proposed derivatives regulation are being published in the April 23, 1998, edition of the Federal Register. Bulletin 13a includes a description of how OTS will implement a related, final interagency "Supervisory Statement on

Investment Securities and End-User Derivative Activities" that will be published in the same issue. The three documents will be mailed to all OTS-regulated thrifts. OTS will welcome comments on its proposed regulation and bulletin. The comment period for both documents will close on June 22, 1998.

"Seeking public comment on a bulletin is an unusual step for OTS," said OTS Director Ellen Seidman. "But this indicates the importance we place not only on managing interest rate risk successfully, but also on assuring that our regulated thrifts fully understand the guidelines we will be applying to assess their risk management performance.

"Our primary goal in taking this action is to further improve OTS' safety and soundness guidance in the critical areas of managing interest rate risk and the risks associated with securities investments and end-user derivatives," Ms. Seidman said. "The reduction in regulatory burden that should flow from these proposals is also a positive."

The proposed derivatives rule would allow federal savings associations to continue to engage in transactions using derivative instruments, if the association is authorized to invest in the assets underlying the instrument and the transaction is otherwise safe and sound. State-chartered associations could continue to use derivative instruments to the extent permitted by their charter and state law, provided the transaction is otherwise safe and sound. The proposed rule makes it clear that reducing risk exposure generally should be the reason thrifts enter into a transaction using a derivative instrument. It also sets forth responsibilities of the board of directors and management with respect to financial derivatives. As of Dec. 31, 1997, OTS said 118 thrifts it regulates reported using derivative instruments with a total net present value of $674 million.

The proposed bulletin also describes the guidelines examiners would use to rate an institution's exposure to interest rate risk - the Sensitivity to Market Risk (S) component of the CAMELS rating system . Since the "S" component rating reflects an assessment of both an institution's current exposure to interest rate changes and its ability to manage that exposure effectively, OTS will use the results of its Net Portfolio Value Model, where available, to measure the institution's current exposure.

"While examiner analysis and judgment are critical in the rating process, a common set of quantitative and qualitative guidelines will serve as a useful starting point in ensuring more consistency in the assignment of ratings," said Ms. Seidman. "Moreover, such guidelines should remove a degree of uncertainty on the part of institutions about what to expect from OTS examiners in this area."

OTS is the only banking agency using a quantitative model to monitor interest rate risk exposure. "Given the complexity of today's financial institutions, it would be more difficult for OTS to evaluate the interest rate risk exposure of 1,100 plus thrifts on a consistent basis without the OTS NPV Model," Ms. Seidman added. OTS initially developed the Net Portfolio Value Model in 1991.

The proposed bulletin also calls for thrifts' boards of directors to frame their interest rate risk limits in terms of their institutions' capital position (their economic capital-to-assets ratios). Investment securities and derivatives - particularly those having the potential to alter an institution's risk profile significantly - should be evaluated in terms of their impact on the interest rate sensitivity of the institution's economic capital. Under the proposed bulletin, institutions with greater capacity to absorb potential losses, as measured in terms of the impact on their economic capital, would have greater latitude in using derivatives and other complex financial instruments than those with lower levels. Similarly, institutions evidencing greater capacity to absorb shocks to their economic capital would, all else being equal, generally receive better "S" component ratings.

The guidance in TB 13a and the new regulation would replace:

- regulations governing forward commitments (12 CFR 563.173)
- regulations governing futures (12 CFR 563.174)
- regulations governing options (12 CFR 563.175)
- Thrift Bulletin 13 -- Responsibilities of the Board of Directors and Management with

Respect to Interest Rate Risk

- Thrift Bulletin 13-1 (Implementation of Thrift Bulletin 13)
- Thrift Bulletin 13-2 (Implementation of Thrift Bulletin 13)
- Thrift Bulletin 52 (Supervisory Statement of Policy on Securities Activities)
- Thrift Bulletin 52-1 ("Mismatched" Floating Rate CMOs),
- Thrift Bulletin 65 (Structured Notes), and
- New Directions Bulletin 95-10

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The Office of Thrift Supervision (OTS), a bureau of the U.S. Treasury, regulates and supervises the nation's thrift industry. OTS' mission is to ensure the safety and soundness of thrift institutions and to support their role as home mortgage lenders and providers of other community credit and financial services.For copies of news releases or other documents call PubliFax at 202/906-5660, or visit the OTS web page at www.ots.treas.gov.

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Related Documents:
Financial Management Policies; Financial Derivatives, Proposed Rule (4/23/98)

FFIEC: Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (4/23/98)