OCC Cautions National Banks About Long-Term Interest Rate Risks

WASHINGTON – The Office of the Comptroller of the Currency issued guidance today alerting national banks to the risk management issues associated with assets and liabilities with embedded options. One example of an embedded option is the right to prepay residential mortgage loans without penalty. When rates fall, mortgage-related loans and securities typically pay down quickly as borrowers refinance at lower interest rates. When rates rise, prepayments generally slow down.

“A number of banks have chased yields in their investment portfolios by acquiring assets with embedded options, hoping to keep their earnings growing during the recent period of low interest rates and weak loan demand,” said Ms. Kathryn E. Dick, Deputy Comptroller for Risk Evaluation. “The increasing volume of options across the balance sheet has made it more important for banks to measure interest rate risk from an economic value perspective. In particular, we are concerned that some banks have locked in a disproportionate volume of their assets at the cyclical low in yields, and may have turned an earnings event into a capital event.”

Ms. Dick defined an “earnings event” as a short-term decline in earnings due to changes in interest rates. “A short-term decline in earnings doesn’t usually pose safety and soundness concerns,” said Ms. Dick. “However, when rate changes cause significant asset impairment, to the point where it has a material effect on the economic value of the bank’s equity, then this does become a safety and soundness issue which might have to be addressed with additional capital. At this point, we believe that the number of national banks with the potential for significant asset impairment is small, but rising.”

The OCC has had a longstanding policy that encourages bankers and examiners to assess interest rate risk both from a near term earnings perspective as well as a longer term equity perspective. Banks with significant holdings of financial instruments with embedded options need to focus on the economic value of their equity, which represents the present value of the expected cash inflows minus the present value of expected cash outflows.

Ms. Dick noted that the increasing presence of options in bank assets, both loans and securities, and now even liabilities, has made cash flows more unpredictable. “The rise in longer-term interest rates has had, and may continue to have, a particularly damaging effect on the values of assets with embedded options. Values decline first because interest rates are rising. As the anticipated maturities of these assets with embedded
options extend, values decline further because of the longer maturities.” Ms Dick described this phenomenon as the “negative convexity” effect.

The OCC is particularly concerned that national banks may fail to appreciate the long-term significance of impairment in asset values, because the initial impact of rising short-term rates may be positive for bank earnings. “Just because earnings rise over the near-term does not mean there isn’t an interest rate risk problem,” said Ms. Dick. “Impaired asset and economic equity values suggest a greater potential for income problems down the road.”

The guidance emphasizes that national banks should take a number of steps to identify, measure and control their exposure to interest rate risk, including:

- Evaluate assets and liabilities to ensure that management has identified all assets and liabilities with embedded options;
- Evaluate exposure to embedded options and apply limits consistent with the board’s risk tolerance;
- Verify that the tools used to measure interest rate risk are appropriate;
- Identify assets with structural weaknesses that may be particularly vulnerable to further increases in rates, and consider risk mitigation strategies if risk exceeds approved risk tolerance;
- Understand the risk to earnings and capital from a rising rate environment, using both parallel and non-parallel rate changes;
- Obtain board approval for any material investment acquisitions that layer on additional interest rate risk.

The guidance also notes that national banks contemplating the transfer of securities from available-for-sale to held-to-maturity should obtain prior approval from their boards of directors, given the significant loss of flexibility associated with that action.

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The OCC charters, regulates and examines approximately 2,000 national banks and 51 federal branches of foreign banks in the U.S., accounting for more than 56 percent of the nation’s banking assets. Its mission is to ensure a safe and sound and competitive national banking system that supports the citizens, communities and economy of the United States.