

TB 67 was rescinded 12/01/00 - obsolete

Handbook: Thrift Activities
 Subject: Interest Rate Risk Management

Section: 520
 TB 67

August 21, 1995

Modification of the Interest Rate Risk Component of the Risk-Based Capital Requirement

RESCINDED

Summary: A savings association that is subject to an Interest Rate Risk (IRR) Component under the Office of Thrift Supervision's (OTS) risk-based capital rule may be able to adjust that Component if the association can demonstrate that the OTS Net Portfolio Value Model overstates its IRR exposure. In addition, a savings association that is "well-capitalized" for purposes of Prompt Corrective Action may use IRR Components calculated by its own internal model in computing its risk-based capital requirement if its IRR model meets certain minimum standards. This Bulletin describes the procedures an institution must follow either to obtain an adjustment to an OTS-calculated IRR Component or to obtain authorization to use its own IRR model to determine its IRR Component.

For Further Information Contact: Risk Management Division, Office of Thrift Supervision, Washington, D.C., (202) 906-6861.

Thrift Bulletin 67

Background

On August 31, 1993, the Office of Thrift Supervision (OTS) issued a final rule incorporating an Interest Rate Risk (IRR) Component into the risk-based capital rule.¹ The preamble to the rule indicated that OTS would establish an appeals process to ensure that capital requirements for interest rate risk would be applied in a fair and equitable manner. On August 15, 1994, OTS issued a draft Thrift Bulletin requesting comment on a proposed appeals process. The draft Bulletin also requested comment on a proposal to allow certain savings associations to use the results of their own IRR models in computing capital requirements for interest rate risk. The comment period closed on September 15, 1994.

Part A of this Bulletin establishes the process that an institution may use to file a request to adjust its IRR Component if it believes that the OTS-calculated IRR Component overstates its IRR exposure. In this Bulletin, an appeal of an IRR Component is referred to as a "request for adjustment." This terminology

replaces the term "appeals process" used in the draft Bulletin to avoid confusion with the supervisory appeals process mandated by Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994.

Part B of this Bulletin establishes the process by which a "well-capitalized" institution may obtain authorization to use its own IRR model to determine its IRR Component.²

A request for adjustment to the IRR Component or a request for authorization to use an internal IRR model to calculate the IRR Component must be made in accordance with the following guidelines.

A. Adjustment of IRR Component

An institution may be able to adjust its IRR Component if it can demonstrate that the OTS Net Portfolio Value Model ("OTS Model") overstates its IRR exposure. To determine if an institution is eligible to request an adjustment, complete the worksheet in Appendix A, "Determining an Institution's Eligibility to Request an Adjustment to the OTS IRR Component."

Eligibility Requirements

To be eligible to request an adjustment, an institution must show that

its IRR Component, as calculated by OTS, would cause the institution to move to a lower Prompt Corrective Action (PCA) category. For example, suppose a "well-capitalized" institution receives an IRR Component that, when deducted from capital, leaves the institution with a total risk-based capital ratio of 9 percent. This institution would be eligible to request an adjustment because deducting the OTS-calculated IRR Component would cause the institution to move from the "well-capitalized" PCA category to the lower "adequately capitalized" category. The eligibility calculations are described in detail in Appendix A.

Basis for Approving Adjustments

An institution may be able to demonstrate that the OTS-calculated IRR Component is overstated if the use of more refined data or more appropriate assumptions than those used in the OTS Model results in a lower Component. Listed below are several examples of reasons for adjusting an institution's IRR Component.

1. The institution demonstrates that aggregation of data on Schedule CMR of the Thrift

¹ See 12 CFR 567.7.

² To be "well-capitalized," an institution must have at least a 10 percent total risk-based capital ratio, a 5 percent leverage ratio, and a 6 percent Tier 1 risk-based capital ratio.

Thrift Bulletin

TB 67

Financial Report results in a material overestimate of the institution's IRR Component. Because the OTS Model estimates interest rate sensitivity on the basis of aggregated data provided in Schedule CMR, the measures it produces are susceptible to aggregation error. Measuring interest rate risk on the basis of less aggregated data than that provided on Schedule CMR might in certain cases yield materially different results.

2. The institution demonstrates that the limitations of Schedule CMR do not accommodate the reporting of relevant information that, if used by the OTS Model, would result in a lower IRR Component. For example, suppose an institution holds a portfolio of adjustable rate assets that are tied to unusual indexes. Because Schedule CMR does not accommodate the reporting of data needed to value such assets, the OTS Model might materially misstate the interest rate sensitivity of those assets.
3. The institution provides documentation that shows the deposit attrition rates used by the OTS Model misstate the interest rate sensitivity of its retail deposits.
4. The institution provides documentation that shows the prepayment performance of its mortgage portfolio justifies the use of prepayment rates different from those used by the OTS Model.

Impermissible Grounds for Requesting an Adjustment

OTS believes that capital requirements for interest rate risk should be based on a uniform measurement

standard that is applied to all institutions on a consistent basis. To maintain consistency and uniformity in the assessment of capital requirements for interest rate risk, OTS will not review requests for adjustment that are based upon proposed changes to the fundamental assumptions on which the OTS Model is based.³

For example, OTS will not accept for review any request for adjustment that is based on the inclusion of the present value of potential future business that has yet to be booked. Similarly, OTS will not review requests for adjustment based on interest rate scenarios that differ from those specified by the regulation.⁴

How to Request an Adjustment

OTS provides each institution filing Schedule CMR a quarterly *IRR Exposure Report* that presents the results of the OTS Model. The Exposure Report displays the institution's IRR profile and the institution's IRR Component, if any. An institution that believes its IRR Component is overstated may, if it is eligible, request an adjustment by completing OTS Form 1586-A, "Request for Adjustment of OTS Interest Rate Risk Component." The form may be obtained from the Risk Management Division in Washington, D.C. (202) 906-6861.

Where to File. Two copies of the completed Form 1586-A should be sent to: IRR Review Committee, Corporate Activities Division, Applications Filing Room, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552. A third copy should be sent to the Regional Director in the appropriate OTS Regional Office.

When to File. Requests for adjustments must be submitted no later than six months after the quarter-

end date on which the IRR Component to be adjusted is based.

Review Process. An IRR Review Committee, established by the OTS Director, will review requests for adjustment. The decision to approve or deny each request will be delegated to the Director of the Risk Management Division, who will be the head of the Committee.

If a request for adjustment is incomplete or otherwise deficient, the IRR Review Committee will return the request to the institution with an explanation of why it has been returned. The institution may submit a revised application within the original six-month time frame. The Committee may grant extensions for good cause.

The Committee intends to review all requests within seventy-five (75) calendar days from the date of receipt of Form 1586-A. If the request is approved, the Committee will notify the institution of its revised IRR Component. If the request is denied, the Committee will provide the institution with the reason(s) for the denial.

Capital Compliance. While an institution's request for adjustment is under consideration, the institution's risk-based capital requirement will be based on the lowest of the OTS-calculated IRR Components from the previous three quarters. Any PCA restrictions that an institution becomes subject to because of

³ OTS welcomes suggestions for changes to the methodology or fundamental assumptions used in the model. Interested parties wishing to share research findings that they believe would result in IRR computations superior to those of the OTS Model may send them to the IRR Review Committee at the address provided elsewhere in this Bulletin. These submissions will not be considered to be requests for adjustments.

⁴ See 12 CFR 567.7.

Thrift Bulletin

TB 67

its capital level and PCA category will remain in effect. The only exception to this policy will be when the institution has received a deferral or waiver of its IRR Component from the OTS Director.⁵

Supplementary Data. If a request for adjustment is approved, the institution may be required to file supplementary information each quarter to enable OTS to make the appropriate adjustments to the institution's IRR Component. The institution will be notified if an approved adjustment is contingent upon the provision of supplementary data.

B. Use of Internal IRR Model to Calculate IRR Component

OTS may authorize certain "well-capitalized" institutions to use their own IRR model to calculate their IRR Component and substitute this Component for the OTS-calculated IRR Component in computing total risk-based capital ratios.

Eligibility Requirements

To be eligible for such an authorization, an institution must remain "well-capitalized" for purposes of PCA after its risk-based capital ratio is adjusted for the current, OTS-derived, IRR Capital Deduction. The IRR Capital Deduction would be determined using the lowest IRR Component from the previous three quarters. In addition, the institution must have an internal model that:

1. Calculates Net Portfolio Value (NPV) in a manner consistent with OTS's definition of NPV, although the institution need not replicate the OTS Model. NPV should include all existing assets, liabilities, and off-balance-sheet contracts. NPV should not include anticipated future business, other than anticipated roll-over of existing retail deposits.

2. Calculates NPV under instantaneous Office of Thrift Supervision

neous, parallel movements in the term structure of interest rates, as described in the IRR rule.

3. Reflects observed market interest rates and prices each quarter.
4. Uses reasonable assumptions regarding future interest rates for accounts having variable or administered rates.
5. Uses reasonable assumptions for prepayment of assets and attrition (including possible early withdrawal) of liabilities.
6. Takes account of all significant embedded options in assets and liabilities (e.g., interest rate caps and floors on adjustable rate instruments, call features on debt).⁶
7. Is used for internal risk management purposes, not just for computation of the risk-based capital ratio.

OTS reserves the right to revise these criteria and may require institutions to re-certify their models under revised criteria. Finally, institutions authorized to use their internal IRR model to calculate their IRR Component must calculate this Component in accordance with the OTS IRR rule.

How to Obtain Authorization to Use Internal IRR Model

An institution meeting the criteria described above may request authority to use its own model for the purpose of calculating its IRR Component by completing OTS Form 1586-I, "Request to Use Internal Model to Calculate Interest Rate Risk Component," which is attached to this Bulletin.

Where to File. One copy of OTS

Form 1586-I should be sent to the IRR Review Committee at the address noted above.

When to File. An institution may file OTS Form 1586-I at any time.

Review Process. An IRR Review Committee, established by the OTS Director, will review an institution's request to use its own IRR model to calculate its IRR Component. The decision to approve or deny each request will be delegated to the Director of the Risk Management Division who will be the head of the Committee.

The IRR Review Committee intends to review each request within twenty (20) calendar days of receipt. The Committee will notify the institution if additional time is needed to review the request.

Institutions will be notified of the Committee's decisions in writing. If a request is approved, OTS will issue a "no-objection" letter authorizing the institution to use its own IRR model to substitute its internally-calculated IRR Component for the OTS-calculated IRR Component. The "no-objection" letter becomes effective on the date it is issued. A "no-objection" letter does not signify OTS endorsement of an institution's model or of the model's results, nor does it eliminate the requirement to file Schedule CMR.

Rescission of a No-Objection Letter

⁵ The OTS Director may defer or waive the IRR Deduction for good cause (see Federal Register, Volume 58, Number 167, pages 45799-45827, August 31, 1993).

⁶ The level of sophistication with which the institution's model handles such options must be commensurate with the types of financial instruments in its portfolio. A mathematically sophisticated options pricing model will not usually be necessary for institutions that are not involved in explicit options contracts (such as interest rate caps, options on futures, etc.) and that do not own structured assets (such as CMOs, REMICS, step-up securities, etc.).

Thrift Bulletin

TB 67

A “no-objection” letter will be rescinded if the institution’s PCA category falls below “well-capitalized.” A “no-objection” letter may also be rescinded if: 1) there is a significant and unsupportable discrepancy between the IRR Components as calculated by OTS and by the institution; 2) a determination is

made by either OTS (*e.g.*, as a result of an examination) or the institution (*e.g.*, as a result of a material change in the way it models IRR) that the institution’s model does not meet the criteria listed above; or 3) the OTS determines that an institution’s IRR level is inconsistent with safe and sound operation.

When a “no-objection” letter is

rescinded, the institution will be notified that it is no longer eligible to calculate its own IRR Component and that, beginning with the next reporting date, it must report its total risk-based capital ratio based upon the OTS-calculated IRR Component.

Attachments



—Kenneth F. Ryder, Jr.
Executive Director of
Research and Analysis

Appendix A Determining an Institution's Eligibility to Request an Adjustment to the OTS IRR Component

To determine if you are eligible to request an adjustment to the Interest Rate Risk (IRR) Component calculated by OTS, please complete the worksheet on page 2 of this appendix.

To be eligible for an adjustment, your institution must move to a lower PCA category when the OTS-calculated IRR Component is deducted from your institution's total risk-based capital position.

For example, consider an institution that, prior to deducting the IRR Component, has (1) a total risk-based capital ratio of 11 percent, (2) a leverage ratio of 6 percent and, (3) a Tier 1 risk-based capital ratio of 7 percent. Such an institution would be considered to be "well-capitalized" under the PCA criteria if the IRR Component were not deducted. If, however, the institution's total risk-based capital ratio falls to 9 percent after deducting the IRR Component, the institution would be considered "adequately capitalized." Because the deduction of the IRR Component causes the institution to fall from the "well-capitalized" to the lower "adequately capitalized" PCA category, the institution would be eligible to request an adjustment.

If, in the above example, the institution's leverage ratio had been 4.5 percent, it would have been in the "adequately capitalized" PCA category. The institution would, therefore, not have fallen into a lower PCA category after deducting the IRR Component. Thus, even though the institution's total risk-based capital ratio decreased from 11 percent to 9 percent, it would not be eligible to file a request for adjustment.

Sources of information used in completing the worksheet are noted on each line item on the worksheet. This information is found on Schedule CCR of the Thrift Financial Report and the Interest Rate Risk Exposure Report.

In preparing the worksheet, the Schedule CCR information may be from either the quarter corresponding to the IRR Component or the following quarter. For example, suppose that, on November 30, you receive your OTS-calculated IRR Component based on September 30 data. To determine if you are eligible to request an adjustment of the September IRR Component, you would calculate the ratios described above using data from the September 30 Schedule CCR. After December 31, you would have the option of using Schedule CCR data from either the September 30 or December 31 submissions.

**Worksheet for Determining Eligibility to Request an Adjustment
to the OTS IRR Component**

To determine if your institution is eligible to request an adjustment to its OTS IRR Component, complete the following line items.

IRR Component for Quarter Ending _____.

Total RBC Ratio Before IRR Component Deduction:

- | | |
|--|----------|
| (1) Core (Tier 1) Capital (Schedule CCR, line 30) | \$ _____ |
| (2) Allowable Supplementary Capital (Schedule CCR, line 35) | _____ |
| (3) Assets Required to be Deducted (Schedule CCR, line 370) | _____ |
| (4) Total Risk-Based Capital (sum of lines 1 and 2, less line 3) | _____ |
| (5) Total Risk-Weighted Assets (Schedule CCR, line 65) | \$ _____ |
| (6) Total Risk-Based Capital Ratio
Before IRR Component Deduction ¹ (line 4 divided by line 5) | _____ % |

Total RBC Ratio After IRR Component Deduction:

- | | |
|--|----------|
| (7) Total Risk-Based Capital from Line 4 Above | \$ _____ |
| (8) IRR Component (use the OTS-calculated IRR Component
for which you are requesting an adjustment,
as shown on the IRR Exposure Report) | _____ |
| (9) Total Risk-Based Capital (line 7 less line 8) | _____ |
| (10) Total Risk-Weighted Assets (Schedule CCR, line 65) | \$ _____ |
| (11) Total Risk-Based Capital Ratio
After IRR Component Deduction ¹ (line 9 divided by line 10) | _____ % |

¹ Make appropriate adjustments for any fully-capitalized items.

**Worksheet for Determining Eligibility to Request an Adjustment
to the OTS IRR Component
(Continued)**

PCA Category Before IRR Deduction:

- (12) Total Risk-Based Capital Ratio Before IRR Component Deduction from Line 6 on Page 2 _____ %
- (13) Tier 1 RBC Ratio (do not deduct the IRR Component) _____ %
- (14) Leverage Ratio (do not deduct the IRR Component) _____ %
- (15) PCA Category Before IRR Component Deduction _____

PCA Category After IRR Deduction:

- (16) Total Risk-Based Capital Ratio After IRR Component Deduction from Line 11 on Page 2 _____ %
- (17) Tier 1 RBC Ratio (do not deduct the IRR Component) _____ %
- (18) Leverage Ratio (do not deduct the IRR Component) _____ %
- (19) PCA Category After IRR Component Deduction _____

If the PCA Category in line 15 is higher than that in line 19, you are eligible to request an adjustment to your IRR Component.

Office of Thrift Supervision
Department of the Treasury



OTS Form 1586-I

*Request to Use Internal Model to Calculate
Interest Rate Risk Component*

Office of Thrift Supervision
Instructions for Request to Use Internal Model to Calculate
Interest Rate Risk Component

To request authorization to use an internal model to calculate your institution's Interest Rate Risk (IRR) Component, submit the attached certification form to: Interest Rate Risk Review Committee, Corporate Activities Division, Applications Filing Room, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552.

To be eligible to request such authorization, your institution's total risk-based capital ratio must be at least 10 percent after the IRR capital deduction *based on OTS-calculated IRR Components*. (Your institution must also have a leverage ratio of at least 5 percent and a Tier 1 risk-based capital ratio of at least 6 percent.)

Use the worksheet on page 2 of this form to determine if you are eligible to request authorization of your model.

PAPERWORK REDUCTION ACT STATEMENT: The Office of Thrift Supervision will use this information to determine if an institution may use an internal interest rate risk model to determine its interest rate risk component. Collection of this information is voluntary.

BURDEN ESTIMATE STATEMENT: Public reporting burden for this collection of information is estimated to average 10 hours per response, including the time for reviewing instructions and completing and reviewing the collection of information. If a valid OMB Control Number does not appear on this form, you are not required to complete this form. Send comments regarding this burden estimate or any other aspect of the collection of information, including suggestions for reducing this burden, to Interest Rate Risk Review Committee, Corporate Activities Division, Applications Filing Room, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552; and to the Office of Management and Budget, Paperwork Reduction Project (1550-0084), Washington, D.C. 20503.

**Worksheet for Determining Eligibility
to use Internal IRR Model**

To determine if you are eligible to use your own IRR model, your total risk-based capital ratio should be calculated using the following line items from the Thrift Financial Report and the Interest Rate Risk Exposure Report.

Total Risk-Based Capital Ratio for Quarter Ending _____.

- | | |
|--|----------|
| (1) Core (Tier 1) Capital (Schedule CCR, line 30) | \$ _____ |
| (2) Allowable Supplementary Capital (Schedule CCR, line 35) | _____ |
| (3) Assets Required to be Deducted (Schedule CCR, line 370) | _____ |
| (4) IRR Capital Deduction ¹ (use lowest of the IRR Capital Components from the IRR Exposure Reports for the preceding three quarters) | _____ |
| (5) Total Risk-Based Capital (sum of lines 1 and 2, less lines 3 and 4) | _____ |
| (6) Total Risk-Weighted Assets (Schedule CCR, line 65) | \$ _____ |
| (7) Total Risk-Based Capital Ratio ² (line 5 divided by line 6) | _____ % |
| (8) Tier 1 Risk-Based Ratio | _____ % |
| (9) Leverage Ratio | _____ % |
| (10) PCA Category After IRR Capital Deduction | _____ |

If the PCA Category in line 10 is "well-capitalized," you are eligible to request authorization to use your own model.

¹ Determine IRR Capital Deduction as if it were in effect.

² Make appropriate adjustments for any fully-capitalized items.

Institution Name: _____

Docket No. _____

Request to Use Internal Model to Calculate Interest Rate Risk Component

The institution named above requests that the Office of Thrift Supervision authorize it to use its internal model to calculate its Interest Rate Risk (IRR) Component. I certify that the IRR model to be used by the institution for this purpose meets the criteria set forth in the section "Eligibility Requirements" of Thrift Bulletin 67, "Modification of the Interest Rate Risk Component of the Risk-Based Capital Requirement."

Signature of Officer Authorized to Certify
Institution's Interest Rate Risk Model

Date

Printed Name

Title