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**Rate-risk plan would require decisions.**

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A Federal Reserve proposal would incorporate interest rate risk into the risk-based capital adequacy standards. The Fed would require banks to raise additional capital if they have more than a "normal" amount of interest rate risk exposure.

The plan would mean new decisions for banks in reporting and structuring their loan portfolios and deposit liabilities.

The Fed reasons that declining interest rates hurt a bank with assets that reprice faster than liabilities, because asset yields may decline relative to funding costs. For a bank with more interest-sensitive liabilities than assets, rising rates may reduce net interest income by increasing the cost of funds relative to yield on assets.

Under the proposal, a bank would place a value on each asset, liability, and off-balance-sheet liability based on its price sensitivity to 1% changes in interest rates.

The net risk-weighted position would then be the amount of assets minus the sum of its liabilities and off-balance-sheet positions.

Spotting Serious Threats

The system is not meant to be precise, but is intended to identify serious threats to a bank's financial condition and to the financial system as a whole. The Fed notes that the capital required as a result of high interest rate risk exposure could increase if internal controls and management are not in place.

The Fed would also review qualitative factors such as asset/liability policies, procedures, systems, and management expertise.

A bank would allocate interest-bearing assets and liabilities, demand deposits, and off-balance-sheet items into one of six time bands on the basis of remaining maturity or next repricing date.

The Fed has chosen "duration analysis" to calculate the effect of interest rate risk fluctuations on capital. The higher the present value of the cash flow of a bank's assets and liabilities, the lower the "duration" of the instrument and the less subject to interest rate risk changes the loan is deemed to be.

A Focus on Fluctuations

Duration analysis serves regulators best because it looks at the immediate effect of rate fluctuations on the market value of capital and focuses more on the availability of capital and its preservation at a specific time.

By contrast, most banks use gap analysis. This crude, outdated method for measuring the mismatch gap is based on the assets and liabilities scheduled to mature or reprice within certain time frames.

A more sophisticated measure is simulation analysis, which calculates the level of future net interest income under different rate scenarios and thereby reflects the future impact of interest rate fluctuations. This is unlike static duration analysis, which focuses on the immediate capital impact.

Risk Categories

The banking agencies would make assumptions regarding maturities, cash flows, coupon rates, and yields on assets and liabilities rather than requiring the banks to report coupon data.

Banks would weight the instruments by risk as:

\* Amortizing instruments that pay both principal and interest periodically.

\* Nonamortizing instruments that involve periodic payments of interest and the payment of principal at maturity.

\* Deep-discount instruments with either no periodic interest payments (zero coupons and other securities quoted on a discount basis) or interest coupons of less than 3%.

\* All liabilities.

Interest bearing instruments not covered would be treated as nonamortizing. Projected prepayments on amortizing instruments would be incorporated in the risk weightings by employing standard assumptions and market expectations. Mortgage derivative products, however, would be categorized as either "high risk" or "nonhigh risk."

Core deposits (demand, NOW, money-market, and savings) have indefinite maturities and can be seen as either very short-term funds or as a stable funding source. For this reason, the Federal Reserve proposes to specify the longest maturity range in which each type of core deposit may be allocated and the maximum amount of core deposits that could be placed in a maturity range.

Time Bands for Core Deposits

Banks would place core deposits into time bands based on assumptions and experience, except that:

\* Cash balances and an equal amount of core deposits would be placed in the shortest time band.

\* Money-market, NOW, and demand deposit account balances would be distributed across the first three time bands with no more than 30% of these balances in the two- to three-year time band.

\* Savings account balances would be distributed across the first four time bands with no more than 30% in the three- to seven-year time band.

Banks would be required to cover "excess" exposure with Tier 1 capital. Subordinated debt (a significant component of Tier 2 capital for U.S. banks) cannot be used, because it is incorporated into measurement of interest rate risk exposure. The Tier 1 capital allocated for rate risk would not be available to meet other risk-based capital requirements.

Using the Futures Market

A bank with a mismatch in assets and liabilities posing high interest rate risk could adjust to the Fed's proposed system by entering the futures market to minimize the risk at the call report date, when reporting of interest rate risk is required.

The next day, the bank could allow its interest rate risk to rise again, by reversing its futures position. However, the Fed would generally expect a bank to maintain adequate capital at all times to cover risk exposure.

Banks should focus on whether they would prefer to report their own anticipated cash flows or average lives on certain types of assets, rather than reporting data based on an instrument's remaining contractual maturity or its next repricing date. Assets with higher cash flows would have a lower risk weighting.

Take the case of a bank that is above the "normal" level of interest rate risk and has assets of only one type (loans of three-year maturity paying 12% interest), while the Federal Reserve assumes an interest of 10% for such assets.

The 12% loan would have a higher present value based on cash flows and should, if evaluated independently under duration analysis, receive a lower risk weighting.

Such a bank would be forced to maintain more capital (as if all its loans were at 10%) rather than the less risky weigh 12% loan should be assigned.

To minimize capital requirements in this scenario, a bank should book only loans with an interest rate no higher than the assumed rate - which, having a lower present value of cash flows, would otherwise be assigned a higher risk weighting. The bank could then take advantage of the Fed's assumptions on cash flows in relation to interest rate risk.

Theoretically, the system may also affect a bank's making loans with equity kickers (that is, interest payments based on profitability of the borrower) in addition to or in lieu of interest.

Because the interest rate portion of the loan may be lower (since the equity kicker is an "unidentifiable cash flow"), such a loan would have a longer duration and therefore would receive a lower risk weighting.

This might encourage banks to make more loans with equity kickers with an interest rate portion or at the rate assumed by the Federal Reserve.

The Fed believes these aberrations will not occur - because a bank portfolio will average out to the Federal Reserve's assumptions, the reporting burdens will be less, and the information provided will still show the relative capital strength of banks with respect to interest rate risk exposure.

But a system that may be efficient from a supervisory perspective may encourage restructuring of loans to take advantage of the capital rules.

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