TB 36-1 was rescinded 3/13/90 by TB 36-2 Attachments A and B. Click HERE to link to TB 36-2

Handbook: Thrift Activities
Subjects: Capital Adequacy

Section: 320
TB 36-1

December 14, 1989

Guidelines on Interest, Prepayment, and Loan Origination Rates

RESCINDED

Summary: This Bulletin offers further guidance on the interest rates, prepayment rates, and loan origination rates that may be used for financial projections contained in capital plans.

For Further Information Contact: Your District Office or the Supervision Policy Division of OTS, Washington, D.C.

Thrift Bulletin 36-1

Purpose:

This Bulletin provides guidance on the interest rates, prepayment rates, and loan origination rates that may be used in preparing financial projections contained in a saving association's capital plan.

Background:

Thrift Bulletin 36 (TB 36), "Guidelines for FIRREA Capital Plans, Exemptions, and Exceptions," issued on November 6, 1989, indicated that the financial projections provided in any savings association's capital plan should be based on the continuation of existing interest rates and regional economic conditions. This Bulletin provides further guidelines on interest rates, prepayment rates, and loan origination rates that may be used in preparing financial projections contained in a saving association's capital plan.

Interest Rate:

Presently, TB 36 requires financial projections to be based on existing interest rates. TB 36 does not specify the date of the "existing interest rates" on which financial projections should be based. To simplify and streamline the review process, the recommended "as of" date for interest rates used in the initial projections should be November 6, 1989. District Directors may approve capital plans from savings associations that have already prepared capital plans using interest rates as of a different date, but such plans should be based on interest rates that are not materially different from those that prevailed on November 6, 1989. Capital plans submitted after January 8, 1990, should be based on interest rates prevailing as of the last business day of the quarter ending prior to the date of submission.

TB 36 requires financial projections to be based on existing interest rates in order to ensure that such projections are not overly optimistic. The use of existing rates is also consistent with economic theory. It is generally agreed that existing interest rates and the existing term structure of interest rates reflect market participants' expectations about future interest rates. Accordingly, we believe that there is strong support for requiring financial forecasts to be based on current interest rates and the implied interest rate forecast embedded in the yield curve.

To facilitate the financial projections review process, we have presented in Table 1 an implied interest rate forecast (the one-month Treasury Bill rate and the five-year Treasury spot rate) that was derived from the Treasury yield curve that existed during the week of November 6, 1989. The rates presented represent a market forecast of interest rates through the fourth quarter of 1994. Interest rates used in capital plans should be conservatively estimated to avoid overstating an institution's prospects. In no event should an institution use rates that provide greater benefit than the rates implied by the November 6, 1989 yield curve that are presented in Table 1 (or rates implied by subsequent quarter-end yield curves). Yields on incremental assets and rates paid on incremental liabilities should be based on the implied rate forecast for Treasuries plus an appropriate spread to compensate for risk or more conservative assumptions.

As a general rule, spreads on incremental assets and liabilities should be consistent with those prevailing in the market in early November (or those prevailing at subsequent quarter-end dates) and should remain constant throughout the forecast period.

For example, during the week of November 6, new fixed rate mortgages were priced at about 9.25 to 9.75 percent, roughly 135 to 165 basis points above the five-year zero coupon Treasury rate that prevailed at that time. (The spread over the five-year Treasury rate is used because five years is a good approximation of the duration of 30 year mortgages.) Although the actual basis point spread over the five-year Treasury spot rate will change over the forecast period, it is difficult, if not impossible, to project accurately the direction or magnitude of change. Consequently, capital plan forecasts should be based on the assumption that spreads will remain constant over the forecast period. Therefore, fixed-rate mortgage loans that are projected to be booked in the fourth quarter of 1990 should be priced at approximately 135 to 165 basis points over the five-year zero coupon rate for that quarter (7.5%), or at 8.85 to 9.15%.

With the exception of rates offered on passbook savings accounts, short-term funding rates used in financial projections should not be permitted to fall below the one-month Treasury bill rates shown in Table 1. Short-funding rates used should be based on an appropriate spread above the projected one-month Treasury rate. Similarly, projected interest rates on incremental long-term funding should exceed the projected five-year Treasury rates in Table 1 by a spread that fully reflects the type of funding and the credit quality of the issuer.

Table 2 provides a list of selected interest rates that prevailed on November 6, 1989 and that can be used as benchmarks for determining spreads on selected assets and liabilities.

Prepayment Rates:

TB 36 is silent with regard to the appropriate selection of prepayment rates for financial projections. The speed at which loans prepay is a critical factor in estimating future net interest income. Clearly, the arbitrary selection of unreasonably favorable assumptions can result in overly optimistic earnings projections. To reduce the opportunity for potential abuse in this area, savings associations, in preparing financial forecasts, should use projected prepayment rates that reflect the market's consensus estimate of prepayments for similar loans. Various market monitoring sources and the mortgage research departments of many investment banking firms publish estimates of anticipated prepayment rates. For mortgages and mortgage-related securities, consensus estimates that are based on an average of the long term prepayment projections of several major investment banking firms would generally be acceptable.

Loan Originations:

Projected volumes of loan originations used in capital plan forecasts should be conservative and should be based on the institution's recent loan origination experience, taking into consideration current national and regional economic conditions and, if appropriate, any seasonality in originations.

Going forward, this Office intends to provide quarterly up-dates of Tables 1 and 2, and selected information on prepayment rates that may be used by OTS district personnel in reviewing capital plans.

Attachments

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TABLE 1

PROJECTED SHORT-TERM AND
LONG-TERM TREASURY
RATES BASED ON YIELD CURVE
(As of the week of November 6, 1989)

PERIOD		ONE-MONTH TREASURY BILL RATE	5-YEAR ZERO COUPON TREASURY RATE
1989:	Q4	8.0	7.9
1990			
	Q1	7.6	7.8
	Q2	7.3	7.7
	Q3	7.2	7.6
	Q4	7.0	7.5
1991			
	Q1	6.9	7.5
	Q2	6.8	7.4
	Q3	6.7	7.3
	Q4	6.6	7.3
1992			
	Q1	6.5	7.3
	Q2	6.4	7.2
	Q3	6.4	7.2
	Q4	6.3	7.2
1993			
	Q1	6.3	7.1
	Q2	6.3	7.1
	Q3	6.3	7.1
	Q4	6.3	7.1
1994			
	Q1	6.3	7.2
	Q2	6.3	7.2
	Q3	6.4	7.2
	Q4	6.7	7.3

TABLE 2

SELECTED INTEREST RATES
(As of November 6, 1989)

Commercial Paper

30 Days	8.65%
60 Days	8.65
90 Days	8.55

London Interbank Offered Rates (LIBOR)

One Month	8.75%
Three Months	8.13
Six Months	8.56
One Year	8.50

Certificate of Deposit

One Month	8.00%
Two Months	8.00
Three Months	7.46
Six Months	7.83
One Year	7.72

Corporate Bonds

1-10yr. High Quality	9.01%
1-10yr. Med. Quality	9.52
10+yr. High Quality	9.18
10+yr. Med. Quality	9.80
High-Yield Corporate	14.26

Other Rates

3-month T-Bill	7.86%
Prime Rate	10.50
Federal Funds	8.75