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Administrator of National Banks

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Contact: Kevin Mukri
(202) 874-5770

OCC Cautions National Banks on "Yield Chasing"

WASHINGTON -- The OCC issued guidance today alerting national banks to the potential risk to future earnings and capital that arises when banks engage in "yield chasing" – taking on higher levels of credit, interest rate and liquidity risk to boost returns on their investment portfolios.

The OCC has observed a number of recent cases in which national banks have taken unwarranted levels of risk to offset declining portfolio yields resulting from prepayments and bond redemptions. The guidance warns banks that as their tolerance for investment risks increases, they need to enhance their risk management framework accordingly.

"While still small, the number of banks with risk-management weaknesses in their investment portfolios has been steadily rising," said Kathryn E. Dick, Director for Treasury and Market Risk. "Our goal is to prevent situations where structural positions built up in the investment portfolio become a drag on earnings for years to come."

In the new guidance, the agency reminded banks about supervisory requirements for several types of securities:

- Non-rated securities: The OCC emphasized that banks must have a documented analysis that supports their determination that the security is the credit equivalent of investment grade, a requirement for the security to be a permissible investment holding.
- Complex asset-backed securities: The OCC cautioned banks to conduct appropriate due diligence before purchasing complex asset-backed security structures and to consider the impact of such purchases on the bank's capital and earnings under a variety of possible default scenarios.
- Lower-rated securities: The OCC cautioned banks to supplement credit ratings from credit rating agencies with internal credit analysis when assuming credit exposures at the lower end of investment grade.

With respect to interest rate risk, the agency cautioned banks about price sensitivity risks of callable securities with long final maturities. It also alerted banks to the reappearance of "range notes," a type of structured note that is highly sensitive to changes in interest rates which has not been used since the early 1990s. Range notes have a high coupon as long as a market index remains below a specified level or within a specified range, but a zero percent coupon if it does not.

The OCC advised national banks to review the volume of their earning assets with embedded short options and establish appropriate limits to control the severity of future problems associated with rapidly changing interest rates.

The OCC also addressed trust preferred stocks, a high yielding security that combines both a high degree of credit and interest rate risk. The agency emphasized that because of these higher risks, banks must have appropriate prudential controls, including minimum quality and diversification requirements, and limits on the percentage of capital allocated to this asset class.

The guidance also addressed two newer asset classes the OCC has seen in national bank portfolios. It cautioned banks that equity-linked CDs, while providing potentially large returns, could also have a zero percent economic return. Therefore, banks interested in this product should adopt very conservative limits. The OCC reemphasized existing guidance that requires banks to have a legitimate insurance need when purchasing bank owned life insurance (BOLI) contracts.

“Our examiners will be spending more time looking at bank investment portfolios and assessing whether risk profiles are consistent with the bank’s capacity to measure, manage and control risk,” said Ms. Dick. “We are looking for a balance here and we’ll discuss our concerns with bank management where we believe they have approached outlier status.”

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