Office of Thrift Supervision
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This document and any attachments are superseded by OCC 2012-2.

March 26, 2004

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Scott M. Albinson

SUBJECT: Risk Management Practices in the Current Interest Rate Environment

Background

The current interest rate environment presents significant asset-liability management challenges for the thrift industry. Since the beginning of the year, the 10-year Treasury rate has fallen almost 60 basis points while the three-month Treasury rate has remained virtually unchanged. Similarly, the cost of a 30-year, fixed-rate mortgage has declined from 5.85 on January 1, 2004 to 5.37 on March 17, 2004, a decrease of 48 basis points.

The decline in mortgage rates has triggered a notable increase in refinance activity. The Mortgage Bankers Association Refinance index closed at 1117.1 for the week ending March 12, 2004, the highest level since July 2003. A sizable portion of this new loan demand is for adjustable rate products, including hybrid mortgage loans such as 5/1s and 10/1s. The changing economic environment has also placed considerable pressure on credit spreads, which are at the tightest levels in years.

The liability side of the balance sheet is also presenting its own unique set of issues. Many of you are wrestling with questions such as: Is now an appropriate time to lock in long-term funding? Are structured advances worth the risk? What's the true effective duration and value of my nonmaturity deposits?

Given this volatile interest rate environment, it may be difficult for you to find acceptable investment products, design effective asset-liability management strategies and address operational issues, such as properly adjusting staffing levels.

Clearly, there is no one right strategy for all institutions under all circumstances. A strategy that works well under one interest rate scenario may prove disastrous for another. For example, in recent years, we have noticed a growing number of consultants and Wall Street firms pitching a variety of balance sheet leveraging strategies, sometimes involving both structured assets and liabilities. When analyzing the relative attractiveness of these strategies, many of you hastily assumed that interest rates wouldn't change. Needless to say, this assumption proved disastrous for some institutions. In many cases, the assets acquired in connection with these leveraged strategies prepaid or were called and thrifts were forced to re-invest these proceeds in lower yielding assets. As a result, the overall returns associated with these leveraging strategies were greatly diminished.

With today's interest rate environment, we believe it is an appropriate time for you to assess how your institution's current strategy, or any new strategy you are contemplating, is likely to perform under a variety of scenarios.

Scenario Analysis

Simulations should be performed from both an economic value perspective and an earnings perspective and should fully consider the effect of embedded options. Earnings analysis is important because it can provide you with a better understanding of how overall financial results will change if, for instance, gains on mortgage loan sales are curtailed or if the cost of short-term funding increases. Armed with such information, you will be better prepared to trim expenses or take other types of preventative measures as soon as the economic environment begins to change.

For simulation purposes, the OTS's NPV model uses parallel interest shocks of +/-100 basis points, +200 basis points to estimate changes in the market value of equity. This approach is generally adequate for regulatory purposes and for small, noncomplex institutions. For larger institutions and for institutions that have a high concentration of complex securities, however, we strongly encourage you to perform more rigorous types of scenario analyses, such as nonparallel shocks to the yield curve. In conducting scenario analysis, you should try to envision a worst-case situation. For instance, if your institution has a high concentration of callable products and short-term borrowings, you may want to consider a scenario where short-term rates rise while long-term rates fall. The drop in long-term rates may accelerate prepayments and the rise in short-term rate will increase your cost of funds. This will adversely impact both sides of the balance sheet.

Examiner Concerns

In coming months, examiners will be looking closely at each institution's risk management process. In general, they will be looking to see if you fully understand the sources of risk in your investment and loan portfolios. Of particular concern is interest rate risk. There is growing evidence within the industry that many firms are opting to purchase longer-term assets in order to take advantage of the steep yield curve. Although such products offer relatively attractive yields, they carry a higher degree of interest rate risk. While a product with a high degree of interest rate risk is not inherently bad, any excessive concentration of risk – whether interest rate risk, credit risk, liquidity risk, or prepayment risk – will be considered unsafe and unsound.

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As part of our evaluation of the risk management process, examiners will also be looking at how well firms are positioned to deal with a potential fall-off in fee income or gains-on-sale. Institutions should assess overall profitability levels given the prospect of a substantial reduction in noninterest income.

Examiners are being instructed to consider earnings and net interest margin in light of the overall risk profile of the institution, its business strategy, and the current economic environment. Examiners will not necessarily criticize thrifts for being conservative or reducing their risk exposure, even if such actions result in reduced profitability. In fact, in some situations the more appropriate strategy may be to de-leverage or shrink the balance sheet rather than obtain higher returns by taking on additional levels of risk.

Risk Management Guidance

Thrift Bulletin 13a provides a discussion of some important elements of an effective risk management program. You should review this document and re-familiarize yourself with our expectations in this area. Below is a summary of some key points in that bulletin.

Board and Senior Management Oversight

- The board of directors should approve broad strategies and major policies relating to market risk management and ensure that management takes the steps necessary to monitor and control market risk. The board of directors should be informed regularly of the institution's risk exposures.

- Senior management should ensure that institution operations are effectively managed, that appropriate risk management policies and procedures are established and maintained, and that the resources are available to conduct the institution's activities in a safe and sound manner.

Lines of Responsibility and Authority for Managing Market Risk

- Institutions should identify the individuals and/or committees responsible for risk management and should ensure there is adequate separation of duties in the key elements of the risk management process to avoid potential conflicts of interest. Institutions should have a risk management function (or unit) with clearly defined duties that is sufficiently independent from its position-taking function.

Adequate Policies and Procedures

- Institutions should have written policies and procedures governing investments and derivatives activity. Those policies should: identify the employees authorized to conduct investment and derivatives activities, their lines of authority, and their responsibilities;

identify the types of authorized investments; and define, where appropriate, position limits and other constraints on each type of authorized investment and derivative instrument.

Investments and Derivatives Activity

- The use of financial derivatives should be limited to transactions and strategies that lower an institution's interest rate risk profile.

- Prior to undertaking any *significant transaction*, management should conduct an analysis of the incremental effect of the proposed transaction on the interest rate risk profile of the institution. The analysis should show the expected change in the institution's net portfolio value (with and without the proposed transaction) assuming an immediate parallel shift in the yield curve of +/-100 and +/-200 basis points. A *significant transaction* is defined as any transaction that might reasonably be expected to increase an institution's sensitivity measure by more than 25 basis points.

If you have any questions about the information in this document, please feel free to contact your regional capital markets specialist or Scott Ciardi, Economic Analysis Division, at (202) 906-6960.

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