RESCINDED

Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

Director

August 15, 1994

Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

MEMORANDUM FOR CHIEF EXECUTIVE OFFICERS

FROM: Jonathan L. Fiechter Jonathan L. Fiechter
Acting Director

SUBJECT: Thrift Bulletin on Interest-Rate Risk Appeals, Certification, and Petitioning Processes

Your comment is requested on the attached proposed Thrift Bulletin on the appeals, certification, and petitioning processes for the interest-rate risk component of the risk-based capital requirement. This proposed Bulletin was developed pursuant to the final interest-rate risk rule of August 31, 1993, which stated that the Office of Thrift Supervision (OTS) "intends to establish an appeals process" to ensure that the IRR component is applied in a fair and equitable manner. (The proposed Bulletin will not appear in the *Federal Register*.)

The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have published proposed rules to incorporate interest-rate risk components in the risk-based capital requirements of commercial banks and expect to finalize these rules during the next year. Once the banking agencies' regulations are finalized, all Federally-insured financial institutions will be subject to an interest-rate risk capital requirement.

Attachment

Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

Request for Comment on Appeals, Certification, and Petitioning Processes for the Interest-Rate Risk Component of the Risk-Based Capital Rule

OTS seeks comment on the attached proposed Thrift Bulletin on the appeals, certification, and petitioning processes for the interest-rate risk component of the risk-based capital rule. This proposed Bulletin describes when an institution can (1) appeal its component and the criteria for an acceptable appeal; (2) apply for the abbreviated certification process; or (3) petition to change the methodology used in the OTS interest-rate risk model.

Dates: Comments must be received on or before September 15, 1994.

Addresses: Send comments to Director, Information Services Division, Public Affairs, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552, Attention Docket 94-149. These submissions may be hand submitted to 1700 G Street N.W., from 9 A.M. to 5 P.M. on business days or they may be sent by facsimile transmission to (202) 906-7755. Submissions must be received by 5 P.M. on the day they are due in order to be considered by the OTS. Late-filed, misaddressed or misidentified submissions will not be considered. Comments will be available for inspection at 1700 G Street, N.W., from 1:00 P.M. until 4:00 P.M. on business days. Visitors will be escorted to and from the Public Reading Room at established intervals.

For Further Information Contact: Bob Kazdin, Senior Project Manager, (202) 906-5759; Ed Irmler, Senior Project Manager, (202) 906-5730; or Anthony G. Cornyn, Deputy Assistant Director for Policy, (202) 906-5727.

Request for Comment

While OTS is interested in receiving comments on all aspects of the proposed Thrift Bulletin, comment is specifically invited on the following issues:

(1) Aside from an abbreviated certification process that would be available to certain highly capitalized institutions, OTS is proposing initially to accept and process appeals only from institutions most adversely affected by the interest-rate risk component; that is, only those institutions that move to a lower Prompt Corrective Action (PCA) category as a result of the imposition of an interest-rate risk (IRR) component would be permitted to appeal. Is this limitation too strict? If so, how should it be modified?

(2) An institution is given six months after the end of the quarter on which the appealed IRR component is based to submit an appeal. Also, OTS has sixty days to review an appeal once an institution's record is deemed complete. Are the timetables for submission and review of an appeal reasonable?

(3) Are the certification standards required of highly capitalized institutions wishing to rely on their own IRR models sufficient and appropriate?

Paperwork Reduction Act

The proposed Thrift Bulletin provides guidance for submission of an appeal of an institution's interest-rate risk component. Institutions that submit an appeal will be required to do so using OTS Form 1586 (see Attachment), which is currently being reviewed for approval by the Office of Management and Budget.

Thrift Bulletin

Handbook: Thrift Activities
Subject: Interest-Rate Risk Appeals, Certification, and Petitioning Processes

Section: 420
TB ___

Appeals, Certification, and Petitioning Processes for Interest-Rate Risk Component of the Risk-Based Capital Rule

Summary: This Bulletin describes when an institution can (1) appeal an interest-rate risk component and the criteria for an acceptable appeal; (2) apply for the abbreviated certification process; or (3) petition to change the methodology in the OTS interest-rate risk model.

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

Thrift Bulletin ____

Background

On August 31, 1993, the Office of Thrift Supervision (OTS) issued its final rule concerning the interest-rate risk component of the risk-based capital requirement (the "IRR component"). The preamble of the final rule states that OTS will provide for the establishment of an appeals process to ensure that the IRR component is applied in a fair and equitable manner.

This Bulletin establishes three methods by which savings associations may obtain authorization to deviate from the interest-rate risk methodology prescribed and currently in use by OTS. First, an institution may appeal its IRR component using the appeals procedures described below. Second, an abbreviated certification process is available for certain highly capitalized institutions. This certification process may result in authorization for the institution to calculate its own interest-rate risk component for regulatory purposes. Finally, an institution may petition OTS to change the methodology used in the OTS model.

A. The Appeals Process

Grounds for Filing and Approving an Appeal

To be eligible to submit an appeal, an institution must show that it would move to a lower Prompt Corrective Action (PCA) category as a result of the imposition of the interest-rate risk component. This criterion is designed to limit use of the appeals process to those institutions that are most adversely affected by the interest-rate risk component and to minimize the cost of processing appeals. To determine whether an institution moves to a lower PCA category, the institution should calculate its risk-based capital ratio based on the credit risk component from its most recent Thrift Financial Report, with and without the appealed IRR component.

In general, an appeal will be approved only in those circumstances in which the institution can show the accuracy of OTS's estimate of its IRR exposure can be significantly improved through the use of (1) more refined data or (2) more appropriate assumptions than those used in the OTS Net Portfolio Value (NPV) Model. Below are examples of some reasons for approving an appeal:

1. The aggregation of data on Schedule CMR results in a significant misestimate of the institution's IRR component. For instance, Schedule CMR collects a single weighted average remaining maturity for all government securities. Their individual remaining maturities may range from one month to twenty years or more. By collecting information separately on short-term and long-term securities, a more accurate valuation of these securities could result.
2. The limitations of Schedule CMR prevent an institution from reporting additional information on existing assets, liabilities, or off-balance-sheet contracts that, if taken into account by the OTS Model, would likely result in a more precise estimate of the institution's IRR exposure. For instance, Schedule CMR does not collect information about interest-rate floors on multifamily and nonresidential mortgages. Thus, an institution that owns significant amounts of such mortgages could have its interest-rate sensitivity misestimated.
3. The institution provides compelling statistical evidence that demonstrates that the attrition rates used by the OTS Model significantly misestimate the interest-rate sensitivity of the institution's retail deposits.

4. The institution provides compelling statistical evidence that the prepayment performance of its mortgage portfolio justifies the use of prepayment estimates different from those used by OTS.

OTS believes that the regulatory capital requirements for interest-rate risk should be based on a uniform measurement standard that applies to all institutions on a consistent basis. For this reason, certain fundamental assumptions on which the NPV Model is based will not be subject to appeal.

For example, the Model defines Net Portfolio Value to include the economic value of existing assets, liabilities, and off-balance sheet contracts; it excludes "franchise value" associated with potential future business that has not yet been booked. Appeals based on the premise that such future business should be included in the OTS definition of Net Portfolio Value will not be accepted for review. Similarly, OTS determines an institution's IRR component based on the specific interest-rate scenarios specified in the OTS capital regulation (12 CFR Part 567, Section 567.7). An appeal that is based on different interest-rate scenarios will not be acceptable.

Process for Appealing IRR Component

Content of Appeal. If an institution believes it meets the criteria described in the section, "Grounds for Filing and Approving an Appeal," it may file an appeal of its IRR component. The appeal should contain the following elements:

1. A completed OTS Form 1586 (see attached) that identifies the line items on the IRR Exposure Report that are being contested. OTS Form 1586 should present the OTS estimates and the institution's estimates of the present values of those line items in the relevant interest-rate scenarios. The institution should recalculate its IRR component using its own estimates for the line items being appealed.

2. For each line item identified in OTS Form 1586, the institution must provide an explanation of why its estimates should be used in place of OTS's estimates. The explanation must include a thorough description of the institution's method of calculation, data inputs, and relevant assumptions.

Where to File. Appeals should be sent to: IRR Appeals Committee, Corporate Activities Division, Applications Filing Room, Office of Thrift Supervision, 1700 G Street, NW, Washington, D.C. 20552. A copy of the appeal should also be sent to the Regional Director in the appropriate Regional Office.

When to File. An institution must submit its appeal no later than six months after the end of the quarter on which the appealed IRR component is based. An exception to this time limit is provided for the December 31, 1993 component and March 31, 1994 component, where the deadline for submission of an appeal is December 31, 1994.

Appeals Committee Review. A committee (hereafter, referred to as the "IRR Appeals Committee") established by, and acting under authority delegated by, the OTS Director will review all appeals. The IRR Appeals Committee will review each appeal to determine its completeness and whether the grounds for an appeal exist. The IRR Appeals Committee will have twenty (20) calendar days from the date of receipt of the appeal to make these determinations. The Committee reserves the right to extend this review period when several appeals are received at the same time.

If the appeal is not complete or does not meet the grounds for submission, the IRR Appeals Committee will return the appeal to the applicant with an explanation of why it has been returned, including a description of additional information needed by the IRR Appeals Committee to consider the appeal. If the institution does not resubmit its appeal with the requested information within the time frame defined above in the "When to File" section, the appeal will be considered withdrawn. Under extenuating circumstances, the IRR Appeals Committee may grant an extension.

If the record is complete and grounds for an appeal are acceptable, the IRR Appeals Committee will notify the institution and will review the appeal to determine whether to approve or deny it.

The IRR Appeals Committee will have sixty (60) calendar days from the date that the appeal record is deemed complete to take action on the appeal and to respond in writing to the applicant.

If the appeal is approved, the IRR Appeals Committee will notify the institution and revise its IRR capital component. If the appeal is denied, the IRR Appeals Committee will notify the institution that no change will be made to its IRR component.

Capital Compliance During Appeal. During the period in which an appeal is under consideration by OTS, the institution will remain subject to its regulatory capital requirement based on the OTS-computed IRR component and the institution must comply with any applicable PCA sanctions. The only exception to this rule is when the institution has received a deferral or waiver of its IRR component from the OTS Director.

Institutions Operating Under Successful Appeals

If an appeal is approved, it may be necessary for the institution to file supplementary information with Schedule CMR each quarter to enable OTS to make the appropriate adjustments to the institution's IRR component. The IRR Appeals Committee will specify the appropriate supplementary information that the appellant must file. If the appellant does not file the necessary information, OTS may withdraw its approval of the appeal.

B. Certification Process for Highly Capitalized Institutions

Certain institutions that are highly capitalized will be eligible to seek authorization to calculate their own IRR component. This certification process is intended to give qualified institutions a strong incentive to develop and maintain a high quality IRR management and measurement capability.

To be eligible to avail itself of the certification process, an institution must (1) have a risk-based capital ratio of at least 12 percent after making the IRR capital deduction as calculated by OTS; and (2) certify that it uses an internal interest-rate risk measurement model that meets the following criteria. The institution's IRR model must:

1. Calculate the IRR component and capital deduction as described in the IRR rule and in the Thrift Financial Report (TFR) Instruction Manual — Schedule CCR.
2. Calculate Net Portfolio Value (NPV) in a manner consistent with the OTS's definition of NPV.
3. Include in NPV all existing assets, liabilities, and off-balance sheet contracts. Anticipated future business, other than anticipated roll-over of existing retail deposits, should be excluded.
4. Calculate NPV under instantaneous, parallel movements in the term structure of interest rates as described in the IRR rule.
5. Reflect observed market interest rates and prices each quarter.
6. Use reasonable assumptions regarding future interest rates for accounts having variable or administered rates.
7. Use reasonable assumptions for prepayment of assets and attrition (including possible early withdrawal) of liabilities.
8. Account for all other significant embedded options in assets and liabilities (e.g., interest rate caps and floors in adjustable rate instruments, call features on debt).
9. Be used for internal risk management purposes, not just for computation of the risk-based capital ratio.

An authorized Officer of the institution must certify that the institution's model complies with the criteria described above and must request authorization to use the institution's own model to complete its IRR component. This certification must be submitted to the IRR Appeals Committee at the address noted above. OTS will determine within 20 calendar days of receipt of the certification whether to object to the institution's use of its own model.

If OTS objects to the institution's use of its own model, the agency will notify the institution in writing that its request has been denied with an explanation of why it has been denied. If OTS does not object, it will issue a "no-objection" letter to the institution. The effect of a no-objection letter will be to permit the institution to substitute its own IRR capital deduction for the amount calculated by OTS. (This deduction is reported on line CCR-380 of Schedule CCR of the TFR.)

A no-objection letter does not signify OTS approval or endorsement of an institution's internal model or of its results, nor does it eliminate the requirement that the institution file Schedule CMR of the TFR each quarter. An institution may rely on its no-objection letter unless and until OTS notifies it in writing that the no-objection letter has been revoked.

OTS reserves the right to revise the criteria for certification of the model from time to time and to require institutions wishing to continue to rely on their own models to certify that the model in question meets these revised criteria.

Grounds for Revocation of a No-Objection Letter

OTS may revoke a no-objection letter if: 1) there is a significant 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 other review) 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 certification criteria listed above; or 3) the OTS determines that an institution's continued use of its own model is inconsistent with safe and sound operation. A no-objection letter will be automatically revoked if the institution's RBC ratio, calculated using the OTS-calculated capital deduction, falls below 12 percent in any quarter.

C. Petitioning for a Regulatory Methodological Change

An institution may petition OTS to change the methodology used in the OTS Model. Such petitions will not be considered appeals.

The OTS IRR rule and NPV Model were developed through notice and comment rulemaking and any revisions will be made in the same manner. In the case of a petition for a methodological change to the NPV Model, the institution must submit sufficient statistical evidence or research findings to demonstrate that an alternative methodology will produce IRR computations superior to those of the NPV Model. The institution should submit a letter to: Risk Management Division, Office of Thrift Supervision, 1700 G Street, NW, Washington, D.C. 20552. The letter should describe the nature of the proposed methodological change and why the change would be an improvement. Any proposed reporting changes to Schedule CMR should also be described.

OTS will review the evidence and findings submitted by the institution. If OTS believes the proposed methodology has merit, OTS may issue a proposed amendment to its capital rule for public comment.

Office of Thrift Supervision
Instructions for Preparing Appeals Submission for Interest-Rate Risk Capital Component

An institution that wishes to appeal its interest-rate risk (IRR) capital component must submit the attached form and send it and any supporting information to: Interest-Rate Risk Appeals Committee, Corporate Activities Division, Applications Filing Room, Office of Thrift Supervision, Washington, D.C. 20552.

The following items in Section 1 of the attached form must be provided for an appeal to be considered for review:

- Institution name and docket number.
- Institution address.
- Name and phone number of contact person at institution.
- The institution's risk-based capital ratio based on the credit risk component from its most recent Thrift Financial Report, with and without IRR component deducted.
- Date appeal is submitted to OTS.
- The OTS present value estimates for total assets, total liabilities, and total off-balance sheet items under three scenarios for changes in interest rates: -200 basis points[1], no change, and +200 basis points.
- The institution's present value estimates for total assets, total liabilities, and total off-balance sheet items under the same three scenarios stipulated in the above paragraph. In calculating these totals, the institution should replace with its own estimates <u>only</u> the particular OTS present value estimates for the line items being appealed.
- The Net Portfolio Value of the institution's portfolio as estimated by OTS and as estimated by the institution, using the three interest-rate scenarios.
- The change in Net Portfolio Value as estimated by OTS and the institution for the -200 and +200 basis point scenarios. The change is calculated by subtracting the base case Net Portfolio Value from the values in each of the -200 basis point and +200 basis point scenarios.
- The capital component based on the OTS' estimates and on the institution's estimates. The capital component is calculated as one-half of the difference between the institution's "Measured IRR" and 2 percent, multiplied by the present value of its assets. The "Measured IRR" is defined as the decline in the institution's Net Portfolio Value, as a percent of assets, due to a plus or minus 200 basis point shock in market interest rates, whichever results in the lower NPV. If the Measured IRR is less than 2 percent, the capital component is zero.

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1. When the 3-month Treasury rate falls below four percent, the -200 basis point scenario is replaced by one in which interest rates decline by an amount equal to one-half the 3-month Treasury rate.

Office of Thrift Supervision
Instructions for Preparing Appeals Submission for Interest-Rate Risk Capital Component

The following information, in Section 2 of the form, must be provided for each line item being appealed. Extra copies of the page may be attached, if necessary.

- The outstanding principal balance of the line item being appealed. For off-balance sheet items, report the notional principal amounts. For mortgages serviced for others, report the outstanding balance of mortgages being serviced.
- The OTS-estimated present value for the line item in the three relevant interest-rate scenarios.
- The institution's own estimates for the line item in the three scenarios.
- The difference between the OTS' and the institution's estimates in each scenario.

The rationale for appealing each line item listed in Section 2 must be included in Section 3. Be sure to include the name of each line item, as it appears on the OTS Exposure Report. The rationale should include:

- A discussion of why the institution believes its own estimates of the economic value and rate sensitivity of the line item are more accurate than the OTS estimates.
- A detailed technical description of the institution's valuation method, discussing thoroughly all equations used to project relevant cash flows (including those for prepayment and deposit attrition) and to calculate *discount factors*.
- Documentation of the sources of any current market or historical data used.

In Section 4 of the form, an authorized Officer of the institution must certify that the information in the form is true and correct.

PAPERWORK REDUCTION ACT STATEMENT: The Office of Thrift Supervision will use this information to assess the merit of a savings association's appeal of its interest-rate risk component. If the appeal is approved, the information subsequently provided will be used to maintain the appeal. Collection of this information is voluntary.

BURDEN ESTIMATE STATEMENT: Public reporting burden for this collection of information is estimated to average 90 hours for the initial response and 10 hours for maintaining the appeal, including the time for reviewing instructions and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of the collection of information to Interest-Rate Risk Appeals 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-XXXX), Washington, D.C. 20503.~~

Institution Name: ______________________ Docket No. ______________

Section 1: Interest-Rate Risk Appeals Submission: Summary Page for Quarter Ending ________

Address: ***(Including Street, City, State and Zip Code)***	**Date Submitted:**
	RBC Ratio with IRR Component Deducted:
Contact: **Phone Number:** ***(Including Area Code)***	**RBC Ratio without IRR Component Deducted:**

		Interest Rate Scenarios (Dollars in Thousands)		
		-200 b.p.1/	Base Case	+200 b.p.
Total Assets	OTS Estimates			
	Institution Estimates			
	Difference			
Total Liabilities	OTS Estimates			
	Institution Estimates			
	Difference			
Total Off-Balance Sheet (OBS)	OTS Estimates			
	Institution Estimates			
	Difference			
Net Portfolio Value (NPV)	OTS Estimates			
	Institution Estimates			
	Difference			
Change in NPV	OTS Estimates			
	Institution Estimates			
	Difference			

Capital Component	OTS Estimate	
	Institution Estimate	
	Difference	

1/ When the 3-month Treasury rate falls below four percent, the downward interest-rate shock is equal to one-half of the 3-month rate.

Institution Name: ____________________ Docket No. ______________

Section 2: Interest-Rate Risk Appeals Submission: Line Items Being Appealed for Quarter Ending ______

		Interest Rate Scenarios		
Line Items Being Appealed	Principal Balance	-200 b.p.1/	Base Case	+200 b.p.
Item ____: OTS Estimates				
Institution Estimates				
Difference				
Item ____: OTS Estimates				
Institution Estimates				
Difference				
Item ____: OTS Estimates				
Institution Estimates				
Difference				

1/ When the 3-month Treasury rate falls below four percent, the downward interest-rate shock is equal to one-half of the 3-month rate.

(Attach continuation pages, if necessary)

Institution Name: ______________________ Docket No. ____________ Page _____ of _____

Section 3: Interest-Rate Risk Appeals Submission: Rationale for Appealing Line Item for Quarter Ending _______

Rationale for Appeal of Line Item ____: ______________________________

(Name of Line Item from IRR Exposure Report)

(Attach continuation pages, if necessary)

Institution Name: ______________________ Docket No. ____________ Page _____ of _____

Section 4: Interest-Rate Risk Appeals Submission: Certification by the Authorized Officer for Quarter Ending _____

I do hereby certify that the information in this form is true and correct to the best of my knowledge.

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Signature of Officer Authorized to Sign Report

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Date