AL 95-1
Subject: Interest Rate Risk

TO: Chief Executive Officers of all National Banks, OCC Department and Division Heads, and all Examining Personnel

PURPOSE

The OCC wants to ensure that all national banks prudently manage their interest rate risk exposures. Given the growing complexity of many commercial banking activities and changes in the interest rate environment, it is an appropriate time to reiterate our expectations, described in Advisory Letter 90-1 and expanded upon in Banking Circular 277, regarding banks' interest rate risk management practices.

REFERENCE

This advisory letter replaces and supersedes Advisory Letter 90-1, on interest rate risk, dated January 2, 1990.

BACKGROUND

Interest rate risk is the potential adverse impact of interest rate movements on an institution's net income and economic value. Advisory 90-1 alerted bankers to our expectations regarding the prudent management of interest rate risk and the need to have capital available to support exposures. We recognized that appropriate risk measurement systems and related management controls would vary depending on the nature and complexity of a given bank's activities. Similarly, we noted that the development and implementation of effective systems would take time.

During the past five years, national bank managers have improved their interest rate risk management systems. In particular, many institutions have evolved from measuring risk via simple re-pricing ("gap") reports to using simulation models to quantify and control the amount of short-term earnings that may be at risk under various interest rate scenarios. Many bankers also have developed or enhanced the ways they measure and control the exposures arising from their medium- and long-term positions. This is often accomplished by projecting the cash flows of significant on- and off-balance sheet positions and deriving their economic values in the current interest rate environment, as well as estimated values under alternative interest rate scenarios.

Despite the progress that has occurred, the OCC continues to encourage banks to implement sufficient interest rate risk management processes. We are most concerned that institutions with material medium- and long-term positions measure and monitor the impact of changes in interest rates on the value of these positions and on the future performance of the bank. Such changes are generally not captured by short-term earnings-at-risk measures.

Shifts in national banks' on- and off-balance sheet structures along with changes in the interest rate environment have heightened our concerns. The value of many banks' medium- and long-term instruments are highly sensitive to changes in the interest rate environment, and such sensitivity can be heightened for those instruments that contain option features -- e.g., the possibility of loan prepayments or the withdrawal of deposit funds. In addition, financial instruments such as CMOs, structured notes, credit card lines, indexed CDs, and off-balance sheet derivative instruments have increased the means by which banks can provide financial services and have given banks more tools for risk management. The complexity of many of these instruments, however, makes it more difficult to determine the sensitivity of their values to changes in interest rates.

OCC POLICY

The OCC expects all national banks to have effective interest rate risk management processes. An effective interest rate risk management process should consist of the same fundamental principles used for the management of other financial risks. These principles are: risk identification, measurement, monitoring and control. Specifically, the OCC expects bankers to have risk management practices that ensure:

Adequate Risk Measurement

Risk measurement systems should be able to identify and quantify the major sources of a bank's interest rate risk exposure on a timely basis. The OCC expects all national banks to have systems that enable them to measure the amount of earnings that may be at risk to changes in interest rates. Bank managers at banks that have significant medium- and long-term positions should be able to assess the longer-term impact of changes in interest rates on the earnings and capital of the bank. The appropriate method for assessing a bank s longer-term exposures will depend upon the maturity and complexity of the bank s assets, liabilities, and off-balance sheet activities and can range from gap reports covering the full maturity range of the bank's activities to economic value of equity measurement systems and simulation models.

The measurement of potential interest rate risk is largely assumption driven. Accordingly, the primary objective of an interest rate risk measurement system is to determine the direction and magnitude of exposure rather than to search for a precise measure.

Bank management should also periodically review the reasonableness and accuracy of the major assumptions used in their risk measurement systems. This review should include an assessment of the impact of those assumptions on the bank's measured exposure. These major assumptions and their impact should be reviewed by the Board of Directors or a committee thereof on, at least, an annual basis.

Effective Risk Monitoring

Senior management and the Board or a committee thereof should receive reports on the bank's interest rate risk profile at least on a quarterly basis, but more frequently as appropriate for the bank's level of risk and the potential that the level of risk could change significantly given the current characteristics of the bank and the interest rate environment.

These reports should allow senior management and the Board or a committee thereof to evaluate the amount of interest rate risk being taken, compliance with their established risk tolerance, and whether management's actions are appropriate in light of the Board's expressed risk tolerance.

Effective Risk Control

It is the responsibility of the Board and senior management to understand and control the interest rate risk exposure of their institution. The Board's tolerance for interest rate risk exposure should be clearly communicated to senior management. Senior management and the Board should establish clear lines of responsibility for measuring and managing risk exposures. They should also ensure that adequate resources are provided to implement effectively a risk management framework consistent with safe and sound practices. The Board and senior management are responsible for ensuring that the bank maintains sufficient capital to support the level of interest rate risk exposure.

An effective interest rate risk management process is an essential component of safe and sound banking practices. National banks should implement interest rate risk management practices consistent with the bank's current level of exposure as well as its potential exposure in reasonably foreseeable interest rate scenarios; for some banks this may mean measuring and controlling both their earnings and economic value at risk. The OCC believes that national banks which continue to adopt and refine their interest rate risk management practices will be better positioned to meet new opportunities successfully in an increasingly competitive and evolving banking environment.

Please feel free to contact the Senior Deputy Comptroller for Capital Markets Staff at (202) 874-5670 or the Chief National Bank Examiner's Office at (202) 874-5070 with any questions or comments.

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