

# RESCINDED



Office of Thrift Supervision  
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

Director

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Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

## TO THE CHIEF EXECUTIVE OFFICER OF EACH SAVINGS ASSOCIATION

In recent months, there has been considerable controversy about the use of financial derivatives -- futures, options, and swaps -- by federally-insured financial institutions. Although OTS has not adopted any new safety and soundness measures relating to derivatives, we thought it would be useful to reiterate our supervisory approach with respect to the use of these products by savings associations and to review the major initiatives that OTS has taken to address the risks associated with derivatives.

The financial derivatives used by thrifts are almost exclusively interest rate risk management tools. For this reason, OTS believes it is essential to assess the use and misuse of these products in the context of an institution's overall interest rate risk exposure. Over the past few years, OTS has taken a number of initiatives to address concerns about interest rate risk in the thrift industry. As a by-product of addressing those concerns, we believe that we have also addressed many of the concerns that have surfaced about the improper use of derivatives. The most important of these initiatives are highlighted below:

**Policies and Procedures.** In 1989, OTS issued Thrift Bulletin 13 which requires all savings associations to set interest rate risk exposure limits and requires certain institutions to have interest rate risk models. The bulletin also emphasizes the importance of adopting effective interest rate risk policies and procedures.

**Surveillance and Monitoring.** In 1991, OTS began using a model developed by our Risk Management Division to measure and monitor the interest rate risk exposure of savings associations. The model employs scenario analysis, also known as "stress testing," to estimate how changes in interest rates affect the financial condition of individual thrifts. In measuring interest rate risk, the model takes into account the effects of derivatives on an institution's overall risk profile. The model uses, as input, information that is provided on Schedule CMR of the Thrift Financial Report.

**Interest Rate Risk Exposure Reports.** Each quarter, the OTS model generates customized interest rate risk exposure reports on individual savings associations. The reports are sent to the savings associations to use as a management tool and are also used by OTS examiners to analyze the exposure of individual institutions. The reports provide information on the level of interest rate risk inherent in an institution's portfolio of assets, liabilities, and off-balance-sheet items, including derivatives. Among other things, this information can be used by management to assess whether derivative contracts are being used to reduce or increase their institution's interest rate risk exposure over a range of interest rate scenarios.

**Comprehensive Data Collection Effort.** In March 1993, Schedule CMR of the Thrift Financial Report was modified to capture more refined information on derivatives. The reporting schedule employs a unique coding system that allows institutions to report detailed information on nearly 300 different types of derivative instruments. As a result of this new system, OTS can estimate the present value of an institution's portfolio of derivatives by contract type.

**OTS Model Enhancements.** In March 1993, OTS updated its interest rate risk model to utilize the expanded information on derivatives noted above. With this new information, the Exposure Reports now display the OTS model's present value estimates of an institution's portfolio of derivatives over a range of interest rate scenarios.

**Capital Requirements.** On August 31, 1993, OTS amended its risk-based capital requirements to take account of interest rate risk. Under the new rule, the results of the OTS interest rate risk model are used to determine the interest rate risk capital requirements of savings associations. Because the OTS model explicitly takes derivatives into account in measuring an institution's interest rate risk exposure, we believe the new rule provides proper incentives with respect to the use of derivatives by savings associations.

**Handbook Chapter on Derivatives.** The Thrift Activities Regulatory Handbook, which was recently distributed, includes a separate chapter on derivatives. That chapter contains guidelines that should be adhered to by savings associations that use derivatives to manage and control risk.

Derivatives can be useful risk management tools. They often provide a means to lower risk exposure with more precision, greater efficiency, and at a lower cost than is possible with on-balance-sheet instruments. However, derivatives can be a source of risk, particularly if they are used for speculative purposes or if they are used improperly. It should be apparent that any institution that uses derivatives should have a thorough understanding of the products and should have policies and procedures in place governing their use. Institutions that do not have the technical expertise to understand these products and monitor their performance should not use them.

Enclosed is a copy of my recent testimony on derivatives before the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance.

We would be interested in any comments you might have on derivatives in general or on OTS' policies and procedures with respect to these instruments. Comments should be directed to Anthony G. Cornyn, Deputy Assistant Director, Risk Management Division, on (202) 906-5727.

Sincerely,

  
Jonathan L. Fiecht  
Acting Director

Enclosure



Testimony  
of

Jonathan Fiechter, Acting Director

Office of Thrift Supervision

concerning

Derivatives Safety and Soundness

before the

Subcommittee on Financial Institutions  
Supervision, Regulation and Deposit Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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Office of Thrift Supervision  
Department of the Treasury

1700 G Street N.W.  
Washington D.C. 20552  
202•906•6288

## INTRODUCTION

Good morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on H.R. 4503, the "Derivatives Safety and Soundness Supervision Act of 1994."

As you know, the explosive growth of derivative financial instruments has drawn attention to the implications of derivatives for the banking system and the financial markets. The dialogue on these issues by public officials, private market participants and the press has been intensive and very healthy. It has helped to "demystify" the world of derivatives and to highlight the benefits as well as the potential risks of these instruments. More importantly, the dialogue has prompted regulators to examine these activities closely and has spurred dealers and end-users to initiate voluntary improvements to their risk management practices.

Over the last several years, the OTS has taken an aggressive, proactive regulatory approach to the management and control of interest rate risk in the thrift institutions that we supervise. We believe that our interest rate risk program also effectively addresses many of the concerns that members of this Subcommittee and others have voiced in the public dialogue about derivatives.

None of the savings associations supervised by OTS acts as a derivatives dealer. Savings associations are end-users of derivatives: they use these products as hedges to manage interest rate risk. As past history of the thrift industry demonstrates all too clearly, effective interest rate risk management is crucial to the safe and sound operation of savings

associations. Therefore, we do not want to discourage their appropriate use as vehicles for interest rate risk management. While I believe that legislation is not necessary at this time, in general the goals of the proposed legislation are consistent with our own interest rate risk program.

#### **BENEFITS OF DERIVATIVES**

Thrifts are in the business of making residential mortgage loans and taking retail deposits. A primary concern of thrift managers is how to manage the interest rate risk generated by these activities. In general, financial institutions wishing to reduce their exposure to interest rate risk do so by altering the composition of their assets and liabilities. For example, an institution that wants to reduce its exposure to rising interest rates might attempt to adjust the liability side of its balance sheet by replacing short-term borrowings with long-term borrowings. Or, it might adjust the asset side of its balance sheet by replacing long-term fixed rate assets with shorter-term or variable rate assets.

Adjusting the mix of assets and liabilities, however, can be a time-consuming, expensive, and cumbersome way to manage interest rate risk exposure and may not be practical during some phases of the business cycle. Alternatively, an institution can adjust its risk exposure -- with more precision, greater efficiency, and often at a lower cost -- by entering into off-balance-sheet transactions with derivatives.

Derivatives also can enhance the ability of financial institutions to serve their customers' needs. For example, derivatives make it easier for lending institutions to offer borrowers the types of loans they want. The 30-year fixed-rate

mortgage is a case in point. Over the last several years, many borrowers have preferred 30-year fixed-rate mortgages over 15-year or adjustable-rate mortgages. However, a fixed-rate mortgage carries considerably greater interest rate risk to lending institutions -- particularly in an environment of increased interest rate volatility. Derivatives allow lenders to cope more efficiently with the risks of holding fixed-rate mortgages by enabling them to transfer some of the risk to others.

The enormous size of the derivatives market reflects the broad range of applications for these products, as well as their acceptance by financial institutions, institutional investors, and corporate treasurers. It is a healthy market -- a global market created and dominated by American financial institutions. And it is a clear example of how the creativity and flexibility of our financial system can create a new industry that is a vibrant part of the nation's economy.

#### **RISKS OF DERIVATIVES: REGULATORY ISSUES**

As with technologically advanced products in other sectors of the economy, the benefits that attend increased use of derivatives are accompanied by challenges for dealers, end-users, and regulators.

Perhaps the most daunting of these challenges is coping with possible systemic risk -- the risk that a mishap in the derivatives market could precipitate a major disruption of the financial system. A frequently mentioned worst-case scenario is that the default of a major derivatives dealer or counterparty could cause other dealers and counterparties to fail, which in turn could set off a chain reaction of failures throughout the

global financial community. As you know, central bankers, other regulators, and market participants are continuing their efforts to ensure that such scenarios remain financial fiction.

The problem of systemic risk arises principally in connection with the activities of institutions that act as dealers in derivatives. As I mentioned at the outset, OTS-supervised thrifts are not derivatives dealers. Their role as end-users of these products presents many other regulatory challenges, however. Meeting these challenges is the focus of the OTS interest rate risk program.

Our primary concern is that derivatives not be used by thrifts for speculation -- a term I use here to refer to the practice of leveraging risk. Put simply, while derivatives offer new ways to reduce risk, they also offer new ways to speculate. Although speculators play a useful role by bearing risks that others are unwilling to bear, OTS does not believe that savings associations, whose liabilities are ultimately backed by the United States government, should be permitted to take excessive or undue risk with derivatives or any other financial instrument. We, therefore, have focused our supervisory attention on ensuring that thrift institutions make appropriate use of derivatives.

Because derivatives are complicated instruments, sophisticated expertise is necessary for their appropriate use. Like any other financial product, derivatives may result in loss to the investor. Any financial instrument, from a U.S. Treasury bond to the most exotic derivative, can be misused. The potential for problems is obviously heightened if thrift managers lack adequate training and experience. Even a well-intentioned institution may use inappropriate products or inadvertently incur greater risk than is prudent unless it is staffed by persons with the necessary skill.

Thus it is critical that there be management understanding and oversight of derivatives activities that is commensurate in scope and complexity with the activities undertaken and the risks assumed. Most thrifts that use derivatives tend to use "plain vanilla" interest rate swaps. Arguably, these are less complex than a 30-year fixed-rate mortgage which contains an embedded option that permits the homeowner to prepay the loan at any time. Nevertheless, the world of derivatives is relatively new and unfamiliar, and is constantly expanding, with new products appearing daily. The lexicon of derivatives is arcane, the theoretical foundation that underlies these products is complex, and the techniques that are used to measure and monitor derivative exposure are very sophisticated.

Finally, without internal controls, prudent policies and sufficient procedures in place at the institution to effectively monitor, analyze and control the thrift's derivatives activities, losses are more likely to occur. Moreover, comprehensive disclosure reporting systems must be available to both institutions and regulators for collecting data and analyzing risks.

#### **OBJECTIVES OF H.R. 4503**

In H.R. 4503, you, Mr. Chairman, along with Chairman Gonzalez and Congressman Leach, have recognized the risks that are posed by the use of derivatives. H.R. 4503 presents an option for a comprehensive framework to address these risks. Among other things, the legislation would:

- o Direct regulators to establish principles and standards relating to capital, comprehensive risk management standards, regulatory examinations, risk

protection and adequate management supervision and oversight over derivatives activities by financial institutions;

- o Make it an unsafe and unsound practice as a matter of law for an institution to engage in derivatives activities without an appropriate management plan and internal controls in place or without sufficient oversight by directors;
- o Permit regulators to establish a comprehensive disclosure reporting system providing the information needed to measure properly the risks associated with the use of derivatives by financial institutions; and
- o Require that the affected agencies undertake derivatives regulation as a joint or coordinated effort.

We fully support each of these objectives and believe that we have regulations or policies in place that are designed to achieve similar goals. Therefore, we believe legislation is not necessary at this time.

#### **THE OTS INTEREST RATE RISK PROGRAM**

A primary focus of OTS' efforts to monitor and supervise thrifts' use of derivatives is through an Interest Rate Risk (IRR) program. Our goal is to determine whether an institution's interest rate risk management program has been effective, and how derivatives activity affects the institution's overall interest rate risk exposure. Financial derivatives -- swaps, options and futures -- are used by thrifts as interest rate risk management

tools. Therefore, rather than evaluating specific derivatives gains or losses in a vacuum, our supervisory focus has been to assess the use of derivatives from a more global perspective.

o **Adoption of Standards to Ensure Appropriate Use of Derivatives**

On August 31, 1993, OTS amended its risk-based capital requirements to take account of interest rate risk. Under the new rule, the results of the OTS interest rate risk model will be used to link the interest rate risk exposure of an institution to its regulatory capital requirements. The OTS model explicitly takes derivatives into account in measuring an institution's interest rate risk exposure. We believe that explicitly incorporating interest rate risk into capital requirements provides further incentives for savings associations to use derivatives to manage and reduce interest rate risk -- not to create new risk.

o **Requirement for Adequate Management Expertise**

Since 1989, OTS has had a thrift bulletin (TB-13) in place that states that the board of directors is responsible for ensuring the prudent management of an institution's interest rate risk and the adoption of safe and sound management practices. It emphasizes the importance of having directors ensure that an institution's policies and procedures are at a level of sophistication commensurate with the institution's activities and portfolio. It also establishes the need for periodic review and oversight by management and the board of directors.

### o Requirement for Adequate Internal Controls

TB-13 requires savings associations to set interest rate risk exposure limits and requires large institutions (those with assets in excess of \$500 million or who hold high-risk mortgage-derivative products) to have interest rate risk models. The Bulletin also emphasizes the importance of adopting effective interest rate risk policies and procedures. Failure to adopt and implement adequate policies and procedures would be considered an unsafe and unsound practice.

### o Comprehensive Reporting and Disclosure Requirements

The OTS requires extensive quarterly reports from thrifts (Schedule CMR of the Thrift Financial Report) to collect information that has enhanced our ability to monitor the use of derivatives by savings associations. This reporting schedule employs a coding system that allows institutions to report detailed information on nearly 300 different types of derivative instruments. With this information, OTS can estimate the present value of an institution's portfolio of derivatives by contract type. (The filing of Schedule CMR is voluntary for small savings associations -- those with assets of less than \$300 million -- that have risk-based capital ratios in excess of 12 percent. Nonetheless, the majority of these "exempt" thrifts have voluntarily chosen to file the quarterly report.) Among those institutions that file Schedule CMR, 85 reported positions in interest rate swaps, 65 reported positions in interest rate options (including interest rate caps and floors) and 12 reported positions in futures.

Since 1991, OTS has had an interest rate risk model that uses, as input, information that is collected on Schedule CMR to

produce Interest Rate Risk Exposure Reports. The model employs scenario analysis, also known as "stress testing," to estimate how changes in interest rates affect the financial condition of individual thrifts. In measuring interest rate risk, the model takes into account the effects of derivatives on an institution's overall risk profile.

Each quarter the model is used to generate customized Interest Rate Risk Exposure Reports. The Exposure Reports include OTS' estimates of the interest rate sensitivity of the institution's assets, liabilities, and off-balance-sheet contracts, including derivatives, under nine different interest rate scenarios. Among other things, this information can be used to assess whether derivative contracts are being used to reduce or increase an institution's interest rate risk exposure over the range of interest rate scenarios. These reports are forwarded to the savings associations to use as a management tool and are provided to OTS supervisory and examination personnel to use in analyzing the exposure of individual institutions.

**o Coordinated Supervision and Regulatory Policies and Practices**

The OTS fully supports and has participated in ongoing efforts among the financial institution regulatory agencies to achieve the goal of effective and appropriate derivatives regulation. While we are not formally a member of the Working Group on Financial Markets, we have participated in staff discussions of issues that affect our supervision of thrifts. We are a member of the Bank Interagency Derivatives Task Force, and have worked with other regulators in that group to improve Derivative reporting and disclosure.

**CONCLUSION**

Futures, options, swaps and other derivatives can be efficient and effective risk management tools. In fact, most depository institutions that have successfully used them have done so to reduce risk. In so doing they have also reduced the risk to the Federal deposit insurance funds. For this reason, we must be careful to avoid creating an environment that discourages savings associations, or any financial institution, from using valuable and legitimate risk reduction tools for fear that their use will invite undue regulatory scrutiny. At the same time, however, institutions that do not understand how to use these products should not use them and thrifts should never use them to speculate.

Mr. Chairman, that concludes my testimony. I would be pleased to address any questions you may have.