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DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 563

[No. 98-116]

RIN 1550-AB13

**Financial Management Policies;
Financial Derivatives**

ACTION: Final Rule.

SUMMARY: The Office of Thrift Supervision (OTS) is issuing a final rule on financial derivatives. The final rule permits savings associations to engage in transactions involving financial derivatives to the extent that these transactions are authorized under applicable law and are otherwise safe and sound. In addition, the final rule describes the responsibilities of a savings association's board of directors and management with respect to financial derivatives. Elsewhere in today's Federal Register, OTS is publishing a Thrift Bulletin that provides supplemental supervisory guidance on the use of financial derivatives.

EFFECTIVE DATE: This final rule is effective January 1, 1999. OTS will not object if an institution wishes to apply this final rule beginning [insert date of publication].

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SUPPLEMENTARY INFORMATION:

I. Background

OTS's current regulations on financial derivatives were first adopted over fifteen years ago.¹ These regulations have remained virtually unchanged, notwithstanding the development of new financial derivative instruments. On April 23, 1998, OTS proposed a comprehensive revision of these outmoded regulations.²

¹ 44 FR 29870 (May 23, 1979)(Forward commitments); 46 FR 36832 (July 16, 1981)(Futures transactions); 47 FR 36625 (August 23, 1982)(Financial options).

² 63 FR 20252 (April 23, 1998).

One of the goals of the proposed rule was to address the broad range of financial derivative transactions in which thrifts may currently engage. The current regulations address three types of financial derivatives: forward commitments, futures transactions and financial options transactions. See 12 CFR 563.173, 563.174 and 563.175. The current rules, thus, do not address all of the derivative instruments that have been developed over the past twenty years. Significantly, these rules do not address interest rate swaps, a derivative instrument that thrifts commonly use to address interest rate risk.

The overriding goal of the proposed rule, however, was to ensure the safe and sound management of the risks associated with financial derivatives. Accordingly, the proposed regulation emphasized that derivatives activities must be conducted in a safe and sound manner, and set forth the responsibilities of the board of directors and management with respect to financial derivatives.

The proposed rule was also intended to reduce regulatory burden consistent with statutory requirements for safe and sound operations. Accordingly, OTS proposed to delete regulatory requirements that were no longer considered to be essential for safety and soundness, redrafted other requirements as guidance, and revised the remaining

existing requirements as broader and more flexible regulatory requirements for all types of financial derivative transactions. OTS's proposed approach, which relied more on guidance than detailed regulations, more closely resembled the bank regulatory agencies' approach with regard to banks' use of financial derivatives.³

At the same time it issued the proposed rule, OTS proposed comprehensive guidance regarding savings associations' risk management practices, including those pertaining to derivatives transactions.⁴ Proposed Thrift Bulletin 13a (TB 13a) ("Management of Interest Rate Risk, Investment Securities, and Derivatives Activities") included specific guidance on how thrifts should implement the Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities" (FFIEC policy statement).⁵

II. Summary of Public Comments.

³ See e.g., OCC Banking Circular 277 (October 27, 1993).

⁴ 63 FR 20257 (April 23, 1998).

⁵ 63 FR 20191 (April 23, 1998). The FFIEC policy statement provides general guidance on sound practices for managing the risks of investment securities and derivatives activities.

The public comment period on the proposed rule and the proposed thrift bulletin closed on June 22, 1998. One commenter, a savings association, filed a comment supporting the proposed rule.

The OTS received twenty-seven comments on proposed TB 13a. The substance of these comments is addressed in connection with the related TB 13a. Some of the commenters also addressed issues related to the proposed rule.

Several commenters suggested that the proposed thrift bulletin and the proposed regulation on financial derivatives should be finalized simultaneously. The OTS believes that TB 13a provides important and necessary guidance on the management of interest rate risk, investment securities and derivatives activities. Accordingly, it has made this guidance effective on the date of publication in the Federal Register. Subject to certain exceptions, however, 12 U.S.C. 4802(b) provides that new regulations and amendments to regulations prescribed by a Federal banking agency which impose additional reporting, disclosures, or other new requirements on an insured depository institution shall take effect on the first day of a calendar quarter which begins on or after the date on which the regulations are published in final form. Section 4802(b) also permits persons who are subject to such regulations to comply with the regulation

before its effective date. Accordingly, OTS will not object if an institution wishes to apply the provisions of this final rule beginning with the date it is published in the Federal Register.

One commenter, a law firm representing numerous savings associations, noted that the proposed rule text would incorporate TB 13a in several places. Proposed § 563.172(c)(2), for example, states that the savings association's board of directors should review TB 13a and other applicable agency guidance on establishing a sound risk management program. Similarly, proposed § 563.172(d)(2) states that management should review the thrift bulletin and other applicable agency guidance on implementing a sound risk management program. The commenter also noted that OTS sought public comment on TB 13a, a procedural step that it does not generally follow for thrift bulletins. The commenter asked OTS to clarify whether the cross-references in the rule text and the procedures followed in promulgating the thrift bulletin were intended to change the legal status of guidance in the bulletin.

The inclusion of cross-references to TB 13a and other agency guidance in the rule text merely serves as a reference point to the board of directors and management in establishing and implementing written policy and procedures on financial derivatives.

As such, the cross-references to TB 13a only provide guidance on how financial derivatives activities may be conducted in a safe and sound manner.⁶ They do not alter the legal status of the guidance contained in the bulletin. Similarly, publication of TB 13a for public comment does not change its legal status as a thrift bulletin. Rather, the bulletin represents the Agency's best judgment in interpreting regulations and statutes which it administers. The administrative procedures used specifically to develop TB 13a were intended to provide OTS with public comment on all possible aspects of the management of interest rate risk, investment securities and derivative activities.

One commenter on the Thrift Bulletin urged the OTS to amend its capital regulations to eliminate the interest rate risk component at 12 CFR 567.7. The agency believes that a review of § 567.7 may have merit. However, neither the proposed Thrift Bulletin nor the notice of proposed rulemaking suggested that the OTS was considering any revision to its capital rules.

⁶ OTS has incorporated other similar cross-references into its regulations. See 12 CFR 562.2(b) which cross-references guidance in OTS bulletins, and examination handbooks.

In order to get the full benefit of public comment on this issue, the OTS will shortly initiate a rulemaking that will examine the need to retain § 567.7 in light of the tools that are currently available to measure and control interest rate risk.

III. Final Rule.

Since no commenter suggested substantive changes to the proposed rule and OTS has identified no other reasons to modify the text, OTS has adopted the proposed rule without substantive change. Elsewhere in today's Federal Register, OTS is also publishing a final TB 13a, which provides supplemental supervisory guidance on the use of financial derivatives.

IV. Executive Order 12866

OTS has determined that this final rule does not constitute a "significant regulatory action" for the purposes of Executive Order 12866.

V. Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, OTS has determined that this final rule does not have a significant economic impact on a substantial number of small entities. The final rule reduces the burden of complying

with detailed regulations and allows for more flexible treatment of derivatives activities for all institutions, including small institutions.

VI. Paperwork Reduction Act

The recordkeeping requirements contained in this final rule have been submitted to and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under OMB Control No. 1550-0094. Comments on all aspects of this information collection should be sent to Office of Management and Budget, Paperwork Reduction Project (1550), Washington, D.C. 20503 with copies to the Office of Thrift Supervision, Regulations and Legislation Division, Chief Counsel's Office, 1700 G Street, NW., Washington, D.C. 20552.

The information collection requirements contained in this rule are found in 12 CFR 563.172. OTS requires this information for the proper supervision of interest rate risk for its regulated savings associations. The likely respondents/recordkeepers are OTS-regulated savings associations.

Respondents/recordkeepers are not required to respond to the collections of information unless the collection displaces a current valid OMB control number.

VII. Unfunded Mandates Reform Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed above, this final rule reduces regulatory burden by eliminating unnecessarily restrictive regulations. OTS has, therefore, determined that the effect of the final rule will not result in expenditures by State, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, OTS has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

List of Subjects in 12 CFR Part 563

Accounting, Advertising, Crime, Currency, Investments, Reporting and recordkeeping requirements, Savings associations, Securities, Surety bonds.

Accordingly, the Office of Thrift Supervision amends part 563, chapter V, title 12, Code of Federal Regulations as set forth below:

PART 563--OPERATIONS

1. The authority citation for part 563 continues to read as follows:

Authority: 12 U.S.C. 375b, 1462, 1462a, 1463, 1464, 1467a, 1468, 1817, 1820, 1828, 3806, 42 U.S.C. 4106.

§§ 563.173, 563.174, 563.175 [Removed]

2. Sections 563.173, 563.174, and 563.175 are removed.

3. Section 563.172 is added to read as follows:

§ 563.172 Financial derivatives.

(a) What is a financial derivative? A financial derivative is a financial contract whose value depends on the value of one or more underlying assets, indices, or reference rates. The most common types of financial derivatives are futures, forward commitments, options, and swaps. A mortgage derivative security, such as a collateralized mortgage obligation or a real estate mortgage investment conduit, is not a financial derivative under this section.

(b) May I engage in transactions involving financial derivatives? (1) If you are a federal savings association, you may engage in a transaction involving a financial derivative if you are authorized to invest in the assets underlying the financial derivative, the transaction is safe and sound, and you otherwise meet the requirements in this section.

(2) If you are a state-chartered savings association, you may engage in a transaction involving a financial derivative if your charter or applicable state law authorizes you to engage in such transactions, the transaction is safe and sound, and you otherwise meet the requirements in this section.

(3) In general, if you engage in a transaction involving a financial derivative, you should do so to reduce your risk exposure.

(c) What are my board of directors' responsibilities with respect to financial derivatives? (1) Your board of directors is responsible for effective oversight of financial derivatives activities.

(2) Before you may engage in any transaction involving a financial derivative, your board of directors must establish written policies and procedures governing authorized financial derivatives. Your board of directors should review Thrift Bulletin 13a, "Management of Interest Rate Risk, Investment Securities, and Derivatives Activities," and other applicable agency guidance on establishing a sound risk management program.

(3) Your board of directors must periodically review:

(i) Compliance with the policies and procedures established under paragraph (c)(2); and

(ii) The adequacy of these policies and procedures to ensure that they continue to be appropriate to the nature and scope of your operations and existing market conditions.

(4) Your board of directors must ensure that management establishes an adequate system of internal controls for transactions involving financial derivatives.

(d) What are management's responsibilities with respect to financial derivatives?

(1) Management is responsible for daily oversight and management of financial

derivatives activities. Management must implement the policies and procedures established by the board of directors and must establish a system of internal controls. This system of internal controls should, at a minimum, provide for periodic reporting to the board of directors and management, segregation of duties, and internal review procedures.

(2) Management must ensure that financial derivatives activities are conducted in a safe and sound manner and should review Thrift Bulletin 13a, "Management of Interest Rate Risk, Investment Securities, and Derivatives Activities" (available at the address listed at § 516.1 of this chapter), and other applicable agency guidance on implementing a sound risk management program.

(e) What records must I keep on financial derivative transactions? You must maintain records adequate to demonstrate compliance with this section and with your board of directors' policies and procedures on financial derivatives.

DATED: November 20, 1998

By the Office of Thrift Supervision.



Ellen Seidman
Director