earnings and its underlying economic value. Changes in interest rates affect a bank's reported earnings by changing its net interest income and the level of other interest-sensitive income and operating expenses. The underlying economic value of the bank's assets, liabilities, and off-balance sheet instruments also is affected by changes in interest rates. These changes occur because the present value of future cash flows and in some cases, the cash flows themselves, are affected when interest rates change. The combined effects of the changes in these present values reflect the change in the bank's underlying economic value.

Interest rate risk is inherent in the role of banks as financial intermediaries. However, a bank that has an excessive level of interest rate risk can face diminished future earnings, impaired liquidity and capital positions, and, ultimately, may jeopardize its solvency.

The agencies believe that safety and soundness requires effective management and measurement of interest rate risk, and each agency has provided supervisory guidance to banks and examiners on this subject. In addition, the agencies believe that a bank's capital adequacy should be assessed in the context of the risks it faces, including interest rate risk. Section 305 of FDICIA Pub. L. 102–242 (12 U.S.C. 1828 note), on which a final rule is being issued at the same time as this statement, specifically requires the agencies to take account of interest rate risk in assessing capital adequacy. Both of these aspects of interest rate risk depend on, among other things, a meaningful measurement of the bank's risk exposure.

The agencies believe that a bank should have an IRR measurement system that is commensurate with the nature and scope of its IRR exposures. Among the difficulties in performing a supervisory evaluation of interest rate risk, however, is that measurement systems and management philosophies can differ significantly from one bank to another. As a result, although two banks may each be well-managed, their measured exposure may not be directly comparable. This difficulty has been magnified by the rapid pace of change in financial markets and instruments themselves.

In implementing Section 305 of FDICIA, and in light of the rapid evolution in financial instruments and practices, the agencies believe there is a need for a more formal supervisory assessment of banks' interest rate risk exposures. To support that effort, the agencies propose a measurement framework that includes a supervisory measurement system (''supervisory model'') that will, on a standardized basis, measure the risk of all banks not exempted from reporting additional information on their IRR exposures. In addition, banks will be encouraged to report, through a voluntary and confidential supplemental Call Report schedule, the results of their internal IRR measurement systems. These measured results would then serve as an additional source of information for an examiner's assessment of the bank's risk management and capital adequacy. The results also would provide information on industry trends and patterns that will better inform both present and future supervisory efforts related to interest rate risk.

The measurement framework described in this policy statement focuses on the exposure to a bank's underlying economic value from movements in market interest rates. The exposure to a bank's economic value, as used in this policy statement, is defined as the change in the present value of its assets, minus the change in the present value of its liabilities, plus the change in the present value of its off-balance sheet interest-rate positions. The agencies haven chosen this focus because they believe that changes in a bank's economic value best reflect the potential impact of embedded options and the potential exposure that the bank's current business activities pose to the bank's future earnings stream, and hence, its ability to sustain adequate capital levels. Changes in economic value measure the effect that a change in interest rates will have on the value of all of the future cash flows generated by a bank's current financial positions, not just those cash flows which affect earnings over the few months or quarters. Thus, changes in economic value provide a more comprehensive measure of risk than measures which focus solely on the exposure to a bank's near-term earnings. It is for this reason that the agencies have amended their capital standards to identify explicitly a bank's exposure to declines in economic value from changes in interest rates as an important factor to consider in evaluating a bank's capital adequacy.

II. Summary of Approach

In assessing the sensitivity of a bank's economic value to changes in interest rates, the agencies are proposing to use the results of a supervisory model and, for those electing to provide such analysis, the results of banks' own internal models. These assessments will rely on data reported in regulatory Call Reports. Recognizing that the burden for reporting IRR exposures would fall most heavily on smaller organizations with limited resources, the policy statement makes provisions for smaller, well-managed institutions that are less likely to be significantly exposed to IRR to be exempt from additional reporting. As described in further detail in the policy statement, the agencies propose that banks with (i) assets under $300 million, (ii) composite supervisory CAMEL ratings of 1 or 2 and, (iii) moderate or low holdings of assets with intermediate and long term maturity or repricing characteristics, be exempted from expanded reporting requirements for IRR.

Banks that are not specifically exempted by the proposed policy statement will submit additional Call Report information on the repricing and maturity of their portfolios. The proposed supervisory model applies a series of IRR risk-weights to a bank's reported repricing and maturity balances. These weights estimate the price sensitivity of a bank's reported balances to a 200 basis point increase and decrease in interest rates. The summation of these balances, along with certain price sensitivity information that a bank may be required to self-report, results in a net risk-weighted exposure for the bank. That exposure represents the estimated change in the bank's economic value to the specified rate change.

The proposed supervisory model represents a refinement of the model presented in the September 1993 notice of proposed rulemaking (September NPR) [58 FR 48206, September 14, 1993]. The September NPR solicited comments on a framework for measuring banks' exposure to IRR for capital purposes pursuant to Section 305 of FDICIA. The final rule for Section 305 does not incorporate an explicit measurement framework for IRR into the agencies' risk-based capital standards. The agencies have concluded that it is appropriate to first collect industry data and evaluate the performance of the measurement framework before explicitly incorporating the results of that framework into their risk-based capital standards. The data collected by the agencies will assist current supervisory efforts and will facilitate the development of a measurement framework that could be explicitly incorporated into capital standards in the future. This proposed policy statement would implement that supervisory measurement framework. The proposed framework is broadly consistent with the one discussed in the September NPR. The agencies, however, have made several refinements to the