Interest Rate Risk Management Program

Examination Objectives

To determine compliance with TB 13a.

To determine if the interest rate risk (IRR) exposure limits set by the institution are prudent and if the institution is operating within those limits.

To identify weaknesses in the IRR measurement systems, internal management reporting, or internal controls.

To determine if the level of IRR is excessive.

To evaluate plans for reducing excessive IRR.

To summarize findings and initiate corrective action as necessary.

Examination Procedures

Level I — Wkp. Ref.

1. Review scoping materials applicable to IRR, including the NPV sensitivity analysis in the most recent IRR Exposure Report. If other examiners performed the review of these scoping materials, obtain a written or oral summary of the review(s). Review any monitoring information. Obtain the modeling folder (if any) from previous analyses performed on the institution.

2. Obtain and review the institution's written policies, procedures, and strategic plans governing IRR, along with the institution's overall business plan.

   - Briefly describe the general philosophy of the IRR policy. Is it consistent with the business plan?
   - Ensure that the policy contains the authorizations described in TB 13a. Specifically, ensure that the policy:

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— Delegates responsibility for the management of IRR.

— Contains the authorizations and restrictions governing the following items:

  ✓ Trading activities

  ✓ Use of derivative and synthetic instruments

  ✓ Hedging strategies.

— Specifies both the contents of management's report to the board on IRR and the frequency with which the board receives the report.

- Does the policy contain IRR exposure limits in terms of changes in NPV in the six alternate interest rate scenarios (+/- 100, 200, and 300 basis points)? What are those limits?
- Are the exposure limits prudent given the institution's capital level, NPV ratio, management ability, and the exposure norms exhibited by similar institutions and the rest of the industry? (If you do not consider these limits prudent, you should work with management and the region's IRR contact to determine appropriate limits. Present revised limits to the board and use them to evaluate the association's level of IRR.)

3. Determine if the institution's IRR exposure (as measured either by OTS or internally) is in compliance with the limits set by the board. (If the institution has assets in excess of $1 billion or holds high-risk mortgage-derivative products, it is responsible for generating its own estimates of NPV sensitivity.)

- What action did the institution take when it discovered noncompliance with the exposure limits?
- Has OTS previously recommended corrective action? If so, has management corrected the problems?

4. If the association uses its own model to generate NPV sensitivity estimates, it must make an effort to explain differences between those estimates and the estimates of OTS's model if the:

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- Differences between the two are substantial.
- OTS estimates exceed the exposure limits, but the internal estimates do not. See Appendix B for a discussion of reasons for differences between OTS estimates and internal estimates.

5. Does management report to the board of directors at the frequency specified in their IRR policy (at least quarterly) regarding the sensitivity of NPV to changes in interest rates? Do these reports contain all information required by the IRR policy?

6. Complete Level II procedures if:

- IRR exposure is high.
- More than two years have passed since a Level II exam.
- Level I procedures raise some concern about IRR management.

LEVEL II

1. Assess the soundness of the association's measurement of IRR relative to the size of the association and the complexity of its balance sheet.

   Note: If the association has at least $1 billion in assets or holds high-risk mortgage-derivative products, it must produce its own measure of NPV sensitivity. It may supplement these measures with other measures of IRR. (If TB 13a requires the institution to establish its own measurement system, and it has not done so, inform your IRR contact immediately and highlight this failing in your examination comment.)

   If the association has less than $1 billion in assets and does not hold high-risk mortgage-derivative products, it may rely solely on the measure of NPV sensitivity produced by OTS Washington for IRR measurement.

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- For measures of IRR generated by the association:
  - Does the method used include all appropriate assets, liabilities, and off-balance-sheet items? Is the information accurate?
  - Are there any material comments about the quality of the model used to estimate IRR (that is, comments about the methodology, data, or assumptions used)? Specifically:
    - ✓ Is the model adequate given the size of the association and the complexity of its balance sheet? See Requirements for TB 13a NPV Models in this Section of the Handbook.
    - ✓ Is management able to explain satisfactorily any major differences between its results and those of OTS's model? (If questions arise regarding the reasonableness of the assumptions or methodology used, contact your region's IRR contact to ensure proper review of the adequacy of the institution's measurement system.)
- For associations using only OTS's model results:
  - Validate OTS's NPV sensitivity estimates. Are there any material comments about the appropriateness of the assumptions made in OTS's model to the association? Does OTS's analysis appear to be a reasonable depiction of the institution's IRR?

7. In view of the now-validated estimates of IRR, do you view this risk excessive? See the Measurement of IRR discussion in this Section for guidance.

8. Review management's IRR strategy.

- What are the goals of the strategy? Are they consistent with board policy?
- Does management have sufficient expertise to implement its strategy?

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9. Review the system of limits and controls over operations, and internal reporting used by management to ensure compliance with the board's limitations on IRR exposure.

10. Does management place specific controls on capital market activities? Have there been violations of these controls?

- Are internal IRR reporting systems sufficiently clear, comprehensive, and timely to permit effective management of IRR and to ensure compliance with board policies?
- Does management demonstrate the reasonableness of assumptions used in IRR analysis?

11. Assess management's ability to control the institution's exposure to IRR.

- Does management have the knowledge and expertise necessary to develop and implement effective asset and liability strategies?

12. Has IRR increased since the last examination? What were the primary sources of the increase? Was this activity consistent with board policy and management's stated strategy on IRR?

- Based on a review of pro-forma financial statements, assess whether the institution plans any major changes in activities and, if so, what is the effect on the institution's risk profile?

13. Review Schedule CMR to determine that the institution reports assets, liabilities, and off-balance-sheet instruments properly. Conduct an analysis of all instruments for which OTS's NPV estimates may be deficient or for which you believe the institution has more accurate estimates, and make adjustments where necessary.

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14. Conduct the Level III procedure if:

- You are considering supervisory action for excessive IRR.
- The institution is appealing your supervisory action.

15. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

LEVEL III

1. Where you deem the level of IRR is excessive, present findings to management or the board of directors, along with any criticisms of management's ability to measure or manage IRR. Instruct management to provide OTS with a board-authorized plan to reduce the level of IRR to an acceptable level and to remedy deficiencies in IRR measurement or management.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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