

# Derivative Instruments and Hedging Program

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## EXAMINATION OBJECTIVES

Determine if the board of directors has adopted a comprehensive hedging policy.

Determine if the association's policies adequately detail the various strategies involving derivatives and hedging.

Determine if the board of directors designates individuals responsible for transactions and specifies appropriate limits of authority.

Determine if management has the expertise to execute the program in conformance with the association's policies.

Determine if the use of derivatives and hedging activity is reasonable based on the association's operations, liquidity position, asset/liability structure, and capital position.

Determine if management and the board of directors adequately monitor the use of derivatives and hedging activity.

Determine if the association complies with regulations, maintains adequate documentation, and accounts for transactions properly.

Determine if there is risk from excessive hedging positions or low correlation between the hedged items and the hedging positions.

Determine if any of the hedging activity is speculative.

## EXAMINATION PROCEDURES

### LEVEL I

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1. Review scoping materials applicable to derivative instruments and hedging. Some scoping materials include: the regulatory profile, previous examination report(s), correspondence, agreements, audit report, management letter, applicable work papers from previous examinations, management discussions from previous examinations, notes on interim monitoring, and agreements with investment consultants or brokers.

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2. Review the previous report of examination and all derivative instruments and hedging-related exceptions noted and determine if management has taken appropriate corrective action.  

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3. Obtain the association's policies and procedures relating to derivatives use and hedging. Determine if the policies and procedures contain the following information:
  - A description of the intended strategies.
  - A list of individuals responsible for executing the transactions for each derivative instrument and established limits of their authority.
  - Maximum amount of outstanding position by type (position limits).
  - Adequate detail of the rationale for determining the hedge ratios.
  - Description of the methods used to monitor the activity.

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4. Review the board minutes to determine that the board of directors receives monthly reports on the association's use of derivatives and hedging activity. Determine if the reports are adequate for decision-making and allow the board of directors to monitor compliance with established guidelines. Board reports should contain the following information:
  - Positions established and offset (volume) by type during the month and realized gains or losses on these positions.
  - Open positions at the reporting date and the unrealized gains or losses.

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5. Determine if management has the expertise to use derivatives and execute a hedge program in accordance with the objectives in the policies and procedures.  

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6. Review the association's IRR Exposure Report to determine if it is using derivatives and hedging activity to lower its interest rate risk.
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7. Summarize findings. Identify areas of concern and management's responses. Update the CEF, if applicable, with any information that will facilitate future examinations. File any exception sheets in the general file.
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8. Review Level II procedures and perform those necessary to test, support, and present conclusions.
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## LEVEL II

1. Obtain a listing of each of the general and subsidiary ledger accounts for each derivative instrument. Perform the following procedures:
- Review a history of the significant transactions for each account to determine the purpose of the transaction and whether it was effective.
  - Compare the actual activity reported on brokers' statements, contract registers, and reports to the board of directors, with the general and subsidiary ledgers.
  - Determine if the association concealed any losses in an account recorded as an asset.
  - Determine the method of accounting used. For instance, deferral, lower of cost or market, marked to market, and determine if it is appropriate.
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2. Review interest rate swaps and determine the following:
    - Whether the spread between the fixed rate and variable rate is reasonable and the matched asset has a positive spread taking into account the net cost of the swap.
    - The amount of the collateral requirements for the interest rate swaps and the location of the collateral.
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3. Assess the overall effectiveness of the hedging program by identifying, analyzing, and determining the following:
    - The assets or liabilities hedged, including dollar amount, maturity, and interest rate.
    - The specific intent of each transaction. For example, was the intent to shorten the term of the asset or extend the term of the liability? Ascertain if each transaction reduced the association's interest rate risk.
    - The method used to derive the hedge ratios and if these ratios are reasonable.
    - The change in value of the hedged asset or liability during the hedge period by comparing the change in the interest rates of the liabilities or market values of the assets during the hedged period.
    - The change in value of the hedged item compared with the gain or loss from the hedging contracts.
    - The effectiveness between the hedging instrument and the matched asset or liability, by comparing the gains or losses from the hedging instrument with the increase or decrease in value of the asset or liability hedged.
    - The effect of the hedge on the overall operation of the thrift.
    - The opportunity cost (gain) of variation margin deposits if significant.
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4. Prepare report comments. Identify transactions or matters that raise safety and soundness concerns. Provide the following information:

- A summary of overall finding.
  - A description of deficiencies.
  - Management's proposed corrective actions.
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5. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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## LEVEL III

1. Contact the regional capital markets specialist or other designated individual(s) for consultation on reviewing any of the hedging strategies. Assistance could involve the following items:

- Expanding the scope of review based on the amount of activity.
  - Determining the reasonableness of hedging strategies.
  - Selecting specific transactions for financial modeling.
  - Participation in management discussions that could involve the thrift's consultants or broker/dealers.
  - Structuring comments for the report of examination.
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2. Contact the regional accountant or the accounting policy division at OTS Washington to discuss the association's accounting for any of the hedging transaction.

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3. Determine if the association has stock that is publicly traded. If so, review the reports filed with the Securities and Exchange Commission, including the 10K (annual) and the 10Q (quarterly) for any mention of derivatives use or hedging activity. Descriptions of activity should be consistent with actual transactions.

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4. Determine the creditworthiness of the counterparties if there is reason for concern about the counterparties' financial strength.

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5. If the association conducts a high level of futures and options trading, review auditors' work papers to determine that they performed an appropriate level of verification of outstanding contracts with various brokers.

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6. If the association conducts active trading, determine the following through observations and discussions with management and other personnel:

- Is there a significant amount of activity with positions open for very short periods?
  - Does the association ensure that the trading and accounting functions are segregated?
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## EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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