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FFIEC Interest Rate Risk Advisory

January 19, 2010

OVERVIEW

On January 7, 2010, the Federal Financial Institutions Examination Council (the "FFIEC") issued an advisory to remind institutions of supervisory expectations for sound practices to manage interest rate risk ("IRR"). Regulators expect all institutions to manage their IRR exposures using processes and systems commensurate with their earnings and capital levels, complexity, business model, risk profile and scope of operations. Regulators have historically expressed a strong interest in IRR, as changes in interest rates have the potential of reducing a bank's earnings and lowering its net worth. Because it is a critical component of the business of banking, IRR cannot be entirely eliminated but must be effectively monitored and managed. In the current environment of historically low short-term interest rates, regulators have reiterated in this advisory the importance of institutions having robust processes for measuring and, where necessary, mitigating their exposure to potential increases in interest rates.

This advisory has been adopted by each of the following financial regulators and is applicable to the institutions regulated by such regulators: (i) the Board of Governors of the Federal Reserve System; (ii) the Federal Deposit Insurance Corporation; (iii) the National Credit Union Administration; (iv) the Office of the Comptroller of the Currency; (v) the Office of Thrift Supervision; and (vi) the FFIEC State Liaison Committee. Each of these regulators has provided regulatory guidance on IRR. The principles set forth in this advisory and the regulators' individual guidance are consistent with the principles established by the Basel Committee on Banking Supervision. While the specific guidance issued and the oversight and surveillance mechanisms used by each of the regulators may differ, supervisory expectations for sound IRR management are broadly consistent. This advisory clarifies various elements of existing guidance and describes selected IRR management techniques used by effective risk managers.

SUMMARY

Financial regulators are issuing this advisory to remind institutions of supervisory expectations regarding sound practices for managing IRR. While regulators recognize that some degree of IRR is inherent in the business of banking, institutions are expected to have sound risk management practices in place to measure, monitor and control IRR exposures.

In this advisory, regulators identify certain guidelines set forth by existing interagency and international guidance with respect to corporate governance, policies and procedures, the measurement and monitoring of IRR including measurement methodologies, stress testing and assumptions, risk mitigating steps, and internal controls and validation in consideration of risks undertaken by an institution, specifically interest rate risk.

In particular, the regulators remind boards of directors that they should understand and be regularly informed about the level and trend of their institutions' IRR exposure. Existing interagency and international guidance identifies the board of directors as having the ultimate responsibility for the risks undertaken by an institution, including IRR. Institutions with an Asset/Liability Committee (ALCO), or similar senior management committee, should ensure the committee actively monitors the IRR profile and has sufficient broad representation across major functions that can directly or indirectly influence the institution's IRR exposure (e.g., lending, investment securities, wholesale and retail funding).

Institutions should ensure IRR exposures are incorporated and evaluated as part of the enterprise-wide risk identification and analysis process. Regulatory supervisors expect institutions to have robust IRR measurement processes and systems to assess exposures relative to established risk tolerances. Such systems should be commensurate with the size and complexity of the institution. Well-managed institutions generally specify IRR tolerances in the context of scenarios of potential changes in market interest rates and a target or range for performance metrics.

The regulators remind institutions to document, monitor and regularly update key assumptions used in IRR measurement models. Further, institutions using derivatives are reminded to establish an effective process for managing interest rate risk. The level of structure and formality in this process should be commensurate with the activities and level of risk approved by senior management and the board. Reliance on outside consultants to assist in the establishment of such a strategy does not absolve the board and senior management of their responsibility to fully understand the risks of derivatives hedging strategies.

Finally, this advisory reminds institutions that validating IRR models, including conducting independent reviews of the logical and conceptual soundness, is a fundamental part of any institution's system of internal controls. The scope of the independent review should involve assessing the institution's measurement of IRR, including the reasonableness of assumptions, the process used in determining assumptions, and the backtesting of assumptions and results. Smaller institutions that do not have the resources to staff an independent review function should have processes in place to ensure the integrity of the various elements of their IRR management processes.

LINKS

A copy of the FFIEC News Release 2010-1 ("NR 2010-1") can be found at http://www.occ.treas.gov/ftp/release/2010-1.htm.

The advisory on interest rate risk management dated January 6, 2010 can be found at http://www.occ.treas.gov/ftp/release/2010-1a.pdf. A list of the regulatory guidance on IRR can be found in Appendix A to the advisory.

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