

Bank:

Date of Exam:

Charter #:

Prepared By:

#10 – Funds Management (Sensitivity to Market Risk) (Risk Focused)

ASSIGNMENT OVERVIEW

In 1996, the Uniform Financial Institutions Rating System (UFIRS) was amended to include a sixth component, Sensitivity to Market Risk “S”. This “S” component rates the degree of market risk taken, management’s ability to identify, measure, monitor, and control that risk, and the financial support provided by earnings and capital. Market risk results primarily from interest rate, foreign exchange rate, commodity price, and equity price volatility. Clearly, most banks’ principal market risk exposure is interest rate risk (IRR). While its effect is less immediate, IRR can substantially impair a bank’s earnings and capital adequacy. Careful evaluation of the bank’s posture and prospects in these areas is essential to determine the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution’s earnings or economic capital. These procedures also focus on the management systems in place to identify and control risk. For additional guidance, refer to the FDIC Examination Manual–Market Risk section and the Joint Agency Policy Statement on Interest Rate Risk for further guidance. Refer to the DOB’s Reference Material documents for a list of reference materials applicable to this procedure.

INSTRUCTIONS

Examiners must follow the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations.

All examiners performing these procedures must be listed above in the “Prepared By” section. All of the CORE ANALYSIS PHASE should be completed. Comments and findings for each step should be made in the comment box below each question. Reference to work paper documentation should also be included here. Documentation is to be sufficient to allow an audit trail of the examiner’s thought process and all significant findings.

Information on the Summary of Findings page must tie back to the findings noted within the procedure. The SEIC/EIC will determine which information in the Summary of Findings will be included in the Report of Examination.

The EIC/AEIC should review this procedure when complete. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be noted on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION’S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANALYSIS PHASE

#10 Funds Management

1. Prior Criticisms

1. Determine whether deficiencies noted in the last examination and most recent internal/external audit have been addressed and/or corrected by management. Detail how deficiencies were corrected. *Include copy of exam and/or audit exceptions and management response in work papers, or summarize exceptions/criticisms below or indicate the page number in the last examination report where deficiencies are noted, if applicable.*

Comment:

2. Asset/Liability Management Policy

2. Review the Asset/Liability Management Policy, and note any deficiencies in the policy or exceptions that have not been approved by the Board or their designee. Refer to [Appendix A](#) for guidance.

Comment:

3. Board / Committee Oversight

3. Determine the adequacy of Board/committee oversight of interest rate risk management considering committee minutes, if available, and the adequacy of the reports submitted to the Board to include: interest rate risk exposure to capital, earnings, future funding sources, uses, and unfunded commitments coupled with the effects of possible movements in interest rates.

Comment:

4. Rate Measurement Systems

4. Determine if the bank employs adequate rate measurement systems for its size and complexity. Comment on the reports the risk monitor generates, exposure to capital and earnings calculated, and significant deficiencies. Comment on the following:

- Type(s) of internal/third party measurement systems used (static gap, simulation, etc.)
- Bank's true asset/liability sensitivity position
- Reasonableness of assumptions and applicability to bank's asset, liability, off-balance sheet instruments and operating environment
- Bank's compliance with internal policy parameters

Include copies of internal analysis of interest rate risk in 10-A of work papers.

Comment:

5. Balance Sheet Changes

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5. Review the UBPR for structural balance sheet changes since the last examination. Consider the following:

- Shifts in maturity/re-pricing characteristics of the investment portfolio, loans, borrowings, or deposits
- Increased holdings of financial instruments
- Fundamental changes in the liability mix between core deposits and other funding sources.
- Unexpected change in the level or trend of securities appreciation/depreciation.

Refer to [Appendix B](#) for further guidance.

Comment:

6. Off-Balance Sheet Activity

6. If the bank engages in any off-balance sheet activity such as swaps, financial futures, forward placements, options, foreign exchange (FX) or secondary market mortgage banking, address the following. For additional guidance, contact the subject matter expert in your region or headquarters. *Refer to the [Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities](#) for guidance.*

- a) Are policies or profiles that describe the bank's services and objectives reasonable and address the following?
 - Specific objectives for the types of securities and derivative instruments? (i.e., earnings potential, liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles)
 - Identification of risk characteristics of permissible investments? (i.e., credit, market, and liquidity risk)
 - Delineate clear lines of responsibility and authority for conducting investment activities?
- b) Determine if the bank is an end-user, intermediary, or an active market user.
- c) Are hedging reports used by the board of directors and/or senior management adequate?
- d) Do independent parties conduct month-end re-evaluation of positions that address the following:
 - Compliance with appropriate investment policies, procedures and limits?
 - Appropriateness of the institution's risk measurement system based on the nature, scope, and complexity of the activities?
 - Timeliness, integrity, and usefulness of reports to the board of directors and senior management?

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Comment:

7. Risk Management

7. Comment on the bank's compliance with the [Joint Agency Policy Statement: Interest Rate Risk \(1996\)](#) (*Federal Register version*).

Refer to the [Advisory on Interest Rate Risk Management \(2010\)](#) and [Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions \(2012\)](#).

Comment:

8. Final Analysis

8. Complete the [Summary of Findings](#). Recommend Sensitivity to Market Risk Rating based on the Uniform Financial Institutions Rating System. *Refer to Supervisory Memorandum 1001 for ratings, definitions and guidance.*

SUMMARY OF FINDINGS

#10 - FUNDS MANAGEMENT

Describe all strengths evident from the evaluation.

Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.

Determine why weaknesses exist and comment on management's response and plan of action. Identify bank personnel making the response.

SUMMARY RISK RATING ASSIGNED: Choose an item.

Risk Rating Definitions:

1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient; NR-Not Rated



Ratings Matrix.xlsm

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM.

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APPENDIX A

Asset Liability Management Policy

Consider the following when evaluating the ALM Policy

1. Has the board of directors formally reviewed/revised the asset liability policy within the last year to ensure its continued relevance?
2. Does the policy include the following important points?
 - Guidelines for monitoring off-balance sheet and hedging activities (including overall position limits), if appropriate?
 - Acceptable maturity mismatches?
 - An interest rate risk measurement and monitoring system?
 - Targeted interest rate risk limits with respect to net interest income and/or economic value of equity?
 - Asset and deposit diversification guidelines?
 - Maturity guidelines for assets and funding sources?
 - Other components or guidelines deemed necessary due to the complexity of the organization.

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APPENDIX B

Balance Sheet Changes

When reviewing the balance sheet for changes, consider the following:

1. Has the bank's balance sheet significantly increased or decreased? (Consider % and dollar volume of change for each category.)
2. What asset categories have demonstrated growth/decline?
3. What liability categories have demonstrated growth/decline?
4. What is the overall effect of the changes based on the following?
 - Has the bank become more or less liquid?
 - Has the bank become more or less interest rate sensitive?
 - Did these positions contribute positively or negatively to capital and earnings?
 - Has the bank utilized potentially volatile funding sources?
 - Did the bank match duration and maturity? (Did the bank go longer on its asset durations & shorter on its funding maturities; or vice versa?)

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