



Sensitivity To Market Risk

“S” Stands for Sensitivity, Social Media,
Swift (Deposit Movement), and Shrinking
NIM

San Francisco Region
Community Bankers Workshop 2024/2025

Disclaimer

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Interest Rate Risk

From



To



Discussion Points

- Interest Rate Trends
- Interest Rate Risk Management
- Examination Focus and Observations
- Case Study
- Resources

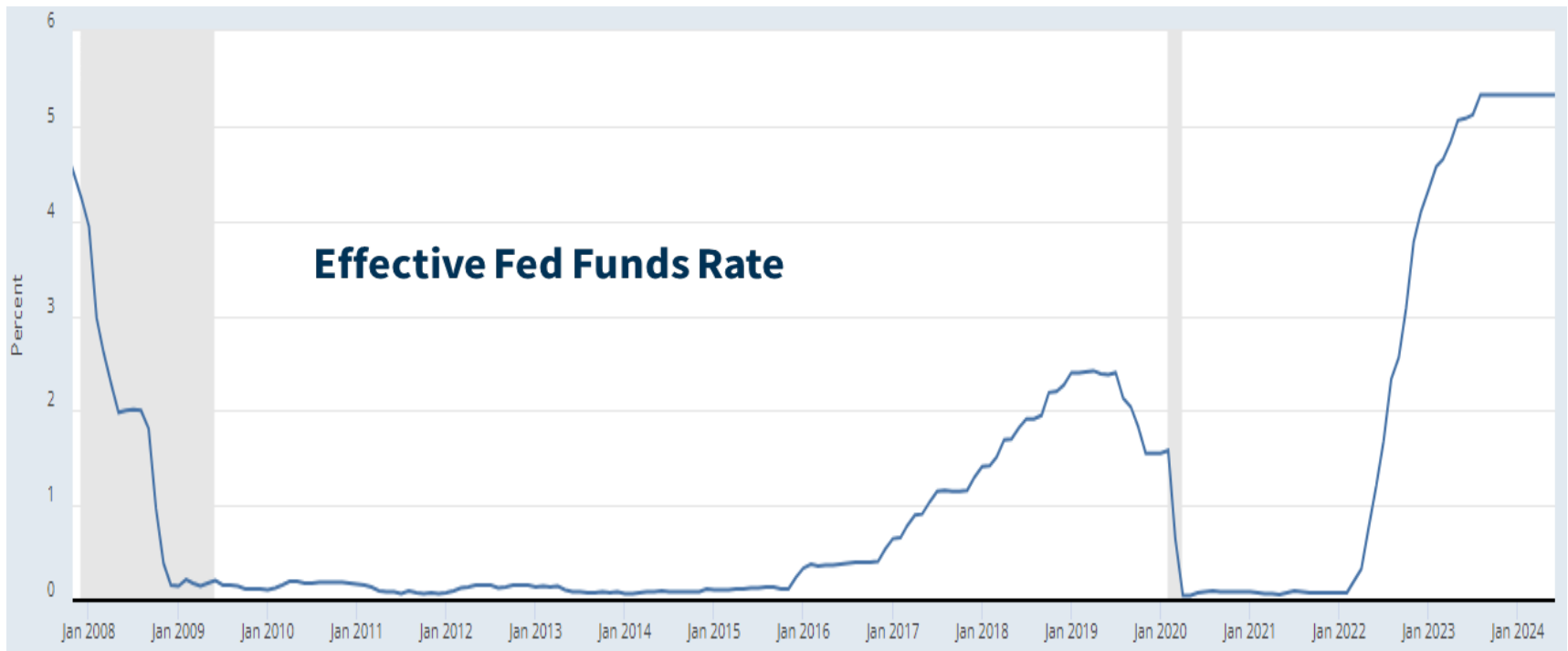




Interest Rate Trends

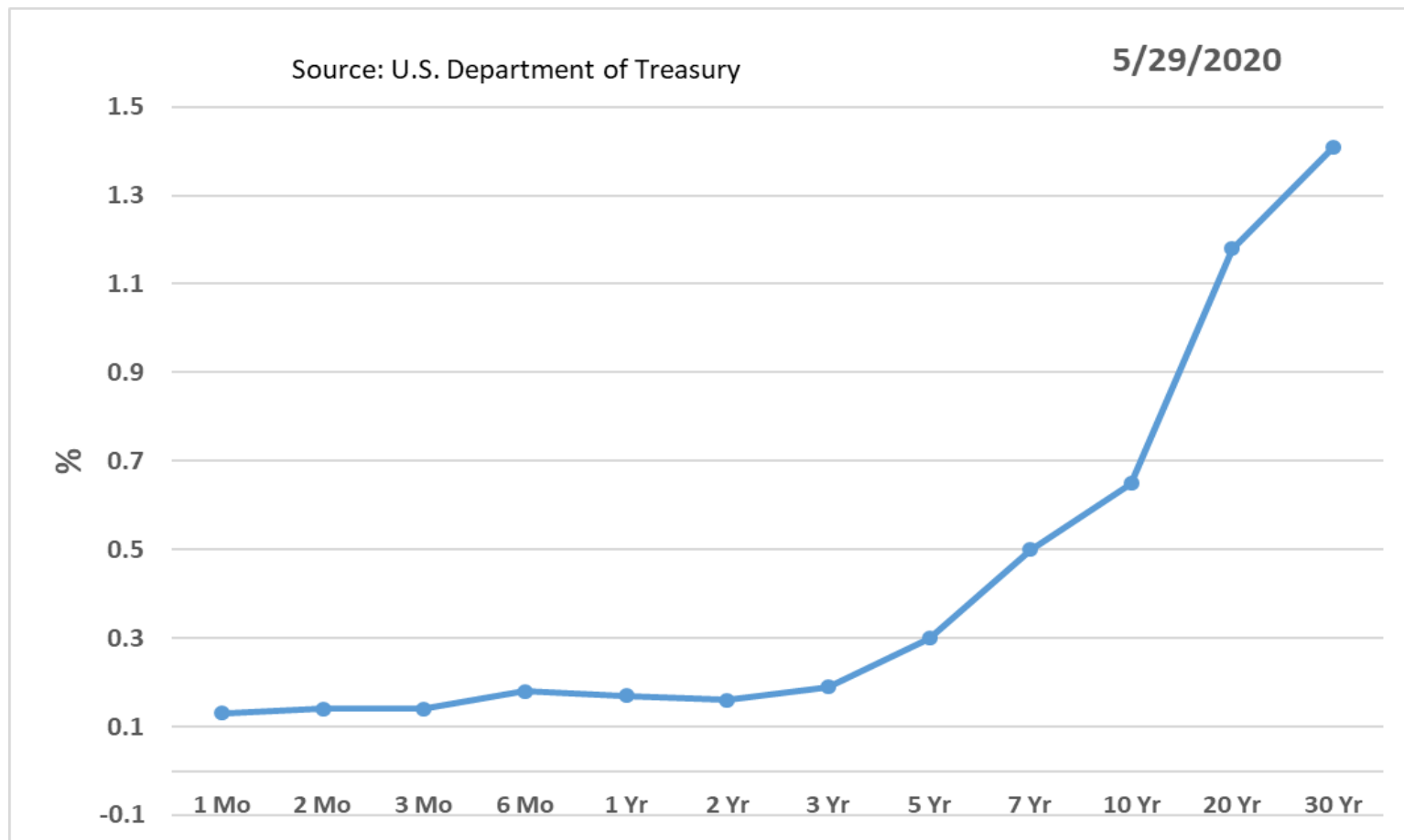
Interest Rate Trends

- From a long period of historically low interest rates...
- To a rapid increase in interest rates...
- To possibly higher interest rates for longer...



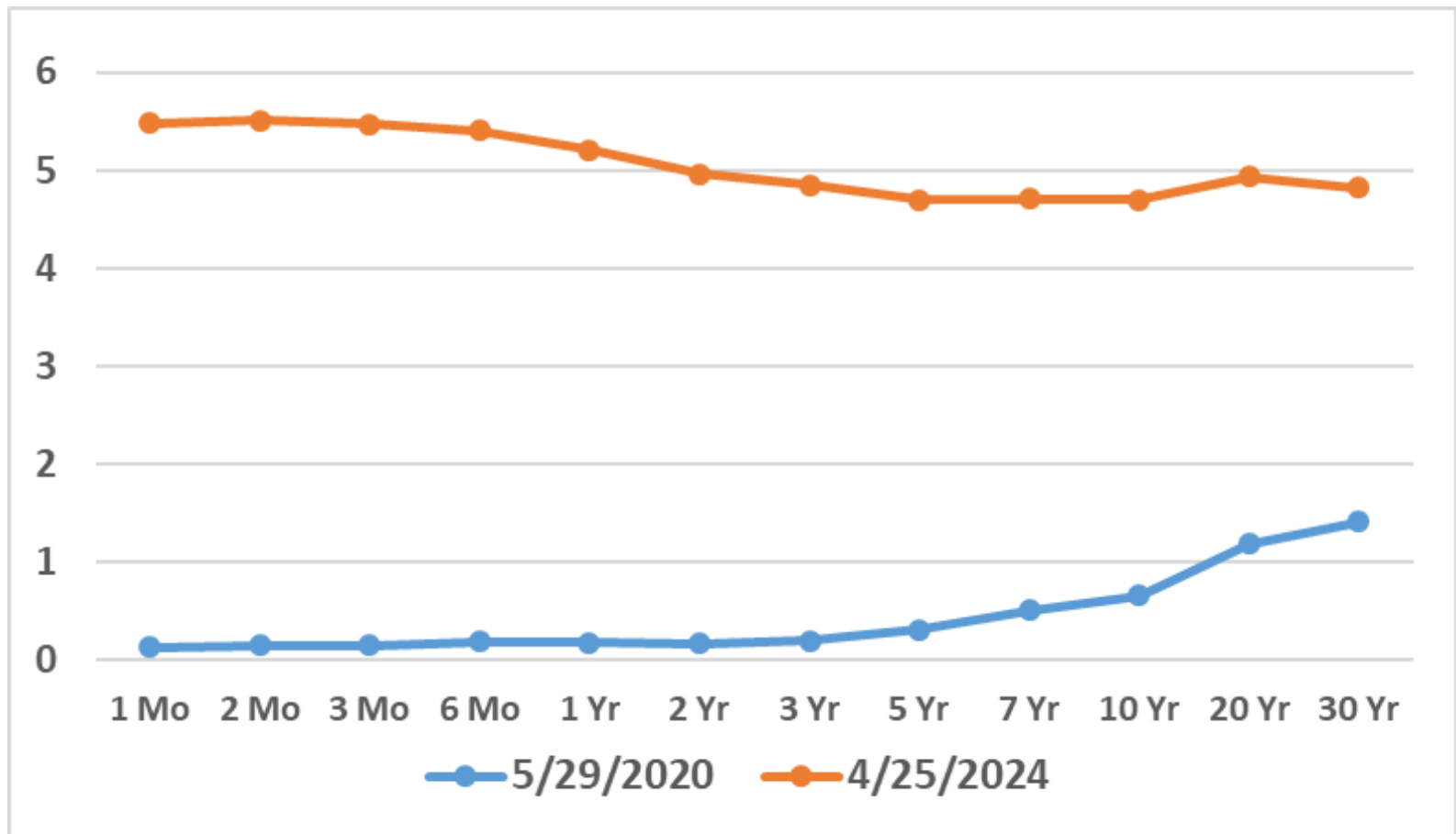
Interest Rate Trends

The US Treasury Yield Curve – Steepening and enticing at the long end



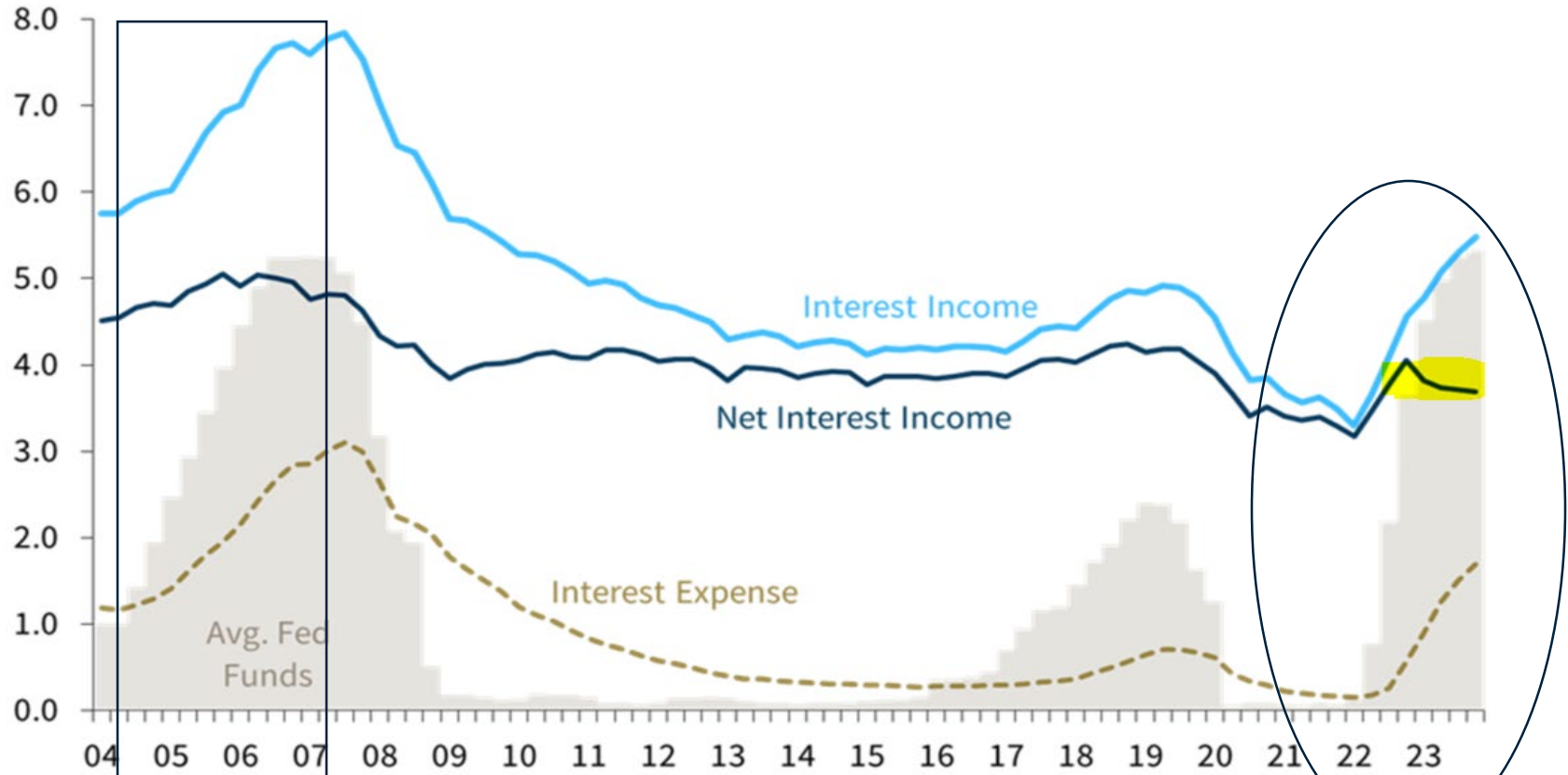
Interest Rate Trends

US Treasury Yield Curve: Comparing 2020 to 2024



Interest Rate Trends

One-Quarter Annualized as Share of Average Earning Assets -- SF Region
Median percent

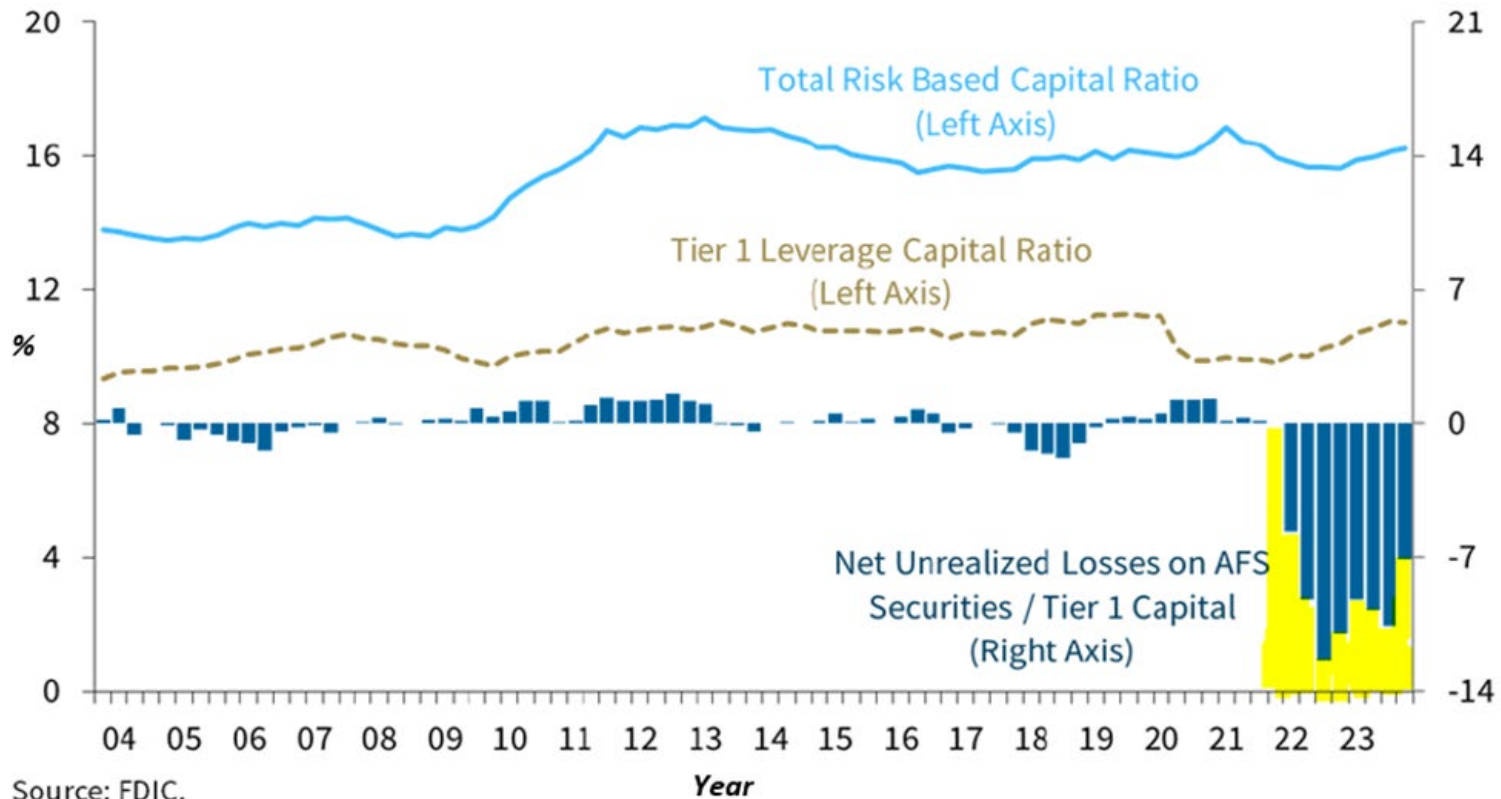


Source: FDIC, Federal Reserve via Haver Analytics (average effective fed funds rate).

Note: Only includes banks in the San Francisco Supervisory Region.

Interest Rate Trends

Capital Indicators -- SF Region
Median percent



Source: FDIC.

Note: Only includes banks in the San Francisco Supervisory Region. AFS = available for sale (carried at fair value).

*Beginning in 2020, community bank leverage ratio adopters stopped reporting risk-based capital ratios.



Interest Rate Risk Management

Interest Rate Risk Management

The adequacy of a bank's IRR program is dependent on its ability to identify, measure, monitor, and control all material interest rate exposures.

Key elements:

- Develop policies and procedures
- Identify and measure risk
- Monitor and report
- Establish internal controls, independent review, and audit program

Interest Rate Risk Management – Policies & Procedures

Board &
Management
Oversight

Strategies,
Risk Limits, &
Controls

Monitoring &
Reporting

Independent
Review &
Internal
Controls

Maintain an
Updated
Policy

Include IRR
in Overall
Risk
Management
Framework

Controls
Over
Mitigation
Activities

Interest Rate Risk Management - Policies & Procedures (Risk Limits)

Board should establish acceptable tolerances:

- Explicit dollar or percentage parameters
- Commensurate with complexity of the bank

Minimum requirements:

- Express as one- and two-year time horizons
- Correspond to the measurement system
- Address all key IRR risks and effect on capital and earnings

Most common issues with risk limits:

- **Limits so high that they are never breached**
- **Limits so low that exceeding them is considered routine and unworthy of action**
- **Lack of context to the financial impact of risk limits**
- **Even when breached, management takes no action to remediate**

Interest Rate Risk Management – Identifying & Measuring Risk

- Modeling
- Assumption driven
 - Deposit betas
 - Decay rates
 - Pre-payment on assets
- Sensitivity analysis



Interest Rate Risk Management - Identifying & Measuring Risk

Earnings Focus



Gap Analysis



Earnings Simulation

Balance Sheet Focus



Economic Value
of Equity (EVE)

Aka: NPV, MVE, PVE, MVPE, etc...

Interest Rate Risk Management – Monitoring & Reporting

Accurate, timely, and informative

- At least quarterly – board and management review
- Complex banks – more frequently

Key Elements

- Identify the source and level of IRR
- Evaluate key assumptions
- Report compliance with policies and risk limits

Interest Rate Risk Management – Internal Controls, Review, & Audit

Internal Controls

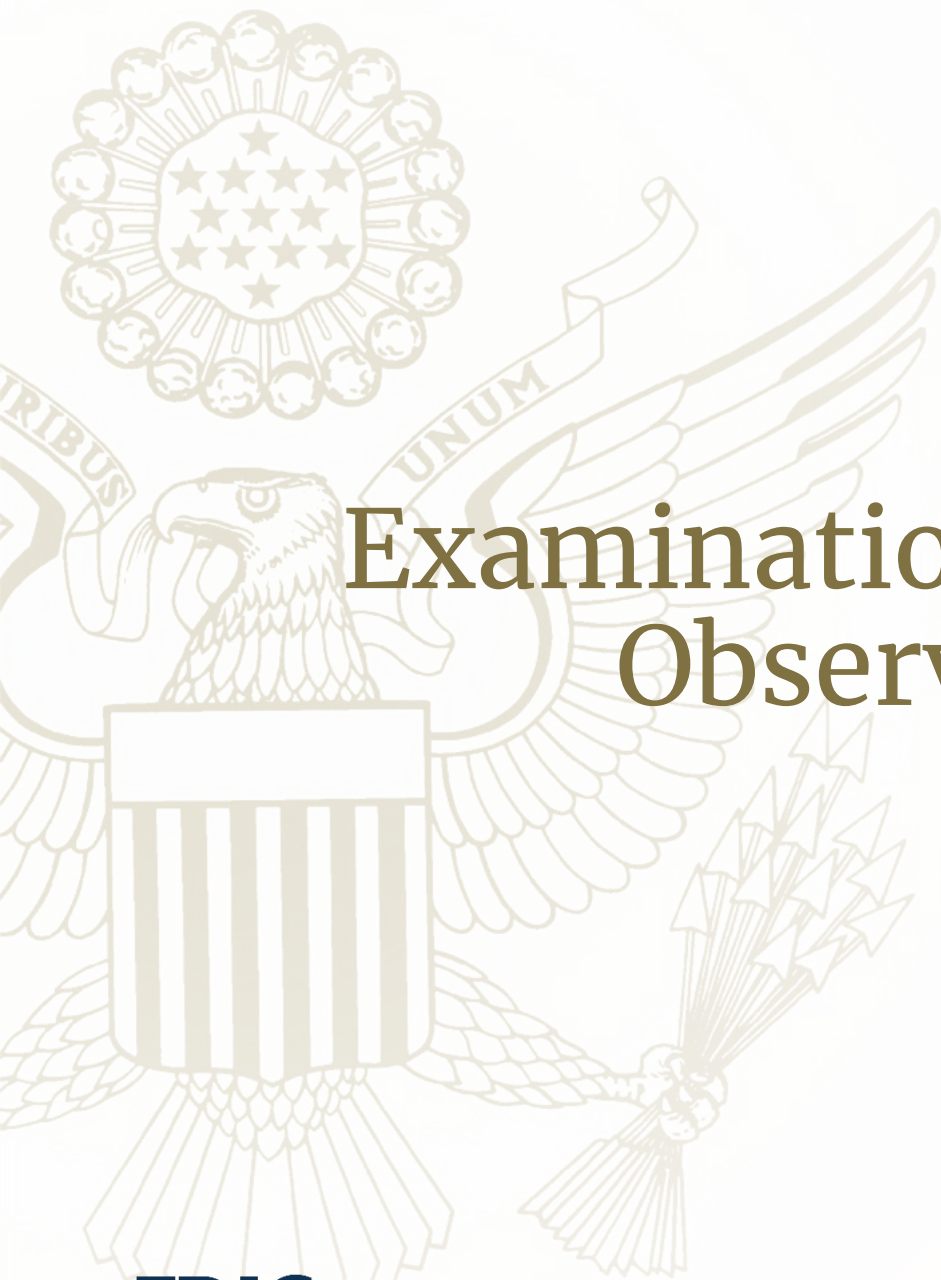
- Enforcement of official lines of authority and separation of duties

Independent Review

- Required at least annually
- Review assumptions, compliance with internal controls, and validity of model scenarios

Audit Program

- Depending on size and complexity, internal or external audit may be required



Examination Focus and Observations

Interest Rate Risk – Examination Focus and Observations

Recent examination focus

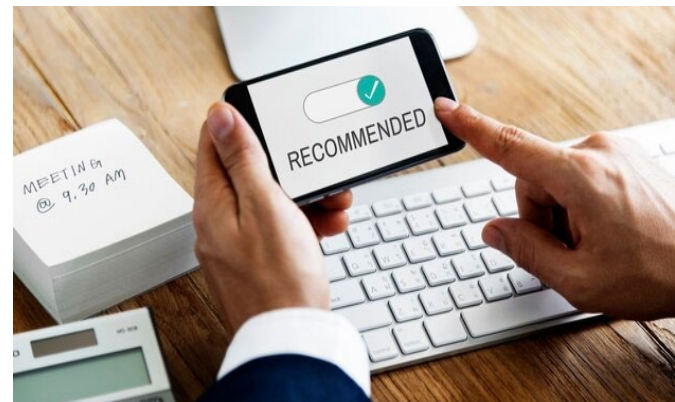
- Updated assumptions for decay rates, betas, pre-payments
- Review of policy limits, do they still make sense
- Back-testing for the time period rates increased rapidly
- Review of time horizons and size/frequency of shock scenarios



Interest Rate Risk – Examination Focus and Observations

Common issues noted during examinations:

- Management oversight weaknesses
- Model deficiencies
- Excessive IRR exposure
- Policy limitations
- Independent review weaknesses



Sensitivity to Market Risk





Case Study

Sensitivity to Market Risk – Case Study

What would you rate SMR? And, why?



Interest Rate Risk – Case Study

SMR Definition – 2 Rating

A rating of 2 indicates that market risk sensitivity is *adequately controlled* **and** that there is only *moderate potential* that the earnings performance or capital position will be adversely affected. Risk management *practices are satisfactory* for the size, sophistication, and market risk accepted by the institution. The *level of earnings and capital provide adequate support* for the degree of market risk taken by the institution.

Interest Rate Risk – Case Study

SMR Definition – 3 Rating

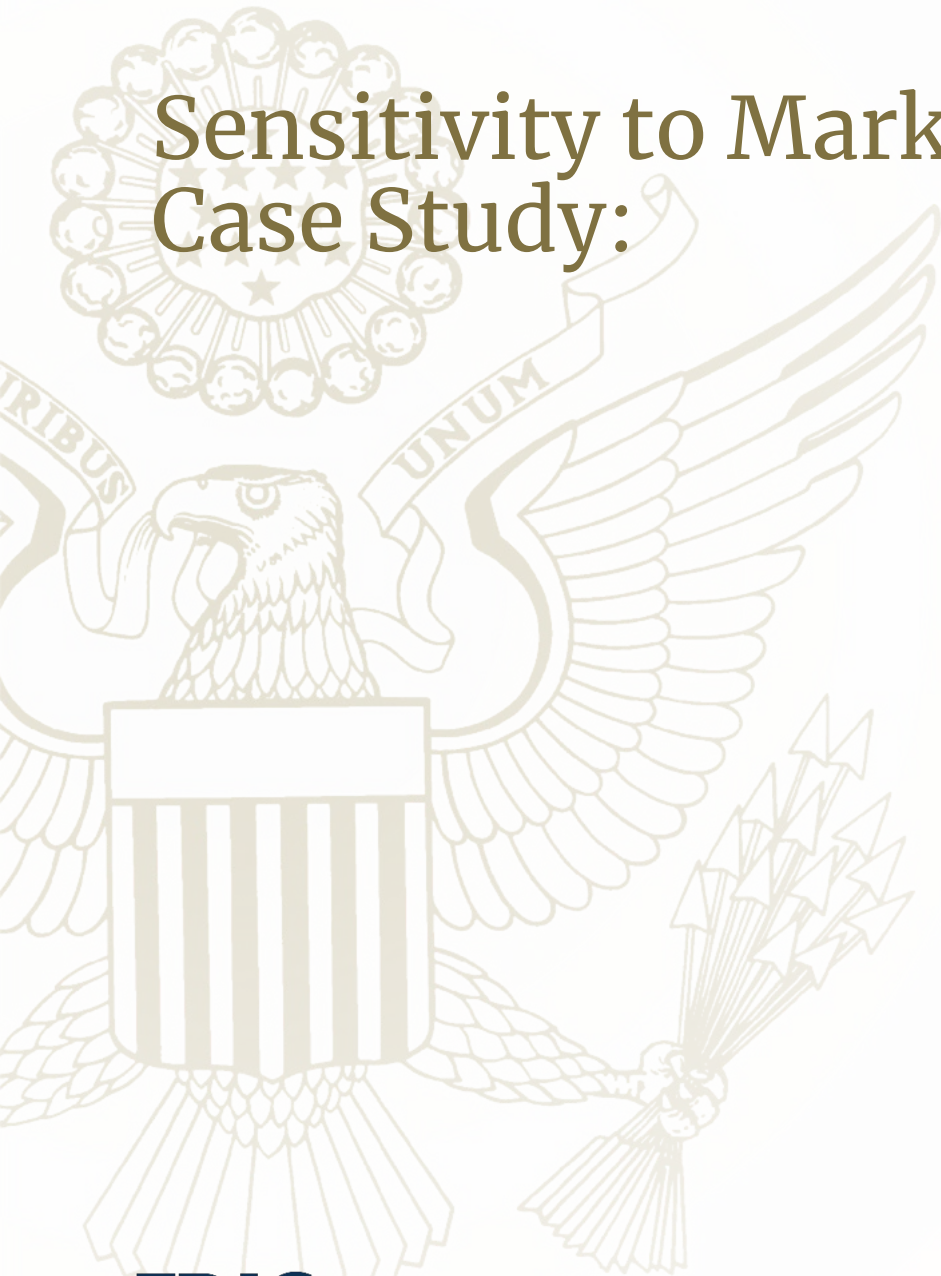
A rating of 3 indicates that *control* of market risk sensitivity *needs improvement* **or** that there is *significant potential* that the earnings performance or capital position will be adversely affected. Risk management *practices need to be improved* given the size, sophistication, and level of market risk accepted by the institution. The *level of earnings and capital may not adequately support* the degree of market risk taken by the institution.

Interest Rate Risk – Case Study

SMR Definition – 4 Rating

A rating of 4 indicates that **control** of market risk sensitivity is **unacceptable** **or** that there is **high potential** that the **earnings performance or capital position will be adversely affected**. Risk management **practices are deficient** for the size, sophistication, and level of market risk accepted by the institution. The level **of earnings and capital provide inadequate support** for the degree of market risk taken by the institution.

Sensitivity to Market Risk – Case Study:





Resources

Sensitivity to Market Risk – Resources

- [1996 Joint Agency Policy Statement on Interest Rate Risk](#)
- [2010 Interagency Advisory on Interest Rate Risk Management](#)
- [2012 Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions](#)



Sensitivity to Market Risk – Resources

- [2013 Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment](#)
- [Winter 2014 Supervisory Insights Articles on Interest Rate Risk](#)
- [Interest Rate Risk – Banker Resource Center \(Includes Technical Assistance Videos\)](#)

