SENSITIVITY TO MARKET RISK

~A CASE STUDY~

- **Objective** – Based on the following information, discuss the below facts and circumstances with your teammates and assign a Sensitivity to Market Risk (SMR) component rating utilizing the provided component rating definitions.

- Exam Date: 9-30-2024

Net Interest Income (NII) at Risk

Basis Point Change in Rates	NII Change ($000)	NII ($000)	NII Change (%)	Established Board Parameters (%)
+300	-1,687	2,463	-40.7	-30
+200	-1,260	2,890	-30.4	-20
+100	-633	3,517	-15.3	-10
0	0	4,150	0	0
-100	335	4,485	8.1	0
-200	190	4,340	4.6	-15
-300	163	4,313	3.9	-15

Economic Value of Equity Profile

Basis Point Change in Rates	EVE Change ($000)	EVE Change (%)	Established Board Parameters (%)
+300	-12,876	-69.1	-65
+200	-9,550	-51.2	-45
+100	-5,653	-30.3	-25
0	0	0	0
-100	4,660	25.0	-25
-200	3,860	20.7	-45
-300	1,226	6.6	-65

- Uniform Bank Performance Report (UBPR) analysis reveals Net Interest Margin compression from 3.27% to 2.98% over the prior year.

- The deposit base has shifted to more interest bearing deposits from non-interest bearing deposits. Overall, deposit levels have declined with a shift to more borrowings.

- The bank's investment portfolio, both available-for-sale (AFS) and held-to-maturity (HTM), and the loan portfolio have declined in fair value due to the increase in interest rates.

- Examiners reviewed the bank's latest interest rate risk model output reporting to the Board of Directors. The net interest income (NII) simulation results depict a liability sensitive position in the 12-month shock simulations. Economic value of equity (EVE) results depict a liability sensitive position in the shock simulation. The results are out of policy and management has formulated a plan that will bring the bank back within policy in the next twelve months. Examiners reviewed the plan and deemed it reasonable.

- Examiners reviewed key deposit assumptions that revealed that management had not updated the assumptions to reflect the experience of the 2022 to 2023 interest rate cycle. In addition, given it has been so long since rates declined, management has opted to use industry assumptions for declining interest rate scenarios for numerous years now. Further, management has yet to include a negative 400 basis points shock scenario in its quarterly analysis.

- Examiners also determined that management has not updated loan prepayment assumptions to reflect the interest rate cycle.

- Examiners requested the independent review of interest rate risk management practices. The independent review determined that risk management practices were satisfactory and no material findings were cited.

- Examiners were provided with the results of a 12-month model back-test completed by management. The back-test focused on model accuracy in a rising rate environment before the Fed began to increase rates. The back-test results depict a wide variance between actual results with projected results. Management is now evaluating the reasons for this wide variance. Early results of that evaluation indicate that the model errors stem from management underestimating the sensitivity of deposits in a rapidly rising rate environment.

- Examiners found that Capital, Earnings, and Asset Quality were satisfactory – all rated "2".

<u>Question</u>: What would you rate the SMR component?

SMR "2" Definition

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.

SMR "3" Definition

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.

SMR "4" Definition

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.