FDIC
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Financial Institution Letter
FIL-46-2013
October 8, 2013

Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment

Summary: The FDIC is re-emphasizing the importance of prudent interest rate risk oversight and risk management processes to ensure FDIC-supervised institutions are prepared for a period of rising interest rates.

Statement of Applicability to Institutions With Total Assets Under $1 Billion: This Financial Institution Letter applies to all FDIC-supervised banks and savings associations, including community institutions.

Distribution:
FDIC-Supervised Banks (Commercial and Savings)
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Suggested Routing:
Chief Executive Officer
Chief Financial Officer
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Related Topics:
Advisory on Interest Rate Risk Management, January 6, 2010:
http://www.fdic.gov/news/news/press/2010/pr1002.pdf

Frequently Asked Questions – Advisory on Interest Rate Risk Management, January 12, 2012 (FIL-2-2012):
http://www.fdic.gov/news/news/financial/2012/fil12002.html

Attachment:
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Highlights:

- The FDIC is re-emphasizing the importance of developing a comprehensive asset-liability and interest rate risk management program.
- Interest rate risk management should be viewed as an ongoing process that requires effective measurement and monitoring, clear communication of modeling results, conformance with policy limits, and appropriate steps to mitigate risk.
- Nationally, a number of institutions report a significantly liability-sensitive balance sheet position, meaning that a marked increase in interest rates could adversely affect net interest income and, in turn, earnings performance.
- For a number of FDIC-supervised institutions, the potential exists for material securities depreciation relative to capital in a rising interest rate environment.
- Examiners will continue to consider the amount of unrealized losses in the investment portfolio and the degree to which institutions are exposed to the risk of realizing losses from depreciated securities when qualitatively assessing capital adequacy and liquidity and assigning examination ratings.
- Net unrealized losses on available-for-sale (AFS) debt securities flow through to equity capital as reported under U.S. generally accepted accounting principles (GAAP). Adverse trends in an institution's GAAP equity can have negative market perception and liquidity implications.

Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment

The FDIC has identified industry trends that highlight the importance of careful management of sensitivity to interest rate risk. Nationally, a number of institutions report a significantly liability-sensitive balance sheet position, meaning that a marked increase in interest rates could adversely affect net interest income and, in turn, earnings performance. For a number of FDIC-supervised institutions, the potential exists for material securities depreciation relative to capital in a rising interest rate environment. Interest rate risk at most banks arises from traditional activities; however, institutions may have hedging positions, embedded optionality, or other strategies that can moderate this sensitivity. This Financial Institution Letter re-emphasizes the importance of prudent interest rate risk oversight and effective risk management processes to ensure all state nonmember institutions are prepared for a period of rising interest rates.

On January 6, 2010, the FDIC joined the other financial regulators[1] in issuing guidance titled *Advisory on Interest Rate Risk Management* (the 2010 Advisory). This guidance was issued when interest rates were trending toward historic lows and the more attractive asset yields were becoming concentrated in longer-duration assets. The issuance was intended to remind institutions of supervisory expectations for managing interest rate risk and that the declining trend in interest rates would not continue indefinitely. The fundamental risk management processes outlined in the 2010 Advisory continue to be relevant today. Institutions that embraced its tenets should have an effective interest rate risk management framework in place to handle potential market volatility.

The FDIC is increasingly concerned that certain institutions may not be sufficiently prepared or positioned for sustained increases in, or volatility of, interest rates. For example, institutions with a decidedly liability-sensitive position could experience declines in net interest income and potential deposit run-off in a rising rate environment. Moreover, rate sensitive liabilities may re-price faster than earning assets as coupons on variable rate loans and investments remain below their floor. Accordingly, the FDIC believes that asset-liability management should be viewed as an ongoing process that requires effective measurement and monitoring systems, clear communication of modeling results, evaluation of exposures relative to established policy limitations, and consideration of risk mitigation options as appropriate. As economic and interest rate cycles evolve, asset-liability management processes should be revisited to confirm that the institution has avoided a speculative position and reduced the likelihood of adverse outcomes. Boards of directors and management are strongly encouraged to analyze on- and off-balance sheet exposure to interest rate volatility and take action as necessary to mitigate potential financial risk.

If interest rates were to rise markedly, institutions that have concentrated bond holdings in long-duration issues could experience severe depreciation of a magnitude that could be material relative to their capital position. Institutions that rely primarily on a long-duration fixed-income portfolio for liquidity could have difficulty meeting short-term cash needs if other marketable assets or funding sources are not readily available. Although net unrealized losses on securities may not flow through to regulatory capital under certain circumstances,[2] examiners consider the amount of unrealized losses in the investment portfolio and an institution's exposure to the possibility of further unrealized losses when qualitatively assessing capital adequacy and liquidity and assigning examination ratings.

[1] The financial regulators that issued the 2010 Advisory are the Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, Office of the Comptroller of the Currency, former Office of Thrift Supervision, and Federal Financial Institutions Examination Council State Liaison Committee.

[2] The Basel III Interim Final Rule, adopted by the FDIC's Board of Directors on July 9, 2013, provides a prospective option for all institutions, other than institutions subject to the rule's advanced approaches, to make a one-time irrevocable election to continue to neutralize accumulated other comprehensive income in a manner consistent with existing rules and financial reporting standards.

Unrealized losses on securities also may reduce equity capital under U.S. generally accepted accounting principles (GAAP)[3]. Specifically, net unrealized losses on trading and available-for-sale securities are reflected in GAAP equity. Under certain circumstances, principally credit impairment, unrealized losses on held-to-maturity debt securities can also reduce GAAP equity. Adverse trends in an institution's GAAP equity can have negative market perception and liquidity implications.

The FDIC is re-emphasizing these practices to ensure state nonmember institutions have adopted a comprehensive asset-liability and interest rate risk management process:

- **Board and Management Oversight –** Effective board governance and oversight are critical to developing a strong asset-liability management process. Boards of directors should be aware of interest rate risk exposure during the business cycle, not just in advance of volatile periods. Therefore, directors need to devise sound policies and a clear understanding of their institution's susceptibility to interest rate volatility and the corresponding impact on earnings and capital. As appropriate, and based on analytical or modeling information, the board may determine that strategies should be developed to balance exposure to interest rates. Furthermore, management should ensure that interest rate risk measurement tools and output provided to board members are accurate and functioning effectively. Notably, Appendix A of Part 364 of the FDIC's Rules and Regulations, *Standards for Safety and Soundness* requires state nonmember institutions to manage interest rate risk appropriately and provide periodic reports that enable boards of directors to assess risk.

- **Policy Framework and Prudent Exposure Limits –** Asset-liability management and investment policies should be revised at least annually to ensure authorities, risk tolerance levels, and exposure limits are prudent. Policy limitations should formalize the board's risk philosophy, guide management's day-to-day decision making, and protect capital from undue risk. Given the potential for prospective interest rate volatility, directorates should review policies and exposure limits to promote safe-and-sound banking.

- **Effective Measurement and Monitoring of Interest Rate Risk –** All institutions should have well-developed risk measurement tools for monitoring interest rate risk. Management should not focus on a single measurement of interest rate risk, but instead review multiple types of data. A variety of modeling techniques, such as gap analyses, earnings simulations, economic value of equity estimations, and various stress tests, are used effectively by financial institutions. The 2010 Advisory recommends a holistic approach that considers a variety of these or other methods to help institutions develop a comprehensive interest rate risk assessment process. In addition, the Advisory suggests that institutions should consider the impact of 300 to 400 basis point interest rate changes on earnings and capital. Boards of directors should revisit and validate the effectiveness of current measurement tools in relation to their institution's rate sensitivity position. To complement standard interest rate risk modeling, institutions with longer-duration securities portfolios should test the sensitivity of their holdings to a hypothetical rising rate environment in terms of risk to earnings and capital.

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[3] Accounting Standards Codification (ASC) Section 320-10-35, *Investments-Debt and Equity Securities – Overall – Subsequent Measurement*, requires that any unrealized holding gains or losses on *trading securities* be reported in earnings and unrealized holding gains and losses on *available-for-sale* (AFS) securities generally be reported in other comprehensive income. *Held-to-maturity* (HTM) securities are measured at amortized cost; therefore, unrealized losses are generally not recognized in the financial statements. However, unrealized losses on HTM securities must be recognized if there is other-than-temporary impairment (OTTI). In general, for AFS and HTM debt securities, the portion of OTTI representing credit loss must be reported in earnings, while the remainder is reported in other comprehensive income. However, unrealized losses on AFS and HTM debt securities that an institution intends to sell or more likely than not will be required to sell before recovery of their amortized cost basis less any current-period credit loss are deemed OTTI, and therefore must be fully reported in current period earnings.

- **Risk Mitigation Strategies –** Financial institutions have a number of approaches that can be used to mitigate risks associated with outsized exposure to interest rate risk. These approaches can include rebalancing earning asset and liability durations, proactively managing non-maturity deposits, increasing capital, and hedging. Financial institutions' use of hedging instruments to mitigate interest rate risk exposure is only appropriate when institutions have the requisite knowledge and expertise to engage in such transactions, including the ability to accurately determine the exposure being hedged and to understand possible effects on the bank's financial performance and capital position. Entering into interest rate derivatives is a potentially complex activity that can have unintended consequences, including amplified losses, if used incorrectly. Institutions should not undertake derivative-based hedging unless the board of directors and senior management fully understand these instruments and their potential risks.

Effectively managing interest rate risk is part of the business of banking, and many institutions have effectively measured, monitored, and controlled exposures to achieve earnings goals. However, significant, unmitigated levels of interest rate or market risk can lead to losses and liquidity constraints when prevailing rates change significantly. The FDIC will continue to review interest rate risk in the normal course of its supervisory activities and offer feedback as appropriate on institutions' risk measurement and mitigation processes to sustain earnings and preserve capital.