Office of the Superintendent
of Financial Institutions Canada

Bureau du surintendant
des institutions financières Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

255, rue Albert
Ottawa, Canada
K1A 0H2

www.osfi-bsif.gc.ca

Guideline

Subject: **Interest Rate Risk Management**

Category: **Sound Business and Financial Practices**

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In July 2004, the Basel Committee on Banking Supervision released the final version of its *Principles for the Management and Supervision of Interest Rate Risk*. These principles support the Pillar 2 approach to interest rate risk in the banking book in the new capital framework. The principles document is the result of significant consultation dating back to before 1993 when the Basel Committee released guidance dealing with the measurement of bank exposure to interest rate risk.

OSFI believes that a risk control framework that manages interest rate risk (IRR) to prudent levels is a cornerstone of sound banking practice. As such, OSFI supports the principles outlined in the Basel Committee's July 2004 document. We would also like to highlight and or make further recommendations with respect to a number of issues outlined below.

1. Board Oversight

OSFI strongly endorses the Basel Committee's view that the Board of Directors is ultimately accountable for the deposit taking institution (DTI). Additionally, OSFI expects that the Board will determine the aggregate risk appetite of the DTI and ensure that control functions responsible for measuring and monitoring this risk are fully segregated and independent from position-taking operations.

OSFI recognizes that treasury operations in a number of DTIs report to the finance function, which is viewed as a key control. Although there is no intention at this time to prescribe reorganizations, OSFI expects financial institutions to maintain an adequate degree of impartial oversight over treasury operations.

2. Senior Management Oversight

OSFI concurs with the Basel Committee's view that senior management should have an integrated view of IRR. We stress that senior management is a key force in "institutionalizing" a control culture across the DTI. As such, we expect senior management to understand IRR management methodologies and encourage discussion between the risk management function(s) and position-taking operations.

OSFI also expects complex DTIs to establish a committee to oversee asset liability management. Such committees would be responsible for managing and vetting the strategic direction of IRR (such as positions and policies) within the DTI. To the extent that risk management personnel form part of this committee, they are expected to be an impartial observer(s) under normal operating conditions and thus not participate in tactical decisions regarding IRR position taking.

3. Measurement of IRR

OSFI supports the Basel Committee's principle that the degree of sophistication of IRR measurement techniques should be commensurate with the degree of risk inherent in the DTI. Where DTIs utilize models to measure and mitigate their IRR exposure, OSFI expects these models to be thoroughly vetted by an independent function.

Additionally, OSFI expects that DTIs will periodically undertake full reviews of their IRR measurement models. The frequency of these reviews depends on various factors, such as complexity of the DTI and size of IRR exposures, nature of market changes and complexity of innovation with respect to measuring IRR.

4. Disclosure of IRR

OSFI endorses the Basel Committee's principles on the disclosure of IRR and will assess the degree of IRR at DTIs based on these principles. OSFI will also review the following additional measures:

- Sensitivity (pre-tax)[1] of net interest income and economic value to parallel shifts in the yield curve of 10, 25, 100 and 200 basis points, the latter metric additionally as a percentage of capital,
- Sensitivity (pre-tax)[1] of net interest income and economic value to three non-parallel shifts in the yield curve to which the DTI is vulnerable,
- Sensitivity (pre-tax)[1] of net interest income and economic value to key rates to which the DTI is vulnerable,

[1] Sensitivities should be measured over a 12-month period.

- Monthly sensitivity and stress testing (the comprehensiveness of which should be commensurate with the size and complexity of the DTI), and
- The robustness of the annual review (at a minimum) of assumptions underlying IRR measurement techniques for less sophisticated DTIs, and more frequent reviews (as appropriate) for complex DTIs.

5. Limit Setting

OSFI fully supports the Basel Committee's view that limits should be commensurate with the risks undertaken by the DTI. A DTI should express limits relative to its balance sheet and earnings base. Limits are expected to be reflective of the DTI's prospective expectations of interest rate volatility and be calibrated to historic utilization levels. Material fluctuations in volatility should result in breaches of the limits. These breaches should prompt discussion on the overall risk direction of the DTI.

6. Funds Transfer Pricing

OSFI believes that the allocation of capital to risk is an integral component of sound IRR management. In the case of complex DTIs, OSFI expects that IRR management and IRR risk will be transferred to centre(s) of expertise, with risk capital and associated profit and loss being allocated and measured accordingly. As part of this process of centralization, OSFI expects complex DTIs to utilize an appropriate fund transfer pricing mechanism to manage this transfer, with such pricing mechanism to be managed independently of position-taking operations.

7. Role of Internal Audit

Due to OSFI's reliance-based supervisory framework, we emphasize the importance of internal audit as a key check in ensuring that control functions are operating effectively. We also encourage management and audit to ensure that any audit findings and follow-up are addressed in a timely manner.

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