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TO: Chief Executive Officer
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FROM: Jeffrey C. Vogel, Commissioner

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SUBJECT: Interest Rate Swaps

The recent period of historically low interest rates has created many interest rate risk challenges in the banking industry. As a result, interest rate swaps are becoming more common. Interest rate swaps are off-balance sheet interest rate risk management tools that have been in existence for many years. Banks commonly use swaps to reduce their general exposure to changing interest rates and/or adjust their interest rate risk posture. While Wyoming state banks have not chosen to utilize interest rate swaps to a large degree, it is a permissible activity provided that it is consistent with bank policy and an adequate level of risk analysis has been completed.

Correspondent banking organizations are actively marketing interest rate swaps. Our review of this information has prompted our office to provide guidance to assist banks with the analysis required to understand the potential risks and outline our expectations for pre-purchase analysis and documentation. While the marketing materials indicate that an interest rate swap is a simple transaction involving the exchange of variable and fixed rate interest streams, bank management must consider, prior to engaging in a transaction, there are many risks involved. Additionally, a high level of expertise, pre-purchase analysis, and ongoing monitoring are required to mitigate the potential exposure to the bank. The purpose of this correspondence is to highlight some of the potential risks as well as provide guidance in regard to the expected level of pre-purchase analysis and documentation.

ASSOCIATED RISKS

Banks are impacted by the risks associated with a specific product or investment. These risks include, but are not limited to operating risk, market risk, credit risk, liquidity risk, and legal risk. The Board of Directors is responsible for identifying, measuring, monitoring, and controlling these risks. As a result, policies and procedures set risk limits and measurement systems test the risk limits and provide monitoring tools.

It is imperative the bank have established policies with risk limits and sufficient measurement systems to capture the potential exposure and the Board of Directors understand the risks associated with a swap transaction. Policies and procedures and measurement tools should be commensurate with the potential exposures for specific products or investments and their overall impact to the financial condition of the bank. The following describes how each broad risk category is impacted by swap transactions.

Operating Risk

Operating risk is the consideration of the bank's ability to manage and quantify the risks associated in a swap transaction. This includes, but is not limited to adequate management expertise, staffing levels, policies, measurement systems, ability to analyze and document the purpose and need of the transaction, internal audits, and internal controls.

Market Risk

Market risk is the effect the swap will have on the net economic value of the bank. More specifically, market risk is made up of interest rate risk, basis risk, and price risk. Interest rate risk is the possibility of loss in the swap's market value due to changes in interest rates. This is the predominant market risk. Basis risk is the possibility of loss due to changes in the relationship between two or more indices. Price risk is the possibility of loss due to changes in the swap spread.

Credit Risk

Credit risk is the exposure related to the ability of a counterparty to meet cash flow obligations related to the swap. Credit risk should be measured by market value, and not notional value. The degree of potential exposure depends on the term to maturity and volatility of interest rates. Credit risk is typically greatest during the early part of the contract because the credit standing of a counterparty is more likely to deteriorate over a longer period of time.

Liquidity Risk

Liquidity risk is the potential a swap cannot be sold or replaced quickly at or close to its economic value. Swaps are traded over the counter, and do not have an established secondary market. However, the market is very broad. In addition, swaps having customized features increase liquidity risk. Swaps with maturities greater than five years are typically less liquid. The analysis of liquidity risk should include periods of market stress or early termination of swap contracts by counterparties. In addition, the impact of the swap on the overall liquidity position of the bank should be considered.

Legal Risk

Legal risk is the potential a swap contract will not be enforceable or legally binding on the counterparty. This includes the adequacy of legal documentation. Legal documentation should include confirmation from the broker specifying the terms of a particular agreement and a master swap agreement specifying the terms for transactions involving the counterparties. All contracts should be reviewed by bank legal counsel.

PRE-PURCHASE ANALYSIS

Management should analyze and document the review of associated risks and potential financial impact to the bank prior to entering a transaction. This analysis is crucial because the value of a swap can be very volatile. The pre-purchase documentation should clearly state the purpose for the transaction and the reason for choosing the terms related to the transaction. The purpose for the transaction should be consistent with the bank's overall strategies. Additionally, documentation regarding the method used to determine the volume and terms of the swap should be maintained. The main goal of pre-purchase analysis is to determine the swap's overall potential impact to the bank. The degree of sophistication in this analysis should be commensurate with the size of the proposed transaction.

PERIODIC MONITORING AND REPORTING

Management should monitor risks associated with a swap and periodically report to the Board of Directors. Periodic review should be done in the context of the bank's overall exposure to changing interest rates. Management should review the terms of the swap and ensure that the performance in relationship to the overall performance of the bank is commensurate with the original intent of the swap transaction. It is important for management to reassess swap positions following changes in interest rates to ensure that hedging strategies remain effective. Additionally, management must consider the effect of interest rate swaps on the banks income.

RISK-BASED CAPITAL CONSIDERATIONS

Interest rate swaps are incorporated into risk-weighted assets by converting the swap into a credit equivalent amount and assigning it to the appropriate credit risk category. A swap's credit equivalent amount is its current replacement cost plus an estimate of future credit exposure. Bank management should refer to outstanding guidance on calculating potential credit exposure and ensuring the appropriate reporting for risk-based capital purposes. It is important for bank management to consider the potential impact on risk-based capital prior to entering a swap transaction.

SUMMARY

The use of interest rate swaps for the management of interest rate risk is permissible for Wyoming state banks. Nevertheless, it is imperative bank management complete an appropriate risk assessment and document the pre-purchase analysis of a swap transaction. Prior to entering into swap transactions, the Board of Directors must ensure internal operations are sufficient to properly manage the risks associated with a swap transaction and bank policies are in place to limit the potential exposure related to these transactions.

If you have any questions, need additional information, or would like to discuss your bank's strategies and policies with regard to off-balance sheet hedging activities, please do not hesitate to contact our office at (307) 777-7797. Our office is interested in allowing state banks to participate in activities that are beneficial to their overall performance. Nevertheless, it is important to establish the proper controls to ensure accurate calculation of potential exposure to minimize the risk to the bank.