

INTEREST RATE RISK AUDIT PROGRAM

A:

The table below lists the procedures being tested. Work paper references are included to eliminate duplicate work paper references. Budget hours should tie out to the Budget/Plan form in section 3 of the Planning File. The “Done By” column identifies the work has been completed when initialed and dated.

AUDIT OBJECTIVE/ PROCEDURE	W/P REF	BUDGET	DONE BY
<p>Oversight and Organization Structure: Determine the extent and effectiveness of senior management and board supervision of the bank’s interest rate risk activities and review the following:</p> <ul style="list-style-type: none"> • Bank’s objectives, strategies, and risk tolerance for interest rate risk. • Instruments and portfolios used by the bank to manage its interest rate risk exposure. • Individuals or units responsible for measuring, managing, and controlling the bank’s interest rate risk. <p>SCOPE: Discussions with management and review corresponding documentation.</p>			
<p>Loan Portfolios: Discuss with management the policies regarding loan pricing and maturities and the development of new loan products or structures.</p> <ul style="list-style-type: none"> • Are there sufficient controls in place to monitor and control the taking of interest rate positions through the bank’s loan activities. <p>Determine how management uses assumptions and methods to assess the effective maturities or repricing dates for loans with unspecified maturities (Credit Card Loans).</p> <ul style="list-style-type: none"> • Does the bank have a large volume of these types of loans or does it plan to within the next 6 to 12 months? <p>Determine if the bank has substantial volumes of medium or long-term fixed rate loans.</p> <ul style="list-style-type: none"> • How does the bank monitor and evaluate the actual or potential appreciation or depreciation in those portfolios. • Does management assess how appreciation or depreciation could affect the bank’s earnings and capital. <p>Determine the volume and \$\$ value of mortgage products and other loans with explicit caps relative to the balance sheet.</p> <ul style="list-style-type: none"> • How does the bank monitor and evaluate the effect of those caps on the bank’s future earnings. • What level of interest rates those caps would come into effect. <p>Determine if the bank periodically assesses how a substantial increase in interest rates may affect the credit performance of its loan portfolio.</p>			

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<p>Does the bank incorporate and enforce prepayment penalties on medium or long-term fixed rate loans.</p> <p>SCOPE: Discussions with management and review corresponding documentation.</p>			
<p>Investment Portfolios: Obtain a current investment trial balance</p> <ul style="list-style-type: none"> • Review all purchases and sales since DATE. • Determine the nature and maturity/repricing composition of the bank's investment portfolio. <p>Determine the bank's investment strategies with regard to interest rate risk management.</p> <ul style="list-style-type: none"> • Are there documented policies/procedures in place outlining the strategies. • Are the bank's classification and accounting treatment for its investment holdings appropriate given management's strategies and actions. <p>Determine if the bank has substantial volumes of medium or long-term fixed rate investments.</p> <ul style="list-style-type: none"> • How does the bank monitor and evaluate the actual or potential appreciation or depreciation in those investments. • Does management assess how appreciation or depreciation could affect the bank's earnings and capital. <p>Determine whether the bank's interest rate risk measurement systems can adequately evaluate securities with embedded options, such as CMO's, and structured notes.</p> <p>SCOPE: Discussions with management and investment accounts as of DATE.</p>			
<p>Deposit Accounts: Determine whether management has analyzed the bank's deposit base.</p> <ul style="list-style-type: none"> • Does the analysis consider the bank's pricing policy as well as how competitors' actions may affect the bank's pricing policy. <p>Determine whether management has estimated how the bank's deposits will react in different rate environments, including whether management has considered:</p> <ul style="list-style-type: none"> • Implicit or explicit floors or ceilings on deposit rates. <p>Determine whether management has analyzed trends in deposit accounts for:</p> <ul style="list-style-type: none"> • Stability of offering rates. • Increasing or declining balances. • Large depositor concentrations. • Seasonal and cyclical variations in deposit balances. <p>Determine if management performs sensitivity analysis on deposit assumptions.</p> <ul style="list-style-type: none"> • Does management analyze how its interest rate exposure may change if those assumptions change or prove to be incorrect and what action, if any, would be taken. 			

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<p>Determine reasonableness of the bank’s assumptions about the effective maturity of the bank’s deposits. Evaluate to what extent the bank’s deposit base can offset interest rate risk exposures.</p> <p>SCOPE: Discussions with management and investment accounts as of DATE.</p>			
<p>Off-Balance Sheet Derivatives:</p> <ul style="list-style-type: none"> • Does LNB utilize off-balance sheet derivatives to manage its IRR? • If so, how is it used? <ul style="list-style-type: none"> ○ Are how value and value sensitivity determined? • Are such actions consistent with the Asset/Liability management policy? <p>SCOPE: Review of supporting documentation and discussion with management.</p>			
<p>Management Information Systems:</p> <p>Determine whether the bank’s management information systems (MIS) provide adequate and timely information for assessing the interest rate risk exposure in the bank’s current balance sheet positions. Consider whether information is available for all the bank’s material portfolios, lines of business, and operating units including:</p> <ul style="list-style-type: none"> • Current outstanding balances, rates/coupons, and repricing indices. • Contractual maturities or repricing dates. • Contractual caps or floors on interest rates. • Scheduled amortizations and repayments. • Introductory “teaser” rates. <p>Determine whether the bank’s method of aggregating data is sufficient for analysis purposes given the nature and scope of the bank’s interest rate risk exposure(s).</p> <p><i>MORTGAGE TESTING – DETERMINE VALUE OF ASSETS FIRST</i></p> <p>Determine whether the bank’s MIS provides sufficient historical, trend, and customer information to help bank personnel formulate and evaluate assumptions regarding customer behavior. Consider, where material, whether information is available to analyze:</p> <ul style="list-style-type: none"> • Loan prepayments. • Early deposit withdrawals. • Spread between administered rate products, such as prime based loans and non-maturity deposit accounts, and market rates of interest. <p>SCOPE: Review supporting documentation and discussion with management.</p>			
<p>Risk Measurement Systems:</p> <p>Determine the type of interest rate risk measurement systems used by the bank and evaluate the adequacy of those systems. Consider whether the measurement system(s):</p> <ul style="list-style-type: none"> • Identify and measure the bank’s major sources of interest rate risk exposure. • Are commensurate with the size, nature, and complexity of the bank’s activities. • Provide estimates of the bank’s exposures in a timely and comprehensive manner. 			

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<ul style="list-style-type: none"> • Measure the bank’s earnings-at-risk from a change in interest rates. • Identify and measure significant medium and long-term positions. • Are capable of handling the risk characteristics of the bank’s business lines and products. <p>Determine if the reports generated are easily understood and complete in a format senior management and the board can readily understand to make timely decisions and monitor compliance with stated objectives and risk limits.</p> <p>Identify the interest rate scenarios the bank uses to measure its potential interest rate risk exposures. Assess the adequacy of such rate scenarios by considering whether they:</p> <ul style="list-style-type: none"> • Cover a reasonable range of potential interest rate movements in light of historical rate movements. • Allow the bank to consider the impact of at least a 200 basis point interest rate change over a one year time horizon. • Reasonably anticipate holding periods or the time it may take to implement risk mitigating actions given the bank’s strategies, activities, market access, and management abilities. • Sufficiently capture the potential risks arising from option-related positions. <p>Discuss with management the key assumptions underlying the bank’s risk measurement models. Determine whether:</p> <ul style="list-style-type: none"> • Assumptions are periodically reviewed for reasonableness. • Major assumptions are documented and their sensitivity tested and communicated to senior management and the board at least annually. • Assumptions are reasonable in light of the bank’s product mix, business strategy, historical experience, and competitive market. • Cash flow assumptions for products with option features are reasonable and consistent with the interest rate scenario that is being evaluated. <p>SCOPE: Review supporting documentation and discussion with management.</p>			
Planning			
Work paper Review			
Report/Exit			
Wrap Up			
Total Plan Hours			