AN INTEREST RATE RISK PARTY

by Steve Brown

Talk about interest rates for any length of time at any party and people's eyes will begin to dart around, as they seek a way to exit the conversation. We have a real problem with that because we enjoy talking about interest rates. After all, we don't have to tell any of our community bank readers that shifting interest rates change what is earned on loans and paid on deposits (and ultimately impacts profitability). Make no mistake, invite us to a party and rest assured we will eventually get around to talking about interest rates.

Why bring all this up this morning, you may be wondering? No, we are not trying to worm our way into your next party, nor are we trying to state the obvious. Rather, we bring this up because regulatory examinations in 2008 are not going to be easy for bankers and being prepared is important. As such, we bring up interest rate risk because it is time once again for community bankers to brush off their models, stress interest rates and present the findings to ALCO and the board of directors.

As we have been saying over the past few days in this publication, banking is all about managing risk and managing interest rate risk is fundamental.

Interest rate risk management requires estimating the probability and impact of adverse affects on assets or liabilities, caused by movement in interest rates. Community bankers know they need to consider the impact of interest rate movement on the balance sheet and income statement and the current market provides a real life example of what can happen when such rates shift abruptly.

Now is also a great time to see how well your interest rate risk model actually predicted what happened to your bank as rates have recently gyrated. Two years ago, the FRB raised rates from 4.50% to 5.25% (as of 2Q 2006). They then held the line on rates until the 3Q of 2007, when they cut by 50bp to 4.75%. It has now been 148 days since the FRB began cutting rates and the impact has been a whopping 225bp. While not exactly immediate and parallel, the last 125bp in cuts came within a span of only 8 days (about as close to immediate as one can get). Did your model catch this impact, have earnings (related to interest rates) moved as expected or are there holes in the model that need to be researched further?

This year looks like it will be a rough one, so bankers should make sure to blow the horn of interest rate risk measurement. Along with credit risk exposure, interest rate risk management is going to be critically important for bankers working to protect profitability and meet regulatory expectations.

For community banks in particular, examiners will be focused on how well the bank's model accurately predicts the impact of interest rate movement. Of perhaps equal importance, examiners will also zero in on how well bank management, the ALCO committee, and the board of directors understand the output of the model and its limitations. Finally, look for examiners to take a close look at how bank management reacts to the results of the model and how the information is integrated into the strategic planning process of the institution.

Banking is all about taking risk, so measuring, monitoring and managing the impact of interest rate movement and volatility on the bank's balance sheet (and adjusting duration and liquidity of various segments of the balance sheet) is critical. Our advice to community bankers is simply not to forget about the importance of interest rate risk and liquidity, as the focus shifts this year toward putting more resources on managing credit risk exposures in the loan portfolio.

BANK NEWS

Trouble

IndyMac Bancorp reported a net loss of $509mm for the 4Q, the first annual loss in its 23-year history. While lots of banks are producing weak earnings, we single this one out as it had the distinction of the lowest average stock price relative to book for the last month (36%) for the industry.

SLMA Slammed

S&P has cut the credit rating on Sallie Mae by 2 notches, downgrading it to just slightly above junk-status. S&P said the company is facing pressure on funding, credit quality and profitability.

Credit Cards

In an effort to support the bottom line, experts say large banks will likely increase credit card fees by about 6% this year. In 2007, banks collected a record $18.1B in penalty fees on credit cards, a 69% increase from 4Ys earlier.

ME Banking

Aimed at its "tech savvy" customers who use modern banking technology, Southern Community B&T ($1.5B, NC) unveiled its Maximum Earnings Banking package. The package offers a 6.0% APY, free online bill pay, and no foreign ATM charges when customers agree to an e-statement instead of a paper one, make 10 debit purchases a month and have one direct deposit or automatic draft per month.

Bank Access Shift

A new study finds 68% of people aged 34 or younger prefer to bank through ATM or Online channels, compared to only 33% of those aged 55 or older.