ADVISORY ON INTEREST RATE RISK - PART 1

by Steve Brown

On Jan 6, regulators released an advisory on interest rate risk management to remind bankers of examiner expectations for managing interest rate risk (IRR). While no one expects the FRB to raise rates any time soon, the notification was interesting nonetheless. The advisory also reminded us of a similar approach taken back in Dec. 2006, when examiners warned bankers to focus on the risks of concentrations in commercial real estate. That action was followed by an ever increasing emphasis during examinations, so bankers should take heed and ensure proper actions are being taken related to IRR risk management.

The purpose of the advisory was a way for regulators to reiterate the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing and internal controls related to the IRR exposures. They also used it to clarify elements of existing guidance and describe certain IRR management techniques that are being used by effective risk managers. Some of the most critical aspects from our perspective are outlined below.

From a high level, bankers are reminded that a steep yield curve can provide opportunities for earnings (lend long, fund short), but this opportunity can pose risk to capital and earnings. In addition, effective IRR management is particularly important for those experiencing downward pressure on earnings and capital due to lower credit quality. Banks holding high levels of IRR or that don't manage their risk will be expected to hold higher levels of capital as a balance. We found it interesting that the word "capital" was used 25x while "earnings" was used only 21x.

Banks will need to ensure IRR exposures are incorporated and evaluated as part of an enterprise-wide risk identification and analysis process. That means bankers will have to run interest rate shocks of sufficient magnitude, regardless of size or complexity (there are nuances here, so we will pick that up in a future edition). Of note, regulators indicated technology now allows all banks to perform comprehensive simulations of the potential impact of changes in market rates on their earnings and capital, so this is probably the death-knell for Call Report driven ALM models. Regulators expect banks to not only perform historical analysis, but also incorporate forward-looking modeling to ensure assumptions are supportable and models are relevant to the bank (including its market, business plan and financial strength). Finally, regulators expect banks to thoroughly document assumptions, while monitoring and regularly updating them if needed.

The advisory also hit hard on governance, policies and procedures. Banks should be aware that if earnings and capital are insufficient to support the IRR risk, then they must either: 1) mitigate the risk, 2) increase capital, or 3) both mitigate and increase capital. Further, the board of directors, ALCO and management need to clearly understand risk tolerance limits and approaches to managing the impact of IRR on earnings and capital. Also, ALCO should include a broad representation across major functions to ensure groups that can directly or indirectly influence IRR exposures (lending, treasury, retail & wholesale funding) are included in the process. Finally, policies and procedures should be tightened to ensure they include new strategies, products, businesses, etc. into the IRR management process. Above all, IRR is to be appropriately incorporated into firm-wide risk management efforts so interrelationships of risk (IRR, credit, liquidity, etc) are understood.

This was a far-reaching advisory that bankers will need to begin adjusting for quickly, in order to be prepared for the next examination. Reviewing the bank's position and taking appropriate action is advised. There were also more points to cover in this advisory, so we'll hit it again tomorrow to assist.

BANK NEWS

Less Focus

The Fed is rumored to be looking to diversify its short-term monetary tools. Later on this year it is expected to announce that the interest rate on excess bank reserves will be its primary liquidity mechanism instead of Fed Funds.

Another Tax

The Obama Administration is floating the prospect of a tax or fee on large banks that took TARP, in an effort to quell public discontent about the quick rebound in bank earnings and as a means to help the budget deficit. In an ironic twist, the Fed separately released information that it posted a record profit for 2009 due to earnings/gains from bond purchases and emergency loans to banks. The Fed returned an estimated $45B to the Treasury, the highest profit in its 96Y history.

No Deduction in 2009

The IRS ruled that it will not permit banks to accelerate the 2010 portion of FDIC insurance assessment for 2009 tax purposes as the 13 quarter payment violates the 12-month rule.

CU Closed

Kern Central CU was closed ($35mm, CA) with Self-Help Fed CU ($75mm, NC) acquiring assets and liabilities.