ADVISORY ON INTEREST RATE RISK - PART 2

by Steve Brown

Yesterday we kicked off our discussion on the new interest rate risk (IRR) advisory from banking regulators and we pick up that discussion further today.

Here are additional areas bankers should be aware of when trying to comply with this new advisory and ensure proper processes are in place to manage IRR exposures.

Models & Measurements. Banks that use third-party models must understand the underlying analytics, assumptions and methodologies in order to ensure they are incorporating that understanding into strategic short term (tactical) and long term (strategic) IRR management. It is important that banks evaluate adverse changes in economic value against future earning & capital. These days, desktop software applications allow even the smallest community bank to perform comprehensive simulations of the potential impact of changes in market rates on their earnings and capital, so regulators are no longer giving a free pass to "basic" modeling approaches. Under the advisory, banks are encouraged to use the full complement of analytical capabilities of their IRR simulation models to evaluate both earnings and changes in market values. In addition, banks are reminded that when using earnings simulation models, IRR exposures are best projected over at least a 2Y period. Finally, when performing dynamic simulations, banks are advised to also run static simulations to provide ALCO or senior management a complete and comparative description of the IRR exposure.

Stress Testing. Part of any good ALM or IRR modeling process includes stress testing. The advisory indicates IRR measurement should be sufficiently robust to capture material on/off-balance sheet positions and incorporate a stress-testing process to quantify the institution's IRR exposure. That means, in many cases, static interest rate shocks consisting of parallel shifts in the yield curve of +/-200bp may not be sufficient to adequately assess exposure. Best practices indicate banks should regularly assess IRR exposures to greater changes in magnitude such as 400bp shifts, as well as simulate changing slopes and twists in the yield curve. Regulators indicate shock scenarios should include but not be limited to: instantaneous and significant changes in the level of interest rates; substantial changes in rates over time; changes in the relationships between key market rates (i.e., basis risk); and changes in the slope (shape) of the yield curve. It is critical that bankers also include sensitivity analysis to help determine assumptions that have the most sensitivity on model output. Finally, regulators remind bankers that when conducting stress tests, consideration should be given to positions in which concentrations exist, because as we have all seen during this most recent credit crisis, such positions may be more difficult to unwind or hedge during periods of stress.

Assumptions. As with any modeling process, assumptions are critical and regulators expect banks to be sure proper review is occurring. The advisory reminds bankers that IRR model assumptions should be monitored and updated regularly, including the reasonableness of asset prepayments, non-maturity deposit price sensitivity and decay rates, and key rate drivers. Specifically, regulators indicate assumptions about non-maturity deposits are critical, particularly in market environments in which customer behaviors may not reflect long-term economic fundamentals, or in which institutions are subject to heightened competition for such deposits. Finally, rate-sensitive and higher-cost deposits (such as brokered & internet), are likely to reflect higher decay rates than other types of deposits. No matter how much analysis or review is done when it comes to IRR, bankers will need to be sure they are performing both historical and forward-looking analyses to support assumptions relevant to their business plans.

The 11 page advisory is worth a close read, as we did not cover all aspects in our 2 day discussion. If the CRE guidance that came out in late 2006 is any indication, bankers had better focus on IRR soon to avoid having issues down the road.

BANK NEWS

FDIC Fees and Compensation

In a split vote, the FDIC agreed to move forward with a proposal that would impose greater deposit insurance fees on banks whose compensation plans encourage risky behavior. The good news is that the proposal focuses on structure and not level of compensation. The bad news is that there is no workable definition of what "risky behavior" is. The proposal may or may not impact community banks and the general concept would be that the more risk on the balance sheet, the more compensation plans should contain a deferred, clawback or long-term equity component to better match that risk. In addition, it also appears that compensation plans will need to have more oversight from independent directors. To the extent there is a gap in best practices, assessment fees would most likely rise.

Low Biz for Small Biz

According to Javelin Strategy & Research, nearly 2/3s of small businesses do not have a business bank account.