THE FUTURE OF INTEREST RATES AND IRR EXAM PREP

by Steve Brown

If you have not figured it out, Punxsutawney Phil and Ben Bernanke are closely related. If you think we are making this up, consider both are in the forecasting business and rumor has it both also secretly watch Jersey Shore. If this does not convince you, then consider that both often say the same thing over and over again. Look no further than last week when the Chairman popped his head up, saw his deflationary shadow and declared 6 more weeks of the same policy. Today, Phil popped his head up, saw his shadow and declared 6 more weeks of winter. The reality is that winter this year isn't what it normally is and having low rates for this extended period of time is creating some issues as well. Interest rates, like the weather, are a volatile and unpredictable force that creates a large element of risk. This concept was the impetuous for last month's interagency FAQ on interest rate risk put out by the regulators. The publication provided insight on what is considered a complex institution, which is good since no one we know considers themselves complex. These institutions include those who hold complex products including, but not limited to, collateralized mortgage obligations, step-up notes, callable agency bonds, convertible FHLB borrowings, alternative CDs, 1-4 family residential mortgage loans/securities and commercial real estate loans/securities. Basically, because of this definition, about 70% of banks under $100mmm could be considered complex and 92% of community banks under $5B qualify. In the past, smaller community banks often saw themselves as immune from the complex institution status, however, with the clarity provided in the FAQ, many would now be considered complex. Similar to Ben and Phil, the FAQ didn't say anything new or unexpected, but served to focus banks on what is important this year when it comes to the IRR portion of the exam. In a nutshell, if you are a complex institution, your IRR model needs to handle individual line items (no more call report data) and be able to quantify optionality. Banks must demonstrate that they have the resources and experience to handle both the modeling (to include back testing and independent review) and management of complex instruments. Assumptions in the model must also be clearly defined, formally stated and supported. When it comes to scenario running, banks should run a growth and a no-growth scenario and indentify the impact on risk between the two. Any new products or strategies should be evaluated within the context of how they quantitatively impact interest rate risk (prior to launching) and banks are expected to run at least an up 400bp shift in addition to a stark non-parallel shift up in the yield curve (often referred to as a "bull steepener"). One clarification that may catch banks by surprise is best practices now dictate that banks should capture both earnings impact and economic value of capital over at least 2Ys (in 12 month increments). Many banks just do 1Y or if they do multiple years, they only analyze the first year. Here, if a 2Y+ view and EVE threshold isn't in your policies, be sure to have a notated discussion around it so regulators know you are doing this. Finally, management should carefully consider deposit and non-maturity deposit decay-rate assumptions. This is particularly critical given how customer behavior's change during periods of stress - such as customers' flight to quality (insured deposits). Also the deterrence value of prepayment penalties during times of near-zero interest rates might influence time-deposit decay rates. Similar considerations should be given to other key rate drivers and prepayment assumptions used in the IRR model. The bottom line is that it is now imperative that institutions of all sizes understand the complexities of their balance sheet, transition away from call report driven models and ensure the banks' models adequately capture risk around both currently held and planned balance sheet items. If you would like our summary of the FAQ with additional hints on how to prepare for the next IRR portion of your exam, please register by following the link in our Related Links section on the bottom right of this page and we will send you a copy. Like Ben's statement last week, Phil's proclamation this morning was closely watched, but will go largely unheralded. While both Phil and Ben's predictions will be entered into the Congressional record, only history will prove which will be the more accurate and which one will have more impact on bank earnings. Our money is on the Chairman.

Related Links:
Registration For IRR FAQ Summary

BANK NEWS

Brand Value

The Brand Finance Banking 500 list that ranks the value of the largest banks in the world and assigns a value has resulted in HSBC coming out 1st. They are followed in order by Wells Fargo, Bank of America, Santander, Chase and then Citi. In the U.S., beyond the names already listed here, other top brands in order were American Express, JPMorgan, Goldman, Visa and Morgan Stanley.

Foreclosure Sales

The Obama Administration is expected to announce a program that will sell foreclosed properties sitting on the balance sheets of FNMA and FHLMC to private investors who would then turn the homes into rentals.

iPad Banking

Citigroup said it has upgraded its application for the iPad originally introduced in July. Features the bank added include: giving users the option to create customizable graphs and charts; ability to see both the front and back sides of check images; ability to send articles and information from within the iPad app to friends through social media and email; analyze spending habits; set financial goals and opening up these capabilities to its credit card customers.