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INVICTUS

Bank Insights

Regulators are Focusing on Community Bank Interest Rate Risk Assumptions

The message from prudential regulators in recent months: Make sure the key assumptions that your bank is using to assess interest rate risk (IRR) are reasonable, forward-looking and specific to your bank's unique scenarios.

Community banks are often getting marked down in their Sensitivity to Market Risk portion of their FDIC exams for having "unsupported or stale" IRR assumptions, the FDIC reported in its latest issue of **Supervisory Insights**.

The FDIC said the common mistakes that banks are making include:

- Using peer averages without considering the bank's unique circumstances.
- Failing to differentiate between rising and falling interest rate scenarios.
- Oversimplifying balance sheet categories.
- Forgetting to evaluate how IRR results would change if the assumptions also change.
- Using off-the shelf vendor assumptions that do not reflect the bank's assets, liabilities and local markets.
- A lack of qualitative adjustment factors to historic data.

The Office of the Comptroller of the Currency, in its latest semi-annual **risk perspective**, reviewed IRR data from more than 1,500 community and mid-sized banks, finding a range of modeling practices and assumptions. The OCC concluded that "outliers in reported exposures and NMD assumptions may indicate diversity in balance sheet profiles or unrealistic or incorrect modeling assumptions."

"They have essentially created a bell-shaped curve for all of the key assumptions in the models," noted Invictus Consulting Group senior partner Adam Mustafa. "If you are on the more aggressive side of the curve, you had better be able to explain why."

The OCC review found that most banks used Economic Value of Equity (EVE) to measure IRR, and the results ranged from a 44 percent loss in EVE to a 29 percent increase. The OCC noted that "banks reporting exposures below the median should carefully consider the risk to capital and ensure the board and senior management understand the potential exposure and are comfortable with the risk."

The OCC reminded banks to conduct sensitivity analysis of non-maturity deposit assumptions "to identify the potential impact of depositor instability." Banks should test assumptions by "applying subtle or significant variations to the repricing or decay rates" to analyze the impact on capital and earnings. The OCC wrote that repricing assumptions must be analyzed carefully to make sure they are realistic.

While the OCC said it was providing the data to show the wide range of practices used for IRR modeling, it did offer some guidance. For instance, the OCC found that the majority of banks used shock and ramp scenarios using up and down parallel rate movements ranging from 50 bps to 400 bps. However, the regulators said that stress scenarios using rate changes of plus 300 bps and plus 400 bps "are appropriate" in the low interest rate environment.

Banks used a wide range of data from Non-Maturity Deposit (NMD) assumptions, which are crucial because they are a "driver of earnings and capital exposures," the OCC indicated. Banks should use assumptions that "reflect the bank's unique profile in order to identify risk properly," the OCC said.

In addition, the FDIC noted that "customer behavior may not reflect past behavior when market rates change in the future."

Banks with large investments in longer-duration securities must develop rising-rate scenario assumptions "where bond depreciation may pose outsized or unintended risk to earnings and capital," the FDIC said. ▪

Tips to Managing Assumptions

- Be aware that historical data may not reflect future trends.
- Use your bank's own historical information for deposit assumptions.
- Assume a minimal level of prepayments.
- Measure the interest rate risk of your current balance sheet.
- If you use a growth assumption, also use a 'no growth" analysis.
- Perform an independent review of your bank's IRR measurements.

Source: FDIC Supervisory Insights

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Common Exam Findings – Interest Rate Risk Management and Modeling

- Insufficient evidence of board and senior management discussion of IRR
- Policy limits unrealistic or uninformed
- Use of default model assumptions
- Inadequate documentation or support of assumptions used
- Lack of assumption sensitivity testing
- Lack of non-parallel yield curve scenarios
- Lack of bank-specific relevant model scenarios
- Lack of back-testing or back-testing over an insufficient period of time
- No regular independent reviews
- Independent reviews do not cover all required areas
- Lack of independent review expertise
- Missing or outdated model validation

Source: FDIC presentation at Georgia Bankers Association

Why Strategic Planning is Key to Interest Rate Risk Management

Banks must incorporate interest rate risk management into their strategic plans – and make sure they have enough capital to withstand unanticipated hits to earnings. That's the message that banks need to hear in in the post-recession regulatory environment.

"Strategic planning should include consideration of potential asset-liability management strategies to minimize earnings volatility and capital exposure under different rate scenarios," the OCC advised in its semi-annual risk perspective.

It noted that as banks re-evaluate their business models to generate returns, "OCC examiners will focus on banks' strategic planning" to make sure that banks have sufficient risk management processes in place. "Banks that extend asset maturities to pick up yield, especially if relying on the stability of non-maturity deposit funding in a rising rate environment, could face significant earnings pressure and capital erosion depending on the severity and timing of interest rate moves," the OCC said.

The reason why interest rate risk oversight is such a key part of the safety and soundness exam is because of the potential impact changing rates can have on earnings and capital, the FDIC stressed in its latest issue of ***Supervisory Insights.***

One way community banks can show examiners they are ready for a changing interest rate environment is by incorporating capital stress testing into their strategic planning process.

Senior management should be ready to discuss their IRR measurement system and risk mitigation strategies with examiners. During that discussion, examiners might be asked about assumptions and how they were developed. The FDIC also advises that well-documented board and ALCO committee minutes will help show examiners that the bank understands its IRR strategies and controls.

"All banks should have an effective asset-liability risk management framework that identifies and monitors the institution's IRR position and its potential impact on earnings and capital," the FDIC said.

At a recent bank seminar in Georgia, FDIC risk examiners presented best practices in interest rate risk management and modeling and stressed that the ultimate responsibility lies with the board of directors.

What Examiners Seek in an IRR Review

- Asset-liability or funds management policies
- Most recent ALCO package
- Minutes of ALCO meetings
- Results of IRR analysis and assumption details
- Material changes to assumptions in last year
- Deposit study
- Sensitivity testing results of assumptions
- Independent review of IRR

Source: FDIC, Supervisory Insights

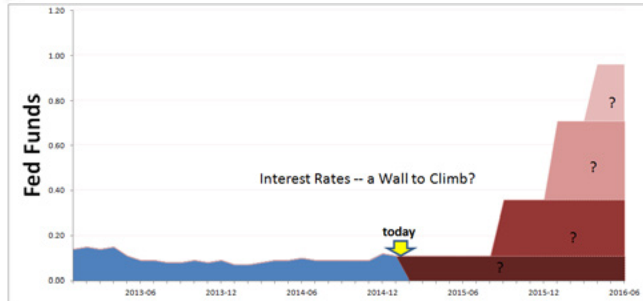
Some bankers in attendance said it was difficult to find directors willing and capable of sitting on ALCO committees, knowing they would be the subject of extra regulatory scrutiny.

"IRR management from a director's perspective is not about projecting how and when rates will change; instead, it is about understanding how the bank will be affected by a range of outcomes and ensuring that assumed risks are reasonable and properly compensated for," Supervisory Insights noted.

The FDIC examiners said that directors must establish policies for risk limits, understand levels and trends of IRR exposures and oversee the implementation of IRR risk management and mitigation policies. They recommended that management report results of IRR modeling at least quarterly, identify sensitivity and reasonableness of assumptions at least annually and determine capital adequacy for the level of interest rate risk.

"Risk mitigation is an ongoing process to maintain exposures within board-approved limits to ensure that earnings and capital are sufficient to allow the bank to withstand adverse interest rate changes," the FDIC wrote in Supervisory Insights.

"Examiners expect banks to have effective IRR policies and measurement procedures in place so boards of directors can make informed decisions about balance sheet management, budgeting and capital adequacy," the FDIC wrote. "This expectation has become increasingly important as the potential for a period of increasing interest rates continues to be identified by the regulators and industry observers as a primary risk facing the industry."



Here are links to IRR supervisory guidance:

- **Joint Agency Policy Statement on Interest Rate Risk**
- **FFIEC Advisory on Interest Rate Risk Management**
- **FFIEC Supervisory Guidance on Interest Rate Risk Management (FAQs)**
- **Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment** ■

RISK-REWARD VS. RISK
A Key Distinction

By Kamal Mustafa – Founder & Chairman

A bank may satisfy a regulatory requirement for an interest rate stress test, yet end up in a situation that's detrimental to the bank's long-term viability, cautions Invictus Chairman Kamal Mustafa.

Regulatory interest rate stress tests are designed to measure the risk profile of a bank under a severely adverse scenario. Those tests are an important part of the regulatory mission.

But what is even more important for a bank is the risk-reward profile of its assets and liabilities under changing interest rate conditions, Mustafa argues. The focus should be on a likely interest rate change, and not necessarily the most extreme circumstances that regulators request.

"Management needs to look at the total picture. That's their long-term job," Mustafa says. "Regulators want to see discrete pieces under extremely adverse conditions. That's a totally different scenario. By doing an interest rate stress test, a bank can meet its regulatory requirements, but have a group of assets and liabilities that are so mismatched that they are not maximizing the bank's potential."

Smart banks need to make sure they have the right profile to not only meet regulatory requirements, but also to position the bank for success. "You can't confuse a regulatory interest rate stress test as a proxy for a risk-reward analysis," Mustafa cautions. "A lot of banks are doing that. They are not looking at the right combinations that would still allow them to pass regulatory scrutiny. That is a highly theoretical exercise and not a replacement for a risk-reward strategy." ■

About the Expert

With a banking/investment banking career spanning more than 40 years, Kamal Mustafa is a major thought leader in the banking and finance industries. He has served as head of corporate finance/credit at Connecticut Bank and Trust; Head of global Mergers & Acquisitions at Citibank; Managing Director of Merger & Acquisitions and Merchant Banking at PaineWebber; Managing Director of KSP, a $1 billion Leveraged-Buyout Fund for John Kluge; founder and Chairman of Bluestone Capital Partners and Wildwood Capital. He founded Invictus Consulting Group in 2008, and serves as chairman and CEO. Mr. Mustafa has been a trustee for the University of Connecticut and continues to sit on a number of corporate boards.

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

Make Sure Your Business Continuity Plan Includes IT

In yet another sign of increasing regulatory focus on cybersecurity, the prudential regulators have added an appendix to the **FFIEC Information Technology Examination Handbook** to cover outsourced technology services. The new section discusses a bank's reliance on third-party service providers and reminds examiners to make sure that there are effective policies to identify, measure, monitor and mitigate risks associated with outsourcing, especially when it comes to recovering IT and critical functions in an emergency.

OCC Deputy Comptroller Beth Dugan repeated those themes in a Feb. 11 **speech** in Chicago. "Financial institutions need to expand their disruption scenarios to consider the impacts of cyber threats not only to themselves and their critical systems and operations, but also from and to their third-party relationships, their customers, and the critical infrastructure components on which they depend."

Study Recommends Cost-Benefit Analyses for Financial Regs

A new Harvard Kennedy School **paper**, "The State and Fate of Community Banking," explores whether the Dodd-Frank law is responsible for community banks' declining market share since 2010. The paper suggests that "inappropriately designed regulation and inadequate regulatory coordination" may be responsible for industry consolidation. It recommends that Congress conduct cost-benefit analyses of financial regulations and simplify capital rules.

FDIC Tells Senate that 'Strong Capital' is Essential

The Senate Banking Committee held **hearings** again this month on the community bank regulatory burden. The FDIC's Doreen Eberley, director of the risk management division, testified that changes to Call Reports are in the works that will include "a more robust process for bank agency users to justify retaining or adding items." She made it clear, however, that "strong capital, strong risk management" is crucial to preserving the long-term health of the industry.

Senior Deputy Comptroller Toney Bland reiterated the OCC's position that the Volcker Rule should not apply at all to community banks with assets of less than $10 billion, noting that it would cost money and resources just for community banks to determine whether they even have compliance obligations.

The Federal Reserve's Maryann Hunter, deputy director of the division of banking supervision and regulation, revealed that the Fed has a new program that involves using "forward-looking risk analytics" to identify at-risk banks that need focused supervision.

CFPB: Exams are Private

The CFPB issued a **bulletin** reminding financial institutions that confidential supervisory information should not be shared. Among items that should not be disclosed are exam reports and documents prepared "by, or on behalf of, or for" the CFPB for use during supervision of a financial institution.

Regulators Release New Regulatory Capital Tool

The OCC, the FDIC and the Fed have developed an **automated tool** to help banks calculate risk-based capital for securitization exposures under the revised capital rules. Use of the tool is discretionary.

Fed Small Bank Rule Will Eliminate Filings

The proposed Fed small bank holding company **rule**, would eliminate some quarterly filings (FRY-9C), which banks have complained are an unnecessary and duplicative burden. The Fed is taking comments on the proposal.

CFPB Prepaid Rule Could Signal Short-Term Credit Actions

An interesting **report** from the Jones Day law firm suggests that the CFPB's proposed prepaid products **rule** could signal future action on checking accounts, because it treats overdraft services as credit. ▪

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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