

Increased Regulatory Scrutiny on Interest Rate Risk

On January 6, 2010 a consortium of regulators released a regulatory advisory entitled "Advisory on Interest Rate Risk Management". The regulatory agencies supporting this advisory consist of the Federal Reserve, the FDIC, the National Credit Union Administration, the OCC, the Office of Thrift Supervision, the Federal Financial Institutions Examination Council and the State Liaison Committee. The regulatory guidance is meant to encourage financial institutions to have the appropriate interest rate risk management policies, procedures and analytical tools in place to manage the rate risk inherent on their balance sheets.

The recent period of exceptionally low short term rates combined with a historically steep yield curve has created an incentive for many banks to "lend long and fund short" thereby earning significant positive carry. The earnings generated by such a strategy have been used to offset increased loan losses and the decline in the value of certain securities portfolios. While the timing and scale of future short term interest rate increases are unknown there is little question that at some point the Fed will begin a period of tightened monetary policy. The regulatory agencies are taking a pre-emptive approach to this potential risk and are making clear by the release of this letter that they expect banks to place more focus on interest rate risk.

More specifically the regulators will be looking at the following areas:

Corporate Governance

- Appropriate policies, procedures and risk limits addressing IR risk.
- Comprehensive systems and standards for measuring IR risk, valuing positions and assessing performance.
- Sufficiently detailed reporting processes to inform the Board and senior management of the level of IR exposure.

Policies and Procedures

- IR risk tolerances should be explicit and address both short term and long term impact on capital and earnings.
- Institutions with significant exposure to basis risk, yield curve risk and convexity risk should establish risk tolerances appropriate for these risks.

IR Risk Measurement and Monitoring

- Simple gap analysis is insufficient and some method of simulation modeling is preferred.
- Banks should use at least a two year time horizon when measuring risk in a simulation model.
- Economic value methodologies should also be used to broaden assessment of IR risk exposure.

Stress Testing

- Stress testing (both sensitivity and scenario analysis) is an integral part of IR risk management.
- Institutions should regularly assess exposures beyond typical industry conventions of 200 bp parallel yield curve movements.
- Stress scenarios should include instantaneous rate shocks, prolonged rate shocks, basis risk, and changes in the slope and shape of the yield curve.

Assumptions

- Proper measurement of IR risk requires regularly assessing the reasonableness of assumptions underlying exposure estimates.
- Assumptions about non-maturity deposits are critical as customer behaviors may not reflect long term economic fundamentals.

On January 29, 2010, Stonemont attended the FDIC's Symposium on Interest Rate Risk Management in Washington D.C. Interest in the topic was very high as evidenced by the fact that the symposium could not accommodate all those who wanted to attend. The conference began with an introduction by Sheila Bair, Chairman of the FDIC, and a speech by Donald Kohn, Vice Chairman of the Board of Governors of the Federal Reserve. While both speakers took pains to emphasize that they do not know when rates will begin to increase they did make one point abundantly clear – the Fed's accommodative policy will not last forever and short term rates will rise. They also pointed out that financial institutions need to treat the management of interest rate risk the same way that they treat both credit and liquidity risk.

The morning session also included two panels entitled “Smaller Banks: Hedging and Other Alternatives to Manage IRR” and “Larger Banks’ Approach to IRR Management and Market Issues”. For the large majority of attendees, the first panel had the most relevance and applicability. In discussing the management of IR risk the panelists stressed the importance of getting the most out of the ALCO process and understanding the cash flows (one memorable quote “yield is an opinion, cash flow is a fact”). Banks need to focus on trends not snapshots and test new and alternative strategies before implementation. With respect to modeling, banks need to understand how much of its IR exposure is being captured by one and two year simulations and take into account “fat tail” events that might be unique to each bank. In many respects the management of IR risk should be treated similarly to the management of liquidity risk – model for worst case scenarios and have a contingency plan in place.

There was also discussion surrounding the question of “on balance sheet” versus “off balance sheet” tools to manage IR risk. In response to a direct question on the subject the regulators in attendance did say that derivatives are an appropriate risk management tool for smaller banks as long as the banks have the appropriate tools and expertise either internal or external. Any derivative strategy should be well thought out and should reflect what the bank believes is the best course of action instead of what it is being “sold” by counterparties.

The afternoon panel consisted of four regulators from the FDIC, the OCC, the Fed, and the OTS and was entitled “Supervisory Expectations for IRR Management”. Those attendees hoping for a clear road map showing how to navigate the new reality were disappointed. The panel spoke more in generalities about their expectations and provided few specifics. However, it was made clear that the regulators are going to require that financial institutions employ more sophisticated analytics around their IR risk management.

What the Future Holds

The various bank regulatory agencies have made clear that they are concerned about the potential IR risk banks will be facing when the Federal Reserve changes its accommodative policy. In particular, regulators are concerned that banks are taking on more liability sensitivity than they might normally as a means to manufacture earnings in a steep yield curve environment. Effective policies, procedures and models to measure the risk are critical. The past practices of relying on a more simplistic gap analysis or modeling out to a one year time horizon only are no longer acceptable.

In addition to more sophisticated ALCO and IR risk modeling, financial institutions need to have the proper expertise to manage the identified risk. If the most effective risk management tool is an off balance sheet instrument the institution should have the proper expertise to properly account for and value the hedge instrument.

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