

Interest-Rate-Risk Management: Addressing the Aftershock

By

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These past four years have produced an exaggerated interest shock environment that has undoubtedly challenged even the most sophisticated interest-rate-sensitivity models. This might be the perfect time to revisit your in-house reporting systems and risk-management service provider.

To understand how the current risk tolerance requirements got started, one must go back 15 years when, in a Joint Agency Final Rule and Policy Statement, two interagency documents related to Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) were proposed. As part of the final rule amending the Office of the Comptroller of the Currency capital guidelines (12.CFR 3.10), proposals were issued to measure the impact of the interest rate changes on a bank’s economic value of equity and a framework under which the OCC would assess a bank’s interest rate risk.

Effective September 1, 1995, a uniform supervisory framework was established to measure and monitor banks’ interest rate exposure by implementing a supervisory model that measures the change in a bank’s economic value of equity (“EVE”) for a given change in interest rates. The proposed policy was designed to enhance safety and soundness while keeping regulatory burden at a manageable level. The statement recommended that a series of risk weights be applied to 200 basis point increases and decreases to the bank’s interest rate risk (“IRR”) alternately labeled “interest rate shock.” Although banks under \$300 million with CAMEL ratings of 1 or 2 were originally exempt, a proviso that “exempted banks were still subject to safety and soundness IRR examinations and must employ sound IRR and management practices” was added. Thus, virtually all banks would become subject to some regulatory interest rate sensitivity or “shock” measurement review.

Whereas most community banks had utilized in-house interest rate and duration models to manage IRR, a supervisory model using expanded call report information was proposed. The new examiner’s requirements, with specific IRR parameters, seemed to make many of the internal models obsolete. Implemented in March 1996, the new call report information spawned a lucrative consulting specialty with multi-page data, tables and charts reflecting expected IRR changes at various levels of prime rate movement. Although the reports were more expansive and detailed than most internal models, questions remain as to their reliability, understandability and suitability.

Fast forward to the year 2001 when the Federal Reserve embarked on a two-year fed funds rate descent from 6.25% to a 40-year low of 1% in 2003. This was followed by a 350 basis point rise by the first quarter of 2006. Reviewing this perfect storm of interest rate volatility offers an excellent opportunity to critique the bank's risk management model by using a "what is" scenario instead of the current "what if" hypotheses by taking the following steps:

1. Reconfirm that your risk management model is a management tool and not simply a regulatory showpiece. A 50-page "data dump" is not a practical working model for management, and especially not for the board of directors. Beware of those brokers and consultants who use only call report information and promote their product as the "fuzz buster model" designed to obviate regulatory criticism. That should not be the purpose of the bank's risk management report.
2. Determine if your model correctly forecasted the direction and magnitude of interest rate movement during the recent whipsaw effect of decline, sudden reversal, and increase in rates. Both the impact on interest margin and capital (EVE) should be scrutinized.
3. Review and ascertain the effectiveness of the model in assisting management in mitigating the negative impact or in changing pricing strategies during the period of steep rate movement. It might be a revelation to find, as in my recent analyses, that interest rate margins are driven more by competitive pricing than by market rates.
4. Analyze the rate movement impact on the Economic Value of Equity (EVE) or Market Value of Equity (MVE). Undoubtedly the findings will reveal that the bank's security portfolio does not re-price proportionally during both the decline and increase in market rates. It might be of interest to note that, in the "what if" scenario, regulators are required to consider the impact of the bank's economic value of equity when it assesses the bank's capital adequacy, whereas in the real, "what is" world, Tier 1 Capital on the Call Report is adjusted to negate the after-tax impact of net unrealized gains and losses on securities. One can only wonder why security market pricing matters for hypothetical changes in interest rates only to be discounted on the Call Report.

There is no better time than the present to evaluate interest rate sensitivity and to determine which model best suits management goals. Choose a service provider that utilizes individualized assumptions and parameters and then take ownership of the process. Make IRR measurement a management tool that is constantly reviewed, updated and, most importantly, user friendly.

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