

AuditOne Advisory

From Bud Genovese, Chairman

In case you haven't seen this yet, below is a recent column on the continuing relevance of IRR written for the July 2011 issue of WIB's *Directors Digest* by Jeremy Taylor, president of AuditOne and CEO of sister company Insight Risk Consulting. Please feel free to forward this informative column to any appropriate people in your bank. And remember, when you need industry-recognized expertise for internal audit and credit review and the highest level of certified technology service, contact the best in the business...

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Thank you. –Bud



Why Are We Wasting Our Time on IRR?

By Jeremy Taylor, AuditOne LLC

It's a fair question. After all, interest rate risk (IRR) isn't going to zap you overnight like a commercial loan loss, or a rogue overdraft-approver, or a withdrawal of funding because somebody said something unfortunate. You run your 200 basis point (bp) rate shock and the potential loss, spread over time, is still only a fraction of what you charged off on loans last quarter. IRR doesn't pack the punch of credit, liquidity, operational (= everything else) risk. And getting a full understanding of it is much tougher. However, you've got to do it; the 1996 Joint Policy Statement said so, and then they added the "S" to "CAMEL". And besides...are you so sure it's so benign? A typical community bank is "modestly asset-sensitive", according to their IRR simulation results. Rates go up, net interest income (NII) goes up. The gains aren't huge but the direction is right, and so it gets the rubber-stamp of approval and it's on to more important things. But you need to be aware of both the limitations and the assumptions of the ALM modeling. Here are three things to think about, in terms of their potential impact on your "true" rate exposure.

1. **Changing yield curve slope.** This was in the January 2010 Interagency Guidance. While simulating non-parallel shocks wasn't necessarily expected of smallest banks, remember that rate shocks generally aren't parallel. Furthermore, if you have rate risk exposure in your balance sheet, it comes from repricing or maturity mismatches. Your IRR simulations are now measuring how a parallel shock translates those mismatches into changes in NII and economic value of equity (EVE); a non-parallel change could have considerably larger effect.
2. **Deposit rates.** Two things to think about here. First, recognize that for various reasons, NII-at-Risk is a far more important management tool than EVE-at-Risk. And that the most important set of assumptions driving your NII-at-Risk profile is the beta factors that translate changes in a market rate like Fed Funds into changes in administered deposit rates. When your IRR model computes the effect of a 100 bp increase in rates, it pushes up MMA, Savings and other rates by 50 bp or 75 or whatever the betas say. Look at the betas carefully. When rates do start to rise, will you be able to drag your feet on deposit rate increases as much as your modeling assumes? Second, there's a rupture ahead: Reg Q repeal. It's not a beta effect, just a one-time shift that your model won't know about. If nobody blinks, the effect of repeal won't be major. But it's a big question-mark.
3. **Enterprise risk management.** Just another buzz word? No, ERM matters, and here's a great illustration of why. You're asset-sensitive, you're looking at (short-term) rates with

nowhere to go but up, so why worry. Consider this: When rates do go up, debt-service costs go up and coverage down. There will be borrowers at the margin pushed to default. And that hit to interest income (as well as the loss provisioning) could easily wipe out the asset-sensitivity benefits. You're now pushed to do credit stress-testing in one part of the bank and NII stress-testing (i.e., rate shock analysis) in another. But what should happen is doing them together. You already pull loan sub-ledger data on floors, rate re-sets, etc. for ALM modeling; why not include stress-test results translated into interest income hits from defaults, for +100 bp, +200, etc. Then you've got the full rate-shock picture. No, it's not easy to do, and no one's (yet) expecting it. But you can't truly understand stress without seeing the full picture.

What you as directors can do about it could be a full article itself. Here are a few quick suggestions:

- **Have at least a couple of directors on ALCO** (i.e., linking it to the board), and have one of them be chair (to force a commitment to drive the process, not pass it off to management).
- **Take your policies seriously.** They're a statement (to management, staff, regulators) as to how you do business and the risk you're willing (and not willing) to take. Identify the risks and make sure you have appropriate controls. Review the document carefully, at least annually.
- **Do your back-testing.** The FIL says you have to. It's less illuminating right now with rates steady. But when they do change, you need to understand whether and, more importantly, why variances arise (between actual and projected/adjusted NII). Which assumptions didn't bear out, and with what effect?
- **Understand the macroeconomics.** Recognize that all risk measures are a composite of two things: the likelihood of something bad happening, and the impact it would have. Likelihood here means which way and how much rates might move. Include outside material, maybe outside speakers, to help understand how/why rates may move differently than expected. The greater the likelihood of rate shock volatility, the more it matters what your balance sheet's structural IRR exposure (the "impact" part) looks like.
- **Question the modeling assumptions.** All institutions should be collecting data to validate or, where necessary, better customize their assumptions. Quarterly changes in assumptions should be discussed and documented. Run your IRR model (or get your vendor to) so as to test the sensitivity of results to changes in assumptions, so you understand which ones matter. Some don't, but others do.

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Bud Genovese is Chairman of AuditOne LLC, a California-based internal audit firm that focuses only on banks and their service providers. Mr. Genovese pioneered the concept of providing comprehensive, affordable, independent internal audit and credit review services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 160 clients throughout the Western United States, and nationally. Contact Bud Genovese at 408-980-8099 or bud.genovese@audit-one.com