

AuditOne Advisory

From Bud Genovese, Chairman

Introducing a New Information Service: The AuditOne Regulatory Advisory

Many clients and bankers have asked us to explain various new regulatory announcements, the content and meaning of FILs, and what steps they must take in order to maintain compliance with changes in the regulatory landscape.

In response to this need, we are kicking off our new informational service... the AuditOne Regulatory Advisory. These communications will elucidate and comment upon regulatory changes and announcements with an emphasis on what banks really need to know and what they should do. We'll send these out on an as-needed basis, responding to and anticipating the pace of regulatory announcements.

Our first AuditOne Regulatory Advisory discusses FIL 2-2010 on Interest Rate Risk and was written by AuditOne president Jeremy D. Taylor. Please feel free to forward this to the appropriate people at your bank. Thank you. --Bud

AuditOne Regulatory Advisory

FIL 2-2010 Financial Institution Management of Interest Rate Risk

The various banking regulatory bodies issued an Interest Rate Risk (IRR) Advisory on January 6th, (<http://www.fdic.gov/news/news/press/2010/pr1002.pdf>), enshrined earlier this week as FIL 2-2010. It's basically a reaffirmation of previous statements on the subject, going back to the 1996 Joint Policy Statement on IRR. While the document puts forth no completely new requirements for IRR management, there are some noteworthy areas of emphasis.

But before getting into that, it's interesting that this was released shortly after the Winter 2009 FDIC Supervisory Insights (http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin09/si_win09.pdf), with an article that touched on the same themes. But it also provided some context missing from the Advisory. It went into, at some length, what regulators see (and recent Call Report data apparently confirms) as a trend towards increasing liability-sensitivity ... at a time when short-term rates have nowhere to go but up. On the asset side, it attributes this to:

- a) fewer construction loans, replaced by longer-term mortgage loans (i.e., effectively replacing credit risk with IRR);
- b) less active securitization markets, so that banks' mortgage assets are staying on the books longer;
- c) extension risk on mortgage assets as rates rise.

On the liability side:

- a) flat core deposit growth, necessitating (shorter-term) wholesale funding sources;
- b) embedded options (e.g., call dates) in some wholesale funding agreements, which would be exercised in a rising rate environment;
- c) government liquidity support programs that could boost funding costs when they get removed.

The Advisory/FIL starts out by noting that funding longer-term assets with shorter-term liabilities may be enticing at a time of credit-related earnings pressures (especially after two years of yield curve steepening). But it comes with a corresponding increase in IRR to earnings and capital. How to manage that risk? Here are some points they emphasize:

- Board, or delegated committee (i.e., ALCO), oversees “establishment, approval, implementation, and annual review of IRR management strategies, policies, procedures, and limits (or risk tolerances).” [pg. 2] Management is responsible for ensuring appropriate execution, within designated authorities.
- “Policies and procedures also should document and provide for controls over permissible hedging strategies and hedging instruments.” [pg. 3]
- Earnings simulations should be run over at least a 2-year period – or more like 5 – 7 years if there’s significant optionality in the balance sheet. [pg. 4]
- Dynamic simulations (using projected balance sheet) are OK, but if they’re used then the bank should also run static simulations off a constant balance sheet. [pg. 4]
- The need to run Economic Value of Equity (as well as earnings) simulations. [pg. 4] Significant EVE-at-Risk exposure can justify assessing higher minimum capital ratios. [pg. 3]
- Stress-testing should include both scenario and sensitivity analysis. [pg. 5] Scenario analysis typically focuses on parallel shocks of +/- 200 basis points (bps). But this should be supplemented with bigger shocks (up to 300 - 400 bps) and by scenarios that capture basis risk, yield curve risk and option risk. It also talks about running both instantaneous and ramped (prolonged) shocks. But they recognize that “not all financial institutions will require the full range of the scenarios discussed above.” An exception to that: shocking up to 400 bps, which will be expected of all institutions. [pg. 6]
- Sensitivity analysis: Test results under different assumptions to understand sensitivity to changing each assumption. Key assumptions should be documented, monitored and regularly updated. They single out asset prepayments; non-maturity deposit pricing sensitivities and decay rates; and key rate drivers, under each rate scenario. Make sure that projections that result in capital below Well-Capitalized or Adequately-Capitalized reflect the higher deposit rates that institution would likely then have to pay. Dynamic simulations: Ensure replacement rates are consistent with assumed balance sheet growth rates. “When assumptions are adjusted from prior reporting periods, the changes and their effects on model outputs should be documented and clearly identified.” [pp. 6-7]
- Discussion on pg. 7 of using derivative hedges – basically warning banks not to do it unless they have solid understanding/expertise, Board-approved hedging strategy, etc.
- Model validation: For vendor-supplied models [pp. 8-9], “the vendor should provide documentation showing a credible independent third party has performed such a function.” The Advisory also stresses independent review of “the reasonableness of assumptions, the process used in determining assumptions, and the back-testing of assumptions and results.”
- In conclusion, the regulators are signaling concern over IRR trends and reasserting how they should be prudently managed, rather than laying out completely new requirements. Based on our extensive exposure to clients’ IRR management practices, the only notable adjustments we expect most will need to make will be to expand the number of simulations they run: going out at least two years (many banks now stop at one), taking parallel shocks out to 300 – 400 bps (at least on the upside), and experimenting with yield curve twists. There will also need to be due attention to documenting assumptions and related sensitivities. But these shouldn’t be major challenges.

Please give us a call if you have questions on any of the above points. And as referenced in the last bullet, regulators expect banks to have regular independent review of their IRR management process and controls; this is something that we at AuditOne perform many times a year for a wide variety of clients. It gives us familiarity with many different IRR models (for banks producing their own reporting in-house) and outsourced vendors.

*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*