

What to Expect During an Interest Rate Risk Review

Given the potential impact of changing interest rates on banks' earnings and capital, bank examinations include a comprehensive review of interest rate risk (IRR) oversight and measurement as well as management's planned strategies for responding to potential changes in market interest rates and the yield curve. Sensitivity to market risk, primarily IRR at most community banks, is inherent to the business of banking and one of the six components of the regulators' Uniform Financial Institutions Rating System. The Sensitivity to Market Risk component rating is assigned at each regular safety-and-soundness examination and is considered by the examiner-in-charge when assigning the overall composite rating, as it can potentially affect all measureable areas of performance.

Throughout the current low-interest rate environment, banks' net interest margins have been squeezed by reduced yields and low loan demand. In response, some banks have extended asset durations in an effort to maximize yields and enhance profitability. Such a strategy can increase earnings as long as the interest rate environment remains fairly stable, but a sustained increase in market interest rates could place these banks in a challenging position. As such, IRR exposure and management oversight remain important aspects of the supervisors' examination and risk assessment processes. Examiners expect banks to have effective IRR policies and measurement procedures in place so boards of directors can make informed decisions about balance sheet manage-

ment, budgeting, and capital adequacy. 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.

This article helps bankers prepare for regulatory reviews of IRR, better understand supervisory expectations, and achieve conformance with outstanding guidance.

Supervisory Expectations

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. This framework should be incorporated in overall risk management efforts and be commensurate with the institution's complexity, activities, and condition. Supervisory expectations related to IRR management are contained primarily in two documents – the 1996 *Joint Agency Policy Statement on Interest Rate Risk* and the 2010 *Interagency Advisory on Interest Rate Risk Management* (see below for links to these two documents as well as additional supporting guidance). As described in these issuances, the cornerstone of an effective IRR management process is an informed directorate, capable management, and appropriate internal resources. The board and senior management should have asset-liability management policies that detail responsibilities, risk limits, and strategies related to the

What to Expect During an IRR Review

continued from pg. 27

management of IRR. In addition, all banks should have a reliable system in place that measures its IRR position and regularly reports this position to senior management and the board.

Bankers should be prepared to discuss the results of their IRR measurement system and potential risks with examiners, as well as key strategies to mitigate these potential risks. Senior management also should be able to describe key assumptions, including the assumption development process, the frequency of internal reporting, and the extent of its independent

review. For its part, the board should understand the risks facing the institution, including the potential impact of interest rate changes on earnings and capital, as well as management's plans to prudently address those risks. Finally, management and the board should be proactive in addressing prior examination and independent review recommendations. Well-documented board and asset-liability management committee (ALCO) meeting minutes will help examiners understand the bank's IRR philosophy, risk management practices, and efforts to control IRR exposure.

Guidance on Prudent Interest Rate Risk Management Issued by the FDIC

Joint Agency Policy Statement on Interest Rate Risk (1996) – Issued in conjunction with the introduction of the Sensitivity to Market Risk, or “S” component to the UFIRS, the policy statement discusses important components of an effective interest rate risk management program and regulatory expectations.
<http://www.fdic.gov/news/news/financial/1996/fil9652.pdf>

Appendix A to Part 364—Interagency Guidelines Establishing Standards for Safety and Soundness (2000) – Requires banks to adequately manage and report their interest rate risk position.
<http://www.fdic.gov/regulations/laws/rules/2000-8630.html>

Interagency Advisory on Interest Rate Risk Management (2010) – Issued to remind institutions of supervisory expectations regarding sound practices for managing interest rate risk. The advisory re-emphasizes and clarifies much of the information in the 1996 Policy Statement.
<http://www.fdic.gov/news/news/press/2010/pr1002.pdf>

Interagency Advisory on Interest Rate Risk Management (2012) – Frequently Asked Questions – Issued to provide the industry more detailed guidance related to interest rate risk management and supervisory expectations. Questions and responses cover topics such as governance, measurement methodologies, stress testing, independent review and assumptions.
<http://www.fdic.gov/news/news/financial/2012/fil12002a.pdf>

Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment, (2013), FDIC Financial Institution Letter 46-2013 – Re-emphasizes the importance of effectively managing interest rate risk in the current low-rate environment and reminds bankers of previously issued guidance.
<http://www.fdic.gov/news/news/financial/2013/fil13046.html>

What Do Examiners Focus on During an IRR Review?

Although examiners request and review a number of items as part of the examination process, one of the most informative and beneficial exchanges of information can be an initial discussion with bank management. We often begin by meeting with senior management to discuss their perspective on how the balance sheet is positioned, potential risks, and any current or potential mitigating strategies. In addition, a general discussion of balance sheet composition, deposit stability, new products, and any planned changes in strategic direction can be very informative. Finally, a high-level dialogue about the results of the institution's IRR measurement system and key assumptions can help facilitate the IRR review.

From there, examiners will start with a review of applicable minutes and the board-approved ALCO policy, with a focus on roles and responsibilities, limits, measurement systems, strategies, and controls. Examiners will follow-up on IRR-related policy exceptions, so they should be well documented in applicable minutes. Management may be asked to describe policy exceptions and related strategies to address the rationale behind a particular deviation from established policies. Further, examiners will review prior examination recommendations and independent review conclusions to determine how management addressed those matters. Management will have an opportunity to explain how it handled previous recommendations and related remedial action; however, this information should be evident in committee minutes, correspondence, or other materials.

Commonly Requested Items for an IRR Review

- Asset-Liability or Funds Management Policies
- Most recent asset-liability management committee (ALCO) package
- Minutes of ALCO meetings since the previous examination
- Results of gap, simulation, economic value of equity (EVE), and any other IRR analysis, as well as assumption details
- List of material changes to key assumptions in the last 12 months
- Deposit Study – if one has been completed
- Sensitivity testing results of key assumptions
- Most recent independent review (including results of validation and back-testing of the IRR measurement system)

What to Expect During an IRR Review

continued from pg. 29

After reviewing the ALCO policies and governance structure, examiners will analyze results from the institution's IRR measurement system to assess how various interest rate scenarios could affect earnings and capital. With few exceptions, financial institutions should have IRR systems that measure short-term (i.e., 1-2 years) and long-term exposure (i.e., beyond 2 years) to changing interest rates, and this should be detailed in the applicable policy. Typically, banks use a combination of basic gap, income simulation, and economic value of equity analysis to measure short- and long-term exposure to changing interest rates. Depending on the magnitude of a bank's rate sensitivity, the examiner likely will have follow-up questions about portfolio management philosophy and depositor behavior. The examiner may inquire about the data and key assumptions (prepayment rates, deposit decay and beta estimates, and driver rates) that are used as inputs to the IRR measurement system, and the frequency of changes to any material assumptions. Management should be prepared to discuss the development and support of key assumptions. In addition, examiners will assess whether the bank has considered an appropriate range of interest rate scenarios including non-parallel rate shocks, and parallel rate shocks ranging from 100 to 400 basis points.

The examiners also will compare asset-liability management policies with actual practices and the bank's level of exposure to determine conformance with the bank's governance framework and risk limits. They will observe and discuss how IRR measurement results are reviewed and acted on by management and the directorate. Board and senior management decisions pertaining to interest rate sensitivity should be sufficiently documented within appli-

cable minutes. Effective risk management practices often include analyzing a range of plausible scenarios such as interest rate shocks and ramps, and changes in the yield curve, depositor behavior, and asset prepayment speeds. There is no hard and fast rule regarding acceptable or excessive exposure because each institution is unique. However, it is clear that the greater the level of IRR to which a bank is exposed, the greater is the need for strong capital and effective risk management practices.

Another area of review involves internal controls and validation of the IRR management process. All banks are expected to regularly review the effectiveness of key internal controls, including the IRR management system, either as part of their internal audit process or by means of an independent review. Examiners will evaluate the scope and results of the independent review, which should include an assessment of the adequacy of internal controls, the appropriateness of the risk measurement system, the accuracy of data inputs (including the reasonableness of key assumptions), the reasonableness of the interest rate scenarios measured, and the validity of the risk measurement calculations. As described in "Developing an In-House Independent Review of Interest Rate Risk Management Systems" in this edition of *Supervisory Insights*, there is no requirement to use a third party to complete independent reviews; knowledgeable and capable bank employees sufficiently removed from the primary IRR function can perform this work. Also, most IRR software vendors provide validations related to the integrity of the software's underlying calculations and workings. For banks that use purchased IRR software, examiners will review such validation certifications as part of the independent review assessment, and

may request a discussion and documentation of back-testing results and any significant variances between projected and actual performance.

Policies and minutes, the results of the IRR measurement system, and internal controls are not the only areas we review, but having a robust and well-developed process with respect to these items will help streamline the examination assessment of your community bank's IRR position.

Communication with the FDIC During and After the IRR Review

The bank examination process is designed to evaluate an institution's performance on a number of levels, but it is also an opportunity to seek guidance from the FDIC to improve internal practices, including IRR management. Although we cannot provide a perspective on future rate movements or advice on strategies to change balance sheet composi-

tion, FDIC examiners review many banks and risk management processes during a given year and will readily share observations and possible enhancements evidenced across the industry. Therefore, communication is a key element in the success of our examinations, and we encourage an active dialogue with financial institutions, especially concerning timely topics such as IRR.

In many cases, examiners' IRR recommendations largely relate to the tenets of the banking agencies' 1996 and 2010 IRR issuances. The agencies provided these guidelines to help banks prudently manage their IRR position and better prepare for potential rate volatility. As a result of our examinations, we may have findings and recommendations involving IRR and will discuss these items with management. Bank management should take this opportunity to clarify issues that are raised, provide other information that may be relevant, and develop a better understanding of the FDIC's expectations.

Frequent Examination Recommendations Concerning Interest Rate Risk

- Establish appropriate risk limits
- Perform 300bp to 400bp interest rate shock scenarios
- Enhance/support key assumptions used to analyze IRR, especially deposit and prepayment assumptions
- Refine sensitivity testing of key assumptions
- Strengthen the independent review process

What to Expect During an IRR Review

continued from pg. 31

If a banker does not understand a particular examination issue or disagrees with a finding, he/she should ask the examiner to provide additional explanation. The examiner will listen to the banker's concerns, provide facts that support the examination team's conclusions, and offer an opportunity for a response. In most cases, disagreements or misunderstandings can be addressed with the examiner-in-charge. If those efforts are not successful, bankers should contact the appropriate Field Supervisor to help resolve the matter. The FDIC is strongly committed to open communication with community banks, and we have the shared goal of safe and sound, profitable banking operations. IRR can be a complex topic and, given the potential impact of changing interest rates on insured institutions, we will take the time needed to fully explain our conclusions and work with bank management teams as they strive to better manage rate sensitivity.

In addition to on-site examination guidance, the FDIC also has field, regional, and national-level subject matter experts available between examinations to provide regulatory guidance and other technical information. Moreover, the FDIC has developed several IRR videos and outreach programs, such as our Directors' Colleges, to help community bankers learn more about IRR and regulatory expectations. We encourage bankers to take advantage of these resources to enhance their IRR management process and understanding of supervisory guidelines.

Conclusion

Exposure to changing interest rates is a fundamental risk every community bank faces. Prudent IRR management and an accurate assessment of a bank's IRR position will contribute to sustainable earnings and capital protection, provide bankers with better information to proactively identify potential risks and opportunities, and help ensure a more efficient examination process.

Frank R. Hughes, CFA
*Senior Examination
Specialist
Kansas City Regional Office
Division of Risk Management
Supervision
fhughes@fdic.gov*

Community Banker Resources

Directors' Resource Center (Virtual Directors' College and Video Library):

<http://www.fdic.gov/regulations/resources/director/video.html>

FDIC Manual of Examination Policies – Sensitivity to Market Risk Section:

<http://www.fdic.gov/regulations/safety/manual/section7-1.html>

Directors' Colleges (Events and Presentation Material):

<http://www.fdic.gov/regulations/resources/director/college.html>

Community Bank Calendar:

<http://www.fdic.gov/regulations/resources/cbi/calendar.html>