



INVICTUS

Bank Insights

Expect Interest Rate Risk Management Scrutiny from Examiners in 2014

Bank examiners will assess how community banks manage interest rate risk (IRR) exposures in 2014. They want to know if a bank's interest rate risk measurement process is adequate based on its risk profile and size.

All the federal regulators repeatedly issued warnings in 2013 about the need to monitor IRR and the responsibility of the board in setting a bank's risk tolerance and then overseeing proper risk controls. The Federal Deposit Insurance Corp. and the Federal Reserve have featured articles on interest rate risk in their most recent community bank publications. The Office of the Comptroller of the Currency cites interest rate risk as a major concern in its latest semi-annual risk **perspective**, saying that examiners are "focusing on banks with significant concentrations in longer-term assets or liability structures that make them vulnerable to quickly increasing rates."

The winter issue of the **Federal Deposit Insurance Corp.'s Supervisory Insights** explores the challenges banks face in proactively managing and assessing their interest rate risk. "The recent environment of sustained low interest rates has led some banks to alter balance sheets in a reach for higher yields," which has increased interest rate risk, writes Doreen R. Eberley, FDIC Director of the Division of Risk Management Supervision.

The FDIC is concerned that many banks could see a significant securities portfolio depreciation in relation to capital when interest rates increase. Banks need to look now at the characteristics and duration of assets, funding sources and off-balance sheet exposures and how they contribute to the bank's overall interest rate risk profile, the FDIC warns.

"To meet the challenge of generating positive earnings and more suitable returns for their stakeholders, many banks have lengthened asset maturities or increased assets with embedded optionality," writes Doug Gray, Managing Examiner at the Federal Reserve Bank of Kansas City, in **Community Bank Connections**.

Examiners want to make sure a bank's policies, procedures, risk limits and strategies governing interest rate risk have been reviewed and approved by senior management and the board of directors. Common mistakes banks are making:

- Risk limits are not defined or appropriate for the bank's risk tolerance, or bank.
- The board is not regularly reviewing the bank's policies, procedures and strategies. Directors need to know the impact of strategic decision on interest rate exposures.
- Policies do not outline specific oversight responsibility

Common Community Bank IRR Exposures

- Mismatch/Repricing risk
- Basic risk
- Prepayment/extension risks
- Yield Curve risk
- Options risk

Source: Federal Reserve, OCC

for measuring, monitoring and controlling interest rate risk. If interest rate exposures exceed the bank's risk limits, the bank's senior management must report that to the board and provide an action plan to get the limits under control, the Fed notes. Examiners will want to see such documentation and progress.

- Banks are using inadequate tools to determine their risk exposures. FDIC examiners have found banks using inadequate stress tests that don't incorporate significant rate shocks (for example, 300- and 400-basis point shocks) and other scenarios specific to the bank's unique risks.
- The models banks are using can't accurately assess the complexity of their bank's balance sheet. Fed examiners say that some banks are using off-the-shelf models that are not customized for their bank. A rural bank, for instance, that has 50 percent of its assets in callable bonds should not rely simply on a maturity gap, the Fed points out.
- Some banks are not comparing the results of stress tests to their internal risk limits.
- Examiners will scrutinize the capabilities and accuracy of internal measurement systems as well as stress testing scenarios and assumptions, the FDIC warns. Some banks are not routinely updating their assumptions, or they are using unreasonable assumptions for a given interest rate shock scenario, such as unrealistic asset prepayments or non-maturity deposit price sensitivity and decay rates, or the bank is not accounting for specific characteristics of assets and liabilities. Some banks are using unrealistic decay rates in their IRR models to show little or no runoff of deposits in a rising market.

OCC examiners will focus on IRR measurement processes, the adequacy of stress scenarios and the support for key modeling assumptions, particularly in on-maturity deposits, the agency says. ■

Inside this issue:

- The CEO Corner: How to Manage IRR, (page 2)
- Rising Rates Not Just a Liability-side Risk, (page 2)
- Assessing Risk in a Bank's Profile, (page 3)
- OCC to Scrutinize Strategic and Capital Planning Processes, (page 4)

THE CEO CORNER

How To Manage IRR In A Changing Economic Environment

By Vito Nardelli

It is clear that coming out of the worst economic environment since the Great Depression, community banks face a challenging credit and earnings cycle. That is why many bank executives and boards of directors are concerned about liquidity and asset quality. Yet current evidence reveals that many financial institutions have high levels of interest rate risk during this period of historically low short-term rates.

Community banks are increasingly liability sensitive, exposing them to increases in interest rates. Also problematic are earnings pressures to offset high loan loss provisions. Community banks may have a heavy reliance on short-term and wholesale funding sources, which tend to be more rate sensitive and less stable than traditional deposits. When rates rise, deposit customers may rapidly transfer funds elsewhere, and wholesale funds may reprice quickly. The risk is particularly acute for institutions with high concentrations of longer-term assets.

During your next regulatory review, examiners might ask whether your institution has stress tested its Interest Rate Risk (IRR). For example, variable-rate assets in which interest rates are below embedded floors will behave more like fixed-rate assets until interest rates again rise above those floors.

Concentrations of longer-maturity assets funded with shorter-maturity liabilities can stress an institution's earnings, liquidity, and capital in a rising rate environment.

It is important that financial institutions plan now for likely increases in interest rates and take steps to mitigate and control the associated risks. It is time for financial institutions to focus on the deposit base and seek ways of extending those deposits with a pricing discipline that considers IRR consequences.

About the Expert



Vito R. Nardelli is an Invictus executive director. During his 30-year financial services career, he excelled at building and maintaining excellent relationships with regulators. He served as the president and COO of OceanFirst Financial Corp, and the president of OceanFirst Bank in

New Jersey before retiring in 2012. Prior to that, he served as the Senior Vice President and Retail Banking Director for Trust Company Bank. He held several leadership positions at First Union National Bank, including president of the Central New Jersey region. He also was executive director of the New Jersey Economic Development Authority in the 1990s. Mr. Nardelli was a Lieutenant Colonel in the United States Air Force Reserve. He received his BS and JD degrees from Fordham University and has an MBA in Executive Management from St. John's University.

Rising Interest Rates: Not Just a Liability-Side Risk

By Leonard DeRoma

While the timing and magnitude may be uncertain, one thing we know for sure is that interest rates will rise. If history and market tendencies are any indication, the yield curve (the difference between longer and shorter rates) will also shift. These two forces will create pressure on bank balance sheets.

Traditionally banks tested their interest rate sensitivity through the ALCO process by running several scenarios against their aggregate fixed and floating assets and liabilities. These scenarios were fairly standard, laddering several shocks and testing the results. This methodology is unrealistic given the current market environment and

the changes that have taken place in bank balance sheets since the 2008 financial crisis. Given the Fed's proclivity to keep rates low, a more realistic scenario will show a slower grinding increase that may be accompanied by rotations in the yield curve. But more interesting than the potential scenarios has been the change to the composition of many banks' balance sheets.

Invictus Consulting Group has worked with many banks that have employed a greater use of caps and floors in their loan pricing. While the floors have supported the interest income in a falling rate environment, the opposite will take place as rates rise.

Simply put, the net interest margin sensitivity response will be non-linear, or asymmetric. As rates grind upward, many of the floors in the extant loan structures will still be in effect, mitigating the bank's ability to get better rates, while the liability side will be responding instantaneously.

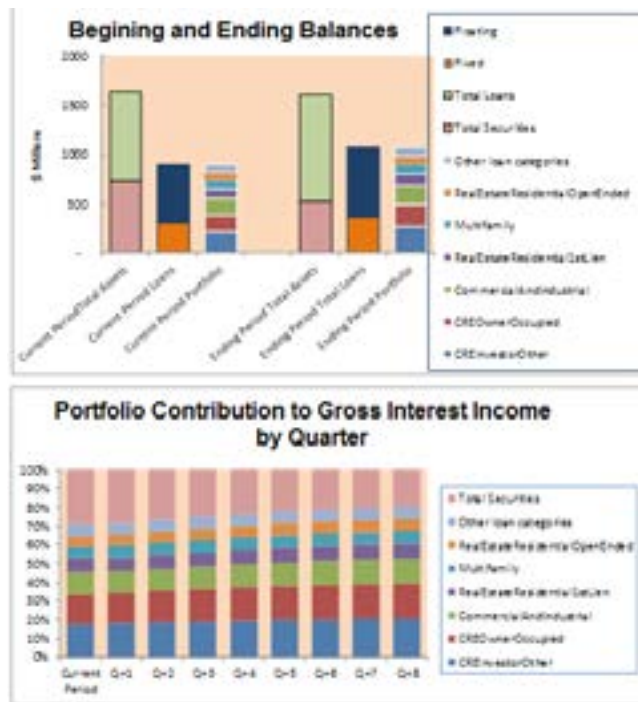
neously. The floors, the spreads, maturities and durations of the loans all depend on the time or vintage of loan origination, the same factors that play an important role in determining relative credit quality and the resulting impact to regulatory capital requirements.

Similarly the influx of deposits since 2008 has forced banks to take on more investment portfolio assets, and in their search for yield, longer-dated assets. Aside from having an impact on the new methods of computing bank liquidity, these assets, many of which are mortgage-based (FHLMC or FNMA) have an embedded repayment optionality, which means their duration can extend as rates rise. Potential market value losses that might be assumed for a given duration of a security will actually be greater because the duration will increase due to their convexity.

Invictus assists its bank clients in gaining an accurate read of the sensitivity of securities and loans under different interest rate scenarios through its LoanLayering™ methodology. Taking a bank's strategy, the vintage of its existing portfolio, the implied duration of new loans, the liability structure, and the investment portfolio, Invictus constructs incisive interest rate stress tests that are unrivaled in the marketplace.

We would be pleased to discuss how we can help you generate meaningful strategic information, and prepare for your next exam.

Here's a sample of the output from our analysis: Using a bank client's strategic plan, we ran our stress test on the loan and securities portfolios, projecting forward two years. For this particular bank, the top graph shows the shifting balances between loans and securities, between fixed and floating rate exposures, and within loans between differing loan types.



About the Expert



Leonard J. DeRoma is a founding partner and CFO at Invictus. He began his career at Citibank in the 1970s working with Kamal Mustafa in corporate finance. Using new techniques, together they developed sophisticated financial planning and modelling tools to help provide financial advisory services to Citibank's corporate finance clients. At Lehman Brothers, he managed global financing activity; for Barclays Capital, U.S. Fixed Income investment banking, trading, capital commitment, derivatives, sales, underwriting, foreign exchange

and research. As the President of Barclays U.S. securities business, he was in charge of product development, was an advisor to the U.S. ALCO committee and chaired the U.S. Risk Management Committee. He managed the same businesses for McDonald Investments and KeyCorp. He has a Bachelor of Science in Electrical Engineering from the Massachusetts Institute of Technology and a Masters of Business Administration from the Harvard Business School. He has served on several industry boards and associations, including the Public Securities Association and the Bond Market Association.

Read Between the Lines

Each month *Bank Insights* reviews news from regulators to give perspective on regulatory challenges.

OCC to Target Strategic and Capital Planning Processes

As we've said before, the OCC and other regulators are zeroing in on the adequacy of strategic and capital planning processes at community banks. Look no further than the **OCC's semi-annual risk perspective**, which lists this issue as the main one for community banks it supervises. Other areas of concern for OCC examiners: IRR, loan underwriting, operational risk and compliance. The good news: OCC enforcement actions were down in 2013 from previous years.

Fed Takes Over Bank Projections

The Federal Reserve sent a letter to the 30 largest U.S. banks notifying them that they will independently project each bank's balance sheet and risk-weighted assets under the supervisory stress scenario within the CCAR program, signaling its skepticism of the projected loan balances that the top 18 banks assumed in the prior CCAR stress tests.

Note: For most of the regional and community banks that have any levels of excess capital, loan growth is the centerpiece of their strategic plan, not dividends and buybacks. With our bank clients, Invictus treats loan growth as the Fed treats dividends and buybacks in CCAR: by assuming that it is achieved irrespective of the economic conditions. This allows us to quantify the impact on the bank's capital requirements. This is not a practical exercise, but a hypothetical one.

However, when regulators are reviewing the bank's strategic plan, they can see that the bank can handle that growth without affecting its capital adequacy, even under severe stress. This is especially important for aggressive growth banks that have loan growth rates of 15 to 20% plus per annum as part of their plan, says Invictus senior partner Adam Mustafa.

FDIC Releases Training Videos on TDRs, ALLL, Municipal Securities

As promised, the FDIC continued rolling out **videos** to help bank directors and officers understand regulatory issues and complicated changes. The agency released four videos in December, saying they address the most common questions the agency gets from bankers.

One on municipal securities addresses examiner expectations, investment policies, monitoring and purchase analysis. An ALLL video provides an overview of regulatory policy statements

and accounting standards. It also illustrates an effective loss migration analysis. The troubled debt restructuring video shows how to identify a TDR, its accounting and regulatory treatment and the multiple note concept. The fourth video is about fair lending.

TruPS and Volcker: Not a Problem

Federal regulators cleared the way for community banks to keep TruPS-backed CDOs as Tier 1 capital. **Regulators announced on Jan. 14** an exemption to the part of the Volcker Rule that considered those CDOs as covered funds. The exemption came about after the American Bankers Association went to court.

The Future of Community Banking

The FDIC has updated its **community bank study** and two words are key: consolidation and earnings. The update notes that while community banks as a whole experienced their best year in 2012 since the crisis, those gains may be short-lived since future earnings growth is dependent on increases in net interest income. There have been virtually no new charters since the crisis began, and the market continues to tighten, with voluntary closures and mergers. Most of the community bank failures since the crisis have been tied to commercial real estate concentrations.

Reviewing Appraisals and Evaluations

The Fed recently provided an **overview** of how examiners look at a community bank's appraisal and evaluation program. Examiners want the collateral valuation process to be independent from loan production and collection, though they concede this may not be possible at small banks. Common mistakes that banks are making: using outdated appraisals or none at all, not using an appraiser certified or licensed by the state, and not meeting the appraisal regulation's minimum standards. ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

For editorial, email Lisa Getter at lgetter@invictusgrp.com.

For information about Invictus, email info@invictusgrp.com.

Next in *Bank Insights*: Unique M&A Analytics