New Standards for Interest Rate Risk Reporting

Expectations for Community Banks

Bank Reporting Sciences

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About Bank Reporting Sciences

- Started in 1998
- Specialize in ALM Reporting & Consulting for Community Banks
- Presently prepare the quarterly Interest Rate Risk reporting for 500+ banks throughout the Nation.

New Standards for Interest Rate Risk Reporting

- Interest Rate Risk is a very hot topic right now and for good reason.
- It is a subject that is very broad, very deep, and getting ever more complex.
- The expectations on community bankers for technical sophistication has never been greater and shows no sign of slowing.

Our **GOALS** for today…

Send you back to your bank with a solid, albeit summary, understanding of the following:

1. The “New Standards” for Interest Rate Risk reporting
2. Specifically what you need to do stay ahead of regulatory expectations
3. Discussing the “New Standards” with your Board and ALCO

The “New Standards” of Interest Rate Risk Reporting

1. Multiple Interest Rate Simulation Techniques
2. Bank Specific, Dynamic Core Deposit Decay Assumptions
3. Dynamic Deposit Pricing Sensitivity Assumptions (aka “BETA’s”)

Multiple Interest Rate Simulation Techniques

1. Historically, assessing IRR has meant performing one interest rate simulation, typically a Shock of rates +/-200 basis points...
2. This analysis produced a set of percentages of potential exposure to earnings and economic value…
3. And that was the Interest Rate Risk analysis.

Multiple Interest Rate Simulation Techniques

1. The days of assessing Interest Rate Risk using one simulation technique are quickly coming to an end.

2. The “New Standard” is measuring Interest Rate Risk through the use of **MULTIPLE** Interest Rate Simulation Techniques

Multiple Interest Rate Simulation Techniques

WHAT does this mean?

WHAT do we do?

Multiple Interest Rate Simulation Techniques

At a minimum, Interest Rate Risk must be measured using a:

1. Shock Technique
2. Ramp Technique
3. Non-parallel Techniques, ideally 3…
    a) A Flattening Curve
    b) A Steepening Curve
    c) An Inverted Curve

New Standards for Interest Rate Risk Reporting

Multiple Interest Rate Simulation Techniques

WHY?

What is the rationale for this?

Multiple Interest Rate Simulation Techniques

1. The intention is to move away from assessing Interest Rate Risk from a single point of view and towards assessing IRR from **MULTIPLE POINTS OF VIEW**.

2. Where Interest Rate Risk is concerned, there is no “right answer”.

3. The best we can hope to do is get a sense of a bank’s interest rate risk exposure by evaluating the Bank under multiple scenarios.

4. Some scenarios are more realistic and have a higher probability of coming to pass.

5. Other scenarios take a more extreme view and have a lower resemblance to reality.

Multiple Interest Rate Simulation Techniques

1. The more realistic scenarios are more valuable from an operational standpoint.

2. The most severe help us prepare for, or a minimum make us aware of, the negative effects of the most extreme conditions.

3. By focusing on only one type of Interest Rate Simulation, our view is greatly limited and we effectively put blinders on to the other possibilities.

4. Like pieces of a puzzle, all of the Interest Rate Simulations put together are what form the overall Interest Rate Risk assessment.

Multiple Interest Rate Simulation Techniques

WHAT do I Recommend?

Multiple Interest Rate Simulation Techniques

Where your actual reporting is concerned, I recommend your bank do the following:

1. Prepare a Ramp simulating rates rising from 100 to 500 basis points. *The Ramp should be treated as the Primary simulation.*

2. Prepare a Shock simulation rates rising from 100 to 500 basis points.

3. *Initially*, prepare 1 Non-parallel simulation, with an eye towards the preparation of at least 3.

Multiple Interest Rate Simulation Techniques

Where your policy is concerned, I recommend you use the following language:

> *It is the Bank's policy to assess the degree to which future Earnings and Economic Value are exposed to Interest Rate Risk through the use of multiple Interest Rate Simulation techniques. These techniques include, but are not limited to: Ramp, Shock, and Non-Parallel simulations.*
>
> *For each simulation type, simulated **increases** in prevailing market interest rate levels will range from +100 basis points to +500 basis points.*
>
> *Simulated **decreases** in prevailing market rates will be constrained by the lowest possible decline in the actual Fed Funds rate as of a given reporting period.*

Multiple Interest Rate Simulation Techniques

What to show your ALCO and Examiners:

1. Show the full breadth and depth of the Interest Rate Risk simulations.

2. Provide documentation of what is actually happening to the market interest rates for each simulation.

3. Summarize on a single page the Earnings-at-Risk and Economic Value of Equity-at-Risk results for each simulation type across all the rate magnitudes matched off against the respective risk limit.

Multiple Interest Rate Simulation Techniques

What to show your Board:

1. Present results of Ramp simulation only as the primary simulation technique. This will avoid overwhelming Board members.

2. Routinely advise the Board that per regulatory expectation the Bank's Interest Rate Risk is fully assessed under multiple Interest Rate Simulation techniques.

3. Advise the Board that the results of the supplemental simulation techniques are available upon request.

4. Only when severe Interest Rate Risk is detected will the full spectrum of Interest Rate Simulation results be presented to the Board.

Dynamic Core Deposit Decay Assumptions

1. The “new standard” expectation is for your bank’s Core Deposit Decay rates to be specific to YOUR bank, and your bank only.

2. No more “peer data”. No more “industry averages”

3. Further, the expectation is that the Core Deposit Decay assumptions react **dynamically** with the Interest Rate Simulation.

New Standards for Interest Rate Risk Reporting

Dynamic Core Deposit Decay Assumptions

WHY?

What is the rationale for this?

Dynamic Core Deposit Decay Assumptions

1. Historically low rates mean most banks are swollen with non-maturity deposits.
2. The rightful concern is over a potential "**Liquidity Crunch**".
3. That is, when rates start to rise again, will there be a meaningful flight of depositors from community banks?
4. Measure the effect of deposit erosion, in a rising rate environment, on the bank's liquidity AND projected interest expense as the bank has to acquire new funding in successively higher rate environments.

Dynamic Core Deposit Decay Assumptions

WHAT does this mean for my bank?

Dynamic Core Deposit Decay Assumptions

1. The Bank will be expected to calculate, or preferably have calculated, its own bank-specific Core Deposit Decay assumptions routinely.

2. The Core Deposit Decay assumptions must be “stressed”.

3. The Interest Rate Risk reporting MUST show the stress placed on Funding Liquidity and projected Interest Margin, and ultimately the Bank’s equity position due to an invariable change in balance sheet mix.

Deposit Pricing Sensitivities (aka “BETA’s”)

1. Here we are talking about the degree to which the Bank will likely adjust the pricing of its non-maturity deposits AND CDs in the face of simulated rising interest rates.

2. Understandably, from the Bank’s standpoint – we want to keep deposit prices as sticky as possible when rates go up thus keeping interest expense under control.

3. The regulatory concern is that this belief **runs the real risk of understating the degree to which the Bank’s future earnings are exposed to rising rates**.

Dynamic Core Deposit Decay Assumptions

WHAT do I Recommend?

Deposit Pricing Sensitivities (aka “BETA’s”)

1. “Pricing Sensitivity Bracketing”
2. In addition to the “normal” assumptions for Deposit Price Sensitivity, also measure the effects of successively higher (more aggressive) sensitivities and lower (less aggressive) sensitivities.
3. This will provide a full spectrum look at the effects on future margin as the Non-Maturity Deposits react differently to successively higher simulated market interest rates.

What is the key takeaway for today?

Don’t Get Blindsided.

Blindsided by unexpected regulatory requests.

Blindsided by real Interest Rate Risk.

We all think “it” will never happen to us or “it” won’t apply to us… until it does.

Then, it’s too late to prepare.

When you're better informed – you're better equipped to deal with a potential problem **BEFORE IT BECOMES A PROBLEM.**

Thank You.