

Interest Rate Risk: Designing a Comprehensive and Concise IRR Program



Western Independent Bankers



Brian Heim, CPA
Principal Member
IRR-analytics, LLC
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Interest Rate Risk: Designing a Comprehensive and Concise IRR Program

- Comprehensive – Captures a range of exposures, meets regulatory expectations, and provides useful information
- Concise – Communicates effectively without causing information overload



Standard IRR Measurements

- GAP
- Earnings simulations (EaR)
- Economic value of equity (EVE)
- Stochastic modeling



Assumptions

- Key model assumptions (in order): Beta, decay, and prepayments
- Should be based on actual quantitative historical analysis with qualitative adjustments
- Should be formally reviewed annually and updated, if necessary
 - Less often: Not meeting regulatory expectations
 - More often: Noise in trend data



Assumptions (continued)

- Documentation for key model assumptions should support and explain model assumptions and any changes/updates (memos)
- Offering and discount rates: Should be based on observable data points and updated as they change; not as important to include ALCO in updates, but ALCO should determine methodology
- Assumptions are very important; however, there are modeling techniques that reduce their significance, which will be discussed in later slides



Policy

- Most banks have policy limits for 12M EaR, 24M EaR, and EVE
- GAP has slowly been written out of policies, but it is often still distributed to ALCO
- Banks with high levels of rate sensitive noninterest income must focus on net income rather than just net interest income
 - Mortgage operations: Refinance activity
- Limits should be based on earnings and capital levels
 - Do the math: Pretax earnings / net interest income
Regulatory capital cushion / regulatory capital*



Policy (continued)

- Most banks use parallel rate shifts for policy measurements, but nonparallel/flattening acceptable and may be more realistic
- Most banks use instantaneous rate shocks for policy measurements, but some use ramped and others use both (additional exposure to ramped?)
- Policy should briefly discuss reporting requirements, including standard monitoring, nonparallel shifts, backtesting, sensitivity testing, and independent review



Policy (continued)

- Policy should address requirements for policy violations
- Guidance requires at least quarterly monitoring of policy limits
- Dashboard report with trends and policy compliance a best practice
 - Best dashboard reports indicate violations with color or “yes/no” toggle
 - Strong practice to have early warning indicators and hard limits
 - Sample dashboard reports available



Nonparallel Rate Shifts

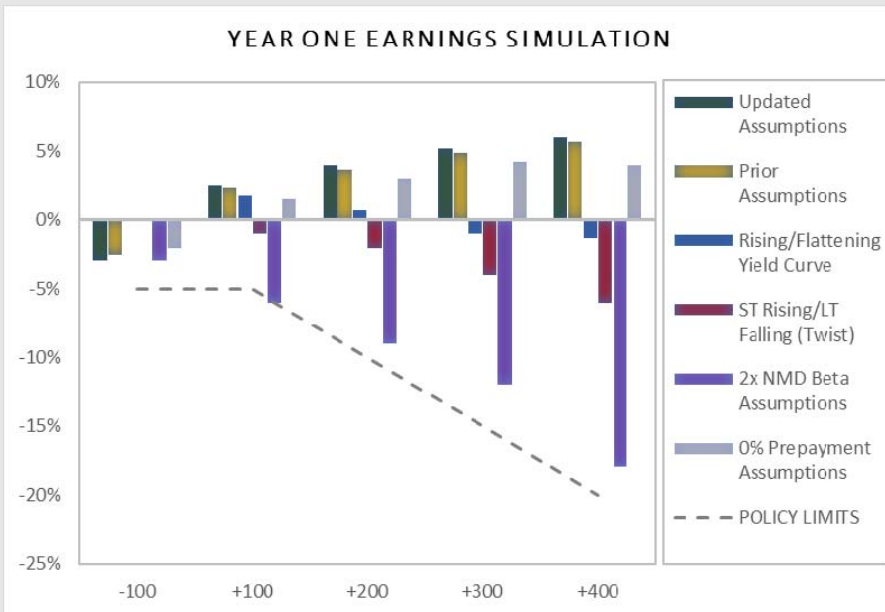
- Banks should measure nonparallel rate shifts at least annually
- Rising/flattening, rising/steepening, falling/flattening, falling/steepening, twist
- What is the most unfavorable shift?
- If additional risk is identified compared to the standard measurements, then nonparallel rate shifts should be monitored more frequently
- Output should be compared directly to standard measurements



Sensitivity Testing

- Banks should conduct sensitivity testing at least annually
- Should reflect stressed adverse customer behavior
- In current rate environment (exposure to rising rates), scenarios might include 2x betas, halved decay terms, or 0% prepayment rates
- This analysis helps determine the impact of assumptions, establish a range of IRR exposures, and defend the use of certain assumptions
- Output should be compared directly to standard measurements





- This single chart shows 30 different data points, compares them directly, and shows policy compliance



Backtesting

- Backtesting required at least annually, including 12M backtest
- Only applicable to earnings simulations
- Most useful backtest is account-level rate/volume/mix analysis
- May become less useful as rates begin to change and require adjustments for fractional rate changes or yield curve shifts; supplemental analysis or reasonableness testing may be needed
- Focusing on category totals can be misleading (see next slide)



Backtesting (continued)

	Forecasted			Actual			Variance			Variance due to:		
	Volume	Rate	Inc.	Volume	Rate	Inc.	Volume	Rate	Inc.	Volume	Rate	Mix
Fed Funds	2,000	0.25%	5	5,000	0.25%	13	3,000	0.00%	8	8	-	-
Loans	8,000	5.00%	400	5,000	5.00%	250	(3,000)	0.00%	(150)	(150)	-	-
Total	10,000	4.05%	405	10,000	2.63%	263	-	-1.43%	(143)	-	(143)	-



Advanced Modeling

- Dynamic versus static balance sheet
- Projections with multiple rate shifts, such as consensus median, high, and low rate paths.
- EaR is not a substitute for more detailed projections/discussions
 - Economic environment accompanied by rate shifts
 - Noninterest income impact
 - Credit stress/debt service



Minimum Reporting

- QUARTERLY (12M EaR, 24M EaR, EVE)
 - Summary dashboard report with trends (and policy compliance)
 - Guidance requires “sufficient detail”
 - Key model assumptions
- ANNUALLY
 - Key model assumption review/update
 - Sensitivity/stress testing
 - Nonparallel rate shifts
 - Backtesting results



Questions?

BrianHeim@IRR-analytics.com

208-867-1167

www.IRR-analytics.com

