Interest Rate Risk for Board Members

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Regulatory guidance identifies the board as having ultimate responsibility for interest rate risk (IRR) taken by an institution. This responsibility is primarily demonstrated through board-approved policies, risk limits, and strategies. In addition, board members should understand and regularly monitor the level and trend of their institution's exposure. Below are some regulatory expectations and industry best practices to help evaluate your IRR program.

The institution's IRR policy (or equivalent) should be concise and communicate the board's risk appetite. The policy should clearly identify permissible hedging instruments, if any. Standard IRR measurement techniques include earnings simulations and economic value of equity calculations. Earnings simulations measure shorter-term IRR exposure and economic value of equity calculations are intended to capture longer-term exposure. GAP reports are still relevant for providing a maturity/repricing snapshot of the balance sheet, but many institutions have discontinued the use of GAP policy risk limits.

Earnings simulation risk limits are commonly based on net *interest* income at risk, but net income at risk should also be monitored if the institution has a meaningful level of rate-sensitive noninterest income, such as mortgage revenue derived from refinance activity. If risk limits are established for net *interest* income only, an analysis should be done to determine the structural impact of those risk limits to net income. For example, a limit of 35% of net interest income at risk may correspond to an unacceptable net loss position at an institution with below average earnings and limited sources of noninterest income. The same risk limit may be perfectly appropriate for an institution with strong earnings and significant noninterest fee income, such as trust revenue.

Risk limits for economic value should be based on the relative change from a base case calculation. As a reasonableness test, regulatory capital levels can serve as a proxy for economic value of equity. For example, if an institution could absorb a 30% reduction in risk-based capital and remain "well capitalized," then a 30% risk limit for economic value of equity may be appropriate. Institutions can have risk limits beyond their regulatory capital buffers, recognizing that regulatory capital is not a perfect substitute for the economic value of equity. Regulatory capital levels will be impacted primarily by earnings over time rather than an instantaneous fair value adjustment.

Monitoring of IRR must be conducted at least quarterly. Board members should receive reports from management that clearly show IRR measurements and indicate policy compliance. Dashboard reports are a best practice for summarizing results, policy compliance, and trends. Historical results should be shown alongside current results to indicate whether the direction of risk is increasing or decreasing. Board members should also periodically monitor results of nonparallel rate shifts, scenarios with stressed assumptions, and backtesting analysis. The frequency of these types of monitoring should occur at least annually. If significant additional risk is detected compared to the quarterly reporting, then supplemental monitoring should occur more frequently.

The most important contribution board members can make to their organization is providing strategic discussion and direction. Risk management is not an exact science and requires thoughtful consideration of possible outcomes. Model simulations and economic value calculations are only part of a comprehensive IRR program. Board members and management should regularly discuss how risk may change in possible real-world scenarios and evaluate appropriate strategies. The number of possible scenarios is unlimited, especially when considering related risks, but hypothetical scenarios can help work through possible risk outcomes. Strategies implemented to adjust risk levels might include investment allocations, loan pricing and maturity structures, terms of loan prepayment penalties, loan floors/caps, funding strategies, early withdrawal penalties, or hedging activities.

As institutions continue to develop and improve enterprise risk management programs, IRR should be incorporated and evaluated as part of that process. Again, hypothetical scenarios can be useful. For example, if the institution is evaluating earnings and capital at risk in a rising rate scenario, consider possible external conditions and how they might impact the balance sheet. Did interest rates increase because of strong economic growth, a Fed response to stagflation, or some other cause? How quickly and how much did rates rise? Did rates rise across the yield curve or was there a steepening/flattening? What is the impact on asset prices, such as real estate, stocks, and bonds? Are borrowers willing and able to service debt at higher rates? Will deposit pricing be affected by returns on alternative investments? As a board member, you are certainly not expected to predict the future; instead, you should consider a range of possible outcomes and provide strategic direction accordingly.

Every financial institution has a unique balance sheet and IRR program. Two institutions using the same ALM model or reporting service may have vastly different IRR programs based on policy elements, model administration, reporting, and oversight. As a board member, the best thing you can do to elevate risk management practices at your institution is to keep asking questions until a clear strategic path emerges.

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