Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

August 6, 2012

What You Can Do If Your Examiner Considers You an IRR Outlier

OCC examiners are on the look-out for interest rate risk outliers. If your bank has been tagged as an IRR outlier you can expect your examiner to suggest (or demand) some changes. If you know you're taking on more interest rate risk and expect examiner interest, you can plan ahead. Here, according to Bill McGuire, president of McGuire Performance Solutions, Scottsdale, Ariz., is what you can do to prepare:

1. Understand fully any potential strategy involving asset side lengthening, pre-test the earnings at risk and equity at risk implications of it, and document the bank's goals and that the IRR issues related to the strategy were properly reviewed.

2. Monitor your ongoing IRR positions at least quarterly. Many banks now monitor their IRR positions monthly, but regulators will expect to see that you're checking in at least quarterly, McGuire says. He advises banks to monitor their IRR positions with an independently validated ALM model that employs accurate (not conservative),

See Page 6

FRB Examiners Now Pushing OCC Capital Adequacy, Risk Management Standards

The OCC's guidance on capital adequacy has been overshadowed by the crush of Basel III-related proposed regulation, but it's no less significant for community banks. As that guidance makes clear, the OCC expects banks of all sizes to build a firm-wide risk program and use that risk program – not PCA/regulatory capital standards – in order to plan for capital. As it happens, OCC-regulated banks may not be the only banks expected to base their capital planning on a foundation of risk management. Federal Reserve Bank examiners have been asking regulated banks to implement similar programs lately, experts say, suggesting that the OCC's capital adequacy guidance has influence beyond OCC examiner ranks.

The OCC's guidance asks banks to track risk across the firm, create risk triggers and tie those triggers to capital adequacy. That's exactly what Fed examiners asked for several banks to do recently, says Molly Curl, a partner in the bank regulatory practice with Grant Thornton, Dallas.

"[The OCC guidance] definitely requires ERM. And we're seeing this

(continued on page 2)

OCC to Seek out IRR Outliers

Community banks have been taking on interest rate risk and the regulators have noticed. With interest rates so low and margins so tight for so long, many community banks have been taking in large amounts of non-maturity deposits and, at the same time, buying longer term investments.

The increased and increasing risk hasn't been lost on the OCC. Last month, the agency put banks at risk for interest rate trouble on notice. OCC exam staff will be looking to identify and investigate "IRR outliers," according to the agency.

"The OCC attempts to identify IRR 'outliers' that represent a higher risk profile due to balance sheet structure and complexity and deficient risk management or measurement processes," said an OCC official from the Office of Market Risk.

(continued on page 4)

BSSA will not be published next week.
Please look for your next issue dated August 20th.

SUBSCRIBER SERVICES

MISSION:

Bank Safety & Soundness Advisor provides independent, executive intelligence on bank exams, enforcement and risk management.

EDITORIAL:

Need us to investigate a topic? Want to express your opinion? Please call or e-mail us.

Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

SUBSCRIPTIONS:

Direct questions about subscriptions to:

Phone: 1-877-320-7147;
Fax: 301-287-2945;
or send an **e-mail** to Customer@banksoundness.com.

Published weekly (48 times a year).
Copyright 2012. Price: $595/yr.

EDITORIAL CONCERNS:

Our goal is to provide you with the most accurate and balanced information available anywhere. If you ever feel we're not living up to this standard, I want to know about it. Please call me, Hugh Kennedy, Group Publisher, direct at 1-800-929-4824 ext. 2213.

ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 200
Gaithersburg, MD 20878-7364

FRB Examiners

(continued from p. 1)

with other banks, not OCC-regulated banks, where examiners are requiring this sort of stress testing and pulling it into the capital plan," Curl says. "We're seeing it for the first time with Federal Reserve Board banks."

One of Curl's clients, a banker at a Fed-regulated bank fresh from an exam, found much in common between the OCC guidance and his examiners recent demands.

"I had a long conversation with a Fed member bank yesterday, a client," she says. "I sent him the OCC guidance last night and he said, this is right on, this is just what they're pushing on me."

Risk triggers

Fed examiners are especially keen to see risk triggers designed and tied to policy, a key element in the OCC guidance, Curl says.

"I was working with a [Fed-regulated] bank a few months ago, a $200 million bank, which needed to do a profit plan. The regulators wanted triggers in the plan. If the bank doesn't meet its budget, it had to define certain actions – what it would do."

This is no small effort. Federal Reserve examiners have been asking regulated banks to set risk triggers for a wide range of risks, all tied back to capital, says Peter Weinstock, a partner in the Dallas offices of Hunton & Williams LLP.

"The Federal Reserve is asking for a lot more asset quality benchmarks for capital planning at healthy banks," he says. "They're expecting a bank to set overall risk tolerances in various areas – not just in credit quality, but in concentrations, too. Then as they approach the risk tolerance, banks are expected not only to adjust their board reporting but also their capital plans. In other words, they need to state what they'll do with capital as they approach those risk tolerances."

"The capital plan will say, for example, that as the bank approaches the risk tolerance, it will reduce concentrations, reduce or eliminate dividends or roll up into raising more capital," he adds.

These expectations have been around for larger banks, but they're making their way down to smaller banks now, too, Weinstock says.

"I'm seeing that focus – on overall risk tolerance working its way into capital plan expectations for certain Reserve banks," he says. "For big banks, the FRB has said they want this, but not for community banks. They just came out with a voluminous proposal for ERM guidance for big banks, systemically important banks, but those concepts, I expect they'll apply them to community banks as well."

FDIC, Fed follow OCC's lead

Fed examiners have been tapping the OCC guidance and it isn't surprising, since examiners from other regulators have followed the OCC's lead in the past, says Michael Guglielmo, Managing Director with Darling Consulting Group, Newburyport, Mass.

"The OCC is the most progressive regulator, in terms of putting out guidance on various things, including the original interest rate risk bulletin that all the other regulators pointed to," he says. "It was the same with the agency's 2011 model risk management guidance. The issued guidance becomes something all examiners adopt. The Fed doesn't have specific guidance [on capital planning] so their examiners will learn through guidance like this."

The OCC may have authored the guidance, but Fed and FDIC banks have become suddenly interested in capital planning, too, he says.

"On the capital planning and stress testing side, we're getting a deluge of requests – mostly from OCC-regulated banks, but also from FDIC and Fed banks," Guglielmo says. "Some are anticipating these requirements from examiners, but others have had specific MRAs [matters requiring attention] in exams. Their examiners want capital planning done. We are seeing this requirement spill over into Fed and FDIC exams."

Op risk

Risk management-tied capital planning isn't the only OCC interest to bleed over into Fed exams. The OCC's operational risk concerns have been working their way into Fed exams, too, Curl says.

"We're seeing operational risk concerns where we didn't see that much in the past," Curl says. "[Comptroller of the Currency] Tom Curry's speech has taken on a life of its own."

Specifically, Fed examiners asking for risk management-tied capital planning are asking some regulated banks to identify and work their way through operational risk what-if scenarios as part of the process.

"[Op risk] is a big part of what the regulators are telling banks to do," she says. "The examiners bring in examples, op risk examples and ask, for example, 'If you lose your head lender, how will that impact the loans he's responsible for? How will it impact capital?' And then they want banks to stress test it. They're asking banks to bring these op risk factors in when they put together the capital plan."

For more on the OCC's capital adequacy guidance and its risk management implications, see "OCC Mandates Enterprise-Wide Risk Management," BSSA, June 18, 2012 and "OCC Guidance Brings Sweeping Change to Capital Planning, Experts Say," BSSA, August 6, 2012. ■

IRR Outliers

(continued from p. 1)

The OCC emphasized its concern with IRR and banks taking on extra interest rate risk in its recently issued bank risk compendium, the Semiannual Risk Perspective.

"Margins are under pressure in the low interest-rate environment due to growth in deposits and weak loan demand. This provides an incentive to increase the duration of the investment portfolio and purchase more complex structured products. Both actions increase exposure to interest rate risk and require heightened risk analysis to fully assess vulnerability," notes the OCC.

"The OCC definitely has some valid concerns here," says Brad Olson, president of Olson Research Associates, Inc., Columbia, Md.

Community banks have been taking in more and more longer term investments and they've been doing it for some time, he adds. "I'm afraid the longer we stay in this low rate environment, the more [interest rate] risk-taking we're going to see."

The regulators are coming around to the notion that, generally speaking, banks have credit risk under control and that interest rate risk has become the bigger concern, suggests Michael Guglielmo, managing director with Darling Consulting Group, Newburyport, Mass.

"Banks have hopefully learned that credit risk is the risk that will kill a bank and they have it under control," he says. "Examiners are not as concerned about this as they were a few years ago. They feel as though the tide has turned and they're now looking at how banks are trying to make up margin – and that brings interest rate risk. Banks are going longer in terms of investment portfolios, duration and assets. They're looking into more structured types of investments. They're just stretching for yield."

Bank balance sheets are in an unusual position right now, explains Bill McGuire, president of McGuire Performance Solutions, Scottsdale, Ariz. In many banks the ratio of short term assets to longer term liabilities is high and rising.

"Most of the change in that ratio since the financial crisis is of course liquidity related, plus some 'waiting for interest to rise' holdings," he says. "The upshot is that short term balance sheet 'mismatch' is strongly towards interest income gains outpacing interest expense increase as interest rates first rise and for probably 12-24 months thereafter."

That means that interest rate risk won't impact many banks in the short run. But longer term balance sheets are a different story, McGuire says.

"Unless there are verifiable matching holdings of contractually long term funding or reliably supplied and rate paid stable core deposits, longer term assets

Examiners Will Assess the Assumptions, Models Behind Your IRR Program

It's a point regulators have been making a lot lately: It is not enough simply to have models in place. Banks need to show not only that the models they use are sound, but also demonstrate that they've put quality assumptions into those models.

The OCC was the first – and so far, only – regulator to release model risk guidance, which it did last year. Now it's clear that examiners will expect banks to apply that guidance to interest rate risk models.

According to the OCC's Office of Market Risk, examiners will not only be checking to see that banks are monitoring their interest rate risk and that they've set risk limits tied to that risk. Examiners will also check to make sure that IRR models and assumptions make sense, too.

"A key focus of current IRR examinations is the quality of IRR model assumptions," said an official in the OCC's Office of Market Risk.

According to the OCC, examiners will vet interest rate risk models across multiple banks and compile their findings. Once they do, they'll synthesize those findings and use them as a tool to help identify IRR outliers with more precision.

"As examinations document key assumptions, stress scenarios, and risk limits and exposures, OCC is able to produce another set of benchmarks for examiners to use in determining bank outliers," the official says. ■

are over-represented compared to longer term liabilities," he says. "This creates exposures to net interest income beyond 24 months if interest rates rise because longer term asset repricing is limited while that on the funding side is greater. If we add in the idea that much of what looks like favorably behaved core deposits is in fact this time around just parking – and will leave for higher returns when interest rates rise – you can see why regulators are worried and searching for IRR outliers in the industry."

Identifying the outliers

So how, exactly, does the OCC plan to identify outliers. It's a process with several steps, the OCC says, but ultimately, examiners will be looking for how your bank fares on four key ratios.

"The IRR assessment process is multi-faceted and produces outliers in several areas," the OCC Market Risk official said. "Ultimately the supervisory office determines what actions to take based on all available supervisory information."

As a first step, examiners will look out for IRR and outliers through a familiar entry point: an assessment of your overall market risk sensitivity or the "S" in your CAMELS score.

"Sensitivity to Market Risk is evaluated on an ongoing basis as part of the risk assessment process for determining a bank's quantity of risk, quality of risk management, and the "S" rating – sensitivity to market risk," the official said. "This risk assessment categorizes banks as having low, moderate, or high quantities of IRR and either weak, acceptable, or strong levels of risk management. So the traditional risk assessment and rating process produces one set of outliers based on quantity of risk and quality of risk management."

Above and beyond the risk assessment process, however, OCC examiners will be using a handful of key ratios, all using data right from bank call reports, to identify the IRR outliers, the official said.

"They're saying: 'Let's just do a simple test to find banks that may have some more interest rate risk issues.' It's about resourcing."

The key ratios are:

1. investment portfolio depreciation to capital;
2. long-term assets to total assets;
3. non-maturity deposits to long-term assets; and
4. residential real estate assets to total assets.

"Supervisory staff [will] incorporate the outlier analysis into their supervisory activities as a tool that may indicate an elevated risk level," the official said. "Bank outlier data can then be compared to other risk assessment data and examination findings in order to determine if additional analysis is warranted."

The OCC's methods will only give examiners a cursory, high-level view into your interest rate risk, suggests McGuire.

"The catch is that regulators do not have very robust tools to identify outlier long term IRR institutions," McGuire says. "Standard top-down ratio screens have to rely on call report data, which has only rudimentary information on actual short term repricing or long term cash flow mismatches. There may still be agency IRR testing models. The OCC at one time had a 'canary model' that included an approximation level IRR test. But again such models are imprecise because granular IRR related data is not readily available."

The ratios are a "blunt tool" compared to what examiners could use, but the OCC is really using them as preliminary indicators, Guglielmo says. They won't be used to determine the last word in your bank's IRR status. Instead, regulators will be using them to identify potential trouble spots, to see if they need to dig a little deeper.

"These ratios are just litmus tests," he says. "All they do is help call out those banks more apt to have interest rate risk issues. It's a way to segment and focus energies on those more apt to have issues."

Using the ratios won't create extra risk for banks, he adds. The OCC regulates a large number of banks with a limited exam staff and this is simply a way to manage exam resources a little more efficiently.

"They're saying: 'Let's just do a simple test to find banks that may have some more interest rate risk issues,'" he says. "It's about resourcing. Once they find those banks, they may put their capital market specialists in those organizations. Those with credit issues will get the credit experts." ■

What You Can Do

(continued from p. 1)

bank-specific behavior assumptions for loan prepayments, core deposit repricing and decay, and CD bump-up options and early withdrawals.

3. Be very careful about how you define core deposits in your IRR modeling. "If a portion of current balances are the result of more rapid growth since, for example, the Lehman crash, carve those out from what long term supply trend balances would be and treat them as short term funds until their true supply motivation is established," McGuire says. " Such 'surge balances' are an area of great regulatory concern right now and properly so given their potential to leave banks rapidly when interest rates rise – just when stable cost funding is most desired." It's important for banks to understand which deposits are traditional core deposits and which are surge deposits because examiners may assume that its 100% surge, he adds (see chart below).

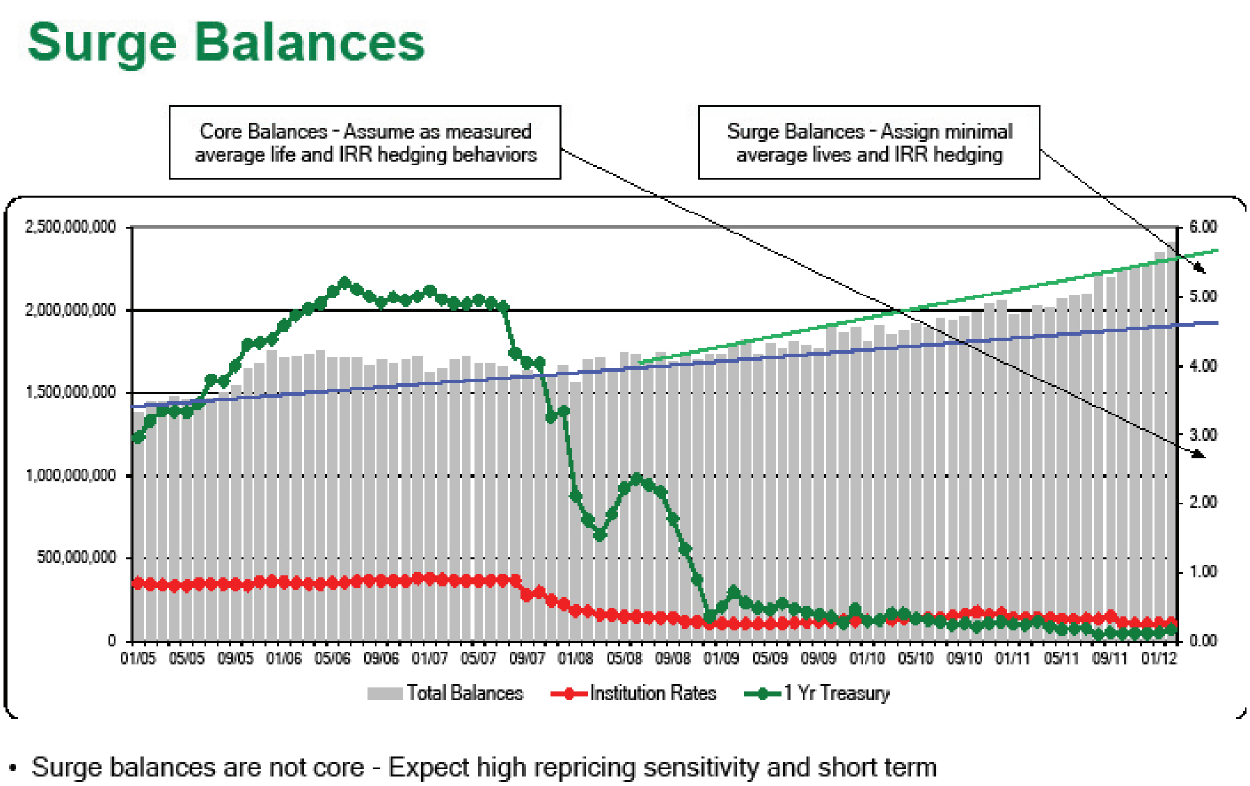
Exam impact

Examiners seem to be asking for risk limits tied to policy for everything lately and interest rate risk is no exception, says Michael Guglielmo, managing director with Darling Consulting Group, Newburyport, Mass. If your examiner sees increased interest rate risk in your bank, they will expect that you and your bank have planned through risk scenarios and set reasonable risk limits.

"Banks are being asked to set risk limits for every conceivable measure out there," he says. "They're more aware of risk profiles than they have been in the past."

If a bank approaches its internal limits or if it takes on too much interest rate risk for an examiner's comfort, some examiners will push banks to make changes to their process, he adds.

"Usually, the examiner will conclude that the bank has unrealistic risk limits," he says. "If they're too broad, examiners will want them tightened up." ■



Source: McGuire Performance Solutions

Copyright© 2012 UCG. No portion of this publication may be reproduced or distributed without the written permission of the publisher. Bank Safety & Soundness Advisor shares 10% of the net proceeds of settlements or jury awards with individuals who provide essential evidence of illegal photocopying or electronic distribution. To report violations contact: Roger Klein, Esq., Howrey LLP, 1299 Pennsylvania Ave. NW, Washington, D.C. 20004-2402. Confidential line: 202-383-6846. For photocopying and electronic redistribution permission, please call Aaron Steinberg at 301-287-2471 or asteinberg@banksoundness.com.