Bank Safety & Soundness Advisor
Executive intelligence on bank exams, enforcement and risk management.
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Think Twice before Self-Reporting Consumer Compliance Violations

CFPB said it would consider giving a break to banks and other financial firms that turn themselves in for violating federal consumer laws. But think twice before you put the agency on speed dial, experts say.

CFPB joined other federal agencies – from the U.S. Sentencing Commission to the Securities and Exchange Commission – that offer a carrot to regulated entities that self-report violations of rules and regulations. The agency said that it would also consider rewarding other "responsible conduct," including firms that proactively self-police for potential violations, quickly and completely remediate harms to consumers, and cooperate with bureau investigators above and beyond what is legally required.

"If a party meaningfully engages in these activities … it may favorably affect the ultimate resolution of a Bureau enforcement investigation," CFPB said in a press release.

The agency said it had a "wide range of options" to properly account for responsible conduct in enforcement investigations. "For example, the Bureau could resolve

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Regulators Push for More Sophistication in IRR

Gap Analysis Not Good Enough Even for Smaller Banks, Experts Say

More than three years ago, the FFIEC threw down the gauntlet on IRR programs telling banks to shape up and prepare for a rising rate environment. But many community banks, it appears, have not yet gotten the message, and now the regulators are at it again.

The latest evidence comes in the OCC's just-released Semi-Annual Risk Perspective. The report identifies IRR as among the agency's principal safety & soundness concerns for small and mid-size banks.

Among the areas that OCC has decided warrant extra supervisory attention: the adequacy of interest rate stress scenarios and modeling assumptions for non-maturity deposits and the growing portfolio of mortgage backed securities shoring up the bottom line at many banks while increasing their exposures to rising interest rates.

"The historically unusual rate climate requires more complex analytics to assess interest rate risk vulnerabilities," the agency declared.

So what are the regulators looking for? What do regulators mean by "more complex" analytics? What are the scenarios that trouble examiners? Are they reflected in your model?

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How to Find the Right IRR Model

Even in the most economically stable times, most community banks have not done enough to effectively manage their interest rate risk. Now, with more regulators and experts seeing the economy on the cusp of a long-awaited increase in rates, the ability to manage IRR is arguably more important than ever.

How do you do more? Is your IRR analysis solution adequate and accurate for some of the twists experts expect when rates rise? What are the earmarks of an IRR program that will not only satisfy regulators but more importantly keep your bank safe and sound? How do you do all this at a time of continuing resource constraints?

The importance of carefully selecting the correct IRR model for your institution is evident in the sheer number of models that do not work.

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Regulator Push

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It is clear that regulators are concerned about the continuing lack of sophistication that is inherent in many models that community banks use, experts say.

One message: stop relying exclusively on a simple gap analysis that only measures the difference between rate-sensitive assets and liabilities and little else that is apt to go wrong in the current environment. At a minimum: banks should be using some sort of simulation analysis to measure rising rates' impact on short-term earnings and other measures to assess capital down the road.

"The smaller banks especially are using tools to measure IRR that we have known for a while are not adequate IRR measurement tools," says Brad Olson, president, Olson Research Associates, Columbia, Md. "I am just stunned by the number of bankers that call and talk about a gap analysis. It is 2013. We knew the weakness of the GAP in the late '70s and early '80s. The only thing that has changed is that more banks are investing in these things."

Gap analysis, he points out, fails to account for some of the main risks that banks are facing today. "You have prepayment and extension risk – which is certainly a focus for the OCC and all regulators – that really cannot be captured," he said. A gap report also cannot capture risk for core deposits that do not have clearly defined maturity structures.

"Even the most traditional banking products cannot appropriately be modeled using gap analysis," he says. "That is what the OCC is referring to when it says it is interested in banks using more complex analytics."

Another regulatory concern: community banks are making behavioral assumptions in their models that use historic data that is apt to be wrong when interest rates finally turn up.

Many banks have been modeling deposits on the assumption that rates on deposits will follow their historic pattern of lagging changes in loans and investments. But history may not repeat itself this time around.

"We have investment-starved depositors out there who are going to be demanding market rates. So, that lag many community banks are modeling may not exist in this cycle," says Orlando B. Hanselman, the education programs director for Fiserv Risk and Compliance, Johnstown, Pa.

Adds Olson: "We have been in a low-rate environment for so long that much smaller rate moves are going to be viewed as attractive. In the past, people may have not blinked at 20-25 basis points. But now, if I have been earning 5 basis points for a long time, 30 basis points is going to sound great. So I am going to go get it."

The latest warning from the OCC certainly has currency, with markets still rattled by the mere hint last month that the Fed might later this year slow the pace of its program to drive rates lower and boost the economy through bond purchases. Banks helped to drag bond prices lower recently as they looked to unload investment portfolios that had suddenly eroded by 5% or more.

Hanselman says regulators are concerned that many community banks are not properly assessing the interplay between interest rate risk and credit risk.

"Some financial institutions are taking unwarranted solace in the fact that they are asset-sensitive or positively gapped because they have a lot of loans that are either adjustable or floating rate, and they have the legal right to re-price them," he says. "But they may not have stress-tested their loan portfolios adequately to understand the risk of payment shock to borrowers in a rising rate environment."

The dilemma: Do we pass along these rising rates where we are allowed to on our floating rate loan customers – and possibly increase credit risk – or do we hold the line on credit risk by eating the interest rate risk? "That is a new phenomenon we have not seen in the past," Hanselman says.

Banks with large bond holdings may be modeling the fact that their investment portfolio is being held to maturity, and that under GAAP rules, they can defer loss recognition when rates rise. But that comes at a cost of net interest margins depressed from the funds not being invested at the higher current rates.

The concentration in the investment portfolio has left banks in need of a more complex IRR model. "Even community banks have a great deal of optionality on their balance sheets that was not there 10 years ago," Hanselman says.

"What regulators are saying is two-fold," he says. "Financial institutions have to improve their mastery of the analytical hierarchy, and they must expand the robustness of their stress testing, particularly when it comes to assessing or forecasting the correlation of rising interest rates with both IRR and credit risk."

"All banks use gap analysis on both contractual and behavioral basis. That is level one. It is a tool you should keep in your tool box. But it is completely inadequate in its entirety. You must go well beyond that," he said. "I cannot see the regulators being satisfied with any financial institution that relies exclusively on gap analysis."

"The examiners are armed. And if they want to hang you, they can hang you."

Other experts see even less tolerance among examiners for weak IRR management practices.

"The expectations for our models are a lot higher," says Michael Guglielmo, a managing director at Darling Consulting, Newburyport, Mass. "The check-the-box approach to risk management is not going to cut it."

He says banks should push for more board involvement in reviewing and discussing the assumptions that underlie their models. "We see more and more examiners pushing a more formal approval process for these assumptions," Guglielmo said, adding that, even if your model is performing adequately, "if you don't have a solid, well-documented process, you run the risk of criticism."

"The examiners are armed," he said, "and if they want to hang you, they can hang you."

"How you communicate is really important, too," Guglielmo added. "A lot more information is going into and coming out of models. How we present that information is going to make or break the decision-making process."

"There is a tipping point, and it does come down to deposit assumptions," Guglielmo said. "If we don't understand how those deposits behave we fool ourselves in believing all deposit growth is here to stay and we put ourselves at risk."

The financial regulators expect each depository institution to manage its IRR exposures using processes and systems commensurate with its complexity, business model, risk profile, and scope of operations. But even smaller institutions can have issues that draw examiner attention.

Guglielmo spoke last month at a BSSA webinar on IRR where he was asked by an official at a $200-million-asset community bank what he could expect from regulators.

"It depends on the kind of exposures you have," he said. "If there is a concentration in a particular type of loan product there might be greater expectations for you."

Regulators want to know if your bank has a glaring exposure that might cause it to become a risk. So you should be prepared to stress test those identified credit concentrations, he says.

"Apply the worst things that you have ever experienced. If you

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Regulator Push

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want to build on that … look to local competitors. What was their experience?" Guglielmo said. "Part of it is understanding what your perfect storm is. What is going to break you? If you have a big concentration eventually (regulators) are going to expect you to do something more." ■

IRR Model

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About 20% of banks' IRR models incorrectly forecast both the direction and magnitude of IRR, estimates Bill McGuire, president of McGuire Performance Solutions. "That is credit risk by definition," McGuire said at a recent BSSA webinar on IRR.

The "right" model, he says, is highly institution specific, powerful enough to assess all IRR drivers embedded in the balance sheet.

Some questions he says every community bank should ask about its model:

• Can it read all the contractual terms of instruments in your balance sheet and all embedded options such as calls, puts, caps and floors?

• Can it analyze behavioral assumptions about trends in core deposits, payments, CD withdrawals?

• Is it supportive of multi-dimensional IRR tests? Can it look at IRR from different perspectives? Not just shocks but changes in the yield curve?

Aside from having verifiable technical capabilities, he said, the model must also be operationally validated, preferably by independent third parties or experienced internal auditors.

Selecting an IRR model is also a budgeting decision, McGuire says. Banks can have "too much" model or "too little" model. Banks should compare model functionality to need – the best solutions, he says, are matched to balance sheet complexity – and consider the all-in cost including specialized staff.

The goal, he says, is to have a model that captures all behaviors in the bank balance sheet – including loan prepayments, pay downs, core deposit re-pricing and decay, as well as CD bump options and early withdrawals. The weakest point in IRR models, McGuire says, are behavior assumptions, the non-contractual behaviors that underlie a large portion of balance sheets.

Institution-specific deposit and loan inputs are preferred and the most accurate. They are also more expensive because more resources are involved in collecting the data. But the cost has been declining, and he says there are more people using the approach than he can remember.

Using peer data as a proxy can be a cost-effective solution for some community banks. "There is a low cost solution out there and it works if your balance sheet has a more simple cast to it, and you don't have large IRR, such as a huge holding of mortgage backed securities or 30-year mortgages."

How core deposits and so-called surge balances behave when interest rates rise, and how those balances are re-priced, he says, is an obviously huge issue for regulators and for banks.

While no one knows for sure what core deposits are going to do going forward, McGuire says the best approach is to use a re-pricing input in your model that is a composite of history and how you think the current market influences will cause your behavior to be different than in the past.

"Re-pricing history can quantify how you have behaved over time to give us a fundamental historic basis for defining betas," he said. "The problem is, we are in this new normal. We have to go one step further. Take what history has shown we have done and adjust it to where we think we are going."

Setting core deposit betas in the current environment is an art. Some factors he suggests:

• Consider the board's re-pricing preferences.

• Look to the historic record, as reflected in quantified forecasts of future rates paid.

• Consider liquidity needs as interest rates rise.

• Beware the adverse effects of high inflation.

Know your customers and competition. Betas from your history will give you the strongest foundation from which to build future betas.

Regulators are concerned that a lot of the deposits in checking and savings accounts are not true core deposits. They are temporarily parked in banks waiting for interest rates to go up. The concern is a lot of money is going to run out on a short-term basis, and if banks bought long-term assets using those funds, there is going to be a liquidity and IRR problem.

Banks should, at the least, assign short average lives to such surge balances, McGuire says.

"This will go a long ways towards making life a lot easier when examiners ask you the question, 'How are you handling surge balances, and by the way, how big of a deal are they?'" he says. "Most regulators will walk in your shop and say, 'All balances are surge balances.' We need to push them back by saying, 'We have thought about it.' That is worth its weight in gold when it comes to compliance, and it is also good business practice."

Some observers believe regulators have gone overboard with their expectations about the breadth of stress tests. They believe a happy medium can be found, and that running a handful of such tests should be sufficient if models are tuned properly.

"You want to know what short-term earnings' exposure looks like using some kind of income simulation," says Brad Olson, president, Olson Research Associates. "You also want to have a longer-term perspective. Don't just rely on a short-term earnings' simulation. You want to have a longer-term economic value simulation."

Banks should look at a handful of stress test environments. Olson believes a 100-200-300 basis-point shock in rates is sufficient to understand your profile. Modeling prepayment risk makes sense because of the likelihood that prepayments will slow down when rates rise. So does modeling different re-pricing betas to gauge the impact on interest expense and earnings. Banks should also examine the nature and source of their surge deposits.

Too many banks, he says, have taken the view "It's not a big deal. It's going to work itself out" when it comes to re-pricing when rates rise. That is a mistake even if the way forward is unclear.

"Banks should be having an open discussion in their ALCO about the main parameters in these models," including prepayment risk, call risk and re-pricing risk, Olson said. "There needs to be frank and open discussion about it – and a realization that you are not going to get into a discussion about what is right and wrong. You just need to be aware of these things."

McGuire also sees a growing "Mission Creep" in the form of growing regulatory expectations for more and different IRR testing.

"We have so much to do in a land of not-enough-staff that there is a potential that we will create mistakes that will result in less accurate forecasts, less accurate decisions, and we will have model risk," he says.

He suggests banks cut back on the frequency of standard testing – doing net interest income testing quarterly instead of monthly and using the off-months to focus on alternative IRR deliverables such as behavior assumption back testing.

"Rote production of monthly IRR compliance tests is rarely useful," McGuire says. "By conducting quarterly IRR tests when possible, resources are made available in off months to do other IRR analysis tasks."

Such a routine can have built-in circuit breakers – such as a 50-basis point increase in interest rates – that would trigger reversion to a monthly NII test.

"If you consider reorienting the production process of supporting your IRR program be sure to get it in your ALM or IRR policy. We have to make sure that the regulatory sector views this as a production enhancement. That shouldn't be hard. I think this is an important way to get not only the same amount of IRR information effectively but to get more IRR information where it really matters. So long as it is in the policy and applied consistently I don't think you will have a problem."

Bill McGuire spoke at the recent BSSA webinar, Interest Rate Risk Management: Optimizing Your Programs. Visit www.banksoundness.com for more information. ■

Self-Report

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an investigation with no public enforcement action, treat the conduct as a less severe type of violation, reduce the number of violations pursued, or reduce the sanctions or penalties sought by the Bureau in an enforcement action," the statement said.

The bureau stressed that in order to get credit the conduct must "substantially exceed the standard of what is required by law." It also made clear that it was not adopting any rule or formula that guaranteed favorable consideration.

The bulletin was seen as something of an olive branch by the consumer-oriented bureau to outline publicly factors that it would consider in determining the outcome of an investigation. But experts also questioned whether many companies would view it as beneficial to admit they may have violated the law.

Many of the enforcement actions that CFPB has taken to-date involve alleged violations of fair-lending laws where there is debate about whether any law at all was violated. A priority for CFPB has been UDAAP which defense lawyers see as an amorphous standard.

"While it is probably natural for financial service providers to examine their own operations and either modify or eliminate practices because they may pose a UDAAP risk, it strikes me as unrealistic to expect such judgmental decisions to be reported to the bureau when they are made," said Chris Willis, a lawyer at Ballard Spahr in Atlanta. "By treating the issue of self-remediation as a black and white issue, I think that the Bulletin ignores the reality that such efforts frequently involve nuanced judgment calls that do not lend themselves to self-reporting a 'violation' of any law."

Scoring points for cooperation could also be tough, he said. The bulletin says companies should respond to an enforcement proceeding by conducting an internal investigation and sharing results with the bureau. But many bureau investigations begin with civil investigative demands that are framed in broad terms and seek information about company operations without identifying specific questionable conduct.

"Will CFPB prove through its conduct that these factors really will have a positive impact or will it engage in enforcement activity that causes people to doubt that?" Willis asked. "That is really an important issue for the industry, and for the agency itself. It is in a position to foster behavior it talks about in the bulletin by positively reinforcing it in a public way. Or it has the possibility of frustrating its own objective by making people believe that doing that kind of responsible behavior is not in their interest."

Ronald L. Rubin, a partner in the Washington office of Hunton & Williams and a former CFPB enforcement attorney, said that if he had to summarize the guidance in one sentence, it would be: "If you tell us something we did not already know and probably were not going to find out, and you are completely cooperative during the investigation that follows, and you make satisfactory changes to prevent the problem from happening again, and you sufficiently reimburse any consumers who were harmed, then we will give you favorable consideration in determining what if any enforcement action is appropriate – there are no guarantees, you have to trust us."

"Voluntary self-reporting can be a risky thing to recommend," Rubin says. "If you are advising a client who has identified a problem, the first thing you should say is, 'Fix the problem right away.'"

Disclaimers the agency has built into the policy make self-reporting potential violations very risky. "There is nothing really firm you can grab onto," Rubin says. "They make it very clear that there are no guarantees. It's a tough call."

A firm may not think something it did was a violation, but by bringing the conduct to the attention of the CFPB, it runs the risk of the agency coming back and saying that it was.

"If it's really a matter of opinion whether you violated the law, you should think long and hard before turning turn yourself in and having that argument with the Bureau," Rubin said. "It's a pretty good bet that their interpretation of what violates the law is going to be stricter than yours." ■