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One More Perspective on Rising Interest Rate Risk(s)

The regulatory world has made it very clear over the past several years that it is concerned about banks in the next rising rate cycle, especially regarding economic value of equity (EVE)-related risks. In the post-crisis era of historically low interest rates, banks have experienced unquestionable pressure to extend maturity terms in the loan portfolio and have been tempted to add option/extension risk in the investment portfolio. This has all been to help moderate downward pressure on aggregate asset yields. On the liability side, deposit balances with greater elasticity have accumulated in non-maturity categories and CD customers have become overweight in short maturity products. When rates do rise, the economic value of those long assets will drop while the short deposit base adjusts at higher market rates. Equity values are, therefore, damaged in this theoretical storyline. Additionally, most banks will experience margin compression and increased earnings challenges. The only question will be…to what degree?

Our position, at Darling Consulting Group (DCG), is that bankers should be careful not to focus on a singular viewpoint that emphasizes rising rate risk mitigation (and especially economic value exposures). Margins/earnings based models reveal that current or falling rate scenarios (i.e., ongoing flattening of the yield curve) are still plausible and may present even greater

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challenges. Despite the near term exposures, higher market rate conditions actually present the *best long-term scenario* for margin performance at many small to mid-sized community banking institutions.

For several reasons, we have also been critical of the use of the EVE method in gauging interest rate risk, specifically when used to project financial performance. To help understand why, it might be worthwhile to travel back in time.

Remember Gap Analysis? The origins of interest rate risk modeling began with gap analysis, which attempted to capture the timing of cash flows and repricing activity on both sides of the balance sheet.

A balance sheet is defined as having a *positive gap* when asset cash flows and repricing (rate-sensitive assets, or RSA) exceed liability maturities and repricing (rate -sensitive liabilities, or RSL).

This would indicate that assets on the current balance sheet turn over more quickly than funding sources when rates rise and fall and implies a direct correlation between margin/earning performance and market rates.

The opposite is true for *negative gap* balance sheets, which have rate-sensitive liabilities that exceed rate-sensitive assets. Margin and earnings performance would be inversely related to market rates for these institutions.

With limitations in technology, gap analysis at one time was the best methodology that banks could use in gauging rate risk. However, even then, bankers understood that there were many critical flaws in gap analysis. These shortcomings limit the ability to accurately measure both volume and direction of potential sensitivities in future income.

Similarly, advocates for the value-based model will argue that EVE should be viewed as an indicator of financial strength/ weakness under a variety of rate scenarios. The truth is, from a practical standpoint, the EVE model merely quantifies cash flows and repricing from the existing balance sheet and reports this information in present/economic value terms. Said a different way, it reports the mismatch risk position (i.e., static gap position) of the current existing balance sheet while using complex financial mathematics. It does not take into account one critical element in assessing financial performance—the reinvestment/replacement of those cash flows. In this regard, the EVE analysis presents some of the same well-documented challenges as GAP analysis in attempting to measure future earnings performance and related sensitivities to market rates.

So Why So Much Emphasis on EVE? To best understand why our regulators hold the model in high regard, it is important to recognize that one primary goal of our regulatory bodies is to help ensure the preservation of capital within the banking system. Here, we unearth the center source of conflict in the earnings vs. EVE debate—it is the difference between looking at the financial institution as a going concern and looking at its balance sheet with the perspective that liquidation of assets and liabilities can result in lost capital. Unfortunately, our examiners have to be concerned with both of these conflicting viewpoints.

What To Do About It? To help address this dual concern of their examiners, bankers should ponder balance sheet risk

management issues from multiple viewpoints. In this regard, community banking institutions and their risk management systems should recognize that financial risks (earnings, liquidity, credit) are collectively interlinked and, therefore, market rate exposures may present more far-reaching implications than margin/earnings sensitivities.

From a liquidity perspective, for example, banks can expect collateral values to depreciate with higher market rates. Slower mortgage prepayments and call options that go unexercised will diminish cash flow liquidity as well. From a credit perspective, higher debt service costs and diminished loan collateral values may impact asset quality. Should credit negatively impact your financial condition, access to wholesale markets may diminish even further (or at least become more costly). In turn, these issues increase the probability that corporate and municipal bonds sales—at depreciated values—will be required to generate cash in satisfying funding needs.

This explains the emergence of Enterprise Risk Management (ERM) concepts that encourage banks to examine risk conditions in an integrated fashion as described above. This approach offers the key to alleviating regulatory concerns regarding your ability to control economic value risks to capital. This also highlights the benefits associated with financial stress testing, an exercise commonly viewed as another fruitless requirement to satisfy examiner check lists. Stress test modeling should be taken seriously and results reviewed carefully.

Consider the following: every institution assumes they will maintain a going concern operation before unexpectedly realizing they are about to experience their demise. This perspective may help you better appreciate the *big picture* viewpoint of the regulators. Community banks, as an industry, need to more consistently apply a holistic approach to understanding the manner in which financial risks are interrelated, integrate operational risk metrics and incorporate their overall risk assessments in their strategy development process. Only then will they position themselves to both effectively navigate this very difficult economic environment and fully address the worst case scenario solvency concerns of the examiners. This will help redirect examiner focus away from the EVE metric in the interest rate risk discussion.

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