The Big Picture

Keeping an eye on your total interest-rate risk management

Just over five years ago, the Federal Financial Institutions Examinations Council issued a policy statement that changed the playing field for the way bankers manage their balance sheets. That 1998 Joint Policy Statement voiced a belief that the bank could no longer measure risks for individual securities in a vacuum. Rather, the council recognized that effective interest-rate risk management should focus “ideally, across the entire institution.” And it said that institutions should know their sensitivity on an “ongoing basis.”

This new level of monitoring required new tools for management. Fortunately, the risk management process can be tailored to the individual bank’s needs. In the words of the FFIEC, the risk management process should be “commensurate with the size, scope and complexity” of the balance sheet.

Simply put, community banks with simple holdings should not be required to monitor interest rate risk with the same tools used by large regional and money center banks. The question then becomes, “What is sufficient for my bank?”

Outlining the Scope

For smaller community banks with little complexity embedded in the balance sheet, a simple gap analysis may be sufficient. For banks that use gap analysis exclusively to measure their interest rate risk, care should be taken to recognize that not all components of the balance sheet move the same amount for the same adjustment in rates, and that re-investment of cash flow may dramatically affect the bank’s future performance. Regulators have routinely questioned the use of static gap as sufficient for balance sheets containing material amounts of callable securities or borrowings, long-term funding or derivative contracts, regardless of the accuracy of the analysis.

As the balance sheet grows in size and complexity, the need for a more comprehensive model develops. Generally, the analysis moves beyond gap analysis to financial models that process income simulations and economic value calculations under a variety of scenarios, and measure the impact of changes in rates to Net Interest Income and the Economic Value of Equity, or EVE. This type of analysis projects earnings, expenses and economic values for each component of the balance sheet over time, usually one or two years, under various rate projections.

For many institutions, the business model requires a more frequent and more robust analysis. Here, the bank generally purchases a license to run a sophisticated asset-liability model “in house.” An in-house solution provides the ability to run virtually unlimited scenarios, at any level of complexity, at any frequency desired. However, the increased ability comes complete with increased commitment of time, staff and dollars.

With any type of model or systems, the level of detail and frequency depends upon the complexity of the balance sheet, the level of risk being measured and the frequency of change in the composition of the balance sheet. Often, an income statement gap model that incorporates dynamic cash flow and the non-parallel nature of interest-rate movements offers superior risk analysis to simulation models that are lacking complexity.

For many community banks the level of risk indicated is quite low, and capital and earnings projections are quite high. For these institutions, a quarterly model...
using major balance sheet categories is sufficient, and is frequently processed by third-party vendors like ICBA Securities, ICBA’s portfolio management subsidiary for community banks.

**System Sophistication**

When making decisions concerning the level of modeling, assess your bank’s needs by asking yourself questions about your complexity such as:

- Will growth patterns materially alter the composition of my bank’s balance sheet in the near future?
- Do my bank’s lines of business change from period to period? Do my spread relationships change materially under different rate environments?
- How stable are my bank’s non-maturity deposits, and should they be treated differently under different rate scenarios?
- How much will a loss of market value on any component of my balance sheet affect the management of the bank?
- Do I have a large number of callable or convertible items on my balance sheet in relation to total assets?
- Do my current measurement techniques indicate a level of interest rate risk that is high compared with my bank’s capital levels and earnings forecast?
- Do I have the available staff to properly maintain a complex financial model?

An honest assessment of the components of interest-rate risk modeling will point you toward the correct decision on model complexity. Remember that the regulatory requirement is to “measure, monitor and manage” your interest rate risk. With that charge, a more basic model structure, accurately processed and properly understood, may be superior to a process that becomes too large to manage and too complex for your management team to understand.

Wade Oliver is director of asset-liability management for ICBA Securities, a member of NASD and SIPC, in Memphis, Tenn.