Jeffrey F. Caughron
Chairman of the Board
The Baker Group LP
jcaughron@GoBaker.com

Riding Out the Storm: Focus on Interest Rate Risk Management

"The relative calm in financial markets recently has caused a significant degree of complacency. The truth of the matter is that we are probably in the eye of the hurricane, and once the eye passes, the banking industry will once again be buffeted by winds of great force in the form of volatile interest rates."
Dr. James V. Baker, 1984

In the wake of unprecedented changes in market conditions and a historic jump in interest rates, regulators can be expected to focus intently on interest rate risk management in coming examinations. Knowing this, it's worth stepping back to review how we got here and consider some key points regarding policies, processes, and procedures to ensure your institution's ALM framework is solid.

Market Conditions:

The two years immediately following the arrival of the COVID pandemic were an extraordinary period of ultra-low interest rates and bond yields coupled with massive growth in excess liquidity and paltry loan demand. Coming into 2022, bank balance sheets around the country had seen an intense etching of this low-rate environment into their current rate structure… deposit rates, loan rates, and bond yields… everything had steadily moved lower to the point where low rates and yields were deeply embedded into the balance sheet. This was not negotiable… these were the cards dealt to every bank in the country. Moreover, the effect on capital ratios of the enormous inflow of deposits and liquidity added an additional challenge. Then suddenly, as Dr. Baker warned all those years ago, the "eye of the storm" passed and interest rate volatility returned with a vengeance. Now Asset/Liability Management is once again a critical point of focus.

Regulators are well aware of the convulsive market developments since the first of the year, and of the industry-wide effect on bank balance sheets. Even for banks exhibiting little interest rate risk exposure, examiners can be expected to emphasize corporate governance, stress testing, back testing, and a general demonstration that management and the board is "on it" with respect to interest rate risk. The risk management protocol and processes need to be in compliance.

Principals of Sound Interest Rate Risk Management:

The FDIC provides observations about best practices for IRR management and frames a prudent approach to interest rate risk. Key points include the following:

- **Reporting System** - Financial institutions should have timely and accurate information about the exposure of their balance sheets to changes in interest rates. This includes separate analysis and reporting of earnings at risk and capital at risk. It's important that the system include simulations or rate shocks of different rate environments, and stress tests of the behavioral assumptions used in the model (e.g., changes in A/L mix, non-maturity deposit behavior, etc.)

- **Corporate Governance** - Management should provide for internal controls and independent reviews to validate the robustness of forecasting models. This includes regular back-testing and model validation as needed to ensure the integrity of the output.

- **Board Involvement** – Directors should have adequate understanding of interest rate risk generally, and of the appropriateness of strategies, policies, and processes used by bank management.

The focus on stress testing of assumptions is important: "Robust measurement of IRR requires that management frequently assess the reasonableness of a model's underlying assumptions."

One way to test the reasonableness of assumptions is back-testing.

The point of a back-test is to learn where variance exists between actual and projected performance and adjust assumptions accordingly. Another method is assumption sensitivity testing whereby key assumptions are changed and the model re-run in order to test the influence of critical assumptions. Regulators specify that as a best practice, "assumption sensitivity testing should be done at least annually and results should be presented to the ALCO or a similar senior management committee, and to the board."

To be sure, the degree of complexity of an interest rate risk model should be commensurate with the complexity of the bank's balance sheet. However, the assumptions testing practice (and others) would seem to necessitate a fairly robust model that has the ability to input critical assumptions in the first place. Garbage in, garbage out. Make sure you're using a top-shelf interest rate risk reporting system.

Internal Control:

Interest Rate Risk processes must be periodically reviewed and measurement systems validated. The depth and formality of independent review will depend on the size and complexity of the bank, but even smaller banks should have an independent review of their IRR processes. For smaller institutions that lack auditing resources, this can be done "by having a qualified staff member – independent of the IRR process – perform the reviews."

With respect to model validation, an in-depth assessment of the mathematical and functional integrity of the model itself should be acquired. This is usually provided by the software vendor for institutions who outsource IRR modeling.

Conclusion:

Interest Rate Risk and ALCO processes will require greater attention in the coming year. Bank managers and directors are advised to assess their current systems, policies, and practices. It is a good idea to revisit basic principles of interest rate risk management, perhaps with educational reviews for directors as well as ALCO members. This will help banks as they ensure the adequacy of asset/liability management reporting systems and the necessary processes for proper and prudent execution of strategy.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact* ***Jeff Caughron at The Baker Group: 800.937.2257, www.GoBaker.com, or email: jcaughron@GoBaker.com.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Jeffrey F. Caughron
Chairman of the Board
The Baker Group LP