2015 RMA IRR Management Survey Executive Summary

The Risk Management Association conducted a survey of interest rate risk (IRR) management practices in early 2015. A total of 42 institutions responded by completing a detailed questionnaire. While the survey was confined to community banks, there was some dispersion in respondents' characteristics. Half of the respondents had publicly-traded stock; over half had a holding company structure; geographic coverage was broad; and there was representation from the OCC, FRB, FDIC, and state in terms of primary regulator. Asset size, meanwhile, covered the full range up to the $20 billion cut-off; 21 of 42 were below $1 billion, 13 in the $1 to 5 billion range, 2 in the $5 to 10 billion, and 6 in the $10 to 20 billion.

Full statistical results are available to all respondents. We provide below some summary highlights from each of the four sections of the survey, but encourage participants to access and analyze the detailed underlying data.

Organizational Structure and Governance

Survey participants were polled on the structure of risk management within the institution and the degree of the Board's involvement in the management process. The survey asked firms to describe their Asset/Liability Management Committee and the degree of attention this committee gives to various measures of risk.

All survey respondents have some type of ALCO (Asset/Liability Management Committee) structure in place at their firm. Roughly a quarter have Management ALCO only, another quarter have separate management and Board ALCOs, and a half have a single ALCO with management and Board representation. Just over half of the institutions hold monthly ALCO meetings, while the rest hold their meetings on a quarterly basis. Although nearly 80% of respondents rated Board understanding of IRR as 4 or better on a 1 (very low) to 7 (very high) scale, the need for ALCO training was emphasized. For 62% of respondents, this training is performed on an occasional, as-requested basis. Training is typically performed by CFO or designee (37%) or model vendor/outsourced provider (22%).

More specialized topics caused the assessment of Board understanding to slip. With regard to Economic Value of Equity (EVE) Economic Value of Equity understanding, for example, the 4 or better ratings fell to 60%. Perhaps, not surprisingly, EVE-at-Risk (EAR) rated considerably lower than Earnings-at-Risk as a useful measurement and management tool. Only 43% rated it 5 (out of 7) or better, whereas the same figure for EAR was 95%. Because most banks have some form of Director representation on ALCO, full Board involvement in IRR matters becomes less important. Its most frequently rated role is to approve ALM policy documents. The Board's primary source of ALM information, for most banks, is ALCO meeting minutes rather than receiving the full IRR report package. Regulators expect to see ALCO review and approval of modeling assumptions; 41% of institutions perform this review annually, while 29% perform it quarterly.

Current/Recent IRR Circumstances

Institutions were then asked to discuss how their institutions have been impacted by the credit and funding dislocations of the recent past. With regard to rate expectations, close to half of the firms surveyed expected a Fed funds rate of 0.75% at year-end 2015, with another quarter expecting 0.50%. By December 31, 2016, approximately a quarter of respondents anticipate a rate of 1.50%, with around a half expecting either 1.25%, 1%, or 0.75%. For 10-year and 30-year Treasury rates, the modal responses (i.e., the highest percentage of respondents) were 2.5% and 2.75% respectively for this year-end. Given expectations of projected rate increases, how are banks performing this active IRR management? Overall, more than three quarters of institutions claim to engage in active management of their IRR exposure. Approximately 24% of firms indicated a shortening of investment portfolio duration, 22% are lengthening their funding duration and 17% are undergoing a shortening of new loan duration; and only 10% indicated derivative hedging.

Approximately half of participating institutions have experienced IRR policy limit violations over the past year. However, many of the violations were seen in declining rate scenarios and were therefore less of a current concern. Generally (70% of cases), no action was taken to bring the bank back within limit. Not surprisingly, regulatory scrutiny of IRR has increased, with 62% of firms either somewhat or strongly agreeing that regulators have been more robust in their exams. The areas getting most enquiry were model assumptions (25% of respondents), IRR limits (18%), exposure (12%), and the simulations being run by the firm (12%).

Almost three quarters of institutions said that new IRR regulations and requirements had significantly increased their compliance burden.

IRR Measurement

The next section assessed institutions' risk measurement methods. Additionally, it aimed to determine how IRR modeling is conducted, controlled, and kept current. While most banks claimed to have model data input controls in place, only 55% are formally documenting it. There was wide variation in the amount of IRR production and ALCO preparation time being spent.

The survey asked about two modeling transitions. Over half of institutions did not transition from a Call Report-based model to one that takes instrument-level core system data before a bank reaches $500 million in assets. For the transition from outsourced to in-house model production, the corresponding figure was $1 billion.

With regard to the frequency of IRR reporting, 64% are generating quarterly reports and 36% are reporting on a monthly basis. For Net Interest Income simulations, 24% are applying immediate shocks only, while 76% are applying both ramped (primarily over 12 months) as well as immediate shocks. When the survey asked how firms approach yield curve shocks, 20% responded that they run only parallel shifts, 5% only non-parallel, and 75% utilize both parallel and non-parallel. When firms perform analysis on rate shocks, 76% are shocking up to 400 basis points (bps) while 20% of firms shock up to 500 bps or more. Given the current low rate levels, 28% are not running negative rate shocks.

In terms of the underlying balance sheet used for NII simulations, 36% of institutions are running them off a constant (or static) balance sheet, 19% are using a projected (or dynamic) balance sheet, and 45% are performing both. Half of the participating banks are running NII simulations two years into the future, a quarter of firms run them for three years, and close to a quarter are simulating four years or more. Approximately 79% claim to be stress-testing their modeling assumptions. Beta factors, which transform a change in market rates (such as Fed funds) into a change in administered deposit rates, are generally set by deposit type. Over two-thirds of respondents keep their betas constant over different rate shocks. Almost half apply rate shocks immediately, the remainder with lags (up to, but generally less than, six months). Nearly 79% validate their betas on internal data, an issue that regulators have come to emphasize.

Decay rate assumptions address the stability of non-maturity deposits and are key drivers of EAR calculations. Approximately 79% of participants customize their assumptions here, rather than the traditional reliance on FDICIA 305 assumptions. Repricing gap reports are produced by 85% of firms and, of those, 80% see those gap results aligning with and corroborating the NII simulation results. All respondents are conducting back-testing on their NII results, with 49% of firms performing the back-test annually, 6% bi-annually, and 43% quarterly. An in-house back-test solution is used by 39% of respondents. Lastly, only 36% include an acceptable threshold for model variance in their IRR policy statement.

Use of Derivative Hedges

The final section of the survey asked participants to discuss their firm's asset/liability management policy and practice with regard to derivative hedging. Firms discussed the value of using derivatives to hedge against IRR exposure, while firms that do not currently utilize derivatives discussed their reasons as well. There is a wide dispersion as to if and how banks address derivatives usage in ALM policy, especially for banks not currently active in this regard. Nearly 36% of respondents are or have used derivative hedges, a figure that correlates with asset size (i.e., more prevalent at the top end of our survey group by asset size). Of those users, on a 1 to 5 satisfaction scale, all rated themselves 3 or higher (i.e., somewhat, very, or extremely satisfied). For the 64% that are non-users, various reasons were cited: most importantly, Board/management discomfort, lack of operational infrastructure, and the costs and complexities of meeting accounting requirements.