Wade Oliver (*woliver@icbasecurities.com*) is senior vice president and senior strategist for ICBA Securities.

Industry Risk, Quantified

The OCC sheds light on potential interest rate risk exposures

By Wade Oliver

Interest rate risk is a fundamental part of banking, and banking fundamentally involves managing this particular risk along with a variety of others. To help banks manage their interest rate risk, the Office of the Comptroller of the Currency compiled data on the interest rate risk (IRR) management practices of midsize banks and community banks. The OCC's survey, issued during the fourth quarter of 2013 and the first quarter of 2014, was designed to assess the range of practices for banks' IRR management.

The OCC distributed a summary of the data compilation, titled "Interest Rate Risk Measurement—Range of Practice Memorandum," during the fourth quarter of 2014. More than 1,500 banks participated.

The resulting memo outlines the types of IRR scenarios banks are using, the range of risk limits used for policy compliance and major assumptions concerning nonmaturity deposit behavior. Although no scenario preference was given for policy compliance, the OCC noted how banks should tie policy limits to a set of "board-approved standard" scenarios while running stress scenarios less frequently. No dictum was given establishing parallel interest rate shocks as the standard, but the memo tabulated results on these types of scenarios.

Table 1

National Statistics on Risk Limits for Parallel Shocks

	12-Month, Net Interest Income			Economic Value of Equity		
Scenario	25th Percentile	Median	75th Percentile	25th Percentile	Median	75th Percentile
-100	-10%	-8%	-5%	-15%	-10%	-5%
100	-10%	-8%	-4%	-15%	-10%	-5%
200	-15%	-10%	-5%	-25%	-20%	-10%
300	-20%	-15%	-10%	-30%	-25%	-15%
400	-25%	-20%	-10%	-40%	-30%	-15%

Source: OCC "Interest Rate Risk Measurement—Range of Practice Memorandum" bank survey, 2014

Since the memo reflects bankers' feedback and not the recommendations of the OCC, these metrics do not establish best practices concerning these policy limits. However, they do provide a well-rounded picture of the risk limits used across the country, which may help in evaluating the types of scenarios and policy limits used by your own community bank's asset-liability committee.

It's important to remember that the data were tabulated over the course of a year and across widely varying business models, so drawing definitive conclusions is problematic. However, it is obvious that on average community banks establish much wider limits on economic value of equity at risk than earnings at risk, and reflect a risk profile well within established policy limits.

The OCC also collected data on decay and repricing assumptions for non-maturity deposits for a +100 basis points (1 percent) move in interest rates. Banks often use different repricing assumptions for each rate scenario simulated, reflecting increased market pressures, which would not be reflected in these charts. These results also reflect a wide range of assumptions, indicating unique funding profiles, customer types, and behaviors across geographies or depositor balances. For these reasons, community banks should use assumptions that reflect the unique environment of their retail footprint and funding sources, rather than relying on default or national assumptions.

Make sure your community bank's interest rate risk model fits its specific franchise and footprint.

Community banks should ensure that the assumptions in their IRR models make sense for their specific franchise and footprint, and that their models are well supported by historic and current balance sheet trends. When evaluating your community bank's own policy limits and assumptions, be sure to:

» Consider how historically low interest rates might affect prepayment speeds and extension risk.

» Evaluate possible changes in liabilities structure, including changes in

Table 2

National Statistics on +100 Basis Points Repricing Rates

Deposit Type	Count	25th Percentile	Median	75th Percentile
MMDA	1,282	25%	40%	55%
High-Yield MMDA	240	35%	50%	76%
NOW-Interest Checking	1,256	15%	23%	35%
Savings	1,282	15%	25%	37%
Other	197	20%	50%	75%

National Statistics on Annual Deposit Decay Rates

Deposit Type	Count	25th Percentile	Median	75th Percentile
MMDA	1,149	12%	21%	36%
High Yield MMDA	213	11%	20%	36%
NOW-Interest Checking	1,131	9%	15%	25%
Savings	1,151	9%	14%	23%
Non-Interest Rate Bearing	1,024	10%	15%	21%
Other	145	11%	17%	32%

Source: OCC "Interest Rate Risk Measurement—Range of Practice Memorandum" bank survey, 2014

Table 3

National Statistics on Earnings at Risk—12-Month, Net Interest Income, Parallel Shocks

Scenario	Number	Largest Loss	25th Percentile	Median	75th Percentile	Largest Gain
-100	1,163	-13%	-4%	-2%	0%	6%
100	1,189	-8%	-1%	1%	4%	16%
200	**1,229**	**-16%**	**-3%**	**2%**	**7%**	**30%**
300	1,220	-24%	-4%	2%	9%	44%
400	1,134	-31%	-6%	3%	12%	57%

National Statistics on Economic Value of Equity, Parallel Shocks

Scenario	Number	Largest Loss	25th Percentile	Median	75th Percentile	Largest Gain
-100	1,289	-17%	-3%	3%	9%	31%
100	1,306	-22%	-7%	-3%	2%	18%
200	**1,343**	**-44%**	**-15%**	**-7%**	**2%**	**29%**
300	1,338	-65%	-23%	-11%	1%	41%
400	1,193	-85%	-31%	-14%	1%	52%

Source: OCC "Interest Rate Risk Measurement—Range of Practice Memorandum" bank survey, 2014 the mix of borrowings, changes in the mix of the deposit base, and changes in the relative costs of different liabilities.

» Assess non-maturity deposit assumptions to identify the potential impact of depositor stability. Using your bank's existing assumptions, add subtle or significant variations to the repricing or decay rates to assess the impact on the bank if depositors are less stable or more price-sensitive than expected.

» Consider liability mix reversion. Understand the impact on IRR levels if the liability mix were to return to its structure experienced at the peak of the last interest rate cycle.

» Incorporate the modeling results into strategic planning, including consideration of strategies that reduce earnings volatility and capital exposure.

IRR is a fundamental part of banking. As such, the management of interest rate risk is crucial to maintaining stable, predictable earnings in various interest rate environments. By adopting a well-rounded process of assumption validation and stress scenarios, resulting IRR reports can be relied upon to monitor and manage interest rate risk. IB

IRR Made Manageable

Vining Sparks can produce a customized interest rate risk report for your community bank. Risk Manager, Vining Sparks' proprietary asset-liability model, is available in three different levels of detail that are suitable for most all community banks, at a nominal cost.

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