P&G Banking ADVISOR

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BANK *Wire*

What's your plan for managing interest rate risk?

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What's your plan for managing interest rate risk?

Federal regulators have traditionally warned banks about the dangers of interest rate risk (IRR). Today, with interest rates potentially poised to rise, it's critical that banks have a robust program for managing IRR.

Assessing your risk

IRR refers to the risk that changes in market interest rates will have an adverse impact on a bank's earnings or capital. Each bank is different, so it's important to assess risk in light of your institution's particular risk profile. (See "4 common sources of interest rate risk" on page 3.)

Federal regulators have observed that many banks use short-term or "more immediately repricing" deposits to fund longer-term loans and investments, which inherently exposes them to some level of IRR. To mitigate this risk, regulators emphasize, banks must implement a risk management program to lessen IRR exposures.

Designing a program

Regulators expect your bank's IRR management program to conform to the following framework, adjusted for its risk profile.

Board oversight. Your board of directors bears the ultimate responsibility for all interest rate risks your bank undertakes. Thus, examiners expect your board (or a designated committee) to understand the different types of IRR, the bank's exposure and the potential impact on that exposure from your business activities. The board also is responsible for overseeing the implementation of IRR management strategies, policies, procedures and risk tolerances.

Policies and procedures. Your bank should have comprehensive policies and procedures — updated regularly — that govern all aspects of IRR management. Among other things, these policies and procedures should:

- Describe the bank's risk tolerance,
- Detail the methods used to identify, quantify and report IRR exposures,
- Identify the persons responsible for ongoing risk measurement and management, and
- Establish necessary controls and risk limits to ensure the program's smooth operation.

Examiners are particularly interested in the board's role when the bank exceeds those risk limits. Does the program direct, for example, the board to require management to develop an action plan to return risk to an acceptable level?

Potential risk mitigation strategies include rebalancing asset and liability durations, proactively managing nonmaturity deposits, increasing capital and hedging.

Regulators warn that banks shouldn't attempt hedging unless the board and senior management fully understand these transactions and their potential risks.

Measurement and monitoring. Examiners expect banks to have robust systems and processes in place to assess their risk exposure — to both earnings and capital — relative to set risk limits. Applicable techniques include measuring short-term earnings risk, such as gap analysis and earnings-at-risk (EAR) models, and measuring long-term capital risk, such as long-term EAR and economic value of equity (EVE) models.

Internal controls and audit. Examiners expect banks to have internal controls to ensure the integrity of their IRR management programs. Your bank should conduct periodic independent reviews of the data inputs and key assumptions in your IRR models, compliance with IRR policies, and the accuracy of reports to your board or asset-liability management committee.

Avoiding the pitfalls

In a recent issue of *FedLinks*, a bulletin focusing on community banks, the Federal Reserve underscored the importance of IRR and the need for a comprehensive risk management program. The publication also discussed the most common weaknesses in community banks' programs, based on examiners' observations. Three recurring IRR management deficiencies were:

1. Discrepancies between board-prescribed risk limits and management's risk measurement tools — for example, the board sets an IRR limit based on EVE, but management's measurement tool doesn't gauge EVE exposures.
2. Use of vendor-supplied IRR model assumptions without evaluating their reasonableness or customizing them.
3. Failure to conduct independent or third-party reviews — the Fed says these reviews can help identify weaknesses, the need for better reporting and other needed improvements.

Act now

Strategies for mitigating IRR take time to implement. Act now to review your program and ensure your bank is prepared for the changes to come. ▲

4 common sources of interest rate risk

For community banks, four common sources of interest rate risk (IRR) are:

Repricing risk. This risk results when a bank's assets and liabilities reprice or mature at different times, narrowing margins between interest income and interest expense.

Option risk. Many bank assets and liabilities contain embedded options, such as the right to prepay a loan or to withdraw deposits early with little or no penalty. The bank is compensated for this flexibility in the form of higher interest rates on loans or lower interest rates on deposits. The risk is that, if interest rates go up, deposit holders will move their funds into higher-yielding investments. If rates go down, borrowers will refinance their loans at a lower rate.

Basis risk. Even when assets and liabilities reprice or mature at similar intervals, changes in their interest rates don't necessarily correlate to market rate changes. For example, if an asset and related liability are tied to different short-term market indexes, the spread between the two can fluctuate, creating basis risk.

Yield curve risk. This risk is derived from the disparate impact of market rate changes on yields from similar instruments with different maturities.

CFPB: What customers are complaining about

The Consumer Financial Protection Bureau (CFPB) recently published its *Consumer Response Annual Report*, which discusses consumer complaints received in 2014. Trends revealed in the report provide banks and other financial institutions with valuable insights into where their potential compliance risks lie.

About the process

The CFPB began accepting consumer complaints in mid-2011 and, as of the end of February 2015, had handled more than 550,000 complaints. The Bureau accepts complaints about a wide range of products and services — including mortgages, bank accounts, student loans, auto loans, credit cards, debt collection and credit reporting.

The CFPB's Consumer Response team screens complaints based on several criteria, including whether they're complete, duplicative of previous submissions, or more suitable for another regulator. Once screened, complaints are sent via secure Web portal to the subject bank or other company for review and, if appropriate, communication with the customer.

The most common complaints involved problems customers face when unable to make payments, particularly delays and ambiguity in the review of their loan modification applications.

After determining the action it will take in response to the complaint, the bank or other company reports back to the customer and the CFPB via the portal. Consumer Response considers the timeliness and content of the response, together with feedback from the customer, in prioritizing complaints for investigation.

Highlights of the report

The CFPB handled more than 250,000 consumer complaints in calendar year 2014. The most common complaints involved debt collection (35%), mortgages (20%), credit reporting (18%), bank accounts (8%) and credit cards (7%). Mortgage-related complaints fell into several categories:

- Problems involving inability to pay (loan modification, collection, foreclosure) — 49%,
- Making payments (loan servicing, payments, escrow accounts) — 35%,
- Applying for the loan (application, originator, mortgage broker) — 8%,
- Signing the agreement (settlement process and costs) — 4%,
- Receiving a credit offer (credit decision/ underwriting) — 2%, and
- Other — 1%.

The most common complaints involved problems customers face when unable to make payments, particularly delays and ambiguity in the review of their loan modification applications. Some customers, for example, felt that they weren't provided a reasonable time to comply with documentation requests. Others complained that they weren't considered for all available loss mitigation options or that the terms were unfavorable. Some customers who were successful in obtaining loan modifications complained that derogatory credit reporting wasn't amended as promised. Other complaints involved issues related to short sales or foreclosure proceedings.

The most common complaints about bank accounts involved account opening, closing or management (47%) and deposits and withdrawals (24%). Account-related issues included complaints about account maintenance fees, legal processing fees for judgments and levies, changes in account terms, confusing marketing, early withdrawal penalties for certificates of deposit, and involuntary account closures.

Issues related to deposits and withdrawals included complaints about transaction holds, the financial institution's right to offset deposit accounts, and unauthorized debit card charges. Also, consumers were frustrated by the handling of error disputes and requests to stop payment of preauthorized electronic debits.

Know your risks

Reviewing the report can help you evaluate your risks related to CFPB examination and enforcement efforts. The full report, dated March 30, 2015, is available at consumerfinance.gov/reports. ▲

When push comes to shove

Maximizing your bank's noninterest income

Have small interest margins put a squeeze on your bank's bottom line? Maximizing your noninterest income may be the difference between a profitable year and a lackluster one.

Focusing on income sources

Common sources of noninterest income include:

- Deposit account service charges (which have had ATM fees reduced by Dodd-Frank),
- Loan origination and servicing fees,
- Overdraft and NSF charges, which have been severely reduced by Regulation E changes, and
- Gains on sales of loans and investment securities.

Noninterest income also may be derived from various products and services — including insurance and annuity products, as well as brokerage, trust and financial planning services.

Fine-tuning collections

Community banks have a history of being easy on customers by waiving NSF fees and other penalties anytime they receive a complaint. Although it's important for bank personnel to have the discretion to waive these fees, high waiver rates — some estimates are higher than 50% — can quickly wipe out substantial amounts of revenue.

To keep waivers under control, set a target level for discretionary waivers and train bank personnel to understand the significance of noninterest income, make good decisions regarding fee waivers and handle

customer complaints. If you haven't already done so, try automating the fee initiation process so that nothing falls through the cracks and incorporate waiver targets into your incentive compensation decisions.

Finally, be sure to include fee waiver data in management reports, which will let you monitor results.

Familiarizing yourself with competitors

Banks often miss opportunities to charge higher fees because they fail to keep tabs on their competitors. Identify the predominant banks in your market and procure their fee schedules. Comparing competitors' fees to your own may uncover significant pricing opportunities.

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That doesn't mean you should increase your fees to match the highest priced banks in your area. But if you find your fee schedule is on the low end of the spectrum, a modest increase can have a substantial impact on your bank's revenue.

If you do increase your fees, monitor your results closely to ensure the strategy produces the desired outcome.

Placing a value on banking relationships

Relationship value pricing can be a highly effective strategy for enhancing fee revenue. It sets prices based on the overall value of a banking relationship with a customer or group of customers, such as a family or a business and its employees.

In its simplest form, relationship value pricing might involve package deals for products or services. A common example is free checking accounts for customers who maintain a minimum loan balance. A more sophisticated approach is to develop customized pricing based on a valuation of the products and services a specific customer receives.

For relationship value pricing to work, your bank must carefully analyze the costs, benefits and potential profitability of each customer relationship. It's also critical to have systems that monitor the relationship. Banks often lose revenue because they're unaware that the relationship has changed. For example, a bank might continue providing free checking even though the related loan has fallen below the minimum balance or has been paid off.

Buying life insurance

Insurance policies on the lives of directors, officers and other key employees can be cost-effective tools for boosting noninterest income. Your bank can buy coverage or use "split-dollar" arrangements to share the costs and benefits of these policies with employees.

Bank-owned life insurance (BOLI) is often used to fund supplemental executive retirement plans, other nonqualified deferred compensation plans and retiree health benefits. BOLI can be a powerful planning tool because a life insurance policy's cash value grows on a tax-deferred basis and, if the policy is held until the insured employee dies, the death benefit is generally tax-free.

A caveat: To enjoy these tax benefits, your bank must comply with strict notice and consent requirements before buying a policy on an employee's life.

Get support

There are many other ways your bank can bolster its revenue streams on the noninterest side of your operations. Your CPA can assist you in crunching the numbers, analyzing the results and implementing new strategies. ▲

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GUIDANCE ISSUED ON REGULATORY CAPITAL RULES

Recently, the OCC, Federal Reserve and FDIC issued answers to frequently asked questions (FAQs) about the revised regulatory capital rules. The FAQs cover several topics, including the definition of capital, high-volatility commercial real estate exposures and credit valuation adjustments. Here's one example:

Q: Can convertible instruments be included in regulatory capital even if they are convertible less than five years after issuance?

A: Convertibility of a capital instrument within five years of issuance does not preclude its qualification as regulatory capital if the instrument is convertible into a capital instrument of a higher quality.... ▲

GET READY FOR NEW CREDIT IMPAIRMENT MODEL

At press time, the Financial Accounting Standards Board was poised to finalize its proposed credit impairment model, perhaps as soon as the fourth quarter of 2015. The new model — known as Current Expected Credit Loss (CECL) — would represent a dramatic departure from current standards, requiring many banks to increase their Allowance for Loan and Lease Losses (ALLL).

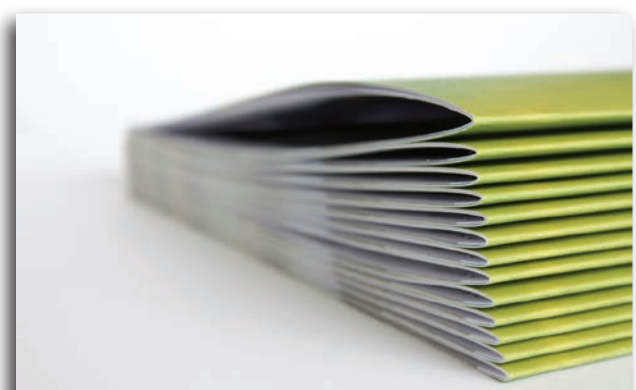
Currently, banks calculate the ALLL based on *incurred* losses. Switching to the proposed CECL model would require banks to recognize an immediate allowance based on all *expected* credit losses over the life of a loan. It also would require banks to collect a significantly larger amount of data in order to make the necessary calculations. It's anticipated that the new model will take effect in 2018 or 2019. ▲

WATCH OUT FOR AUDITOR-INDEPENDENCE RULES

The Center for Audit Quality and the American Institute of Certified Public Accountants (AICPA) want banks and their audit firms to be mindful of certain auditor-independence requirements for FDICIA banks. FDICIA banks are those that have $500 million or more in assets and are subject to the audit and reporting requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991.

Auditors that perform audits of FDICIA banks must comply with the independence standards of the AICPA, the SEC and the Public Company Accounting Oversight Board (PCAOB). In many areas, the SEC rules take precedence because they're more restrictive than the other organizations' rules. For example, the SEC takes the position that auditors are prohibited from providing typing and word processing services, or financial statement templates that aren't publicly available to the audit client, because these would be considered prohibited financial statement preparation services.

To avoid auditor-independence issues, FDICIA banks shouldn't rely on their auditors for financial statement production services — including drafting, typing, formatting, printing or binding. Banks should either perform these tasks themselves or engage a third-party provider for assistance. ▲



P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

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