AuditOne LLC

Risk-Managed Internal Audit and Credit Review Expertise

NEWS

AuditOne Advisory: Flat and Inverted Yield Curve Implications for Interest Rate Risk

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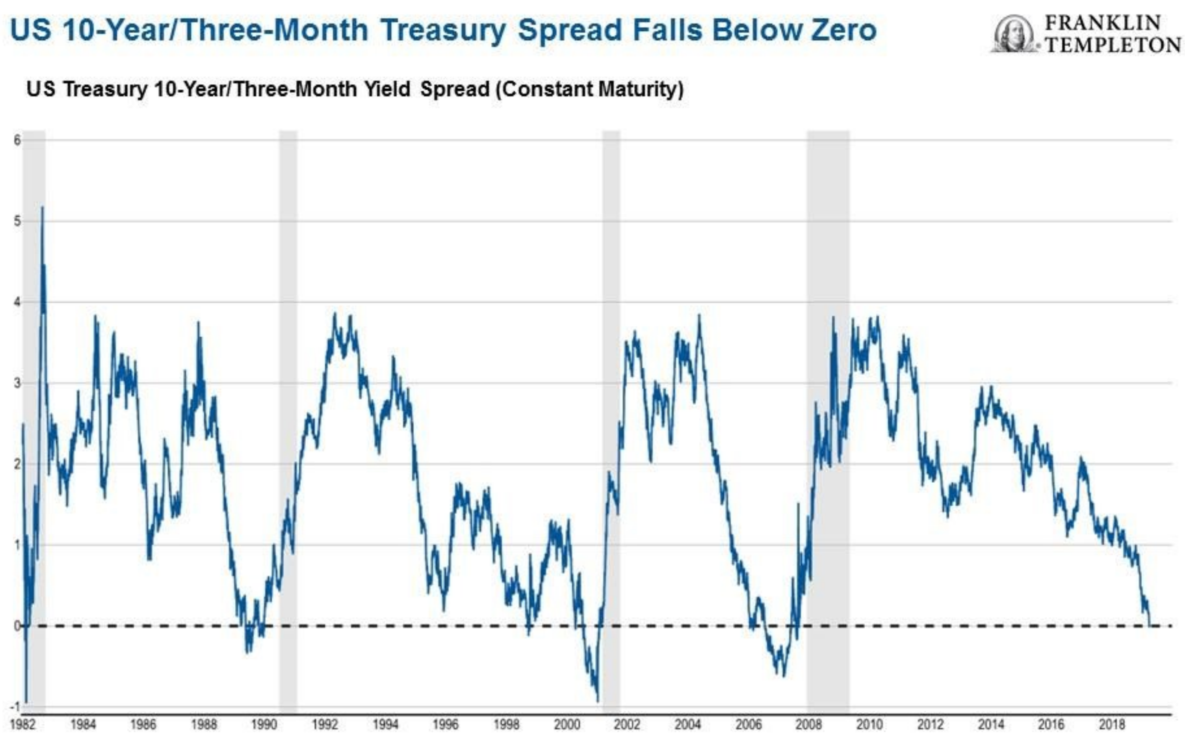
AuditOne Advisory

From Bud Genovese, Chairman

Our ALM Practice Director, David Kellerman, has offered timely suggestions to consider relative to your Interest Rate Risk (IRR) Modeling based on the recent trends in the yield curve. In addition, he presents the importance of reviewing with ALCO and the Board how the current yield curve trend and new model assumptions may impact loans and your IRR profile. Please share this with colleagues having responsibilities related to IRR modeling. We hope you find this information useful, thank you! – Bud

Implications of Flat and Inverted Yield Curves for Interest Rate Risk (IRR) Modeling

The current yield curve has turned inverted (negative spreads between the 10-year Treasury bond and the 3-month Treasury bill). A flat or inverted yield curve has preceded the last seven recessions; but a recession has not automatically followed a flat or inverted yield curve. It implies expectations of declines to come in short-term rates.



Sources: Franklin Templeton Capital Markets Insights Group, US Federal Reserve, Macrobond. The chart illustrates the spread between 10-Year Treasury notes and three-month Treasury bills. Values on the y-axis below zero represent inversion. Shaded areas represent US recessions.

What are the implications for financial institutions as they model their interest rate risk?

Scenarios:

Institutions typically run parallel rate shocks. However, many institutions also run non-parallel rate scenarios. We highly recommend running rate scenarios that simulate a steepening of the curve and a further inversion. In "normal" periods of an upward sloping yield curve, flattener rate scenarios should also be run. This will help identify whether there is any embedded risk in the balance sheet that might be revealed through these non-parallel scenarios. The 2010 Advisory on Interest Rate Risk Management included guidance on running rate scenarios "across different tenors to reflect changing slopes and twists of the yield curve".

Focus of Risk Management:

For over a decade now institutions have largely disregarded the risk profile for down rate scenarios. If the projected change in net interest income (NII) was outside of limits, ALCO and/or the Board allowed for the exception without the need for mitigating action plans, citing the remote likelihood of lower rates as the reason. The markets now have priced into rates a decrease in the Fed Funds rate in 2019 and perhaps another two decreases in 2020. IRR risk in down rate scenarios needs to be understood and addressed.

IRR Assumptions:

Perhaps the assumption that is impacted the most by a flat or inverted yield curve are loan prepayment assumptions. Incentives to prepay an existing fixed rate loan to move to a variable rate loan are not the same in flat and inverted yield curve environments. Institutions should at least consider whether existing assumptions for prepayments are still valid in this rate environment.

Additionally, we have seen two dynamics during the 2015-2018 rate cycle (increasing short-term rates) that are worthy of mention. Most institutions have successfully lagged increasing their posted rates for non-maturity deposits (NMDs) without an impact on NMD balances. However, we now see preliminary indications of deposit rates starting to move up, and some institutions have modeled in a “catch-up” period in case rates continue to rise whereby deposit betas for the next 100 basis point increase in rates will have a beta higher than the normal beta assumption, with the normal beta resuming after the 100 basis point increase.

Additionally, loan betas are now being discussed. These betas are almost always set at 100%. That seems to be holding true for loans tied to an index; however, loans priced individually (not directly tied to an index) have seen actual betas lower than 100% during this past rate cycle. Institutions are encouraged to do a correlation analysis for loan betas (similar to what is done for deposit betas) to see if the standard 100% beta for all loans still applies.

Average life (decay rate) assumptions have been influenced by the prolonged period of low rates, and institutions are advised to consider whether historical analysis of deposit average lives computed from 2008 until today are truly a sound foundation for future expectations.

Finally:

A reminder that best practices include a formal review of model assumptions at least annually by ALCO and/or the Board. Support for assumptions is important. Additionally, sensitivity analysis on key model assumptions should be conducted at least annually. These analyses keep ALCO and the Board informed of the potential impact that varying assumption levels might have on the IRR profile.

AuditOne LLC – Company Overview

AuditOne LLC is a leading provider of risk management services to financial institutions in the Western US and nationally. Our sole focus enables us to deliver effective and efficient internal audit and credit review services. This exclusive focus translates into exceptional benefits to our clients, including regional and community banks, credit unions and other financial institutions. We have experience with all regulatory authorities and offer a full selection of audit services comprising Asset/Liability Management (ALM) audits, ADA Website Compliance Review, IT/Information Security, Network Tests, Credit Review/ALLL, BSA/Compliance, ACH rules Compliance, Operations, Trust and SOX/FDICIA Testing, plus many specialty areas within each of these.

Our deep expertise is your edge. For more information on this article, please contact David Kellerman, ALM Practice Director, AuditOne LLC. For information on how our services can help reduce risk at your institution, contact Jeremy Taylor, CEO, at Contact Us. Also, for more information about AuditOne LLC and all our audit services see www.AuditOneLLC.com.

AuditOne has been audited for compliance with the QAR requirements of the Institute for Internal Auditors (IIA).

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