

B&B REVIEW

Financial Services and Transactions

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BANKS ADVISED TO USE CORPORATE GOVERNANCE TO MANAGE RISK OF RISING INTEREST RATES

INTRODUCTION

There's no rest for the weary among bank risk managers. While liquidity risks were paramount in late 2008 and credit risks continue to loom large, now comes heightened attention to interest rate risk (IRR) as regulators and economists predict that rates have nowhere to go but up as the economy improves.

Two recent communications from banking supervisors demonstrate regulatory concern with IRR. First, on January 7, 2010, the Federal Financial Institution Examination Council (FFIEC) released an "advisory" on interest rate risk management (Advisory). The Advisory has been adopted by each of the federal financial regulators, including the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision.

In addition, the FDIC recently provided IRR guidance in its "*Supervisory Insights*" publication, in an article entitled, "Nowhere to Go But Up: Managing Interest Rate Risk in a Low-Rate Environment."

Both the Advisory and the "*Supervisory Insights*" article contain detailed technical guidance for asset liability professionals at banks responsible for managing IRR, such as advice on how to measure IRR and how to "stress test" for IRR. The purpose of this *B&B Review* is to summarize banking supervisors' expectations as to the proper corporate governance to ensure that such professionals can and do perform their roles.

BOARD ROLE

It is a familiar refrain of the banking regulators that a bank's board of directors has the ultimate responsibility for the risks undertaken by an institution. The Advisory makes it clear that these risks include IRR.

Bank boards must first understand the level and trends in their institution's IRR. This might require some special director education efforts, perhaps by outside consultants used by the institution in asset/liability management. Making a greater effort in continuing education for boards is a long-term trend in corporate governance generally.

Second, boards must insist that they regularly be informed about the bank's IRR exposure. This means that boards should require that management regularly report at board meetings on IRR management and in between meetings as necessary. For example, if the Federal Reserve Board were to announce an interest rate hike, it would be appropriate for management to communicate immediately with board members as to the bank's expected response rather than waiting for the next board meeting.

Third, bank boards must review at least annually the policies and procedures for managing IRR, including the limits and controls over risk taking, or "risk tolerances," in place in the bank's asset/liability process. The Advisory states that bank boards should understand the effect that IRR strategies might have on the credit, liquidity and



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operating risks of the institution. For example, a bank that aggressively repriced consumer loans in a rising rate environment as part of its IRR management might trigger credit problems because increases in interest rates on loans often increase the rate of default.

MANAGEMENT ROLE

The Advisory contemplates that many banks will have an Asset/Liability Committee (ALCO) or similar senior management committee responsible for ensuring that board-approved strategies for managing IRR are executed. In particular, the Advisory states that management is responsible for maintaining:

- **Policies and Procedures.** Policies and procedures for IRR management, including risk tolerances approved by the board;
- **Systems.** Systems for measuring IRR, valuing positions and assessing performance; and
- **Reporting.** Reporting processes for informing senior management and the board on IRR exposure, providing both aggregate information as well as supporting detail such as assumptions used.

RELIANCE ON OUTSIDE CONSULTANTS

Both the Advisory and the “Supervisory Insights” article acknowledge that many banks properly use outside consultants to assist in IRR management. For example, banks that have undertaken hedging activities based on derivatives often use such third party consultants.

The banking supervisors make it clear that bank boards and bank senior management remain responsible for the IRR management function and the results generated by strategies recommended by third parties. The use of “experts” may help a corporate director meet the requirements of the “business judgment rule” in other contexts, but in the context of a bank board such use does not, in the eyes of banking supervisors, relieve directors of their obligation to understand fully the risks of all IRR strategies employed.

INDEPENDENT AUDITORS

Independent auditors also have a role in the corporate governance for IRR. It is management’s responsibility to prepare footnote disclosure on the use of derivative instruments, such as interest rate swaps, for its financial statements. However, the company’s independent auditors will comment on the disclosure prepared by management to state whether, in the auditors’ opinion, such disclosure fails to disclose matters that may have a material effect on the financial statements. Bank boards should keep themselves fully informed as to any concerns that the bank’s auditors might have with the footnote disclosures or ALCO process.