

∞ **ALM 101** ∞

AN INTRODUCTION TO INTEREST RATE RISK (IRR)

**PRESENTED BY
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SESSION 1



AN INTRODUCTION TO INTEREST RATE RISK (IRR)

∞ **OBJECTIVES** ∞

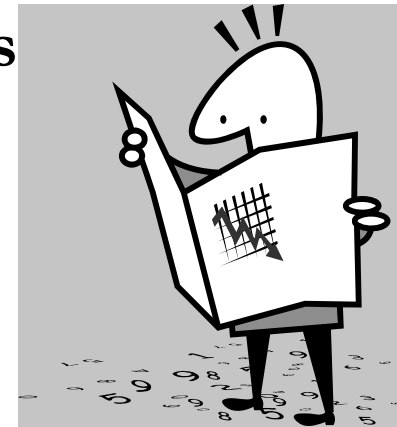
What You Will Learn —

How we got to where we are today

The nature of IRR and its components

HISTORY OF INTEREST RATE REGULATION

- ❖ Traditionally there was little regulation of banks going into the Roaring 20s (1920s)
 - ◆ Little regulatory oversight
 - ◆ Few restrictions on banking activities
 - ◆ Economic ups and downs
 - ◆ Economic depression of 1930s
 - ◆ Stock market crash
 - ◆ Very high unemployment
 - ◆ Led to bank failures—25% of all U.S. banks failed
 - ◆ Near zero level of confidence in the banking system



HISTORY OF INTEREST RATE REGULATION

- ❖ The U.S. Government began to act
- ❖ The result was strong regulation of financial institutions with the goal of restoring confidence in the banking system

Strong regulation imposed

FDIC/deposit insurance (\$3,000)

Strong Federal Reserve, and later NCUA

Additional laws enacted

Competition taken out of banking system

Interstate banking banned

Interlocking ownership banned

Branching severely restricted

Regulated interest rates — through Federal Reserve Reg Q, rates were maintained at an artificially low level so that the Fed could control the maximum rate paid

Preference for S&Ls savings rate, 25 basis points — this preference allowed S&Ls to accumulate what we would now refer to as hot money or rate-sensitive deposits. These short-term, rate-sensitive deposits were used to make long-term mortgage loans



HISTORY OF INTEREST RATE REGULATION

RESULTING IN –

- ❖ **Stable economic times from 1940-1978**
 - Bank failures almost non-existent
 - Stable low rates
 - High level of public confidence
 - Because they were considered so safe, financial institutions were allowed to operate with 3%-5% capital

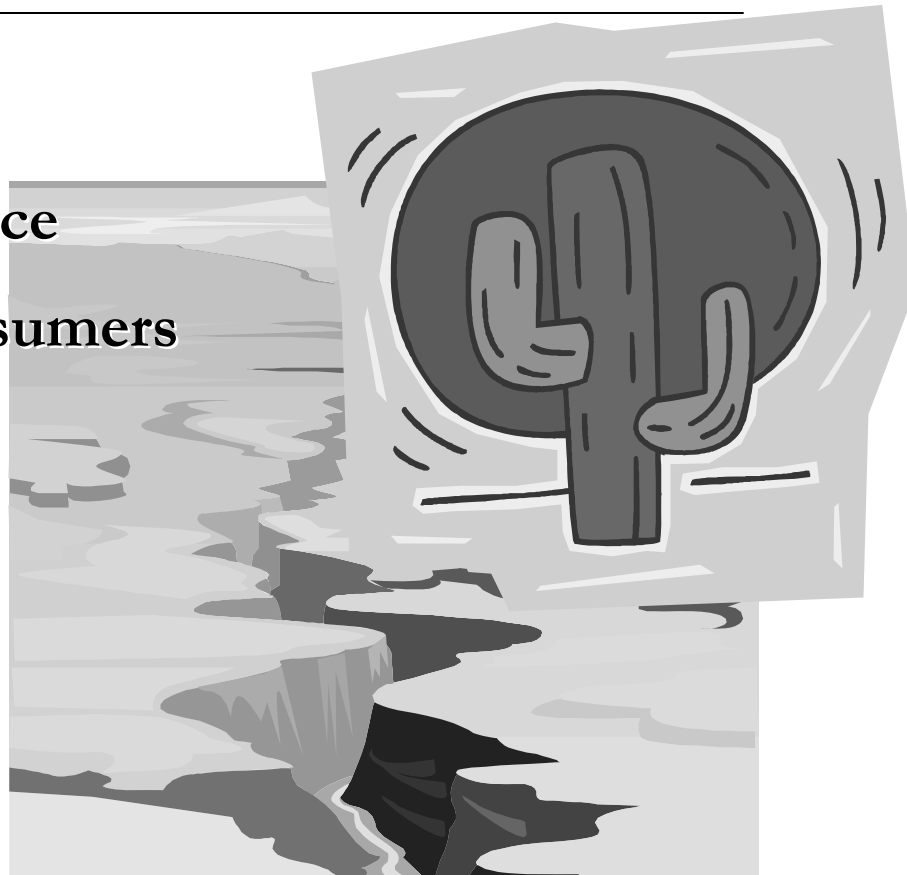
❖ **Leading to . . .**



HISTORY OF INTEREST RATE REGULATION

LEADING TO . . .

- Low levels of service
- High costs to consumers
- By the mid-70's regulated Money Market Mutual Funds evolved and were paying 6%-7% yields with very low risk



HISTORY OF INTEREST RATE REGULATION

- ❖ Interest rates were deregulated beginning in 1978



Rates floated to market levels immediately

Unanticipated high levels of inflation caused interest rates to skyrocket

As a result of deregulation, all financial institutions became exposed to the economic forces of competition

REGULATED VS. DEREGULATED RATES

- ❖ Interest rates were deregulated beginning in 1978 (cont'd)

As a result of deregulation, all financial institutions became exposed to the economic forces of competition



COMPARATIVE OF REGULATED RATES VS. DEREGULATED RATES

	Regulated Rate Era			Deregulated Rate Era		
	1940 to 1978			1978 to 2007		
	HIGH	LOW	RANGE	HIGH	LOW	RANGE
30 YEAR CONV. FR MRTG	9.50%	5.44%	4.06%	18.55%	5.43%	13.12%
WSJ PRIME LENDING RATE	11.68%	2.00%	9.68%	20.50%	4.00%	16.50%
OVERNIGHT SAVINGS RATE	10.76%	0.80%	9.96%	19.08%	1.00%	18.08%

INTEREST RATE RISK (IRR)

❖ IRR Defined:

The potential that adverse changes in prevailing rates of interest for liabilities (such as shares and deposits) and assets (such as loans and investments) may adversely affect the credit union's net interest spread, net income and capital/net worth. The capital/net worth may be impacted both as to book value and market value.

INTEREST RATE RISK (IRR)

- ❖ **Savings and loan industry failed—
primarily due to IRR**
- ❖ **Many banks failed**
- ❖ **FDIC was propped up with taxpayer
subsidies of \$150+ Billion (equal to
\$1 Trillion in 2007 dollars)**
- ❖ **Zero Dollars (\$ -0-) went to NCUSIF**

INTEREST RATE RISK

❖ Management's Responsibility

- ✓ Determine the amount of acceptable IRR and state limits in written policies and procedures
- ✓ Measure and quantify IRR
- ✓ Maintain IRR level on an ongoing basis
- ✓ Take corrective action when necessary



❧ **SESSION 1** ❧

SUMMARY

- ❖ **Started with No Regulation**
- ❖ **Depression and Bank Failures**
- ❖ **Strong Regulation and Control**
- ❖ **Poor Service to Customers**
- ❖ **Deregulation in 1978**
- ❖ **S&L and Bank Failures—this time government was on the hook**
- ❖ **Middle Ground—very competitive**

**We at Mark H. Smith
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wish you success

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