Three Key Components in Outsourced IRR

Loan delinquencies are at their lowest level in over a decade, according to the Fed. While the continued improvement in asset quality is great news for banks, it has resulted in a noticeable shift in exam resources from loan review to IRR and liquidity. As a result, bankers are telling us they don't have the time or expertise to perform all of the compliance work and still execute the strategic plan necessary to grow their bank.

The logical solution is to outsource your IRR analysis, but you have to be careful about selecting the right level of service for your bank to remain compliant with the regulatory guidance. It's not as simple as sending off a data file and getting a report back in five days. At a minimum, the outsourcing process should include three key components: objectivity, creativity, and horsepower.

Objectivity

The primary assumptions in any IRR model are asset prepayments, deposit repricing, and decay rates. Guidance says they should be bank specific and established with loan and deposit data provided by the bank. Avoid providers that use industry averages. These generally don't give a realistic view of your own experience. The quantitative part of assumption development will likely get the most attention from regulators. A detailed narrative report will avoid questions about how you came up with the assumptions you're using—they should be justified in the report and backed up by studies and work papers.

Creativity

This is the qualitative part of the assumption development process. It is subjective input such as the stability of your customer base, what your market competition is like, or how strategic initiatives might impact assumptions used—influencers that you don't see in the numbers. The data might point to a historical decay rate of 72 months, but the customer base could be shrinking, leading to a more conservative 48-month rate.

Horsepower

The qualitative and quantitative (2Q) method is all for naught if there isn't a way to produce the analysis. The reports provided by the model should summarize the level of risk, the trend, and policy compliance for VAR (value at risk) and EAR (earnings at risk). The best things about outsourcing are you don't have to buy the model, and you don't have to learn how to maintain it either.

Lastly, ensure the outsourcing vendor has the expertise to provide additional services including exam and audit support, ALCO participation, and board training. The service provider should review the results, key assumptions, and modeling scenarios with your board annually to ensure compliance with the 1996 Joint Agency Policy Statement on IRR. These are all critical parts of IRR management that should be incorporated in any outsourcing program.

As a former FDIC examiner, I oversee Plansmith's ALM advisory services. Contact me for a free consultation on how outsourcing your IRR might work for you.

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