

MEMORANDUM

To: *Interest Rate Risk Management* Customers
From: Sheshunoff Information Services
Subject: Highlights

Interest rates are at lows not seen in generations. While some observers expect significant increases in rates soon and others don't foresee increases for at least a year, rates clearly have no way to go except higher. As rates rise, banks can expect to see fewer loan prepayments and more early redemption of time deposits. These "embedded" options are a major source of rate risk and must be measured, monitored, and managed carefully. Rising rates will also put more pressure on borrowers with floating rate loans. This is an example of risk inter-relationships. In this case, rate risk leading to credit defaults. Good risk managers need to capture such inter-relationships. Lastly, the current crisis has clearly revealed the misapplications of VaR. All of the issues above are reflected in our manual. This update of *Interest Rate Risk Management* specifically addresses VaR. Past and future updates keep everything current. Some of the topics being added and updated include the following:

- In Chapter 5, "Economic Value Simulation," we updated the **explanation of VaR limitations** and added a new subsection explaining **how to convert EVE to VaR**.
- In Chapter 6, "Measuring the Rate Risk of Indeterminate Maturity, Administered Rate, and Putable Deposits," we added a new exhibit illustrating a **simple decay analysis calculation** and a new exhibit illustrating **portfolio construction for replicating portfolio analysis**.

- In Chapter 10, “Using Models and Managing Model Risk,” we have added a new subsection covering **model error, model flaws, and model obsolescence**.
- In Chapter 12, “ALM Policies, Management Structures, and Risk Limits,” we have expanded the discussion of how to **estimate the bank’s risk appetite**. Five specific alternative methods for the top-down approach are added.
- In addition, **charts, graphs, and statistical charts were updated** throughout Chapters 2, 5, 6, 11, and 15.