RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 2nd Q 2011

The Federal Reserve Bank of Chicago (Seventh District) Supervision group follows current and emerging risk trends on an on-going basis. This Risk Perspectives newsletter is designed to highlight a few current risk topics and some potential risk topics on the horizon for the Seventh District and its supervised financial institutions. The newsletter is not intended as an exhaustive list of the current or potential risk topics and should not be relied upon as such. We encourage each of our supervised financial institutions to remain informed about current and potential risks to its institution.

Current Risk Topics

Strategic Plans – Growth in a Difficult Environment

The current, difficult operating environment emphasizes the importance of a structured and disciplined strategic planning process. Without a well-conceived and developed strategy, the seeds of future problems are likely being sown. One filter to use in assessing a growth plan is to determine if an Institution interested in expanding in size or product offerings, is expanding from a position of strength or a position of weakness. “Expanding from a position of strength” means leveraging a competitive advantage. Identifying and exploiting a competitive advantage is paramount to achieving a growth rate in excess of the market as a whole. A competitive advantage can be a number of things including: 1) Distribution – an attractive branch network or alternative means of effectively reaching customers or potential customers; 2) Products – value-added products that both commercial and/or retail customers find attractive; 3) Costs – either from a cost of funds perspective or as a low-cost producer; 4) People – a particular area of expertise or valuable customer relationships; 5) Technology – a back office or front office technology platform that differentiates you from your competition; 6) Financial strength – conveying confidence to the market in the on-going viability of the institution.

It’s unlikely that any institution decides to “compete from a position of weakness”. However, this is likely a default position especially when an institution is absent a compelling means of positively differentiating your institution from the market as a whole. This includes 1) diluting underwriting standards to win business, 2) Easing of terms such as reducing the cost of credit or extending tenor; 3) Weaker covenant requirements such as limiting maintenance covenants. While exceptions due occur from time to time (although these should be appropriately vetted, reported, and monitored), competing from a position of weakness is not a successful long-term proposition.

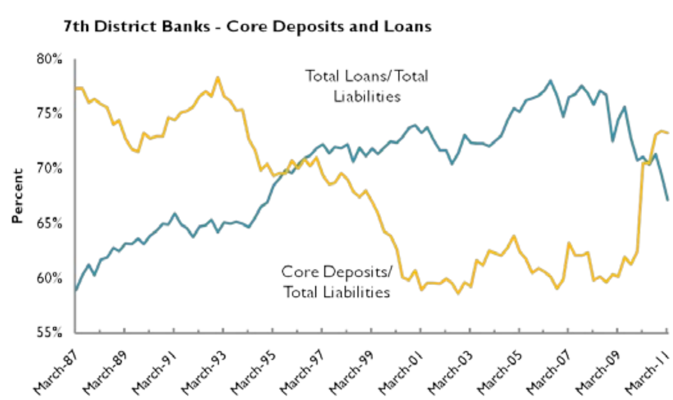
Strategy development is a critically important element of corporate governance and among the most important responsibilities of the Board of Directors and management. As such, this will continue as an area of supervisory attention in the future.

Second mortgage liens

Residential real estate in general continues to show considerable weakness and housing markets have yet to stabilize. In particular, credits secured by second lien positions are especially exposed to falling collateral values. CoreLogic, a real estate analytics firm, estimates that as much as a quarter of Illinois real estate mortgages and up to a third of Michigan mortgages are in excess of the value of the underlying property; essentially placing several second lien position in an unsecured position. This lack of equity places strain on asset recovery values and may lead to increased losses in the event of default. Proactive credit risk management practices to monitor and control risk exposures in second lien mortgage portfolios is important to mitigate the impact of declining asset values and exposure to under-secured revolving lines of credit or second mortgage loans.

Non Maturity Deposit Modeling

Non-Maturity Deposits (NMDs) comprise a significantly larger portion of Seventh District bank balance sheets than they did a few years ago. A buildup of NMDs is common during recessions, but this trend tends to reverse itself when the economy expands. Moreover, past economic cycles have seen traditionally (Uniform Banking Performance Report-UBPR) defined “core” funding—non brokered, insured deposits including NMDs—return to historical levels from their recessionary peak at some institutions. By some measures the degree of the recent increase in NMDs has been greater than those in recent history, suggesting coinciding decreases could also be larger. The new found deposits may also be more sensitive to rate increases than some institutions project, behaving more like rate sensitive or “noncore” funding than part of a resilient funding base. Predicting deposit behavior is also difficult as there have been few short-term interest rate movements recently with which to compare NMD behavior. Short-term rate increases could compress bank net interest margins more than many institutions predict.



Loan volumes typically run counter to the trend in NMDs, increasing during expansions and contracting during recessions. Consequently, when cheap NMDs are most desired by banks to fund loans, they are scarcer. Institutions counting on funding eventual loan growth with recessionary inflows of NMDs should carefully consider the long term stability of that funding.

Troubled Debt Restructure (TDR)

As the economy pushes towards a slow recovery, banks continue to work with borrowers to modify loans that enable borrowers to make their payments during a period of financial strain. For many of these loans, the end result is the hope that banks will not have to foreclose on a property and/or enable the loan to generate a return on their assets. The challenging aspect is finding a concession that works within a borrower's means and benefits the bank. Recent guidance by the Financial Accounting Standards Board (FASB) within the Accounting Standards Update (ASU) 2011-02 (effective 9-30-11) has brought TDR's into the forefront again. The key clarifications include the following three points: 1) Creditors must compare the new rate to a market rate of interest, NOT prior effective interest rates (prohibiting the use of debtor guidance), 2) Indicates that a **temporary** or permanent increase in contractual interest rate due to a restructuring does not preclude that a concession is being granted and 3) States where a restructuring which results in delay of payment that is insignificant is not a concession. Additionally, effective with the March 2011 Call Report, consumer loans are now included in the scope of reporting and lease modifications have been excluded. This is to be consistent with external reporting on the 10K and 10Q. Furthermore, the banking agencies are requiring banks to provide another level of granularity on the Call Reports breaking out a miscellaneous category into specific loan types.

TDRs present some challenges to institutions and as a result expose themselves to risks in several areas including:

- Increased operational risk in the identification, monitoring and Management Information Systems (MIS) of new TDR's on a bank's loan system causing potential regulatory & financial reporting errors
- Increased credit risk due to possible lack of impairment testing on TDR's that were not identified prior to ASU
- Increased accounting or disclosure risk due to misapplication of ASU guidance 2011-02 & 2010-20, respectively.

Merchant Risk Management

Recently, the importance of merchant risk management controls has been highlighted by the significant increase in debit and credit card fraud activity. One of the most common methods involves the use of unauthorized card readers and micro cameras to illegally obtain card and cardholder information which is commonly referred to as "skimming." The Payment Card Industry Security Standards Council (PCI SSC) developed minimum security standards for merchants, service providers, developers and manufacturers of payment card hardware (i.e. terminals). The Payment Card Industry Data Security Standard (PCI DSS) is a global data security standard that *any* business of *any* size must adhere to in order to accept payment cards. Often times, merchant contracts do not contain the necessary provisions as they were created long ago when current threats were unknown or did not exist. Institutions offering payment card services (e.g. acquiring, sponsoring and issuing banks) should enforce merchant risk management controls required by PCI DSS via contracts and ongoing due diligence to detect and prevent card fraud.

Model Risk

Model risk played a role in the 2008 financial crisis when the formulas being used to price and rate the tranches of mortgage backed securities got the variable expressing correlation wrong. A large number of banks made bets based on these imperfect numbers and the meltdown ensued. Regulators responded by issuing SR 11-7: the supervisory guidance for model risk management. Model risk is the probability of adverse consequences stemming from incorrect or misused model outputs. The guidance breaks down model risk into two components: fundamental errors and usage errors. Fundamental errors stem from unrealistic assumptions, data limitations, and uncertainties in the future. While usage errors are defined as human mistakes by both the developers and the users of the models. Model risk should be managed like any other risk with governance and controls put in place to assess and monitor. Improvements in the way models are estimated and prudence in the application of models can be achieved with enhanced model risk management.

More information on SR 11-7, along with all SR letters, is available on the Federal Reserve Board's website.

Social Media: An Emerging Consumer Compliance Risk[1]

The use of social media has grown beyond the initial uses for personal social interaction and uses can be found across nearly every industry, including financial services. Over the past few years, financial institutions have increasingly used social media outlets to market their products and services over the internet, which has increased their exposure to operational, reputational, and compliance risks. As social media outlets become more prevalent in today's society, more financial institutions have decided to use them as an advertising platform. The increased volume of participants, widespread visibility to consumers, and immediacy of information have led to defining these activities as an emerging risk.

Potential consumer compliance concerns applicable to the use of social media include regulatory non-compliance of consumer protection laws such as: Equal Credit Opportunity Act, Truth-in-Savings Act, Truth-in-Lending Act, Community Reinvestment Act, Fair Debt Collection Practices Act, Privacy of Consumer Information Act, and Unfair, Deceptive, or Abusive Acts or Practices. Financial institutions are primarily using social media to provide consumers with basic information such as banking hours, community events, and organizational updates. Nonetheless, an increasing number of institutions are involved in activities that inherently pose a higher degree of risk such as the advertisement of deposit and loan products, receipt of consumer complaints, and the collection of consumer debts.

Given the potential compliance concerns associated with the use social media, financial institutions need to ensure their consumer compliance risk management programs are capable of identifying and controlling these emerging risks.

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[1] *We define social media as the use of internet-based applications with the ability to broadcast and to distribute information, such as Facebook, Twitter, LinkedIN, Youtube, and Wiki's, etc*