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. This 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.

Supervisory Guidance

The Federal Reserve Board of Governors periodically releases Supervision and Regulation Letters, commonly known as SR Letters, which address significant policy and procedural matters related to the Federal Reserve System’s supervisory responsibilities. The following SR letters were released in fourth quarter 2012, and a complete listing of SR Letters is available on the Federal Reserve Board’s website:

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Current Risk Topics

A continued high level of correlation between the operating environment and financial institutions’ risk profiles is expected to influence the overall banking outlook for 2013. For financial institutions, sizeable revenue growth from traditional sources in the expected economic environment could remain challenging. Competition for loan growth, and possibly experienced commercial lenders, may intensify in 2013. Maintaining appropriate underwriting standards and compensation for additional credit risk exposures will be areas to watch in the coming year.

In this environment, effective strategic planning is critical. Financial institutions that decide to move into alternative or new credit sectors for revenue sources are encouraged to consider strategy development and execution. Organic growth may involve the introduction of new product lines to
improve revenue and profit growth. Equally important will be implementation of risk management practices around these new product lines. Given the aforementioned outlook, the following comments and observations are specific to four separate credit segments including retail, commercial and industrial, commercial real estate, and agriculture.

**Credit Risk Outlook for 2013**

**Retail**

As highlighted in the 2Q 2012 Risk Perspectives newsletter, home equity line of credit (HELOC) maturity risk remains one of the leading risk factors of retail lending. In light of continued diminished property values, many banks continue to be challenged by maturing HELOCs’ renewal, extension and conversion issues. These issues include payment shocks to borrowers who are expected to switch from repayment of “interest only” to “principal plus Interest payments,” troubled debt restructuring implications, and high loan-to-value monitoring and reporting guidelines. Financial institutions are encouraged to review supervisory guidance on appropriate risk management of HELOCs found in SR 05-11, *Interagency Credit Risk Management Guidance for Home Equity Lending*.

Another key piece of supervisory guidance with respect to HELOCs can be found in SR 12-3, *Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit*. This SR letter provides guidance on the treatment of HELOCs where the first liens may not be fully collectable. The guidance addresses expectations for financial institutions to place junior liens on non-accrual status if the corresponding first lien loan is not performing as agreed. An increase in aggregate non-accrual levels for U.S. banks in 1Q 2012 likely reflects adherence to this guidance.

On January 10, 2013 the Consumer Financial Protection Bureau issued an amendment to Regulation Z, *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act*. This rule prohibits all banks from making residential mortgage loans without regard to a borrower’s repayment ability and subjects noncompliant creditors to unprecedented liability. The rule sets forth the specific income verification requirements, product features and underwriting criteria that banks must follow for residential mortgage loans to be treated as “qualified mortgages” and, therefore, subject to certain protections from liability. Financial institutions are encouraged to assess the impact of this rule, together with other rules and requirements stipulated in the Dodd-Frank Act, on their respective primary and secondary mortgage activities.

**Commercial and Industrial (C&I)**

The marketplace for C&I loans is highly competitive. Soft loan demand, the low interest rate environment, and strong market liquidity from banks and investors flush with cash has heightened the level of competition for C&I lending and will continue to make loan growth for our institutions very challenging into 2013.
Anecdotally, financial institutions have responded to these dynamics in a number of ways, including:

- Granting pricing and structural concessions in order to maintain or potentially grow market share;
- Increasing leverage tolerance;
- Entering into new lending areas and business lines; and
- Exploring mergers and acquisitions and other shareholder value maximization strategies.

While there appears to be increased appetite for additional credit risk exposure in some portfolios, corresponding levels of enhanced returns will likely be influenced by the due diligence and planning a management team conducts in advance of implementing any new business strategy.

In these situations there are a number of potential risks to consider. First, aggressive growth targets may incent more aggressive terms or riskier borrowers. Also, new growth that occurs outside of a financial institution’s traditional geographic footprint presents the risk of unfamiliar markets that may differ from the traditional footprint. Finally, banks entering into new lending niches without lending staff possessing expertise in these sectors can pose a risk to appropriate due diligence and sound underwriting practices. In this competitive environment, strategy development and execution are critical executive management and director responsibilities. An important component of the planning process is the assessment of potential changes in the financial institution’s risk profile, as well as ensuring that the risk management structure is appropriate for any new lending activities.

**Commercial Real Estate (CRE)**

The multifamily market has experienced a strong recovery since vacancy rates peaked around 8% in 2008 and has likely benefited at the expense of decreasing homeownership. According to Appraisal Research, current renters are more concerned with mobility for job purposes and not being constrained by a difficult to sell home or condo. Vacancy is estimated to stabilize at the current historically low levels of around 4% with limited supply coming online in the next few years. Additionally, according the 2010 U.S. Census, large metro areas have been experiencing double digit growth rates as more people are choosing to live close to the central business districts of those cities. This phenomenon could lead to increased demand for multifamily.

CRE remains a significant part of financial institutions’ balance sheets and many industry participants have indicated the segment is likely to be a larger part of new originations going forward than it has been in the last few years. Selected participants indicate this increase in CRE loans will continue as financial institutions clean up loan portfolios and shift resources from workout functions to new business generation. The combined low interest rates and rising transaction volume continues to influence loan demand in this credit sector.

Going forward, as financial institutions increasingly rely on CRE as a source of new loans, the need for sound underwriting and stress testing practices to address downside risk on both a transaction, as well as portfolio level, remains critical. Guarantor analysis should include investigating the ability to support credits in time of need, and pricing should reflect risk in the current environment.


**Agriculture**

Grain crop production for the U.S. and the 7th District was better than forecasted by the USDA in late fall, but down significantly from 2011 results. Soybeans averaged 39 bushels per acre, down from 41 bushels last year, a decline of 7%.

Production results varied state by state. Soybean averages were enhanced by very late in the season rains that were too late to help corn production, and bean results were down just 15% for Iowa and 10% in Illinois. The reduction in corn and soybean yields pressured end users and livestock/dairy/fish producers alike with the October futures average for December 2012 corn equaling $7.50 a bushel and the October futures for November 2012 soybeans equaling $15.39. Price pressure is expected to remain fairly comparable in the immediate future, given the adverse weather conditions that southern hemisphere growers are facing currently.

The Agricultural credit outlook for 2013 is mixed. Critical factors to consider include:

- The number of banks and producers adversely impacted by the 2012 drought;
- Whether or not dry soil/subsoil be recharged by spring, and 2013 weather conditions;
- Potential increase in production costs, particularly oil related products;
- The adverse impact(s) of limited barge traffic on the Mississippi River, and;
- The lack of agriculture policy reform in the extension of the 2008 Farm Bill, resulting in continued uncertainty as the bill now expires September 30, 2013.

Financial institutions are encouraged to proactively work with affected borrowers, per SR 12-13, FFIEC Statement on the Impact of Drought Conditions on Financial Institutions. Specifically, the letter notes while observing safe and sound credit practices, bankers should expedite lending decisions, extend and/or restructure as necessary, ease credit terms and/or waive loan fees, and consider Farm Service Agency and Small Business Administration loan guarantee programs, as appropriate. While credit rating downgrades and/or classifications of individual credits will occur, the workout process for drought affected customers should be strongly encouraged.
Municipal Bond Credit Risk Management

Financial institutions continue to actively buy municipal bonds, with exposures increasing substantially over the last several years driven by relatively higher yields and the perception that municipal bonds have fairly low credit risk. While credit losses on municipal bonds have generally been low relative to other types of investment securities, historical data reveals heightened credit risk in certain segments of the municipal bond market.

In general, municipal securities are categorized into two types - general obligation debt and revenue bonds. General obligation bonds are widely considered by investors to have the lowest inherent credit risk relative to other municipal bond issuers due the strength of the general taxing authority granted to the issuer. However, even general obligation bonds are subject to varying degrees of credit risk, due largely to variations in state support and state laws surrounding taxing authority restrictions. Likewise, revenue bonds exhibit variations in their credit risk profile depending on the nature of the revenue sources backing the securities. Essential service revenues such as water and sewer fees have historically continued to meet obligations even under adverse economic conditions. However, non-essential projects such as industrial revenue, special assessment, and real estate development bonds have the vast majority of historical credit losses within the sector.

Recently, the Federal Reserve released SR 12-15, Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings. This guidance redefines “investment grade” permissible securities using criteria that emphasize the need for all financial institutions to conduct more rigorous internal credit evaluations and monitoring of investments, including municipal issuers. SR 12-15 identifies several key factors that financial institutions may want to consider when evaluating the creditworthiness of municipal securities. For general obligation bonds, this includes the debt profile, stability of tax revenues, diversity of revenue sources, and degree of taxing authority. For revenue bonds, this includes the nature of the project, issuer financial condition, annual debt service, reserve levels, and legal covenants. These factors should be considered in addition to other broader criteria such as economic and demographic trends, as well as credit spreads and general default risk compared to other bonds of similar investment grade quality.
Bank Secrecy Act/Anti-Money Laundering (BSA/AML) and Office of Financial Assets Control (OFAC) Violations

In 2012, there were many well-publicized supervisory enforcement orders and fines addressing financial institutions’ BSA/AML and OFAC violations. These actions led to the assessment of more than $3.3 billion in fines and settlements against financial institutions. Further, media have reported ongoing investigations conducted by the Department of Justice and other regulatory agencies. These events demonstrate that financial institutions remain subject to significant BSA/AML/OFAC risks, which requires strong risk management and internal control capabilities to mitigate potential exposures. Most control breakdowns leading to the recent actions reflected the following specific areas of weakness, which institutions should consider in assessing the strength of their BSA/AML and OFAC programs: ineffective compliance cultures, inadequate risk management, and noncompliance with jurisdictional requirements.

Financial institutions have experienced control breakdowns when the “tone at the top” has been ineffective or inconsistent. In these cases, the failure of senior management and the board of directors to establish a strong culture of compliance have reflected some combination of weak investment in compliance staff, technology and training; not imposing consequences for noncompliance; and a general lack of high expectations for business ethics and integrity. The current challenging earnings environment has led to financial institution cost cutting initiatives that can place pressure on the ability to develop and maintain strong risk management frameworks. Most financial institutions have been seeking to increase revenue through the addition of new products and services, and in some cases have implemented business processes without establishing commensurate BSA/AML and OFAC risk controls. Other supervisory observations include reduced business compliance resources allocated to existing products. These factors resulted in inadequate risk identification and mitigation processes.

Foreign institutions with U.S. operations often implement controls designed to meet the legal requirements of the parent company’s home country, which may reflect lower standards and expectations of U.S. laws and regulations. Recent OFAC settlements demonstrate selected financial institutions established risk management capabilities that were inconsistent with the minimum requirements governing the U.S. operations of foreign institutions’ subsidiaries and affiliates.

While recent supervisory actions have required financial institutions to improve a wide variety of controls, the control failures themselves are viewed more to be symptoms and outcomes rather than representing the root cause of the BSA/AML and OFAC compliance deficiencies. In order for financial institutions’ BSA/AML and OFAC compliance programs to meet supervisory expectations, Boards of Directors and management must establish a strong compliance risk management culture surrounding BSA/AML/OFAC, regularly ensure resources are sufficient to assess and appropriately manage risks, and implement controls designed to meet the legal requirements of the jurisdictions in which the entity operates.