RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 2nd Quarter 2013

The Federal Reserve Bank of Chicago’s (Seventh District) Supervision & Regulation Department tracks current and emerging risk trends on an ongoing basis. This Risk Perspectives newsletter is designed to highlight a few of the timeliest themes for the Seventh District’s supervised financial institutions. This newsletter is not intended to be an exhaustive list of the current or potential risks and should not be relied upon as such. We encourage each of our supervised financial institutions to keep abreast of risk trends most relevant to their individual operations and business models.

Regulatory Capital Rules Finalized

The Federal Reserve Board on July 2 approved a final rule regarding capital standards at banking organizations in the United States. The rule addressed capital requirements set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as implemented Basel III regulatory capital standards in the United States. The Federal Reserve Board noted in its press release the following summary of the rule:

The final rule minimizes burden on smaller, less complex financial institutions; It establishes an integrated regulatory capital framework that addresses shortcomings in capital requirements, particularly for larger, internationally active banking organizations, that became apparent during the recent financial crisis.

A link to the entire press release can be found here. The final rule was coordinated with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC).

Supervisory Guidance

The Federal Reserve Board of Governors periodically releases Supervision and Regulation Letters, commonly known as SR Letters, to address significant policy and procedural matters related to the Federal Reserve System’s supervisory responsibilities. The following SR Letters were released in the second quarter 2013. A complete listing of SR Letters is available on the Federal Reserve Board’s website.

**SR 13-13 / CA 13-10** Supervisory Considerations for the Communication of Supervisory Findings

**SR 13-12** Commodity Futures Trading Commission (CFTC) Swap Clearing Rules

**SR 13-11** Filing Procedures for Annual Independent Audits and Reports Required Under Federal Deposit Insurance Corporation (FDIC) Rules

**SR 13-10** Format for Safety-and-Soundness Reports of Examination and Inspection for Community State Member Banks and Holding
Companies Rated Composite "4" or "5"

**SR 13-9 / CA 13-6**

Minimum Standards for Prioritization and Handling Borrower Files with Imminent Scheduled Foreclosure Sale

### Current Risk Topics

**District Bank Performance**

The banking industry nationwide posted record profits for the first quarter of 2013. However, profitability was in part driven by one-time gains reflected in non-interest income, provision expense declines and gains in the investment bank subsidiaries at some of the country’s largest banks. In the Seventh District, Return on Average Assets (ROAA) for Q1 2013 fell from 0.82% to 0.75%, due primarily to net interest income compression, but this was partially offset by provision expense decreases. Over the past few years, aggregate provision expense in the District has steadily dropped from around 1.3% of average assets in 2010 to 26 basis points in the first quarter of 2013. Although financial results from the second quarter are still preliminary, earnings press releases and disclosures to date suggest first quarter trends continued in the second quarter. Headline profits continue to appear quite healthy, but may mask some of the same important underlying trends – falling provisions and one-time benefits, rather than profits from margin expansion.

Net interest margins (NIM) in this low interest rate environment have been compressed as loans and securities re-price at lower rates, while deposits, already near the lower bound of 0% interest expense, remain and have been growing, thus compressing NIM. To put this into context, NIM in the late 90s peaked around 4.0% compared to Q1 2013 7G results of 3.0%. While there has been some increase in non-interest income from last year, this has not been enough to offset the drop in interest income in most institutions.

**Modeling Complex Products**

As banks struggle to maintain or expand net interest margin (NIM) in today’s low rate environment, financial institutions may be tempted to implement non-traditional strategies to increase profitability. In addition, some of these non-traditional strategies may involve complex products, which may not only increase inherent and legal risk, but are also prone to model risk. The marketplace contains certain complex products that require data which is difficult to obtain. In addition, some complex products rely on risk measurements that use highly subjective assumptions. A few examples of common complex products include asset backed securities and mortgage servicing rights (MSRs). Asset backed securities and other securitized instruments can be complex to model for economic valuation because they require underlying collateral data and are largely impacted by the structure of repayment of cash flows. MSRs can be difficult
for banks to model for interest rate risk, as interest sensitive fee income needs to be measured in net interest income interest rate risk modeling.

Many banks engage in third party relationships to measure interest rate risk. Third party models can be proprietary and therefore may lack transparency. It is important for bank management to understand model capabilities, applicability, limitations and assumptions. The Federal Reserve SR Letter 11-7 provides Guidance on Model Risk Management and speaks specifically to validation of vendor and other third-party products banks of all sizes should follow for model governance.

Student Loans

Nationally, student loan delinquencies have drawn attention from policy makers to household consumers. Both student loan debt and delinquencies have risen significantly in the past seven years, with the latter outpacing the former. In addition, approximately one third of the total U.S. student debt outstanding resides on financial institutions’ balance sheets. Included in this total is roughly $238 billion government guaranteed loans originated by financial institutions prior to the termination of the Federal Family Education Program in June 2010. However, the overall risk to financial institutions appears to be limited. The historical loss rate among financial institutions from government guaranteed loans is low because lenders are generally reimbursed a minimum of 97% of uncollected principal and interest if a borrower becomes delinquent (provided the lender complies with the servicer requirements). The delinquency rates for private student loans have been improving post-crisis. Since 2009, private lenders have tightened underwriting polices and required cosigners for an increasing portion of loans.

While the current inherent risk of student loans may be limited, ancillary impacts of student loan delinquencies on a banks borrowing population should be considered. Prudent risk management calls for banks to incorporate borrower student loan obligations when assessing repayment risk of consumer portfolios. Inadequately high student loan debt may inhibit access to credit, which could negatively impact bank growth objectives. Private student loans are largely variable rate products subject to payment shocks upon re-pricing. Lastly, a deficit reduction policy may result in a pullback in government guaranteed student loans and, by extension, a growth opportunity for lenders. Entry into this business requires an appropriate review of new products as well as controls for approval and underwriting processes.

The Expansion of Vendor Management Risk

Traditionally, vendor management has been a focus of both banks and supervisors as an information technology (IT) risk management perspective. Information technology is a critical factor needed to support the organization’s strategic goals and business objectives, and therefore vendor management of IT services is embedded within firms’ risk management practices. While vendor management within IT remains an important risk management element, recent trends indicate the scope of outsourced services is expanding beyond core processing and information technology to areas such as anti-money laundering transaction monitoring, loan portfolio analysis, interest rate risk modeling, compliance functions, risk management services, customer service centers, consumer credit information, etc. Consequently, the risks posed by outsourcing, both in the traditional and non-traditional sense, have increased in accordance with the volume, scope, and pressure-driven decisions associated with these arrangements. Potential increased risks
include data security risk as external vendors are increasingly given access to sensitive corporate and confidential information; concentration risk due to utilization of vendor services to perform multiple activities; reputational risk resulting from customer dissatisfaction or vendor failure and compliance risk due to vendors’ non-compliance with various laws and regulations and supervisory guidance. The risks associated with these arrangements should be regularly communicated to the board since the overall responsibility lies with the bank’s board of directors and senior management.

While financial institutions can delegate a wide range of activities to a third party, the risk and responsibility for compliance and oversight cannot be delegated. As such, the decision to outsource should be carefully evaluated and aligned with the bank’s strategic goals and include the following controls: preparing a risk assessment, developing a robust vendor due diligence, creating a well-defined vendor contract and providing a structure for ongoing monitoring and oversight. To this end, financial institutions should establish a vendor management program that provides a framework for management to identify, measure, monitor, and control the risk associated with outsourcing activities.

**CFPB Issues Final Rules Impacting Mortgage Servicing**

On January 17, 2013 the Consumer Financial Protection Bureau (CFPB) issued several new mortgage rules regarding mortgage loan servicing, which amend the Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z). These new rules will significantly impact financial institutions’ mortgage loan servicing and loss mitigation practices.

Nine major topics are addressed in the amendments to Regulations X and Z. For Regulation X, these amendments include prohibiting servicers from charging a borrower for forced-placed insurance coverage unless the servicer has a reasonable basis to believe the borrower failed to maintain hazardous insurance. In addition, servicers are required to comply with certain error resolution procedures, including providing the borrower written notification of the results of an investigation within 30 to 45 days. Other amendments to Regulation X include requiring servicers to establish certain policies and procedures. A full list of the amendments to Regulation X can be found here.

Regulation Z amendments also pertain to mortgage servicers. The amendments require servicers to provide a periodic statement for each billing cycle for most instances and provide notification to consumers with adjustable rate mortgage between 210 and 240 days prior to the first payment of the newly adjusted rate. A complete outline of the rule can be found on the CFPB’s website.