



RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 1st Quarter 2014

The Federal Reserve Bank of Chicago (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.

Volcker Rule Finalized

On December 10, 2013, five federal agencies issued final rules to implement section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) known commonly as the Volcker rule.

The [Volcker rule](#) prohibits insured depository institutions and companies affiliated with insured depository institutions ("banking entities") from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. The final rules also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds.

Like the Dodd-Frank Act, the final rules provide exemptions for certain activities, including market making, underwriting, hedging, trading in government obligations, insurance company activities, and organizing and offering hedge funds or private equity funds. The final rules also clarify that certain activities are not prohibited, including acting as agent, broker, or custodian.

Furthermore, on January 14, 2014, an interim final rule was approved to permit banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDSOs) from the investment prohibitions of the Volcker Rule. Under the interim final rule, the agencies permit the retention of an interest in or sponsorship of covered funds by banking entities if certain qualifications are met.

The compliance requirements under the final rules vary based on the size of the banking entity and the scope of activities conducted. Banking entities with significant trading operations will be required to establish a detailed compliance program and those firms' CEOs will be required to attest that their financial institutions' program is reasonably designed to achieve compliance with the final rule. Independent testing and analysis of an institution's compliance program will also be required. The final rules reduce the burden on smaller, less-complex institutions by limiting their compliance and reporting requirements. Additionally, a banking entity that does not engage in covered trading activities will not need to establish a compliance program.

Final Rule: Enhanced Prudential Standards of Dodd-Frank Act (DFA) Section 165

On February 18, 2014, the Board of Governors of the Federal Reserve System approved a final rule establishing enhanced prudential standards for certain banking organizations pursuant to the requirements of Section 165 of the Dodd-Frank Act (DFA). The final rule establishes a number of enhanced prudential standards for large U.S. bank holding companies and foreign banking organizations to help increase the resiliency of their operations. These standards address requirements for liquidity, risk management, and capital. It also requires a foreign banking organization with a significant U.S. presence to establish an intermediate holding company over its U.S. subsidiaries, which will facilitate consistent supervision and regulation of the U.S. operations of the foreign bank. The final rule was required by section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The full text is published in the [Federal Register](#).

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 page identifies some of the key SR Letters released in the first quarter of 2014. A complete listing of SR Letters is [available](#) on the Federal Reserve Board's website.

SR 14-3	Supervisory Guidance on Dodd-Frank Act Company-Run Stress Testing for Banking Organizations with Total Consolidated Assets of More Than \$10 Billion but Less Than \$50 Billion
SR 14-2/CA 14-1	Enhancing Transparency in the Federal Reserve's Applications Process
SR 14-1	Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies - Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions (SR letter 12-17/CA letter 12-14)

Current Risk Topics

District Bank Performance Overview

With few exceptions, District bank aggregate loan balances have risen across most categories over the past year, marking continued improvements in loan demand. In the year ending December 2013, almost 60% of banks in the District increased their commercial and industrial loan balances, pointing to broad-based growth in a sector where growth had previously been concentrated at larger institutions.

Rising balances among all categories of commercial real estate loans also added to signs of building demand for credit. However, interest income on these loans dropped 3.1% in aggregate which illustrates the downward pressure the low-rate environment is applying to net interest margins.

Asset quality improvement continues to drive shrinking provision expenses, which in turn have helped support earnings ratios. As credit quality further improves, banks may consider booking negative provisions. Lowering the ALLL through a negative provision is permitted under generally accepted accounting principles (GAAP). Accounting standards for loan losses allow banks to reduce reserves through negative provisions, and regulators are not opposed to the practice provided that the decision is well supported.

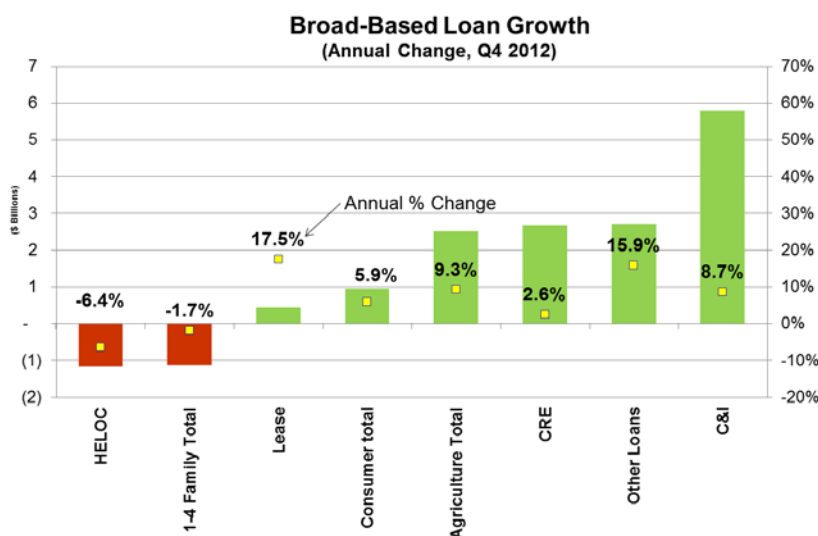
Improvements in credit quality have also had the effect of generating additional competition among lenders. Many banks are being faced with difficult decisions about whether—or how much—to ease their underwriting standards.

Credit Risk Update

Retail Credit

Retail loans declined 1% in 2013 from the previous year. Despite the decline in total loans, auto and other consumer loans in the 7th District experienced year-over-year growth of 5% and 7% respectively. Credit performance continued to improve in 2013 for all retail products except for home equity line of credit (HELOCs) and government student loans. Credit standards in 2013 appeared to be somewhat more liberal for mortgages as well as credit card, auto loans and other consumer loans.

In 2014, we do not expect retail credit trends to deviate much from those observed in 2013. For residential mortgages, we expect to see two divergent trends. On the one hand, loan origination is forecasted to



decline due to a significant decrease in refinance transactions as interest rates increase. Additionally, the market is expected to continue to adapt to the new Qualified Mortgage (QM) regulations by eliminating products that do not fit the QM rules. On the other hand, this downward origination trend will likely be offset by banks' loosening credit standards and higher appetite for riskier retail loans. For HELOCs, 2014 is expected to reflect continued challenges due to maturing HELOC renewal, extension and conversion issues. Resetting HELOCs into higher payment has caused potential payment shocks and jumps in delinquencies. Auto loan lending in 2014 is expected to continue to grow as a result of pent up consumer demand and relatively strong auto credit performance during the crisis. Strong competition in auto lending has pushed auto financing pricing down. Whether or not the pricing can provide banks with an appropriate risk-adjusted return remains to be seen. Financial Institutions that use pricing models are expected to comply with [SR 11-7](#), *Model Risk Management*, and demonstrate that there is proper governance structure in place to track and monitor interest rate setting practices.

Firms that originate residential mortgages including both QMs and Non-QMs can find safety-and-soundness expectations in [SR 13-20 / CA 13-23](#), *Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans*. The Statement indicates that regardless of whether residential mortgages are QMs or not, financial institutions are expected to underwrite loans in a prudent fashion and address key risk areas in mortgage lending. Firms that have HELOCs on their books are expected to review supervisory guidance on appropriate risk management of HELOCs in [SR 05-11](#), *Interagency Credit Risk Management Guidance for Home Equity Lending*, and [SR 12-3](#), *Allowance Estimation Process for Junior Lien and HELOCs*.

Commercial Real Estate (CRE)

The apartment market is starting to exhibit signs of stress that could be of concern with increasing vacancy and continued increases in supply. Liquidity has been ample in this sector with banks as well as private investors seeing the strong fundamentals since 2009 as an opportunity to grow portfolios with limited risk as homeownership continues to struggle.

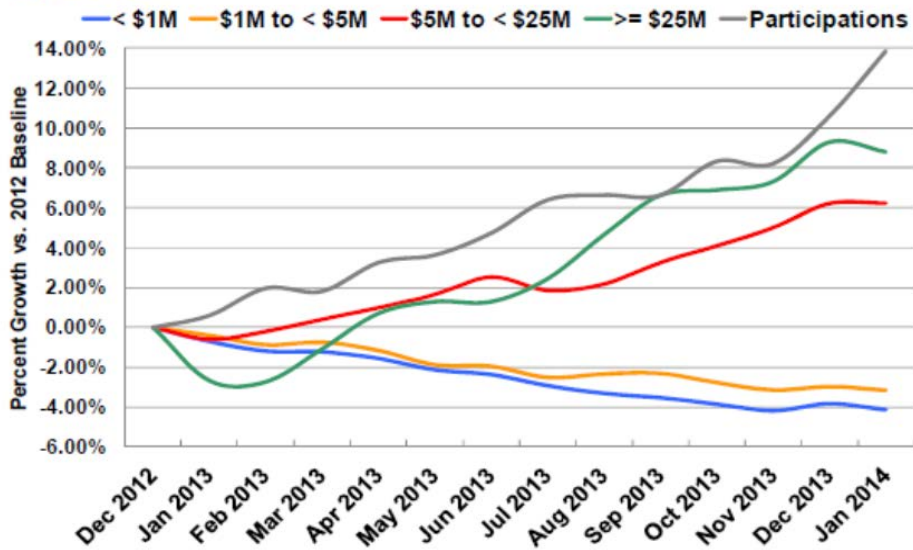
Industry participants indicate that strong fundamentals across CRE sectors combined with historically low rates have resulted in institutions looking to grow portfolios at a strong pace. Lack of significant new construction for the last several years has led most to believe that this sector may provide growth opportunities.

As financial institutions continue to seek new CRE originations the need for sound underwriting and stress testing practices to address the downside risk on a transaction, as well as a portfolio level, remain critical. Guarantor analysis should include investigating the ability to support credits in time of need and take into account how those guarantors actually performed during the recession. Controls around the growth plans should be thoroughly investigated including thresholds and parameters that would signal increased downside risk.

Commercial and Industrial (C&I)

Automated Financial Systems (AFS) data shows that the most growth in C&I outstandings is occurring in syndicated and large loan markets (>\$25MM). Demand from smaller borrowers (loans less than \$5MM) remains weak.

**Growth in Outstandings - December 2012 Baseline
By Loan Size**



Source: AFS C&I Pricing Trends, February 2014

M&A lending reached \$360B in 2013, up 40% year-over-year according to Thompson Reuters LPC. A survey conducted by Thompson Reuters LPC reported more bankers expect M&A to increase in 2014. Banks seeking loan growth and/or yield may increasingly participate in these financings.

The January 2014 [FRB: Senior Loan Officer Opinion Survey on Bank Lending Practices](#), as well as anecdotal observations by bankers indicate leverage and other standards on leveraged lending are expected to tighten somewhat in response to supervisory guidance on leveraged lending issued in March 2013 [SR 13-3](#).

Agricultural Lending

The outlook for agricultural producers for 2014 is mixed. Prospects for the pork, dairy and chicken/turkey producers are favorable following the decline in feed costs last year and increasing demand. Cattle operators remain challenged as an extended period of lower production costs is needed along with increasing demand before returning to profitability. After several years of shrinking herd size due to declining demand, high feed prices, and the 2011-2013 drought, the January 1, 2014 cow/calf herd was at a size last seen January 1, 1951. Prevailing low grain prices coupled with low USDA long-range price forecasts could result in modest profits, or even potential losses, for grain farmers this year depending upon production costs. For any appreciable grain price fluctuation to occur, there would have to be a sizable supply disruption (e.g. sustained Ukraine/Russia situation) and/or a marked increase in demand after the U.S. “bin busting” corn and soybean harvest of 2013. The USDA World Agriculture Supply & Demand Estimates report as of February 10, 2014 predicts U.S. ending stocks for corn will improve to 17.1% of use while soybeans compare similarly to last year at 4.5%. Predictions for worldwide ending stocks for corn are 15.8% and soybeans 26.7% of use, respectively, with nominal upward price pressure forecast.

Given the passage of the new Farm Bill was delayed until February 2014, several new provisions that require rule writing do not go into effect until 2015. With the removal of direct payments to producers, borrowers and lenders have to re-calibrate risk mitigation practices for the new “normal” under the 2014 Farm Bill; which is especially crucial in a year with low spring federal crop price insurance levels for corn and soybeans. Drought conditions across the District have abated with the exception of some sections of western Illinois and most of Iowa. The USDA 3-month drought monitor precipitation forecast does not show much relief through May making timely precipitation throughout the growing season key to achieving normal or better yields. With the chance for a La Nina weather effect to limit grain production in 2014, industry insiders anticipate grain farmers may give consideration to paying the higher premium for crop insurance with harvest price option.

Land prices are stabilizing with some softening noted in certain markets. The February 2014 issue of the [Ag Letter](#) published by this Reserve Bank notes a District wide increase in land values of 5% during 2013; however results varied widely with Indiana up 14% while Iowa posted a 2% loss. During the fourth quarter, softening land values were noted across Iowa and Wisconsin with each reporting a 1% decline. Industry experts are in general agreement that there is no land balloon set to burst. Price declines will continue to occur gradually as long as grain prices remain low and no supply disruption occurs or unforeseen increase in demand emerges. If land prices decline materially it could cause collateral margin compression for some borrowers and bankers are expected to respond by stress testing as appropriate for the farming operation.

Classifying Investment Securities

Credit rating agencies were viewed by some to play a key role in the financial crisis due to their role with sub-prime mortgage backed securities. Beginning with the implementation of the Dodd-Frank Act in 2010, Section 939A required Federal Regulatory Agencies to remove references to, or requirements for reliance on, nationally recognized statistical rating organization (NRSRO) credit ratings. In June 2012 the OCC released *Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment*. The guidance redefined “Investment Grade” as an issuer having “adequate capacity” to meet the financial commitments under the security for the projected life of the investment. It also included guidance to help determine standards of creditworthiness and expectations for a bank’s risk management practices. This was followed by [SR 12-15](#), *Investing in Securities without Reliance on NRSRO Ratings*, which reiterates the OCC guidance.¹ On October 29, 2013, the Federal Reserve issued [SR 13-18](#), *Uniform Agreement on the Classification of Securities Held by Depository Institutions*. The new interagency guidance applies the credit worthiness standards adopted in 2012 and supersedes SR 04-9 which relied heavily on NRSRO credit ratings. Importantly, long-standing definitions of classifications (Substandard, Doubtful and Loss) remain the same, but SR 13-18 requires an independent assessment of credit risk.

The move away from reliance on external credit ratings is viewed as a positive step forward to strengthening risk management practices of the investment securities portfolio. Often reliance on credit ratings served as a convenient crutch which led banks to acquire securities without fully understanding the risks of their investments. Banks that did not rely exclusively on external credit ratings and have established due diligence and ongoing monitoring processes should not find it difficult to comply with new supervisory standards. Banks that need to strengthen this area could consider leveraging their loan portfolio credit risk

¹Under the Federal Reserve Act, Reg H references the OCC’s 12 CFR Part 1 which holds state member banks to the same investment authority standard as national banks.

management practices.

At the same time some new challenges may emerge. The definition of adequate capacity can be ambiguous and subject to interpretation. The classification guidance also notes sub-investment grade debt securities possessing characteristics that are “distinctly or predominantly speculative” as being generally subject to classification. Sometimes the characteristics of investment grade and sub-investment grade as defined in the new guidance may not be mutually exclusive. Under these circumstances careful consideration should be made as to the speculative nature of issuers. Some characteristics of speculative can include issuers that are highly leveraged, have volatile earnings track records, operate in volatile industries, or possess other qualities that would elevate an issuer’s probability of default and be deemed speculative by traditional credit standards. Market indicators should be used to support the assessment of investment quality. An issuer whose market spreads or yields exceed those of investment grade issuers will often negate support for an investment grade assessment. Exposures in speculative securities would not be deemed a safe and sound banking practice.

For financial institutions with large credit sensitive exposures in the investment portfolio, or those that are considering significant changes, bankers ensure that their respective risk appetite and resources are consistent with the supervisory expectations and standards noted.

Vendor Risk Management

On December 5, 2013 the Federal Reserve issued [SR 13-19 / CA 13-21](#) , *Guidance on Managing Outsourcing Risk*, to assist financial institutions in understanding and managing the risks associated with outsourcing a bank activity to a service provider to perform that activity. This guidance applies to all service provider relationships regardless of the type of bank activity that is outsourced. The guidance describes risks from the use of service providers; board of directors and senior management responsibilities; and service provider risk management programs.

If not managed effectively, the use of service providers may expose financial institutions to risks that can result in regulatory action, financial loss, litigation, and loss of reputation. Financial institutions that use service providers to perform operational functions can present risks to the institutions. Potential risks can range from the outsourced risk itself to the use of the service provider.

Using a service provider does not release the financial institutions’ board of directors or senior management of the responsibility of the service provider or the operational functions that are conducted. Board-approved policies for the use of service providers are expected to be included in the board of director minutes.

A financial institution’s service provider risk management program should be risk-focused and provide oversight and controls commensurate with the level of risk presented by the outsourcing arrangements in which the financial institution is engaged. It should focus on outsourced activities that have a substantial impact on a financial institution’s financial condition, are critical to the institution’s ongoing operations, involve sensitive customer information or new bank products or services, or pose material compliance risk.

While the activities necessary to implement an effective service provider risk management program can vary based on the scope and nature of a financial institution’s outsourced activities, effective programs

usually include the following core elements:

- Risk assessments;
- Due diligence and selection of service providers;
- Contract provisions and considerations;
- Incentive compensation review;
- Oversight and monitoring of service providers; and
- Business continuity and contingency plans.

Financial institutions' increasing reliance on vendors for business functions require strong vendor management program practices. A key objective is to ensure the vendor meets the financial institutions' business needs and operates in a manner consistent with senior management and board of director's enterprise wide risk management expectations.