



RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 3rd 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

Interest Rate and Liquidity Risk in Today's environment

Low rates, a flatter yield curve, and relatively high levels of deposits have left some institutions feeling flush with liquidity and concerned about maintaining or improving earnings. Institutions may also be feeling that interest rate risk is minimized given the August FOMC announcement that the federal funds (FF) target rate is likely to remain exceptionally low through mid 2013.

While there may be a degree of certainty about the stability of short term rates for the next twelve or so months, institutions should be cautious not to assume this automatically equates to little or no interest rate risk. There are many national and global economic risk factors that impact the medium to long end of the Treasury and other rate curves. For instance, the Federal Reserve Board's recent announcement of "Operation Twist" is only one factor influencing Treasury and mortgage rates. Further, the announcement of a prolonged low FF target rate does not mean other short term rates will perfectly correlate. For example, LIBOR, a popular reference rate for financial instruments, is influenced by events other than US federal funds target rate. Thus it is important to keep in mind that an additional degree of uncertainty remains with any rates not directly influenced by the Federal Reserve Board and that basis risk could be an important risk at some institutions. Balance sheet structure and future asset repricing will also impact rate risk and margins.

With margins under rate pressure and loan demand reported to remain constrained, institutions are looking for strategies to maintain or improve earnings. Balance sheet strategies have been implemented to optimize FDIC insurance premiums. To minimize premium expense with a recently modified FDIC insurance premium calculation, some institutions are actively limiting on-balance sheet liabilities in order to minimize balance sheet inflation. Institutions are also looking to new products, fee income and new business lines to bolster earnings. Institutions are encouraged to apply appropriate

due diligence to any new on or off balance sheet strategies, and to ensure that the appropriate risk management infrastructure is in place prior to launching any new strategies.

Money Market Mutual Funds (MMFs)

On-going concern with European Union sovereign and bank debt poses increased, though thus far manageable, broken buck risk exposure for predominately prime MMFs (\$1.5 trillion and 60% of total industry assets) and more modestly for tax exempt/muni MMFs (\$288 billion total industry assets). Prime MMFs' EU bank counterparty debt exposure stems from their investments in both unsecured (commercial paper, bank deposits) and secured (repo) debt approaching 47% of total investments for the top ten largest prime MMFs according to the most recent (August 2011) Fitch survey on the subject. Muni MMFs exposure stems predominately from their investments in variable rate demand obligations (VRDOs) which are in turn impacted by EU banks serving as credit and liquidity enhancers for VRDOs.

Prime MMF managers according to the August Fitch trend survey have scaled back longer term and/or overall absolute exposure to perceived higher risk peripheral EU bank counterparties in favor of better credit rated exposure and to preserve liquidity for concerned investors. Some funds are proactively and transparently disclosing EU portfolio percentage exposures on websites and in internal client communications. On a macro scale, U.S. MMFs retrenching and/or not rolling over wholesale dollar funding for EU banks led to central banks' filling this void. The EU/broken buck concern coupled with historically low MMF yields has contributed to declines in overall MMF assets and accumulating MMF fee waivers over the past three years. Prime MMFs outflows have peaked over the past two quarters. Cash investors since 2008 have opted for safer, insured bank deposits and those investors remaining in MMFs are migrating to U.S. government MMFs despite August rating agency downgrade of U.S. long term debt. All of these trends, and others, argue for increased vigilance, contingency and scenario planning for broken buck exposure posed by unexpected credit rating downgrades of EU bank debt and ripple impacts on their counterparties and/or ongoing "market event" driven uncertainties.

Residential Mortgage Update

According to Corelogic and Case-Shillerⁱ, residential real estate values have fallen to 2003 levels on a nominal basis and to year 2000 levels on an inflation adjusted basis. Two major markets in our district, Detroit and Chicago, are down over 48% and 32%, respectively, since their peaks in 2006. Some market analysts are projecting further price declines based on many headwinds including high unemployment, negative equity positions, shadow inventory of pre-foreclosures, shift in homeownership attitudes, and low-income growth. Housing demand is soft despite the lowest mortgage rates in decades. The weak economy and the decline in housing prices have also negatively affected second lien loan portfolios.

Severely delinquent home equity loans remains high in many markets nationally while delinquency rates in the 7th district have begun to fall slightly. A significant influence in delinquency trends is whether or not the borrower is in a negative equity position. Negative equity plagues 23% of all mortgage holders in the U.S. according to CoreLogicⁱⁱ. Further, these borrowers are far more likely to have a home equity loan. Pre-foreclosure rates for borrowers with negative equity are 7 times higher than positive equity

loans. As negative equity positions increase so does the probability of strategic default. When loan-to-value reaches 150% strategic defaults have very little relationship to low credit scores but are largely influenced by borrower attitudes. In a survey by PewResearch, 41% of mortgage borrowers stated that strategic default would be a reasonable solution to debt problems.

Home Equity term renewals are challenging for most institutions as negative equity poses many problems. These issues include policy violations, ALLL implications, potential changes in capital requirements, and a reinforcement of strategic default thinking. Some banks are changing amortization schedules and terms to ameliorate risk. Given the very weak housing environment and its negative impact on first and second lien mortgage portfolios, management needs to assess existing risk management practices and ensure that at risk borrowers are identified and that action plans are established to address repayment or collateral deficiencies.

SR 11-9 (Authentication Supplement) and Account takeover Fraud

Account takeover fraud targeting corporate customers of financial institutions has increased dramatically in recent years, exposing limitations of prior guidance (SR 05-19) intended to address these and related threats. In response, SR 11-9, issued July 29 with an implementation deadline of January 1, 2012, clarifies SR 05-19 control expectations for financial institutions and sets new expectations for minimum control levels, including: annual risk assessments that differentiate retail and corporate accounts and are responsive to emerging threats, layered security for all "high-risk" transactions (including transaction monitoring and detection of anomalous account activity), and specific improvements to customer awareness and education. Certain weak authentication methods are also specifically disallowed for high-risk transactions. While some institutions may not be able to conform to the new guidance before the deadline, institutions must be able to demonstrate diligent, good faith effort to conform (including completed risk assessment, gap analysis, and service provider engagement by year-end 2011) and cannot take the position that they are waiting on service provider action to conform. Liability for losses due to account takeover fraud remains unclear, with both financial institutions and corporate customers winning judgments in 2011.

More information on SR 11-9, along with all SR letters, is [available](#) on the Federal Reserve Board's website.

ⁱ Calculated Risk Report of Real Home Prices and Prices to Rent on August 30, 2011 <http://www.calculatedriskblog.com/2011/08/real-house-prices-and-price-to-rent.html>

ⁱⁱ Core Logic Negative Equity report of September 13, 2011; http://www.corelogic.com/about-us/news/asset_upload_file75_12141.pdf