



Risk Perspectives

Highlights of Risk Monitoring in the Seventh District – 1st Q 2012

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

Interagency Guidance on Allowance Estimation Practices Released

In late January 2012, the federal banking agencies issued the *Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit*. This guidance reminds domestic banking organizations to consider all credit quality indicators relevant to junior liens loans and lines of credit. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien has been modified. Institutions should ensure during the allowance for loan and lease loss (ALLL) estimation process sufficient information is gathered to adequately assess the probable loss incurred within junior lien portfolios.

In addition, based on the rapid growth in home equity lending during the 2003-2007 timeframe, a significant volume of home equity lines of credit (HELOCs) will be approaching the end of their draw periods in the next several years. These lines will either convert to amortizing loans or have principal due as a balloon payment. An institution with a significant number of HELOCs should ensure that its ALLL methodology appropriately captures the elevated borrower default risk associated with any upcoming payment shocks. For further information, please click [here](#) to be directed to the Federal Reserve Board of Governor's web site to view the released guidance.

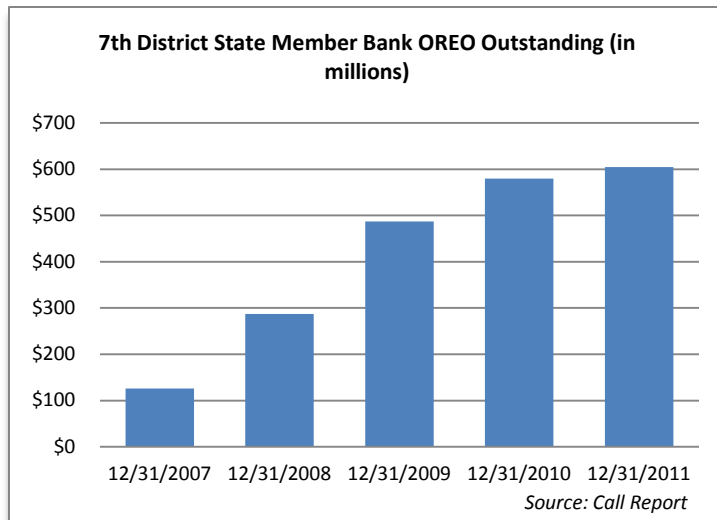
Asset Exchanges

Banks continue to face challenges in the post-recession economic environment, as sticky levels of Other Real Estate Owned (OREO) remain on balance sheets. Such levels can hinder a bank's profitability. As such, banks are increasingly exploring unique and creative strategies to dispose of or reduce both non-performing assets and OREO.

One emerging strategy involves so-called "asset exchanges," whereby third parties or marketing agents offer to purchase problem assets from institutions in exchange for performing assets. Asset exchanges, if properly executed with reputable counterparties and subjected to the appropriate level of due diligence, could achieve the following objectives: reduce nonperforming assets on financial institutions' balance sheets; enable loan portfolio diversification; and increased earnings. However, banks could run

the risk of overstated asset values for acquired assets and lack of expertise/infrastructure to manage the newly acquired assets in an asset exchange strategy.

The Federal Reserve Board of Governors released Supervision and Regulation Letter 11-15, entitled *The Disposal of Assets through Exchanges* in late 2011 on the subject. The letter identifies the lack of appropriate, up-front due diligence and inappropriate assumptions used in determining the fair value of the



purchased assets as potential risks associated with these transactions. A lack of due diligence in the process could result in institutions being required to recognize losses shortly after inception of the transaction.

A link to the guidance, along with an asset exchange example can be found [here](#). This document provides risk management considerations banks should assess before entering into such transactions.

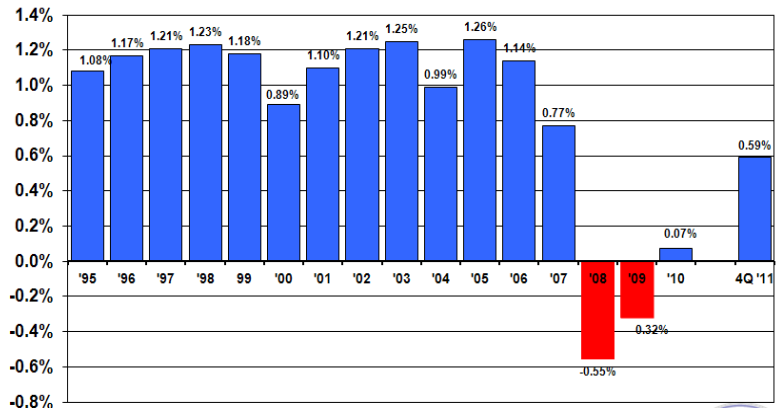
Social Media

The growth of social media has altered Internet usage and fostered new models of communication and collaboration. Social media is defined as a group of internet-based applications that allow the creation and exchange of user-generated content. With the exponential growth in the use of social media, the level of information technology risk to both business and consumers increases. Inherent risks of social media include information leakage, disinformation, exposure to malware and viruses, and social engineering. Failure to implement proper controls and safeguards can result in reputational damage, adverse legal action, identity theft, and compromised device security. Banks are encouraged to partially mitigate such risks through ensuring antivirus and anti-malware software is installed and up to date. Other examples of sound risk management practices to combat social media risk include developing and implementing training and awareness programs, and regularly monitoring the bank Web site. As a reminder, banks should remain cognizant of the importance of only broadcasting public information through social media delivery channels.

District Earnings Trends

Banks in the 7th District have seen some modest improvement in earnings over the past year as asset quality continues to improve, resulting in lower loan loss provisions. However, aggregate earnings at banks in the District are still far below pre-crisis levels. Aggregate loan volumes in the District stayed practically unchanged from prior quarters as new lending opportunities remain a challenge due to weak demand and increasing market competition.

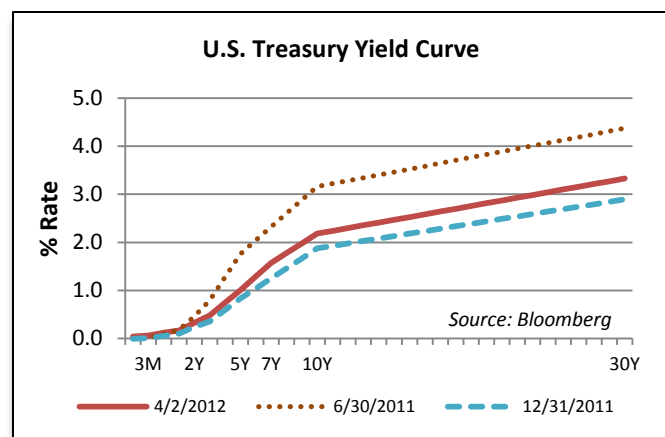
Earnings District ROAA



Meager loan growth remains a concern for District banks as firms have reported to supervisory staff that market competition is increasing and firms are contending with aggressive pricing. Anecdotally, commercial and industrial (C&I) deals have experienced increased price competition; changing deal structures; some stretching of advance rates; and increased exceptions to policy. Firms are reminded that prudent risk management and loan underwriting standards should be in place to assess the changing market and associated risks.

Balance Sheet Strategies in the Current Environment

7th District banks have experienced strong non-maturity deposit growth since 2008, yet the current lending and interest rate environments challenges banks to deploy these funds profitably. Bankers' views on the timing and magnitude of interest rate movements remain mixed, and have led them to consider a number of potential strategies that may either mitigate exposure to rising rates or add incremental risk to a bank's profile to enhance earnings today. The Federal Open Markets Committee has signaled the target Federal Funds rate will likely remain exceptionally low through mid-2014; however, banks remain exposed to changes in the shape of the yield curve and basis risk in the near term.



A bank's board of directors and senior management should understand bank strategies and measure, monitor, and control changing risk profiles. Risk management systems and pricing tools should capture the cash flow volatility of any new products added to the balance sheet. In today's rate environment, 7th

district banks should remain mindful of risk strategies and products that fit within an institution's overall risk tolerance and be well understood by management prior to execution.

2012 Comprehensive Capital Analysis and Review (CCAR)

During Q1 2012, the Federal Reserve released a paper describing the methodology used in the stress test of the CCAR exercise. A link to this methodology can be found [here](#) on the Federal Reserve Board of Governors web site. Summary results of the annual CCAR exercise are also available on the Federal Reserve public [web site](#).