



## Risk Perspectives

### Highlights of Risk Monitoring in the Seventh District – 2nd 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.

#### **TAG Expiration**

The Transaction Account Guarantee (“TAG”) program is scheduled to sunset December 31, 2012 unless Congress takes action. The TAG program was originally implemented by the FDIC during the financial crisis and was later modified and incorporated into the Dodd-Frank Act, Section 343. The program provides unlimited deposit insurance for all non-interest bearing transactional accounts (DDA, NOW) with all banks automatically included as there is no opt-in requirements like with the original FDIC program. While the largest banks have the most significant volume of TAG accounts, both in terms of absolute dollars and as a percent of assets, the expiry of this program should be a topic of management discussion for all institutions. TAG related deposit volumes have increased notably at institutions of all sizes and deposit insurance is often an important contributor to deposit stability. Bank management should be taking steps to ensure that they are aware of the volume of TAG accounts in their institutions. Further, they should have plans to address potential deposit attrition due to insurance levels for non-interest bearing transactional accounts reverting to \$250,000. Bank management is encouraged to identify the number and dollar amount of accounts currently covered under TAG; conduct analysis on those accounts to determine “stickiness;” and be prepared to replace any lost deposits with alternative funding if needed. Once analysis has been conducted to help determine likelihood of the account remaining with the institution, management should incorporate this analysis into their cash flow scenarios and their contingency funding plan stress tests.

#### **Money Market Funds Reform Proposals**

SEC Chairperson Shapiro announced a lack of majority support from the SEC Commissioners for the proposed Money Market Fund (MMF) reforms. These reforms were to reduce high systemic risk posed by potential investor runs triggered by destabilized net asset values (NAVs). This issue has been highlighted by the Dodd-Frank provision which eliminates the possibility of governmental support to MMF's in such a crisis. The proposed, now sidelined, reforms included imposing 1-5% capital requirements coupled with 3-5% “holdback” restrictions on investor redemptions was met with strongest industry pushback. For now, the MMF industry has successfully argued that enhanced May 2010 SEC 2a-7 rules governing MMFs effectively mitigate broken buck systemic risk. Furthermore,

adoption of reforms would jeopardize the financial viability of continued MMF sponsorship, pose higher capital costs and/or on balance sheet exposure to financial firm sponsors and ultimately result in higher credit costs to a plethora of government and private debt issuers. However, Chairman Shapiro argues that other policy makers must act to reduce systemic risk. Her statement reflects the new Dodd-Frank landscape; "there is no "back-up plan" in place if we experience another run on money market funds because money market funds effectively are operating without a net." The FSOC has the tools to bring reform across both non-bank and bank MMF sponsors.

FSOC (July report) and certain FRBs as well have weighed in on the financial stability concerns posed by the MMF broken buck risk. The NY FRB Economic Policy area recently issued a discussion paper that considers a similar MMF investor holdback reform proposal, and the Boston FRB Risk and Policy just issued a whitepaper discussing at least 21 MMFs that would have broken the buck without direct fund sponsor support provided during 2007-2011 and underscoring the point that MMF exposure to credit risk may be masked by actual or perceived fund sponsor support. The OCC's final adoption of enhanced Regulation 9 rules governing non-publicly offered MMFs (e.g. short term investment funds offered only to fiduciary clients) is also pending, which largely mirror the May 2010 SEC 2a7 rules, and consistent with FSOC directives to harmonize agency rules.

With the above as backdrop, a number of Seventh District banks' MMF complexes are challenged by continuing post-crisis net outflows (particularly prime MMFs) as investors struggle to balance risk and reward with low interest rates in favor of the above noted TAG safety net offered by bank deposits. Additionally, MMF fee waivers are mounting as fund sponsors insulate investors from negative yields and some mid-tier players are exiting the business. In the wake of the European Central Bank's reducing interest paid on deposits to 0%, previously higher yielding (versus U.S.) European MMFs are now impacted by prospective and actual negative yields, and several have closed their funds to new investors to preserve yield to existing clients.

Bank balance sheets and funding profiles have generally benefitted from MMF client concerns regarding the current U.S. economic environment and fluctuating European counterparty exposure, as well as the MMF reform debate. Alternatively, MMFs could see inflows when the TAG program sunsets, if the Fed discontinues paying 25 basis points on interest on excess reserves, or if banks begin charging for the use of their balance sheets.

Institutions with significant MMF activities should demonstrate their ability to stress test MMF exposures in compliance with SEC rules and supervisory expectations. Stress tests for short duration funds should include interest rates, liquidity, credit downgrades and defaults. Results of these stress tests should be directed to capital and liquidity risk management.

### **Data Leak Prevention**

Data Leak Prevention (DLP) should be on the top of mind for all institutions as DLP is not just an IT problem, but a business strategy and security problem. Data leaks can be characterized as the intentional or unintentional disclosure of information to non-trusted environments. This can include hacking, malware, inappropriate use of social media, theft of devices and loss of removable storage.

The risks to institutions include operational, legal, and reputation risk, all of which can result in significant financial loss.

The average cost to remediate data leak exposures was \$7.2 million in 2010. Internal breaches are prevalent and include such sources as errant emails and improper access controls including a specific example reflecting a job transfer where shared drive access was not updated. Incidents are trending upward. Also, breaches are not always detected right away, some taking years to surface, and records are often not recovered.

The steps for improving controls include developing an inventory, classifying the information, and then risk-assessing points of leakage at rest and in motion. Then, controls should be identified and tested periodically.

An information security program should be documented and should address the protection of all sensitive information with regular updates to risk assessments and controls through continuous monitoring. Training and security awareness programs should be implemented to address the human element.

### **Home Equity Lines of Credit (HELOCs)**

Many home equity lines of credit were originated at the height of the real estate bubble. HELOC maturity is expected to peak between 2014 and 2017 for the largest banks. With the significant decline in home values, along with continued high unemployment and other economic strains, these maturing HELOCs could result in increased credit risk at many institutions. It's important for institutions to be aware of the maturity distribution of their HELOC portfolio to better understand the risks of these portfolios.

There are some HELOC renewal practices that financial institutions should avoid due to the increased risk of future defaults and losses. These practices include not receiving new appraisals or income verification on current lines, renewing loans without following appropriate underwriting guidelines, obtaining appraisals, but making no substantive changes to credit terms despite changes in LTV, and rolling maturing loans into one-year interest only terms. HELOC renewals and conversions should be treated as new loans, and underwritten accordingly. Prudent underwriting practices for HELOC renewals include obtaining a new appraisal, new credit report, and income verification, as well as rewriting the notes to current guidelines and getting appropriate approval for any exceptions to policy. Additionally, periodic account analysis should be performed including re-scoring of accounts, updating credit bureaus, and collecting updated financial information on borrowers. If a HELOC is in a negative equity situation, management may want to consider converting it to an amortizing loan.

Converting a HELOC to an amortizing loan, forcing a large pay down, or dividing the loan into two pieces – revolver and amortizing, are some examples of ways institutions can reduce the risk of future defaults and losses. When structuring these renewal terms, management will want to consider the impact of a payment shock to the borrower, as even without a change in interest rates, the inclusion of principal will often more than double the monthly payments.

Banks should also be cognizant of appropriately classifying TDRs in consideration of borrower financial difficulties, or any concessions granted, and ensure to report High LTV lending and exceptions to the board on all renewals.