RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 1st Q 2013

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 for the Seventh District and its supervised financial institutions. This 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.

Supervisory Guidance

The Federal Reserve Board of Governors periodically releases Supervision and Regulation Letters, commonly known as SR Letters, which address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. The following SR letters were released in fourth quarter 2012, and a complete listing of SR Letters is available on the Federal Reserve Board's website:

SR 13-8 / CA 13-5	Extension of the Use of Indicative Ratings for Savings and Loan Holding Companies
SR 13-7 / CA 13-4	State Member Bank Branching Considerations
SR 13-6 / CA 13-3	Supervisory Practices Regarding Banking Organizations and their Borrowers and Other Customers Affected by a Major Disaster or Emergency
SR 13-5	Revisions to the Required Data Fields for the Interagency Loan Data Request
SR 13-4	Advanced Approaches Risk-Based Capital Rule Examination Guidance on the Board's Public Website
SR 13-3	Interagency Guidance on Leveraged Lending
SR 13-1 / CA 13-1	Supplemental Policy Statement on the Internal Audit Function and its Outsourcing

Current Risk Topics

New Product Development

The current yield curve may incent financial institutions to implement non-traditional strategies to increase profitability. Financial institutions that are looking to increase interest income through increased risk exposure or expansion into new products should also consider both the near and longer term financial risks of those decisions. Taking on additional credit or interest rate risk can lead to higher yield today but may also increase an institution's risk exposure. Additional risk factors such as the possibility of an illiquid market or increased price volatility should be considered when developing these types of strategies.

Higher potential yields can be obtained by investing on the long end of the yield curve, but this comes at the risk of decreased fixed income values if selected interest rates rise. Likewise, reaching further down the credit curve could increase potential yield, but deterioration in credit quality or market liquidity could lead to increased financial losses.

In addition to searching for asset yield, financial institutions may look to maintain their current low cost of funds. While most financial institutions are flush with short term deposits, the current interest rate environment can create challenges in attracting long term funding. To bridge the gap between supply and demand, financial institutions may offer new products such as those linked to market indices or structured products to attract long term funding. While these strategies may maintain the current cost of funds, the non-traditional nature of innovative products can lead to additional risk. The funding stability of new products may differ from traditional deposits depending on the structure of the funding. For products tied to a market indicator, negative changes to the underlying index could create incentives for depositors to withdraw their funds early. Depending on the size of the position, an early or quick withdrawal of funds could impact an institution's liquidity position. For those products that rely on third parties to service the product or participate in the risk transfer, there is also the potential for counterparty credit risk if the third party defaults on its obligation. Innovative products can introduce additional risk that should be identified and well understood as part of the product development process.

Institutions that have new products on either side of the balance sheet should develop a new product development process to help identify and manage potential new risk. This process should align new product offerings with the strategic direction and overall risk tolerance of the institution. Along with perceived benefits, incorporating additional risk and risk management strategies can help strengthen a new product development process and provide management with a strong understanding of how new products might complement the overall bank strategy.

Credit Risk – Agricultural Lending Update

The outlook for agricultural producers for 2013 remains challenging. Lingering drought conditions persist across Midwestern states which will likely influence 2013 production and industry profitability. While conditions are approaching nearly normal for Indiana, Michigan and Illinois, both Wisconsin and Iowa remain challenged. The above average precipitation during the period of March through April could bring welcome relief for all but the western half of Iowa. However, timely precipitation will be required throughout the growing season in order to produce "normal" grain crop yields given the depleted topsoil and subsoil conditions. Additionally, while grain prices and futures prices have moderated from last fall, livestock and dairy producers continue to remain under stress due to high feed costs.

There are several positive factors for agriculture producers. Crop insurance coverage equated to 85% of grain production in 2012. Industry insiders predict similar, if not greater, coverage for grain producers in 2013 and more producers to select the fall price option.

For those farmers that did file crop insurance claims in 2012, insurance checks often protected them from losses, and in some cases, resulted in above average income for those farmers that elected the fall pricing option. For farmers with good yields, the higher grain prices actually resulted in record profits.

High and/or rising land values continue to be noted in the Midwest. However, until commodity prices decline and/or interest rates rise, industry insiders do not anticipate that land values will decline any time soon.

Financial institutions are encouraged to proactively work with affected borrowers, per SR Letter 12-13, FFIEC Statement on the Impact of Drought Conditions on Financial Institutions. Specifically, this guidance encourages bankers to expedite lending decisions, extend and/or restructure as necessary, ease credit terms and/or waive loan fees, and consider Farm Service Agency and Small Business Administration loan guarantee programs, as appropriate, while observing safe and sound credit practices. While credit rating downgrades and/or classifications of individual credits will occur, efforts to prudently modify loans that help agricultural borrowers recover financially is being supported by all federal banking regulatory authorities.

Ability to Repay and Qualified Mortgages – CFPB Rule Issuance January 2013

The Consumer Financial Protection Bureau (CFPB) issued several new mortgage related rules in January 2013, one of which was the Ability to Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z). The CFPB also issued revised final rules in May 2013. These new rules are effective January 2014 and will impact the way financial institutions conduct business and the way mortgage markets operate. A brief summary of the rules is highlighted below, but please refer to the CFPB rule (the “Rule”) for details.

Ability to Repay (ATR):

Under the ATR general option, the creditor must make a reasonable and good faith determination that the consumer will have a reasonable ability to repay the loan according to its terms. To make this determination a creditor must consider at least the following eight underwriting factors:

- Current or reasonably expected income or assets
- The consumer’s current employment status
- The monthly payment on the loan
- The monthly payment on any “simultaneous loan”
- Monthly payments for mortgage related obligations
- Current debt obligations, alimony and child support
- Monthly debt-to-income or residual income
- Credit History

Qualified Mortgages (QM):

The Qualified Mortgages are broken down into three categories.

QM General Features - 3 Requirements

- Limits on Loan Features
- Points and Fees Cap
- Underwriting Requirements - 43% DTI

QM Temporary Alternative - 3 Requirements

- Limits on Loan Features
- Points and Fees Cap
- Underwriting Requirements - Eligible for purchase by federal agencies

QM Small Creditor

- Applicable to creditors with $2 Billion or less and 500 or less first lien loan originations.
- Originations must be held in portfolio for 3 years
- Two year transitional period does not require creditor to be in rural or underserved areas.
- If above criteria are met, loans are not subject to 43% DTI.

For loans that meet the QM definition, the Rule provides two degrees of protection against liability for violating it, depending on whether the QM is a "higher-priced covered transaction."

<u>First degree of protection - Safe Harbor:</u>

The purpose of safe harbor is to create an additional legal protection for the creditor to defend a claim. A borrower could not claim that the bank did not make a reasonable or good faith determination of the borrower's repayment ability if the bank proves that it has satisfied all the qualified mortgage requirements. Consumers can still legally challenge their lender under this rule if they believe that the loan does not meet the definition of QM.

<u>Second degree of protection - Rebuttable Presumption:</u>

Under this option, the loan would be presumed to comply with the Rule; however, a borrower could rebut the presumption by showing that the creditor did not make a reasonable and good faith determination of the consumer's repayment ability. In this case, the consumer must show that the monthly payment would leave the consumer with insufficient residual income or assets other than the secured property with which to meet living expenses.