



RISK PERSPECTIVES

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

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 SR Letters were released in the second quarter of 2014. A complete listing of SR Letters is [available](#) on the Federal Reserve Board's website.

[SR 14-5/CA 14-4](#)

Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods

[SR 14-4](#)

Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Banking Organizations with \$10-\$50 Billion in Total Consolidated Assets

Proposal to Modify Regulations for Capital Planning and Stress Testing

On June 12, 2014, the Federal Reserve Board released a [proposal](#) to modify the regulations for capital planning and stress testing that would shift the start date of the capital plan and stress test cycles from October 1 of a given calendar year to January 1 of the following calendar year. Under the proposed rule, a bank holding company with total consolidated assets of \$50 billion or more would be required to submit its capital plan and stress test results to the Federal Reserve by April 5, three months later than under the current rulemakings.

A bank holding company with total consolidated assets of more than \$10 billion but less than \$50 billion would be required to submit its stress test results to the Federal Reserve by July 31. Savings and loan holding companies and state member banks subject to the stress tests under the Dodd-Frank Wall Street Reform and Consumer Protection Act also would be required to submit their results several months later than under the current rules. The proposed rule would make the new schedule effective beginning with the 2015-2016 capital plan and stress test cycles. For the upcoming 2014-2015 capital plan cycle, the schedule would be unchanged from prior years.

The proposed rule includes a number of further measures to alter the capital planning and stress test

processes. For example, it proposes to modify the capital plan rule to limit a large bank holding company's ability to make capital distributions to the extent that its actual capital issuances were less than the amount indicated in its capital plan. It also clarifies the application of the capital plan rule to apply to a large bank holding company that is a subsidiary of a U.S. intermediate holding company of a foreign banking organization and make other technical, clarifying changes.

Dodd-Frank Act Stress Testing for \$10-\$50 Billion Companies

On October 9, 2012, the US Federal banking agencies issued the [final rules](#) for Dodd-Frank Act Stress Testing (DFAST). These rules required companies with more than \$10 billion of total consolidated assets to conduct annual company-run stress tests. On March 6, 2014, final supervisory guidance related to DFAST ([SR 14-3](#)) was released for companies with more than \$10 billion but less than \$50 billion in total consolidated assets. SR 14-3 confirms that these \$10-\$50 billion companies are not subject to the Federal Reserve's: Capital Plan Rule, annual Comprehensive Capital Analysis and Review (CCAR), Supervisory Stress Tests, or the FR Y-14 related data collections. However, the final guidance highlights that \$10-\$50 billion companies are required to conduct first DFAST tests based 3rd quarter data with a 9-quarter horizon.

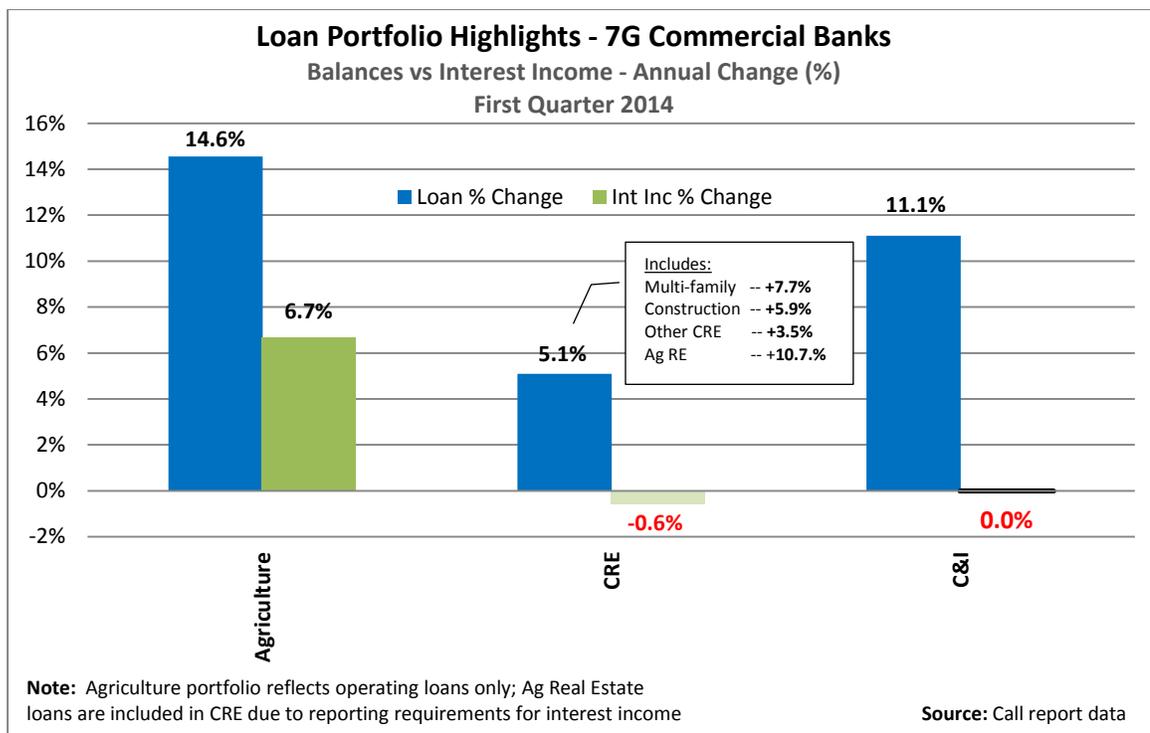
There are 43 Bank Holding Companies and 11 State Member Banks that were subject to DFAST at the onset of the exercise in the fall of 2013, and the first DFAST submissions were filed March 31, 2014. However, the \$10-\$50 billion companies are not required to publish results until the 2015 cycle. This streamlined, less granular exercise consists of general principles to evaluate a company's ability to conduct satisfactory tests from a qualitative standpoint. There are no requirements of firms in this scope to meet minimum ratios and there is no formal supervisory approval of results. As a reminder, specific requirements of DFAST and capital stress testing do not apply to banks or bank holding companies with total assets less than \$10 billion.

Current Risk Topics

District Bank Performance – Core Earnings Weaken

First quarter 2014 earnings at commercial banks located in the Seventh District demonstrated how low interest rates garnered from loan portfolios continue to put pressure on net interest income and ultimately earnings performance. Almost half of the approximately 1,000 banks in the District experienced a year-over-year decline in one or more of the following income statement categories: net income, interest income from loans, and so-called "core earnings," or pre-provision net revenue. Pressure on revenues was especially noted for both Commercial & Industrial (C&I) and Commercial Real Estate (CRE), which historically have been two key profit centers for banks in the District.

According to call report data, C&I loan balances grew 11.1% on an annual basis in the first quarter, as shown in the Loan Portfolio Highlights graph below, even as interest income collected from those portfolios was exactly flat (0.0% growth). Among CRE loans, District average balances increased 5.1% while CRE actual interest income for the District fell 0.6%. Lower interest income was a key factor in pushing pre-provision net revenues to about 1.2% of average assets, its lowest level since the beginning of financial crisis



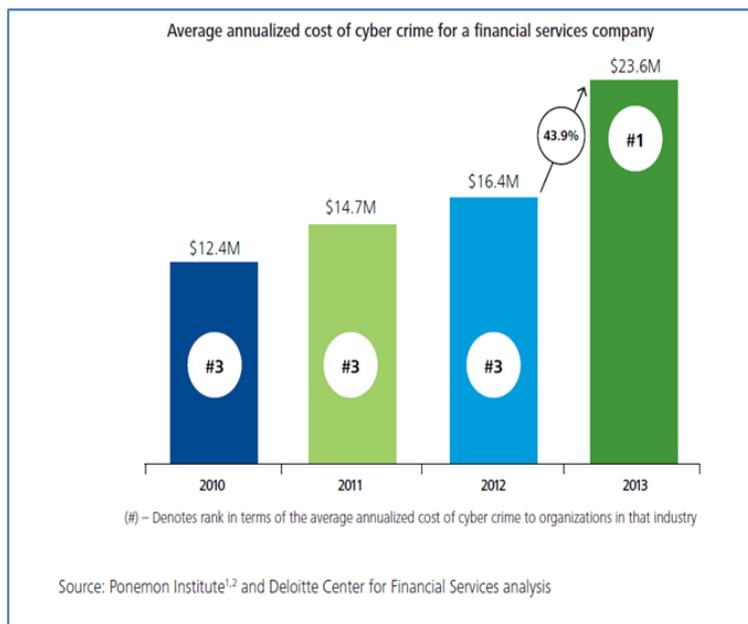
recovery.

Bank performance in the first quarter 2014 held some promising signs for District banks, including signs that widening demand for credit is appearing in some loan segments that were previously struggling from negative growth. While C&I loan balances were among the first credit classes to rebound in the wake of the recession, CRE and Agriculture loans have only recently gained momentum. The 5.1% growth in CRE balances drew on increases from all three major CRE sub-categories: Multi-family, Construction & Development and Nonfarm Nonresidential. In the case of agriculture lending, balances rose 14.6% on an annual basis due largely to District crop producers' efforts to manage a sharp decline in commodity prices that began in 2013. The first quarter's encouraging signs for bankers also included a noticeable uptick in mergers and acquisitions activities and, in some cases, highly competitive bidding.

In summary, first quarter 2014 results reflected some of the improving economic conditions that bankers and their customers alike have been waiting for since the financial crisis. But quarterly earnings continue to lack a rebound in loan yields, which is typically a feature of broad-based recoveries.

Cybersecurity Update

Financial institutions are increasingly dependent on information technology and telecommunications to deliver services to consumers and businesses despite the risk of cyber threats such activity poses. Examples of cyber threats include, but are not limited to, malware, corporate ACH takeovers, distributed denial of services attacks, and data leakage. Disruption, degradation, or unauthorized access to systems and data that support these services can affect critical business processes and undermine confidence in the nation's financial services sector. The overall impact can be illustrated in the significant escalation of cost that firms are spending to address these risks.



The figure to the left further represents the magnitude of the risk currently facing financial firms with no end in sight.

Numerous initiatives have been launched to raise awareness and improve cybersecurity risk management practices. In February 2014, the National Institute of Standards and Technology (NIST) released the [Framework for Improving Critical Infrastructure Cybersecurity Version 1.0](#). The framework was a result of President Obama's [Executive Order 13636](#) which called for a voluntary, risk-based Cybersecurity Framework on a set of existing standards, guidelines and practices

to help organizations manage cybersecurity related risks. While the concepts are not necessarily new, the framework provides an organized approach and common language for the industry and organizations of various size and complexity to address and manage cyber risk in a cost-effective way based on business needs. The framework focuses on five functions (i.e. identify, protect, detect, respond and recover) that allow organizations to understand and shape its cybersecurity program. NIST also released a [Roadmap document](#) to accompany the framework. The roadmap document lays out a path toward future framework versions and ways to identify and address key areas for cybersecurity development, alignment and collaboration.

The Federal Financial Institutions Examination Council (FFIEC) is also taking a number of steps to raise the awareness of financial institutions and their critical third-party service providers with respect to cybersecurity. In June 2013, the FFIEC established the Cybersecurity and Critical Infrastructure Working Group (CCIWG). The CCIWG has been collaborating with intelligence, law enforcement, Homeland Security, and industry officials to make sure member agencies have accurate and timely threat information to assist institutions in protecting themselves and their customers from the growing risk posed by cyber threats. These activities are part of a broad FFIEC cybersecurity awareness initiative that covers institutions of all sizes and complexity. In addition, FFIEC members are piloting a cybersecurity assessment program for federal and state banking regulators to assess the vulnerability of institutions and service providers to cyber threats and their preparedness to react to and effectively defend against cyber risks. The cybersecurity assessment builds upon key aspects of existing supervisory expectations addressed in the FFIEC IT Handbooks and other regulatory guidance.

The cybersecurity assessment will help the FFIEC member agencies make risk-informed decisions to identify and prioritize actions to enhance the effectiveness of cybersecurity-related supervisory programs, guidance and examiner training. It will also be beneficial in identifying actions that can strengthen institutions' overall

level of preparedness and ability to address the evolving and increasing cyber threats. It is important to note that the pilot assessment does not impose new expectations for institutions, nor will it result in any new examination ratings.

Given the ever increasing use of and dependency on technology, cyber risks will continue to be a significant issue for the foreseeable future. With that, efforts to provide structures to address cyber risks, awareness programs to highlight the exposures, and effective sharing of information in the industry will help in defending against the various threats that are on the horizon.

More information about the Cybersecurity Framework development process from NIST can be found on the NIST Cybersecurity Framework [website](#).

Challenges with Providing Banking Services to Marijuana Related Businesses

Numerous states have enacted laws regarding the decriminalization and legalization of marijuana and/or marijuana related businesses. Given the developments in state laws with regards to marijuana and the expansion of the legalized marijuana industry, a dichotomy now exists between state and federal law, as marijuana remains illegal under federal law.

On August 29, 2013, the Deputy Attorney General James Cole announced that the Department of Justice (DOJ) would not challenge various States' legalization efforts. In addition, the DOJ issued the [Cole Memo](#) which stipulates eight priorities law enforcement should consider when determining whether or not to take action against marijuana-related businesses.

The Financial Crimes Enforcement Network released guidance [FIN-2014-G001](#) on February 14, 2014 which clarifies how financial institutions may provide services to marijuana related businesses consistent with their Bank Secrecy Act obligations. This guidance provides three main takeaways on how financial institutions might manage prospective relationships with marijuana related businesses:

1. Financial Institutions must conduct customer due diligence to consider whether a marijuana-related business violates one of the Cole Memo priorities or State law.
2. Financial Institutions must file Suspicious Activity Reports using new and specific identifying language on all marijuana related businesses.
3. Financial institutions must report currency transactions in connection with marijuana-related businesses the same as they would in any other context, consistent with existing regulations and with the same thresholds that apply. Marijuana-related businesses are not eligible for consideration for an exemption with respect to a bank's CTR obligations under [§1020.315 \(b\)\(6\)](#).