RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 2015 Issue No. 1

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 current themes for supervised financial institutions in the Seventh District. 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 within the last two quarters of 2014. A complete listing of SR Letters is available on the Federal Reserve Board's website.

SR 14-10	Release of the 2014 Federal Financial Institutions Examination Council's Bank Secrecy Act/Anti-Money Laundering Examination Manual
SR 14-9	Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program
SR 14-8	Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies
SR 14-7	Loan Coverage Requirements for Safety and Soundness Examinations of Community Banks
SR 14-6	Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

Final Rule to Implement Section 622 of the Dodd-Frank Act

On November 5, 2014, the Federal Reserve Board issued a final rule to implement section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which generally prohibits a financial company from combining with another company if the ratio of the resulting company's liabilities exceeds 10 percent of the aggregate consolidated liabilities of all financial companies.

Under the final rule, if a financial company has reached the 10 percent concentration limit, the company could not acquire control of another company under merchant banking authority. The final rule also adds an exemption to clarify that a financial company may continue to engage in securitization activities if it has reached the limit.

Financial companies subject to the limit include insured depository institutions, bank holding companies, savings and loan holding companies, foreign banking organizations, companies that control insured depository institutions, and nonbank financial companies designated by the Financial Stability Oversight Council for Board supervision.

Final Amendment to Regulation HH and Payment System Risk Policy

On October 28, 2014, the Federal Reserve Board issued a final rule that amends the Regulation HH risk-management standards for financial market utilities that have been designated as systemically important by the Financial Stability Oversight Council and for which the Board has standard-setting authority pursuant to Title VIII of the Dodd-Frank Act. The Board also announced final revisions to part I of the Federal Reserve Policy on Payment System Risk, which is applicable to financial market infrastructures more generally, including those operated by the Federal Reserve Banks.

Key amendments to the rule and revisions to the policy include establishing separate standards to address credit risk and liquidity risk, new requirements on recovery and orderly wind-down planning, a new standard on general business risk, a new standard on tiered participation arrangements, and heightened requirements on transparency and disclosure.

Institutions subject to the rule are expected to be in compliance with the requirements as of December 31, 2014, which is the effective date of the final rule. Later compliance dates apply to several new or heightened requirements as explained in the Federal Register notices.

Final Risk Retention Rule

On October 22, 2014, federal supervisory agencies approved the final Risk Retention Rule requiring sponsors of securitization transactions to retain risk in those transactions. This final rule implements the risk retention requirements in the Dodd-Frank Act.

The final rule largely retains the risk retention framework contained in the proposal issued by the agencies in August 2013 and generally requires sponsors of asset-backed securities (ABS) to retain not less than five percent of the credit risk of assets collateralizing ABS issuance. The rule also sets forth prohibitions on transferring or hedging credit risk that the sponsor is required to retain.

As required by the Dodd-Frank Act, the final rule defines a "qualified residential mortgage" (QRM) and exempts securitizations of QRMs from the risk retention requirement. The final rule aligns the QRM definition with that of a qualified mortgage as defined by the Consumer Financial Protection Bureau. Under the final rule, the agencies are given specific review cycles and are allowed to request a review of the QRM definition at any time. The final rule also does not require any retention for securitizations of commercial loans, commercial mortgages, or automobile loans if they meet specific standards for high quality underwriting.

The effective date of the rule is one year after publication in the Federal Register, which occurred on

December 24, 2014, for residential mortgage-backed securitizations and two years after publication for all other securitization types.

Final Rule to Modify Regulations for Capital Planning and Stress Testing

On October 17, 2014, the Federal Reserve Board issued a final rule to modify the regulations for capital planning and stress testing and released instructions for the 2015 capital planning cycle.

The final rule adjusts the due date for bank holding companies (BHCs) with total consolidated assets of $50 billion or more to submit their capital plans and stress test results. For the 2015 capital plan cycle, these BHCs were required to submit capital plans on or before January 5, 2015, unchanged from prior years. For subsequent cycles, beginning in 2016, participating BHCs will be required to submit their capital plans and stress testing results to the Federal Reserve on or before April 5. In addition to the timing change, the final rule includes modifications and clarifications to the existing capital plans and stress test rules.

Liquidity Coverage Ratio Finalized

On September 3, 2014, federal banking regulators finalized the Liquidity Coverage Ratio. The Liquidity Coverage Rule will create a standardized minimum liquidity requirement for large and internationally active banking organizations. Each institution will be required to hold high quality, liquid assets (HQLA) such as central bank reserves and government and corporate debt that can be converted easily and quickly into cash in an amount equal to or greater than its projected cash outflows minus its projected cash inflows during a 30-day stress period. The ratio of the firm's liquid assets to its projected net cash outflow is its liquidity coverage ratio, or LCR.

The LCR will apply to all banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure and to these banking organizations' subsidiary depository institutions that have assets of $10 billion or more. The rule will also apply a less stringent, modified LCR to BHCs and savings and loan holding companies that do not meet these thresholds, but have $50 billion or more in total assets. BHCs and savings and loan holding companies with substantial insurance or commercial operations are not covered by the final rule.

The rule is generally consistent with the Basel Committee's LCR standard, but is more stringent in certain areas, including a shorter transition period for implementation. The accelerated transition period reflects a desire to maintain the improved liquidity positions that U.S. institutions have established since the financial crisis, in part as a result of supervisory oversight by U.S. bank regulators. U.S. firms will be required to be fully compliant with the rule by January 1, 2017.

Guidance for Home Equity Lines of Credit Nearing their End-of-Draw Periods

Federal agencies and the Conference of State Bank Supervisors (CSBS) issued guidance to financial institutions regarding home equity lines of credit (HELOCs) nearing their "end-of-draw" periods, which occurs when the principal amount of the HELOC must begin to be repaid. The HELOC guidance encourages financial institutions to effectively communicate with borrowers about the pending reset and provides broad principles for managing risk as HELOCs reach their end-of-draw periods.

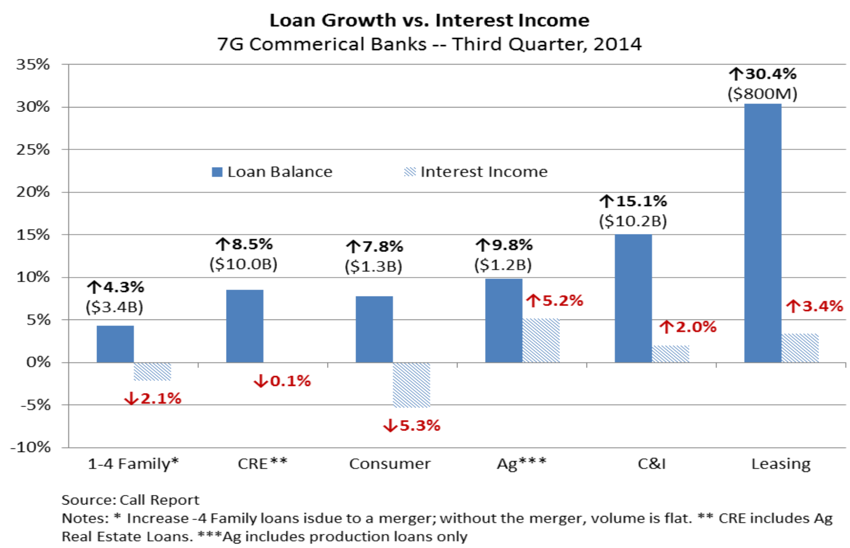
The agencies and CSBS recognize that financial institutions and borrowers may face challenges as HELOCs near their end-of-draw periods. Many borrowers will continue to meet their contractual obligations when their loan resets to an amortizing payment or reaches a balloon maturity. However, some may find it difficult to make higher payments or to refinance their existing loans due to changes in their financial circumstances or declines in property values.

The guidance describes how financial institutions can effectively manage their potential exposures under these circumstances. This includes an emphasis on thoroughly understanding potential exposures as well as consistent, effective responses to HELOC borrowers unable to meet their contractual obligations. The appropriate accounting and reporting procedures for HELOCs nearing their end-of-draw periods are also discussed.

Current Risk Topics

Q3 2014 District Bank Performance

Seventh District banks continued to report record profits during the third quarter on a dollar volume basis, driven by improvements in interest income and cost of funds. Over half (57%) of commercial banks located in the District reported increased interest income compared to the same period a year ago, and Seventh District banks also outperformed the U.S. in annual interest income growth.[1]



Despite accelerating loan growth at Seventh District banks during the third quarter, loan yields remain depressed for all key loan categories (see graph), reflecting competitive pricing pressure and the low interest rate environment. While commercial and industrial (C&I) and commercial real estate (CRE) loan balances grew 15.1% and 8.4% on an annual basis during the third quarter, respectively, interest income for these categories was close to flat. Banks are adding loans at a very quick pace, but only appear to be breaking even in incremental dollar volume of interest they collect.

Over three-quarters (76%) of commercial banks in the District reported annual growth in total loan balances during the third quarter. Construction loans increased 15.1% percent on an annual basis, which is significant

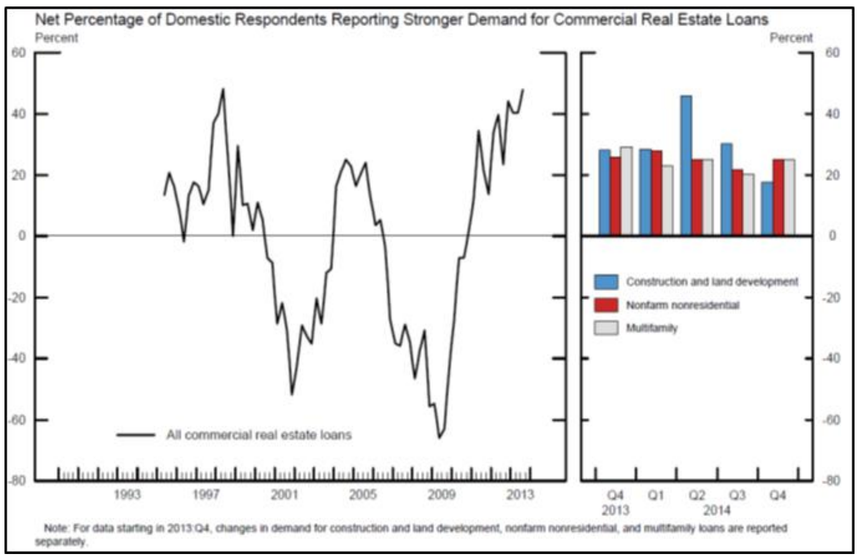
[1] Seventh District institutions reported a 1.8% annual increase in interest income. U.S. banks in aggregate experienced 0.4% annual growth in interest income.

because this has been one of the slowest sectors to recover after the financial crisis. Auto loans (8% increase) drove the increase in consumer loans as banks continue to pursue this sector. Finally, Ag loans rose about 10% after a record high projected harvest of corn and soybeans led to a 50% drop in crop prices since June 2013, translating to higher loan demand and lower repayment rates among grain producers.

Q4 2014 Earnings Predictions

Analysts are not as optimistic about expected fourth quarter earnings. Pressure on net interest margin is expected to continue as rates remain at historical lows. Plunging oil prices may cause a rise in defaults and a slowdown in lending to the energy sector. Although some Seventh District banks serve the energy sector, the aggregate impact that falling oil prices will have on Seventh District banks remains to be determined.

Commercial Real Estate (CRE)



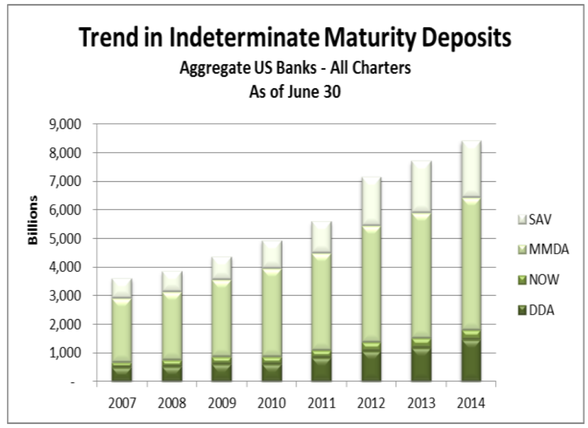
Despite continued strong fundamentals in multifamily markets – including the persistence of low vacancy rates – institutions should monitor the apartment sector's growing construction pipeline. Supply increases may result in rising vacancy rates and limit the ability of landlords to increase rents. Liquidity has been ample in this sector as banks as well as private investors see the strong conditions since 2009 as an opportunity to grow portfolios. Some perceive risk to be low because homeownership rates continue to struggle.

Most of the growth in multifamily lending portfolios over the last 18 months has been within the banking sector, as GSE and mortgage backed securities portfolios have been stable or declined. Industry participants indicate that strong fundamentals across CRE sectors combined with historically low interest rates have resulted in institutions looking to grow portfolios at a strong pace. Lack of significant new construction during the past several years has led most to believe that this sector may provide growth opportunities. The October 2014 FRB: Senior Loan Officer Opinion Survey on Bank Lending Practices indicates banks eased standards on construction and land development loans, while standards for nonfarm nonresidential and loans secured by multifamily residential properties remained unchanged. On the demand side, modest net fractions of banks reported stronger demand for all three categories of commercial real estate.

As financial institutions continue to seek new CRE originations, there remains a critical need for sound underwriting and stress testing practices to address the downside risk embedded within individual transactions and broader loan portfolios. Sound underwriting should include an analysis of the adequacy of borrower equity contributions as well as the ability and willingness of the guarantor to support credits in time of need. Controls around growth plans should be thoroughly vetted, including thresholds and parameters that would signal an increase in downside risk.

Deposit Modeling - Update

In the years subsequent to the financial crisis, indeterminate maturity deposit levels at financial institutions have grown substantially as depositors have sought the relative safety and liquidity offered by FDIC insured accounts. There are divergent opinions as to what may happen to these balances when interest rates begin to normalize back to historical levels. Bank managers should understand the potential impact to both the net interest margin and the economic value of equity of an organization to deposit product migration and/or deposit disintermediation associated with rising interest rates.



The banking industry typically quantifies the potential earnings and valuation risks from changing interest rate scenarios by using interest rate risk (IRR) models. These models require repricing and maturity assumptions for indeterminate maturity deposits – among other products – under each modeled interest rate scenario. Given that indeterminate maturity deposits – for example, DDAs, MMDAs and savings accounts – do not have contractual maturities or indexed rates, their attrition and repricing assumptions can be more challenging to model from an IRR perspective. Behavioral characteristics drive deposit run-off and repricing, and that behavior varies considerably across different interest rate scenarios.

As interest rates rise, higher yielding deposits – for example, time certificates of deposits – may become increasingly attractive to the depositor. Bank managers who do not accurately capture the potential migration or disintermediation of lower-cost indeterminate maturity deposits to higher-cost products, or do not accurately estimate the higher repricing beta necessary to retain the indeterminate maturity balance, may underestimate the potential risk to earnings and economic valuation posed by a rise in rates. Robust deposit data collection and account segmentation may help to facilitate the quantitative development of these IRR model assumptions.

Given that indeterminate maturity deposits often comprise a material portion of the balance sheet, a relatively small error in assumptions could lead to large mis-estimation of risk. Strong IRR management programs will include sensitivity testing of model assumptions to help bank managers understand the potential dollar impact if an assumption used within IRR models is inaccurate. Strong sensitivity testing regimes include all major assumptions and apply meaningful stressed scenarios to measure such impacts.

Money Market Reform Impact

On July 23, 2014, the Securities and Exchange Commission (SEC) issued their final amendments governing publicly offered Money Market Mutual Funds (MMFs). These amendments were spurred by the Financial Stability Oversight Council encouragement of the SEC to implement a second round[2] of rules designed to mitigate perceived high-priority short-term wholesale systemic funding risk posed by destabilizing MMF

[2] The SEC issued the first round risk migrating rules in May 2010 which implemented required stress testing and more stringent credit and liquidity restrictions on MMFs.

investor runs. A two-year countdown is now underway for both MMFs' financial firm sponsors and governing boards to make operational, legal, accounting, investment and product changes. MMF investors will have to weigh cash management and liquidity options before the October 14, 2016 effective date. These final amendments will have a significant impact on the liquidity interplay between MMFs and bank balance sheets over the next two years. Financial firm impact will likely be felt on several fronts, not the least of which is those firms serving as sponsors of/investment managers for MMFs.[3] Fiduciary firms will to recalibrate their prudent selection of cash management investment options and many firms will need to monitor their capital and liquidity coverage ratios for negative impacts from a migration of MMF investors seeking safer alternatives in bank balance sheets. An overview of the Final SEC Rules is provided in Exhibit 1 (Source: Fidelity MMF Rule Reforms, Market Perspectives).

EXHIBIT 1: Overview of Final 2014 SEC Rules

Fund Type	Net Asset Value (NAV)	Liquidity Fee	Redemption Gate
U.S. Treasury	Stable	No	No
Government	Stable	No	No
Retail Municipal/Tax-Exempt	Stable	**Yes**	**Yes**
Retail Prime/General Purpose	Stable	**Yes**	**Yes**
Institutional Municipal/Tax-Exempt	**Floating**	**Yes**	**Yes**
Institutional Prime/General Purpose	**Floating**	**Yes**	**Yes**

Money Market Mutual Fund Reform	Final Rule	Implementation Date
Floating NAV	Applicable funds will price and transact at a net asset value per share that can change, or "float," based on pricing the underlying fund holdings out to four decimal places ($1.0000)	**October 14, 2016**
Liquidity Fee	If a fund's weekly liquid assets were to fall below 30%, fund's board may impose a 2% fee on redemptions If a fund's weekly liquid assets were to fall below 10%, redemptions will be subject to a 1% fee, unless fund's board determines otherwise	**October 14, 2016**
Redemption Gate	If a fund's weekly liquid assets were to fall below 30%, fund's board may suspend redemptions for up to 10 days	**October 14, 2016**
Retail Fund Definition	Retail funds limit shareholders to beneficial ownership by "natural persons" (individuals) Institutional funds are open to any shareholders, including individuals, small businesses, and large corporations	**October 14, 2016**

Fundamentally, the final rules alter the MMF landscape by removing the amortized cost methodology (ACM) option from all prime and tax-free institutional[4] MMFs and requiring them to "float" their share prices/Net Asset Value (NAV) to four decimal points. All retail and governmental MMFs can continue to utilize the ACM and strike their share prices at $1 NAV. Governing boards for all non-government MMFs will now have the option of imposing gates and/or liquidity fees for proscribed times and amounts if weekly liquidity thresholds are breached. In short, qualifying Governmental MMFs[5] are investors' only option after October 2016 for a $1 NAV MMF without also incurring gate/liquidity fee impediments upon exiting the fund.

Market conditions since the crisis have proven especially vexing for a consolidating MMF industry. MMF fees have been waived in ever increasing amounts in order to preserve $1NAV for clients, while MMFs are faced with an ever dwindling supply of eligible investments. The recent and temporary launch of the Federal Reserve's overnight Reverse Repo Program (RRP) has provided welcome yield and supply as many yield-starved MMFs have bid up to eligible caps on these repo offerings. The Federal Reserve continues to weigh the impact of the RRP on short-term funding markets and whether it might serve as an effective additional tool for executing monetary policy.

3 Federal Reserve regulates 14 ($1.3Tr in assets) of the largest 25 MMFs ($2.4Tr assets) from a holding company sponsor perspective or 54% of the total assets of the top 25 MMFs.

4 Prime MMFs are the riskiest type of the 3 types of MMFs because of their investments in non-government, unsecured commercial paper issuer debt; institutional MMFs are distinguished from retail MMFs under the new rules by virtue of the latter defined as those having "natural person" investors, e.g. social security numbers issued to underlying investor

5 Government MMFs under new amendments would be required to hold more than 99.5% of their holdings in governmental securities including cash, US Treasuries and securities issued by US federal agencies or debt backed by US debt. Notably, for this purpose, government securities do not include securities issued by state or city governments -- the assets held by most tax-exempt money market funds.