



# RISK PERSPECTIVES

## Highlights of Risk Monitoring in the Seventh District – 1<sup>st</sup> Q 2011

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

#### Municipal Finances

State finances are making headline news, and the \$2.8 trillion Muni Fund industry experienced volatile markets with fourth quarter market price declines, higher yields and record outflows going into 2011. Industry analysts are mixed in their forecasts of the performance of municipal debt. Financial institutions should ensure that they are aware of their exposure and are employing

appropriate risk management practices, including pre-purchase analysis and on-going monitoring for credit, market, liquidity and other risks. Institutions can be exposed to the municipal market in a variety of ways, including ownership of investment securities, municipal deposits, variable rate demand notes sponsorship and support, sponsored mutual funds, asset management products, and lines of credit or direct loans to municipalities. Institutions can also be indirectly exposed to municipalities if their loan customers rely heavily upon a state or local municipality for a large portion of their revenue stream.

Seventh District State Budget Shortfalls			
	2010	Proj. 2011	Proj. 2012
Illinois	\$14.3 B	\$13.5 B	\$15 B
Indiana	\$1.4 B	\$1.3 B	\$270 M
Iowa	\$1.3 B	\$1.1 B	\$294 M
Michigan	\$3.3 B	\$2 B	\$1.8 B
Wisconsin	\$3.2 B	\$3.4 B	\$1.8 B

- **Credit Risk** – Financial institutions may be exposed to credit risk through their holding of investment securities, support of variable rate demand notes, and lines of credit or loans to municipalities.
- **Market/ Liquidity Risk** – Deterioration in credit quality (real or perceived) may impact the marketability and liquidity value of municipal investment securities. Further, bankers need to be aware of contingent liabilities associated with support of Variable Rate Demand Notes (VRDN) or other lines of credit.
- **Fiduciary Risk** - Firms holding managed municipal mutual funds (MMF) that are 2a-7 MMF funds may face potential break-the-buck risk to a firms' capital.

## Residential Real Estate

The residential real estate market continues to show considerable strain. Housing markets remain weak, prices continue to ease, and Other Real Estate Owned (OREO) levels and shadow inventories are expected to dampen housing markets through 2011. In addition, strategic defaults and a substantial volume of delinquent first mortgages coupled with performing second mortgages place additional strain on residential portfolios and may result in elevated losses on poorly monitored residential mortgage portfolios. Lastly, a significant portion of both the district's as well as the nation's borrowers are underwater.

## Asset Management and OREO Practices

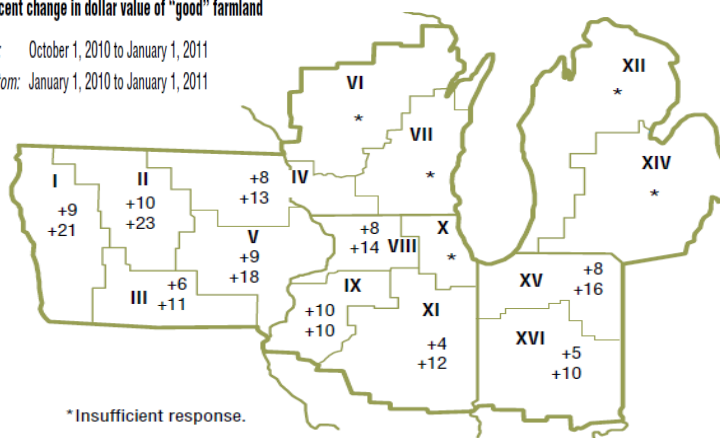
Banks' exposure to elevated volumes of OREO remains a concern here in the Seventh District as well as system-wide. Despite continual marketing efforts, price reductions and even available financing, OREO volumes remain elevated. Foreclosed construction properties remain the single largest contributor to OREO levels in the Seventh District, representing 50% of the total. OREO presents several risks to banks, including: 1) elevated levels of nonearning assets, 2) upfront and ongoing maintenance costs, 3) extended marketing times and potential for fraud from nominee purchases, and 4) subsequent flipping of properties. Strong OREO management and disposition strategies include, among others, formal written policies and strategies that govern the investment, management, maintenance, leasing, marketing, and ultimately sale of OREO assets, as well as OREO aging reports, periodic refreshing of asset valuations to ensure appropriate market pricing, and monitoring of property conditions through an OREO condition report.

## Agricultural Real Estate

Percent change in dollar value of "good" farmland

Top: October 1, 2010 to January 1, 2011

Bottom: January 1, 2010 to January 1, 2011



The recent, and in some cases, large increases in agricultural real estate prices, especially in traditional agriculturally reliant areas of the Seventh District, have supervisors, bankers, and even Reserve Bank presidents increasingly cognizant of the potential for inflated valuations. Kansas City Reserve Bank President Thomas Hoenig noted, in an interview with Bloomberg on 17 February 2011, that the farmland boom may be an

“unsustainable bubble.” A confluence of factors are impacting land prices, including large increases in

agricultural commodity prices, an influx of new non-agrarian investors (including hedge funds), and historically low borrower interest rates. Institutions are exposed to a potential decline in agricultural land values in a number of ways, including increased leverage when purchasing agricultural land tracts and cash flow difficulties arising from excessive leverage brought on by increased borrowing availability.

### **ALLL Trends and Proposal by the FASB and IASB**

Coverage ratios are one indication of adequacy of reserve levels. Supervisors in the Seventh District noticed a moderate increasing trend in the median ALLL coverage of total loans as well as coverage of nonperforming loans. As loan portfolios stabilize for some Seventh District institutions, these institutions may feel they can release some reserves. Examiners will be monitoring the release of reserves, broadly defined as a reduction in provision levels, for appropriateness.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a loan impairment proposal for comment on January 31. The proposal moves U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) from an incurred loss to an expected loss model that would utilize more forward-looking data to estimate credit losses. The impact of the proposed standard would be to recognize loan losses earlier than under the current model based on management's estimate of expected future credit losses. A revised expected loss approach for estimating credit loss would require institutions to revise ALLL estimation processes and increase ALLL levels.

### **Managing Data Integrity through the use of Spreadsheets**

Financial institutions utilize user developed applications (UDAs) such as spreadsheets to support critical decision making processes, and financial and regulatory reporting requirements. Some examples of critical spreadsheets may be those used for board reporting, to calculate allowance for loan loss reserves, income and condition statements, yield analysis and stress testing and other modeling tools that project potential conditions based on changing assumptions and variables. Activities for critical spreadsheets such as data input, development of formulas, creating data linkages, changes, testing and backup may rely on and be controlled by the local administrator of the spreadsheet and may not be subject to formal access, integrity and availability policies, procedures and controls.

The potential business risk of possible financial condition misstatements or erroneous assumptions in decision making models warrants a closer look at the controls in place to mitigate those risks. As with many information systems risk management processes, the first step in managing the population is to identify the current inventory and risk rank that population according to its criticality. Next, based on risk, the population should be subject to testing/validation and controls should be in place to secure and maintain the integrity of the spreadsheets. Lastly, a formal framework and repeatable process should be implemented to ensure ongoing integrity and control.

## Potential Risk Topics On the Horizon...

**Risk Retention - The Agencies** (OCC, FRB, FDIC, SEC, FHFA, and HUD) issued on March 29 a notice of proposed rules (comment period until June 10) to implement the credit risk retention requirement set forth in the Dodd-Frank Act. The proposed rule requires securitizers of residential mortgages to retain at least five percent of the credit risk of the collateralized assets. The Agencies believe that the new credit risk retention requirements will help address the weaknesses and failures of the mortgage securitization process and markets, by providing incentives for firms to monitor and ensure the quality of mortgage assets. The requirements will also help align the interests of the financial institutions with investors.

### **Supervisory Guidance on Model Risk Management – SR 11-7**

On April 4, 2011 the Federal Reserve Board released SR Letter 11-7, which provides supervisory guidance on model risk management. SR 11-7 discusses model risk management with respect to model development, implementation, use, governance, policies, and controls. It also provides guidance on model validation, including expectations for vendor or third-party models and guidance relating to back testing and sensitivity testing.

A complete listing of SR Letters released is [available](#) on Federal Reserve Board's website.