Risk Perspectives

Highlights of Risk Monitoring in the Seventh District – 4th Q 2011

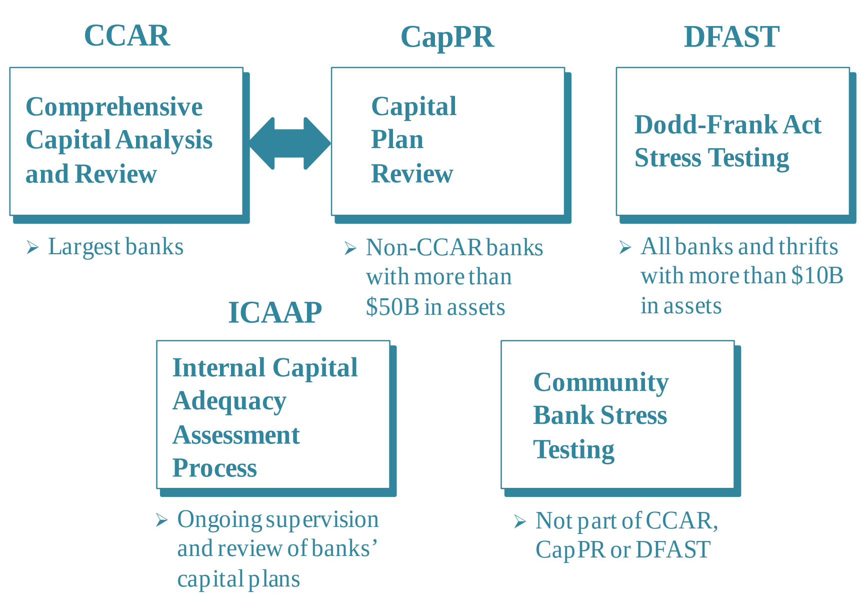
The Federal Reserve Bank of Chicago (Seventh District) Supervision group follows current and emerging risk trends on an on-going basis. This Risk Perspectives newsletter is designed to highlight a few current risk topics and some potential risk topics on the horizon for the Seventh District and its supervised 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

Making Heads or Tails of Capital Stress Testing

Since the enactment of the Dodd-Frank Act in mid-2010, there has been a tremendous amount of attention paid to capital stress testing. Although the concept behind capital stress testing is relatively simple, its formal implementation can range from basic to very complex, leading to confusion among industry observers and participants about what stress testing means and how it may affect them. At its core, capital stress testing attempts to quantify the impact on a financial institution given adverse conditions. Those conditions could include macroeconomic factors such as changes in GDP or the national unemployment rate, or a sharp decline in the stock market. They could also include more regional events, such as the loss of a major local business. Stress elements can be even more specific to an individual institution, such as changes in the company's net interest margin or the impact on loan growth of the departure of a key lending team.

The exercise of stress testing involves converting assumptions such as the negative circumstances mentioned above into a quantifiable estimated impact on a banking institution. The advantage of analyzing capital through stress testing versus traditional capital ratio analyses is its prospective nature. Stress testing looks into the future in an attempt to capture outcomes that are difficult to envision with a static capital calculation. The thought process behind stress testing can be just



as important as the outcome, since a robust process will better identify emerging risks.

There are a multitude of stress testing methods being used by banks, both within and outside of the regulatory framework. The ones displayed on the preceding page are supervisory processes that are reviewed by the Federal Reserve. The Comprehensive Capital Analysis and Review (CCAR) applies to nineteen of the nation's largest banks, and is a formalized process requiring a detailed capital plan and the submission of data. These firms were asked to submit their plans by January 9, 2012, and evaluation by the Federal Reserve will be the basis for approving or rejecting certain requested capital actions. The Capital Plan Review (CapPR) is very similar to CCAR, but applies to a group of twelve banks with more than $50 billion in assets that are not part of the CCAR exercise. The timetable for CapPR coincides with that of CCAR, and as with CCAR, capital plans submitted by participant banks will be used to determine whether requested capital actions will be approved.

Perhaps the highest profile method, Dodd-Frank Act Stress Testing (DFAST), has yet to fully take shape and is not currently being implemented. The rules under DFAST are still being written; with the current expectation initial stress tests under the DFAST mandate will take place using data as of September 30, 2012. DFAST applies to banks with more than $10 billion in assets, thus a larger group than the CCAR and CapPR exercises.

It is important to note that there is no expectation for community banks to implement CCAR- or CapPR-like programs, and DFAST requirements do not apply to small community banks less than $10 billion in assets. These programs all apply only to larger institutions. There are, however, elements of stress testing in the Federal Reserve's guidance applicable to all banks in certain areas, such as commercial real estate concentrations, liquidity, and interest rate risk. Stress testing can be a useful way for any bank to identify and quantify the effects of emerging risks.

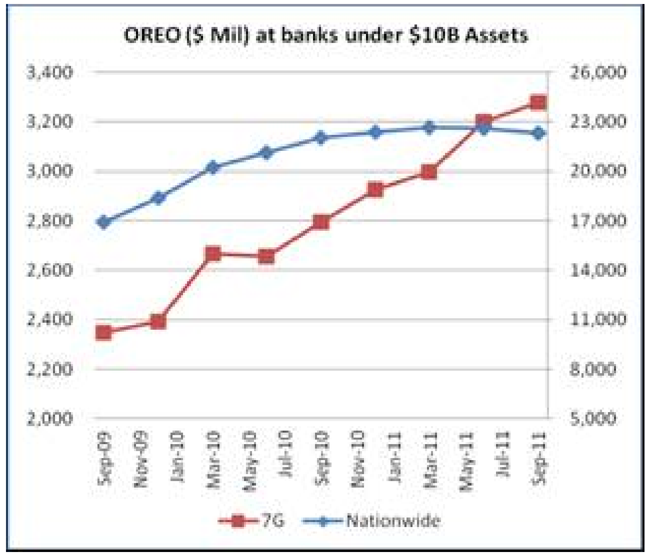
The field of stress testing is a constantly evolving one. For large banks, the Supervisory Capital Assessment Program (SCAP) in 2009 laid the foundation CCAR and CapPR. In the case of DFAST, our final rules will reflect the latest thinking by regulators on the discipline of stress testing.

Commercial Real Estate Trends

Bifurcation of the CRE market remains constant. High quality assets are trading at pre-recession levels while other assets are finding limited liquidity, with stress in the CMBS market and at regional and community banks. Select portions of the CRE market have seen sizeable reductions in capitalization rates. However, the number of such quality CRE projects remains limited and highly competitive. The majority of Commercial Real Estate (CRE) spreads are widening with respect to the 10 year Treasury rate. Capitalization rates may be elevated due to investor caution, as industry analysts contend limited Net Operating Income (NOI) growth in the first few years command higher rates today to compensate for this risk. Prudent risk management practices are needed to ensure rent, price, and vacancy assumptions remain in line with the quality of the CRE asset as this bifurcation persists.

Other Real Estate Owned Trends

Other Real Estate Owned (OREO) portfolios at institutions under $10B in total assets have been steadily increasing in the 7th District, as shown on the graph to the right. Further, 7th District OREO levels exceed national levels in this sector of the banking industry. Unlike larger institutions, the data suggests community banks may not have the ability to utilize alternative strategies such as bulk sales to manage problem portfolios. The recently released SR 11-15 on the Disposal of Problem Assets through Exchanges is applicable to all sized institutions. Banks considering alternatives for disposing these assets are encouraged to read this guidance, which is available on the Federal Reserve Board's web site.



Servicemembers Civil Relief Act – An Escalating Consumer Compliance Risk

Formerly known as the Soldiers' and Sailors' Civil Relief Act of 1940, the Servicemembers Civil Relief Act (SCRA) was formally signed into law in 2003. Recent legal cases and increased attention from regulatory agencies has heightened consumer awareness of SCRA. As a result, compliance, legal, and reputational risk can elevate for firms lacking the risk management to properly monitor adherence with this law. SCRA provides certain benefits to covered military members, including but not limited to protection from eviction, foreclosure, and default judgment. SCRA also increases the limit of guaranteed life insurance by the federal government and reduces the interest rate on covered transactions. A number of large financial institutions recently acknowledged SCRA violations which resulted in multi-million dollar settlements and/or civil monetary penalties. These findings and overall awareness ultimately led to the creation of the Office of Servicemember Affairs within the recently formed Consumer Financial Protection Bureau. Given the potential compliance concerns associated with SCRA, financial institutions should ensure consumer compliance risk management programs are capable of identifying and abiding by the SCRA for its servicemember customers.

Step Up Bonds

Today's persistently low rate environment has caused many banks to search for additional yield in their investment purchases. One higher-yielding investment that is increasingly held by many banks is step-up bonds. Step-up bonds are a type of structured note where the coupon increases or "steps up" according to a predetermined schedule. Step-up bonds also often contain a simultaneous call option whereby the issuer is allowed to redeem the security at each coupon step-up date at no cost. This call feature creates potential uncertainty in the timing of principal payments and amount of interest received, and as a result, additional market price volatility and reinvestment risk. While community banks often invest in Agency step-up bonds, large institutions have increased their issuance of this product type. Risk management practices should consider the market risk these products can exhibit prior to purchase. A thorough review of the call risk and the market value implications from market rate increases exceeding determined step up increases are key elements to consider. Risk management systems and pricing tools should capture the cash flow volatility of these products if purchased.

FASB's Financial Instruments Project and Trends in the Allowance for Loan & Lease Losses (ALLL)

The May 2010 proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* is expected to be re-exposed in 2012. Since the initial proposal, extensive discussions have ensued surrounding classification and measurement of financial instruments, impairment of financial instruments, and hedge accounting. The FASB has distributed discussion papers on various aspects of the project and has communicated changes that are likely to appear in the re-exposed standard. Examples of changes to existing standards include the elimination of the Held-to-Maturity investment category and the addition of fair value information to be shown parenthetically on the face of the balance sheet. The recognition principle for measuring impairment is also anticipated to be impacted, moving towards a more forward looking loss recognition principle based on expected losses. As re-exposure of the standard gets closer, financial institutions need to be proactive in understanding how significantly the potential changes might impact their institution, and be poised to analyze the actual impact of the re-exposed standard once it is issued in 2012. Many good high level summaries exist today explaining the proposed changes and it is assured that those will be quickly updated once the proposal is re-exposed.

Regarding the ALLL, regulators are reporting a significant number of banks released reserves in 2011, as measured by the overall change in the ALLL. It is understood that as the credit quality of portfolios improves and delinquency and charge-off rates start to decline, changes to the ALLL will occur. Support for changes in the ALLL methodology should be well documented and should reflect the credit quality of the portfolio.

Financial Institution Fraud Outlook

With the continuing global financial crisis and lack of improvement in the real estate market, financial institution fraud will continue to be a high risk for banks. As evidenced by the increase in mortgage loan fraud Suspicious Activity Report filings, mortgage fraud continues to be a problem and the sluggish housing market will likely remain an appealing climate for fraud perpetrators. Often targeting distressed homeowners, some prevalent mortgage fraud schemes are foreclosure rescue scams, mortgage modification scams and short sale fraud. Commercial loans are also at high risk for fraud due to the slow recovery of the real estate market. Borrowers, who encounter refinancing difficulties due to outstanding loan balances higher than collateral values, may misrepresent their assets or property value to qualify for loans. Financial institutions should also be alert to insider fraud. According to the Association of Certified Fraud Examiners, employees pose the greatest fraud threat in this current economy. Budget cuts at many banks have resulted in a reduction of compliance and risk management functions creating more opportunities for fraud, as well as longer periods of time between when the fraud starts and when it is detected. Financial pressure, both personally and professionally, has also increased and can weigh into the rationalization of committing such acts.