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**

**Operational Risk Perspective**

Earlier this year, federal banking supervisors identified a prominent increase in operational risk. The risk of operational failure is embedded in every activity and product of an institution - from processing, accounting, and information systems to the implementation of credit risk management processes.

During the financial crisis, credit and liquidity risks were a central focal point for bankers. As banks have emerged from the crisis, there have been concerns expressed regarding increased operational risk levels due to the allocation of resources by banks to credit concerns and perhaps away from other areas of the bank. As stated in the Federal Reserve Board of Governors’ Supervision and Regulation Letter 95-51 entitled *Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies*, operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. Two drivers of operational risk are the complexity of an organization and the volume of new products.

Given the wide net cast by operational risk, it is increasingly difficult to identify and mitigate all of the areas that might cause an unexpected loss. Adding to that difficulty are emerging operational risk areas such as banks’ use of social media, the increasing demand for new technology and customized client solutions, as well as the increasing and emerging banking regulations that may have an operational risk impact.

As discussed in the Basel Committee on Banking Supervision’s June 2011 document *Principles for the Sound Management of Operational Risk*, it is the responsibility of the board of directors to ensure a strong operational risk management culture exists that reflects the size, complexity, and risk profile of their respective organizations. A strong operational risk framework includes the establishment of a code of conduct or ethics policy; risk appetite and tolerance statement; and risk management policy. Senior management should develop a robust governance structure; ensure the identification of operational risk
in all material products, services, activities, processes, and systems; and implement a process to monitor the operational risk profile and material exposures to loss. Institutions should develop, implement, and maintain an operational risk framework; have a strong control environment; have a well-defined business continuity plan in place; and where applicable, public disclosures should allow stakeholders to assess the bank’s approach to operational risk management.

A renewed emphasis on mitigating operational risk may help to ensure that an institution is not derailed unexpectedly as it manages through its asset quality problems.

**Consumer Compliance - Emerging Product Risk**

Several existing or new products have been identified as having the potential for significant consumer compliance risk, including Unfair or Deceptive Acts or Practices risk. Some of these risks have been outlined in recent public regulatory orders and settlements. Proactive compliance risk management including practical, comprehensive analysis of compliance risks during the new product approval process is helpful to manage the products and associated consumer compliance risks.

<table>
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<tr>
<th>EMERGING CONSUMER PRODUCTS</th>
<th>Pre-Paid, Reloadable Cards</th>
<th>Deposit Advance Lending Products</th>
<th>Credit Card Add-On Products</th>
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<tr>
<td><strong>General purpose reloadable pre-paid cards are an emerging product for many banking institutions.</strong></td>
<td>The Deposit Advance product offered by several institutions allows checking account customers to borrow against anticipated direct deposits for short term, small dollar amount loans.</td>
<td>Several institutions have offered credit card add-on products, such as credit monitoring or payment protection.</td>
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<td><strong>Primary risks associated with the product</strong></td>
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<td>Misleading marketing such as claims that the card will assist in rebuilding credit</td>
<td>Provides a very expensive form of credit as fees are charged per dollar increment</td>
<td>Fees for services not rendered or inability to activate</td>
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<td>Cost relative to traditional accounts</td>
<td>Steering risk for both UDAP, ECOA</td>
<td>No opt-out process</td>
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<td>Potential lack of full disclosure of terms and cost</td>
<td>No evaluation of repayment ability, can generate a cycle of debt</td>
<td>Inability to cancel the add-on product</td>
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<td>May target vulnerable populations (i.e. students, individuals with poor credit, lower income, public aid recipients)</td>
<td>Product features including balloon payments and frequent roll-overs may target vulnerable populations (i.e. public aid recipients, financially vulnerable)</td>
<td>Selling tactics, such as push marketing or targeting ineligible consumers (i.e. disabled or unemployed)</td>
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<td>Excessive fees</td>
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<td>Steering risk for vulnerable populations (lower FICO, financially less sophisticated)</td>
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<td>Potential lack of Regulation E protections</td>
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<tr>
<td>Not FDIC insured</td>
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Some key risks that should be addressed in compliance risk management programs include the following: disclosures (Are costs and fees clearly disclosed to customers?); marketing (How are target customers identified? Are alternative or less costly products/solutions solicited?); controls (Are there consumer complaints? Who uses the product?); and product features (Are terms fully explained? What factors are considered when determining customer eligibility?).

**Agriculture Conditions**

The 2012 drought that has plagued 60% of the continental U.S. has created stressed conditions for grain, livestock and dairy producers. The drought has resulted in declining grain yield projections and
increasing grain prices that have driven up the cost to feed livestock. Aggravating conditions, burnt pastures forced livestock producers to purchase silage and hay, driving up alternative feed prices and tightening supplies. Producers are making strategic decisions on future herd size in the face of higher costs to limit losses and restore profitability.

It is noted that U.S. farmers are generally in their strongest financial position in history, buoyed by less debt (record lows), record-high grain and land prices, plus greater production and exports. In 2011, U.S. farm income totaled $98.1 billion, a record high – even with significant crop and pasture losses in Texas and other states. The financial condition of the 387 Seventh District agricultural banks is relatively strong with returns on average assets in excess of 1%, Tier 1 capital ratios nearing 10% and noncurrent loans averaging 1.25%.

Although the level of participation in crop insurance for 2012 is not yet known, 84% of eligible land was covered by crop insurance in 2011 thus protecting many grain producers. Industry experts believe that insurance coverage for 2012 will be similar to 2011, if not higher following the 2011 Texas drought. Livestock and dairy producers are not covered by current Farm Bill program disaster assistance. However, the House and Senate are each working to craft emergency drought assistance bills, which would further mitigate potential exposures.

While the crop insurance industry will likely suffer losses this year, it has been 10 years since the last loss event. The U.S. Department of Agriculture’s Risk Management Agency (RMA) via The Federal Crop Insurance Corporation, reinsures a group of private insurance companies, known as Approved Insurance Providers (AIPs), who sell Multiple Peril Crop Insurance (MPCI) authorized under the Federal Crop Insurance Act. MPCI is written by the RMA. If an AIP fails, all claims are fully backed by the federal government. RMA guarantees and fully backs each federal crop insurance claim, and each year stress tests are conducted for every AIP to assess whether they have the financial reserves to meet 400% of the potential loss on their crop insurance book of business. Each firm passed the July 1, 2012 stress test.

Bankers should monitor their agri-business borrowers for stressed financial conditions and take appropriate actions. Strategic planning for 2013 is critical to properly address risks posed by possible troubled farm borrowers. Bankers may refer the Federal Reserve Board of Governors’ Supervision and Regulation Letter 11-14 entitled Supervisory Expectations for Risk Management of Agricultural Credit Risk for additional guidance.

Swap Clearing Rules

One result of the financial crisis was that the G20 member countries committed to mandate clearing of standardized over-the-counter (OTC) derivative contracts. In the U.S., under the Dodd-Frank Act, the Commodities Futures Trading Commission (CFTC) is primarily responsible for promulgating regulations for the mandatory clearing of swaps through central counterparties. These requirements are quickly approaching and are likely to be phased in starting early next year.

Mandatory clearing will not apply to a swap if one of the counterparties is not a financial entity, is using swaps to hedge or mitigate commercial risk, and notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps. Once the regulations take effect, it will be illegal for an entity to engage in a mandated swap unless that swap
is “cleared” (swap is submitted for clearing to a registered derivatives clearing organization) or one of the parties is able to claim the promulgated “end-user exemption.”

While several of the largest banking institutions already clear swaps among each other, swaps among many more institutions will need to move into clearing. For many banking institutions not among the largest, the new clearing requirements will require substantial changes and efforts to clear swaps (and the largest banking institutions have challenges to clear swaps with all their customers). These changes will result in new liquidity, operational, credit and compliance risk for financial institutions. Of special note for liquidity risk, estimates from the Bank of International Settlements, International Monetary Fund and many others put the total collateral required to clear swaps between a few hundred billion to over a trillion U.S. dollars.

While the U.S. has already taken these actions to implement mandatory clearing requirements, other jurisdictions are expected to implement similar mandates. If successfully implemented, these reforms are expected to reduce the systemic risk of the OTC derivatives market and the interconnectedness of its participants. However, there is likely to be both temporary and permanent differences in how these requirements are implemented. The substantial reforms to the market for OTC derivatives in the U.S. and other jurisdictions may leave many ambiguities and challenges in the near term.

Potential Risk Topics on the Horizon

**Basel III Notices of Proposed Rulemaking (NPRs)** - On June 7, 2012, the Agencies (FRB, FDIC, and OCC) jointly released three NPRs on enhancements to regulatory capital requirements for banking institutions in the U.S. The NPRs were developed to improve the resiliency of the US Banking system, increase the quantity and quality of regulatory capital, enhance risk sensitivity, address weaknesses identified over the past several years, and to address the requirements of the Dodd-Frank Act. Institutions are encouraged to review the NPRs in detail and to provide written feedback to the Agencies via the commentary period which has been extended to October 22, 2012.

The Agencies developed a regulatory capital estimation tool intended to assist in estimating the potential effects of the Basel III and Standardized Approach NPRs on an institution’s capital ratios.

**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 release in the 3rd quarter of 2012, with a complete listing of SR Letters available on Federal Reserve Board’s website:

**SR 12-12 / CA 12-11** Implementation of a New Process for Requesting Guidance from the Federal Reserve Regarding Bank and Nonbank Acquisitions and Other Proposals

**SR 12-11 / CA 12-10** Guidance on a Lender’s Decision to Discontinue Foreclosure Proceedings