



# RISK PERSPECTIVES

## Highlights of Risk Monitoring in the Seventh District – 2015 Issue No. 2

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 in 2015. A complete listing of SR Letters is [available](#) on the Federal Reserve Board's website.

<a href="#">SR 15-7</a>	Governance Structure of the Large Institution Supervision Coordinating Committee (LISCC) Supervisory Program
<a href="#">SR 15-6</a>	Interagency Frequently Asked Questions (FAQs) on the Regulatory Capital Rule
<a href="#">SR 15-5 / CA 15-2</a>	Guidance to Encourage Financial Institutions' Youth Savings Programs and Address Related Frequently Asked Questions
<a href="#">SR 15-4</a>	Tool for Calculating Capital Requirements Using the Simplified Supervisory Formula Approach
<a href="#">SR 15-3</a>	FFIEC Information Technology Examination Handbook Updates
<a href="#">SR 15-2 / CA 15-1</a>	Guidance on Private Student Loans with Graduated Repayment Terms at Origination

### Federal Reserve Releases Results of Comprehensive Capital Analysis and Review

On March 11, 2015, the Federal Reserve [announced](#) the results of the annual Comprehensive Capital Analysis and Review (CCAR). In its fifth year, CCAR evaluates the capital planning processes and capital adequacy of the largest U.S.-based bank holding companies. When considering an institution's capital plan, the Federal Reserve considers both quantitative and qualitative factors. These include, respectively, a firm's projected capital ratios under a hypothetical scenario of severe economic and financial market stress and the strength of the firm's capital planning processes.

Although, the Federal Reserve did not object to the capital plans of 28 out of 31 bank holding companies

participating in CCAR, one institution received a conditional non-objection based on qualitative grounds. In addition, the Federal Reserve objected to two firms' plans based on qualitative grounds.

U.S. firms have substantially increased their capital since the first round of stress tests led by the Federal Reserve in 2009. The common equity capital ratio--which compares high-quality capital to risk-weighted assets--of the 31 bank holding companies in the 2015 CCAR has more than doubled from 5.5 percent in the first quarter of 2009 to 12.5 percent in the fourth quarter of 2014, reflecting an increase in common equity capital of more than \$641 billion to \$1.1 trillion during the same period. The firms, collectively, are projecting that they will continue building capital from the second quarter of 2015 through the second quarter of 2016.

## Agencies Issue Final Rule on Minimum Requirements for Appraisal Management Companies

On April 30, 2015, six federal financial regulatory agencies issued a [final rule](#) that implements minimum requirements for state registration and supervision of appraisal management companies (AMCs).

An AMC is an entity that provides appraisal management services to lenders or underwriters or other principals in the secondary mortgage markets. These appraisal management services include contracting with licensed and certified appraisers to perform appraisal assignments.

The final rule implements amendments to Title XI of the Financial Institution Reform, Recovery, and Enforcement Act of 1989 made by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Under the rule, states may elect to register and supervise AMCs. The final rule does not compel a state to establish an AMC registration and supervision program, and no penalty is imposed on a state that does not establish a regulatory structure for AMCs. However, in states that have not established a regulatory structure after 36 months from the effective date of this final rule, any non-federally regulated AMC is barred by section 1124 of Title XI from providing appraisal management services for federally related transactions. A state may adopt a regulatory structure for AMCs after this 36-month period, which would lift this restriction.

Under the final rule, participating states must apply certain minimum requirements in the registration and supervision of appraisal management companies. An AMC that is a subsidiary of an insured depository institution and is regulated by a federal financial institution regulatory agency (a federally regulated AMC) must meet the same minimum requirements as state-regulated AMCs except for the requirement to register with a state.

This final rule will become effective 60 days after publication in the Federal Register. The compliance date for federally regulated AMCs is no later than 12 months from the effective date of this rule. A participating state will specify the compliance deadline for state-regulated AMCs.

## Final Rule to expand the applicability of its Small Bank Holding Company Policy Statement and also apply it to certain savings and loan holding companies

On April 9, 2015, the Federal Reserve Board issued a [final rule](#) to expand the applicability of its Small Bank Holding Company Policy Statement and also apply it to certain savings and loan holding companies.

The policy statement facilitates the transfer of ownership of small community banks and savings associations by allowing their holding companies to operate with higher levels of debt than would normally be permitted. While holding companies that qualify for the policy statement are excluded from consolidated capital requirements, their depository institution subsidiaries continue to be subject to minimum capital requirements.

The final rule raises the asset threshold of the policy statement from \$500 million to \$1 billion in total consolidated assets. It also expands the application of the policy statement to savings and loan holding companies. All firms must still meet certain qualitative requirements, including those pertaining to nonbanking activities, off-balance sheet activities, and publicly-registered debt and equity. The final rule implements a law passed by the congress in December 2014 and is effective 30 days after publication in the Federal Register.

## Federal Reserve Issues "Strategies for Improving the U.S. Payment System"

On January 26, 2015, the Federal Reserve issued "Strategies for Improving the U.S. Payment System," which presents a multi-faceted plan for collaborating with payment system stakeholders including large and small businesses, emerging payments firms, card networks, payment processors, consumers and financial institutions to enhance the speed, safety and efficiency of the U.S. payment system.

"Strategies for Improving the U.S. Payment System" communicates desired outcomes for the payment system and outlines the strategies and tactics the Federal Reserve will pursue, in collaboration with stakeholders, to help the country achieve these outcomes. The paper outlines the Federal Reserve's intent to establish a task force to identify effective approaches for implementing safe, ubiquitous, faster payment capabilities. The paper also calls for a task force to advise the Federal Reserve on reducing payment fraud and advancing the safety, security and resiliency of the payment system. Additionally, the Federal Reserve will pursue efforts to enhance payment system efficiency through work on standards, directories and business-to-business payment improvements, alongside efforts to enhance Fed-provided services for same-day automated clearing house (ACH), risk management and settlement.

"This plan reflects the contributions and commitment of thousands of payment system participants who shared their expertise and perspectives during the past 18 months," stated Esther George, president of the Federal Reserve Bank of Kansas City and a member of the Federal Reserve's Financial Services Policy Committee. "Consequently, we believe the strategies and tactics in the plan have broad support and strong prospects for success." George will serve as executive sponsor for the payment system improvement initiative, a joint effort of the Federal Reserve Banks and Board of Governors.

The Federal Reserve's strategic direction for financial services focuses on improving the end-to-end speed, safety and efficiency of the payment system. The Federal Reserve undertook an extensive 18-month research program aimed at identifying key gaps and opportunities, gaining industry and end-user

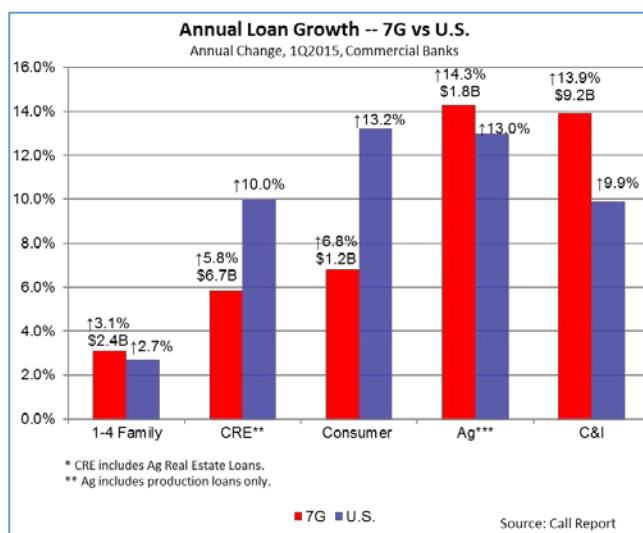
perspectives on needs and priorities and defining ways to achieve payment improvements. "Strategies for Improving the U.S. Payment System" details the conclusions of those efforts.

## Current Risk Topics

### Q1 2015 Seventh District Bank Performance Update

Seventh District first quarter 2015 Pre-provision Net Revenue (PPNR), which is often used to approximate "core" bank earnings, increased almost 10.0% annually and 5.0% from the prior quarter, the largest quarterly increase since mid-2013. This increase was largely driven by broad based increases in fee income from loan sales driven by significant refinancing and new home purchase demand arising from early 2015's historically low mortgage rates.

Loan growth remained strong during the first quarter with a 9.8% annual increase in aggregate loan volumes. The District's loan portfolio experienced broad year-over-year loan growth across most segments, most notably in the commercial and industrial (+13.9%) and agriculture production (+14.3%) segments. Although still strong, growth in commercial real estate loans, especially construction and multifamily, appears to have moderated during the first quarter in the Seventh District, raising a question whether the moderation was seasonal. Nevertheless, the favorable growth in aggregate loan balances has not translated into a corresponding increase in interest income as concerns regarding declining yields and compressed margins persist. Loan interest income increased 2.5% from the prior year.



Interest expense at commercial banks in the District declined 3.7% from the prior year, which helped offset declining yields for loans, but funding costs appear to have reached their lower bound. The declining yield and compressed margin dynamic may incentivize some organizations to enter into new products or services to garner short-term revenue.

### Enhanced Prudential Standards Update

The Enhanced Prudential Standards, requiring large banking organizations to meet certain risk management, capital, and liquidity management standards, went into effect on January 1, 2015 for large domestic institutions. Large foreign banking organizations will not be subject to the requirements until July 2016; however, they will also become subject to additional, specific requirements. Additionally, recently approved quantitative liquidity standards, known as the Liquidity Coverage Ratio (LCR), became effective for the largest financial institutions on January 1, 2015, while the remaining firms, which generally consists of firms with assets between \$50 and \$250 billion, are required to comply with a modified liquidity ratio beginning January 1, 2016.

The Enhanced Prudential Standards require large banking organizations, both domestic and foreign, to comply with enhanced liquidity risk-management standards, conduct liquidity stress tests, and hold a buffer of highly liquid assets based on projected stressed liquidity needs. These enhancements are intended to create a robust liquidity risk management framework and improve the resiliency of banking organizations and the financial system. The Enhanced Prudential Standards require large banking organizations to develop robust daily cash flow reporting systems as well as monthly stress testing. To meet the expectations of the requirements and make informed liquidity risk management decisions, many organizations will need to enhance data quality and reporting to ensure timely and accurate information is available. Technology and resource allocation appear to be common challenges facing organizations subject to liquidity requirements.

## **Cyber Security Update**

Over the past six months, cyber-threat events across various industries (e.g. insider threats, card breaches and other data breaches) continue to highlight the continuous need for firms to have a robust strategy to understand, assess and mitigate cyber security risks. The cyber security landscape is expected to continue evolving with an increase in both the volume and sophistication of attacks. Given the relatively low cost of entry and lack of severe penalties for cybercrime, it is expected that the threat will be coming from a wider range of threat actors than ever before. Therefore, it is critical that firms understand the threats posed by this evolving landscape to employ the right cyber defenses and effectively perform those controls.

In line with the continued focus on cyber security and also vendor management, the FFIEC has recently released updates to the FFIEC IT handbook with the addition of Appendix J. Appendix J discusses the four elements of Business Continuity Planning that financial institutions should address to promote the resilience of outsourced technology services. Specifically:

- *Third-party management* addresses a financial institution's responsibility to control the business continuity risks associated with its Technology Service Providers (TSPs) and their subcontractors.
- *Third-party capacity* addresses the potential impact of a significant disruption on a third-party servicer's ability to restore services to multiple clients.
- *Testing with TSPs* addresses the importance of validating business continuity plans with TSPs and provides considerations for a robust third-party testing program.
- *Cyber resilience* addresses aspects of BCP unique to disruptions caused by cyber events.

Electronic versions of the Business Continuity Planning Booklet, as well as the other FFIEC Information Technology Examination Handbook booklets, are available at <http://ithandbook.ffiec.gov/it-booklets.aspx>.

## **Current Expected Credit Loss Model Expected to be Finalized in 2015**

The Financial Accounting Standards Board has reported that their project "Accounting for Financial Instruments: Impairment" is in the "final standard" stage with an estimated completion during the fourth quarter of 2015.

FASB has stated "The FASB's proposed model would utilize a single 'expected credit loss' measurement objective for the recognition of credit losses, replacing the multiple existing impairment models in U.S. GAAP, which generally require that a loss be 'incurred' before it is recognized. Under the proposal, management would be required to estimate the cash flows that it does not expect to collect, using all

available information, including historical experience and reasonable and supportable forecasts about the future.”

Publicly the model has been referred to as CECL (see-sill), an acronym standing for Current Expected Credit Loss model. In coordinating the implementation of the CECL Model, banking regulators are working together to ensure consistency in our approach, including communication and training, as well as transition considerations and guidance.

FASB project updates, including the latest update on the CECL model can be found on the [FASB Project Update](#) site page.