RISK PERSPECTIVES

Highlights of Risk Monitoring in the Seventh District – 2015 Issue No. 3

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 since the last issue. A complete listing of SR Letters released in 2015 is available on the Federal Reserve Board's website.

SR 15-9	FFIEC Cybersecurity Assessment Tool for Chief Executive Officers and Boards of Directors
SR 15-8	Name Check Process for Domestic and International Applications

Federal Reserve approves final rule requiring systemically important U.S Bank Holding companies to further strengthen their capital positions

On July 20, 2015, the Federal Reserve approved a final rule requiring the largest, most systematically important U.S bank holding companies to further strengthen their capital positions. Under the rule, a firm that is identified as a global systemically important bank holding company, or GSIB, is required to hold additional capital to increase its resiliency in light of the greater threat it poses to the financial stability of the United States. The final rule establishes the criteria for identifying a GSIB and the methods that those firms will use to calculate a risk-based capital surcharge, which is calibrated to each firm's overall systemic risk.

"A key purpose of the capital surcharge is to require the firms themselves to bear the costs that their failure would impose on others," Chair Janet L. Yellen said in a statement. "In practice, this final rule will confront these firms with a choice: they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system. Either outcome would enhance financial stability."

Because the final rule relies on individual GSIB data that will change over time, the currently estimated surcharges may not reflect the surcharges that would apply to a GSIB when the rule becomes effective.

Agencies release statement on Dodd-Frank Act company-run Stress Tests at Medium-sized Financial Companies

On June 2nd, federal banking agencies communicated the disclosure requirements for the annual stress tests conducted by financial institutions with consolidated assets between $10 billion and $50 billion. These firms are required to conduct annual, company-run stress tests and disclose the results to the public in order to satisfy a provision of the Dodd Frank Act. The disclosure will include a description of the types of risks included in the stress test, a summary of the methodologies used. As previously iterated by Federal banking agencies, medium sized companies are not subject to stress tests conducted by the agencies or the Federal Reserve's annual Comprehensive Capital Assessment and Review (CCAR).

Federal Reserve Board issues report on the Economic Well-Being of U.S. Households

The Federal Reserve's latest survey of the financial and economic condition of American households finds that individuals' overall perceptions of financial well-being improved modestly between 2013 and 2014 and their optimism about future financial prospects increased significantly. The survey covers topics such as housing and living arrangements, banking and credit access, education and student loan debt, savings behavior, and retirement preparedness. Sixty-five percent of adult respondents considered their families to be either "doing okay" or "living comfortably" financially. However, the survey revealed a lack of economic preparedness – only 53 percent of respondents indicated that they could cover hypothetical emergency expenses costing $400 without selling something or borrowing money. The housing market outlook from surveyed homeowners remained generally positive – 43 percent believe that their house increased in value over the past year and 39 percent expect home values in their neighborhood to rise in the coming year.

Twenty-three percent of the adult population has some form of education debt; however, this debt is not exclusively student loans. Fourteen percent of those with education debt say that some of that debt is on credit cards. The survey results also suggested that many individuals are not adequately prepared for retirement. Thirty-one percent of non-retirees have no retirement savings or pension, including nearly a quarter of those older than 45. Consistent with a lack of preparedness for retirement, 38 percent of non-retired respondents say that they do not plan to retire or plan to keep working as long as possible. Among lower-income respondents, whose household income is less than $40,000 per year, 55 percent plan to keep working as long as possible or never plan to retire.

Agencies announce EGRPRA Outreach Meeting in Kansas City focusing on rural

banking issues

Federal banking agencies held an outreach meeting at the Federal Reserve Bank of Kansas City on Tuesday, August 4th as part of their regulatory review under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). The meeting focused on rural banking issues and featured panel presentations by industry participants and consumer and community groups. EGRPRA requires the federal banking agencies, along with the FFIEC, to conduct a review at least every 10 years to identify outdated regulations. The agenda included banker discussions on capital-related rules and the Community Reinvestment Act (CRA) as well as a consumer and community group discussion on related issues with respect to Federal Banking Agency Regulations. The meeting concluded with a discussion on securities, money laundering, safety and soundness, and rule of procedure regulations. An EGRPRA outreach meeting is set to take place at the Federal Reserve Bank of Chicago on October 19th.

Current Risk Topics

Commercial Real Estate (CRE)

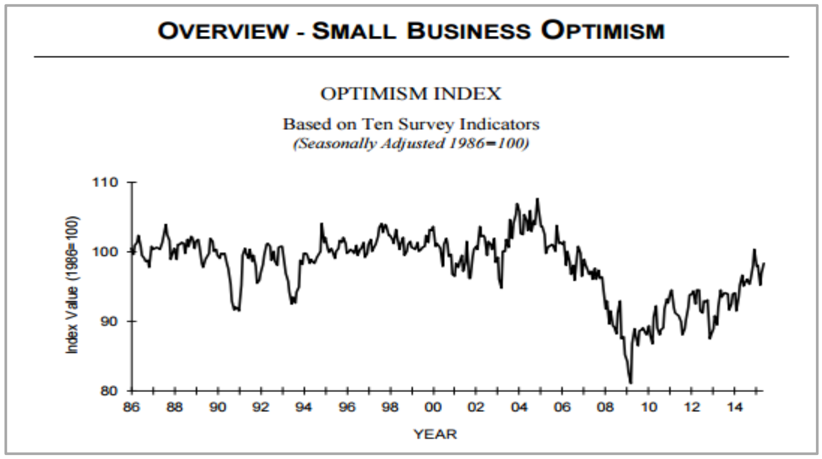
Strong market fundamentals, coupled with the abundance of capital to pursue investment opportunities have continued to fuel growth in CRE portfolios. Price indices for the four major property types (office, retail, industrial, and multifamily) have exceeded the pre-recession peaks in the major markets (Boston, Chicago, Los Angeles, San Francisco, New York, and Washington, DC) as defined by Moody's/Real Capital Analytics.

According to Real Estate Information Standards (REIS), over 160,000 apartment units were constructed in 2014, the highest number of new units since 2001. Despite record deliveries, market fundamentals remain strong and national average vacancy rate is now approaching its 20-year low of 4.0%, as reported by CBRE. Effective rent levels also remained high, and exceeded pre-recession peaks in most major markets, indicating continued strength in demand. The supply of apartments is expected to continue to grow with 213,000 units slated for completion by the end of 2015.

According to the April 2015 Senior Loan Officer Survey, demand for CRE loans, including multifamily, are increasing at the same time that banks are loosening underwriting standards. Continued sustained strength in the CRE market combined with increased competition reported by banks may lead to conditions where portfolios may become increasingly less resilient to downturns in the CRE sector.

Commercial & Industrial (C&I) Lending

Corporate borrowers are acting upon positive signs in the US economy. Small Business' outlook on the U.S. economy is on the rise. The National Federation of Independent Business's (NFIB) Index of Small Business Optimism in May hit 98.3, which is finally into normal range after having spent the last 6 years post credit crisis below the average of 98. Loan growth has been solid ahead of the expected Federal Reserve interest rate moves in the second half of 2015. C&I loans are being underwritten to tight pricing and loose terms in a competitive lending environment (both from banks and other financial companies). Terms may be stabilizing as the April 2015 Senior Loan Officer Opinion Survey reported little change to bank lending standards. The 7th District benefits from the relative lack of exposure to the hard hit energy sector as credit performance has continued to be strong outside of energy.



In the leveraged loan space, the supply-demand imbalance in the leveraged loan market continued through the first quarter. This puts downward pressure on leverage loan spreads and sets the stage for potential further loosening of covenants and other loan stipulations. The efficacy of recent leveraged loan guidance and supervisory efforts will be tested. Exogenous factors persist (China, Greece, and Puerto Rico), but there has been limited effect on the US economy so far.

Chicago's Debt Downgrade

Headlines have drawn much attention to issuers of municipal debt in the Chicagoland area. Specifically the City of Chicago was downgraded to junk bond status by Moody's Investor Services in May of this year. Moody's viewed an Illinois Supreme Court ruling against legislation aimed at reforming state pension benefits as having negative implications for the city, in light of the city's large and growing unfunded pension obligations.

Chicago, like the State of Illinois and other municipalities, has committed to providing pensions to city employees. However, despite meeting statutory requirements (set by Illinois legislature), the city's contributions and current position remains a large unfunded portion that will likely need to be made up eventually. Statutory changes made to address the unfunded status are set to soon take hold requiring a significant increase in pension contributions. In fact, Chicago's pension contributions were expected to increase from about \$480 million in 2014 to about \$1.05 billion in 2015, according to the city of Chicago's 2014 Annual Financial Analysis.[1]

As the City's credit ratings have declined, comparisons and fears that Chicago might follow a similar path to Detroit and other communities into bankruptcy have emerged. There are some key tax base and bankruptcy differences, however, between Chicago and Detroit.

From a financial institution aspect, there are a few things to consider:

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[1] https://www.cityofchicago.org/content/dam/city/depts/obm/supp_info/2015Budget/AFA_2014_Final_web.pdf

- Direct exposure can come in the form of credit risk associated with municipal securities or loans to the City or related entities (e.g. Chicago Public Schools), or in the form of liquidity risk associated with deposits from these municipalities.
- For financial institutions lending in Chicago, consider the potential tax increases and their impact on real estate lending and leasing. A significant rise in property taxes can effect property valuations, as well as borrower cash flows and profitability.
- Also for bank lending, property tax increases could reduce the pace of new business as other markets may look more economical.

Other Illinois or Chicago-area municipalities not in the headlines may also be in a weak financial condition, particularly those that rely on state funding (given the state of Illinois' financial condition) or a common tax base that may already be constrained in its ability to absorb further tax increases. For example, the City of Chicago, Chicago City School District and Cook County share much of the same tax base.

Cyber Insurance

With the increase in cyber related incidents including nation-state sponsored attacks against the financial sector, cyber insurance has become a more attractive option for financial institutions looking to mitigate their potential cyber related exposures. Cyber insurance policies are designed to cover both first party loss (e.g., data breach management, business interruption, response and remediation, cyber extortion, etc.) and third party loss (e.g., litigation damages, identity theft/credit enrollments, etc.). Cyber insurance policies typically indemnify for losses resulting from both external hackers and insider threats, and are triggered by a cyber event and/or litigation. Premiums associated with cyber insurance typically are in the range of $20,000 - $35,000 for every $1 million in coverage. Historically, institutions have relied upon business disruption and electronic crime insurance to help mitigate and offset cyber related risks. In today's heightened cyber aware environment, insurance companies have crafted specific cyber exclusions into these traditional insurance products, and the current judicial landscape has consistently found cyber exclusions to be enforceable.

U.S. Migrates to EMV Chip Card and Prepares for October 1, 2015 Counterfeit Card Liability Shift

After a record breaking year for data breaches and increases in credit card fraud, the United States is moving away from magnetic strip technology and migrating to EMV (Europay, Mastercard, and Visa) chip cards. By generating a unique, one-time code for every transaction, EMV chip technology will protect consumers and reduce card-present fraud by making it much more difficult for fraudsters to counterfeit cards.

Currently card issuers are liable for all card-present fraud, which has proven very costly considering some of the large-scale breaches (i.e. Target, Home Depot, T.J. Maxx). However, come October 2015, card-present fraud liability will shift to the party that has not adopted EMV chip technology. This means that if a chip card is used at a magnetic strip-only card reader and the transaction is fraudulent, the merchant will now be liable. There are some exceptions, as liability for automated fuel dispensers and ATM transactions will not shift until October 2017. For more information on the fraud liability shift go to Understanding the 2015 U.S. Fraud Liability Shifts published by the EMV Migration Forum and Smart Card Alliance.

The October 2015 liability shift encourages the implementation of EMV; however, EMV deployment is not mandatory. While many merchants are behind on implementation or have chosen not to implement EMV and some institutions have indicated they will not be able to meet the October 1 deadline; issuers, merchants, acquirers and processors alike should be planning for the liability shifts and be aware of the risks associated with not deploying EMV solutions. Furthermore, although the rollout of EMV is expected to significantly reduce card-present fraud, fraud is expected to migrate elsewhere, such as card-not-present. In anticipation of fraud migration, institutions should consider potential fraud migration paths and proactively implement countermeasures to reduce risk.