Banking in the Ninth

September 2013

Ninth District Highlights

How a Supervisor Reads a Risk List

We focus this issue of *Banking in the Ninth* on our risk list. Some of the risks we identify may immediately resonate with readers; the risks we focus on may even match your own list. For example, we identify the tough earnings environment as a key risk. Bankers routinely highlight weaker-than-expected earnings growth as a primary challenge to overcome.

Our take on the earnings challenge, however, may differ from that of bankers. We highlight the risk that low earnings may encourage banks to take on too much risk. Most bankers I talk with are concerned with low earnings in and of themselves. We also identify the risk to banks from the agricultural sector. This may strike some as odd. The agricultural sector by many metrics shows great strength. Indeed, the extraordinary performance of agriculture itself activates our radar, as our concern arises from performance that may prove unsustainable.

This description makes us—and other supervisors who take a similar view—sound excessively focused on the downside. We can and should debate the degree to which supervisors should always identify what can go wrong. And without question supervisors should identify and recognize the effective practices that most banks routinely implement.

Ron Feldman

But the fact that supervisors should concentrate on potential future snares seems right to me. Indeed, the rationale for bank supervision links our existence to taking a contrarian view. One rationale for supervision starts with deposit insurance, which protects depositors from bearing losses that a bank failure would normally impose.

Continued inside

SAFETY and SOUNDNESS UPDATE

The 2013 FRB Minneapolis High and Emerging Risk List

We previously published a list of 2012 risks that supervisory staff at the Federal Reserve Bank of Minneapolis identified as potentially adversely affecting supervised institutions. That list focused on continuing asset quality concerns and also identified capital, interest rate risk, earnings, and municipal securities as emerging areas of concern for bank supervisors. With the improvement in credit quality over the past several months, our 2013 high and emerging risk list takes on a substantially different tone. In this article, we will briefly discuss those risks that supervisory staff consider high or elevated in 2013. Federal Reserve Bank supervisory staff will monitor developments related to these risks both at individual institutions and on a portfolio level. The complete risk list is available at www.minneapolisfed.org/pubs/bankingninth/13-09/2013_risk_list.pdf.

Continued inside

Earnings and Related Risks Top the List of Concerns for Supervisory Staff

We assess risks on two dimensions—the level of concern and the level of exposure. Level of concern measures the prospects that the risk will produce adverse financial outcomes, the immediacy of the risk, and the potential for losses. This analysis, which results in a rating of high, elevated, moderate, or low, focuses on the inherent risk in the absence of controls or mitigants an institution may have implemented. Level of exposure measures the breadth of Ninth District institutions affected or potentially affected by a risk and is considered significant, moderate, or low. We also identify the trend for each risk.

We rate earnings risk as having a high level of concern, the only risk to receive that designation in 2013. Not only did supervisory staff assign a high level of concern, but they also found a significant percentage of District financial institutions potentially exposed to this risk. We also think the trend of this risk is increasing. Earnings risk is not a risk of immediate loss. Rather, we view it resulting from actions banks are taking or may take in response to the factors driving relatively low earnings, including low interest rates, low loan demand, declining fee income, and increasing compliance costs. Net interest margins continue to narrow, with the median tax equivalent net interest income at District banks falling to 3.66 percent of average assets in 2012. Although pretax net operating income to average assets has recovered from the 2009 low of 0.90 percent of average assets to 1.26 percent in 2012, much of the improvement resulted from reduced or negative loan loss provisions. We see limited future growth to earnings from declining loan loss provisions and the low cost of funds. Finally, banks' operating costs could potentially increase as they maintain or expand infrastructure for technology, compliance, and audit. The long-term trend of relatively low earnings can place pressures on bank management and directors to take more risk than they might have previously considered. Boards of directors need to ensure that actions taken to augment earnings are evaluated fully and implemented with care to avoid undesired losses in the future.

Indeed, several of the other risks we identified as significant areas of concern stem from actions some District banks have taken or are contemplating in an effort to address declining earnings. Supervisory concerns related to investment securities risk; interest rate risk (IRR); vendor management; and to a lesser extent fraud and internal controls, compliance, and Bank Secrecy Act risks derive from strategies to improve earnings. Supervisory staff considered each of these risks elevated, with a moderate level of exposure and an increasing trend. We discuss these risks in more detail.

Financial institutions have increased credit risk and/or IRR assumed in their investment portfolios. Credit risk is increasing as investments shift from U.S. Treasury and agency instruments to municipal and corporate bonds as well as private label mortgage-backed securities. This shift enhances yields but naturally increases risk. Some banks have acquired higher risk investments without understanding policies and systems commensurate with the risks inherent in the investments. These concerns are heightened at those banks that have acquired concentrations in more complex instruments. Many of these same investments also increase an institution's exposure to IRR; the shift in investments extends the duration of the portfolio and increases exposure to options risk from structured securities. The increase in demand deposits that many banks experienced during and after the financial crisis appears to mitigate some of the potential IRR. However, these deposits could shift out of banks or into rate-sensitive deposits as rates increase, which can raise IRR. Many banks' IRR models may need to be adjusted to consider this potential change in deposit structure. Banks need to ensure that their policies, procedures, and models reflect the current investment activities and that

assumptions are consistent with the current operating environment.

Other banks are responding to declining earnings by moving into new products, often with help from third party vendors. Such shifts increase vendor management risk. Banks can incur legal, reputational, compliance, and operational risk if a service provider fails to adequately perform contracted services. In addition, banks may have little influence on vendor practices if the banks are a small client. Banks can mitigate these challenges by thoroughly understanding the risks of new activities and vendors. Banks must achieve this understanding prior to launching new products or entering into new vendor relationships.

Banks also address earnings pressures by cutting costs. Banks make such cuts prudently all the time. Supervisory concerns can increase if such cost reductions significantly undercut internal controls, compliance, and audit functions. Cuts to these functions can increase a bank's susceptibility to losses from fraud or vendor management risk. Supervisors also expect banks that outsource to ensure that their contracts clearly spell out the responsibilities of the parties; compliance with laws, regulations, and supervisory expectations remain with the bank even when outsourcing.

The desire of banks to cut costs in compliance seems higher risk given the potential that compliance standards have increased. Supervisors and Congress have demonstrated a continued strong interest in compliance with Bank Secrecy Act/Anti-Money Laundering standards requiring continued attention to this area. Further, new rules that go into effect in January 2014 affect nearly all facets of residential mortgage origination and servicing. The rules will require banks to adopt new procedures and processes, provide training, and enhance internal controls to manage risks related to residential mortgage lending.

Other Elevated Risks

Supervisory staff identified two credit-related risks—agricultural lending and commercial real estate (CRE)—as elevated with significant exposure. We view agricultural lending risk as elevated due to the potential for high commodity and land

Continued on back

Ninth District Highlights continued

This insurance works because the revenue-raising authority of the U.S. government stands behind it. Deposit insurance without government support has a relatively poor record.

Supervision can limit the potential loss that the government and those funding the government bear. It does so by working with banks to identify and limit excessive risk-taking. The role of limiting potential loss naturally leads supervisors to try to identify those risks that might ultimately generate bank weakness and even failure. The reaction to bank failure from observers often focuses on supervisors taking a too rosy view of the risk and the future. Certainly, supervisory assessments and/or responses to developments in the residential real estate market were insufficient prior to the financial crisis.

In this light, please read our risk list not as a forecast or view that supervisors are always right. It is a list of the potential problem areas that may occur or spread in the future. Indeed, the fact that we create the list and respond to it makes it less likely that the risks mentioned actually end up imposing much cost. From this viewpoint, supervisors sound like an optimistic group, although I am not sure I would go that far.

–Ron Feldman
Executive Vice President and
Senior Policy Advisor, SRC

prices, low interest rates, and strong domestic and international demand to change adversely for banks. Commodity prices have fallen significantly from last year's record highs on projections of increased supply and stable demand. This decline, if sustained, could reduce farm income and land values, leading to a reduction in agricultural borrowers' debt service capacity. The heavy dependence on agricultural lending for many banks in the District justifies continued supervisory and institution monitoring.

CRE problem loans continue to decline in volume, although other real estate holdings of District banks remain elevated. District banks experienced an increase in CRE loans outstanding in 2012 for the first time in several years, with most of the growth in North Dakota.

Information security risk is elevated with moderate exposure and an increasing trend. Most public attention has focused on coordinated distributed denial of service attacks directed at large institutions. Small banks also have exposure to fraud and operational losses involving compromised security. Identity theft and fraud schemes increasingly rely on access to the banks' systems through technology interfaces. Suspicious activity report filings indicate identity theft from customers as the first step in fraudulently transferring funds from customer accounts.

Conclusion

Supervisory staff has identified the risks discussed above—along with the complete risk list—as likely to affect District banks in the near term. The applicability of each risk to specific institutions will vary. Where applicable, bank management and boards of directors should stay aware of these risks and ensure that they are taking appropriate mitigating actions.