Federal Reserve Bank of Minneapolis High and Emerging Risk List
June 30, 2014
(using data as of December 31, 2013)

Development of the Risk List begins with the identification of areas of risk potentially faced by Ninth District financial institutions. SRC management then assesses each risk based on the level of concern, level of exposure, and trend, as defined in the table below. The table on page 2 lists all risks considered and shows the level of concern and level of exposure for the current period and the prior year-end. The report includes trend data only for the current period. While there is a slight bias toward issues affecting state member banks (SMBs), the process assesses risk exposure of all Ninth District banks and holding companies. Risk group members have completed write-ups for the risks rated high or elevated, regardless of exposure, and for any risk rated moderate with a significant exposure level. Write-ups are organized in order of severity of risk, as measured first by level of concern and then by level of exposure and trend. Finally, we do not comment on risk dimensions that are not currently areas of concern.

Level of Concern Measures the District's assessment of the risk area, considering: (1) prospects that the risk will give rise to an adverse financial impact (2) immediacy of the risk and (3) potential for losses. The focus is on inherent risk in the absence of controls or mitigants an institution may have implemented.	**High** – Current problem area, or one likely to become a problem area in the next 1-2 years, that if realized would have a significant impact on institutions in terms of operating losses, rating downgrades, or failures. **Elevated** – Either a current problem area that has a less significant impact on institutions than a high-risk area or an area that is potentially high impact but less likely to develop in the next 1-2 years. **Moderate** – A concern that is notable for some reason, but the impact is not likely to be significant in the near term. **Low** – Little to no risk of a significant impact in the next 1-2 years.
Level of Exposure Measures the relative percentage of institutions believed to face current or likely exposure to the risk at an elevated level.[1]	**% - Significant** – Affects a substantial number (more than 33%) of SMBs and holding companies **% - Moderate** – Affects a significant percentage (5% to 33%) of SMBs and holding companies **% - Low** – Affects only a few SMBs and holding companies (less than 5%)
Trend	⇧ **Increasing** ⇔ **Stable** ⇩ **Decreasing**

[1] For example, all institutions face some degree of liquidity risk and IRR. The exposure level measures the proportion of institutions believed to face a moderate or higher level of risk.

Risk	12-31-2013		6-30-2014		
	Level of Concern	Exposure	Level of Concern	Exposure	Trend
Credit Risk					
Commercial Real Estate	Moderate	%	Moderate	%	↔
Commercial and Industrial	Moderate	%	Moderate	%	↔
Agricultural	**Elevated**	%	Elevated	%	↑
Consumer	Moderate	%	Moderate	%	↑
Residential Real Estate	Moderate	%	Moderate	%	↔
Other Real Estate Owned	Moderate	%	Moderate	%	↓
Investment Securities	**Elevated**	%	**Moderate**	%	↔
Market and Liquidity Risk					
Liquidity Risk	Low	%	Low	%	↔
Interest Rate Risk	**Elevated**	%	Elevated	%	↑
Operational Risk					
Information Security/Cyber Security Risk	**Elevated**	%	**High**	%	↑
Other IT	Moderate	%	Moderate	%	↔
Vendor Management	**Elevated**	%	Elevated	%	↑
Fraud and Internal Controls	**Elevated**	%	**Moderate**	%	↔
Accounting and Auditing	Low	%	**Moderate**	%	↑
Legal and Compliance Risk					
Bank Secrecy Act/Anti-Money Laundering/Office of Foreign Assets Control	**Elevated**	%	Elevated	%	↑
Consumer Compliance	**Elevated**	%	Elevated	%	↑
Capital Risk	Moderate	%	Moderate	%	↔
Earnings Risk	**High**	%	**Elevated**[2]	%	↔
Strategic Risk	Moderate	%	**High**[2]	%	↑
Energy Sector Risk	Low	%	**Moderate**	%	↑

Bold type indicates a change from the prior risk list.

[2] Change in the level of concern and trend for earnings risk reflects a redefinition of earnings and strategic risk. Strategic risk ratings were also changed to reflect this redefinition.

Strategic Risk

Summary

Strategic risk is the risk that financial institutions will incur losses by pursuing new or high-risk activities or will change business strategies in response to actual or perceived threats to the entity's continued viability. The long-term environment of low interest rates, nominal loan growth, declining noninterest income, and increasing costs has caused banks of all sizes to reassess options for remaining independent or improving profitability. Banks may take actions to address these concerns without first establishing appropriate control structures, which could lead to financial losses and reputational harm.

Discussion

Banks are increasingly citing concern related to the long-term viability of their business models. Many bankers are considering various actions they believe necessary to remain in business. This concern is particularly pronounced at community banking organizations which traditionally are more heavily dependent on net interest income than their larger competitors. In addition, these institutions note that their ability to absorb increasing costs from new regulations and cyber security threats is more limited than larger institutions.

To counter declining earnings and lagging loan growth, community banks are exploring an array of options that increase risk to the organization. Several banks have expanded into new markets by acquiring institutions or branches outside their current geographic footprint. In some cases, the addition of a new geography has resulted in entering or expanding product lines with which the bank has limited familiarity. Other institutions, while not expanding their geographic footprint, have added new products or returned to the practice of purchasing out-of-area loan participations. Without proper due diligence, controls, and staffing, any of these expansions can result in significant losses.

Other institutions have responded by changing the strategies used to manage their investment portfolios. A few banks have made significant investments in corporate or foreign bonds without first ensuring that necessary risk controls were in place. Other banks have extended the duration on securities portfolios, including some that have made decisions to do a wholesale restructuring of the portfolio. Still others have pursued balance sheet leveraging strategies.

Regardless of which action a bank pursues, the organization is potentially exposed to risks with which the management team and board may not be fully familiar. As a result, the bank's ability to identify, measure, monitor, and control the risk may not be as fully developed as necessary given the risk it has assumed. The inability to assess and control these risks could lead to unforeseen losses.

Supervisory Response

- Identify and review new product and service offerings at supervised institutions to ensure that management and the board have appropriately assessed the risks associated with the activity and that the institution established proper controls prior to introducing the product or service.
- Identify planned changes in business strategy or operations, discuss potential risks that may arise, and provide guidance on regulatory requirements associated with new activities. During processing of expansionary applications, identify potential changes in business strategy or products and ascertain management's plans to control risks associated with these products.
- Identify balance sheet or income statement trends that may indicate a change in product or service offerings or other strategic initiatives at supervised institutions.

Information Security/Cyber Security Risk

Summary

Information security risk is risk of losses, both financial losses and damage to an institution's reputation, due to an information security breach and remains a key concern as banks continue to have a very high and increasing reliance on technology. Distributed denial of service (DDoS) attacks and other web-based attacks across all industries continue to increase, with the financial sector remaining a common target. Hackers are using new attack vectors, such as mobile devices, to launch and control attacks. The number and types of information security threats increase almost daily. Recent examples include the Target Corp. breach, Heartbleed vulnerability, and an increase in ATM skimming. In addition, all banks continue to be exposed to fraud and operational losses involving compromised security of their or their customers' information (account takeovers).

Discussion

DDoS attacks are meant to disrupt public websites by flooding networks and servers with traffic, either delaying or preventing legitimate customer traffic. The attacks could also disrupt business operations since links between public and internal web applications may also be affected. These DDoS attacks are increasing in frequency and severity. The Q4 2013 Prolexic Quarterly Global DDoS Attack Report indicates the total number of DDoS attacks increased year over year by 26% and average attack duration was up 29%. Banks have been frequent targets of sophisticated DDoS attacks. To date, few attacks have been directed at Ninth District entities; however, perpetrators have named District organizations as potential future targets.

Recent articles indicate the estimated cost of the fourth quarter 2013 Target Corp. breach could top $1 billion for card issuers. Most Ninth District SMBs reportedly reissued credit and debit cards as a result of this breach. Impacted banks throughout the country are suing both Target Corp. and Trustwave (the Payment Card Industry (PCI) vendor Target contracted with to assess compliance with PCI security standards). Trustwave is a large vendor in this space and the impact of the suit could have broad implications on PCI compliance activities. While banks may recover some losses as a result of these lawsuits, the initial expenses associated with card reissuance were substantial. Likewise, a systemic reaction to move to "chip and PIN" technology could impose longer-term costs on financial institutions.

Many District banks reportedly have not looked at the Heartbleed vulnerability or followed up with vendors to ensure their websites are not exposed. Some banks appear to be placing excessive reliance on vendors to identify and address this risk. Reportedly, many may not realize that even if their servers have been patched by the vendor, the bank may need to notify customers to change passwords if there is any chance there could have been a compromise before the patch was applied.

Fraud associated with information security breaches at a bank or its customers continues to be prevalent. District SMBs have identified several instances of identity theft and customer account takeover. Losses associated with account takeover can be significant since business accounts are the primary targets and transfers of funds typically are accomplished through large wire transfers. ATM card skimming has also become more widespread and is difficult to detect. To help mitigate this risk, banks need to consider their ability to monitor the machines remotely, determine if the location would make it easy to tamper with the machine, regularly make physical checks of the machine to look for any sign of tampering, and educate customers on signs that a machine may have been altered.

Supervisory Response

- Expand information shared with institutions related to information security risk, the impact of the issue on community banks, and steps they can take to mitigate and control the risk.
- Work with bank management to develop enhanced understanding of the types of questions they should be asking about information security, both in their organization and when dealing with vendors.
- Banks should have appropriate procedures in place to minimize risks of loss due to account takeover. These procedures include “call back” processes for wire transfers initiated by telephone or email and ensuring that staff who process wire transfers have access to information about customers’ “normal” transaction behavior.

Agricultural Credit Risk

Summary

Agricultural credit risk is the risk of losses due to deteriorating agricultural credits. Although crop farmers have had record income in recent years due to strong yields and high prices, projections for 2014 suggest a material decline in net farm income is on the horizon. Not only are many crop prices falling, but input costs have risen, resulting in some farmers projecting negative cash flows. This scenario, should it continue, could lead to a correction in farmland values. The lower asset values together with deteriorating cash flow prospects are occurring as loan growth is picking up, suggesting a potential for increased credit issues at agriculturally-focused banks.

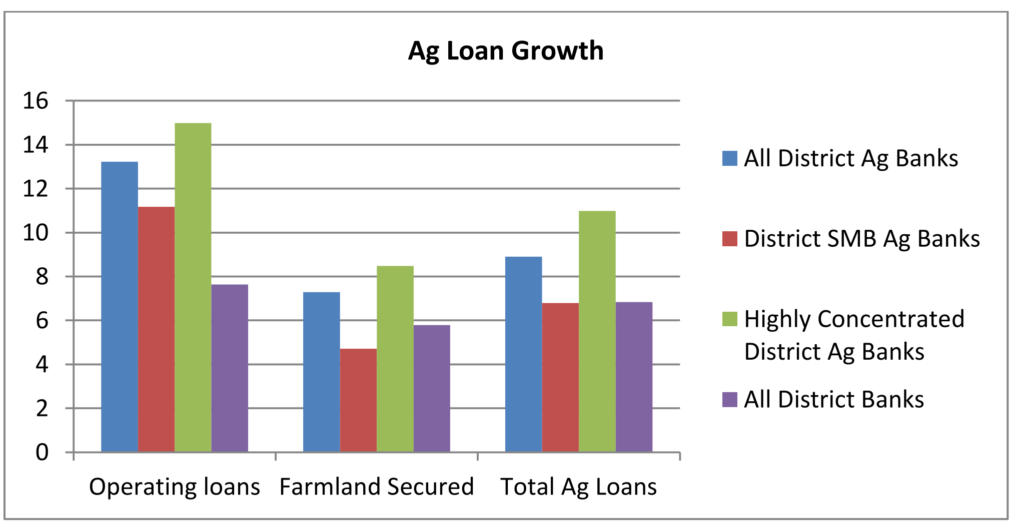
Discussion

The Ninth District has a heavy concentration of agriculturally-focused banks, with 53.6% of institutions having total agricultural loans equal to or greater than either 25% of total loans or 100% of tier 1 capital plus the allowance for loan and lease losses (ALLL) as of March 31, 2014. Of these, 118 institutions (18.6% of all District institutions) are highly concentrated in agricultural lending, with total agricultural loans exceeding 300% of tier 1 capital plus the ALLL. For SMBs, 56% are agricultural banks with 11 (17%) being highly concentrated. Median and maximum concentrations for agricultural banks are noted in the table below.

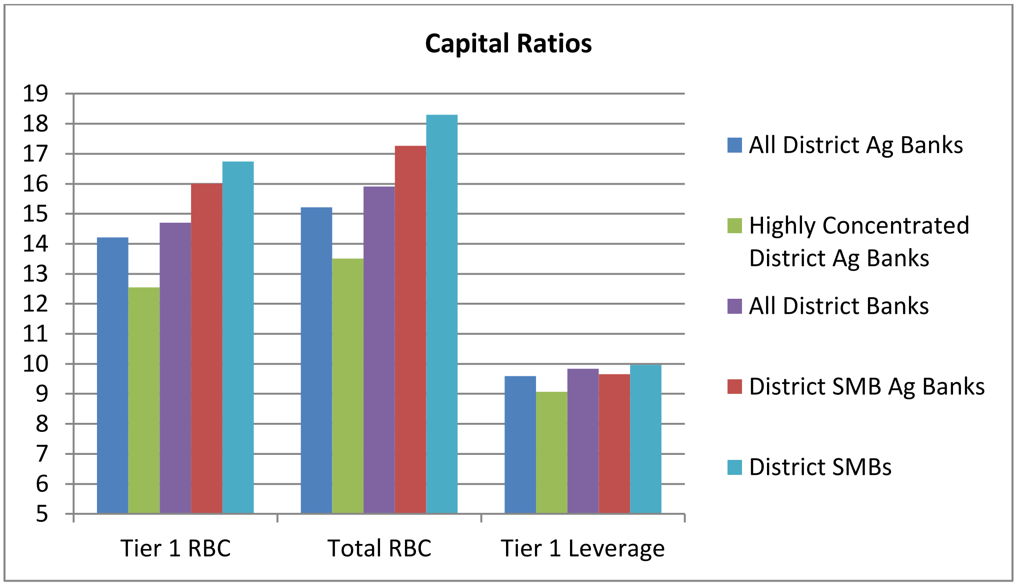
Agricultural Bank Loan Concentrations

	Median		Maximum	
	% of Capital	% of Loans	% of Capital	% of Loans
All District Ag Banks	238.69	45.86	935.56	95.17
SMB Ag Banks	230.99	47.00	526.85	79.86

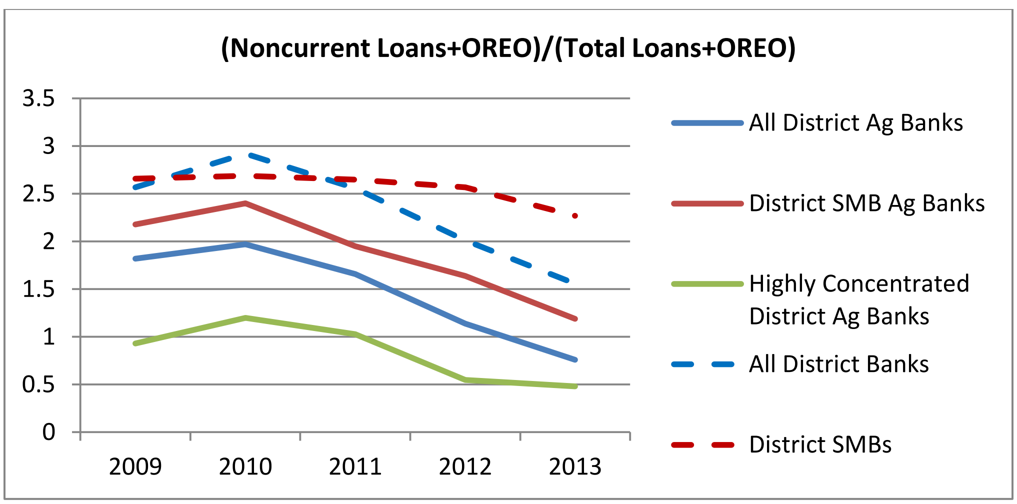
As shown below, first quarter 2014 data indicate increased agricultural loan activity at District agricultural banks with total agricultural loans growing approximately 9% on average. Median growth in operating loans between March 31, 2013, and March 31, 2014, was 13.2% at District agricultural banks (15.0% at highly concentrated agricultural banks). Farmland-secured loans increased 7.3% (8.5% at



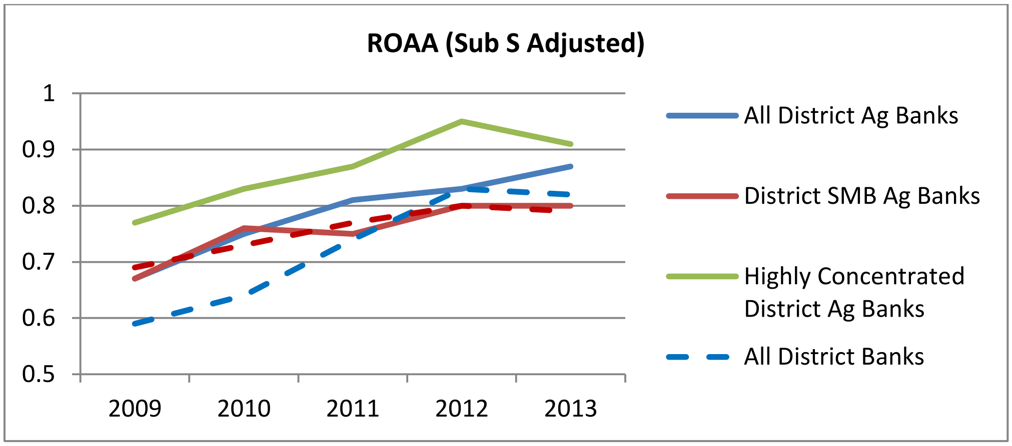
highly concentrated banks) over the same period.[3] Agricultural loan growth was slower for all District banks than at agriculturally concentrated banks. While renewed loan growth should result in improved earnings, the increased activity could represent a growing number of borrowers who are carrying over operating debt from prior crop years or increased lending based on collateral value rather than cash flow. Further since both Districtwide and for SMBs, agricultural banks have lower average capital ratios than nonagricultural banks and this trend is most pronounced for highly concentrated banks, some may not be well positioned to absorb a substantial increase in losses.



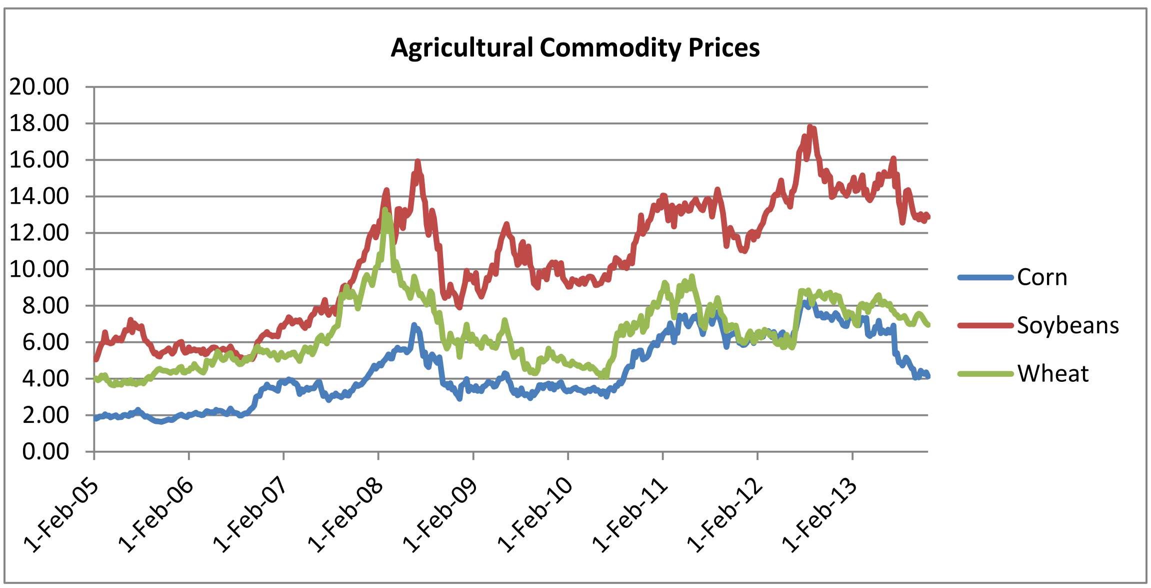
At the District level, agriculturally-focused banks have shown stronger asset quality and earnings than nonagricultural banks for the past several years, with highly concentrated agricultural banks performing even better than their less concentrated counterparts, as shown in the graphs below. For SMBs, similar trends are observed with respect to asset quality, but earnings at SMB agricultural banks are generally the same as those at nonagricultural SMBs.



[3] The growth rate for All District Banks is calculated based on the change in total loans in each category at all District institutions. Medians are not used because of the large number of banks with no agricultural loan activity.



Recent years have been boom years for the District's agricultural community, with elevated commodity prices, favorable weather conditions, and improved crop genetics all contributing to increased production levels. Improvements in crop insurance products, a historically low interest rate environment, and strong commodity prices through the first half of 2013 all contributed to record levels of farm income. In years when yields were below average, crop insurance programs helped support income levels.

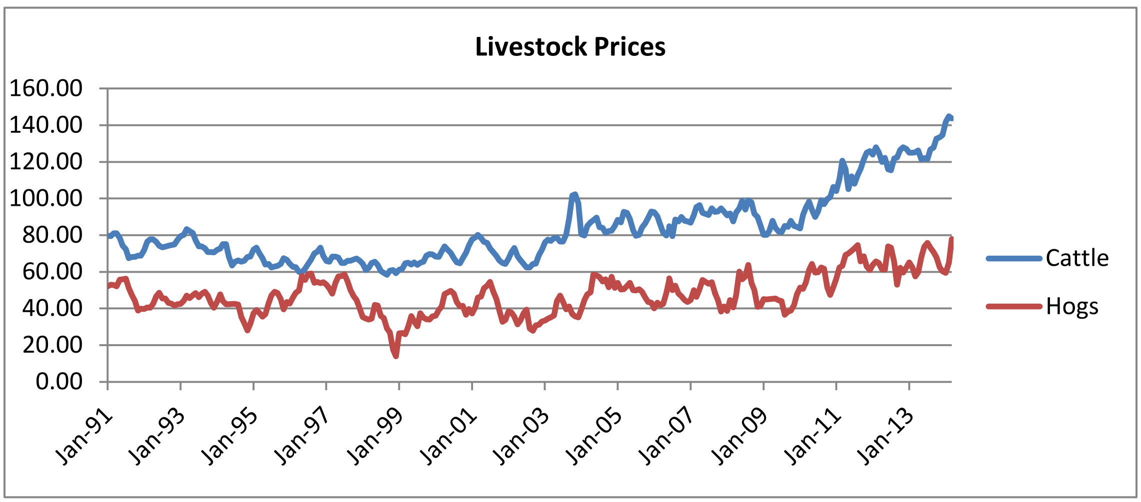


With the decline in corn and soybean prices last year (illustrated above) and farm income projected to decline 26.6% in 2014, the agricultural economy may be entering a cooling-off period. The decreasing income level has the potential for a significant impact on agriculturally-concentrated District communities as farmers decrease discretionary spending. The lower commodity prices and income levels may exert downward pressure on capital expenditures such as machinery and equipment and could decrease the demand for farmland. The reduced demand for farmland may slow the rapid rise of farmland values, resulting in only the most productive land being sold at current price levels.

Farmland has become an increasingly large component of farmers' balance sheets. The ratio of farmland-to-total assets increased from 74% in 1990 to 78% in 2000 and is forecasted to have reached 82% in 2013.

Similarly, farmland debt has become a larger component of farmers' total debt. Farmland debt totaled 52% of total debt in 1990 and 2000 and was forecasted to increase to 58% last year. The rise in farmland debt has not matched the rapid rise in farmland values, indicating there is some margin available for farmland value contraction; however, the trend bears watching.

The high commodity prices over the last three years, coupled with exceptional drought conditions in the hay-growing regions of the country, led to an increase in feed costs and a reduction of livestock on feed. Livestock numbers at the end of 2013 were the lowest in several decades. Feed costs have decreased, and livestock growers are slowly rebuilding their herds. Both slaughter cattle prices and feeder cattle prices are at historic highs, as shown below, and are expected to remain high during the herd rebuilding process. The cost of raising hogs is often dictated by the price of feed and the mortality rate, as hogs are very susceptible to numerous diseases. Currently, a virus is affecting a large number of young pigs, potentially reducing the future supply of slaughter hogs in the near term and increasing prices. Losses have been estimated at over 4 million piglets by the National Pork Producers Council (other estimates place the losses at up to 7 million piglets).



Supervisory Response

- Continue monitoring agricultural lending practices in agriculturally-concentrated banks, focusing on underwriting practices, and timely response to changing conditions.

- Monitor the impact of moisture conditions on likely farm yields and prices and on bank loan performance.

- Continue to monitor agricultural land prices, including "no sale" auctions.

- Conduct and assess the 2014 agricultural lending survey.

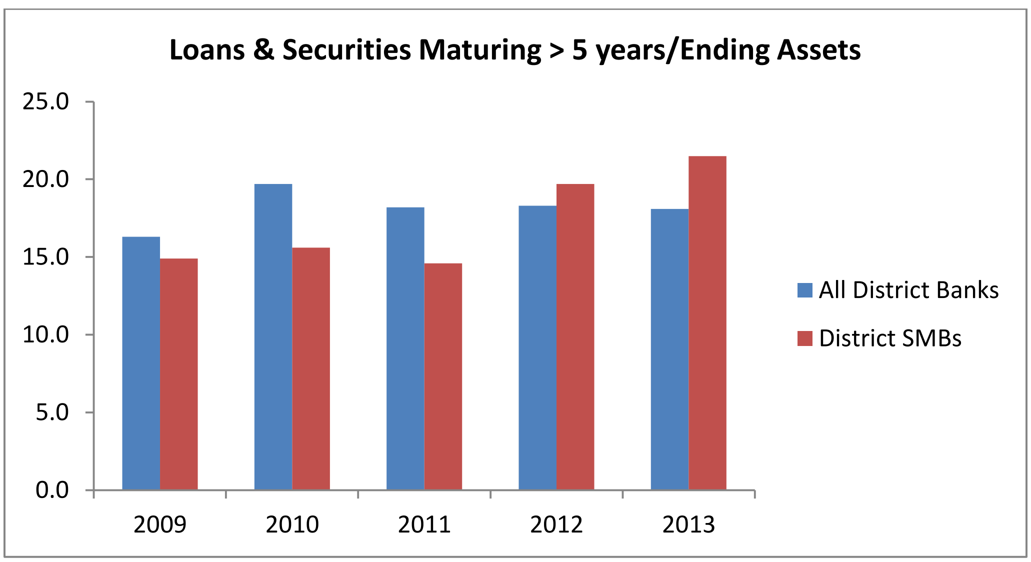
Interest Rate Risk

Summary

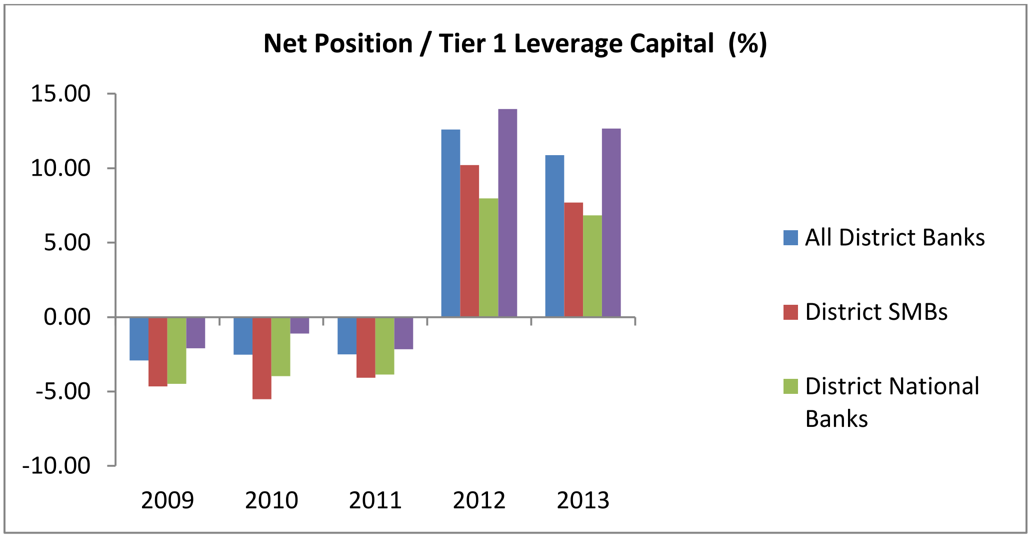
Interest rate risk is the exposure of an institution's financial condition to adverse movements in interest rates. The prolonged period of low interest rates places continued pressure on earnings and may prompt some banks to increase their exposure to IRR. Also, the unprecedented level of deposits placed in banking institutions throughout the District as a result of the financial crisis (frequently referred to as "surge deposits") is a cause for potential concern. These are primarily nonmaturity deposits that may be more susceptible to runoff or conversion into interest-bearing time deposits if interest rates increase. The resulting "lives" or decay rates may be materially shorter than noted with traditional core deposits, making historical data a potentially poor indicator of future depositor behavior. Further, if bank management and directors are not familiar with the models used to project the impact of interest rate changes critical assumptions may not have been adjusted to reflect potential changes in behavior, leading to reduced reliability of projections and simulations.

Discussion

As shown in the chart below, District SMBs appear to be further increasing loan and securities maturities, while at District banks as a whole, the decreasing loan maturities offset increasing securities maturities. This could suggest that SMBs have a greater exposure to rising rates in the short term than do other Ninth District institutions. Federal Reserve System (FRS) models as of December 31, 2013, show only nominal change in exposure to IRR at SMBs compared to exposure as of June 30, 2013; though the exposure remains higher than for other District banks (data presented in this section covers community banks only). However, data derived from Call Reports and FRS models are incomplete as classes of assets that are significant at some institutions (for example interest bearing bank balances) are excluded from key ratio calculations.



The chart below shows the December 31, 2013 FRS model results for net change in economic value (net position) measured against tier 1 capital in the event of a +200 basis point movement in interest rates for all banks across the Ninth District. The models show that most banks are asset sensitive; however, given the difficulty of modeling depositor behavior based on historical data, the impact of changes in rates may not be accurately reflected in the models. Specifically, an increase in interest rates could result in deposit runoffs and/or conversion of nonmaturity deposits into interest-bearing time deposits at faster rates than historically seen, since many nonmaturity deposits may be characterized as surge deposits (that is, deposits that are currently being "parked" at banks in nonmaturity deposit categories due to the low rate environment and a flight to quality) rather than true core deposits. This result could cause an increase in funding costs as banks try to retain or replace these deposits. Other factors, such as loan floors that may be so far above the current base rate that interest rates on loans at the floor cannot be increased until rates increase by a relatively large amount or likely changes in prepayment rates as interest rates rise, also complicate the IRR measurement process. These uncertainties might result in models overstating the extent to which banks are positively positioned for a rise in interest rates.



Supervisory Response

- Continue to caution bankers about additional risks from yield chasing, moving down the yield curve, and taking on more structured investments to pick up incremental yield.
- Review institution modeling processes with a focus on ensuring that:
    - Management and the board understand key assumptions and weaknesses in models being deployed
    - Assumptions, including those for deposit betas, decay rates, and changes in deposit mix consider the impact of large and surge deposits
    - Appropriate scenario analyses and stress tests are run to identify exposure under a variety of rate environments and stress scenarios.

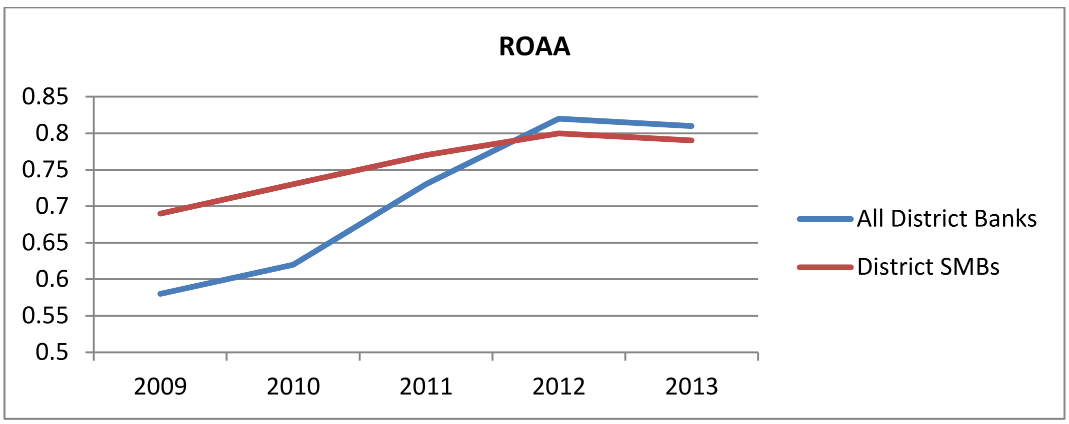
Earnings

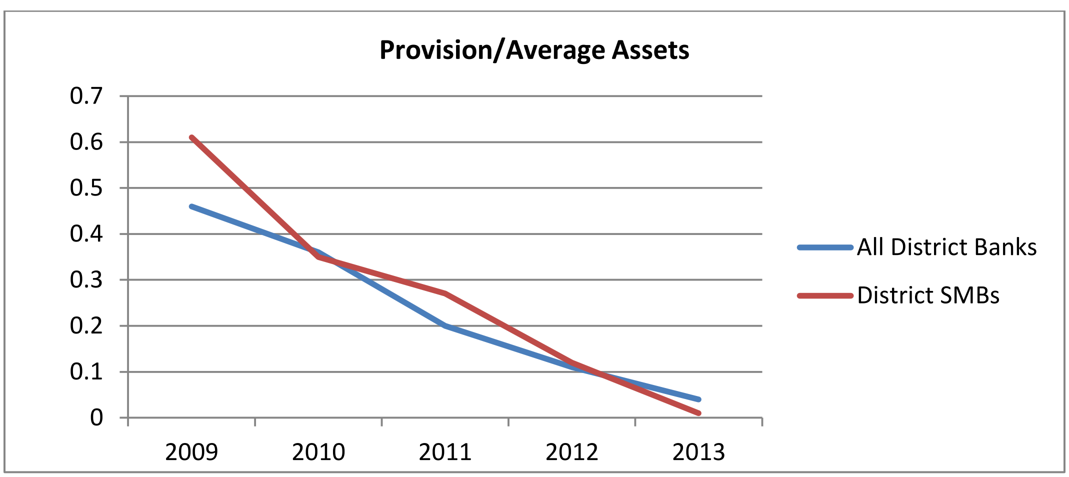
Summary

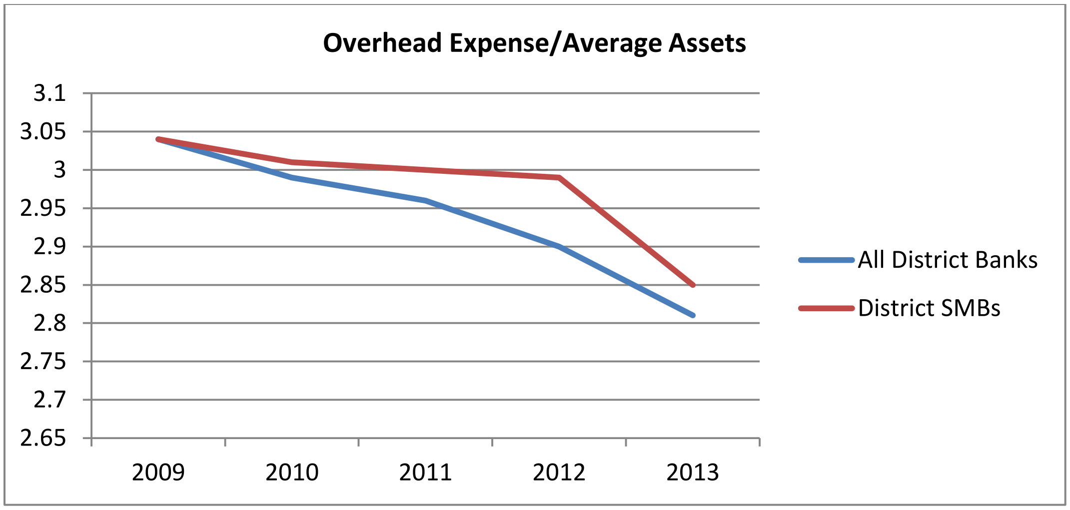
Earnings risk is defined as the risk that earnings will not be sufficient to support asset growth while allowing appropriate capital retention. Factors including historically low interest rates, continuing low loan demand, and increasing compliance costs are leading to lower than "normal" earnings at many institutions, both nationally and across the District. Community banks faced with these pressures view them as a critical challenge.

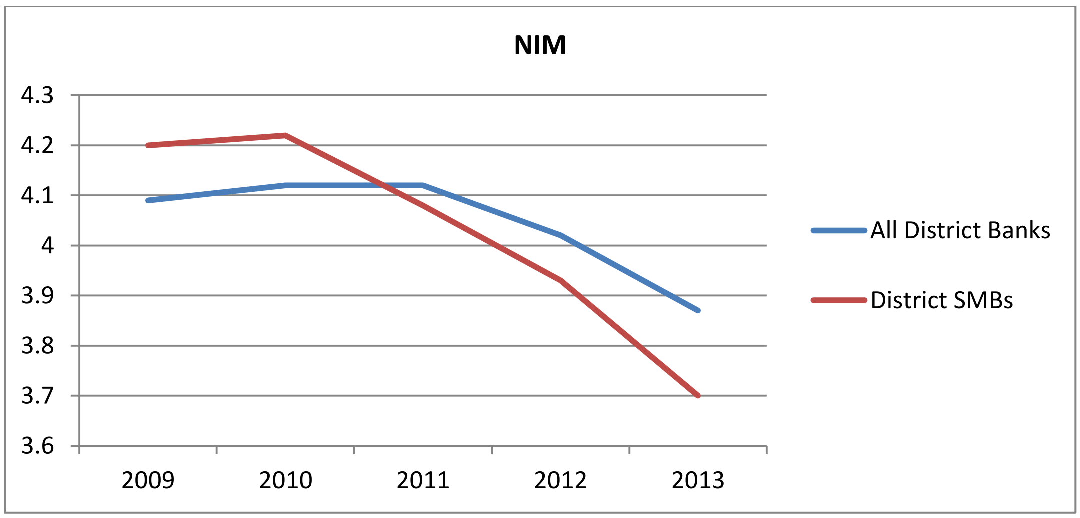
Discussion

As shown in the graph below, the median subchapter S adjusted ROAA for Ninth District banks has recovered in recent years but has leveled off at 0.81%. While this represents a substantial improvement over earnings during the financial crisis years, it remains below historical norms. Further improvement in 2012 and 2013 has largely been the result of reduced provisioning and overhead costs, which have disguised weakness in core earnings. Indeed, median net interest margins (tax equivalent net interest income- to-average earning assets) fell over the same period, as shown in the three graphs below. The capacity for reduced provisioning and lowering overhead costs may already be exhausted, with provisions near zero and the easiest overhead cost reductions recognized.









Falling median net interest margins over the past two years have been driven by a number of factors, including a greater share of lower-yielding short-term assets and securities, roll-off of higher-yielding loans and securities in a sustained low interest rate environment, low loan volume, and little room to reduce funding costs. Noninterest income has provided little support to the ROAA and essentially has been flat relative to average assets. Despite the decline in core earnings and the poor prospects for improvement in the near term, the risk is not critical because relatively low asset growth has allowed most banks to retain adequate capital despite lower than normal earnings.

<u>Supervisory Response</u>

- Closely assess core earnings and the prospects for achieving improvements in core earnings. Ensure that banks considering actions designed to enhance earnings, which may increase strategic and other risks, have considered all the risks associated with planned activities rather than viewing the potential earnings improvement in isolation.
- Identify those institutions exhibiting the largest degree of earnings risk and follow up as necessary.

Vendor Management Risk

Summary

Vendor management risk is the risk of financial loss or reputational damage resulting from actions of a vendor on behalf of or in providing services to a financial institution. To offset continued earnings pressure and increase efficiency, banks have steadily expanded the volume and types of activities outsourced to third parties. Bankers often rely on vendors heavily, regardless of the area being outsourced. Consequently, there is a greater likelihood that management may enter into third-party relationships without fully understanding or mitigating the existing and/or resulting risks. An increased focus on risk management and due diligence is particularly important regarding vendors providing non-IT services which often are not scrutinized as closely in traditional vendor risk management programs. The recent breach at Target Corp. is a direct example of risks related to ineffective controls over third-party relationships.

Discussion

Outsourcing activities may result in increased risk to the institution in a number of ways. A bank may incur legal, reputational, and operational risk (and possibly losses) if a service provider fails to adequately provide contracted services. Vendors that interact directly with consumers as agent or representative of a financial institution can give rise to unique consumer compliance risks if not properly supervised. Concentration or systemic risks arise if multiple firms rely on a limited number of service providers or if the providers are in limited locations. This concentration could have a significant impact on business resiliency. Third-party service providers may themselves outsource some functions to subcontractors that may not have adequate controls and risk management processes in place.

A specific driver of elevated risk is the growing trend of outsourcing non-IT services; these relationships have not traditionally received the same level of due diligence, risk assessment, or ongoing monitoring as have IT relationships. Outsourced non-IT services may include loan servicing, IRR modeling, loan portfolio analysis, payment processing (such as ACH and remote deposit capture), wealth management, and risk management, among others. Bank management needs to ensure appropriate oversight of all critical vendors rather than focusing solely on IT service provider activities. Service providers should have risk management processes and controls in place that are comparable to what the bank would have implemented if performing the same function in house.

To date, supervision of vendors at Ninth District institutions has largely focused on IT vendors. Based on examinations to date, it is possible that as examination attention focuses on the full range of outsourced activity, weaknesses in vendor management may be identified more frequently. Bankers need to understand the basic requirements of SR 13-19/CA 13-21, Guidance on Managing Outsourcing Risk. These include:

- Establishing a board-approved policy/program for vendor risk management
- Preparing a comprehensive list of service providers and identifying critical vendors
- Performing an overall assessment of third-party risks, including more in-depth assessments for critical vendors
- Establishing due diligence standards for new relationships.

Supervisory Response

- Provide guidance to bank management to help foster understanding of the requirements of SR 13-19/CA 13-21.

- Coordinate vendor management-related supervisory work across safety and soundness and compliance examination functions where possible. Apply additional scrutiny to new products being delivered through a third-party vendor arrangement.

Bank Secrecy Act/Anti-Money Laundering/Office of Foreign Assets Control Risk

Summary

This risk is the risk of legal and compliance costs and reputational damage associated with failure to comply with BSA/AML/OFAC obligations. In addition to direct costs, institutions face significant opportunity costs associated with the inability to expand through acquisitions when significant compliance issues are outstanding. The Financial Crimes Enforcement Network (FinCEN) continues to implement its recent initiative to enforce the BSA more effectively and its current director is focused on enhancement of the Bureau's enforcement and compliance functions.

High profile BSA/AML enforcement actions have continued during the first half of 2014. Services such as payday lending, third-party payment processors and marijuana-related businesses have been subjects of elevated scrutiny. A growing concern is the practice of some banks terminating relationships with higher-risk but legal entities ("de-risking") with these customers either migrating to smaller banks or being unable to obtain banking services. An example in the Ninth District is the closure of accounts related to money service businesses serving Somali customers. Ninth District examination findings are primarily related to deficiencies in banks' BSA/AML and OFAC compliance programs related to internal controls and independent testing. However, examiners have noted an increase in OFAC oversight weaknesses at both large and community bank organizations.

Discussion

The Department of Justice (DOJ) launched an initiative in 2013 ("Operation Choke Point") to target banks that provide payment processing services to a broad range of financial ventures, including payday lenders, that may be operating in noncompliance with some state laws. The DOJ and multiple state attorneys general are weighing civil and criminal actions against dozens of banks, sending subpoenas to more than 50 payment processors and the banks that do business with them. These actions rely on banks' responsibility to "know their customers" and detect and report suspicious activity as a basis for requiring banks to deny access to the payment system to businesses that may engage in transactions in violation of state usury or licensing laws.

A second source of increased BSA/AML/OFAC risk is a conflict between state laws permitting certain types of marijuana use and distribution in nearly half the states (including Michigan and Montana) and the District of Columbia, and the federal Controlled Substance Act of 1970 (CSA). The CSA makes it a federal crime to possess, grow, or distribute marijuana. Therefore, marijuana-related businesses are often unable to obtain financial services, since banks cannot (under federal law) knowingly engage in a monetary transaction involving criminally derived property.

In February 2014, FinCEN issued guidance intending to clarify how financial institutions can provide services to marijuana-related businesses and remain consistent with the BSA. In particular, the FinCEN guidance includes detailed ongoing customer due diligence monitoring as well as SAR filing requirements. However, some of these obligations are unique to this customer type, and the guidance has spurred numerous questions regarding its application, specifically, the failure to provide a definition of "marijuana-related" businesses. As currently construed, this term is very broad and potentially covers any business doing business with a dispensary (i.e., a landlord). District banks should ensure they have appropriate procedures in place to identify and file SARs on all marijuana-related businesses.

Finally, recent District examinations have identified an increase in the number of entities with weaknesses in various aspects of their OFAC compliance programs. OFAC is an office of the U.S. Treasury that administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against entities such as targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction.

Supervisory Response

Payment processing:

- Review payments activities, including remote deposit capture arrangements, to identify institutions processing payments directly or indirectly for high-risk businesses to ensure appropriate risk controls are in place.

Marijuana-related businesses:

- Ensure that institutions, particularly those in or bordering states that have legalized marijuana for some purposes, are familiar with the FinCEN guidance and have identified any covered customers.

OFAC:

- Review OFAC compliance programs as part of the BSA review and ensure banks have implemented an appropriate compliance program, including:
    - Designating an OFAC officer
    - Ensuring continuity of the OFAC compliance program when the OFAC officer leaves the institution or assumes other responsibilities
    - Maintaining up-to-date screening tools
    - Developing effective remediation programs when OFAC weaknesses are identified.

Consumer Compliance Risk

Summary

Consumer compliance risk, in general, is the risk of legal or regulatory sanctions, financial loss, consumer harm, or damage to reputation and franchise value caused by failure to comply with or adhere to:

- Consumer protection laws, regulations, or standards
- The bank's own policies, procedures, code of conduct, and ethical standards
- Principles of integrity and fair dealing applicable to the bank's business activities.

Consumer compliance risk is concentrated in new regulatory requirements and standards, particularly those applicable to mortgage lending. Community banks have devoted significant resources to implementing changes to comply with new mortgage regulations and other regulatory changes in the past year. Banks also will need to be diligent about ensuring that product changes and vendor-issued products and services comply with regulatory requirements.

Discussion

Regulatory Impact:
The Consumer Financial Protection Bureau (CFPB) issued its mortgage rules in January 2013; most became effective in January 2014. The new residential real estate loan rules present compliance challenges for banks, which must devote substantial time to understanding the new requirements, analyzing risks, implementing new policies and procedures, and modifying compliance risk management programs. Further, the CFPB must issue more new rules under the Dodd-Frank Act (DFA), such as those related to additional data reporting requirements, and has already issued the new mortgage loan integrated disclosure regulation, which was not required by the DFA. The CFPB also continues to issue changes to other compliance regulatory requirements, many of which will affect community banks.

Other areas of potential compliance risk for supervised institutions including:

- ***Compliance Management Program.*** Given the expanded regulatory requirements, which often are highly technical, compliance management program resources may be stressed. Some banks might have to add staff to compliance management programs; however, banks are concerned with the impact such an action will have on earnings. This increase in staffing constitutes a further challenge for community banks, especially those in rural areas, as they seek to attract personnel with the skill sets to manage compliance with the expanded regulatory requirements.
- ***New Products, Services, and Business Lines.*** Due to earnings pressure or the new mortgage rules, banks might engage in new activities necessitating the adaption of the compliance management programs to reflect new or changed risks (see the Strategic Risk write-up). These risks could stem from new products, services, processes, or business lines. Some banks have used external third parties to assist with or manage new products, and yet these banks must fully understand the risks associated with the new activity (see the Vendor Management Risk write-up).
- ***Fairness and Consumer Impact.*** The continued focus on fairness and consumer harm requires banks to ensure compliance activities consider these factors. Banks must adapt compliance management programs to be more proactive and to assess risks relating to fairness and consumer harm potentially caused by the bank's products, services, and processes, including the use of third parties. Also, banks should evaluate consumer complaints and customer service issues in their fairness and consumer harm analyses. In addition, banks must monitor and respond to areas of heightened consumer

protection scrutiny, such as third-party payment processing relationships with payday lenders, add-on products, and prepaid cards.

Supervisory Response

- Continue monitoring compliance risk issues and sharing that information, along with related compliance management recommendations, through outreach efforts.
- Identify issues arising from vendor management and changes in product offerings (see the Vendor Management Risk write-up).
- Review complaint volume for fairness issues in customer-facing activities.

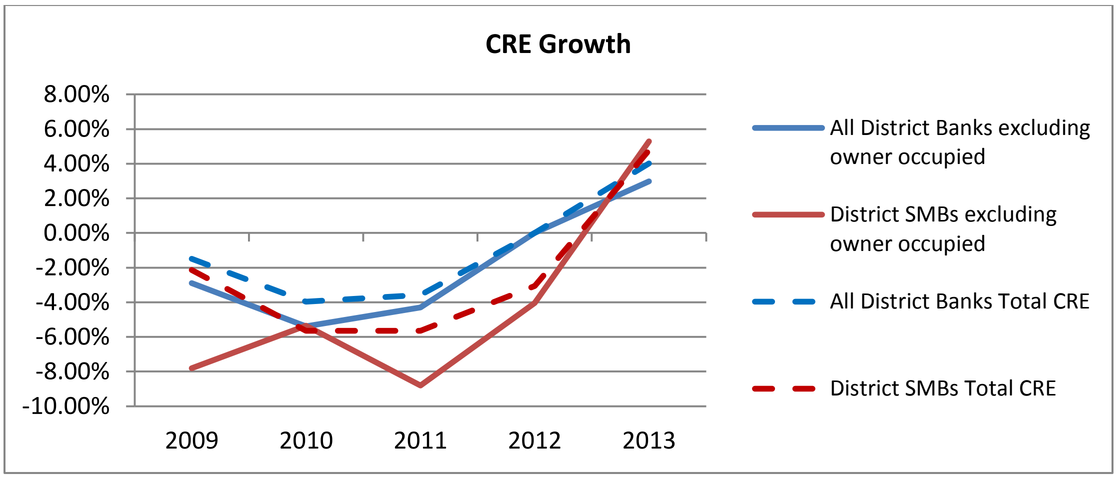
Commercial Real Estate Risk

<u>Summary</u>

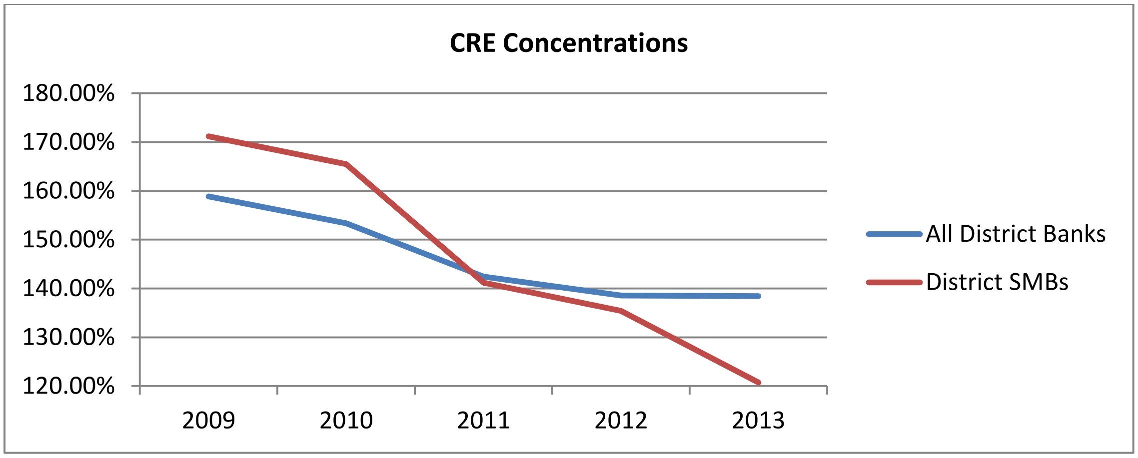
Commercial real estate risk is the risk of loss from deficiencies in commercial real estate lending practices. Prior concerns for CRE primarily resulted from high concentrations and losses that banks in the Ninth District experienced during the financial crisis. However, asset quality indicators have shown general improvement in CRE portfolios, as most problem loans have been identified and resolved. CRE concentrations have fallen from previous highs due to heavy charge offs but are showing signs of renewed growth at Ninth District banks.

<u>Discussion</u>

With the data showing stable/improving CRE trends, many Ninth District banks are now beginning to focus more on lending than on problem loan workouts, which could start the return to higher CRE levels. The following graph shows a general rise in CRE lending in 2013 after several years of decline. Growth in CRE loans at Ninth District institutions is concentrated in the lower risk areas of nonfarm, nonresidential loans rather than in the higher-risk segments of construction and land development.

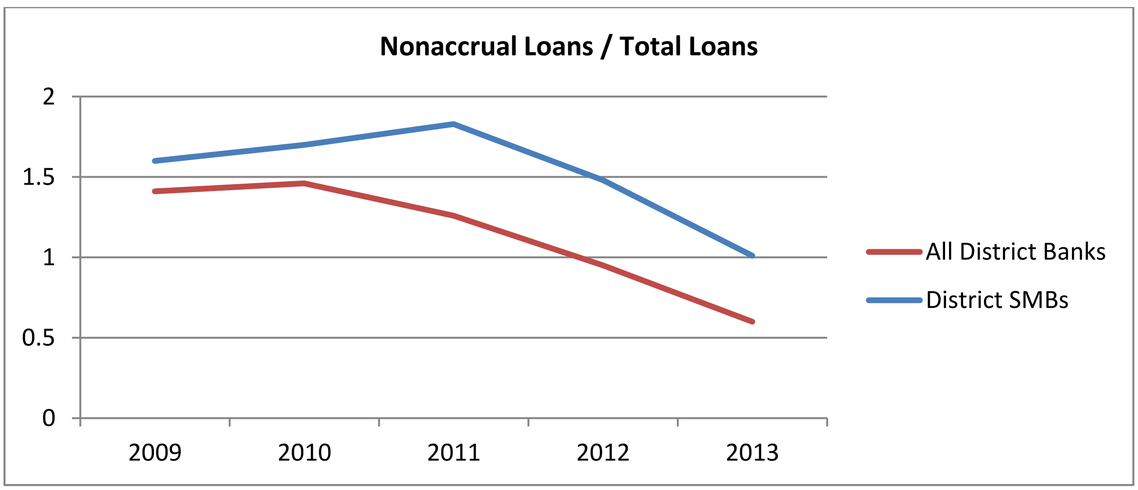


Construction and land development loans remain below pre-crisis levels, while multifamily lending continues to increase, albeit off a smaller base. CRE concentrations at SMBs within the District continue to decline; however, the decline in concentrations at all District banks reversed slightly in 2013.

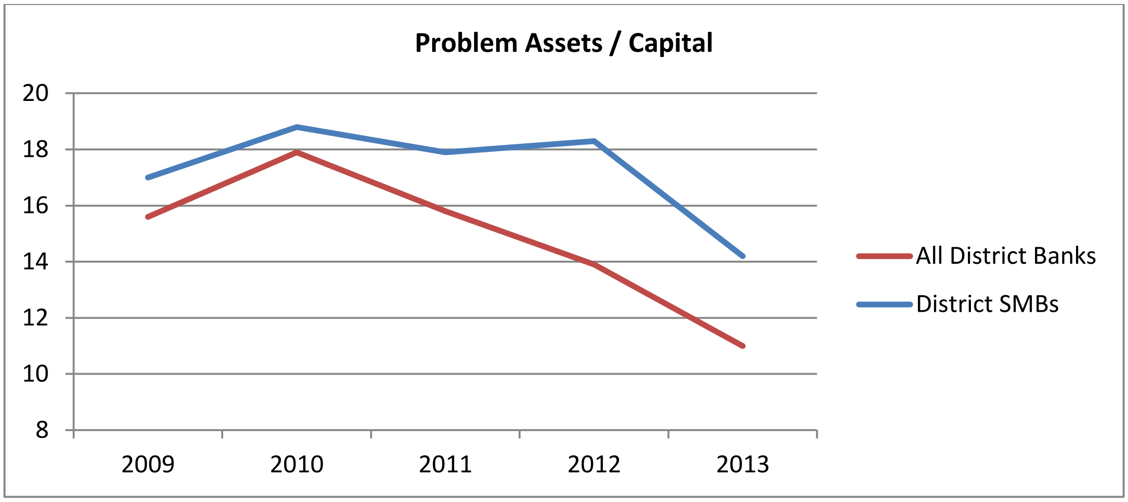


While some markets still lack pre-crisis levels of loan demand, other markets are experiencing strong CRE loan demand, especially for multifamily CRE. These markets include the Twin Cities, Sioux Falls, Bozeman, and western North Dakota (the Bakken area). Although much of this loan demand may be funded locally, many other banks in the Ninth District that are not experiencing local loan demand may consider reentering the CRE participation market. Several SMBs have indicated they have been solicited to purchase out-of-territory CRE participations, primarily hotel and multifamily housing loans, and some have already done so. Potential concerns regarding purchasing these loans are well known, including not fully understanding the credit risk in loan(s) purchased, difficulty monitoring credits/properties outside the bank's normal lending territory, and limited power to act if loan performance deteriorates.

Overall loan quality continues to improve as the volume of nonaccrual loans (primarily CRE loans) relative to total loans continues a declining trend that began in 2011.



Additionally, problem assets (restructured, nonaccrual, and other real estate owned (OREO)) are declining relative to capital. While the declining trend began in 2010 for all banks in the District, it only began declining for SMBs in 2012.



Recent discussions with other Ninth District regulators and results of national surveys have noted that an increasing number of institutions are loosening credit underwriting standards to retain existing customers or attract new ones. Loosening actions include releasing guarantors, extending repayment terms, and reducing loan covenants. These reduced underwriting standards, if not used sparingly, could lead to increased problem loans if conditions deteriorate.

Supervisory Response

- Focus on new/renewed CRE loans to determine the quality of underwriting and banks' risk appetite. Higher risk tolerances should be supported by sound credit risk management processes.
- Include a review of multifamily loans at examinations of banks experiencing organic or purchased multifamily loan growth to determine quality, underwriting standards, and appropriate monitoring policies and practices.