Office of the
Comptroller of the Currency

Semiannual Risk Perspective

From the National Risk Committee

Fall 2020

Contents

About This Report ii

Executive Summary 1

Part I: Operating Environment 3
Economic Recovery Under Way, but Significant Downside Risks Remain 3
Financial Conditions Ease 4

Part II: Bank Performance 6
Pandemic Significantly Alters Banking Environment With Related Decline in Economic Activity 6

Part III: Special Topic on Emerging Themes 9

Part IV: Trends in Key Risks 12
A. Credit Risk Is Increasing 12
B. Bank Financial Performance 13
C. Operational Risk 15
D. Compliance and the Bank Secrecy Act 17

Part V: Supervisory Actions 19
Outstanding MRA Concerns 19

About This Report

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks and federal savings associations and licenses, regulates, and supervises the federal branches and agencies of foreign banking organizations.[1] The OCC supervises these banks to ensure they operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

The OCC's National Risk Committee (NRC) monitors the condition of the federal banking system and identifies key risks. The NRC also monitors emerging threats to the system's safety and soundness and ability to provide fair access to financial services and treat customers fairly. NRC members include senior agency officials who supervise banks of all sizes and develop bank supervisory policy. The NRC meets quarterly and issues guidance to examiners that provides perspective on industry trends and highlights issues requiring attention.

The OCC's *Semiannual Risk Perspective* addresses key issues facing banks, focusing on those that pose threats to the safety and soundness of banks and their compliance with applicable laws and regulations. This fall 2020 report presents data in five main areas: the operating environment, bank performance, special topic on emerging themes, trends in key risks, and supervisory actions. The report reflects data as of June 30, 2020, unless otherwise indicated.

The OCC welcomes feedback by email: NRCReport@occ.treas.gov.

[1] Throughout this report, the term "banks" refers collectively to national banks, federal savings associations, and federal branches and agencies.

Executive Summary

Key Takeaways

- The COVID-19 pandemic and efforts to contain its spread in the United States caused a historic economic downturn in early 2020. Economic activity rebounded in the third quarter, but there is significant ongoing financial risk.
- Banks remain in strong condition with sound capital and liquidity levels. Bank profitability is stressed due to low interest rates and increasing levels of provisions for problem loans.

Key Risk Themes

- Credit risk is increasing as the economic downturn affects customer ability to service debts.
- Strategic risk is an emerging issue due to the impact on bank profitability from a historically low-rate environment and potential credit stress.
- Operational risk is elevated as banks respond to altered work environments and an evolving and complex operating environment. Cybersecurity threats are a key driver of the heightened operational risk environment.
- Compliance risk is elevated due to a combination of altered work environments and the requirement to quickly implement new federal, state, and proprietary programs designed to support businesses and consumers.

Banks maintained their strong financial condition for the first six months of the pandemic. Many banks benefited from fee income from government programs aimed at offsetting the financial harm to businesses and consumers. The key risk themes facing the federal banking system are credit, strategic, operational, and compliance risks.

Credit risk is evolving as government assistance programs expire and unemployment levels remain elevated. Assistance programs have suppressed past-due levels.

Strategic risk affecting profitability is an emerging issue due to actions by the Board of Governors of the Federal Reserve System to support financial markets and restart the economy. Historically low interest rates for a long time period will negatively affect profitability. During the second quarter of 2020 (the first full quarter of the U.S. response to the pandemic), net income declined sharply due to higher loan loss provisions and lower net interest margins (NIM) primarily due to banks holding high levels of low yielding assets. Second-quarter NIM was the lowest measured in the past 30 years. Banks will face pressure to improve earnings through cost cutting and increasing risk, in both credit and investments.

Financial institutions are adjusting to a changing cyber landscape to protect their operations and customers from cyber criminals and fraud while many employees are working remotely. Banks adjusted operating models to accommodate large-scale telework but are having to manage the complexities of unique security and internal control challenges. Additionally, the adoption of new and innovative products and operating models in the financial sector requires banks to manage rapid technological and operational changes to business processes.

Banks expedited the implementation of assistance programs, which elevated compliance risk. These programs include the Coronavirus Aid, Relief, and Economic Security (CARES) Act's Paycheck Protection Program (PPP) and other federal, state, and bank-initiated forbearance and

deferred payment programs. These programs featured increased compliance responsibilities and high transaction volumes while banks were trying to assess the impact of a weakened economy.

Refer to part III of this report, which highlights the emerging trends in payment products and services.

Part I: Operating Environment

Economic Recovery Under Way, but Significant Downside Risks Remain

The COVID-19 pandemic and efforts to contain its spread in the United States triggered a historic economic downturn beginning in March 2020. Although real economic growth fell in the first quarter at a 5.0 percent annualized rate, the bulk of the contraction occurred in the second quarter, when U.S. real gross domestic product (GDP) contracted at an unprecedented annualized rate of 31.4 percent. The private service sector suffered the most, with massive job losses in high-touch industries, such as leisure, hospitality, and retail trade. For context, real GDP declined 10.1 percent between the fourth quarter of 2019 and the second quarter of 2020, compared with a peak-to-trough decline of 4.0 percent during the 2008–2009 recession.

The rebound in economic growth began in May 2020 when states implemented phased reopening plans that allowed some businesses to resume operations and rehire workers. Economic activity surged in May and June as consumers released pent-up demand and the economy regained 7.5 million jobs. The rebound, however, lost some momentum in late June and July when increases in COVID-19 cases caused southern and western states to pause or partially reverse their reopening plans. Nonetheless, economic growth sharply rebounded in the third quarter with historic GDP growth, resulting in GDP only slightly below first-quarter levels. Consumer spending and small business optimism increased sharply, reflecting improving economic confidence. The September 2020 unemployment rate of 7.9 percent was down from the April 2020 peak of 14.7 percent, and the labor force participation rate of 61.4 percent, while well off its pre-pandemic level, was essentially flat with the June 2020 rate.

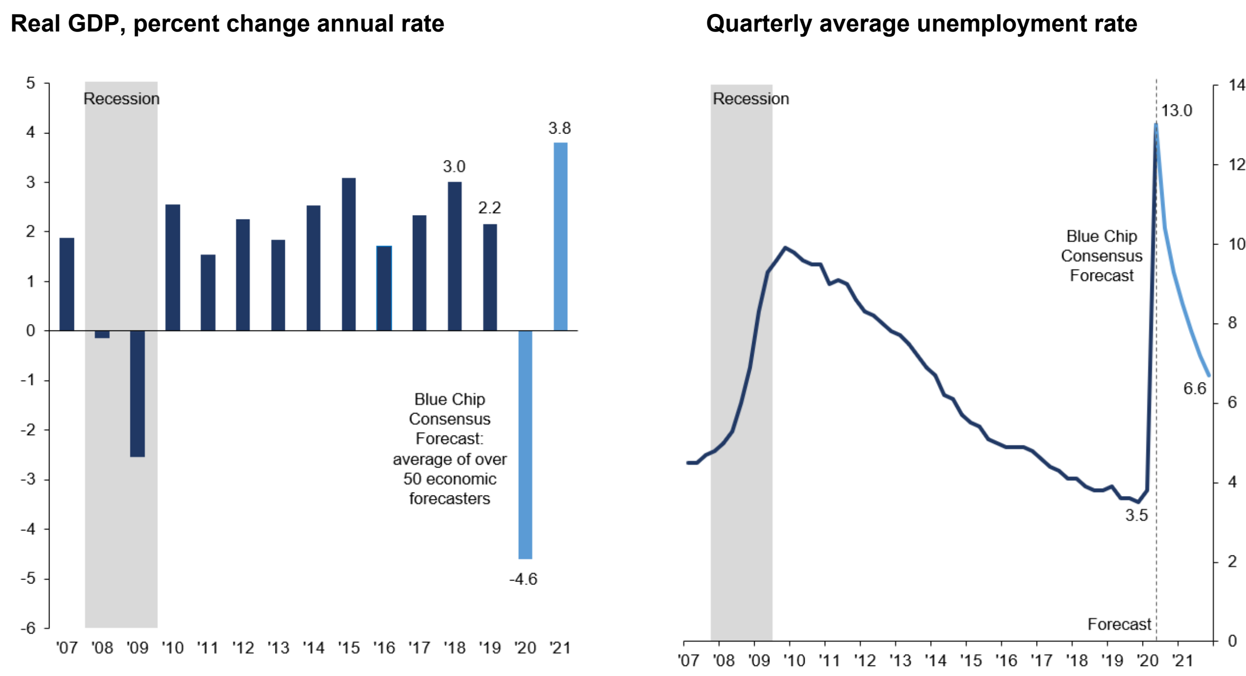
Residential housing has been resilient. U.S. residential investment boomed from rock bottom interest rates and a limited supply of homes. Housing starts are back to late 2019 levels. Existing and new single-family home sales are 4.1 percent and 41.2 percent above their February 2020 levels, respectively. National average single-family home prices continue to appreciate, although the pace of appreciation slowed.

Two of the primary risks to the economic recovery are the virus's path and uncertainty around income support from government stimulus programs. The increase in COVID-19 cases over the summer showed that spikes in virus infections can slow economic activity when local authorities restrict business activity. If a second wave of cases occurs, states maintain or increase business restrictions, and concerned consumers pull back spending, the recovery's strength will diminish as incomes decline and businesses close.

At the onset of the COVID-19 pandemic, the government implemented strong fiscal and monetary policies to support the economy. Fiscal support programs under the CARES Act more than offset lost wages from unemployment, pushing U.S. personal income 10 percent higher in April 2020 compared with February 2020. The higher income, in turn, supported consumption and household debt service. Several CARES Act programs, however, have expired. The personal stimulus check program was a one-time benefit distributed mostly in April 2020. The $600 per week supplemental unemployment insurance benefit program expired at the end of July 2020, and the PPP stopped accepting new applications in August 2020.

The Blue Chip Consensus Forecast as of September 2020 (refer to figure 1) is for annual U.S. real GDP to contract 4.6 percent in 2020. The consensus forecast is for annualized real GDP growth of 24 percent for the third quarter of 2020, with growth slowing to 4.9 percent in the fourth quarter. The forecast for annual real GDP growth is 3.8 percent in 2021, with growth slowing throughout the year. The quarterly average unemployment rate peaked at 13.0 percent in the second quarter of 2020 and is forecast to decline to 6.6 percent by the fourth quarter of 2021.

Figure 1: GDP and Unemployment Trends



Sources: U.S. Bureau of Economic Analysis, Bureau of Labor Statistics (historical data through 2Q:2020); Blue Chip Economic Indicators (September 2020)

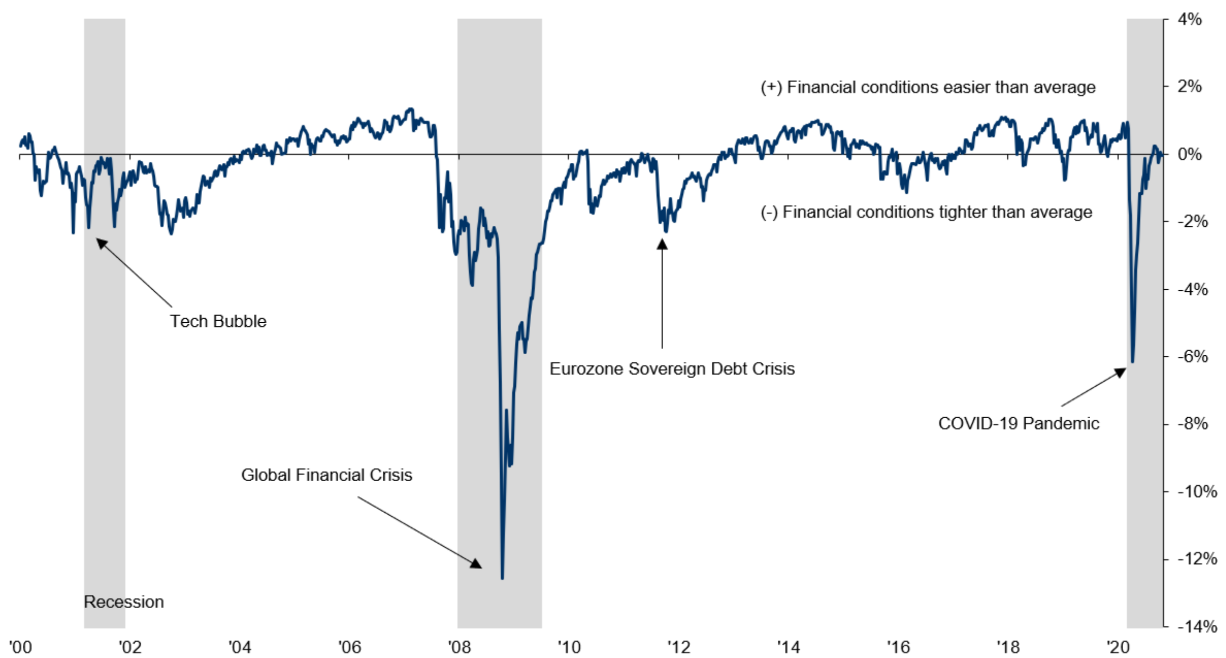
Financial Conditions Ease

Fiscal and monetary policy stimulus helped mitigate some of the initial economic effects of the pandemic that affected financial markets in the first half of 2020. Equity and bond markets stabilized after declining sharply from highs set in the first quarter. The Federal Reserve continued to implement accommodative measures while communicating that policy rates will remain low through 2022. U.S. Treasury market volatility declined to pre-COVID-19 levels as measured by bid-ask spreads and options market indexes. Other measures of financial conditions continued to ease as benchmark equity indexes and other risk assets rose to all-time highs (refer to figure 2). Tightening credit spreads accompanied the upward move in equity markets. Investment grade and high-yield corporate bonds witnessed a record amount of new issuance as borrowing costs fell to record lows. The combination of fiscal and monetary policy stimulus further supported market functioning and credit intermediation.

U.S. equity market volatility, measured by the S&P 500 VIX Index, fell dramatically during the second and third quarter of 2020. Market participants increased allocations to riskier assets while continuing to absorb the rise in supply of safe assets. Risk repricing generally followed

announcements by central banks to establish or increase asset purchase programs, liquidity facilities, and direct lending. In wholesale funding markets, repo and U.S. dollar funding market liquidity improved following the Federal Reserve's introduction of facilities to improve liquidity conditions (e.g., swap lines and commercial paper facilities). Higher demand for U.S. Treasuries and fixed-income assets helped ease broad funding conditions in bond markets despite the rise in issuance. Areas of dislocation persist in some parts of the market as funding and credit conditions remain uncertain. For instance, higher-risk municipal bond indexes continue to trade off their pre-crisis peaks as risks remain despite more aggressive policy actions. As of early October 2020, equity markets have recovered from the COVID-19-related sell-off with the S&P 500 near record highs, although international equity indexes underperformed U.S. benchmarks.

Figure 2: U.S. Financial Conditions Index



Source: Bloomberg (data through October 2, 2020)

Note: The U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions while a negative value indicates tighter financial conditions relative to pre-crisis norms.

Part II: Bank Performance

Pandemic Significantly Alters Banking Environment With Related Decline in Economic Activity

Before the onset of the COVID-19 pandemic and associated economic distress, bank balance sheets were in a strong position with historically high capital ratios and ample liquidity. These strong positions, as well as forbearance and monetary and fiscal policy measures, provide banks with greater resilience to manage through the pandemic. Risk-based ratios had increased over the past decade because of higher capital levels and lower risk in the system as measured by risk-weighted assets.

Bank liquidity levels are sound because of sharp increases in deposits due to a flight to quality by customers resulting in increased cash levels. The federal banking system's liquid assets[2] to total assets was at 15.3 percent at the end of 2019. Cash reserves created by the Federal Reserve injected additional liquidity, increasing cash balances by almost $900 billion and raising the share of liquid assets to 22.5 percent as of June 2020.

The financial effects of the credit, strategic, operational, and compliance risks remain uncertain in the near-term as banks adapt to the effects of the COVID-19 pandemic. As table 1 shows, earnings were down for the federal banking system and for smaller banks. The declines resulted from continued pressure on NIM and a significant increase in provisions in the first half of 2020. Growth in provisioning was more pronounced for the system, driven by the largest banks that in first-quarter 2020 also had to recognize the impact from the implementation of the current expected credit loss (CECL) accounting standard, with an overall increase of 355 percent compared with 2019. For smaller banks, provisions increased 197 percent; charge-offs and provisions, however, tended to be more predominant in the fourth quarter. Noninterest income for smaller banks increased on gains from loan sales and fees from loan originations. In addition to gains on loan sales, larger banks also saw an increase in trading revenues.

[2] Liquid assets are defined as cash, U.S. Treasury securities, and net Fed Funds.

Table 1: Trends in Bank Net Income

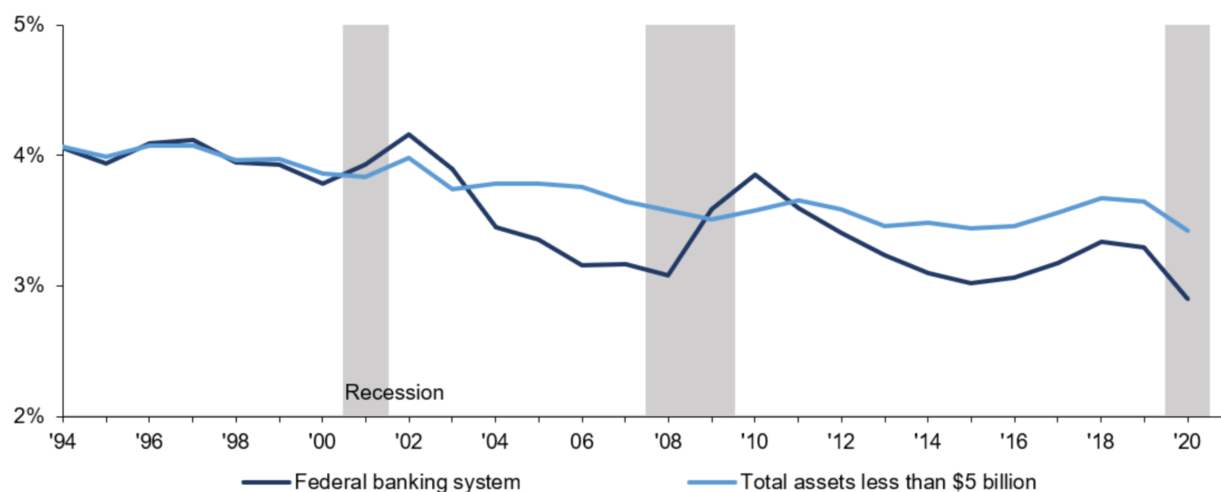
	Federal banking system			Banks with total assets of less than $5 billion		
	6/30/2019	6/30/2020	Y/Y % change	6/30/2019	6/30/2020	Y/Y % change
Year-to-date revenues in billions of dollars						
Net interest income	183.5	173.7	-5.3%	8.0	8.2	2.9%
Noninterest income	96.9	99.0	2.2%	2.9	3.5	23.6%
Year-to-date expenses in billions of dollars						
Provisioning	19.5	88.8	354.8%	0.3	1.0	197.4%
Noninterest expense	156.1	166.2	6.5%	7.3	7.8	6.6%
Net income	**84.7**	**18.9**	**-77.7%**	**2.7**	**2.6**	**-5.3%**

Source: Integrated Banking Information System (OCC)

Note: Data are merger-adjusted and held constant for banks in continuous operation for the first quarter of 2015 to the second quarter of 2020. Banks with less than $5 billion in total assets exclude credit card and trust institutions.

In addition to the emerging credit cycle, bank profitability will struggle as banks face continued stress from low interest rates (refer to figure 3). NIM, which declined for banks of all sizes over the past year, is a driver of most banks' revenues and profits. Like the overall decline in net income, the NIM drop was much more pronounced for the large banks over the last year.

Figure 3: Trend in Net Interest Margins



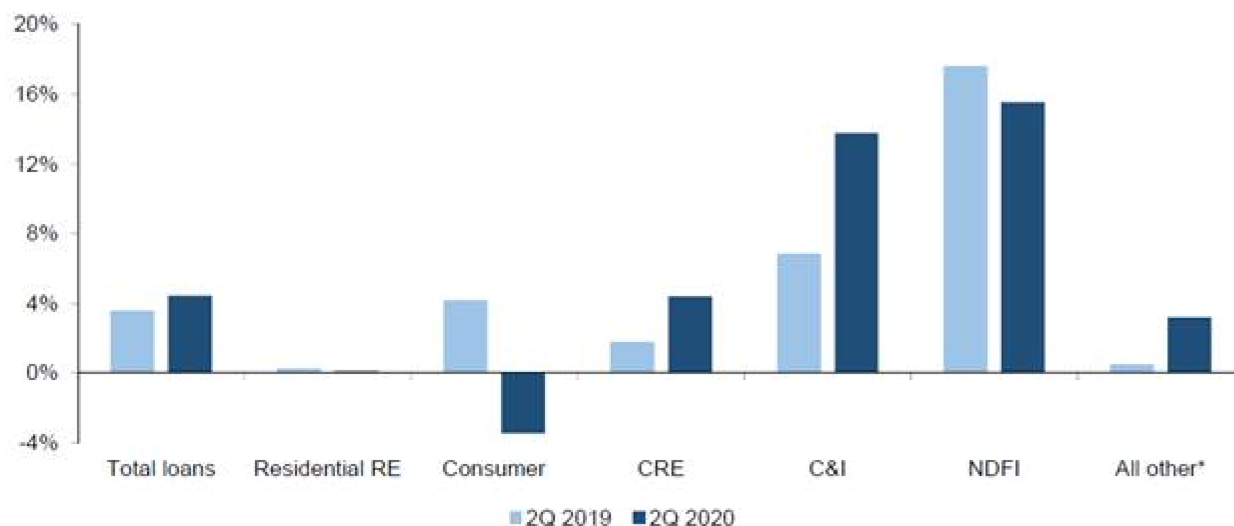
Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2019 and annualized for the first half of 2020. Banks with less than $5 billion in total assets exclude credit card and trust institutions.

Increased economic uncertainty and the effect of the CARES Act PPP program drove an increase in total loan growth (refer to figure 4). Companies increased cash holdings as a safety buffer by drawing down on bank lines of credit and accessing the public debt markets at the beginning of

the COVID-19 crisis. Of note, commercial and industrial (C&I) loan growth doubled compared with a year earlier mainly due to line-of-credit drawdowns. In contrast to business lending, a plunge in consumer spending resulted in a decline in consumer loans.

Figure 4: Year-Over-Year Change in Loan Balances



Source: Integrated Banking Information System (OCC)

* All other includes agriculture loans and loans to government, banks, and municipalities.

Note: Data are merger-adjusted and held constant for banks in continuous operation for the first quarter of 2015 to the second quarter of 2020. Banks with less than $5 billion in total assets exclude credit card and trust institutions. RE is real estate, CRE is commercial real estate, and NDFI are non-financial depository institutions. CRE includes commercial mortgages and construction loans.

Part III: Special Topic on Emerging Themes

Payment processing is a fundamental component of banking. Effective controls and sound risk management of payment systems are essential to maintaining the safety and soundness of the federal banking system. Increased demand for more accessible and functional payment mechanisms has resulted in technological advances and new innovative products and services. These products offer faster and more streamlined payment services and have opened the payment ecosystem to new entrants. As customers continue to expect faster and more expanded payment services, banks are pressured to develop, introduce, and implement new or innovative payment services to remain competitive. This rapid change driven by recent innovations contributed to an increasingly complex operating environment for payments.

The number and value of non-cash U.S. payments continue to increase, reaching 174.2 billion transactions and $97.04 trillion in value in 2018. Wholesale payments account for a large percentage of the value of payments, while increases in the volume of transactions is driven by retail transactions.[3] Consumers are increasingly relying on electronic means to transact payments, with a corresponding decline in the use of more traditional methods. Remote card payments, commonly used for e-commerce and online bill payment transactions, reached $3.29 trillion in 2018, nearly matching the value of payments made by using in-person cards.[4] In a recent Federal Reserve Bank of Atlanta study of consumer payment choice, nearly 75 percent of consumers used online banking, with 60 percent of consumers using mobile banking services.[5] Notably, nearly half of the consumers surveyed had at least one nonbank payment account such as PayPal or Venmo.[6] Reported interest in electronic and other forms of contactless payment has increased due to the COVID-19 pandemic.

Digital currencies and crypto-assets are becoming more widely accepted and used. A survey conducted by the Bank for International Settlements (BIS) in 2019 indicated that 80 percent of the 66 central banks that responded, representing one-fifth of the world's population, are working on central bank digital currencies.[7]

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[3] Refer to "The 2019 Federal Reserve Payments Study." Non-cash U.S. payments addressed in that study are debit card, credit card, automated clearing house, and check payments.

[4] Refer to "The 2019 Federal Reserve Payments Study," pp. 2 and 5.

[5] Refer to the Federal Reserve's "2019 Survey of Consumer Payment Choice," p. 5.

[6] Ibid.

[7] Refer to the Bank for International Settlements' *Impending Arrival—A Sequel to the Survey on Central Bank Digital Currency* (January 2020), p. 3.

Other survey evidence suggests that nearly 40 million Americans own cryptocurrencies.[8] Currently, there are several thousand cryptocurrencies in circulation with a market capitalization of about $329 billion. Bitcoin remains the largest, representing 58.5 percent of the total market capitalization,[9] and some major U.S. retailers now accept bitcoin as a form of payment.[10]

Faster and more versatile payment services can offer many benefits to banks and customers. The increased use of mobile technologies, application programming interfaces, and contactless payment devices and the emergence of distributed ledger technologies have broadened the delivery channels and functionality of payment systems. The adoption of these innovative delivery channels, however, may require additional or different controls to continue to safeguard against fraud, terrorist financing, or operational errors. Banks should have effective processes in place to manage changes to critical business processes and keep policies and procedures up-to-date with the implementation of new payment products and services.

The increasing speed of payments and use of alternative delivery channels require banks to maintain comprehensive operational resilience frameworks commensurate with the volume and complexity of the payment processes being supported. A bank's ability to maintain and support critical payment operations against different threat scenarios and quickly respond to incidents, such as security breaches and fraud, is essential. The expansion of payment services across multiple delivery channels and the introduction of new entrants into the payment ecosystem has provided a wider threat landscape that malicious actors may seek to exploit. Banks should ensure that operational resilience, cybersecurity, Bank Secrecy Act (BSA), and fraud controls keep pace with the changing payment landscape.

While banks are evolving and adapting to these changes in payment systems, many are using third-party relationships to manage new technologies and payment products. As part of this growth, banks are entering into partnerships with nonbanks to offer faster payment functionality, especially for retail payment services. Banks should conduct appropriate due diligence and oversight commensurate with the risk of the payment activity to manage these third-party relationships.[11]

In addition to partnering with banks, an increasing number of nonbanks have been offering payment services directly to customers outside of more traditional banking relationships. Over the past decade, an increasing amount of user-facing payment activity has moved from banks and their service providers to other nonbank companies that engage in banking activities. This is particularly true in retail, where some activity is migrating to payment companies that may compete with traditional banks. Payment activity being conducted by these newer entrants outside the banking industry may be subject to less regulatory oversight. Banks should ensure

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[8] OCC Interpretative Letter 1170, at p. 4, note 14 (July 22, 2020), citing Helen Partz, "11% of Americans Own Bitcoin, Major Awareness Increased Since 2017," Yahoo Finance (April 30, 2019).

[9] Top 100 Cryptocurrencies by Market Capitalization, Coinmarketcap.com (last visited September 21, 2020).

[10] For example, bitcoin is accepted at retailers including Starbucks, Nordstrom, and Whole Foods.

[11] Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," and OCC Bulletin 2020-10, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29."

that their strategic planning and risk management processes are sufficiently robust to be able to adapt to this changing environment and manage, partner, or compete with new entrants as needed.

Maintaining safe and sound payment systems continues to be a fundamental component of banking. As the processing of payments evolves and new entrants are introduced into the payment ecosystems, it is important that bank's risk management and controls keep pace with this change. Controls include governing the integrity, timeliness, security, and resilience of payments regardless of the technologies used or innovative process used. OCC supervision will continue to focus on the integrity of banks' payment systems to maintain the safety and soundness of the federal banking system.

Part IV: Trends in Key Risks

A. Credit Risk Is Increasing

Commercial, retail, and mortgage credit risks are increasing. Reduced business activities and record levels of unemployment have adversely affected customers' ability to service debts, and nonperforming loans have increased. Losses, however, have yet to fully materialize across many segments of the banking industry. The system-wide offering of proprietary relief and mandated programs coupled with unprecedented stimulus efforts is likely masking potential losses within the financial services industry.

From a commercial lending perspective, challenges are present in most sectors. Businesses that were weak before the pandemic, including highly leveraged borrowers, are especially vulnerable. Commercial real estate, oil and gas, retail businesses, transportation, leisure and hospitality, and agricultural lending are areas of increasing risk exposure. Commercial borrowers' cash flows have been negatively affected, including businesses that do not offer telework flexibility (e.g., high-touch businesses such as retail and hospitality). As a result, levels of special mention and classified assets are increasing.

From a retail lending perspective, quickly emerging credit, operational, reputation, and compliance risks due to widespread COVID-19 crisis stay-at-home orders have resulted in rapidly increasing volumes of business service reductions/closures, unemployment claims, and mandatory (federal/state) or voluntary (financial institutions) payment, foreclosure, or repossession relief programs for all types of retail loans.

Banks should continue to work prudently with borrowers that are or may become unable to meet their ongoing contractual payment obligations. The OCC expects banks to maintain accurate and timely loan risk ratings based on the borrower's financial condition, repayment ability, and ability to manage through the COVID-19 crisis. This includes maintaining an appropriate allowance for loan and lease losses or allowance for credit loss (ACL), as applicable. As detailed in the Federal Financial Institutions Examination Council's (FFIEC) "Joint Statement on Additional Loan Accommodations Related to COVID-19,"[12] issued on August 3, 2020, it is important to maintain prudent loan modification options. These options include evaluating the borrower's willingness and ability to repay, extending terms that are consistent with the nature and duration of the hardship, having affordable and sustainable payment requirements, and promoting orderly repayment of all amounts owed. The CARES Act and related regulatory guidance have also provided temporary relief of certain reporting requirements when considering troubled debt restructurings.

The ACL should continue to reflect the risks in the loan portfolio with qualitative factors considering current environmental issues and potential modeling issues related to the pandemic. This includes assessing the potential for financial impact from the pandemic on borrowers. Several banks transitioned to the CECL model during the first quarter of 2020. Some banks

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[12] Refer to OCC Bulletin 2020-72, "Credit Administration: Joint Statement on Additional Loan Accommodations Related to COVID-19."

deferred planned CECL implementation based on the flexibility provided by the CARES Act. Banks substantially increased their loan loss provisions during both the first and second quarters of 2020 reflecting the expected increases in loan losses in the coming periods.

B. Bank Financial Performance

Bank profitability is emerging as a strategic risk as banks are challenged by low interest rates, credit quality concerns, significant asset growth in low yielding assets, and weak loan demand. As discussed in the bank performance section, NIMs significantly declined in 2020 (refer to figure 3) and will affect future profitability and business plans.

Most banks have asset-sensitive balance sheets contributing to the margin reduction as interest rates sharply declined early in 2020. Deposits and assets at OCC banks increased by $1.7 trillion with growth of $1.5 trillion in large banks since year end 2019 (refer to table 2). Most of the growth was in low-yielding assets, which had a negative impact on margins. The combination of the low-rate environment and uncertainty around the stability of recent balance-sheet growth creates a difficult environment for profitability. Similarly, bank fiduciaries are experiencing intense fee compression driven by competition, digital disruptors, and increased investor demand for lower cost products and services. Reputation, compliance, and strategic risks are elevated as asset managers seek alternative revenue sources or ways to reduce costs. Bank management should consider the need for liquidity with the need for internal capital generation through earnings.

Significant balance-sheet growth, in addition to declining interest rates, affected large bank margins. Ninety percent of the asset growth was in low-yielding interest-bearing bank balances, Fed Funds sold, repurchase agreements, and U.S. Treasury securities, which suppressed interest income growth. In today’s low interest rate environment, these investments, though highly liquid, put additional strain on profitability. Banks are operating with excess high-quality liquid assets and should monitor the stability of the recent deposit inflows.

Banks deployed new funding into a mix of loans and liquid investments. The banks benefited from increasing loan portfolios because of the PPP, as shown in table 2. The growth in commercial loans was almost entirely in PPP loans. In midsize banks, 34 percent of balance sheet growth was also in interest-bearing bank balances, while commercial loans and U.S. Treasuries grew 29 percent and 14 percent, respectively. For community banks, 41 percent of asset growth was in commercial loans, 34 percent in interest-bearing bank balances, and 11 percent in real estate loans.

Table 2: Top Three Areas of Balance-Sheet Growth (12/31/19–6/30/20) ($'s in Billions)

Large Banks

Total six-month asset growth	**$1,471**	
Interest-bearing bank balances	$832	57%
U.S. Treasury and agency debt	$270	18%
Federal funds sold/resales	$226	15%
% of total asset growth		90%

Midsize Banks

Total six-month asset growth	**$114**	
Interest-bearing bank balances	$39	34%
Commercial loans	$34	29%
U.S. Treasury and agency debt	$16	14%
% of total asset growth		77%

Community Banks

Total six-month asset growth	**$98**	
Commercial loans	$40	41%
Interest-bearing bank balances	$33	34%
Real estate loans	$10	11%
% of total asset growth		86%

London Interbank Offered Rate

The London Interbank Offered Rate (Libor) is referenced globally for a variety of financial products and related processes, and its cessation could affect banks of all sizes through direct or indirect exposure. Seamless transition to a new rate(s) is important to operational, compliance, legal, and reputation risks. A seamless transition is also important to prevent balance-sheet destabilization and negative financial impact. In anticipation of Libor's cessation at the end of 2021, banks should continue to apply sound risk management principles to ensure successful transition.

Most OCC banks have either quantified Libor exposure or are in the process of quantifying exposure. Larger banks are identifying exposures in various asset, liability, derivative, and asset management products. In community banks, exposures have been heavily weighted toward the asset side of the balance sheet. Banks are working to assess third party impacts and exposures. Banks continue to work through fallback language and are in various stages of identifying and negotiating language in legacy contracts and incorporating language in new contracts.

Libor cessation is also a concern for asset managers to the extent they manage or service assets tied to Libor, use Libor in their investment or performance models or operational processes, or serve as corporate trustee for securities tied to Libor.

The OCC continues to communicate with external stakeholders on potential Libor cessation. Banks can reference OCC Bulletin 2017-43, "New, Modified, or Expanded Bank Products and Services: Risk Management Principles," as they incorporate new Libor-related changes. In July 2020, the FFIEC Libor working group published a "Joint Statement on Managing the Libor Transition." The joint statement highlighted the risks of the transition away from Libor and encouraged supervised institutions to continue efforts to prepare for and mitigate these risks. In July 2020, the OCC published OCC Bulletin 2020-68, "FFIEC Statement on Managing the Libor Transition and Guidance for Banks," which expanded on the earlier FFIEC Libor working group statement and provided additional guidance and information about risk management for the Libor transition.

There are still many challenges that market participants face with respect to replacing Libor. It is important for banks to recognize and plan for migration to other potential replacement rates and adjustment methodologies including a date at which they will cease to originate Libor-indexed loans without sufficient fallback language. It is also important that bank management consider potential Libor exposure in services provided by third parties such as contract servicing, systems, and models. The plan should be based on the assessment of the bank's Libor exposures and need for replacement rates.

The International Swaps and Derivatives Association is working with market participants to develop fallback language addressing the replacement rates for derivatives contracts. The association will finalize a supplement to the 2006 International Swaps and Derivatives Association definitions and a protocol to allow firms to incorporate the fallback language into new and legacy interbank offering rate derivatives contracts.

The OCC will continue to assess Libor exposures in OCC-supervised banks and the safety and soundness of their preparation plans to transition to another reference rate. During 2021, the OCC will increase its oversight, particularly for banks with significant Libor exposure or less-developed transition processes.

C. Operational Risk

Cybersecurity

Banks should remain vigilant concerning cybersecurity control and risk management practices as banks face continuous threat from cyber actors. These actors have become less inhibited and more sophisticated with their knowledge of the financial institution operations and vulnerabilities in bank applications or systems. In addition to exploiting susceptibilities, cyber actors continue to use popular exploitation methods, such as phishing and credential theft, to compromise bank systems.

While banks overall have adequate cybersecurity systems, examiners continue to identify concerns in banks related to bank information technology (IT) systems, change management, and information security.

The financial sector continues to see an increase in ransomware attacks with cyber actors using phishing emails as the main attack vector. Recently, cyber actors have elevated their tactics to not only target and encrypt bank data while compelling payment but also threaten to auction or publish customer information on the dark web. Banks should have a clear understanding of the impact of a ransomware attack and the potential effects on the banks' customers and third parties. Potential operational impacts from ransomware include disruption of core business activities, operational outages, lockout of business data, and switching to manual operations. Downstream impacts to customer data from a ransomware attack include stealing and removing data and monetizing and auctioning customer and supplier information. Banks should be able to identify and respond to new threats in a timely manner to prevent potentially significant impacts. Bank personnel should be made aware of possible threats that may affect their line of business,

and the board of directors and senior management should be informed of critical cybersecurity threats that may affect the bank, its customers, or suppliers.

Because of increased ransomware attacks in banks, the OCC and the Federal Deposit Insurance Corporation issued a joint statement on heightened cybersecurity risk."[13] The statement, issued on January 16, 2020, elaborated on processes and controls articulated in the *Interagency Guidelines Establishing Information Security Standards* and *FFIEC IT Examination Handbook* booklets. The joint statement highlighted sound risk management principles for cybersecurity as response and resilience capabilities, specifically patch management, multifactor authentication, and system configuration. Additionally, the statement highlighted that banks should maintain off-site and off-line backups and regularly test their restoration practices consistent with industry standards and frameworks, such as Sheltered Harbor's data vaulting approach.

The joint statement reminded banks to establish strong customer and user access management processes, including use of strong authentication controls, such as multifactor authentication. The statement addresses network configuration and system hardening, focusing on the need for defined and verified network and software system settings, routine review and validation of settings, and timely implementation of security updates and system patches.

Comprehensive Operational Resilience Frameworks

The potential for operational disruptions, whether caused by physical disaster, pandemic event, cyber attack, or other similar events, underscores the need for effective incident response controls and operational resilience capabilities. These can help ensure the ongoing delivery of financial products and services in a safe and sound manner. Operational resilience capabilities should be designed to address all hazards and minimize the impact of disruptions or outages to critical operations, including the ability to respond and recover from destructive cyber attacks such as ransomware.

Adoption of New and Innovative Products

Banks continue to modify business models and introduce innovative products and services, which increase change management risk. Many of these changes are driven by the need to compete with new and emerging customer-driven technologies or new entrants to the marketplace. Examples include new payment channels and the drive toward faster and real-time payments. While technological advances have spurred the development of new products designed to foster faster payments, these innovations have contributed to an increasingly complex operating environment. Risk and control environments need to keep pace to address these changes.

Other Contributors to Elevated Operational Risk

Economic shocks from the COVID-19 pandemic, low interest rates, and other factors may challenge banks in maintaining or increasing profitability. In response to similar challenges, banks have traditionally cut costs to maintain margins. Key control functions and processes, such

[13] Refer to OCC Bulletin 2020-5, "Cybersecurity: Joint Statement on Heightened Cybersecurity Risk."

as risk management, audit, compliance, and staff development, should be maintained to ensure risk management oversight during times of economic stress. Growth in bank employees' teleworking during the crisis increased controls risks. Cost-cutting considerations need to be carefully balanced with a proper control and testing environment as well as risk management practices that can prevent increased losses. Banks' focus should be on adapting technology systems and operational processes for current and future changes to industry standards and regulatory requirements. Examples include changes necessitated by Libor's potential cessation and pending CECL requirements discussed in the sections on credit risk and bank financial performance, respectively.

D. Compliance and the Bank Secrecy Act

Compliance risk is increasing, driven by government programs and mandates related to the CARES Act and state government requirements. These factors can create challenges for full and accurate implementation of bank policies to meet BSA, consumer protection, and fair lending requirements. Specifically, these include responsibilities associated with underwriting and opening new accounts, monitoring customer activity, processing transactions and loan modifications, servicing loans, communicating with customers, and meeting BSA and Office of Foreign Assets Control compliance obligations.

Bank Secrecy Act

Criminals continue to adapt scams and money-laundering techniques to the new environment created by the COVID-19 pandemic. Through these schemes, criminals scam people into moving illicit money on their behalf through funds transfers, physical movement of cash, or various other methods. Banks should be vigilant in identifying potentially illicit activity, including monitoring for schemes designed to take advantage of people affected by the COVID-19 pandemic and other means that criminals can use to exploit the situation. COVID-19-related scams are likely to increase if the pandemic is protracted. Examples include scams targeting people in need of care by advertising and trafficking counterfeit medicines and phishing schemes with the aim of stealing personal and financial information. Criminals and terrorists may exploit the public's goodwill by setting up fake charities to accept donations that appear to be intended to help others suffering from the pandemic. Other scams include work-from-home schemes aimed at people who are out of work or those looking to earn a living while quarantined at home.

Banks can monitor information provided by law enforcement agencies and international anti-money-laundering standard-setting organizations regarding how criminals adapt scams and money-laundering techniques to exploit vulnerabilities created by the pandemic. The Financial Crimes Enforcement Network website includes a coronavirus updates section that provides common red flags and COVID-19-related schemes. Banks should be aware of evolving typologies and ensure that their anti-money-laundering programs are commensurate with their risk profile.

Banks should implement appropriate risk-based adjustments in their BSA systems based on COVID-19-related circumstances and keep examiners updated on potential BSA and sanctions compliance issues, including potential delays in meeting regulatory requirements. Banks should

track and manage deferred actions and any other departures from standard processes or procedures, so they can appropriately adjust their systems after the operating environment has returned to normal. The OCC is adjusting its risk-based approach for BSA compliance examinations based on these circumstances and will consider the impact of COVID-19-related measures on BSA compliance in determining any new supervisory response.

Consumer Compliance

Banks should follow effective change management and compliance risk management processes to identify, measure, monitor, and control the emerging risks related to consumer products or services associated with the COVID-19 pandemic. Pandemic-related changes in bank staffing and availability may affect banks' ability to comply with CARES Act provisions and other regulatory requirements. In addition, banks' strategies for processing consumer requests and applications may vary with implementation, increasing the risk of disparate treatment and disparate impact on a prohibited basis. Appropriate monitoring measures help banks provide fair and consistent assistance and support to applicants and borrowers.

Branch closures, reduced operations, and communication issues (e.g., limited hours, lobby or location closures, and strained call center capacity) may result in increased customer complaints that could indicate operational or compliance-related issues. Banks must remain diligent to ensure compliance with consumer protection, fair lending, and other laws and regulations when dealing with applicants for new or modified loans and working with customers affected by the COVID-19 pandemic. Additionally, the increased reliance on remote work environments may create challenges to maintaining safeguards for protecting consumers' personal information and for monitoring customer interactions for consistency with bank policies and procedures.

Banks are encouraged to review interagency and Consumer Financial Protection Bureau statements that provide information on working with borrowers affected by the pandemic. These statements clarify the agencies' supervisory and enforcement priorities and approaches for fair lending and other consumer protection laws during the pandemic.

The OCC considers the unique circumstances affecting borrowers and banks due to the COVID-19 pandemic and will consider banks' good faith efforts designed to support customers and comply with applicable laws and regulations.

Community Reinvestment Act

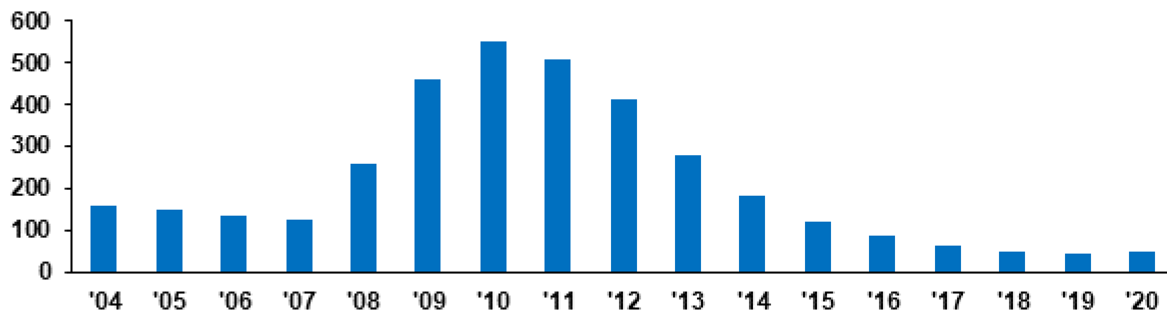
Banks are advised to follow effective change management and compliance risk management processes to identify, measure, monitor, and control emerging risks that may be associated with implementing the final Community Reinvestment Act (CRA) rule published on June 5, 2020 (June 2020 rule).[14] Banks may need to adapt operational systems, establish a system of controls including developing new policies and procedures, and train personnel to ensure compliance with the June 2020 rule. Bank personnel responsible for administering bank compliance with the CRA may access OCC resources to ensure that they are aware of new OCC policies and procedures established to implement the June 2020 rule as they are issued.

[14] Refer to "Community Reinvestment Act Regulations," 85 Fed. Reg. 34734-834.

Part V: Supervisory Actions

Banks rated 3, 4, or 5 have not changed materially (refer to figure 5). As of the second quarter of 2020, there were 48 banks with 3, 4, or 5 ratings, an increase from 44 in the fourth quarter of 2019.

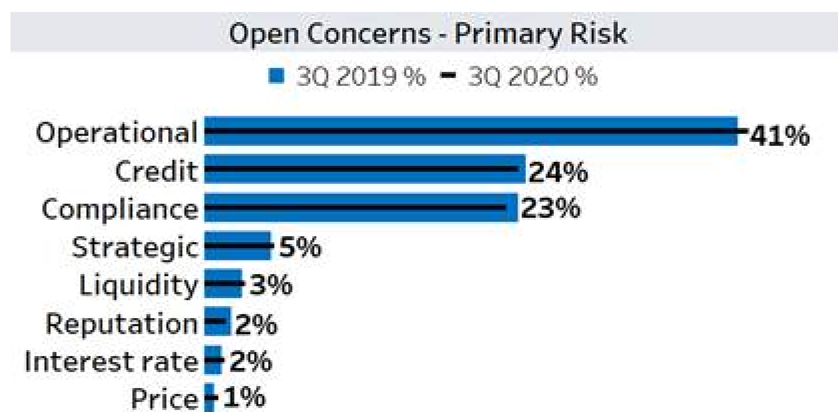
Figure 5: Number of Banks Rated 3, 4, or 5 Is Low



Outstanding MRA Concerns

The OCC communicates supervisory concerns to a bank's board and management in the form of MRA concerns or enforcement actions (EA). Supervisory concerns include practices that deviate from sound governance, internal control, or risk management principles.[15] Such deviations, if not addressed appropriately, could adversely affect a bank's condition or risk profile, result in violations of laws or regulations, and result in EAs. The number of open MRAs is basically unchanged from the second quarter of 2019. Figure 6 shows the composition of outstanding MRA concerns.

Figure 6: Open Matters Requiring Attention



Note: Figures do not add to 100 percent because of rounding.

[15] Refer to OCC Bulletin 2019-44, "Comptroller's Handbook Examination Process Series: Updated Booklets and Rescissions."