Office of the
Comptroller of the Currency

Semiannual Risk Perspective

From the National Risk Committee

Spring 2020

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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 spring 2020 risk perspective focuses on the financial impact from the COVID-19 pandemic on the federal banking industry. The report presents data in four main areas: the operating environment, bank performance, special risk topic, and trends in key risks. The report reflects data as of December 31, 2019, 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

- At the beginning of the COVID-19 pandemic, banks were in strong condition with sound capital, liquidity, and strong asset quality. The rapid decline in economic conditions will broadly affect bank earnings, credit quality, operations, and capital.
- Market risk volatility stabilized since the beginning of the pandemic as the creation of numerous Federal Reserve funding facilities improved market liquidity.

Key Risk Themes

- Bank profitability will be challenged as interest rates are at historic lows, past due loans and provisions for loan losses are increasing, and operational expenses are rising.
- Record high unemployment levels and business closings will stress credit risk management.
- Operational risk is elevated with banks implementing new processes and procedures, adopting pandemic related continuity plans, and responding to increased fraud and cyber risk.
- Compliance risk is increasing due to new assistance programs for consumers and small businesses, resulting in high call volumes and reassigned staff implementing new practices and procedures.

This report was prepared during the April to early June time period. During this time, states began phased reopening of their economies. As restrictions loosened, business activity started to increase in May. Economic data releases in early June showed signs of recovery, with a gain in nonfarm payrolls, increase in residential building permits, and a jump in retail sales. If these positive trends continue, the depth and breadth of credit issues discussed in this report may be less severe. Additionally, higher employment will influence the level of mortgage forbearance requests and potentially reduce delinquencies. While the current Blue Chip consensus forecast is for growth to resume in the second half of 2020, the strength and path of the recovery remains uncertain. Bank profitability remains dependent on the depth and duration of the economic downturn that is difficult to predict. Banks are taking appropriate action through increased credit provision expenses to prepare for potential increased credit stress.

The response to the COVID-19 pandemic triggered a broad-based shock to the U.S. and global economies. The National Bureau of Economic Research declared that the U.S. economy entered a recession in February 2020. The speed and depth of the downturn rapidly disrupted business and consumer economic activity, pushing unemployment up to its highest rate in 80 years, pummeling consumer and business confidence and spending. As a result, banks are facing a substantial increase in credit and operational risks. Before the economic downturn brought on by the pandemic, the banking sector was in a position of considerable strength, with sound capital and liquidity, low problem assets, and effective risk management systems. Matters requiring attention (MRA) and banks rated 4 and 5 were at 10-year lows, reflecting the strong economy

and banks' sound risk management practices. The strength of the federal banking system allowed banks to proactively work with borrowers and be a source of strength when the pandemic started.

Financial institutions are beginning to see the adverse credit effects of the economic shock through increased customer forbearance requests and higher provisions for loan losses. While the duration of the downturn is not yet known, stress on balance sheets, earnings, and operations will continue through 2020. Bank management should proactively work with borrowers as individual circumstances warrant and within provisions of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and other relief programs.

The broad themes facing the federal banking system are weak financial performance, elevated credit, and operational risks. Higher credit losses, higher overhead expenses, and lower net interest income affecting financial performance. The onset of the pandemic created an uncertain credit environment testing the resiliency of both commercial and retail loan portfolios. Credit risk management practices need to be flexible and proactive to meet the challenges of the current environment. Operational risk is heightened as banks amended business processes and engaged third parties to support widespread remote work capabilities, increased technological capacity, and solutions to maintain operations under elevated operational volumes.

The OCC is actively monitoring risks to the federal banking system and is working closely with other federal banking regulators.

The following issue may develop into a key risk and warrants awareness among bankers and examiners:

- Compliance risk is elevated due to a combination of altered operations, employees working remotely, and the requirement to operationalize new federal, state, and propriety programs designed to support consumers such as the CARES Act, Paycheck Protection Program (PPP), and a variety of forbearance and deferred payment programs. Among other challenges these conditions complicate the compliance responsibilities associated with managing high transaction volumes and various programs of consumer and business lending in a weakened economy.

Refer to part III of this report, which highlights government relief programs as a special risk topic.

Part I: Operating Environment

Significant Rapid and Large Shock to U.S. and Global Economy

The COVID-19 pandemic and containment efforts locked down large swaths of the United States and global economy and poses the greatest economic challenge since the Great Depression.

By mid-April, more than 80 percent of U.S. counties were under stay-at-home orders for nonessential workers. Throughout May, nearly every state started to implement phased reopening plans, partially lifting stay-at-home orders. By the end of May, only 10 percent of counties continued to have stay-home-measures in place. Counties that remained in stay-at-home order tended to be large, more urban counties in the Northeast and on the West Coast. Recent data releases suggest that states reopening their economies and support from fiscal stimulus programs may allow for the recovery to begin in the third quarter.

Over 42 million workers applied for unemployment insurance from mid-March through the end of May, which represents one in five of those previously employed. Consumer and business confidence plunged, leading to large drops in spending in March and April, but confidence appears to have bottomed out with no additional declines in May. April retail sales dropped a record 16.4 percent following an 8.7 percent decline in March compared to February.

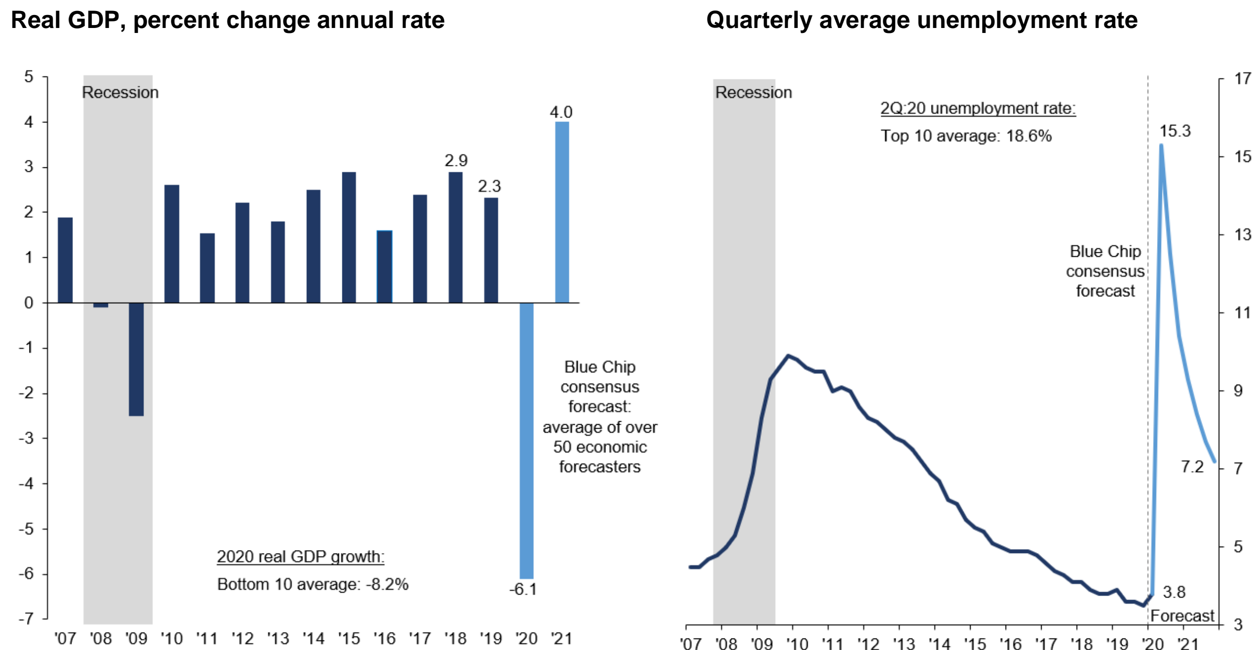
The collapse of oil prices roiled financial markets and will have a net negative economic impact on the United States and other oil producing countries. Demand for oil in the United States and abroad was down an estimated 30 percent in April on a year-over-year basis, creating excess supply. The lack of additional U.S. storage capacity also compounded the downward pressure on West Texas Intermediate (WTI) oil prices resulting in strong price declines in April. However, additional production cuts announced by OPEC+ nations and stronger demand from states partially reopening their economies helped revive oil prices throughout May. Nonetheless, bankruptcies of U.S. oil producing and support companies both large and small are likely to surge, which will lead to additional job losses and economic stress in the local economies of oil-producing regions.

The ultimate depth and duration of the economic downturn and the speed and size of recovery remain uncertain. Future economic conditions depend highly on the severity of the pandemic, length of the government containment responses, and the efficacy of fiscal and central bank policies.

The Blue Chip Consensus Forecast as of June 2020 (see figure 1) is for annual U.S. real gross domestic product (GDP) to contract 6.1 percent in 2020 and then grow 4.0 percent in 2021. The forecast shows a deep downturn in the second quarter of 2020, which is partially offset by above trend growth in the second half of the year. Above trend growth is forecast to continue in 2021, although growth is expected to slow throughout the year. Projected unemployment averages 15.3 percent in the second quarter of 2020 before declining to 7.2 percent by the fourth quarter of 2021. Reflecting the high degree of uncertainty and downside risk, 10 percent of the forecasts included in the Blue Chip Consensus indicated that the unemployment rate would be18.6 percent

in the second quarter of 2020 and would remain at 9.8 percent in the fourth quarter of 2021. As of publication of this report, the official May unemployment rate stood at 13.3 percent.[2]

Figure 1: GDP and Unemployment Trends



Sources: U.S. Bureau of Economic Analysis, Bureau of Labor Statistics (historical data through 1Q:2020); Blue Chip Economic Indicators (June 2020)

Market Volatility Spikes

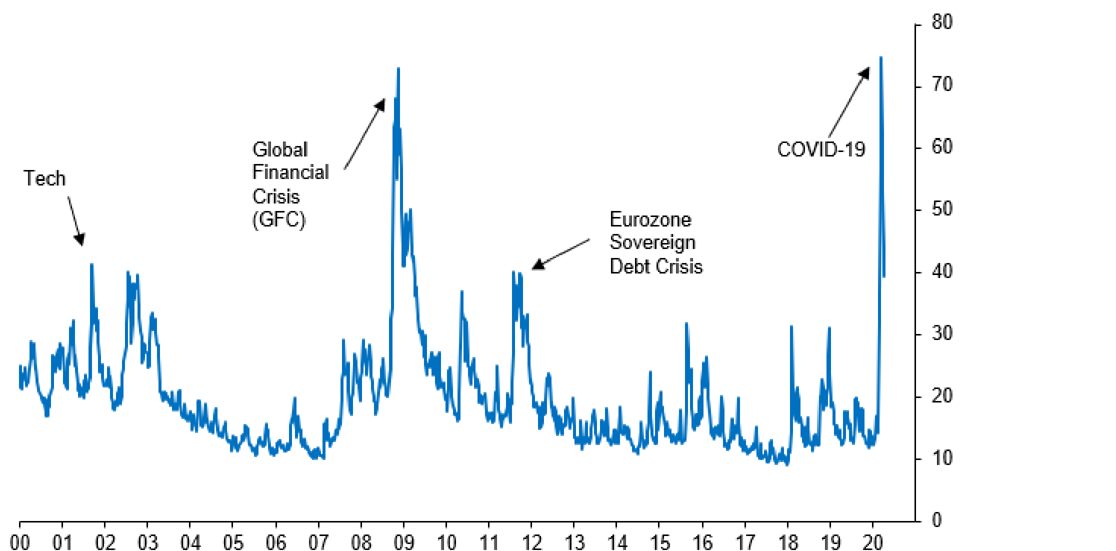
The growing economic impact of the pandemic substantially affected financial markets. Equity and bond market volatility spiked quickly as market participants grew concerned about the economic implications of the spread of the pandemic across the globe. The Board of Governors of the Federal Reserve System reduced the federal funds target rate 150 bps in the first quarter of 2020 and long-term Treasury yields hit record lows. U.S. Treasury market volatility also increased during this period as measured by bid-ask spreads and the bond indices, with levels eclipsing those of the 2008-2009 global financial crisis. Other measures of financial conditions deteriorated sharply in March and April with asset price volatility rising across markets. Widening credit spreads accompanied the rise in market volatility and tight funding conditions. Conditions improved in May due to the effect of programs to improve market liquidity.

U.S. equity market volatility, measured by the S&P 500 VIX Index, spiked to levels slightly above the peak experienced during the 2008–2009 global financial crisis (see figure 2). The trading focus shifted from leveraged trades to participants preferring safe-haven investments, including U.S. Treasury bonds, amplifying concerns over market liquidity. Market participants sold riskier assets (equities, high yield credit, etc.) for safe assets, increasing volatility as liquidity declined further making price discovery difficult. Sharp price drops resulted in a broad

[2] The Bureau of Labor Statistics (BLS) notes that the official unemployment rate includes misclassification errors. If these errors were corrected, BLS stated that the May unemployment rate would be 16.3 percent.

market retreat. International equity indexes underperformed U.S. benchmarks. As of early June, markets have recovered most of their sell off with the S&P 500 rebounding over 45 percent from the March lows.

Figure 2: S&P 500 Volatility Index (VIX Index)



Sources: Chicago Board Options Exchange (CBOE); Standard & Poor's; Bloomberg

Note: VIX Index is a market estimate of the expected volatility of the S&P 500 index. Calculated using the midpoint of real-time S&P 500 option bid/ask quotes. Weekly end-of-period levels.

Part II: Bank Performance

The Banking Environment Is Significantly Altered by the Pandemic and the Unprecedented Decline in Economic Activity

Before the pandemic and the associated economic distress, bank capital ratios continued at historically high levels through year-end 2019. This stands in stark contrast to the levels for the federal banking system ahead of the 2008–2009 recession. Tier 1 risk-based ratios have increased over the past decade as a result of both higher capital levels and lower risk in the system as measured by risk-weighted assets, which is the denominator in the ratio. These factors indicate greater resilience as banks manage through the pandemic. In 2006, the tier 1 risk-based capital ratio for the system was 10.1 percent, compared to 13.3 percent at year-end 2019. For banks with less than $1 billion in assets, there was a similar improvement from 14.8 percent to 17.7 percent over this same time period.

Bank liquidity levels were sound because of policy developments and an emphasis on stronger risk management since the end of the last recession. The federal banking system's liquid assets[3] to total assets was at 15.5 percent at the end of 2019, up from just 2.6 percent as of 2006.

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

Banks are managing through the COVID-19 pandemic by adapting to the current environment, but the outlook is uncertain. Substantial deposit inflows, credit line draw downs, and new government programs contributed to larger balance sheets and a new set of financial risks including deposit stability uncertainty. Earnings stress is evident as provision expenses grew dramatically in the first quarter of 2020 with the second quarter of 2020 provision expenses expected to remain high while net interest income and margin pressures increase from the collapse of the yield curve.

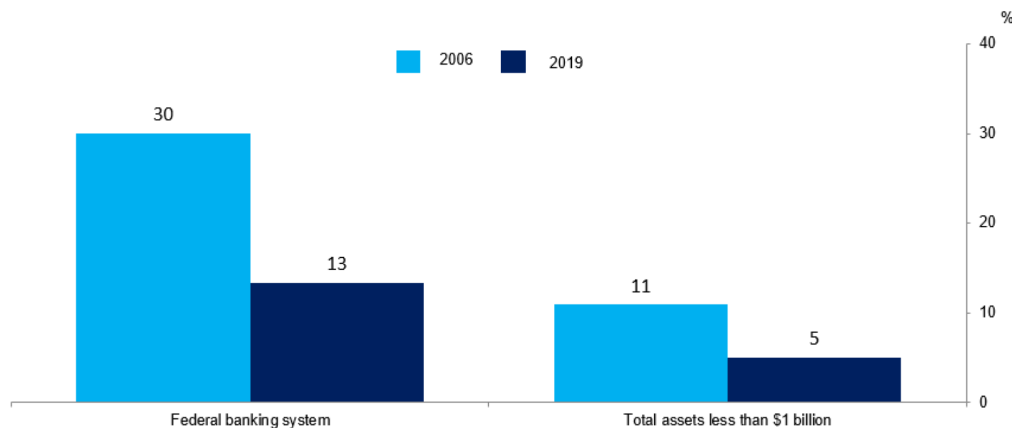
Banks liquidity risk management processes and systems were sufficient during the early stages of the pandemic and supported by Contingency Funding Plans (CFP). Because of the market turmoil, many banks saw their market-based liquidity early warning indicators triggered by the sharp market moves in equities, credit, U.S. Treasury, and other markets. Although markets deteriorated rapidly, bank liquidity was minimally affected, and banks remained well capitalized. Some banks invoked their CFPs as a defensive measure to engage in heightened monitoring and management of bank liquidity.

The federal banking system demonstrated its strength by absorbing the liquidity needs of its borrowers, as deposit growth grew as a result of flight to quality from volatile investments. Businesses quickly built up their own liquidity through record bond issuance in March and April, drawing down credit lines, and/or arranging new credit facilities. Banks were able to meet $425 billion of revolving loan draws in the month of March. Borrower credit demand was largely defensive in nature to build balance sheet liquidity. Many corporations deployed increased cash positions into short term Treasuries or deposited the money back into their bank deposit accounts leading to $800 billion of deposit inflows in March.[4]

Bank funding is much less volatile and focused on stable deposits. As figure 3 shows, the federal banking system's share of funding dedicated to non-deposit sources declined from 30 percent of liabilities to 13 percent of liabilities since 2006. Also, banks with less than $1 billion in asset size reduced their non-deposit share from 11 percent to 5 percent. Funding-related stress, which was a key risk factor in 2008–2009, is less of a risk in the current downturn.

[4] Federal Reserve Board's FRB H.8 data.

Figure 3: Trends in Non-Deposit Funding



Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2019. Banks with less than $1 billion in total assets exclude credit card and trust institutions.

Part III: Special Topic in Emerging Risks

Government Relief Programs

Government implemented initiatives and stimulus measures such as the CARES Act, including the PPP, to reduce the economic damage and to improve market liquidity. Globally, central banks implemented actions to restore credit markets and improve market liquidity by focusing on lower key funding rates. These measures established temporary facilities to improve smooth function in various funding markets including commercial paper, corporate and municipal bond markets, business lending, and central bank lines. Credit, operational, and compliance risks are heightened as banks implement programs to assist businesses and consumers, evaluate portfolio resiliency, and assess future performance, during the economic downturn.

Government programs required banks to act quickly to modify operational processes while also functioning with high levels of employees working at home and absenteeism. Banks addressed higher transaction volumes related to customers receiving stimulus payments, increased loan demand, and recent changes in regulatory requirements (e.g., changes in accounting rules), which affect bank systems, processes, and controls. The volume of change and short timelines for implementing changes placed additional strains on banks already operating in a stressed environment. Some banks are leveraging innovative technologies and third parties, including fintech firms, to help manage these challenges. Bank risk management programs should maintain effective controls for third-party due diligence and monitoring and other oversight processes, operational errors, heightened cyber security risks, and potential fraud related to stimulus programs.

Banks are balancing a surge in requests for assistance with consumer and small business loans, deposits, and availability of stimulus checks. Additionally, banks should interpret and implement CARES Act mandates in a manner consistent with applicable fair lending, and other consumer protection and compliance laws and regulations. The current operating environment is evolving

in response to national emergency measures and testing banks' abilities to implement regulatory controls, while meeting urgent needs of customers.

The high volume of lending-related requests elevates risk when banks cannot promptly process requests because of reduced staffing or because resources are shifted to other priorities. This could cause breakdowns in controls related to account management, servicing management, flood insurance coverage, credit bureau reporting, and complying with applicable laws and regulations.

Part IV: Trends in Key Risks

A. Credit Risk Increased Sharply, Stressing Banks' Balance Sheets

Commercial credit risk is increasing. Volatility in the credit environment grew as the pandemic intensified and broadly affected the economy and employment conditions. Credit risk increased as banks implemented loan relief programs, evaluated portfolio resiliency, and assessed future credit performance for an economic downturn whose depth and duration remains uncertain. Operational, compliance, and reputational risk also increased due to the higher volume of problem borrowers. Nearly every asset class on banks' balance sheets has been or likely will be affected. Companies and industries face elevated risk of default, bankruptcy, or dissolution due to the sharp decline in revenues coupled with uncertain near-term prospects for recovery as well as longer-term uncertainties.

As indicated in OCC Bulletin 2020-35, "Troubled Debt Restructurings: Interagency Statement on Loan Modifications and Reporting for Banks Working with Customers Affected by COVID-19 (Revised)," banks are encouraged to work prudently with their borrowers. Banks also need to appropriately recognize credit risk to capital through timely determinations of risk ratings, accrual status, and allowance adequacy.

Immediate industry-wide credit deterioration was swift and concentrated in several vulnerable sectors. The response to the pandemic disrupted global and domestic business supply chains across multiple industries and affected business supply chains. Leverage is elevated in nonfinancial companies across many industries including travel, entertainment, energy, hospitality, retail, transportation, residential home building, electronics, restaurants, small businesses, and nursing homes. Credit agency rating downgrades of public companies included many energy sector borrowers and leveraged loans that exhibit weaker underwriting and fewer covenant protections, increasing the risk of payment stress. Additionally, corporate borrowers drew down credit lines or requested new facilities to preserve liquidity and pay expenses. The pandemic will further slow economic growth, placing stress on borrowers and significantly affecting commercial and consumer credit exposures over the next several quarters.

Impacts to the energy sector are significant because of lower crude oil and refined petroleum product prices caused by a simultaneous steep reduction in demand and a slow supply reduction arising in part from disagreements among major oil producing countries. Oil and gas ancillary services are also negatively affected. Commercial real estate lending is adversely affected as borrower net operating income is stressed by restrictions on business activities, lost revenues, and potential loss of tenants. Additionally, there are significant uncertainties in the outlook for real estate space demand going forward, especially in the retail and office segments. Management should consider the length and duration of local business restrictions and their impact on property valuations.

Banks should update their portfolio management practices regarding stress tests to incorporate both the direct and indirect impacts of changing economic and market conditions. Other actions banks may be considering include further increasing staffing in operations, collections, and loan workout functions to work with strained borrowers. The volume of borrowers that may pursue

relief or hardship programs will challenge banks to provide sufficient staffing to respond in a timely and appropriate manner.

Adverse impacts on retail credit portfolios increased as emergency related stay-at-home orders negatively affected business and consumer behaviors. Significant levels of unemployment weakened retail credit performance. Many lenders are also initiating proprietary relief programs in addition to the mandates at the federal and state levels. These programs include forbearance on payments through waivers, deferrals, or extensions coupled with no negative reporting to credit bureaus when borrowers meet forbearance conditions. Relief program enrollments and delinquencies increased sharply. The timing of peak enrollments and delinquencies is uncertain and depends on the duration and depth of the downturn and the speed of returning to normal conditions.

Mortgage loan relief programs enable borrowers to forego regular payments during the relief period. Many banks and nonbank entities that service loans for investors are required by servicing contracts to continue making principal and interest payments to support related securities even when payments are not received from underlying borrowers. Such conditions, if required for an extended period, may create liquidity issues for some servicers, particularly nonbank servicers. During such periods, entities that service loans for themselves or others are expected to continue making collateral protecting insurance and tax payments normally derived from regular payments to escrow accounts.

Ginnie Mae and the government-sponsored enterprises are providing additional liquidity or other relief for U.S. government guaranteed loans and other federally backed mortgages. Non-mortgage retail loan relief programs vary across a wide spectrum of terms and conditions related to credit cards, auto, home-equity lines, etc. Lenders and servicers should clearly communicate the nature of relief offered and the expectations for payment resumption. Additionally, there needs to be a clear understanding of operational issues in implementing changes to borrower payment schedules and monitoring for issues. Lenders should communicate how and when interest will be subject to repayment by the borrower in cases where interest continues to be charged while regular payments are waived, deferred, or extended, including the impact on credit bureau reporting. Finally, an evaluation of the propriety of continued interest accruals as well as the collectability of any relief period accrued interest should be performed.

The allowance for credit losses should continue to appropriately reflect the risks in the loan portfolio with qualitative factors considering current environmental issues. This includes assessing the potential for financial impact from the pandemic on borrowers. Several banks began their transition to the current expected credit loss (CECL) model during the first quarter of 2020. Some banks may defer planned CECL implementation based on the flexibility provided by the CARES Act. Banks substantially increased their loan loss provision expenses in the first quarter of 2020 reflecting the expected increases in loan losses in the coming periods. Second quarter provision expenses are expected to substantially increase as the extent of the economic downturn develops.

B. Net Interest Margins, Interest Rate Risk, and London InterBank Offered Rate

The interest rate environment continues to be challenging for banks as downward pressure remains on the yield curve with sharp declines in U.S. Treasury yields. The net interest margins (NIM) is the biggest contributor to earnings for most banks. Community banks generally are more reliant than larger banks on NIM due to their more limited non-interest income. The NIM outlook for 2020 is uncertain given the volatile rate environment and global pressures, which may encourage banks to take additional risk. Risks include reducing credit standards, yield chasing for longer term assets, or entering new products or services to mitigate the NIM compression.

Asset yields declined as the Federal Reserve began reducing the Federal Funds Target rate in July 2019 and have suffered additional declines since the start of the pandemic. Margins compressed as asset yield declines exceeded interest cost reductions. Lower rate expectations for the near future will continue to hold yields to lower levels further stressing earning performance.

Overall, banks have asset sensitive balance sheets, which negatively affects earnings when interest rates decline and remain low. OCC data on bank interest rate risk exposures show that 75 percent of banks expect to lose net interest income if interest rates decline. Most banks expected to lose less than 5 percent of net interest income if rates decline by 1 percent, which occurred in the first quarter of 2020. Sound bank risk management practices include reviewing potential exposure to declining interest rates and managing exposures to established risk limits to provide opportunities in this challenging environment. The cost of mitigating heightened interest rate exposure typically rises as the adverse interest rate scenario becomes more likely. Operating with properly structured risk management systems and controls that are commensurate with risk taking are necessary for addressing earnings and interest rate risk changes in times of low and volatile market yields.

London InterBank Offered Rate

Banks should continue preparations to transition away from the London InterBank Offered Rate (Libor) and manage the associated risks. Libor is used for a variety of financial products and related processes. The reliance on Libor increases the risk of market disruptions, litigation, and destabilized balance sheets if existing contracts cannot seamlessly transition to a new rate(s) or if acceptable replacement rate(s) do not attract sufficient market-wide acceptance. A bank's risk exposure from Libor's cessation depends on the bank's specific circumstances. The OCC is increasing oversight of this area through 2020 and 2021 to evaluate bank preparedness for Libor's anticipated cessation.

It is important for bank management to recognize and plan for migration to other potential replacement rates and adjustment methodologies, based on the assessment of the bank's Libor exposures and needs for replacement rates. Market participants have been working with the public sector to seek solutions. For example, the Alternative Reference Rate Committee selected Secured Overnight Finance Rate to be the replacement rate and has recommended fallback language for various contracts. The International Swaps and Derivatives Association has been working with market participants and making progress in replacing Libor in its standardized

contracts. In spite of these efforts, there are still many challenges that market participants face with respect to replacing Libor in their products. Libor's cessation poses operational risk, compliance risk, litigation risk, financial risk, as well as consumer protection, and reputational risk.

Change assessment of the potential impact on operations should guide the development of risk management strategies to address changes. Assessment of these risks could include analysis of customer impact, amending contracts, updating systems and applications, revising and testing models, and ensuring appropriate contractual fallback language and disclosures to clients.

The cessation could also affect consumer products, such as adjustable rate mortgages, private student loans, credit cards, reverse mortgages, and home equity lines of credit. Consideration should be given to existing safety and soundness standards and consumer protection laws in planning for and implementing disclosure and communications with consumers. It is also important to assess whether third-party providers are similarly on track to modify their systems, considering the pending changes.

Many existing contracts do not include sufficient provisions addressing the replacement rate ("fallback language") in the event that Libor becomes permanently unavailable. It is important that bank management assess existing contract fallback language, including contracts serviced by third parties. Depending on a bank's specific circumstances, plans should be implemented to ensure robust fallback language with clear and executable terms. If not addressed, inadequate fallback language could pose safety and soundness risk.

C. Operational Risk

COVID-19 Pandemic Impact and Response

In response to the pandemic, banks effectively implemented business continuity plans to protect customers and staff while maintaining ongoing operations. Banks amended business processes and engaged third parties to support widespread telework capabilities, increased technical capacity, and leveraged innovative solutions to maintain operations under current government requirements. These solutions included enabling work at home technologies for staff and directing customers to online or automated processes for transactions and inquiries (e.g., online, and mobile banking applications and interactive voice response systems). Banks have taken steps to protect customers and employees at physical locations by consolidating branch operations and limiting walk-in traffic, leveraging multiple production sites to separate operational staff, employing staggered work schedules, and implementing other steps to adhere to social distancing guidelines.

While these processes allow banks to maintain their operations and continue to serve their customers, they also have the potential to introduce new risks. Examples of potential risks and control considerations for alternate operational processes implemented as part of pandemic related continuity plans include:

- Implementation of teleworking strategies using virtual private networks (VPN), virtual conferencing services, and other remote telecommunication technologies can increase cybersecurity vulnerabilities. These new or expanded connections and productivity tools need to be properly configured, secured, and appropriately monitored. Additional steps may be necessary to properly segment and secure bank networks if employees use personal devices to connect to bank systems.
- Increased use of online and mobile systems by customers, bank staff and third-party service providers may stress or adversely affect banks' telecommunications capacity. Technology infrastructures should be effectively managed to provide for additional telecommunications bandwidth where needed to maintain appropriate service levels.
- Sensitive processes performed outside of bank-owned or authorized properties and devices can increase the risk of fraud and potential for exposure of customer sensitive information. Appropriate monitoring and oversight can include the use of data loss prevention tools, call back procedures, and increased employee awareness of privacy and phishing mitigation procedures.
- Rapid implementation of new systems, including automation or processes to address evolving operating environments and customer needs, may stress existing change management processes. Appropriate change management, and where applicable, third-party risk management, should be applied based on risk.
- Operational workloads, service levels, and third-party service provider performance should be closely monitored so that potential reductions in their service delivery levels because of pandemic responses and other operational issues can be addressed in a timely manner while continuing to meet banking customer needs.

Risk management and audit oversight of bank operations needs to keep pace with the rapid implementation of pandemic-related business continuity plans and transitioning from traditional operations to a heightened operational level. Independent oversight and validation of controls' effectiveness is essential to safeguard operational integrity in the current stressed environment.

Heightened Cyber Risk Environment

Cyber threat actors continue to target banks, their customers, and their third parties. These threats continue to adapt and elevate due to increased criminal activity and sophistication. Phishing threats against bank customers and staff are elevated, and there have been an increasing number of attacks focused on the use of virtual private networks, virtual teleconferencing services, and other remote telecommunication technologies because of widespread transitions to telework models.

Malicious actors continue to target the financial industry with disruptive attacks through phishing, destructive malware, ransomware, and other cyber threats. The trend of increased criminal activity is expected to continue for the foreseeable future and may increase further as banks navigate through the economic disruption.

The OCC and the Federal Deposit Insurance Corporation (FDIC) issued a "Joint Statement on Heightened Cybersecurity Risk" on January 16, 2020. This statement highlighted that implementing and maintaining effective cybersecurity controls are critical to protecting banks

from malicious activity, especially in periods of heightened risk. Sound risk management controls for cybersecurity include:

- Review, update, and test backup, incident response, and business continuity plans ensuring data is sufficiently segregated.
- Protect against unauthorized access through use of strong authentication.
- Securely configure systems and services to protect against malware and malicious actors' access.

Even with preventive controls in place, banks may fall victim to disruptive or destructive cyber-attacks. Bank management should consider measures to enhance the resilience of systems and operations against cyber threats. These can include maintaining system backups either on logically segmented portions of the network or offline media. Testing recovery capabilities to respond to ransomware or other destructive malware that encrypts or corrupts data, including backup data, helps banks mitigate the impact of attacks. The board and management play a critical role in responding to an attack and should clearly understand their roles and responsibilities.

D. Compliance Risk Is Increasing

Compliance risk is increasing, driven by a combination of reduced operations, employees teleworking, and rapidly changing customer service environment. These factors can create challenges for full and accurate implementation of bank policies to fulfill Bank Secrecy Act (BSA), consumer protection, and fair lending requirements. The high volume of PPP applications and the short processing time frames particularly elevate bank risks. These conditions may complicate BSA, consumer protection, and fair lending compliance responsibilities associated with underwriting and opening new accounts, monitoring customer activity, communicating with customers, and timely meeting BSA and Office of Foreign Assets Control (OFAC) reporting requirements.

Bank Secrecy Act

The OCC issued a statement clarifying BSA regulatory and risk management expectations recognizing that there may be reasonable delays in meeting BSA compliance obligations during the COVID-19 pandemic. The statement highlighted that the Financial Crimes Enforcement Network (FinCEN) provided regulatory relief under the risk-based approach to BSA compliance. OFAC has issued a statement recognizing that the pandemic may cause delays in compliance. The OCC recognizes that pandemic response measures and programs may affect timely compliance with bank obligations implementing BSA programs and OFAC-administered sanctions (e.g., on-boarding processes, customer due diligence updates, suspicious activity alert investigations, and blocking reports).

Banks are encouraged to monitor information provided by law enforcement agencies and international anti-money laundering standard-setting organizations regarding the ways that criminals are adapting scams and money laundering techniques to exploit vulnerabilities created by the pandemic. The U.S. Federal Bureau of Investigation website includes common red flags

for identifying COVID-19-related schemes. Banks should be aware of evolving typologies and ensure 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 their examiners updated on potential BSA and sanctions compliance issues, including potential delays in meeting regulatory reporting requirements. Any deferred actions and temporary waivers should be tracked and managed so that banks can appropriately readjust 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 and Fair Lending

Banks should follow established change management and compliance risk management processes to identify, measure, monitor, and control the emerging risks associated with the COVID-19 national emergency. Emergency-related changes in bank staffing may affect the ability of banks to comply with CARES Act provisions and other regulatory requirements. In addition, banks' strategies for processing consumer requests and applications will vary with implementation, increasing the risk of disparate treatment and disparate impact on a prohibited basis. Appropriate monitoring measures will 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. 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 financial 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 to banks working with borrowers affected by the COVID-19 pandemic. These statements clarify the agencies' supervisory and enforcement priorities and approaches for fair lending and other consumer protection laws during the COVID-19 pandemic.

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