Office of the
Comptroller of the Currency

Semiannual Risk Perspective

From the National Risk Committee

Spring 2021

Contents

About This Report ii

Executive Summary 1
First Quarter 2021 Financial Condition 2
OCC Initiatives 2

Part I: Operating Environment 3
Strong Economic Growth Forecast for 2021 3
Financial Conditions Ease 5

Part II: Bank Performance 7
Banks are Weathering the Shock of the COVID-19 Crisis With Resilience Although a Low Interest Rate Environment and Uncertainty About the Path of the Recovery Could Continue to Challenge Bank Profitability 7

Part III: Special Topic on Emerging Themes 12
Low Interest Rate Environment 12
Earnings Pressures in the Current Environment 12
Similarities with Recent History 14

Part IV: Trends in Key Risks 16
A. Credit Risk Is Elevated 16
B. Libor Cessation 17
C. Operational Risk 18
D. Compliance Risk and the Bank Secrecy Act 20
Bank Secrecy Act 21
Consumer Compliance 22

Part V: Supervisory Actions 23

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 2021 report presents data in five main areas: the operating environment, bank performance, a special topic on emerging themes, trends in key risks, and supervisory actions. The report reflects data as of December 31, 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

- Banks maintained sound capital and liquidity levels in 2020. Bank profitability remains stressed due to low interest rates and low loan demand.
- Increasing business and consumer confidence, vaccinations, and higher employment levels are improving economic prospects for 2021 and 2022.

Key Risk Themes

- Credit risk is elevated and evolving as the economic downturn continues to affect borrowers' ability to service debts. Assistance programs and federal, state, and local stimulus programs have suppressed credit issues.
- Strategic risk associated with banks' management of net interest margin (NIM) compression and efforts to improve earnings is elevated. Banks attempting to improve earnings may implement measures including cost cutting, increasing credit risk (both credit and investments), or extending duration.
- Operational risk is elevated due to a complex operating environment and increasing cybersecurity threats.
- Compliance risk is elevated as banks' expedited efforts to implement assistance programs continue to challenge established change management, product, and service risk management practices.

Credit risk is evolving one year into the pandemic. Problem loan levels remain manageable as government support programs muted the financial impact to commercial and retail borrowers. However, commercial real estate (CRE), especially office and retail properties, remains stressed with expectations of higher problem loans and losses as these affected industries adjust to changing business and consumer preferences.

A low and flat yield curve pushed earning asset yields down in 2020 and compressed bank NIMs, despite a reduction in funding costs. Stimulus measures, limited investment options, reduced lending opportunities, and significant loan prepayments placed downward pressure on NIMs. Substantial deposit inflows resulted in additional highly liquid assets and lower margins as banks struggled to find yield. Duration extension in investment portfolios, reduced borrowing costs, and expense cuts provided some mitigation to margin compression in 2021.

Operational risk remains elevated. A flexible, risk-focused approach to operational resilience, underpinned by scenario analyses, surveillance and reporting, and management of third-party risk, is important for banks. While efforts to strengthen operational resilience may not prevent a disruption from occurring, a pragmatic, well-constructed approach to operational resilience can help minimize the adverse effects of and enhance a bank's ability to withstand an operational disruption.

Compliance risk is elevated as banks' expedited efforts to implement assistance programs continue to challenge change management, product, and service risk management practices. These programs include the Coronavirus Aid, Relief, and Economic Security (CARES) Act's Paycheck Protection Program (PPP) and federal, state, and bank-initiated forbearance and deferred payment programs. These programs feature increased compliance responsibilities, high transaction volumes, and new fraud typologies, at a time when banks continue to respond to a changing operating environment.

First Quarter 2021 Financial Condition

Financial conditions improved in the first quarter of 2021. Economic growth projections increased as significant progress is being made on vaccinations and fewer governmental restrictions. Banks reported stronger earnings due to reserve releases as problem asset levels remain manageable in the first quarter.

OCC Initiatives

The OCC is engaged domestically and internationally on issues related to climate change. As the prudential supervisor of the federal banking system, we focus on safety, soundness, and fair access and treatment of customers. Our role is to ensure that supervised institutions reasonably anticipate, understand, and mitigate risks through robust risk management systems. Risks can manifest in many forms over time in product type, operating models, and geographies. Banks may face risk relative to climate change through physical conditions or transitions in the economy. Accordingly, in common with other supervisors, the OCC is developing its knowledge of the risks in this area by engaging with relevant stakeholders.

The special topic on emerging themes in part III of this report highlights the impact of lower interest rates on key bank financial performance indicators.

Part I: Operating Environment

Strong Economic Growth Forecast for 2021

The economy ended 2020 with real gross domestic product (GDP) declining 3.5 percent for the year. The vaccine rollout started in January 2021 and has steadily progressed. As of early April, more than 3 million vaccine doses were being administered each day and the share of the U.S. population with at least one dose was up to 36 percent. April projections estimate that 80 percent of Americans will be have access to a vaccine by early July.

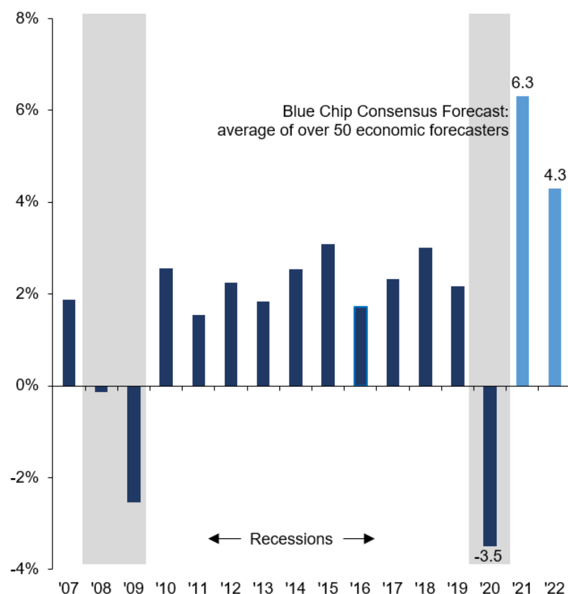
Economic growth is forecasted to increase dramatically in 2021 as people are vaccinated, restrictions are eased, and consumers regain confidence and increase expenditures. Activity is expected to surge in currently depressed service sector industries such as accommodation and food services, arts and entertainment, and transportation. Much of the household income generated by the stimulus from last year was saved, which may bolster spending as the economy reopens. Further, personal income is set to jump this year from the additional COVID-19 relief packages enacted in December 2020 and March 2021. The relief packages included stimulus checks to millions of people, federal enhancement to unemployment benefits, housing rental assistance, small business support, an extension of the housing eviction moratorium, and other items.

The Blue-Chip Consensus (consensus) forecast is for strong annual growth of 6.3 percent in 2021 (see figure 1). The consensus expects annual real GDP growth to slow in 2022 to a still robust 4.3 percent, as pent up demand is exhausted and stimulus effects wane. Despite the forecast of strong growth for the next two years, risks remain. Forecasts are predicated on a successful vaccine rollout, with vaccines that are effective against all strains of the virus. If production or distribution problems arise, or if the vaccines are less effective than currently thought, economic growth in 2021 could be weaker than forecast.

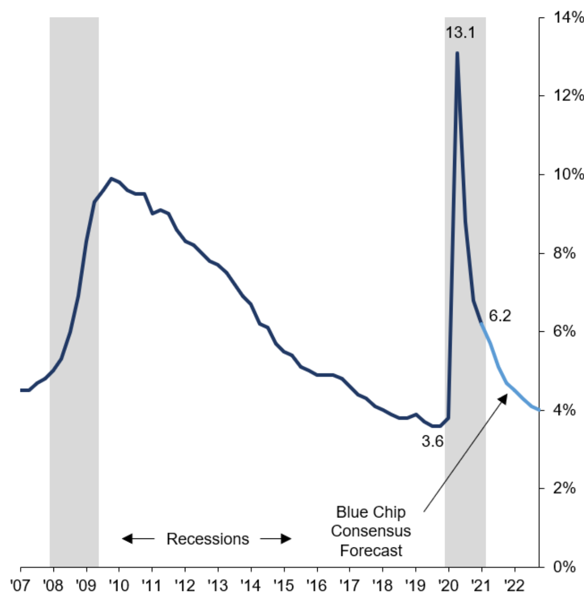
The vaccine rollout and reduction in restrictions are expected to support stronger demand for goods and services. The labor market is forecast to improve in 2021 as businesses gain confidence to hire. The consensus forecast is for the quarterly unemployment rate to fall sharply in 2021, ending the year at 4.7 percent (see figure 1). The pace of improvement, however, is expected to slow in 2022, with the unemployment rate declining to 4.0 percent.

Figure 1: GDP and Unemployment Trends

Real GDP, percent change annual rate



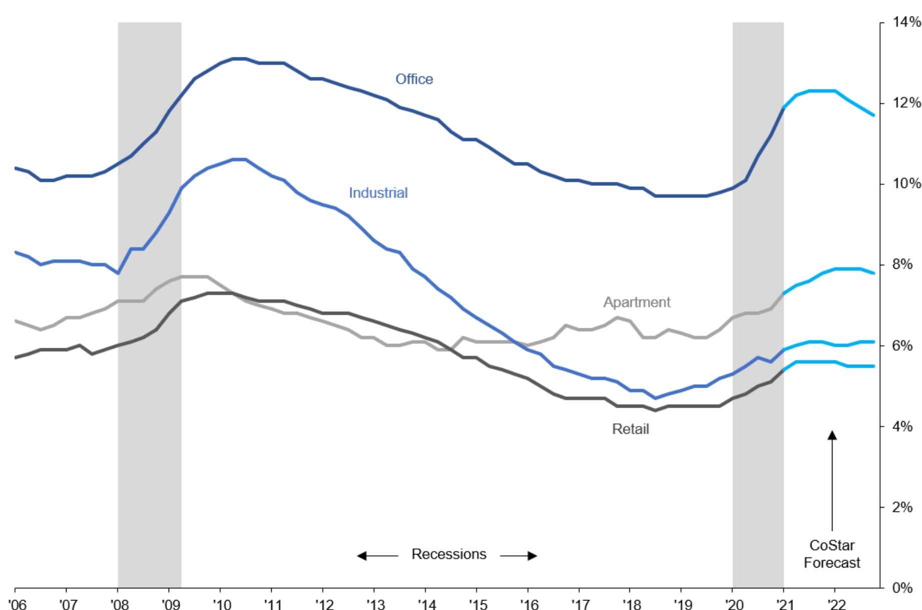
Quarterly average unemployment rate



Sources: U.S. Bureau of Economic Analysis; Bureau of Labor Statistics (historical data through 1Q:2021); Blue Chip Economic Indicators (April 2021)

Residential real estate market performance was strong during the crisis. High demand for suburban homes and migration to certain geographies, low supply of homes for sale, historically low interest rates that reduced mortgage burdens, and forbearance programs designed to help borrowers overcome hardships, supported prices across the country despite massive disruption to the economy. According to Black Knight, average single-family home prices rose 11 percent year-over-year through December 2020, with more than 95 percent of metros recording home price increases of more than 5 percent. In contrast, the pandemic adversely affected nearly every type of CRE, causing vacancies to rise in 2020, while prices and operating income declined (see figure 2). For example, the shift to a remote working environment has office property tenants evaluating their long-term space needs. Restaurants, gyms, entertainment, and other types of retail that depend on close customer contact face risk of closure until social distancing restrictions relax in some geographies. However, warehouse properties have benefitted from the COVID-19 pandemic due to the accelerated shift to e-commerce. With people buying more merchandise from online retailers, demand for logistics space increased. However, an increase in warehouse construction projects may lead to supply growth outpacing demand, pushing vacancies higher in 2021.

Figure 2: Commercial Real Estate Vacancies



Source: CoStar Portfolio Strategy (historical data through 4Q:2020, baseline forecast updated January 2021)

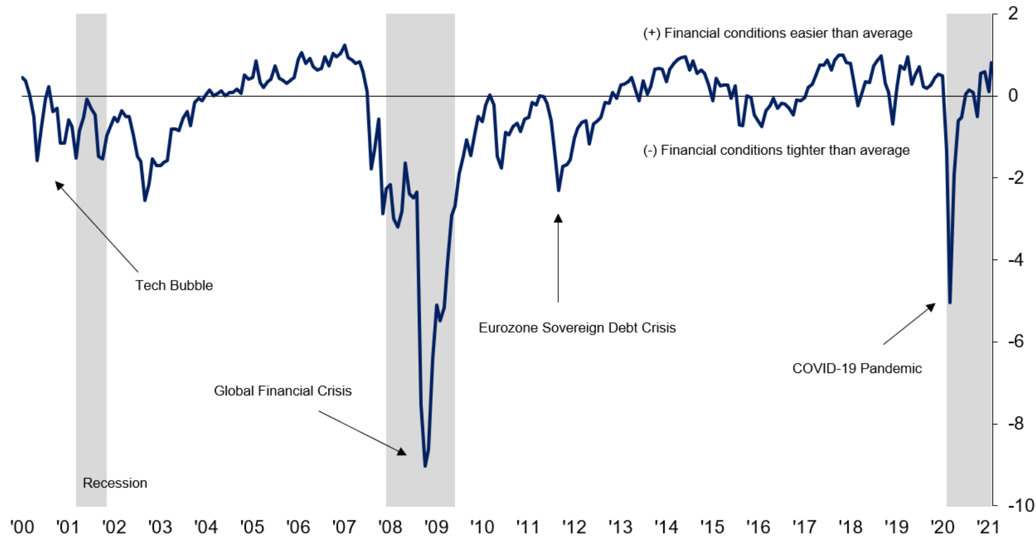
The consensus forecast is for short-term interest rates to remain near zero over the next two years, while long-term rates increase as the economy recovers. The consensus expects the Consumer Price Index to initially spike to over three percent in 2021, mostly due to base year effects, but then moderate to slightly over two percent in 2022. Moderate inflation will allow the Federal Reserve to keep short-term rates near zero percent. The consensus forecasts the 10-year Treasury yield to increase as economic growth accelerates, ending 2022 at 2.1 percent—still low by historical standards. Interest rates could rise higher than forecast if inflation or the economy expands more than expected, based on concerns the economy would overheat. While inflation is expected to rise this year, the risk of sustained and significantly higher inflation remains low. The economy has a large amount of unused capacity that would need to be recovered before sustained inflation could take root. According to the Congressional Budget Office, real GDP was about three percent below its long-term potential in the fourth quarter of 2020, and there were over eight million fewer Americans working in March 2021 than were employed before the pandemic.

Financial Conditions Ease

Fiscal and monetary stimulus mitigated the stresses from the pandemic in the financial markets. The Federal Reserve remained accommodative while communicating that policy rates will remain low. Rates on long-maturity U.S. Treasury notes and bonds increased on higher growth and inflation expectations. The yield curve steepened as a result. More balanced demand for U.S. Treasuries and fixed-income assets generally supported broad funding conditions in bond markets despite the rise in issuance. In the first quarter of 2021, longer maturity Treasury rates rose steadily as further fiscal stimulus was expected, vaccine distribution bolstered growth prospects, and inflation uncertainty increased. In wholesale markets, repo and U.S. dollar funding market liquidity remained near pre-pandemic levels.

Equity and corporate fixed-income market prices moved higher. Other measures of financial conditions further eased while other risk assets rose to all-time highs (see figure 3). Risk repricing followed announcements by central banks to continue accommodative support and prospects of government stimulus programs. Equity market volatility, measured by the S&P 500 VIX Index, touched pre-pandemic lows. Credit spreads tightened and accompanied the upward move in equity markets. Investment grade and high-yield corporate bonds saw high issuance as borrowing costs were at record lows. The combination of fiscal and monetary policy stimulus further supported market functioning and credit intermediation. As of March 2021, international equity indexes underperformed U.S. benchmarks over the past year.

Figure 3: U.S. Financial Conditions Index



Source: Bloomberg (data through February 22, 2021)

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.

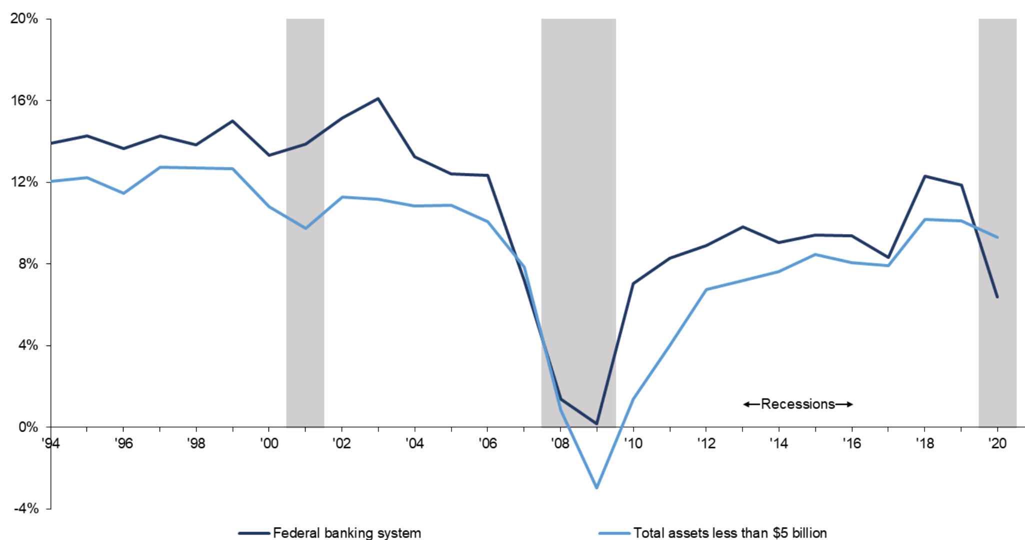
Part II: Bank Performance

Banks are Weathering the Shock of the COVID-19 Crisis With Resilience Although a Low Interest Rate Environment and Uncertainty About the Path of the Recovery Could Continue to Challenge Bank Profitability

Banks entered 2020 and the outbreak of COVID-19 with historically high levels of capital and liquidity to support credit stress. Moreover, exceptional support from monetary and fiscal policy bolstered banks' balance sheets, earnings, and credit quality, and expectations are for additional policy support through 2021. By year-end 2020, although the tier 1 leverage ratio declined slightly, capital remained sound and well above the prior 25-year average. The Federal Reserve provided unprecedented support by injecting an outsized amount of cash reserves. As a result, the system's liquid assets[2] as a percent of total assets surged to 23.9 percent at the end of 2020, up from an already elevated level of 15.3 percent in 2019.

These factors will likely continue to provide resilience in 2021 as banks manage through the ongoing crisis and uncertainty in vaccine rollout, effectiveness against emerging variants, and government restrictions. Low loan yields are expected to continue to weigh on compressed NIMs and overall profitability. As shown in figure 4, system-wide return on equity significantly decreased in 2020, driven primarily by the largest banks and decreased to a lesser extent by banks with less than $5 billion in assets.

Figure 4: Trend in Bank Return on Equity



Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2020. Banks with less than $5 billion in total assets exclude credit card and trust banks.

As banks braced for the potential for credit deterioration in 2020, earnings for the federal banking system plunged 43.9 percent from pre-COVID-19 levels, whereas earnings for small

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

banks increased modestly (see table 1). The decline in earnings for the system primarily reflects a sharp rise in loan loss provisions, driven by the largest banks that transitioned to the current expected credit loss (CECL) accounting standard in the first quarter of 2020 and the pandemic. Having recognized significant loan loss reserves in the first half of the year, low net loan growth caused quarterly loan loss provision expense to decline to near zero in the fourth quarter as the economy improved and reported past dues remained muted. The second factor weighing on system earnings was a decline of 7.4 percent in net interest income from 2019. For smaller banks, provisions were also up significantly over the past year, but this was offset by revenue growth—primarily from noninterest income on gains from loan sales.

Table 1: Trends in Bank Net Income

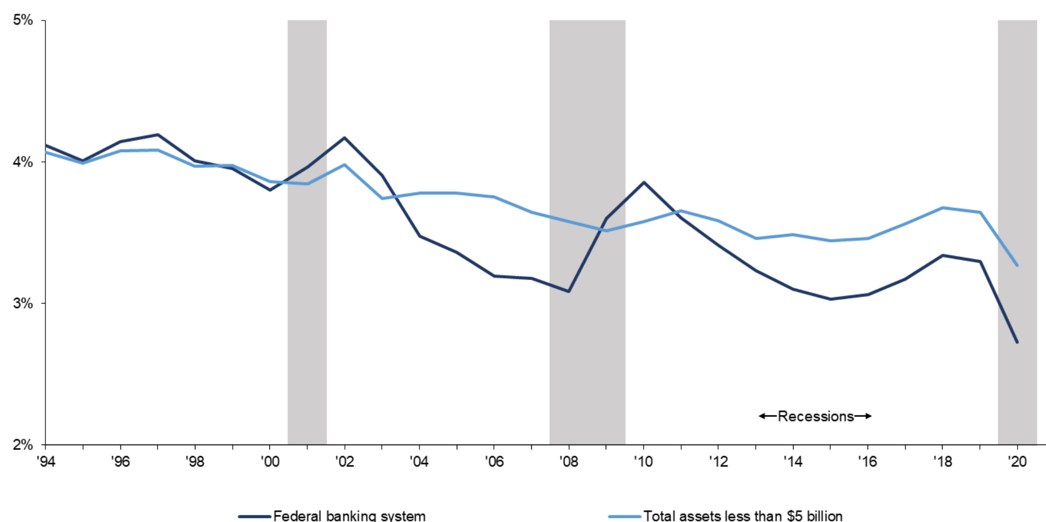
	Federal banking system			Banks with total assets of less than $5 billion		
	2019	2020	Y/Y % change	2019	2020	Y/Y % change
Year-to-date revenues in billions of dollars						
Net interest income	363.7	336.7	-7.4%	16.2	16.4	1.3%
Noninterest income	195.5	198.9	1.7%	6.2	8.1	31.1%
Year-to-date expenses in billions of dollars						
Provisioning	40.7	98.6	142.1%	0.75	1.60	113.6%
Noninterest expense	320.5	332.2	3.6%	15.0	16.1	7.0%
Net income	**159.1**	**89.2**	**-43.9%**	**5.6**	**5.8**	**4.0%**

Source: Integrated Banking Information System (OCC)

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

In addition to uncertainty in the credit cycle, bank profitability will be tested as banks face continued stress from low interest rates (see figure 5). NIM, which declined for banks of all sizes over the past year, is a significant driver of most banks' revenues and profits. The decline in NIM for the federal banking system was driven by the largest banks, dropping to a low of 2.7 percent. The decline in loan growth and yields exacerbated large banks' drop in NIM. The Federal Reserve's monetary policy actions in response to the pandemic-induced decline in economic activity resulted in a boost in liquidity across the banking system that flowed to lower-yielding, highly liquid assets.

Figure 5: Trend in Net Interest Margins

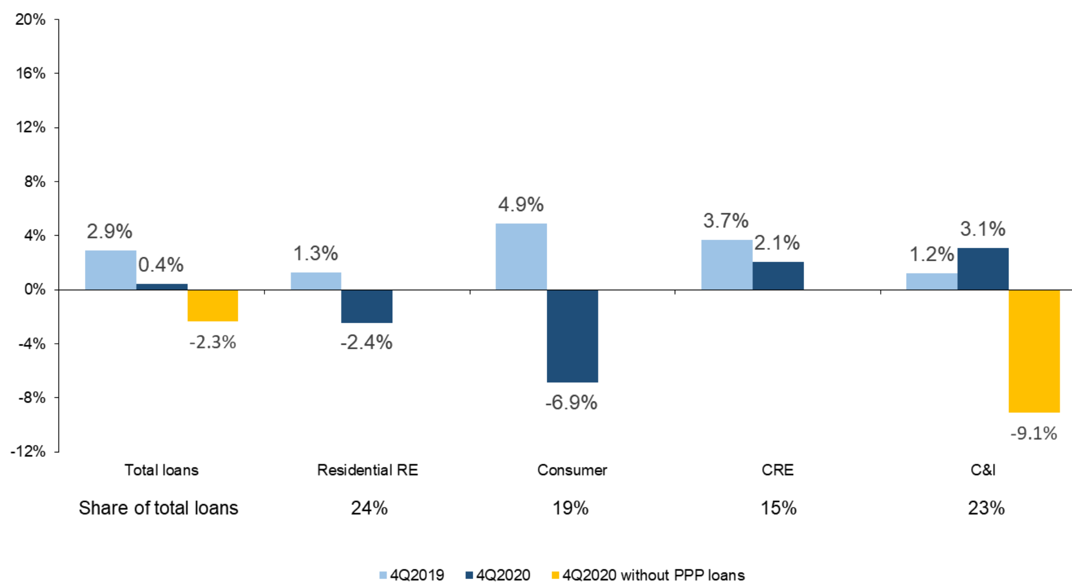


Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2020. Banks with less than $5 billion in total assets exclude credit card and trust banks.

Increased economic uncertainty and a significant pullback in consumer spending brought about by the sharpest plunge in employment in 80 years resulted in anemic total loan growth for the system in 2020, as shown in figure 6. Excluding lending related to the CARES Act's PPP program, total loans contracted 2.3 percent from levels a year earlier. Commercial and Industrial loans (C&I) loans, where most of the PPP small business loans were categorized, grew 3.1 percent through the fourth quarter but would have contracted 9.1 percent without PPP lending. Residential real estate and other consumer loans, which make up 43 percent of total loans, declined by 2.4 and 6.9 percent, respectively. CRE was the only key loan product that grew, expanding by 2.1 percent. Although a second round of $284 billion in PPP lending began in January 2021, loan demand outside of the PPP program will likely remain weak in the first half of this year. Removal of business restrictions in the 2nd quarter of 2021 will be positive for loan growth through 2021.

Figure 6: Year-Over-Year Change in Loan Balances



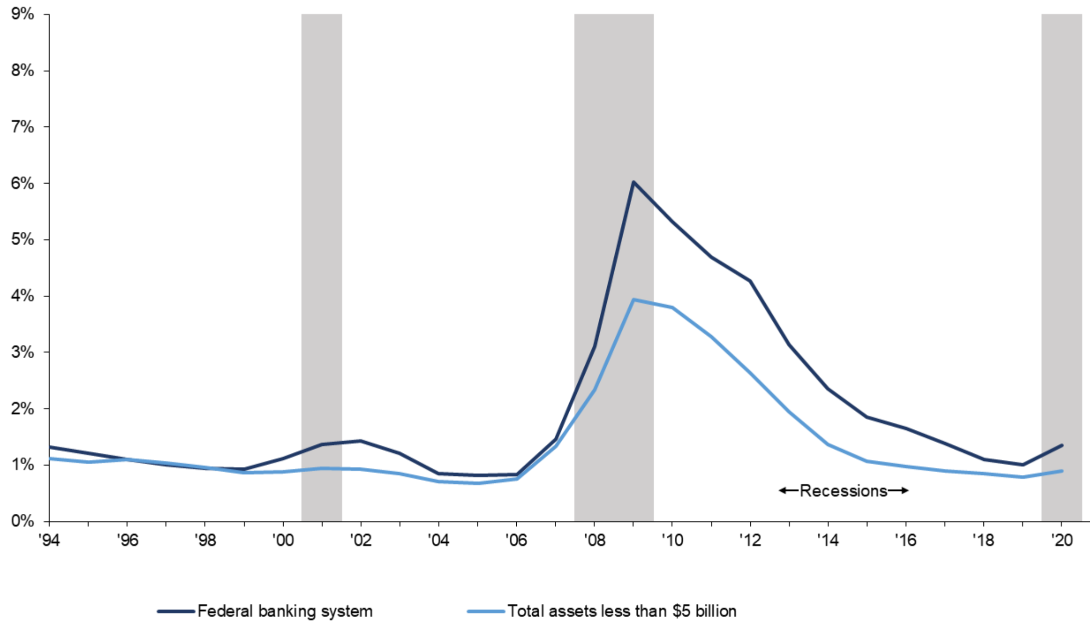
Source: Integrated Banking Information System (OCC)

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

Despite the exceptional decline in economic activity from the spread of COVID-19 and local restrictions, total nonperforming loans[3] did not reflect a material deterioration for either the system or smaller banks through year-end 2020, as shown in figure 7. This is in large part due to the stimulus programs, CARES Act, and various forbearance programs that are still ongoing. Given the expectation for continued support, a meaningful deterioration in credit quality may not manifest itself until the latter half of 2021 or later.

[3] Nonperforming loans are 90 days or more past due plus nonaccruals.

Figure 7: Trend in Total Nonperforming Loans



Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2020. Banks with less than $5 billion in total assets exclude credit card and trust banks.

Part III: Special Topic on Emerging Themes

Low Interest Rate Environment

Pre-COVID-19 interest rates were supportive of financial markets profitability. Interest rates began to decline in early 2019 due to financial market volatility. With the onset of COVID-19, business restrictions, and the sharp decline in financial markets, interest rates fell to close to zero percent on risk-free securities. The sharp decline in interest rates and increased provision expenses impacted NIMs and profitability. In efforts to buffer the dynamic economic environment, banks made strategic decisions to swap duration, credit risk, and liquidity risk for earnings. Depositor flight to stability, financial innovation competition, global economic impacts, and regulatory changes pressure income streams including margin and noninterest income. If previous experience is a precursor to today's environment, the sufficiency of noninterest income is an important tool for assessing viability of net income.

Low interest rate policy coupled with a modestly sloped yield curve pushed earning asset yields down in 2020. Downward pressure on NIMs is exacerbated by an influx of deposits from Federal Reserve Board stimulus measures (e.g. PPP and Main Street Lending Program) coupled with limited opportunities for higher yielding assets without accepting increased risk from duration, credit, or liquidity. This conundrum resulted in deposit growth, largely invested in highly liquid assets, contributing to lower margins. As a result, bank balance sheets have become more liquid since the onset of the pandemic, as demonstrated by a variety of measures including the liquidity coverage ratio. Investment portfolio duration extension, reduced borrowing costs, and expense cuts moderated margin compression impact to earnings.

Earnings Pressures in the Current Environment

Earnings performance for community banks was better than larger banks in 2020, primarily due to NIM benefits from PPP lending and stable noninterest income from gains on loan sales. Historically, a steepening yield curve in a low rate environment, as seen in early 2021, has been most beneficial for NIMs in credit card banks. In prior interest rate cycles, a steepening yield curve generally adversely affected large bank NIMs while community and midsize bank NIMs slowly improved as the challenge to generate or purchase higher yielding assets continued despite a steepening yield curve. Credit card banks and banks that can maintain or improve noninterest income will likely benefit the most from a steepening yield curve. The stability and sustainability of noninterest income in community banks may be challenged by a steepening yield curve given recent reliance on gains on loan sales as a noninterest income source.

Banks are reporting record low NIMs driven by the low and flat yield curve coupled with growth in low yielding assets funded by deposit inflows. Prior to the COVID-19 pandemic, the yield curve had been steadily flattening. Yields dropped in early 2020 (see table 2) at the onset of the COVID-19 pandemic as the Federal Open Market Committee implemented two Fed Funds rate cuts in March 2020, reducing the rate range to 0 percent to 0.25 percent, and took additional actions, such as U.S. Treasury security and agency mortgage-backed securities (MBS) purchases, to support market stability and the overall economy. Short-term U.S. Treasury yields fell and the curve flattened significantly in the first quarter of 2020.

Table 2: Treasury Rates

U.S. Treasury	8/29/2019	3/17/2020	4/1/2020	12/29/2020
30Y	1.97	1.63	1.27	1.67
10Y	1.50	1.02	0.62	0.94
5Y	1.40	0.66	0.37	0.37
2Y	1.53	0.47	0.23	0.12
10Y-2Y	-0.03	0.55	0.39	0.82

Source: Bloomberg

Generally, larger banks experienced significant NIM compression in 2020. The median NIM at midsize and large banks declined 61 basis points (bps) to 2.69 percent and 71 bps to 2.30 percent, respectively. Large banks experienced a much more pronounced decline in earning asset yields as loan balances declined and nonmaturity deposits (NMD) increased. These cash flows resulted in an increase of cash and due from banks, Fed Funds sold, and reverse repo balances from 13.5 percent to 21 percent of total assets in 2020. Midsize banks experienced a similar increase in NMD growth during this time but saw lower loan balance declines and liquid asset increases due, in part, to PPP loan originations. Midsize and large banks were also able to use deposit increases to reduce exposures to higher cost certificates of deposit and borrowings, which helped to partially offset NIM compression.

Community banks experienced a more moderate NIM decline of 32 bps to 3.36 percent. PPP lending served as a primary mitigant to NIM compression in community banks. An increasing but small number of community banks are holding investment types that were not held the prior year. New types observed include municipal bonds and asset-backed securities, indicating a potential growing appetite for credit risk in investment and loan portfolios as banks search for yield. Pre-provision net revenues as a percent of average assets remained stable in community banks through 2020 despite lower net interest income. Stable noninterest income, driven by gains on the sale of loans, was a key driver of this trend. Over the last 20 years, noninterest expenses as a percentage of average assets have largely tracked NIM in community banks as banks strive to reduce operating expenses when the NIM contracts. The stability and sustainability of these sources may be key to community bank earnings in the current low or potentially increasing rate environment.

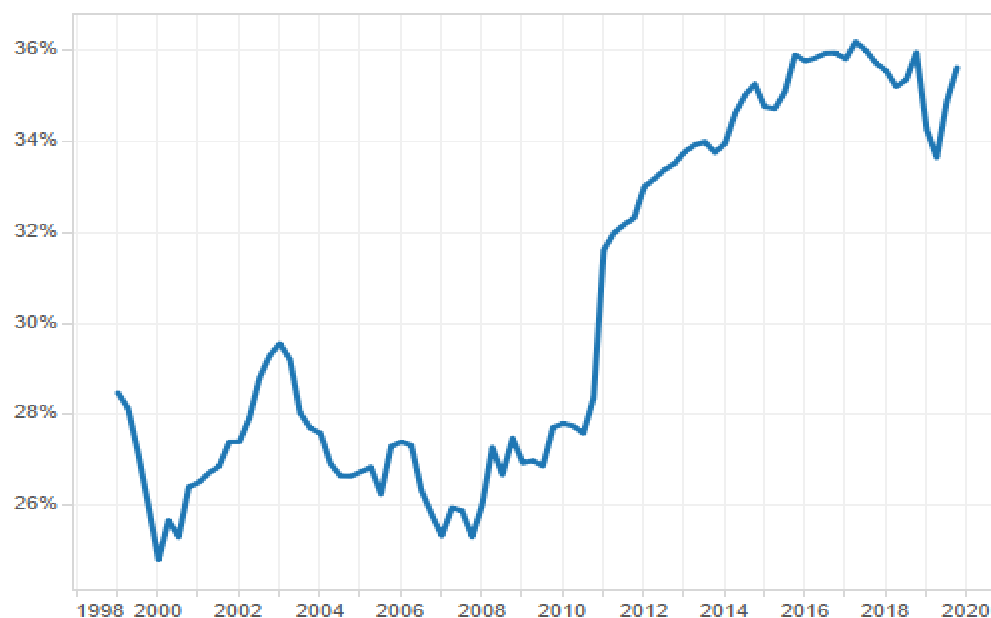
The strategic risk associated with how banks manage NIM compression and earnings carries additional risks. Overhead cost reduction, investment portfolio duration extension, or increased credit risk in the investment portfolio may offer opportunities to improve yield or mitigate NIM compression impact on earnings in the current rate and lending environment. However, they also present new or increased risks that banks must appropriately manage and closely monitor.

Given this complex environment, banks are employing a variety of strategies including:

- Reducing costs: Median efficiency ratios spiked in the first quarter of 2020. The median large bank ratio remains elevated, but community and midsize ratios declined back down to pre-2020 levels by year-end 2020.

- Duration extension: Banks are extending duration in investment portfolios to improve asset yields and earnings (see figure 8). Banks increased their longer-term securities in the second half of 2020. Large and midsize banks invested in primarily longer-term residential MBS while community banks invested in a mix of residential MBS and municipals bonds.

Figure 8: Long-Term (>3 years) Assets as a Percentage of Total Assets



Source: Integrated Banking Information System, Call Reports

Similarities with Recent History

The current environment resembles 2012–2013 when concerns centered on margin pressure from weak loan growth, a shift from loans to lower-yielding cash and securities, and the Federal Reserve's low interest rate policy driving a shift to lower yields as assets matured. Profitability was tied to banks' ability to reduce expenses or grow revenue and concerns rose that pressure for loan and revenue growth would lead to higher risks as banks searched for yield. Net interest income continued to erode through year-end 2012 and into 2013 despite improving loan growth and steepening yield curve due to weak loan pricing.

Despite the steepening yield curve, community bank median and midsize bank median NIMs slowly increased through 2013. Large bank median NIM saw a spike in early 2013 but then declined significantly, and credit card bank median NIM declined into early 2013 with a substantial run-up to 6 percent by mid-2013. During this time, investment portfolios increased volumes of municipals, commercial MBS, and asset-backed securities. At the end of 2013, concerns were raised regarding whether funding costs would begin to sharply increase as rates normalized, pressuring banks struggling to grow loan and asset yields.

2012–2013 as a Guide

A primary concern today is how banks will offset NIM compression given the current low and unstable slope in the rate environment and a lack of lending opportunities. As noted, banks have extended duration and added new products in investment portfolios, as well as reduced expenses. If the yield curve continues to steepen, there could be similar observations and concerns to those in 2012–2013. Several factors could temper the general expectation that banks, particularly community and midsize, will benefit as yields rise.

Credit quality trajectory is critical to supporting earnings that could be realized from the steepening curve. Community and midsize banks may experience downward NIM pressure as support measures (e.g., PPP) provided some mitigation to rate declines. Should credit quality hold firm during the recovery from the pandemic, competition and the desire for yield could again push down loan yields and pressure underwriting quality.

Investment portfolio duration and surge deposit behavior may also limit the upside realized from a steepening yield curve. Interest rate risk already embedded into investment portfolios for banks that traded duration for yield, could limit the benefit realized from rising yields. Deposit instability could also increase as rates rise, and higher-yield alternatives become available to depositors. The surge of deposits that banks experienced during the pandemic could reverse, forcing banks into higher-cost funding sources if the outflow exceeds current excess liquid assets. Noninterest income stability and sustainability may continue to be critical, particularly for smaller banks, as a mix of these factors continues to pressure net interest margins.

Part IV: Trends in Key Risks

A. Credit Risk Is Elevated

Commercial credit risk remains elevated while retail and mortgage risk has moderated, but traditional risk metrics continue to be muted by government actions and other programs protecting troubled borrowers. Reduced business activities and high levels of unemployment adversely affected borrowers' ability to service debts. Nonperforming loans increased especially in CRE. Loan losses, however, have yet to fully materialize, as expected, across many segments of the banking industry. This has resulted in some banks taking reserve releases due to lower than projected losses and past dues in the first quarter of 2021. The system-wide offering of proprietary relief and mandated programs coupled with unprecedented stimulus efforts may be deferring potential losses within the financial services industry.

Commercial credit risk increased over the last year, largely attributable to the restrictions put in place in response to the pandemic. The commercial credit environment continues to exhibit elevated risk levels and evolving risk trends. While the pace of commercial bankruptcies moderated, asset-quality deterioration has surfaced through elevated, but manageable, special mention and classified assets, nonperforming loans, troubled debt restructurings, loan loss provisions, and loss charge-offs. Industries exhibiting pronounced deterioration include real estate (including nonresidential CRE and real estate services), retail, restaurants, oil and gas, equipment manufacturing (excluding autos), transportation services, and commercial services. The impact varies by geography. Businesses that were weak before the pandemic, including highly leveraged borrowers, are especially vulnerable. In response to risks, many banks strengthened their risk management systems and increased their commercial loan loss reserves.

The level of retail and mortgage credit risk has moderated and stabilized with borrower assistance programs, the improving outlook for GDP, and employment growth over 2021. Nevertheless, we continue to anticipate higher retail and mortgage delinquency and loss rates to materialize within negatively impacted segments of borrowers who will not be able to resume contractual payments at the end of their relief period. Absent an additional significant market shock that causes another increase in risk profile, banks are sufficiently reserved for the current level of credit risks embedded within their retail and mortgage portfolios. Additionally, the present strength of asset valuations, particularly home values, will help mitigate the severity of losses.

The continued foreclosure moratoriums, while maintaining homeownership for troubled consumers, could delay the realization of losses if customers are unable to qualify for longer-term payment programs. However, more prudent underwriting since the last recession and the current strength of the housing market are mitigating factors.

Although a vast majority of consumers have been able to make contractual loan payments, there remains a highly impacted segment that continues to rely on additional stimulus and loan accommodations. Closures resulting from the pandemic disproportionately impacted lower-wage earners, specifically in the travel, leisure, and hospitality industries. This segment of consumers

remains highly vulnerable and may not be able to resume contractual loan payments once their loan accommodation or beneficial moratoriums end.

Consistent with interagency statements, prudent bank managers should closely monitor the performance of all credit portfolios and adjust operational processes for compliance with laws and regulations. Banks continue to work prudently with borrowers who are or may become unable to meet their contractual payment obligations. The OCC issued OCC Bulletin 2020-72, "Credit Administration: Joint Statement on Additional Loan Accommodations Related to COVID-19," in August 2020 on prudent risk management principles for banks to consider while working with borrowers as loans near the end of initial loan accommodation periods applicable during the COVID-19 outbreak. The OCC expects banks to maintain accurate and timely loan risk ratings based on borrower financial condition, repayment ability, and ability to manage through the pandemic. This includes maintaining an appropriate allowance for loan and lease losses (ALLL) or allowance for credit loss (ACL), as applicable.

Appropriate ALLL or ACL analyses 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 analysis includes assessing the pandemic's financial impact on borrowers. Although ALLL and ACL levels remain elevated to account for the high level of uncertainty presented by the pandemic, we are beginning to see release reserve during the fourth quarter of 2020 and the first quarter of 2021.

Proactive banks continue to monitor material exposures or concentrations in distressed industries, markets, or consumer products highly affected by the pandemic. In addition, they should assess the adequacy of credit administration processes, including workout programs, staffing and expertise, loan accommodation programs, and resources for back-office functions.

B. Libor Cessation

London Interbank Offered Rate (Libor)

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 properly mitigate operational, compliance, legal, and reputation risks. A seamless transition is also important to prevent balance-sheet destabilization and negative financial impact. While originally expected to cease at the end of 2021, the ICE Benchmark Administration Limited (IBA) published a consultation with a request for feedback on potential Libor cessation that would result in the publication of overnight and one-, three-, six-, and 12-month U.S. dollar (USD) Libor through June 30, 2023. Despite the short extension for some Libor maturities, banks should continue to apply sound risk management principles to ensure successful transition.

The agencies issued a joint statement in November 2020 that encouraged banks to cease entering into new contracts that use USD Libor as a reference rate as soon as practicable, but no later than December 31, 2021. Failure to cease entering into new Libor contracts after December 31, 2021, or to prepare for disruptions to USD Libor would create safety and soundness risks. The agencies

recognized that there may be limited circumstances (e.g., market making and hedging) when it would be appropriate for a bank to enter into new USD Libor contracts after that date if the publication of USD Libor is extended beyond December 31, 2021. Additionally, the statement discusses that banks need to establish an appropriate oversight mechanism for transitioning loans away from Libor for those loans that mature after June 30, 2023, when all remaining Libor rates are discontinued.

In OCC Bulletin 2021-7, "Libor Transition: Self-Assessment Tool for Banks," the OCC provided a tool for banks to evaluate their preparedness for the cessation of Libor. The tool can be used to assess the appropriateness of a bank's Libor transition plan, bank management's execution of the bank's transition plan, and related oversight and reporting. The bulletin emphasizes that Libor cessation preparedness assessments be risk-based and a bank's transition plans, oversight, and reporting might not need to include all points in the self-assessment. Additionally, the tool provides management an opportunity to assess its preparations for moving to another rate as there are several new rates in the market continuing to mature.

The International Swaps and Derivatives Association (ISDA) launched the Interbank Offered Rate (IBOR) Fallbacks Supplement and IBOR Fallbacks Protocol in October 2020. The supplement amended ISDA's standard definitions for interest rate derivatives to incorporate robust fallbacks for derivatives linked to certain IBORs, with the changes made effective January 25, 2021.

The OCC will continue to assess Libor exposures in supervised banks and the safety and soundness of their preparation plans to transition to another reference rate, as well as the plans for ensuring compliance with consumer protection regulations. The OCC is increasing its oversight through 2021, particularly for banks with significant Libor exposure or less-developed transition processes, as noted in Bulletin 2021-7.

C. Operational Risk

Cybersecurity

Operational risk remains elevated. The ongoing monitoring and adjusting of internal controls, risk management practices, and risk mitigation strategies to adapt to the increasingly complex technology infrastructure and cybersecurity environment are critical. Cyber actors continue to focus on exploiting vulnerabilities identified in bank systems and third-party providers of information technology services. While cyber actors continue to conduct their attacks primarily for financial gain, cyber actors also conduct attacks for intelligence gathering and other nefarious purposes. Cyber actors have also increasingly targeted third parties and those in the software supply chain. Phishing remains the primary tool to gain access to IT systems. Banks should remain diligent in detecting and protecting against cyber threats, ransomware attacks, and fraudulent unemployment or economic impact payments.

Ransomware attacks continue to increase in all sectors and companies, including the financial sector. To increase pressure on organizations to pay extortion demands, cyber intruders have evolved their tactics to demand payment in exchange for not releasing sensitive information

obtained during a cyber attack. Ransomware has evolved to ransomware as a service, whereby multiple intruders coordinate their activities to conduct a single intrusion event, making it more challenging for any bank to defend against such attacks. Banks should assess the impact a potential ransomware attack may have on their operations and business processes and incorporate business continuity plans into their risk management procedures. Banks should be mindful of the downstream impact that an intrusion would have on customers and suppliers and consider protocols for containing the intrusion, providing appropriate notifications to affected entities, and securing immutable, off-line storage of critical data.

Supply chain risks have evolved, and threat actors are increasingly exploiting vulnerabilities in IT systems and services to conduct malicious cyber activities. Companies that develop software to help maintain information technology infrastructure have been compromised in order to spread malicious software through updates to their products, impacting thousands of customers including government agencies, financial sector entities, and technology service providers. These attacks demonstrate the need for banks to assess the risks emanating from their suppliers and third parties and develop a comprehensive cooperative approach to operational resilience.

To address the myriad possible threats to banks (e.g., cyber, physical, or natural disasters), the OCC, Federal Deposit Insurance Corporation, and Federal Reserve Board issued an interagency paper Sound Practices to Strengthen Operation Resilience, on October 30, 2020. The paper outlines existing regulations and guidance to highlight the need for a flexible operational resilience approach that can enhance banks' ability to prepare, adapt, withstand, and recover from disruptions and to continue operations. The paper informs banks that operational risk and business continuity management include sound practices to strengthen operational resilience and to consider third-party risks.

Innovation and Adoption of New Products and Services

Innovation and technological advances continue to spur the development of new products and services designed to meet customer needs and service expectations. These innovations may contribute to an increasingly complex operating environment.

Examples of recent innovations include faster and real-time payment products, increased use of mobile and digital technologies to deliver financial services, application programming interfaces, data aggregation services, and contactless payment devices. The emergence of distributed ledger technologies and digital assets like cryptocurrencies and stablecoins will continue to broaden delivery channels and the functionality of financial services.

The adoption of new innovative technologies to facilitate financial services can offer many benefits to both banks and their customers, but appropriate due diligence, change management and risk management is essential to successful implementation. Risk and control environments need to keep pace to address innovation and emerging trends. Unwarranted risk may occur if risk is not fully understood or effective controls are not fully developed. Examiners will continue to assess how banks are managing risks related to changes in operating environments driven by these innovations.

Banks may also require additional or different controls to safeguard against fraud, financial crimes, violations of consumer protection or fair lending laws, or operational errors and to maintain comprehensive operational resilience frameworks commensurate with the size and complexity of products, services, and operations being supported. Strategic planning and risk management processes should be sufficiently robust to manage, partner, or compete with new fintech entrants as needed.

Third-Party Risk Management

Third-party risk management continues to be an area of heightened supervisory focus. When adopting new products and services, some banks may lack the specialized risk management and expertise needed to properly assess and mitigate the risks to the bank and may need to rely on third-party resources. Further, as banks use third-party relationships to market and service new products, it is essential for them to conduct appropriate due diligence commensurate with the risks that the new services and providers pose to the bank, and to monitor third-party activities to ensure compliance with applicable laws and regulations.

In addition, many banks rely on service providers for critical operations; consolidation in the industry has concentrated critical information processing services to a small number of technology service providers. It is important for banks to understand and mitigate the cyber-related risks when engaging third parties. Effective due diligence and monitoring processes include assessment of third parties' management of cyber-related risks and resiliency capabilities.

D. Compliance Risk and the Bank Secrecy Act

Compliance risk is increasing, driven by regulatory changes, policy initiatives related to the COVID-19 pandemic, and the compliance-related priorities of Congress and the administration. Banks should be diligent to appropriately monitor and manage changes and associated risks, and ensure new processes incorporated into their compliance risk management programs are effective.

Banks continue to be challenged to implement proactive compliance risk management programs and will need to remain agile to quickly adapt. These factors can create challenges for full and accurate implementation of bank policies to meet the Bank Secrecy Act (BSA), consumer protection, and fair lending requirements. Specific areas of challenge may include responsibilities associated with underwriting and opening new accounts, monitoring customer activity, processing transactions, loan modifications, servicing loans, communicating with customers, complying with consumer protection law and treating customers fairly, complying with consumer protection laws, and meeting BSA and Office of Foreign Assets Control (OFAC) compliance obligations as well as regulatory and policy actions by the Consumer Financial Protection Bureau (CFPB).

Banks face further challenges in adapting compliance operations to respond to the rapid pace of regulatory change in key compliance areas, BSA reforms and guidance implemented by the

Regulatory Reform Working Group and the significant changes to the BSA as a result of the AML Act of 2020.

Bank Secrecy Act

Criminals continue to formulate and adapt scams and money-laundering techniques to the new financial environment created by the COVID-19 pandemic. Through these scams, criminals deceive people into moving illicit money on their behalf through funds transfers, physical movement of cash, multiple personal accounts being used at the behest of a customer's "employer," peer-to-peer payment platforms, and various other methods. Banks should remain vigilant in identifying potentially illicit activity and monitoring for fraud typologies that have emerged or evolved during the COVID-19 pandemic. Examples of these typologies include account compromise, phishing, and the use of malware, malicious websites and downloads, domain name system hijacking or spoofing, and fraudulent mobile applications. Medical-related frauds (COVID-19 cures, tests, vaccines, and services), imposter scams, and elder abuse have also increased during the pandemic. 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. Criminal rings have also been targeting economic impact payments related to the pandemic like the CARES Act, and unemployment insurance programs. Some states have been severely impacted by fraudulent unemployment claims using fake or stolen personal and financial information.

Banks should monitor for and be aware of evolving and emerging financial crime typologies and ensure that their anti-money laundering (AML) programs are commensurate with their risk profile. Banks can monitor information provided by law enforcement agencies and international AML standard-setting organizations regarding how criminals adapt scams and money-laundering techniques to exploit vulnerabilities created by the pandemic. The Financial Crimes Enforcement Network (FinCEN) website includes a COVID-19 updates section that provides common red flags and guidance on COVID-19-related fraud schemes and typologies.[4]

Banks should make appropriate risk-based adjustments in their BSA/AML/OFAC compliance programs based on COVID-19-related circumstances and keep examiners updated on potential BSA/AML/OFAC or sanctions compliance issues, including potential delays in meeting regulatory requirements. Banks should track and manage any deferred actions and other departures from standard processes or procedures and adjust as necessary upon return to office work. The OCC will consider the impact of COVID-19-related measures on BSA compliance in determining any new supervisory response, if needed.

---

[4] See FinCEN Coronavirus Updates, available at https://www.fincen.gov/coronavirus. See also, FIN-2020-A005, FinCEN Advisory on Cybercrime and Cyber-Enabled Crime Exploiting the Coronavirus Disease 2019 (COVID-19) Pandemic (July 3, 2020), available at https://www.fincen.gov/resources/advisories/fincen-advisory-fin-2020-a005.

Consumer Compliance

Effective change management and compliance risk management are important processes to identify, measure, monitor, and control the changing and emerging risks related to consumer products or services. These products and services include assistance programs, loan modifications and forbearance accommodations, handling of customer complaints, and communications with customers associated with the COVID-19 pandemic and related policy initiatives, recent regulatory and policy actions by the CFPB, and the associated regulatory uncertainty.

Pandemic-related changes in availability of bank staff may affect banks' ability to comply with CARES Act provisions and other regulatory requirements. Bank post-implementation monitoring and testing is critical to determine that products, processes, or systems are working as intended. In the COVID-19 pandemic environment, a bank's compliance testing or audit plan may need to be updated to account for new requirements and processes to allow for earlier detection and correction of issues. 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.

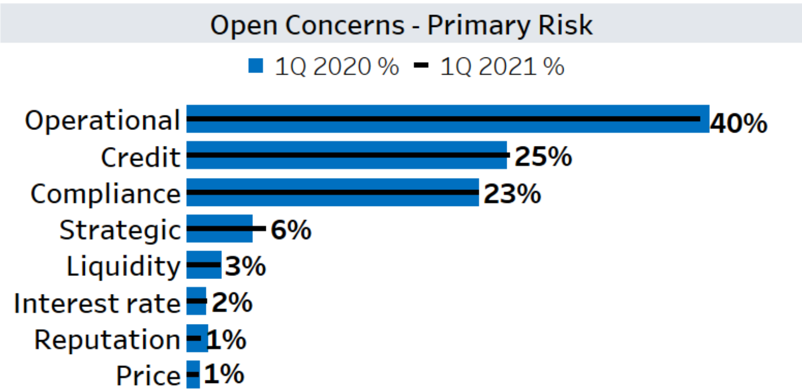
Monitoring complaints is an important component of an effective compliance risk management program, especially during the COVID-19 pandemic where multiple changes to bank processes and requirements may directly or indirectly affect customers. Customer feedback can serve as an early warning indicator as the first sign of a potential problem. Customers' complaints may raise awareness of issues that were unintended or identify potential process breakdowns where a program was not implemented as anticipated or was not clearly explained. This is particularly important when working with customers receiving accommodations, such as forbearance, to ensure they clearly understand available options moving forward.

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

Part V: Supervisory Actions

The OCC communicates supervisory concerns to a bank's board and management in the form of Matters Requiring Attention (MRAs). MRA concerns include practices that deviate from sound governance, internal control, or risk management principles.[5] 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 Enforcement Actions. The number of open MRAs is basically unchanged (-1 percent) from the first quarter of 2020. Figure 9 shows the composition of outstanding MRA concerns.

Figure 9: Outstanding MRA Concerns



Figures do not add to 100 due to rounding.

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