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COVID-19: Continuing Impact on Risk Management for Financial Institutions

The financial services industry continues to be focused on responding to the diverse set of challenges presented by the economic and operational fallout from the pandemic. While the transition to work from home arrangements has gone relatively well, organizations are now challenged with assessing and balancing the risks of a phased return to the workplace coupled with longer-term remote working arrangements. In addition, the financial impacts are becoming more transparent with U.S. banking results dominated by increased provisions for credit losses and lower interest income resulting from a sustained decrease in interest rates, albeit offset by increased trading revenues for some.

These unprecedented challenges will continue to have a broad impact on the risk profile of financial institutions for some time, both financial and operational, particularly around the following themes:

Financial Impacts

The economic fallout from measures taken to contain the impact of the pandemic has had extensive and unforeseen consequences resulting in extreme stresses on institutions' funding sources, borrower credit quality and exposures to market volatility. Firms' ability to perform timely and actionable stress testing forecasts for capital, liquidity, credit and market risks will be continuously tested.

Business Resilience

While institutions have made improvements over recent years, the pandemic has exposed weaknesses in business' resilience and continuity planning processes given the systemic nature and severity of the disruption. Institutions are continuing to tactically respond to weaknesses identified in their business and operational functions. Operational risks such as Vendor Risk and IT Security / Cyber Risk have become more prevalent due to remote work arrangements and increased external threats. Fulfilling fiduciary duties and decision making remain challenging for Boards of Directors and Management due to mobility and telecommuting constraints.

Regulatory Compliance Risk and Fraud

Increasing incentives and opportunities, including the new and evolving economic stimulus programs and extended remote working arrangements will lead to greater fraud risk and require implementation of more robust fraud and compliance risk management programs. Changing customer behavior due to COVID-19 may also cause challenges in areas such as transaction monitoring. Further, alternative work arrangements and resource availability may exacerbate regulatory compliance concerns and challenge firms' ability to deliver against regulatory program deliveries where deadlines remain unchanged (e.g., LIBOR transition).

Litigation and Regulatory Enforcement Risk

The increased risk for litigation comes in many forms, from Paycheck Protection Program (PPP) loan forgiveness and inequitable customer prioritization, valuation of less liquid financial instruments, failure to disclose risk exposure due to the pandemic and M&A breach of contract challenges. Institutions need to carefully assess changes to their litigation risk profile and preparedness for addressing greater litigation volume including resources and infrastructure around e-discovery, data and record retention.

Relief measures such as the The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) will also lead to increased regulatory scrutiny on the implementation of these programs. Institutions should be prepared to address regulatory oversight on how they implemented these programs and put in place plans and procedures to support the likely reviews and investigations by regulators.

COVID-19 Impact on Regulatory Priorities

While institutions of all sizes are dealing with COVID-19 related disruptions, regulators have also had to adjust their supervisory approach and expectations. Regulators including the Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) have issued guidance granting flexibility in implementing certain new regulatory requirements and adjusting their priorities to allow institutions to focus on their most pressing issues and customers affected by the pandemic. Agencies have stated that:

> *Examiners will consider the unique, evolving, and potentially long-term nature of the issues confronting institutions and exercise appropriate flexibility in their supervisory response… Examiners will continue to assess institutions in accordance with existing agency policies and procedures and may provide supervisory feedback, or downgrade an institution's composite or component ratings, when conditions have deteriorated. In conducting their supervisory assessment, examiners will consider whether institution management has managed risk appropriately, including taking appropriate actions in response to stresses caused by COVID-19 impacts.*[1]

1. Board of Governors of the Federal Reserve System, "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions," June 2020 https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200623a1.pdf

The FRB, FDIC and OCC in conjunction with the state bank and credit union regulators issued examiner guidance (i.e., interagency guidance)[2] on June 23rd where they recognized the need for flexibility under the current circumstances but also highlighted key risk areas of focus in light of COVID-19. Of note, it has been made clear that regulators will be assessing how management has reacted to this crisis. The interagency guidance specifically mentions that:

> *Examiners should assess the reasonableness of management's actions in response to the pandemic given the institution's business strategy and operational capacity in the distressed economic and business environment in which the institution operates.*

Additionally, on the back of the FRB stress testing results and the publishing of sensitivity analyses around COVID-19 downturn scenarios, the Board is also requiring banks to re-evaluate their longer-term capital plans and all large banks will be required to resubmit and update their capital plans later this year to reflect current stresses during this period of uncertainty.[3]

In Summary

As the situation continues to evolve, it is more important than ever for risk management teams to stay agile, regularly assess and engage with key stakeholders (including regulators) on changes to the institutions risk profile and be able to demonstrate the appropriateness and reasonableness of management's response to the pandemic.

2. Board of Governors of the Federal Reserve System, "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions," June 2020 https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200623a1.pdf

3. Board of Governors of the Federal Reserve System, "Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event," June 25, 2020 https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm

COVID-19 Risk Impact Summary

The following table summarizes the impact of COVID-19 on several key regulatory priorities and recommended steps institutions can take to address these issues.

RISK IMPACT	IMPACT OF COVID-19	CONSIDERATIONS
	Financial Impacts	
Credit Risk	The credit risk of certain counterparties in specific sectors and geographies have been substantially affected. Retail and wholesale counterparties may look to take advantage of forbearance plans available per updated federal/state guidance, restructure existing loan terms or delay payments. Collateral on secured loans may be devalued. Inputs and assumptions into new Current Expected Credit Loss (CECL) model frameworks may also not hold under current conditions.	Evaluate portfolios for workouts and credit concentrations (e.g., specific industries), including the increased use and frequency of stress testing to inform risk mitigating actions. Revisit credit risk model assumptions and overlays for impact on provisioning levels, including CECL model inputs as necessary.
Market Risk	Recent increased market volatility has had impacts on pricing, valuations and margin settlements. A sustained decrease in interest rates has increased spread pressure and will continue to weigh on profitability.	Reassess market risk modeling frameworks as current assumptions may not hold under current conditions. Consider updating model overlays to capture risks not represented in model outputs.
Liquidity Risk	In response to COVID-19, Central Banks across the globe including the Federal Reserve and European Central Bank have taken a variety of actions to address market stresses and liquidity. However, institutions may still be experiencing liquidity constraints due to COVID-19 related disruptions.	Closely monitor market developments and identify impacts to the liquidity risk profile. Enhance frequency and granularity of liquidity risk measurement processes including stress testing scenario design and assumptions. Review contingency funding plans (CFP) and CFP triggers for adequacy.
Capital	Regulators have explicitly stated that they will assess the reasonableness of management's response to the pandemic and the impact on long term strategy. Regulators will also focus on how plans for independent risk management and audit assessments have been affected. As institutions face increased losses, expenses and declines in cash flow, they are being encouraged per interagency guidance to use capital buffers for lending related activities, but regulators will also be assessing capital levels against risk profile to ensure adequacy.	Work with key stakeholders to identify and manage risks associated with the pandemic including their effects on business strategy and understand the risks caused by external factors (i.e., factors outside of management's control) versus internal. Work with internal audit and independent risk management teams to adjust audit plans as necessary due to the pandemic and incorporate additional procedures to review areas with heightened risk (e.g., reviewing remote work technology controls). Engage frequently with stakeholders (including regulators) to monitor capital plans including projections and actions for ensuring capital adequacy.

RISK IMPACT	IMPACT OF COVID-19	CONSIDERATIONS
	Business Resilience	
Operational Resilience	COVID-19 has highlighted areas lacking operational resilient in business models, vendors, supply chains, risk processes, business continuity management, etc.	Proactively assess weakness and develop plans to address shortfalls in operational resiliency to meet internal and external (i.e., regulators) stakeholder expectations.
IT / Cyber / Cloud / Digitization Risks	With a fundamental shift to remote working, there is increased stress on organizations' IT infrastructures and greater internal and external security threats.	Review and consider enhancing existing controls for remote working arrangements. Provide training refreshers on firm policies related to remote work including information governance and cyber.
Vendor Risk Management	Third parties providing critical services may be disrupted by COVID-19 mitigation measures and require alternative work arrangements which may introduce additional risks.	Review and engage with your critical vendor population to identify impacts on the continuity of service. Work with vendors to establish how they are planning to continue critical operations and risk mitigation plans.
	Regulatory Compliance and Fraud Risk	
BSA / AML, Sanctions Compliance	Remote work arrangements may present logistical challenges for transaction monitoring and customer due diligence depending on data security policies and system infrastructure. Banks turning to their business continuity plans to weather the COVID-19 pandemic as their employees work from home, must refine their risk-based approach to BSA/AML compliance. Expected customer behavior may differ due to the pandemic, with a large number of businesses closing. Inability to collect original documents and perform on-site visits pose additional challenges to perform customer due diligence (CDD) for purposes of enhanced CDD.	Work with technology teams to confirm availability of systems and data for transaction monitoring and/or available workarounds. Review the efficiency ratings of alerts produced by the system, especially those produced by behavioral-based rules and scenarios. Tune and align your transaction-monitoring system with the modified customer behavior focusing on highest risks without losing sight of potential money laundering activity. Broaden your methods of obtaining documents or conducting interviews to include newer forms of technology, provided that those technologies are sufficiently reliable and appropriate in the circumstances. Update your underlying policies and procedures to reflect these changes and communicate these changes to regulators.
Fraud Risk	The Financial Crimes Enforcement Network (FinCEN) has called upon financial institutions to be vigilant for fraud schemes related to COVID-19 and has requested that related suspicious activity reports ("SARs") be filed with a "COVID19" label in the report.[4]	Adopt appropriate mitigation measures to identify and report any COVID-19 related scams, such as investment scams and those that attempt to manipulate new remote protocols enabling fraud and abuse.

4. FinCEN, "The Financial Crimes Enforcement Network (FinCEN) Encourages Financial Institutions to Communicate Concerns Related to the Coronavirus Disease 2019 (COVID-19) and to Remain Alert to Related Illicit Financial Activity," March 16, 2020 https://www.fincen.gov/news/news-releases/financial-crimes-enforcement-network-fincen-encourages-financial-institutions

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RISK IMPACT	IMPACT OF COVID-19	CONSIDERATIONS
	Regulatory Compliance and Fraud Risk	
Consumer Financial Protection	The CARES Act was signed into law to provide stimulus to those adversely affected by COVID-19. Provisions related to consumer financial protection cover the following areas for certain Federally-backed loans: — Mortgage Loan Forbearance; — Foreclosure Relief; and — Student Loan Payment Suspension. Note individual state regulators have also issued their own guidance on these areas.	Assess impact of the provisions of the CARES Act upon the organization's business activities, business risk profile and risk and compliance management processes. Implement remedial actions, procedures and training to ensure compliance. Continue to stay up to date on latest guidance at the federal/state levels and its impact on business processes and all lines of defense.

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