

# SEMIANNUAL RISK PERSPECTIVE

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FROM THE NATIONAL RISK COMMITTEE

FALL 2021

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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.<sup>1</sup> The OCC supervises these banks to ensure they operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

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

The OCC's *Semiannual Risk Perspective* addresses key issues facing banks, focusing on those that pose threats to the safety and soundness of banks and their compliance with applicable laws and regulations. This fall 2021 report presents data in five main areas: the operating environment, bank performance, special topics in emerging risks, trends in key risks, and supervisory actions. The report reflects data as of June 30, 2021, unless otherwise indicated.

The OCC welcomes feedback by email: [NRCReport@occ.treas.gov](mailto:NRCReport@occ.treas.gov).

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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 are showing resilience in the current environment with satisfactory credit quality and strong earnings, but weak loan demand and low net interest margins (NIM) continue to weigh on performance.
- ▶ While the response to the delta variant is expected to contribute to slower gross domestic product (GDP) growth in the second half of the year, the deceleration caused by the variant's spread is not expected to be large due to increased business activity.

## KEY RISK THEMES



### OPERATIONAL RISK

Operational risk is elevated as banks respond to an evolving and increasingly complex operating environment and evolving cyber risks.



### CREDIT RISK

Credit risk is moderate as widespread government programs and appropriate risk management have limited the potential credit impact of the pandemic, though some areas warrant continued attention.



### COMPLIANCE RISK

Compliance risk is heightened, driven by regulatory changes and policy initiatives that continue to challenge bank risk management.



### STRATEGIC RISK

Strategic actions taken by banks to offset the impacts of low yields and NIM compression on earnings remain a risk.

Operational risk remains elevated as cyber attacks evolve, become more sophisticated, and cause damage to more industries. The OCC has observed an increase in ransomware attacks in financial services. These attacks continue to leverage phishing emails targeting employees and compromised credentials to gain access to networks through remote access channels. Once access is gained, the attackers conduct ransomware and other extortion campaigns.

Credit risk remains moderate. Loan portfolios have been resilient and widespread credit deterioration has not materialized from the crisis due to appropriate risk management by banks, improvements in economic activity, and the remaining effects of pandemic-related government actions and relief programs. However, the duration of the pandemic, its impact on demand for credit, and the effects of nonbank competition may put pressure on some banks' willingness and ability to maintain credit discipline as the economy recovers and loan growth opportunities return.

Compliance risk remains heightened, as banks' efforts to serve customers in the end stages of assistance programs create challenges for change management, as well as for product and service risk management practices. Assistance 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. The conclusion of these programs creates increased compliance responsibilities, high transaction volumes, and new types of fraud, as banks continue to respond to a changing operating environment.

Strategic risk associated with banks' management of NIM compression and efforts to improve earnings is elevated. Stimulus measures, low-yield investment options, and reduced lending opportunities fueled deposit inflows that resulted in additional highly liquid assets and lower margins as banks struggled to find yield. Banks may attempt to further improve earnings through measures including increasing credit risk (in both loans and investments), extending loan duration, and cost cutting.

The OCC encourages banks to guard against complacency to ensure financial resilience without compromising effective risk management systems that support sound business models and strategic and operating plans. When done properly, growth can provide significant benefits to consumers, communities, investors, and the economy. Banks should remain vigilant when considering growth, new profit opportunities to avoid excessive risk taking, and should maintain adequate controls when managing investment and lending programs.

## OCC CLIMATE RISK INITIATIVE

The OCC is committed to acting on the risk that climate change presents to the financial system. These risks are driven by impacts of climate change on households, communities, businesses, and governments across the United States and around the world. Banks are exposed to physical and transition risks presented by climate change, which may impact the safety and soundness of supervised institutions.

Physical risks refer to harm to people and property arising from acute, climate-related disaster events such as hurricanes, wildfires, floods, and heatwaves, as well as more gradual, chronic phenomena such as sea level rise. Banks have shown historical resilience in dealing with these events using risk mitigation tactics including insurance and working with borrowers in affected areas. However, the increased severity, frequency, and breadth of extreme weather due to climate change is likely to impact economies and borrowers in ways that deviate from historical experience ([Sixth Assessment Report](#)). Banks will need to consider risk management process to deal with these and other, longer-term physical risk implications.

Transition risks relate to the adjustment to a low-carbon economy and include associated changes from government policy, technology, and consumer/investor sentiment. This risk is particularly important if the transition is disorderly and abrupt. For example, several large companies are making commitments to transition to lower carbon emissions, and they will likely influence vendors and suppliers to do the same, which may exacerbate the risk. Thus, banks are likely to see some impact from this economic transition, potentially abruptly and likely long term. There are significant challenges to understanding the timing as well as the direct and indirect implications of transition risk.

Both these risks can have an associated material impact on the financial system by damaging property, impeding business activity, shifting the values of assets (both up and down), and affecting income. Banks will need to consider potential corresponding climate change risks across all the existing traditional risk areas based on the bank's size, complexity, and business model. To address these risks, the OCC plans to issue climate risk management principles for large banks.

These principles will build on the [Basel Committee's Task Force on Climate-Related Financial Risks](#) (TCFR). The principles are intended to help direct the focus of institutions on the foundational questions to determine the materiality of climate risk and establishing a risk management framework. The principles will also provide a basis for development of more complex, mature, climate risk management expectations. Therefore, the principles will represent a first step toward addressing some of the challenges and providing high level supervisory expectations regarding the management of exposures to climate-related financial risks.

There are significant and complex challenges in understanding these risks. Some of the key issues include the need for evolving climate change

- risk management frameworks,
- data,
- risk measurements,
- disclosures,
- scenario analysis, and
- consumer/community implications.

The OCC is taking a brisk but deliberate approach to advance the development of risk management frameworks and gather relevant information to understand these challenges. The agency's focus is on ensuring banks establish sound risk management frameworks to measure, monitor, and control risk presented by climate change. To accomplish these objectives, we have done the following:

- Appointed a Climate Change Risk Officer
- Established an internal climate risk implementation committee
- Joined the Network for Greening the Financial System (NGFS)
- Continued participation in climate related Basel initiatives
- Participated in the development of recommendations for the Financial Stability Oversight Council Climate Risk report
- Conducted a range of practice activity review at the largest banks
- Engaged more extensively with industry and climate groups
- Committed to publishing large bank climate risk management principles for feedback

The OCC plans to focus initially on large banks given the significance and complexity of the climate risks they face. During 2022, the OCC plans to finalize climate risk management framework guidance for large banks and to develop more detailed expectations by risk area. We will review the large banks' progress toward establishing climate risk management capabilities. We also plan to conduct additional industry outreach. The OCC also issued a [request](#) for both academic-focused papers and policy-focused research on climate risk in banking and finance. We will utilize the information gathered to inform our development of further supervisory principles on climate risk. We anticipate a more in-depth discussion of climate risk and the status of supervisory expectations in the Spring 2022 *Semiannual Risk Perspective*.

The special topic in part III of this report highlights community banks.

# OPERATING ENVIRONMENT

## U.S. ECONOMIC GROWTH EXPECTED TO MODERATE IN 2022

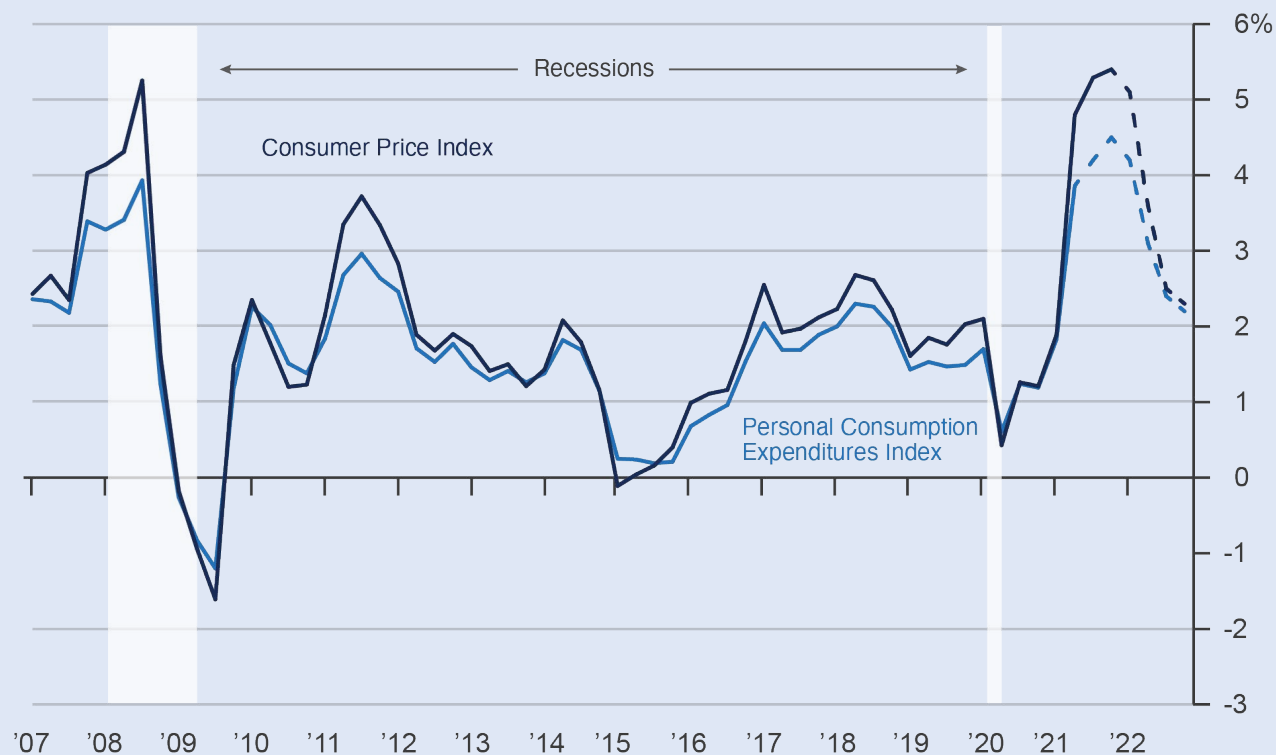
U.S. economic growth was very strong in the first half of the year as widespread vaccinations, removal of COVID-19 restrictions, and fiscal stimulus unleashed consumer spending. Real GDP surpassed its pre-pandemic peak in the second quarter of 2021, but the sudden surge in growth occurred with a still-active pandemic, which created frictions and dislocations in the economy. Business activity is negatively impacted due to an insufficient number of workers and increased costs to do business. Job openings surged to record levels, especially in the leisure and hospitality sector. However, sidelined workers have been slow to return to the labor market, causing wages to increase as firms try to entice workers into filling open positions. Retail sales are far above pre-pandemic levels, but global supply chain problems slowed industrial production and supplier deliveries. As a result, retail inventories fell and consumers bid up prices of products in short supply.

Given these pressures, inflation, as measured by the change in the Consumer Price Index, spiked to over 5 percent on a year-over-year basis in the third quarter of 2021. With much of the increase in inflation originating from goods and services heavily affected by COVID-19 dislocations, the Blue Chip Consensus expects inflation to decline to 2.3 percent by the end of 2022 as supply chain and labor supply issues resolve. See figure 1. There is uncertainty in this forecast. If inflationary tailwinds affect consumer and business expectations, currently elevated inflation could become sustained. This could cause the Federal Reserve to increase short-term interest rates more quickly and aggressively than expected to bring inflation under control. Under this scenario, higher interest rates could slow economic growth.



## FIGURE 1: INFLATION FORECAST TO SLOW IN 2022

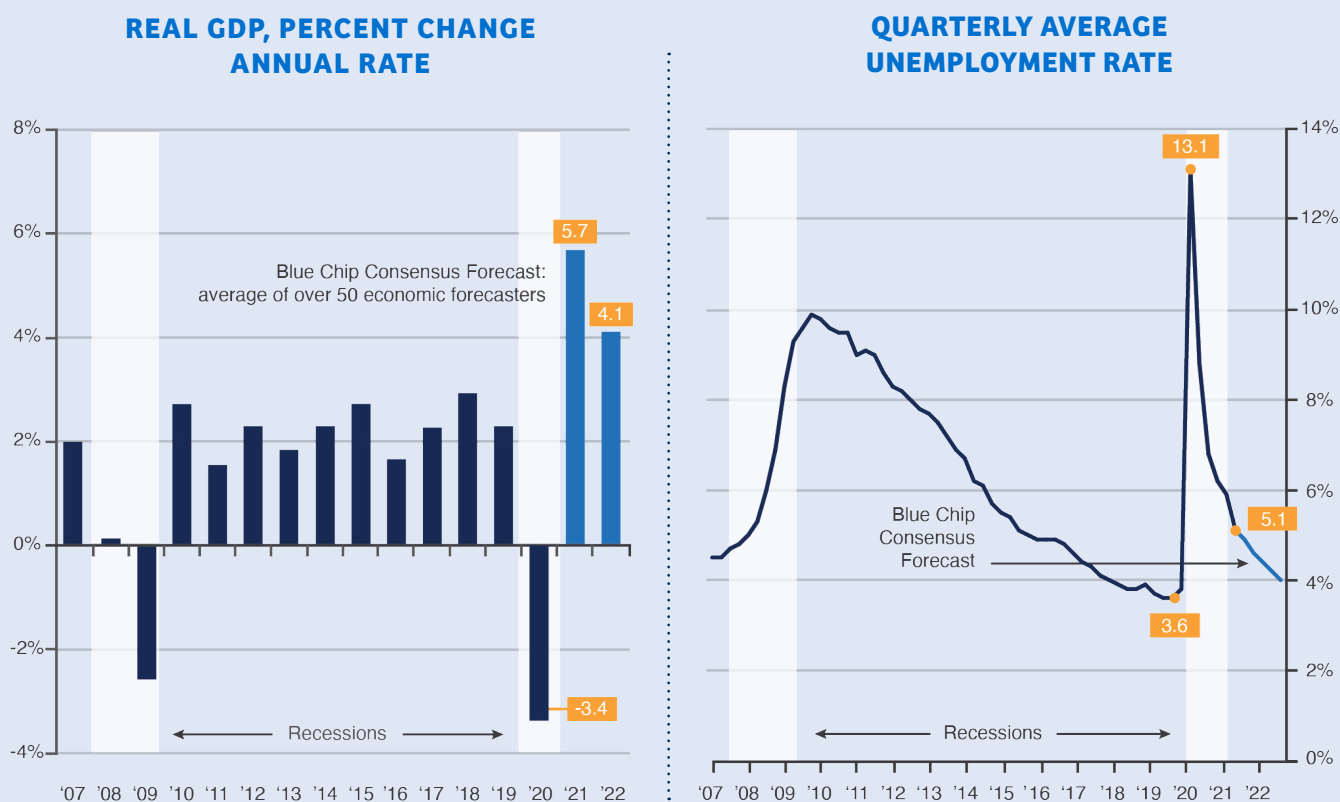
### QUARTERLY, YEAR-OVER-YEAR PERCENT CHANGE



Sources: Bureau of Economic Analysis (2Q:2021); Bureau of Labor Statistics (3Q:2021); Blue Chip Economic Indicators (October 2021)

Even with no early interest rate hikes to counter inflation, the Blue Chip Consensus forecast is that real GDP growth will moderate in the latter half of 2021 as the initial surge from reopening passes and the boost from fiscal stimulus wanes. The rapid spread of the delta variant infections is another headwind to growth, having caused consumer spending to slow. While the delta variant contributed to slower GDP growth in the second half of the year, the deceleration is not expected to derail the recovery. The Blue Chip Consensus forecast is for annualized real GDP growth to decelerate from its peak of 6.7 percent in the second quarter of 2021 to 5.3 percent in the fourth quarter of 2021, bringing the full-year forecast down to 5.7 percent. For the full year 2022, real GDP growth is expected to downshift further to 4.1 percent, a rate that is still double the pre-pandemic average. The quarterly average unemployment rate is expected to continue to improve next year, falling to 4.0 percent by the end of 2022. See figure 2.

**FIGURE 2: GDP AND UNEMPLOYMENT TRENDS**



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics (3Q:2021); Blue Chip Economic Indicators (October 2021)

## HIGH LEVEL OF BUSINESS DEBT REMAINS A RISK

Nonfinancial corporate debt, already at record levels in the fourth quarter of 2019, surged higher in the first half of 2020. The large increase in debt was driven by corporations drawing down revolving lines of credit to offset anticipated revenue and funding disruptions caused by the pandemic; by issuing of new bonds to lock in historically low interest rates; and by some smaller corporations accessing PPP funding. Although the surge in debt slowed in the second half of 2020 as corporations began repaying their credit lines and a high percentage of PPP loans were forgiven, the level of total corporate debt continued to rise in 2021.

Business debt is beneficial when it is used to finance capital investments and research and development, which enhance competitiveness and lead to future sales growth. However, high levels of business debt can also be a risk to the financial system. In recent years, low interest rates have driven low-investment-grade and non-investment-grade debt to account for a larger share of total nonfinancial corporate debt. Further, higher debt is a concern if it is used to finance investments with little or no return; diverts funds from productive investment by financing stock buybacks or higher dividend payments; or acts as a disincentive to corporate deleveraging. More generally, large amounts of debt, coupled with a greater share of debt held

by higher-risk borrowers, increase the risk of default in the event of unexpected earnings decline from an economic downturn or a sharp increase in interest rates.

While the 2020 recession caused historic disruption in the economy, fiscal and monetary support programs allowed for an unusually rapid and strong recovery. Much of this support translated into a large rebound in corporate profits. Quarterly nonfinancial corporate profits before taxation rose from \$1.4 trillion in the fourth quarter of 2019 to \$1.8 trillion in the second quarter of 2021, which improved corporate interest coverage ratios. Further, nonfinancial corporations are highly liquid, holding a record amount of cash on their balance sheets of \$2 trillion in the second quarter of 2021. While current strong earnings and cash buffers mitigate the risk posed by the record amount of debt, these mitigants could dissolve if firms increase transfers of cash to shareholders, debt service increases from higher-than-expected interest rates, earnings growth decelerates from slower economic growth, or earnings fall from another economic downturn.

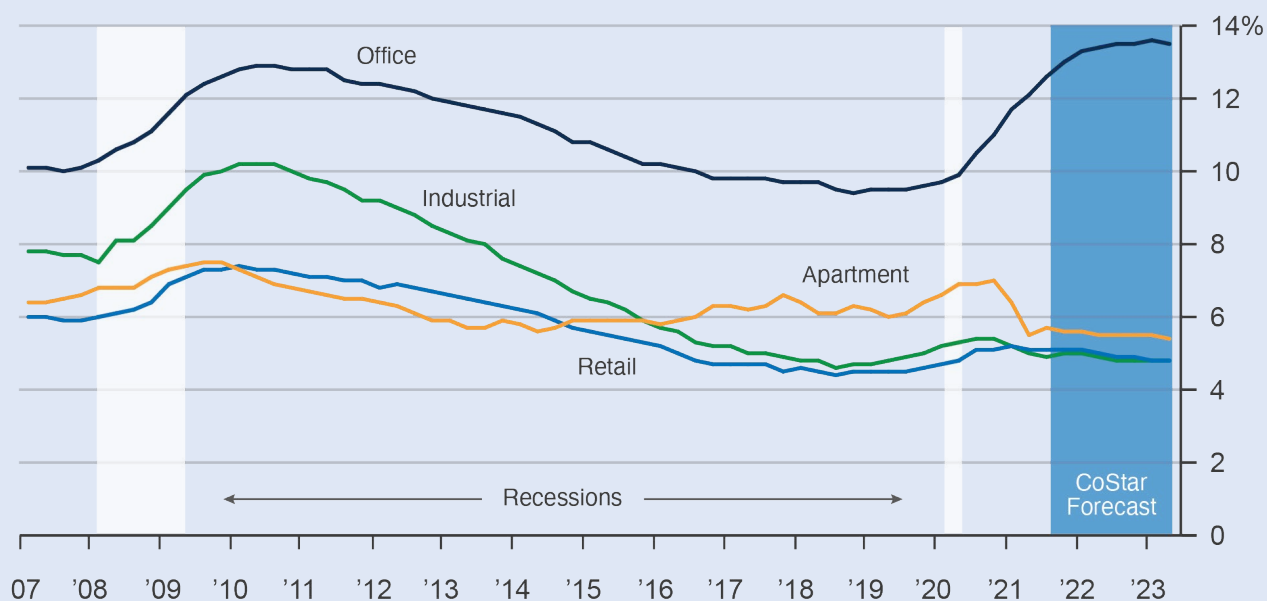
## COMMERCIAL REAL ESTATE STRESS TO CONTINUE IN SOME SEGMENTS

The impact of the pandemic reduced demand for nearly every type of commercial real estate (CRE) and caused vacancies to rise. See figure 3. While some CRE segments began to recover during the first half of 2021, others are still vulnerable or remain under stress. The office sector continued to deteriorate in the first half of 2021 as businesses reduced demand for space due to the shift to increased telework. The outlook for the office sector is highly uncertain and the sector is forecast to deteriorate through 2022. The retail sector saw an immediate negative impact at the start of the pandemic but began to stabilize this spring once vaccinations became widely available. Similarly, national hotel occupancy improved significantly since the beginning of the year. Despite these gains, retail establishments and hotels in many urban settings remain in a depressed state due to their reliance on office workers and business travelers, respectively. Demand for multifamily apartments held up well throughout the pandemic, but properties that provide low-income housing could see rising vacancies as federal stimulus payments run out.

The outlook for CRE overall remains uncertain and is dependent on how new COVID variants impact economic activity, as well as how the pandemic alters long-term economic behaviors. Multifamily and industrial asset valuations resumed strong growth in 2021, which could push already low capitalization rates even lower. This raises the risk of overly optimistic valuations as investors reach for yield. Properties most at risk of a sustained drop in income and asset values are offices, hotels in urban locations or that cater to business travelers, shopping malls, and strip malls.

**FIGURE 3: OFFICE SECTOR FORECAST TO HAVE CONTINUED STRESS IN 2022**

**COMMERCIAL REAL ESTATE VACANCY RATES**



Source: CoStar Portfolio Strategy (historical data through 2Q:2021, baseline forecast updated July 2021)

## RESIDENTIAL REAL ESTATE

Residential mortgage defaults and foreclosures may rise as COVID-related government relief programs end. Under the CARES Act, mortgages owned or insured by the federal government (about 75 percent of all mortgages) were protected from foreclosure, and homeowners could temporarily suspend mortgage payments. According to Black Knight, more than 8 million borrowers benefitted from a COVID-related forbearance program during the pandemic period that began in March 2020. As of September 2021, more than one million borrowers remain in forbearance. A large volume of these forbearance loans is scheduled to expire this fall at which point borrowers must resume payments. For borrowers who are experiencing hardship and are unable to refinance their loans at lower interest rates, federal agencies, banks, and private investors are offering COVID-related modifications. These modifications could result in a 25 percent reduction in monthly principal and interest payments to help struggling borrowers keep their homes. However, foreclosures are still predicted to rise for those borrowers who are unable to make payments, sell their property, or do not have sufficient home equity.

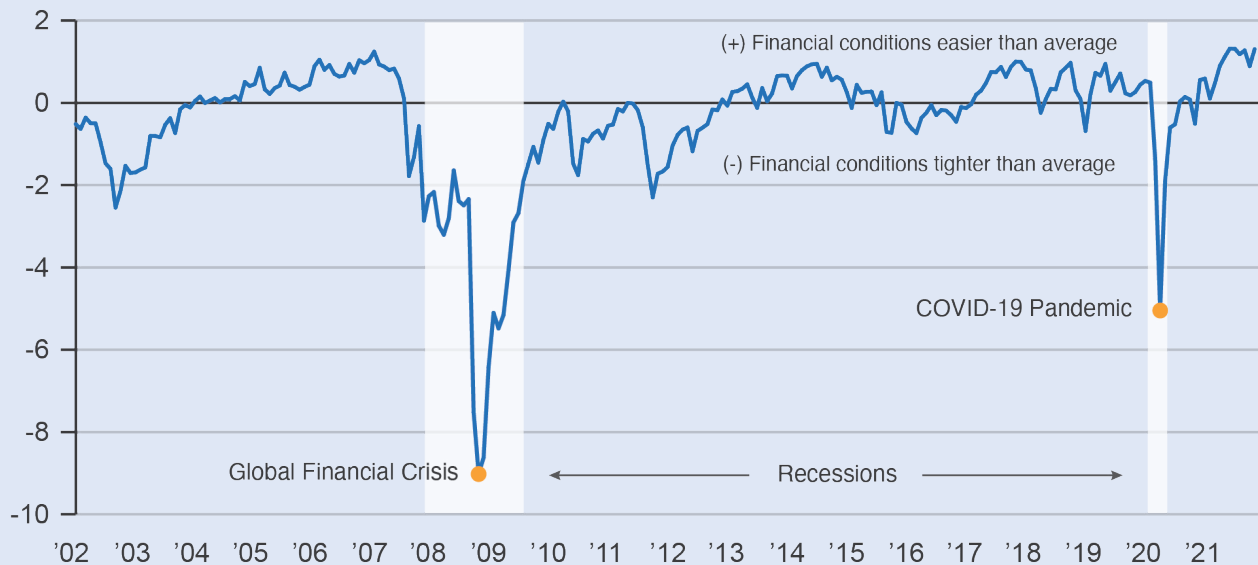
# FINANCIAL CONDITIONS REMAIN FAVORABLE

Financial conditions remained favorable in 2021 as fiscal and monetary stimulus continued to support financial markets. See figure 4. The Federal Reserve remained historically accommodative. The Federal Reserve doubled the amount of assets held on its balance sheet and short-term rates were set near zero over the past 18 months. Market participants expect a gradual reduction of asset purchases over the next few quarters and continuing low short-term interest rates next year. Strong economic growth and inflationary pressures are both expected to moderate in the coming quarters but remain above prior cycle peaks. As a result, rates on long-maturity Treasury notes and bonds decreased in early 2021. The yield curve flattened modestly in the first half of 2021 but has since widened in the latter half of 2021. See figure 5.

Continued strong demand for U.S. Treasuries and fixed-income assets supported favorable funding conditions in bond markets despite record issuance. An announcement of a reduction in its asset purchase programs in the next few months may pressure longer-duration yields higher. In wholesale markets, repo and U.S. dollar funding market liquidity remained near pre-pandemic levels, and the announcement of new standing facilities should ensure smooth market function.

**FIGURE 4: FINANCIAL CONDITIONS REMAIN FAVORABLE**

## U.S. FINANCIAL CONDITIONS INDEX



Source: Bloomberg (data through October 20, 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.

**FIGURE 5: U.S. TREASURY YIELD TERM SPREAD (10Y-3M), BASIS POINTS**



Source: Bloomberg (data through October 20, 2021)

Equity and corporate fixed income market prices moved higher on expectations for higher corporate revenues. Other measures of financial conditions further eased as other risk assets continued to reach all-time highs. Risk pricing remained at low levels as global central banks remained committed to continuing accommodative support, raising prospects for further fiscal stimulus. Survey-based inflation expectations and market-based measures diverged slightly since late spring as economic participants expected higher inflation in the near term. Equity market volatility, measured by the S&P 500 VIX Index, continues to remain in a tight range. Credit spreads tightened alongside the upward move in equity markets. Investment grade and high-yield corporate bonds continued to see record issuance as borrowing costs and investor demand remained favorable. Several risks may increase volatility in asset markets in the next few quarters, including a reduction of accommodative policy, pandemic-related developments, and inflation dynamics. As of October 2021, international equity indexes underperformed U.S. benchmarks over the past year.

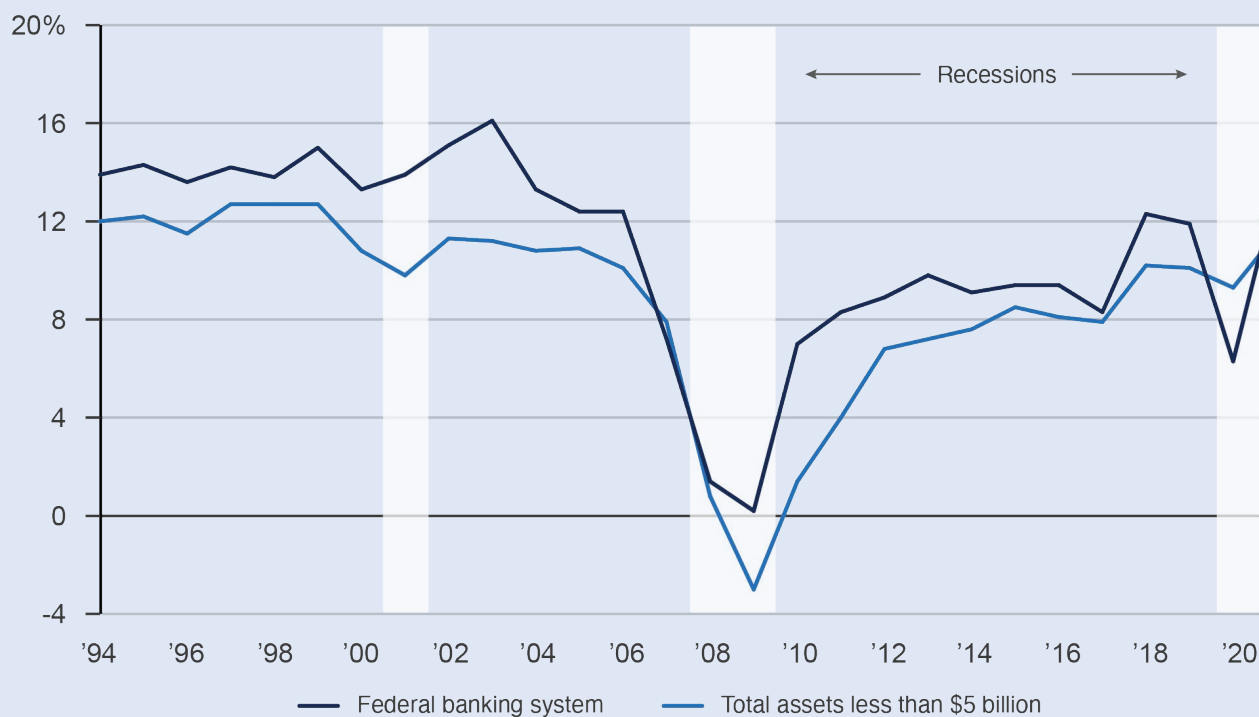
# BANK PERFORMANCE

## BANKS' RECENT STABILIZATION IS LIKELY TO CONTINUE, ALTHOUGH OUTLOOK IS FOR LOW INTEREST RATES TO PERSIST WHILE LOAN DEMAND REMAINS UNCERTAIN

The banking system weathered the crisis with resilience, and bank returns bounced back sharply in 2021. Asset quality, having averted material deterioration, is expected to remain stable due to the strong macroeconomic rebound and faster-than-anticipated improvement in unemployment. As the economic and credit outlook continues to improve, earnings will continue to rise in the second half of 2021, as banks released reserves in response to unrealized losses and an improved credit outlook. Unique circumstances shaped by the pandemic have also created opportunities for banks to generate revenue by recognizing fees associated with participation in the PPP and boosting noninterest income through net gains from sales of loans, although both of these revenue streams will be temporary. Loan demand, however, continues to trail the macroeconomic recovery as decreased loan demand during the pandemic increased cash on hand for firms, the vaccine rollout has been uneven across the United States, and the emergence of the delta variant created uncertainty about the strength of the recovery.

As shown in figure 6, return on equity as of June 2021 on an annualized basis is up significantly from the depth of the pandemic. It is also above its pre-COVID level for both the federal banking system, which is driven by the largest banks, and for banks with assets less than \$5 billion. Current trends will likely continue to provide resilience for the remainder of 2021, but since some of the bounce-back is due to temporary factors, the outlook remains reliant on managing NIM pressures and a return of loan demand.

**FIGURE 6: TREND IN BANK RETURN ON EQUITY**



Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2020 and annualized for the first half of 2021. Banks with less than \$5 billion in total assets exclude credit card and trust institutions.

As credit quality stabilized throughout 2020, reserve releases that began in the first quarter of 2021 have resulted in a substantive increase in net income (refer to table 1). Provisions in the first half of the year were negative \$23.5 billion for the federal banking system, driven by the largest banks that transitioned to the current expected credit loss (CECL) accounting standard in the first quarter of 2020 and strong credit performance due to stabilization measures. Provisions were only \$100 million at banks with less than \$5 billion in assets. The large reserve releases more than offset a decline of 7.8 percent in net interest income for the system.

Community banks saw a much different path driven mostly by PPP loans that generate fees once loans are forgiven, contributing to a 6.6 percent gain in net interest income. Noninterest income also provided support to revenues for both the system and community banks, driven in large part by loan servicing fees, gains from loan sales, and other noninterest income.

Although reserve releases will likely continue over the next few quarters, this will only provide temporary improvement to profitability. Fee income from PPP lending will also wane as PPP loans are forgiven or repaid. Sustained profitability will require banks to continue to manage expenses and maintain prudent loan growth in other segments of their loan portfolios.



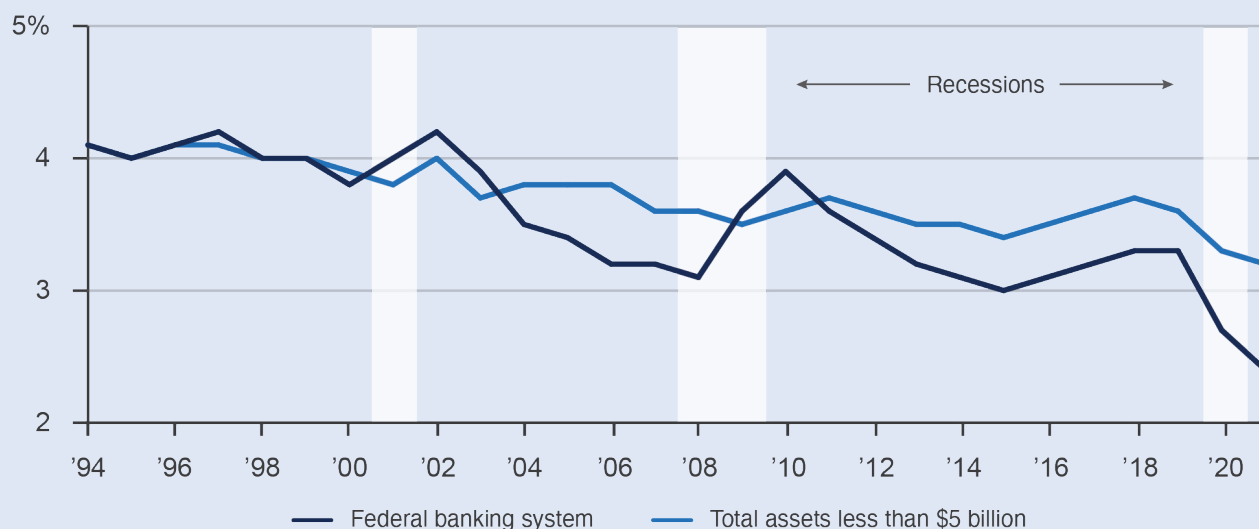
**TABLE 1: TRENDS IN BANK NET INCOME**

	Federal banking system			Banks with total assets of less than \$5 billion		
	06/30/2020	06/30/2021	YoY % change	06/30/2020	06/30/2021	YoY % change
<b>Year-to-date revenues in billions of dollars</b>						
<b>Net interest income</b>	173.3	159.8	-7.85%	7.7	8.2	6.6%
<b>Noninterest income</b>	99.0	108.1	9.20%	3.4	4.3	28.0%
<b>Year-to-date expenses in billions of dollars</b>						
<b>Provisioning</b>	88.9	-23.5	-126.5%	0.9	0.1	-88.3%
<b>Noninterest expense</b>	166.1	167.7	1.0%	7.3	8.2	11.4%
<b>Net income</b>	<b>18.6</b>	<b>97.5</b>	<b>424.5%</b>	<b>2.4</b>	<b>3.5</b>	<b>44.6%</b>

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 second quarter of 2021. Banks with less than \$5 billion in total assets exclude credit card and trust institutions.

Although credit conditions improved significantly from the uncertainty at the onset of the [pandemic](#) low interest rates will continue to weigh on profitability. NIMs continue to face pressure from both historically low interest rates and the excess liquidity that has accumulated on bank balance sheets (refer to figure 7). NIM, which continued to drift downward for banks of all sizes over the past year, is a significant driver of most banks' revenues and profits. For community banks, NIM declined by 9 basis points, to an all-time low of 3.2 percent. The drop in NIM for the federal banking system was more pronounced, driven by the largest banks, declining by 32 basis points, and setting a new all-time low of 2.4 percent. The drop for the system was exacerbated by a decline in both loans and loan yields as a result of the significant influx of lower-yielding assets as the Federal Reserve continued quantitative easing by providing ample liquidity to banks.

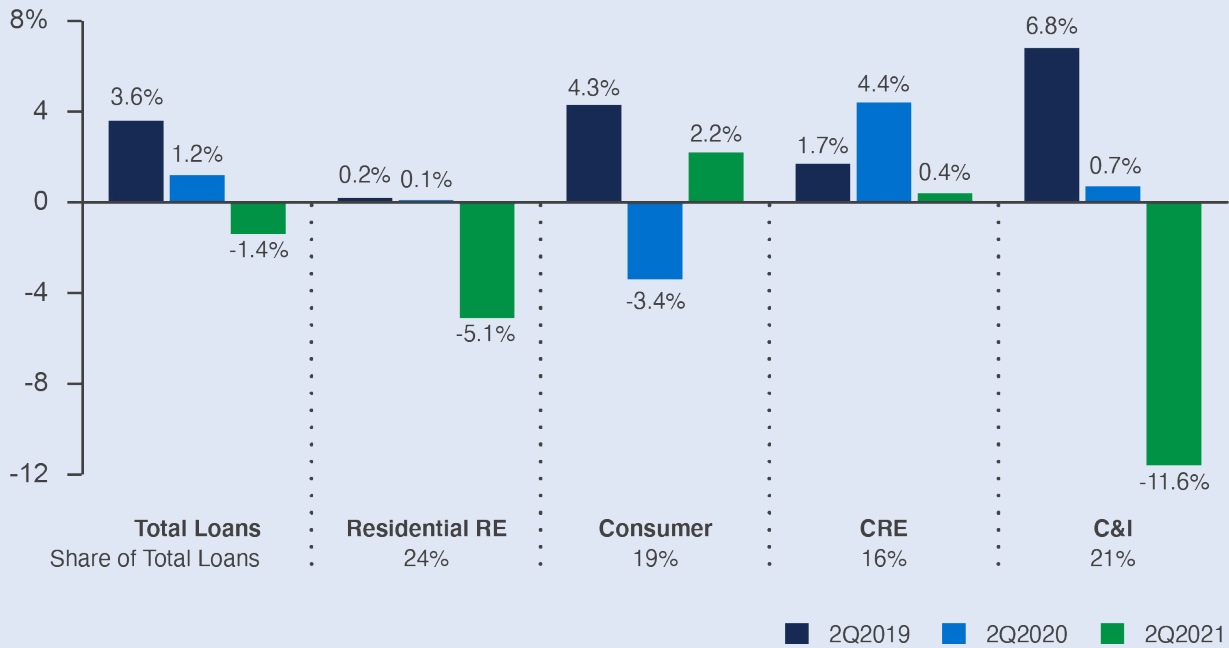
**FIGURE 7: TREND IN NET INTEREST MARGINS**

Source: Integrated Banking Information System (OCC)

Note: Annual data through year-end 2020 and annualized for the first half of 2021. Banks with less than \$5 billion in total assets exclude credit card and trust institutions.

PPP lending was a tailwind for loan growth in 2020. However, with the program ending in May 2021 increased traditional loan demand will become more important for net interest income, especially since interest rates are expected to remain historically low in the near term. Figure 8 shows that, excluding PPP loans, in the second quarter of 2021 total loan balances declined 1.4 percent from year-ago levels. Residential real estate and commercial and industrial (C&I) loans, which combined make up 45 percent of total loans, declined by 5.1 percent and 11.6 percent, respectively. Driven by a strong rebound in consumer spending in the first half of the year, consumer loans increased 2.2 percent. For smaller banks, loan growth slowed to 3.3 percent, weighed down by a decline in residential real estate loans on balance sheet, which make up almost 30 percent of their loan portfolios. With the benefits of the PPP loan program beginning to dissipate, performance in the second half of 2021 will depend heavily on growth in other segments of banks' loan portfolios.

**FIGURE 8: YEAR-OVER-YEAR CHANGE IN LOAN BALANCES, EXCLUDING PPP LOANS**



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 second quarter of 2021. Banks with less than \$5 billion in total assets exclude credit card and trust institutions. RE is real estate and CRE is commercial real estate. CRE includes commercial mortgages and construction loans. Total and C&I loans exclude PPP loan balances from all time periods.

## SPECIAL TOPICS

## OCC COMMUNITY BANKS

More than 80 percent of OCC supervised-institutions are national banks and federal savings associations with less than \$15 billion in total assets (collectively, community banks). The OCC's community bank portfolio consists of various types of charters and special designations, including stock and mutual savings associations (commonly referred to as thrifts), insured and uninsured trust banks, trust savings associations, and minority depository institutions. These community banks serve as the foundation of many cities and small towns across the United States and remain diverse in composition, size, geography, and services.

Community banks serve an integral and vital role in the U.S. economy and have persevered during the pandemic. Most community banks entered 2020 with high capital levels, strong liquidity, stable profitability, and low past due loan levels. Community banks were active PPP lending participants (see table 2).

**TABLE 2: COMMUNITY AND MIDSIZE BANKS PPP LOANS**

Business unit	PPP loans, \$ millions					YoY % change	PPP to tier 1 capital & ALLL	PPP as % of gross loans
	Q2:2020	Q3:2020	Q4:2020	Q1:2021	Q2:2021			
CBS	40.9	41.9	31.2	36.5	25.7	- 37.20%	28.13%	4.94%
MBS	35.7	35.8	29.3	32.8	19.7	- 44.85%	21.78%	3.37%
<b>Total</b>	<b>76.6</b>	<b>77.7</b>	<b>60.5</b>	<b>69.2</b>	<b>45.4</b>	<b>- 40.77%</b>	<b>24.97%</b>	<b>4.11%</b>

Source: OCC Information Systems

Note: CBS = community bank; MBS = midsize banks

Community banks effectively weathered the economic turmoil and uncertainty created by government restrictions on activity, employee work at home, and income pressures resulting from the pandemic. Throughout this period, community banks served their communities by working with affected customers and supporting small businesses.

Community banks have used prudent balance sheet management during the low rate cycle and implemented strategies to increase fee income and reduce operating expenses. Furthermore, some banks have assumed increased credit and interest rate risk consistent with their operating strategies. We encourage community banks to ensure financial resilience, without compromising sound business models and strategic plans, to avoid excessive risk taking, and to maintain adequate controls when managing investment and lending programs and third-party relationships.

The effects of the delta variant created ambiguity on the strength of the financial recovery and may impact risks within community banks. The expiration of federal stimulus programs, eviction moratoriums, and other support programs presents a near-term challenge to community banks. Community banks face strategic risk challenges as some struggle to generate loans and deposits, sustain or expand technological capabilities, and recruit and retain strong talent. Effective strategic planning is important as community banks consider new products, services, and partnerships to remain relevant. Community banks must consider if they have the right talent and expertise in management and on the board of directors. Management and board succession are also a challenge. To adapt to all these challenges, community banks may need to expand their hiring pool to include talent from nonbank industries, broaden hiring flexibilities (including remote work or alternative schedules), and maintain and invest in technology capability. As a result of these challenges, merger and acquisition activity tends to be relatively higher among community banks.

Retail credit risk has stabilized. Steady trends are noted in declining unemployment levels, delinquencies, and forbearance requests. The volume of forbearance relief requests and approvals is low and has been declining since mid-2020. Operational, reputational, compliance, and credit risks may increase as banks handle increased activity in loss mitigation and default servicing, particularly after the relief programs expire. The OCC encourages bankers to remain proactive and diligent when assessing consumer impact and working with customers.

Community banks tend to rely more heavily on third parties for operations and product delivery. Operational changes, remote procedures, and new risks associated with the pandemic have changed the audit landscape. Community banks should ensure risk managers understand the impact of known and potential operational changes due to COVID-19. This may include revisiting initial risk assessments and modifying planned procedures to ensure pandemic-related risks and associated controls are evaluated.

# TRENDS IN KEY RISKS

## A. OPERATIONAL RISK IS ELEVATED AS BANKS RESPOND TO AN EVOLVING AND INCREASINGLY COMPLEX OPERATING ENVIRONMENT

### CYBERSECURITY

Operational risk remains elevated as cyber attacks evolve, become more sophisticated, and cause damage to a variety of industries. The OCC has observed an increase in ransomware attacks in financial services. These attacks typically leverage phishing emails targeting employees and compromised credentials to gain access to networks through remote access channels. Once access is gained, the attackers conduct ransomware and other extortion campaigns.

Cyber actors continue to exploit publicly known and unaddressed software vulnerabilities against public and private sector organizations worldwide. Expansion of remote financial services via personally owned computers and mobile devices, remote work options, such as virtual private networks, and reliance on third-party providers to include cloud-based environments, increase the importance of effective cyber controls. To mitigate against cyber risks, banks should adopt robust threat and vulnerability monitoring processes and implement stringent and adaptive security measures such as multi-factor authentication or equivalent controls to authenticate access to sensitive systems. Network systems should be properly configured and have effective patch management processes in place. Banks should also ensure that critical systems and records are backed up and stored in immutable formats that are isolated from ransomware or other destructive malware attacks.

Supply chain risk continues to increase and evolve as attacks target vulnerabilities in software systems commonly used by large numbers of OCC supervised banks. Threat actors are increasingly exploiting vulnerabilities in third-party hardware and software systems to conduct malicious cyber activities. These attacks demonstrate the importance of banks assessing the risks from their third parties, inclusive of the supply chain, and developing a comprehensive approach to operational resilience.

Providing additional perspective on these risks, the Federal Financial Institutions Examination Council (FFIEC) published the “[Architecture, Infrastructure, and Operations](#)” booklet of the *FFIEC Information Technology Examination Handbook* (IT Handbook) on June 30, 2021. This booklet is one in a series of booklets that compose the IT Handbook. The booklet discusses the interconnectedness among an entity’s assets, processes, and third-party service providers. The booklet also discusses principles and practices for promoting safety and soundness, including secure and resilient architecture design, infrastructure implementation, and operation of information technology systems.

Additionally, on August 11, 2021, the FFIEC on behalf of its members issued “[Authentication and Access to Financial Institution Services and Systems](#),” which replaces authentication guidance issued in 2005 and 2011. This guidance reflects the change in the threat environment and addresses risk management principles and practices that can support authentication of customers and a wider range of users, including employees, board members, third parties, service accounts, applications, and devices. For this population of customers and users that access digital banking services and information systems, it provides financial institutions with examples of effective risk management principles and practices for authentication and access, which are critical to combating cyber risks, including ransomware.

## INNOVATION AND ADOPTION OF NEW PRODUCTS AND SERVICES

Innovation and technological advances continue to spur the development of new products, services, and delivery channels designed to meet changing customer needs, preferences, and service expectations. Adoption of these new products and services contribute to an increasingly complex operating environment.

Examples of areas of continuing innovation 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. Distributed ledger technology and digital assets, including stablecoins and other crypto-assets, may broaden delivery channels and the functionality of financial services. The OCC is approaching crypto-related activities in the federal banking system very carefully with a high degree of caution and expects its supervised institutions to do the same. OCC-supervised institutions should reach out to the appropriate OCC supervisory office before engaging in crypto-related activity.

The adoption of innovative technologies to facilitate financial services can offer many benefits to both banks and their customers. However, innovation may present risks. As such, risk management inclusive of due diligence and change management is important for fulfilling responsible innovation strategies and successfully adopting technology. Risk management and control environments should keep pace with innovation and emerging trends and a comprehensive understanding of risk should be achieved to preserve effective controls. Examiners will continue to assess how banks are managing risks related to changes in operating environments driven by innovative products, services, and delivery channels.

Innovation may increase the importance of adopting enhanced controls, or adjusting control designs, in order to maintain comprehensive operational resilience frameworks commensurate with the size and complexity of products, services, and operations being supported. In addition, strategic planning and risk management processes sufficiently address the benefits and risks of engaging in third-party relationships, inclusive of financial technology (fintech) firms.

## THIRD-PARTY RISK MANAGEMENT AND OTHER OPERATIONAL RISKS

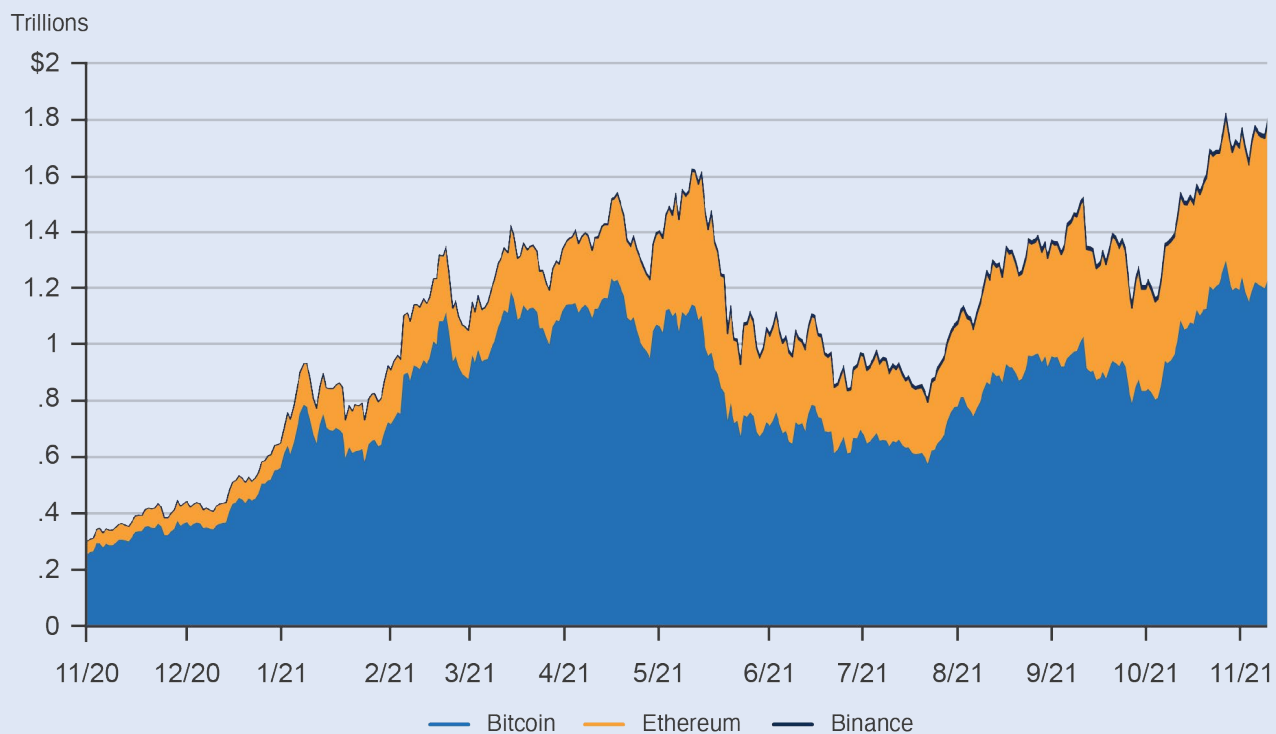
Third-party risk management continues to be an area of supervisory focus. Banks may lack the expertise or technology needed to offer products and services and may therefore rely on third parties to perform or assist in the performance of these functions. Banks should conduct risk-based due diligence commensurate with the criticality of the activity provided by the third party. This is especially true when introducing new products, services, or delivery channels or when entering into partnerships where the third party provides a critical function. Similarly, third parties are subject to the same cyber and other risks that banks experience. Banks should have a sound understanding of how third parties manage these risks. On July 19, 2021, the OCC, with the Federal Reserve and FDIC, requested comment on [proposed interagency guidance on third-party relationship risk management](#). The comment period for this proposed guidance closed on October 18, 2021. If finalized, this guidance would update OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance.”

## DIGITAL ASSETS IN THE BANKING SECTOR

The financial and public sector is displaying increasing interest in opportunities related to digital assets as the total market capitalization of cryptocurrencies and other digital assets significantly increased since September 2020 over the past twelve months (see figure 9). Growing interest in cryptocurrencies has led some banks to explore the development of crypto-custody services, crypto-asset derivative products, or the provision of access to third-party crypto-related products.

While crypto-asset based products and services can create opportunities for banks and their customers, they can also carry significant risks. Banks should conduct due diligence and risk management as with other new, modified, and expanded services. Refer to OCC Bulletin 2017 23, “[New, Modified, or Expanded Bank Products and Services: Risk Management Principles](#).” This includes ensuring sufficient knowledge and expertise in the underlying products and services and processes to identify and address strategic, operational, compliance, and reputational risks. Sound risk management of crypto-related product offerings includes alignment with a bank’s strategic goals, risk appetite, resources, and expertise.

**FIGURE 9: GROWTH IN CRYPTO-ASSETS**



Source: Coin Metrics

Note: The top three crypto-assets total 98 percent of all crypto-assets.

The OCC engaged with the Federal Reserve and FDIC (the agencies) in a Digital Assets Policy Initiative. The initiative encompassed a series of staff-level “policy sprints” focused on developing a commonly understood vocabulary for using consistent terms regarding the use of crypto-assets by banking organizations; identifying and assessing key risks and considering legal permissibility related to potential crypto-asset activities conducted by banking organizations; and identifying areas that may benefit from additional clarification. Based on this preliminary and foundational level staff work, the agencies recently announced that throughout 2022 they plan to provide greater clarity on whether certain activities related to crypto-assets conducted by banks are legally permissible and to provide expectations for safety and soundness, consumer protection, and compliance with existing laws and regulations. The agencies’ work will focus on crypto-asset custody services, facilitation of customer purchases and sales of crypto-assets, loans collateralized by crypto-assets, issuance and distribution of stablecoins, and activities involving the holding of crypto-assets on balance sheet

[The President’s Working Group on Financial Markets released a report](#) discussing stablecoins and Decentralized Finance. The report identified key gaps in prudential authority over stablecoins used for payments purposes. The report contains recommendations regarding proposed legislation that Congress should enact to address risks related to stablecoins.



## OTHER OPERATIONAL RISKS

The banking industry experienced a great deal of change over the last two years in response to the pandemic. In many instances, bank-wide change management processes were truncated in order to quickly respond to customer and organizational changes and needs, including the adoption of new technology. Banks quickly responded to implement government assistance programs, such as the CARES Act's PPP and federal, state, and bank-initiated forbearance and deferred payment programs, without the more deliberate due diligence process typically undertaken in a less stressed environment.

The expiration of these forbearance and deferred payment programs may expose the industry to stresses on foreclosure and loss mitigation programs. Banks should ensure appropriate process controls are in place for customer protections and also to monitor for potential fraud. Operational risk is often a lagging indicator, and some of the risk exposure may manifest in the coming quarters.

### B. CREDIT RISK IS MODERATE THOUGH SOME AREAS WARRANT ATTENTION

## COMMERCIAL

As the economy rebounded, criticized assets for commercial and industrial loans in OCC-supervised banks declined slightly and now represent a manageable level of exposure relative to capital. Commercial real estate criticized assets started showing signs of stabilization for most property types, while call report data suggest little regional stress in most commercial real estate portfolios. However, the delta variant has affected the economic outlook, and several topics warrant attention.

Commercial real estate remains an area of particular concern since it is a significant concentration of credit for many OCC midsize and community banks. Changing consumer and business preferences related to shopping, travel, and returning to the office may lead to medium- and long-term income and valuation challenges in certain commercial real estate sectors. Stress in the retail sector, particularly in retail strip malls, remains noteworthy and will warrant continued attention. The hospitality sector continues to face challenges, particularly for businesses dependent on business travel. The office sector warrants attention in the medium term because leasing activity for office space remains subdued and sublease availability continues to rise in many markets. Additionally, it remains important for lenders to remain attentive to the effects of eviction moratoriums on the multifamily sector.

High corporate leverage is a potential concern. Outstanding nonfinancial corporate debt continues to increase as a percentage of U.S. GDP, and lender protections in corporate credit agreements have weakened. These trends preceded the pandemic. Longer-term, however, these high debt burdens may increase fragility in the corporate sector. While corporate debt markets are operating well, and policy

support measures have kept debt service costs low, the use of corporate debt for dividend and stock buybacks could pose future risks by further increasing leverage. Therefore, it is important for bank management to remain attentive to risks posed by growing exposure to corporate bond and loan markets, including indirect exposure. It is also important to identify vulnerable borrowers, industries, or other portfolio segments and risks to asset quality in these portfolios if interest rates rise or corporate debt markets experience increased volatility or deterioration.

Pandemic-related supply chain disruptions are a potential concern and have the possibility to limit borrower revenue and cash flow, while inflationary pressures could cause interest rates and labor costs to rise. To date, examiners have not reported material risk-rating changes associated with supply chain or inflation risks.

Reference rate transition risk warrants attention. The OCC continues to encourage banks to cease entering into new contracts that use the London Interbank Offered Rate (LIBOR) as a reference rate as soon as practicable, but no later than December 31, 2021. The renewal of commercial loans to a different index could pose operational risk. Additional comments on LIBOR transition are discussed in section D of this report, “Earnings Risk and LIBOR Transition.”

Adoption of the CECL accounting standard presents credit, operational, strategic, and reputation risks warranting attention. The 2023 implementation time frame for community banks provides time for preparation, methodology selections, and process development. While inherent risk is currently low for community banks that have not yet implemented the standard, this will change as 2023 approaches and adoption returns to the forefront of supervisory activities in banks where implementation is under way.

## RETAIL

Despite the elevated level of unemployment throughout 2021, retail delinquency and losses remained stable and did not significantly increase as expected at the outset of the pandemic. Reasons for these suppressed delinquency and loss rates include significant federal, state, and local stimulus, widespread mandated and voluntary forbearance programs across all products, more resilient underwriting since the last recession, and strong residential real estate and automobile values. Retail losses are not projected to return to pre-pandemic levels until the latter half of 2022 or 2023. As economic conditions improve, most banks have begun to reenter credit markets or ease credit standards that were tightened during the pandemic. As banks reengage, management needs to remain vigilant and maintain its focus on sound credit risk management practices, impacts of borrower assistance programs provided through the pandemic, potential bureau score inflation, and potentially inflated collateral values (including residential real estate, automobile, recreational vehicles, and marine craft) while avoiding complacency in lending activities.

As the economy emerges and recovers from the COVID-19 pandemic, a higher volume of mortgage loans benefiting from COVID-19 forbearance began expiring in June 2021 and will continue into early 2022. The level of mortgage customers remaining on forbearance significantly decreased from the 9 percent peak reported in May 2020, but the 2.3 percent of mortgage borrowers still receiving forbearance as of October 2021 are likely the most financially stressed and may have fewer options available. Although data indicate

that forbearance customers generally have a significant level of home equity, which will likely mitigate loss in the event of foreclosure absent a sale of the property, these elevated levels of forbearance pose increased operational, compliance, and reputation risks that will require diligent oversight. This includes the identification and management of borrowers approaching the end of their forbearance and operational preparedness to properly manage the elevated level of requests for modification and the reengagement of foreclosure activity.

## **C. COMPLIANCE RISK IS HEIGHTENED, DRIVEN BY REGULATORY CHANGES AND POLICY INITIATIVES THAT CONTINUE TO CHALLENGE BANK RISK MANAGEMENT**

Compliance risk is heightened as banks adjust to regulatory changes and initiate efforts to serve customers in the final stages of assistance programs and initiatives related to the COVID-19 pandemic. Like their initial implementation, the conclusion of these programs creates increased compliance responsibilities, high transaction volumes, and new fraud types at a time when banks continue to respond to a changing operating environment. Banks should continue to monitor and manage changes and associated risks; to ensure that new processes incorporated into their compliance risk management programs are effective and address changes in laws and regulations; to manage operational challenges; and to ensure compliance obligations are fulfilled while functioning with staff working remotely. Banks are encouraged to review interagency, OCC, Financial Crimes Enforcement Network (FinCEN), and Consumer Financial Protection Bureau (CFPB) issuances and guidance.

Banks continue to face challenges to implementing proactive compliance risk management programs and will need to remain agile to quickly adapt. Specific areas of challenge continue to include responsibilities associated with underwriting and opening new accounts, monitoring customer activity, processing transactions, making loan modifications, servicing loans, communicating with customers, complying with consumer protection laws, and treating customers fairly. Additional challenges also include meeting Bank Secrecy Act (BSA) and Office of Foreign Assets Control (OFAC) compliance obligations, as well as adapting to regulatory and policy actions by the CFPB.

### **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 the criminals' behalf through funds transfers, physical movement of cash, multiple personal accounts used supposedly 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 methods that have emerged or evolved during the COVID-19 pandemic. Examples

of fraud 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), impostor scams, and elder abuse also increased during the pandemic. Criminals and terrorists may exploit the public’s goodwill by establishing 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, including CARES Act and unemployment insurance payments. Some states have been severely affected by fraudulent unemployment claims using fake or stolen personal and financial information.

Banks can monitor information provided by law enforcement agencies and international anti-money laundering (AML) standard-setting organizations regarding how criminals adapt scams and money laundering techniques to exploit vulnerabilities created by the pandemic. The [FinCEN](#) website includes a COVID-19 update section that describes common red flags and provides guidance on COVID-19-related fraud schemes.

Timely communication from banks to examiners should focus on potential BSA/AML 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 in-office work. The OCC will consider the impact of COVID-19-related measures on BSA compliance in determining any new supervisory response, if needed.

Consistent with the requirements of section 6101(b)(2)(C) of the AML Act of 2020, FinCEN issued the “[Anti-Money Laundering and Countering the Financing of Terrorism National Priorities](#)” (National Priorities) on June 30, 2021. The federal banking agencies, FinCEN, and state bank and credit union regulators issued an [Interagency Statement on the Issuance of the National Priorities](#) that clarified that the issuance of the National Priorities does not result in an immediate change in BSA/AML regulatory requirements; that banks are not required to incorporate the National Priorities into their risk-based BSA compliance programs until the effective date of a final rule by FinCEN addressing the National Priorities; and that the agencies will not examine for the incorporation of the National Priorities until the effective date of final revised regulations.

## 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 and services. Support programs for these products and services include assistance programs, loan modifications and forbearance accommodations, handling of customer complaints, and communications with customers on pandemic-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 continue to affect the actions banks must take to comply with CARES Act provisions and other regulatory requirements. Bank post-implementation

monitoring and testing are critical to determine that products are being delivered, and processes or systems are working, as intended. In the continuing COVID-19 pandemic environment, a bank may determine that it should update its compliance testing or audit plan to account for waves of new requirements and processes and allow for earlier detection and correction of issues. In addition, banks' strategies for processing consumer requests and applications may vary with implementation, increasing the importance of monitoring for potential disparate treatment and disparate impact on a prohibited basis.

Monitoring complaints is an important component of an effective compliance risk management program, especially as the pandemic continues to spur multiple changes to bank processes and requirements that may directly or indirectly affect customers. Customer feedback and complaints can serve as an early warning indicator of a potential problem.

## COMMUNITY REINVESTMENT ACT / FAIR LENDING

In September 2021, the OCC issued a proposal to rescind and replace the regulation implementing the Community Reinvestment Act (CRA) rule published on June 5, 2020 (June 2020 rule). Until a new rule is finalized, banks should refer to OCC Bulletin 2020-99, "Community Reinvestment Act: Key Provisions of the June 2020 CRA Rule and Frequently Asked Questions," regarding implementation of the June 2020 rule. Banks also should implement effective change management and compliance risk management processes and stay informed of emerging risks that may be associated with potential changes in the CRA rule. In addition, numerous government agencies, including the OCC, are scrutinizing issues of appraisal bias and implications for all types of property valuations, including automated valuation models. This government-wide effort has the potential for significant future fair lending-related action.

### D. EARNINGS RISK AND LIBOR TRANSITION

## EARNINGS PRESSURE IN THE CURRENT LOW INTEREST RATE ENVIRONMENT

Strategic actions taken by banks to offset earnings impacts from NIM compression continue to be a risk. Banks continued to extend investment portfolio duration in search of yield through the second quarter of 2021. Additionally, credit risk exposure in community bank investment portfolios increased as these institutions expanded their security holdings. Banks continue to improve efficiency by cutting costs, as evidenced by the downward trend in noninterest expenses as a percentage of average assets carried through the second quarter of 2021. Upward pressure on interest rates and U.S. Treasury yields as a result of expectations for future inflation and Federal Reserve bond purchase tapering also poses increasing risks to banks.

NIM compression continued into 2021 as banks struggled to find higher yields. Liquid assets continued to increase as deposit balances grew and loans declined as a percentage of assets. Recent Federal Reserve reverse repurchase (repo) agreement operations illustrate extreme liquidity levels in institutions with few options for yield. As of October 2021, participants were placing approximately \$1.5 trillion at the Federal Reserve’s overnight reverse repo facility and receiving low interest rates. The Federal Reserve’s mid-June 2021 decision to increase interest on excess reserves resulted in the rate paid on the Federal Reserve’s overnight reverse repos increasing to 0.05 percent and usage of the facility increasing to over \$1 trillion by late July 2021.

Return on assets (ROA) declined in large and community banks in the second quarter, ending a four-quarter upward trend. Further NIM compression and asset growth reduced large bank ROAs despite continued negative provision expenses. Lower noninterest income and loan growth pushed down ROAs in community banks. Noninterest income continues to be critical in community banks, where net interest income is closely tracking noninterest expenses. Midsize bank ROAs continued to improve in the second quarter due to negative provision expenses, lower noninterest expenses, and a slight decline in assets. Longer-term U.S. Treasury yields started to rise in the first quarter of 2021, helping to reverse the declining loan yield trend in midsize and community banks and to slow the declining trend in large banks. The benefit, which occurred in part due to expectations for higher inflation and for an eventual increase in short-term rates as vaccinations and government stimulus support economic recovery, was short-lived as yields fell in the second and third quarters, and the yield curve has remained modestly upward sloped. (See table 3)

**TABLE 3: CHANGE IN U.S. TREASURY RATES (%)**

U.S. Treasury	12/31/2019	12/31/2020	3/31/2021	6/30/2021	8/5/2021
30Y	2.39	1.65	2.41	2.06	1.86
10Y	1.92	0.93	1.74	1.45	1.23
5Y	1.69	0.36	0.92	0.87	0.72
2Y	1.58	0.13	0.16	0.25	0.21
<b>10Y-2Y</b>	<b>0.34</b>	<b>0.80</b>	<b>1.58</b>	<b>1.20</b>	<b>1.02</b>

Source: Bloomberg

Potential interest rate and U.S. Treasury yield increases resulting from inflation concerns, Federal Reserve tapering, and future rate expectations may pose increasing risks to banks’ investment portfolio gains, noninterest income sources, and deposit stability. The industry saw unrealized investment portfolio gains decline 60 percent as a result of the long-term U.S. Treasury yield increase in March 2021. Yields subsequently declined in the second quarter and portfolio gains partially recovered, but first-quarter results highlight the risk that rising yields pose challenges to banks that supported earnings by accepting additional duration. Increasing yields, combined with other factors such as home affordability, may also negatively impact institutions that are overly reliant on noninterest income generated from loan and lease sales.

Gains on loan and lease sales grew 136 percent in community banks in 2020 and represented 23 percent of noninterest income, up from 12 percent as of year-end 2019. Rising rates could impact deposit stability due to the considerable deposit surge during the pandemic resulting from government stimulus measures and limited opportunities for investment without taking on duration.

## LIBOR TRANSITION

Banks should cease entering into new contracts that use LIBOR no later than December 31, 2021, except in limited circumstances, as described in [OCC Bulletin 2020-104, “Joint Statement on U.S. Dollar Libor Transition.”](#) Banks should be making significant progress toward reference rate transition as we enter the last 18 months preceding full LIBOR cessation. New contracts that mature after year-end 2021 should either reference an alternative rate to LIBOR or contain robust fallback language. Banks should also identify contracts that extend beyond June 30, 2023 and implement a plan to identify and address insufficient fallback language in those contracts.

LIBOR extension and recent legislative developments have reduced but not mitigated risk associated with LIBOR cessation. The U.K. Financial Conduct Authority confirmed in March 2021 the extension of overnight and 1-, 3-, 6-, and 12-month LIBOR to June 30, 2023. The extension should allow for material amounts of LIBOR-referenced contracts to mature and provide banks more time to work through issues in legacy contracts arising from the cessation of LIBOR, such as insufficient fallback language. Total U.S. dollar LIBOR exposure is projected to decline from \$223 trillion as of year-end 2020 to \$90 trillion at June 30, 2023, with consumer and business loans declining from \$6.2 trillion to \$3.2 trillion. New York and Alabama passed legislation earlier this year that addresses the fallback language issue for contracts governed by their respective states by making the “recommended benchmark replacement” (e.g., the Secured Overnight Financing Rate (SOFR) published by the Federal Reserve Bank of New York) the rate in any contract that is silent on fallback language or that includes fallback language with a LIBOR-based rate. The U.S. Congress is looking into similar legislative action.

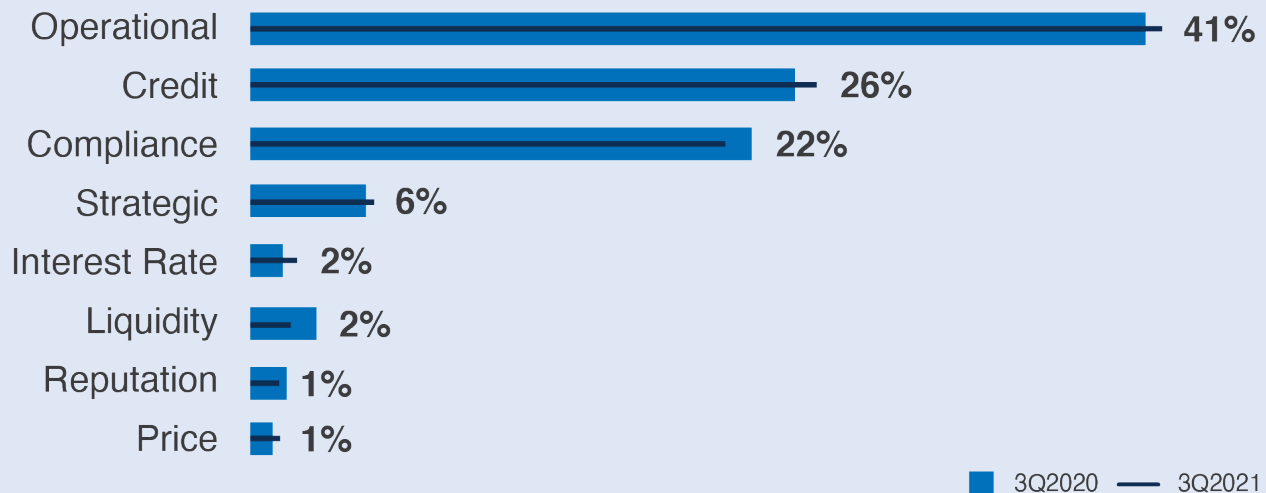
Multiple alternative reference rates have emerged as potential replacements for LIBOR. The OCC has communicated that a bank may use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs. While not endorsing any specific rate, the OCC expects the replacement alternative reference rate to be robust and remain robust (i.e., compliant with International Organization of Securities Commissions principles) through times of stress. The robustness of a reference rate will depend on multiple factors, including whether the underlying data are sufficiently long and reflect the competitive forces of supply and demand; the methodology is sufficiently transparent to allow for independent rate confirmation; and the market for financial instruments that use the rate is sufficiently deep and liquid enough to allow the bank to manage associated market risks. The OCC will continue to work closely with institutions as they transition away from LIBOR to alternative reference rates.

# SUPERVISORY CONCERNS

The OCC communicates supervisory concerns to a bank's board and management in the form of matters requiring attention (MRA). MRA concerns include practices that deviate from sound governance, internal control, or risk management principles. Such deviations, if not addressed, could adversely affect a bank's condition or risk profile, result in violations of laws or regulations, and result in enforcement actions. Figure 10 shows the composition of outstanding MRA concerns.

**FIGURE 10: SUPERVISORY CONCERNS**

**OPEN CONCERNS - PRIMARY RISK**



Source: OCC data

Note: Figures do not add to 100 due to rounding.