Aldrich & Bonnefin, PLC

Counsel to Bankers' Compliance Group presents

The Impact of the COVID-19 Pandemic on Banks and the Current Bank Regulatory Climate

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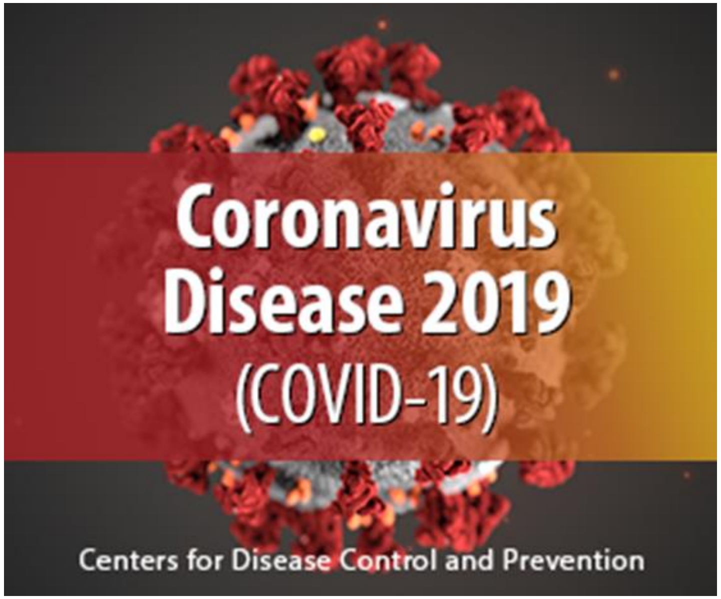
Interagency Examiner Guidance



Overview of Interagency Examiner Guidance

- Titled "*Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic*"
- Issued on June 23, 2020 (FDIC FIL-64-2020)
- By the OCC, FRB, FDIC and NCUA (the "Agencies")

Overview of Interagency Examiner Guidance

- Gives some insight into the regulators' expectations when examining banks during the pandemic

- We'll reference some more recent releases from the regulators during our discussion of the Interagency Examiner Guidance

  - **FRB's Community Banking Connections** (Second Issue 2021)

  - **FRB's Supervision and Regulation Report** (April 2021)

  - **FDIC's Quarterly Banking Profile** (Second Quarter 2021)

  - **OCC's Semiannual Risk Perspective** (Spring 2021)

General Approach to Examinations During the Pandemic

- Examiners will consider the unique, evolving and potentially long-term issues institutions face as a result of COVID-19
- The Agencies express awareness that stresses caused by the pandemic can adversely impact an institution's financial condition and operational capabilities
  - Even where appropriate governance and risk management systems have been implemented

General Approach to Examinations During the Pandemic

- However, examiners will continue to assess institutions in accordance with existing agency policies
- Will provide supervisory feedback and may downgrade ratings
- Appropriate and timely actions taken in good faith relying on supervisory statements will not be subject to criticism or supervisory action (*hopefully*)

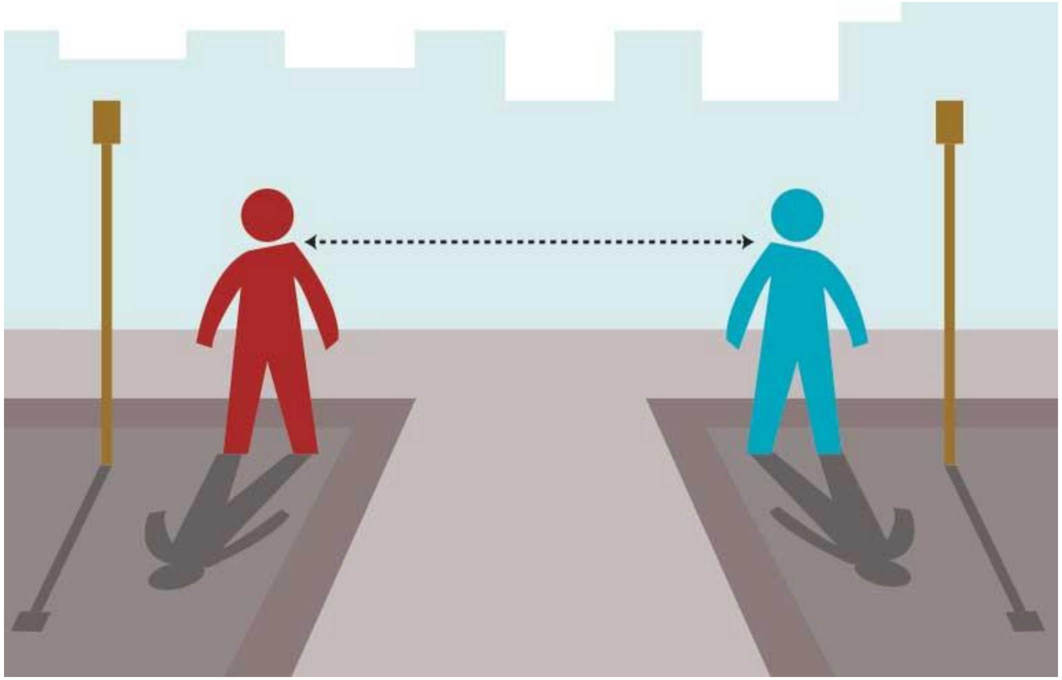
General Approach to Examinations During the Pandemic

- Agencies realize that the pandemic may have a significant impact on the economy for an extended period

- Realize that some institutions may face extensive asset quality issues
  - Business failures
  - Interruption of borrower income
  - Increases in borrower operating costs
  - Volatile or declining collateral values

General Approach to Examinations During the Pandemic

- Realize that many institutions have modified operational processes



Side note …

- FRB Community Banking Connections, Second Issue 2021:
  - “The flexibility we afforded to our institutions during the pandemic should remain”
  - “The key message is that examiners should not criticize bank management for taking prudent steps to support their communities and customers”
  - But banks “do need to be aware of risks to their portfolios and appropriately manage them”

Supervisory Assessment

- Examiners (and directors) must maintain a clear understanding of the condition of the institution
- Examiners will consider the bank's effectiveness of risk assessment and response to economic changes

Supervisory Assessment

- Examiners will give appropriate recognition to the extent weaknesses were caused by <u>external</u> economic problems related to COVID-19

- Examiners will assess reasonableness of management's actions in response to the pandemic

Side note …

- FRB Community Banking Connections, Second Issue 2021:
  - Banks "do need to be aware of risks to their portfolios and appropriately manage them"
  - "Banks have leveraged operational resiliency to demonstrate innovation and ingenuity" (such as with the PPP)
  - "With ingenuity and innovation comes the need for increased focus on the evolving risk profile that results"

Enforcement Decisions

- If a formal/informal enforcement action is warranted, the Agencies will tailor responses to the bank's specific issues and management's willingness to resolve the issue

- Will consider whether management has:
  - Appropriately planned for financial resiliency and continuity of operations
  - Implemented prudent policies
  - Is pursuing a realistic resolution of the issues confronting the institution

Effectiveness of Institution's Assessment of Risk

- Examiners will also evaluate whether management has appropriately assessed the risk associated with COVID-19

- Will consider whether the bank's risk assessment reflects the institution's asset quality given the prevailing economic conditions

Effectiveness of Institution's Assessment of Risk

- Examiners will evaluate:
  - Management's initial and ongoing assessment of the risks
  - If management understands how COVID-19 may effect funding, liquidity, operations and sensitivity to market risk
  - Risk identification and reporting processes

CAMELS Component Ratings

- Examiners will continue to assign supervisory ratings in accordance with CAMELS
  - **C**apital Adequacy
  - **A**sset Quality
  - **M**anagement
  - **E**arnings
  - **L**iquidity
  - **S**ensitivity to Market Risk

- We'll discuss some of the more interesting takeaways. See the guidance for more details

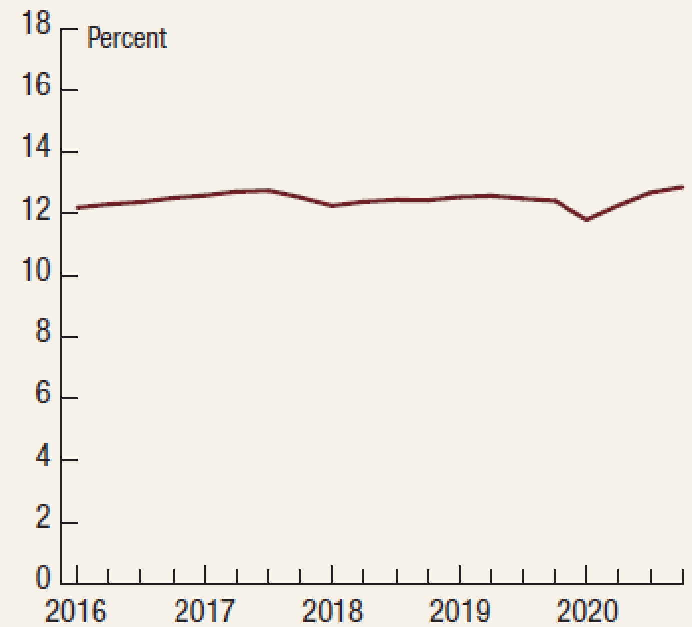
Capital Adequacy

- Institutions may experience:
  - Cash flow decreases, asset losses, operational losses, extraordinary expenses, unexpected deposit growth or declines, and contingent liabilities
  - Significant temporary balance sheet growth due increased lending, large deposit inflows or inflows from government programs
- If an institution’s risk profile is not supported by capital levels, determine whether management has a satisfactory plan to maintain capital adequacy and (if needed) build capital

Side note …

- FRB Supervision and Regulation Report (April 2021)
  - “Banks entered the COVID event with strong capital positions and built further capital last year.”
  - “As of year-end 2020, capital ratios remain well above regulatory minimums at nearly all firms, providing a buffer to absorb losses and support lending as the economy recovers.”

Figure 1. Aggregate common equity tier 1 (CET1) capital ratio



Note: CET1 capital ratio is the ratio of common equity tier 1 capital to risk-weighted assets. See the data appendix for further information.

Source: Call Report and FR Y-9C.

Asset Quality

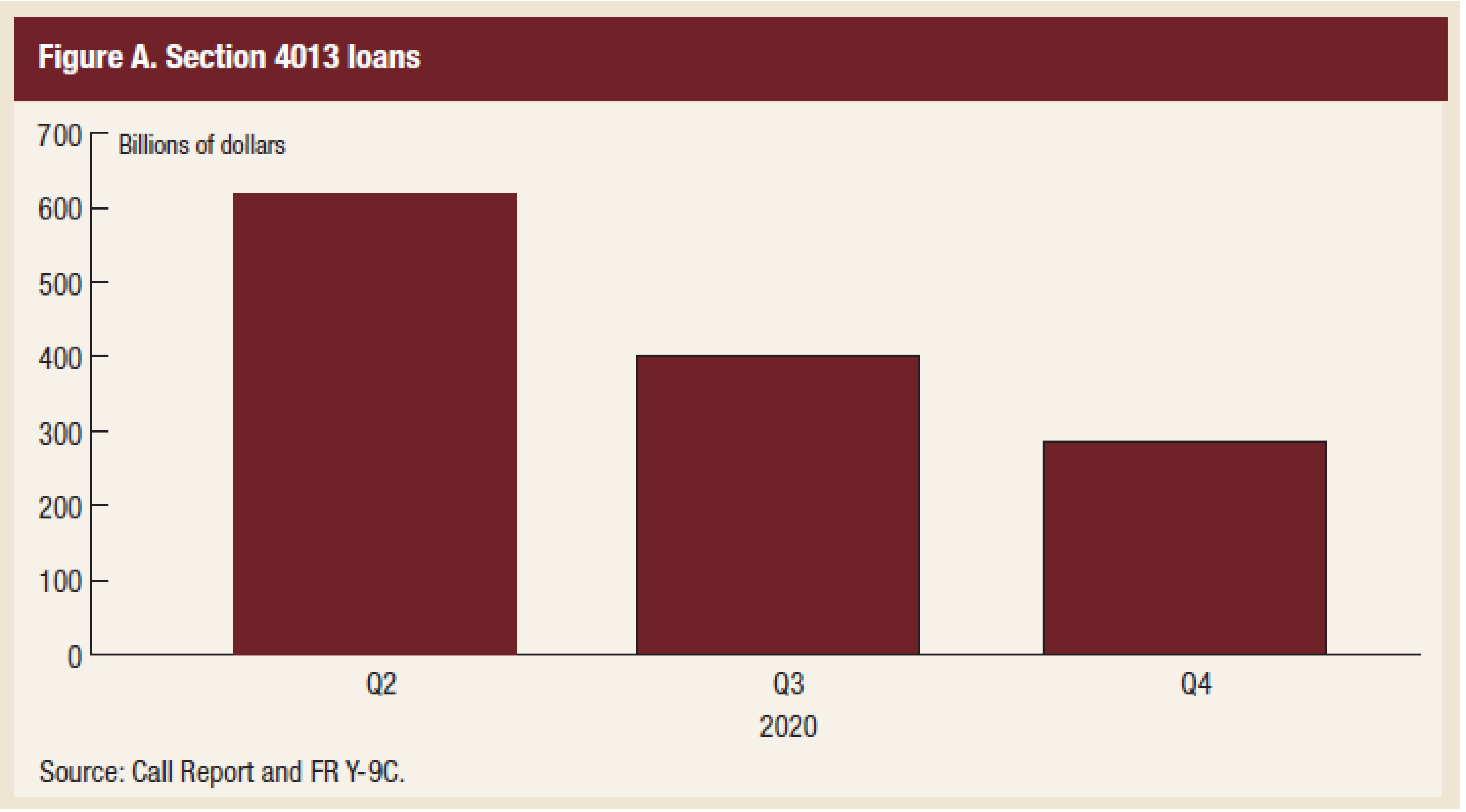
- Classification of credits

- Credit risk review
- New loans

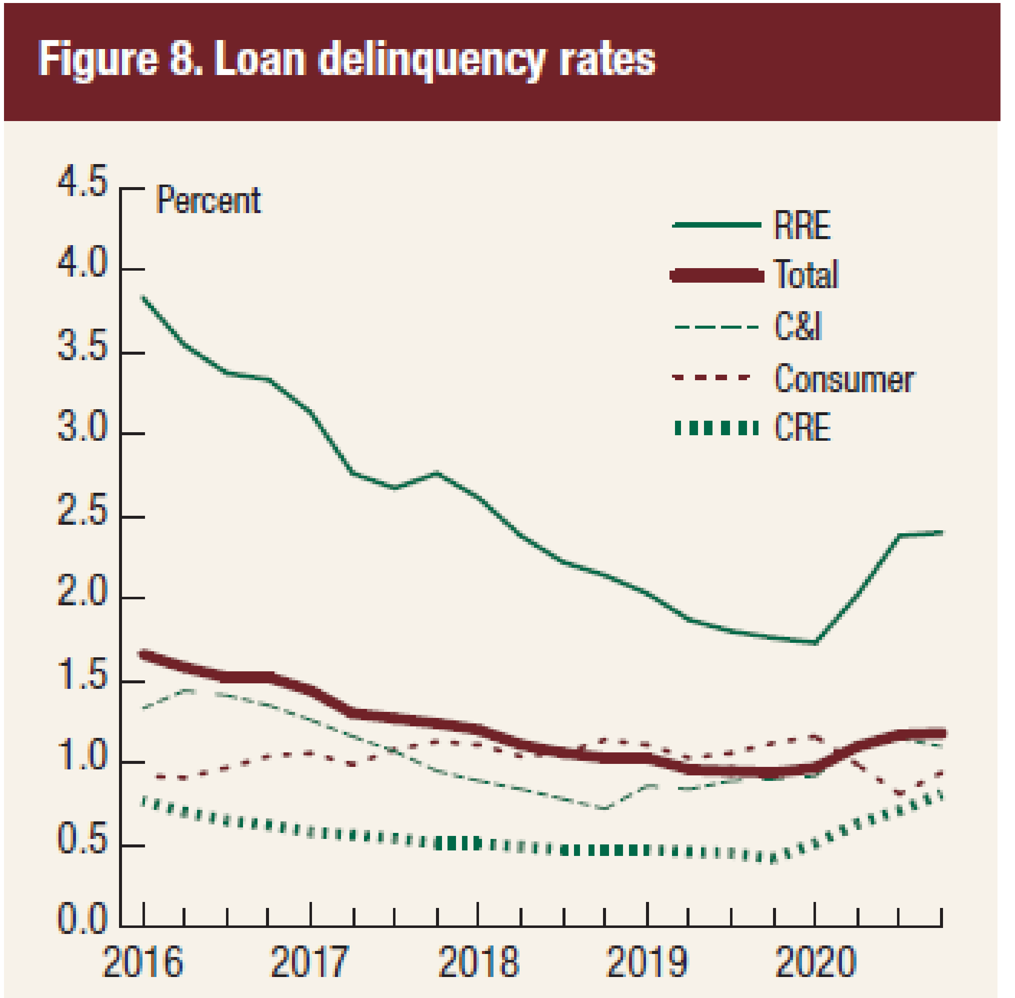
Asset Quality

- Paycheck Protection Program

- Credit modifications



Source: FRB Supervision and Regulatory Report (1Q 2021) (https://www.federalreserve.gov/publications/2021-april-supervision-and-regulation-report.htm)



Note: Delinquent loans are those 90+ days past due or in nonaccrual status.

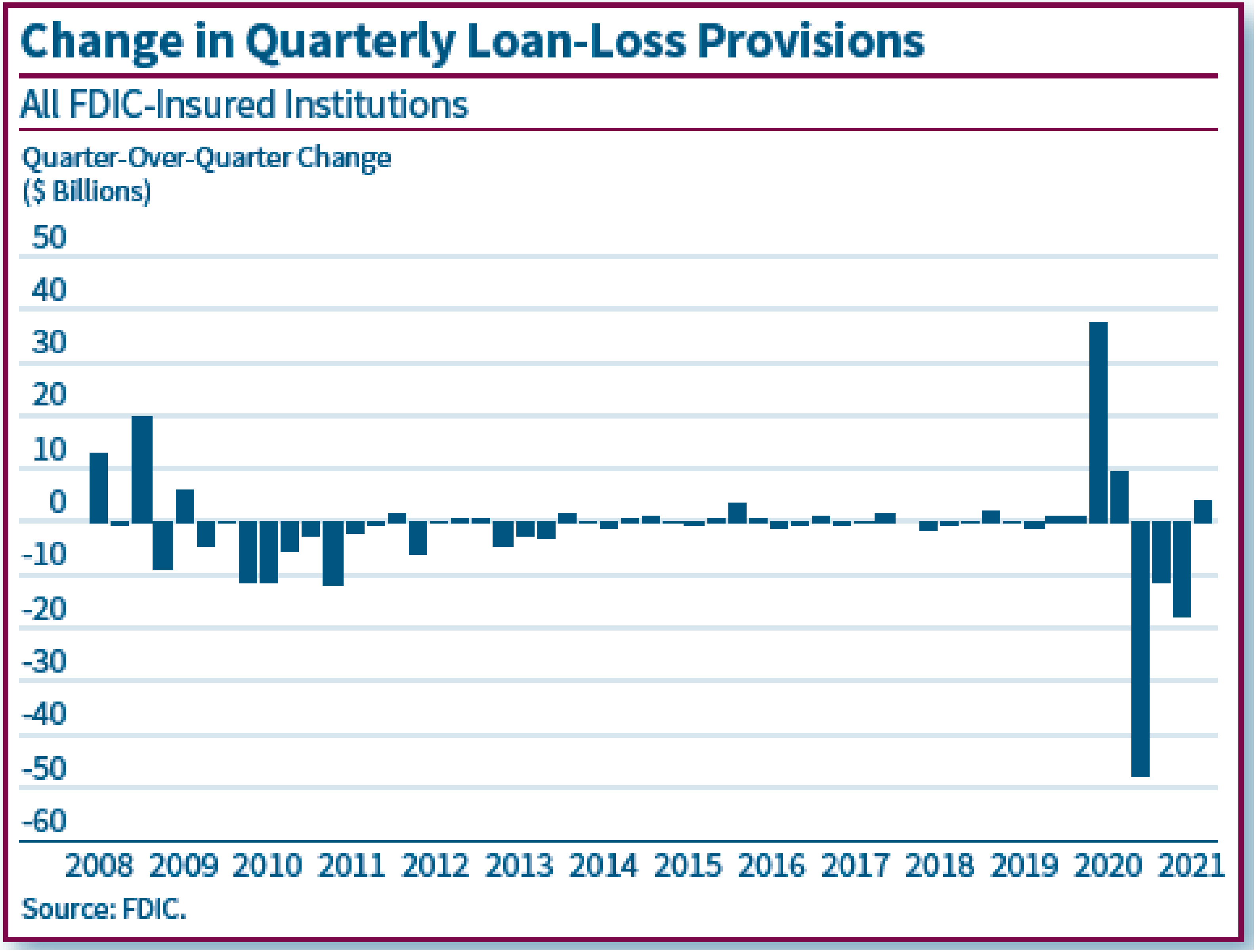
Source: Call Report and FR Y-9C.

Source: FRB Supervision and Regulatory Report (1Q 2021) (https://www.federalreserve.gov/publications/2021-april-supervision-and-regulation-report.htm)

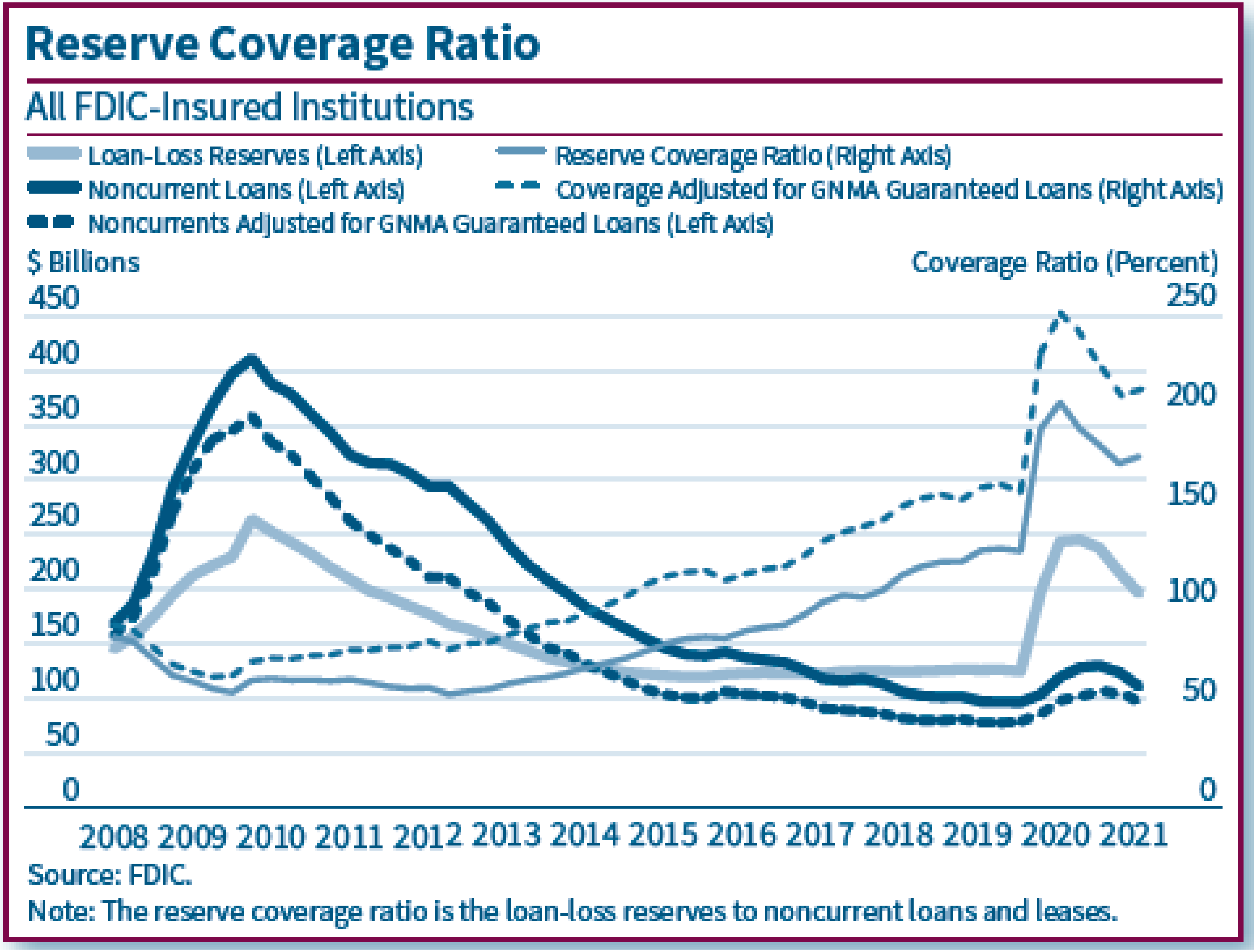
Asset Quality

- Allowance for Loan & Lease Losses (ALLL) or Allowances for Credit Losses (ACL) under CECL

- Management may need to consider qualitative adjustments to credit loss estimates



Source: FDIC Quarterly Report Second Quarter 2021
(https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/)



Source: FDIC Quarterly Report Second Quarter 2021 (https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/)

Asset Quality

- Real estate values

Side note …

- OCC Semiannual Risk Perspective (Spring 2021):
  - “Problem loan levels remain manageable as government support programs muted the financial impact to commercial and retail borrowers.”
  - However, [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.”
  - “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.”

Management

- Unprecedented issues
- How well has management responded?
- Examiners will evaluate an institution on its ability to properly identify and manage risks
- Examiners will distinguish between problems caused by management and those caused by outside factors

Management

- Operational risk

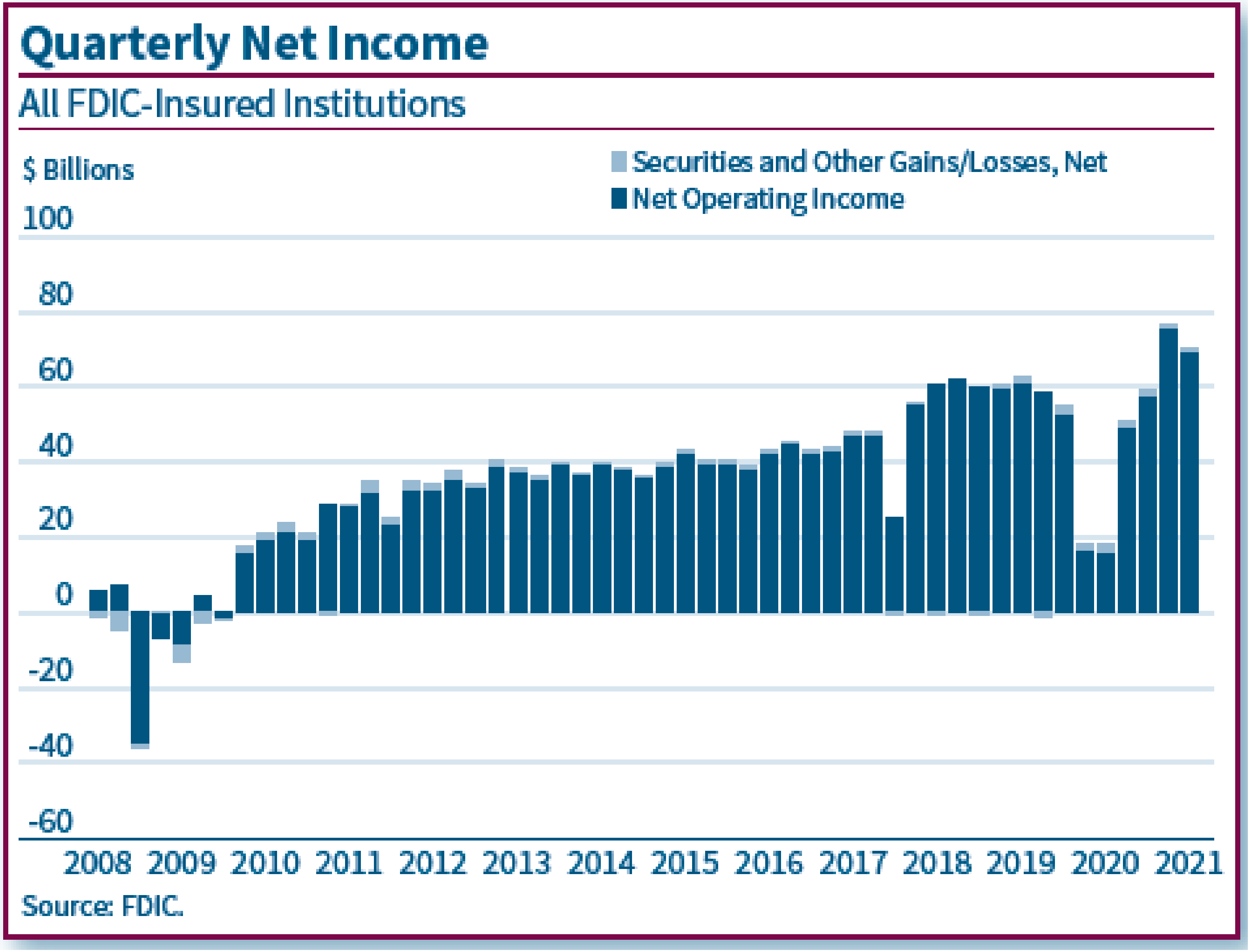
- Independent risk management and audit

Side note …

- OCC Semiannual Risk Perspective (Spring 2021):
  - “Operational risk remains elevated.”
  - “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 <u>increasingly complex</u> operating environment.”
  - “A flexible, risk-focused approach to operational resilience, underpinned by scenario analyses, surveillance and reporting, and management of third-party risk, is <u>important</u> for banks”
  - “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 <u>critical</u>”

Earnings

- Examiners will consider the duration of any reductions to core earnings caused by the pandemic
- Increased personnel, legal, IT and fraud expenses may impact earnings
- Examiners will assess quantity, quality and trend of earnings due to pandemic
- Low interest rates present challenges

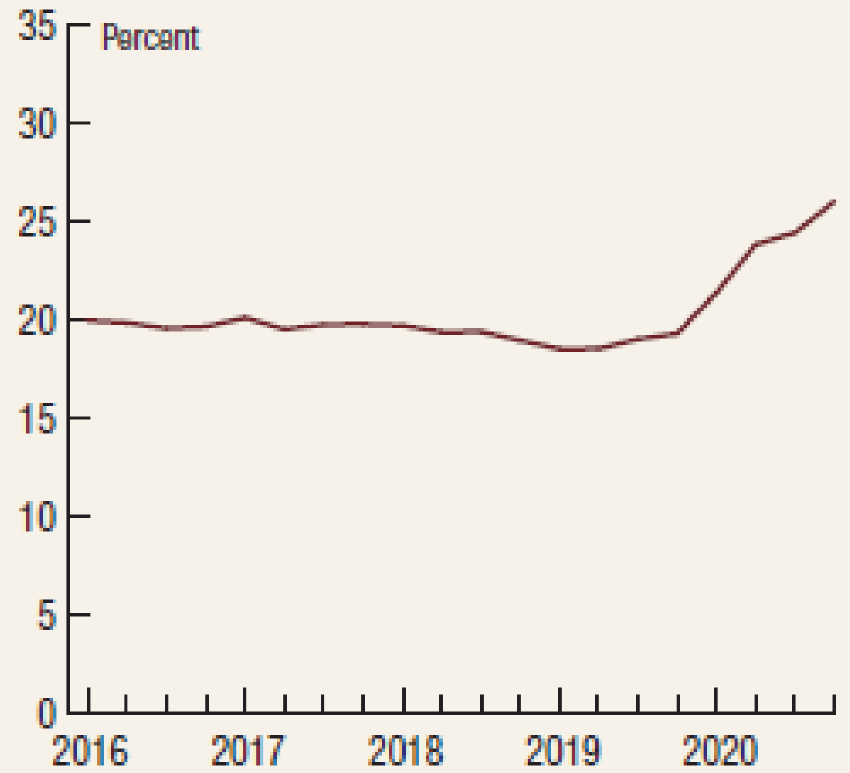


Source: FDIC Quarterly Report Second Quarter 2021
(https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/)

Liquidity

- Uncertainty about impact of COVID-19
- Examiners will evaluate management's ability to reassess/revise liquidity planning

Figure 2. Liquid assets as a share of total assets



Note: Liquid assets are cash plus estimates of securities that qualify as high-quality liquid assets (HQLA) as defined by the liquidity coverage ratio requirement. See the data appendix for further information.

Source: FR Y-9C.

Source: FRB Supervision and Regulatory Report (1Q 2021) (https://www.federalreserve.gov/publications/2021-april-supervision-and-regulation-report.htm)

Sensitivity to Market Risk

- Many institutions may experience temporary shifts in their interest rate profiles from changes in cash flows
  - For example, the amount or timing of cash flows may be altered by deterioration in loan and bond portfolios
  - Or by deferment agreements and programs

Additional Key Takeaways from FRB's Community Banking Connections

(Second Issue 2021)

FRB Community Banking Connections

- “The pandemic has highlighted the importance of third party arrangements to a bank’s operational resilience and created new challenges in risk management”
- “Banking industry regulators consider proactive succession planning and management a key governance tool in promoting a bank’s resilience in difficult times”

Overview of Other COVID-19 Regulatory Relief

Interagency Interim Final Rule re Supplementary Leverage Ratio

- Effective June 1, 2020 (85 FR 32980)
- Temporarily allowed exclusion of U.S. treasury securities and deposits at federal reserve banks from the SLR for large depository institutions
- Intended to expand balance sheets in order to provide credit to households/businesses during the pandemic
- Expired March 31, 2021
- Many hoped it would be extended, but it wasn't

Interagency IFRs re Community Bank Leveraged Ratio (CBLR)

- On April 23, 2020, the banking regulators issued two IFRs as COVID-19-related relief measures
- IFR which temporarily reduced the CBLR from 9% to 8% percent (85 FR 22924)
- IFR providing for a graduated transition of the CBLR back to 9% (85 FR 22930)
  - 8% for the remainder of 2020
  - 8.5% for 2021
  - 9% beginning January 1, 2022
- IFRs adopted as final rules in August 2020

Interagency IFRs re Liquidity Coverage Ratio (LCR)

- From March 2020 to May 2020 three IFRs were issued
- Intended to neutralize the regulatory capital effects of participating in the MMMLF Facility and the PPPLF, and are required to continue to neutralize the LCR effects of participating in these facilities
- In addition, PPP loans will receive a 0% risk weight under the' regulatory capital rules
- Final rule (effective December 28, 2020) adopted the IFRs without change (85 FR 68242)

Temporary Regulatory Relief for Community Banks Exceeding Asset Thresholds

- The FRB, FDIC and OCC issued an IFR giving community banks more time to reduce their balance sheets if they exceeded certain asset thresholds due to COVID-19
  - Such as due to a bank's participation in the PPP
- Became effective December 2, 2020 (85 FR 77345)
- Applies to community banks with less than $10 billion in total assets as of Dec. 31, 2019

Temporary Regulatory Relief for Community Banks Exceeding Asset Thresholds

- If certain conditions met, a community bank that crosses a threshold will not be treated as having crossed the threshold
  - Will have until Jan. 1, 2022 (at the earliest) to either reduce its size or prepare for new regulatory/reporting standards
- For details refer to the IFR which is available at https://www/fdic.gov/news/board/2020/2020-11-17-notational-fr-a.pdf

FDIC’s Final Rule re Deposit Insurance Assessment

- In June 2020, the FDIC issued a final rule that mitigates the deposit insurance assessment effects of a bank’s participation in the PPP, PPPLF and MMMLF (85 FR 38282)

- The FDIC began applying the modifications in calculating an institution’s deposit insurance assessment for call reports as of June 30, 2020

CECL Relief

- Section 4014(b) of the CARES Act
- Provides that no insured depository institution, bank holding company, or any affiliate thereof is to be required to comply with CECL during the period beginning on the date of enactment of the CARES Act and ending on the earlier of:
  - The date on which the national emergency concerning the COVID-19 outbreak declared by the president on March 13, 2020 under the National Emergencies Act (50 USC 1601 *et seq.*) terminates
  - December 31, 2020

CECL Relief

- On March 31, 2020, the FRB, FDIC and OCC issued an IFR to provide institutions that were required to implement CECL in 2020 relief due to the economic impact of the COVID-19 pandemic (85 FR 17723)

- On September 30, 2020, the agencies issued a final rule consistent with the March 2020 IFR with certain clarifications and minor adjustments (85 FR 61577)

CECL Relief

- Institutions that implemented CECL before the end of 2020 have the option to delay for 2 years an estimate of CECL's effect on regulatory capital
- Provides for a 3 year transition period
- The final rule allows institutions that choose to implement CECL in 2020, even if they are not required to do so, to use the transition provision
- Regulators also issued a joint statement to provide further guidance
- Consult with accountants

Loan Modifications

- Section 4013 of the CARES Act
  - Provides institutions the option to temporarily suspend certain requirements under the GAAP related to troubled debt restructurings (TDRs)
  - To account for the effects of COVID-19

Loan Modifications

– "*Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus*" (March 2020)

– Referred to here as the "Initial Loan Modification Statement"

- Encouraged institutions to work constructively with COVID-19 affected borrowers
- Said they will not criticize institutions that mitigate credit risk through prudent actions consistent with S&S practices
- Said institutions have broad discretion to implement prudent modification programs

Loan Modifications

- Initial Loan Modification Statement (cont.)
  - To be eligible under Section 4013, a loan modification must be:
    - Related to the COVID-19 pandemic;
    - Made for a loan that was not more than 30 days past due as of December 31, 2019; and
    - Made between March 1, 2020 and December 31, 2020
  - Eligible loan modifications under Section 4013 are not required to be reported as TDRs

Loan Modifications

- Initial Loan Modification Statement (cont.)
  - Further relief for loan modifications not eligible under Section 4013
  - ASC Subtopic 310-40: a restructuring of a debt constitutes a TDR if the lender, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider
  - However, the Initial Modification Statement provides that short-term modifications made in good faith in response to COVID-19 to borrowers who are current on their loan (i.e., not more than 30 days past due on payments at the time of the modification program) are not TDRs

Loan Modifications

- "*Joint Statement on Additional Loan Accommodations Related to COVID-19*" (August 2020)
  - Provides that if a borrower continues to experience financial challenges after an initial accommodation, it **may be prudent** to consider additional accommodation options to mitigate losses for the borrower and lender
  - When considering additional accommodations it is generally appropriate to assess each loan based upon its fundamental risk characteristics

Loan Modifications

- FDIC FAQs for Financial Institutions Affected by COVID-19 (May 2021)
  - "Encourages financial institutions to provide borrowers affected in a variety of ways by the COVID-19 outbreak with payment accommodations that facilitate their ability to work through the immediate impact of the virus."
  - "Such assistance provided in a **prudent** manner to borrowers facing short-term setbacks could help the borrower and a community to recover."
  - "The FDIC understands that effective loan accommodation programs may involve protracted resolutions, but all should be ultimately targeted toward loan repayment."

Certain Special Programs

FRB’s Main Street Lending Program

- Intended to support lending to small and medium-sized for profit businesses and nonprofit organizations that were in sound financial condition before the onset of the COVID-19 pandemic
- Eligible lenders were able to originate new loans or increase the size of existing loans made to eligible borrowers
- Terminated on January 8, 2021

FRB's Facility Programs

- Money Market Mutual Fund Liquidity Facility
  - FRB Boston made loans available to eligible financial institutions secured by high-quality assets purchased by the financial institution from money market mutual funds
  - Ceased extending credit on March 31, 2021
- PPP Liquidity Facility
  - Extended credit to eligible financial institutions that originate PPP loans taking the loans as collateral
  - Ceased July 30, 2020

Emergency Capital Investment Program

- Deadline to submit an application under the ECIP was September 1, 2021
- Provides up to $9 billion in capital directly to Community Development Financial Institutions and Minority Depository Institutions
- To support the provision of loans, grants, and forbearance for small and minority businesses and consumers in low income communities
- Banking regulators issued an IFR in March 2021 providing that preferred stock issued under the ECIP qualifies as additional tier 1 capital and that subordinated debt issued under the ECIP qualifies as tier 2 capital

We're adjourned!

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