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# Financial regulators issue examiner guidance for assessing COVID-19's effects

*Impacts to safety and soundness rating*

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On June 23, 2020, several federal financial regulatory agencies*, in conjunction with state financial regulators, jointly issued examiner guidance to outline **supervisory principles for assessing the safety and soundness of institutions** given the ongoing impacts of the COVID-19 pandemic. The guidance provides a principles-based approach for examiners to apply to existing safety and soundness examination procedures in this current environment.

## Purpose and background

**Purpose**: Provides guidance to examiners for considering the "**unique, evolving, and potentially long-term nature**" of the issues confronting financial institutions in the wake of the COVID-19 pandemic so that they can "exercise appropriate flexibility" in their supervisory response.

- Examiners will **continue to conduct their examinations** following their respective agencies' supervisory and examination policies and procedures and ratings systems.

**Background on the current environment**: Stay-at-home and social distancing requirements are adversely **impacting consumers, commercial customers, markets, and operations of financial institutions themselves.** This may lead to business failures, loss of jobs, interruptions to borrower income streams/operating costs, volatile asset prices, and government stimulus.

**Potential impacts:** Individual financial institutions are experiencing varying **degrees of impact across the supervisory risk categories, notably credit, liquidity, market, operational, cyber, and compliance risks**.

- There are new and modified products, operational processes, controls, and responses by risk management and internal audit to consider.

**Supervisory perspectives**: Examiners will consider whether management, in good faith, has **properly identified and is prudently managing the risks associated with the pandemic**, including longer-term planning and business strategies.

- While examiners will not criticize institutions for working with borrowers, they will need to **distinguish between problems caused by management and those caused by external factors beyond management's control.**

**The federal financial institution regulatory agencies are the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (Board), Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA).*

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## Deloitte's Key Takeaways

### Pre-pandemic business models will be evaluated, as will post-pandemic strategies

- As banking organizations go through their financial planning cycles, building in multiple scenarios as part of financial and capital planning will likely stress current data and reporting infrastructures
- Investments for streamlined workflows, data aggregation, and analytics should continue given current the real-time need for information

### Operational, compliance, and cyber risks and costs may increase for many institutions

- Ongoing operational resiliency issues are top-of-mind and should continue to factor into "breaking down" siloes between cybersecurity, operations/operational risk, information security, information technology infrastructure, and business continuity

### Regulators have been supportive of lender participation in PPP, Main Street other FRB programs

- Tracking of CARES Act, regulatory response measures, and Federal Reserve programs will need to reflect lenders' use, borrower risks, and overall impact to a banking organization's financial profile
- Reporting and transparency will be key for the board, senior management, and external stakeholders

### Internal controls evolution as risks and operations continue to change (remote work)

- Rapid changes in operational processes and increasing fraud and cyber threats may result in a heightened risk environment

### Remote work environments to be reviewed

- Existing control design and effectiveness will need to be evaluated in current remote work environment
- More frequent self-assessment and analytics of control environment are necessities

### Managements' response to the pandemic will be weighed

- Management's response to changing conditions will be challenged with continued phase-in, work from home strategies that require self-monitoring and reporting that is dynamic
- Internal Audit and Independent Risk Oversight should understand and adapt controls monitoring and testing plans to the evolving risk profile

### Unique, evolving, and longer-term impact to financial firms

- Build in key stakeholder communications among board, senior management, business management across the three lines of defense

### Recovery for firms could be uneven/localized

- Ensure local/regional/national impacts are built into existing legal entity, business, and product views of reporting

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## Effectiveness of an Institution's Assessment of Risk

- **Institution's initial as well as ongoing risk identification & reporting processes** based on the information available & local economic recovery is assessed
- Examiners recognize that issues/risks effecting the institution are **complex, evolving, and may involve protracted resolution**
- The **scope of examination is adjusted** depending on the quality and thoroughness of management's assessment of risk
- Quality of an institution's risk assessments will be deemed, as appropriate, in the **examiner's assessment of supervisory ratings**

## CAMELS or ROCA Component Ratings[1]

When assessing the component ratings for CAMELS or ROCA, or analogous component ratings for holding companies, examiners will consider the following:

### Capital Adequacy

✓ Evaluate **capital relative to the nature and extent of the institution's risks** considering its **regulatory capital ratios, capital planning, capital projections, and distribution plans, risk management practices** and whether an institution maintains a fundamentally sound financial condition and management's plan to maintain capital adequacy & build capital when needed

### Asset Quality

✓ Assess credits in line with the **interagency credit classification standards**, while recognizing the constraints posed by the pandemic

✓ Consider whether management has been **able to identify loans and investments substantially affected by the pandemic** and recognize any deterioration in a timely manner, including any potential loss exposure

✓ Assess **management's ability to implement prudent credit modifications and underwriting, maintain appropriate loan risk ratings, designate appropriate accrual status on affected loans, and provide for an appropriate Allowance for Loan and Lease Losses (ALLL) or Allowances for Credit Losses (ACLs**), as applicable. In making these assessments, examiners will give consideration to the items below.

1. *Classification of Credits*
2. *Credit Risk Review*
3. *New Loans*
4. *Paycheck Protection Program*
5. *Credit Modifications*
6. *Nonaccrual*
7. *ALLL or ACLs*
8. *Obligations of Taxing Authorities*
9. *Real Estate Values*
10. *Appraisal and Evaluation Delays*

**1. CAMELS:** Uniform Financial Institutions Rating System - The NCUA uses the CAMEL rating system, which does not include the S – sensitivity to market risk. NCUA examiners will continue to consider sensitivity to market risk and liquidity risk when rating the L component.

**ROCA:** Rating System for U.S. Branches and Agencies of Foreign Banking Organizations

- The ROCA rating does not contain a component rating for earnings, liquidity, sensitivity to market risk. Examiners will assess the effect of a pandemic on liquidity, sensitivity to market risk as part of the risk management component of the ROCA rating. Branches and agencies of FBOs do not maintain regulatory capital separate from their foreign parent organizations. Federal branches and agencies of FBOs are instead required to maintain capital equivalency deposits as set forth in 12 CFR 28.15, and state-licensed branches and agencies may be subject to similar requirements through their respective state supervisors.

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## Asset Quality

**1 Classification of Credits**

- ✓ Assess each loan based on the fundamental characteristics affecting the collectability of that particular credit, while acknowledging that supporting documentation may be limited and cash flow projections may be highly uncertain
- ✓ Review management's assessment of the borrower's repayment ability and financial condition as well as the institution's collateral protection, when uncertain cash flow projections exist
- ✓ Renewed, extended, or modified loan will not be subjected to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance, provided that the borrower has ability to repay its debts according to reasonable modified terms
- ✓ Apply appropriate credit classification and charge-off standards in cases where information indicates a loan will not be repaid under reasonable terms
- ✓ Assess the reasonableness of management's plans for workouts and pursuing foreclosure of collateral on nonperforming assets

**2 Credit Risk Review**

- ✓ Assess the institution's support for any delays or reductions in scope of credit risk reviews recognizing that the rapidly changing environment and limited operational capacity may temporarily affect the institution's ability to meet normal expectations of loan review
- ✓ Consider management's plan to complete appropriate reviews within a reasonable amount of time

**3 New Loans**

- ✓ Assess the appropriateness of the institution's underwriting standards by reviewing a sample of loans originated during or after the pandemic, or by reviewing the institution's reports, as appropriate
- ✓ Review management's analysis of borrower projections given the local economic conditions during the recovery
- ✓ Consider whether the institution has sufficient controls and expertise for the new or expanded activities to focus on possible change in the institution's business strategy to focus on new lines of business or expand into new markets

**4 Paycheck Protection Program**

- ✓ Assess an institution's safety and soundness without criticizing institutions that participate in the PPP in accordance with SBA program guidelines

**5 Credit Modifications**

- ✓ Assess the appropriateness of an institution's policies and procedures for credit renewals, extensions, or modifications
- ✓ Avoid criticizing institutions for working with borrowers as part of a risk mitigation strategy intended to improve existing loans, even if the restructured loans have or develop weaknesses that ultimately result in adverse credit classification
- ✓ Avoid criticizing management for engaging in prudent loan modifications and working with borrowers in a safe and sound manner
- ✓ Review loan modifications to evaluate whether management is applying appropriate loan risk grades and making appropriate accrual status decisions on loans affected by the pandemic
- ✓ Exercise judgment in reviewing loan modifications and not automatically adversely risk rate credits that were modified
- ✓ Evaluate loan modification practices by considering the CARES Act and Revised Interagency Statement

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## Asset Quality

**6 Nonaccrual**

- ✓ Confirm that institutions continue to follow applicable regulatory reporting instructions, as well as the institutions' internal accounting policies, when reporting nonaccrual assets in regulatory reports
- ✓ Review institution practices against appropriate charge-off guidance regarding accrued interest and principal

**7 Allowance for Loan and Lease Losses (ALLL) or Allowances for Credit Losses (ACLs)**

- ✓ Review an institution's methodology for calculating the ALLL or ACLs, as applicable, by assessing whether management has considered relevant available information about the collectability of the institution's loan portfolio, along with any changes to the institution's lending practices and economic conditions as a result of the pandemic
- ✓ Evaluate how an institution considered the effect of the pandemic in its ALLL or ACLs estimation process, as applicable, and whether the resulting estimates are in conformity with GAAP and regulatory reporting requirements
- ✓ Assess management's process for updating estimates of loan losses in the ALLL or ACLs, as applicable, as the institution obtains additional information
- ✓ Understand that management may need to consider qualitative adjustments to credit loss estimates for information not already captured in the loss estimation process
- ✓ Understand that management may need more time to determine the effect of the pandemic on some borrowers' ability to pay and assess the value of underlying collateral
- ✓ Determine whether management has maintained the ALLL or ACLs, as applicable, at an appropriate level within a range of loss estimates even when loan-specific information is not yet available

**8 Obligations of Taxing Authorities**

- ✓ Confirm that institutions monitor their risk exposures in municipal bonds to assess whether those bonds continue to be the credit equivalent of an investment grade security and are appropriately classified, consistent with the interagency credit classification standards
- ✓ Confirm that management is using relevant information to conduct credit risk assessments that are timely, accurate, and consistent with internal policies, regulatory requirements, and accounting standards
- ✓ Review the institution's loan and investment portfolios to assess credit that has been extended to taxing authorities

**9 Real Estate Values**

- ✓ Assess the institution's policies and practices for valuing collateral in real estate markets for both existing and new real estate loans
- ✓ Ascertain whether estimates of collateral values are based on assumptions that are prudent and realistic

**10 Appraisal and Evaluation Delays**

- ✓ Evaluate whether an institution is making best efforts to obtain a credible valuation of real property collateral before the loan closing and how any backlog of appraisals or evaluations is being addressed
- ✓ Evaluate if the institution's underwriting is consistent with the principles in the agencies' Standards for Safety and Soundness and Real Estate Lending Standards

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## Management

- ✓ Evaluate **risk management policies and its abilities to prudently manage the risks due to pandemic** considering the circumstances surrounding the decisions made. **Institutions should update their risk assessments and factor** in the learnings into long-term business strategies
- ✓ Evaluate management based on the **reasonableness of management's response to the pandemic**. As additional information becomes available, examiners expect management to update risk assessments, measure the effectiveness of its response, and adjust, as necessary
- ✓ Evaluate **ability to properly identify and prudently manage risks associated with the pandemic**, considering the extraordinary circumstances surrounding the decisions made to work with borrowers and the large number of those impacted
- ✓ Evaluate the extent to which **management factors the results of these efforts into its longer-term business strategy** – recognizing evolution to local and national recovery – including branching, mergers, or other restructuring
- ✓ Distinguish between **problems caused by the institution's management and those caused by external factors beyond management's control**. Provided prudent planning and policies are in place and management is pursuing realistic resolution of the institution's problems, management of an institution with problems largely related to the pandemic may warrant a more favorable rating than management of an institution operating with problems stemming from weak risk management practices that are, or should have been, substantially within the institution's control

## Operational Risk

- ✓ Assess actions management has taken to **adapt fraud and cybersecurity controls** to manage heightened risks related to the adjusted operating environment.
- ✓ Review how management has **assessed institutions' third parties' controls and service delivery performance capabilities post crisis**
- ✓ Consider the impacts on the **control environment from instances of imprudent cost cutting, insufficient staffing, or delays in implementing** needed updates

## Independent Risk Management and Audit

- ✓ Consider how COVID-19-related responses may **impact plans and schedules for internal audit and independent risk management reviews**, including the need to **incorporate audits or reviews of new operational processes and programs**
- ✓ Review the use of remote work technologies and teleconferencing systems for work-at-home arrangements, along with the **elimination of physical controls present in many office environments**
- ✓ Review **risk management and audit monitoring of programs to support consumers and businesses such as PPP, mortgage deferrals, loan forbearance, and other new programs** that may pose credit, legal, and compliance risks if not properly managed.

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## Earnings

- ✓ Evaluate **accounting for and estimating allowances for accrued interest from modified loans** in accordance with GAAP and Call Report instructions
- ✓ Assess the **quantity, quality, and trend of prior earnings** as well as the pandemic's influence on earnings prospects; impact on the institution's major business lines & significant customers; revisions to the its budget and strategic plan, including projections from participation in government programs related to the pandemic
- ✓ Due to the **increased level of loan modifications associated with the pandemic**, levels of deferred interest in relation to total earnings may be elevated
- ✓ Evaluate how institutions are **accounting for and estimating allowances for accrued interest from modified loans**, as applicable, in accordance with GAAP and Call Report instructions
- ✓ **Ongoing operational issues**, such as increased personnel, legal, IT, and fraud expenses may also impact earnings
- ✓ Assess the **quantity, quality, and trend of prior earnings** as well as the pandemic's influence on earnings prospects
- ✓ Assess impact on major business lines and significant customers
- ✓ Consider the adequacy and reasonableness of any revisions to the institution's budget and strategic plan, including projections from participation in government programs related to the pandemic.

## Liquidity

- ✓ Consider the nature and timing of **pandemic-related inflows and outflows** when reviewing the adequacy of an institution's liquidity and be cognizant of how management is employing **any influx of liquid resources**
- ✓ Evaluate **fluctuations in liquidity resulting from the receipt of customers' Economic Assistance Payments, customers' flight to quality, participation in various government lending programs or borrowing facilities, or deposit outflows as depositors**, including municipalities, draw on savings or reserves
- ✓ Evaluate **management's ability to reassess or revise liquidity planning to accommodate changes from the pandemic**
- ✓ Evaluate **use of the discount window or other Federal Reserve lending programs or prudent use of its liquidity buffer** to support economic recovery, in accordance with the institution's liquidity risk management framework
- ✓ Although the ROCA rating does not contain a liquidity component rating, funding, liquidity risk, and risk management are important factors in the assessment of branches and agencies of FBOs
- ✓ Assess the **effect of a pandemic on liquidity as part of the risk management component of the ROCA rating**

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## Sensitivity to Market Risk

- ✓ Consider **sensitivity in the form of the interest rate risk profile** and determine **procedures for reviewing and updating its asset and liability management models for any unusual fluctuations in deposit balances, adjustments to loan payments, changes in interest rates, and other modifications**
- ✓ Ensure the **integrity, accuracy, and reasonableness of the models in cash flows associated with the pandemic**
- ✓ **Recognize** that management may need time to **fully assess any changes to the institution's interest rate risk profile** and **distinguish between permanent structural changes versus short-term fluctuations during a transitional period**
- ✓ Determine whether management has **procedures for reviewing and updating its asset and liability management models for any unusual fluctuations in deposit balances, adjustments to loan payments, changes in interest rates,** and other modifications to ensure the integrity, accuracy, and reasonableness of the models
- ✓ ROCA rating does not contain a component for market sensitivity. **Consider sensitivity in the form of the interest rate risk profile, risk management, and effects from the pandemic in the assessment of the risk management component**

## Risk Management of a Branch or Agency of an FBO

- ✓ Recognize **challenges to the FBO head office of a branch or agency** as well **as local management**
- ✓ Focus on the **assessment factors outlined in the interagency ROCA rating system**, and consider these factors in the context of the pandemic
- ✓ Evaluate the **level of support provided by the home office in restoring operations** and the appropriateness of risk management considering the changing operating environment and economic conditions due to a pandemic

# Reference

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Board of Governors of the Federal Reserve (FRB) et. al, "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions," accessed on June 23, 2020.

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