Risks Capturing Regulatory Attention & Potential Mitigations

regulatory CECL risk management

Summary: Recently, the OCC released its annual report on the federal banking system's condition. Although the average capital levels were good and the federal banking system's liquidity ratio was more than 3x the historical average, certain risks in the industry have increased. We give you some of the report highlights, including three important areas of focus for increased risk.

Today is National Groundhog Day, when we all wait to see if the groundhog will see its shadow — indicating six more weeks of winter — or not, which sends the signal that spring is soon here. This tradition originated in 1887 with the Pennsylvania Dutch. These days, the star of the show is Pennsylvania's own groundhog, Punxsutawney Phil. Whatever weather Phil predicts with his shadow, we can start preparing.

Bankers can start preparing for more than weather with the recent 2021 OCC Annual Report, which outlines the federal banking system's condition and supervision priorities. We take a closer look at the findings, including areas of increased risk, as they apply to all institutions, not just those regulated by the OCC.

Capital and liquidity levels

While the pandemic upended many business sectors, financial institutions (FIs) entered into the pandemic with healthy fundamentals and that has since improved. The OCC reports that "*banks remained well capitalized at 8.6% of average total assets through the first half of calendar year 2021.*" The average capital leverage ratio from 1984-2019 was 7.5%. Along with the high capital levels, the federal banking system's liquidity ratio went beyond 3x the historical average, due to an influx of deposits from unprecedented fiscal and monetary stimulus during the pandemic. For Q2 2021, the liquidity ratio was 24%.

Increased risks

While capital and liquidity levels were robust, with change comes the need for increased risk management. Here are some of the specific risks receiving increased regulatory attention and PCBB's suggestions for mitigation.

1. **Cyber.** With digital banking, remote working conditions, and competitive pressures driving new third-party relationships, community financial institutions (CFIs) are faced with greater cyber risks. These risks range from ransomware attacks to business email compromise and everything in between. The biggest evidence of this ongoing challenge was the Log4j vulnerability that wreaked havoc for many companies. We expect these types of cyber threats will only continue.

Mitigation suggestion: It is more important than ever to run software updates, patch known vulnerabilities, and set up systems to review your network for threats regularly. Make sure that your IT group is kept up-to-date on all the latest cyber threats and communicates with management and the board regularly. Cybersecurity is a company-wide risk, not just an IT risk.

2. **Compliance.** With greater regulatory oversight to address the above risks and others (including pandemic-related risks, CECL risk management, etc.), CFIs may find it more challenging and sometimes costlier to meet the new guidelines. More personnel may be needed, while the labor market is extremely tight, and still regulators expect CFIs to be compliant.

Mitigation suggestion: CFIs should do their best to stay on top of all these regulations and plan for more regulatory changes in the future, to be adequately prepared. With ever-increasing labor costs, soliciting third parties for their services in certain cases, such as with CECL, may be the best option for many institutions.

3. **Strategic.** While many FIs were profitable last year, managing earnings with historically low net interest margins has been an ongoing, material risk. Margins are expected to improve with rising rates, yet the ongoing pressure to reduce fees continues.

Mitigation suggestion: CFIs can assess their strategic risk by profitability modeling. Profitability modeling helps CFIs to plan for various economic scenarios by adjusting the levers of interest rates, fee income, and funding costs with various outcomes. CFIs can be prepared by finding the right combination ahead of time.

It is a challenging time for CFIs. Yet, most are in better shape now than ever. As always, the key to risk management is to identify, measure, monitor, and control your institution's risks. By doing so, your institution should be able to ride out these challenges successfully.

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ECONOMY & RATES

Rates As Of: 02/02/2022 06:43AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.19	-0.03	0.13
6M	0.48	-0.01	0.29
1Y	0.78	-0.01	0.38
2Y	1.18	-0.01	0.43
5Y	1.63	0.01	0.36
10Y	1.80	0.01	0.28
30Y	2.11	0.00	0.20

FF Market	FF Disc	IORB
0.08	0.25	0.15
SOFR	**Prime**	**OBFR**
0.05	3.25	0.07