FOUR QUADRANTS OF PANDEMIC RISK

FOR BANK BOARDS

IN THE WAKE OF COVID-19

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Helping Community Financial Firms Navigate the Four Quadrants of Pandemic Risk

In the wake of the COVID-19 pandemic, community financial institutions (FIs) have entered uncharted waters when it comes to navigating risk. In fact, it is the inherently unfathomable nature of the current risk landscape, which may itself present the greatest operating challenge for community lenders, according to a federal examiner.

RADD LLC, a compliance advisory firm focused on credit unions and community banks, attended the American Bankers' Association Risk and Compliance Virtual Conference held in July. Additionally, we interviewed numerous industry experts and conducted proprietary research to map out the threat landscape for regional institutions in the age of declining profitability and operational uncertainty. We have synthesized our findings into four quadrants of risk for bank boards to prioritize, as the U.S. recovers from an unprecedented public health crisis, with no end in sight.

Beyond rapidly deteriorating credit risks, community banks and credit unions find themselves vulnerable to fraud via the misappropriation of Paycheck Protection Program loan funds and increasingly aggressive cyber-threats. Additionally, smaller FIs have become more susceptible to anti-money-laundering (AML) risks, as compliance has taken a back seat to the rapid-fire issuance of PPP credit to distressed borrowers.

In the following light paper, RADD will probe the emerging risk landscape for community FIs in the age of COVID-19 and provide regulatorily vetted guidance for bank boards to ensure that management is charting the best possible course for a tempest of unforeseeable duration.

CREDIT RISK

4 Quadrants of Pandemic Risk

According to a senior OCC official who spoke at the ABA Conference, credit risk is the most crucial issue facing FIs, large and small. In particular, this regulator highlighted the vulnerability of bank credit portfolios that have disproportionately higher exposures to commercial real estate debt, with an emphasis on the hospitality sector.

Specifically, commercial real estate lending has been adversely impacted by borrower's depleted net operating incomes, as a result of pandemic restrictions on business activity, plummeting revenues, and the possible displacement and relocation of tenants.

With an uncertain outlook for America's recovery prospects, management needs to weigh the lifespan of local business restrictions and their correlation to property valuations, notes the OCC in its latest Semiannual Risk Perspective[1]. Broadly speaking, the regulator advises: "Nearly every asset class on banks' balance sheets has been or likely will be affected. Companies and industries face elevated risk of default, bankruptcy, or dissolution due to the sharp decline in revenues coupled with uncertain near-term prospects for recovery as well as longer-term uncertainties[1]."

The OCC further projects that the pandemic will stunt global growth, "placing stress on borrowers and significantly affecting commercial and consumer credit exposures over the next several quarters[1]."

While the OCC encourages banks to be more flexible with their borrowers, the regulator also cautions that lenders "need to appropriately recognize credit risk to capital through timely determinations of risk ratings, accrual status, and allowance adequacy[1]."

Management should take note and update their portfolio management processes, particularly with regards to stress testing in a distressed market cycle.

[1] https://www.foxbusiness.com/financials/community-banks-shine-during-ppp-loan-rush-as-big-banks-fall-short

While community FIs have been able to respond more nimbly to the cash crunch than large lenders, enabling them to bypass the head-office logjam that has stymied applicants seeking PPP loans from big banks – along with millions of others – they are also easier prey for bad actors[2].

Consider that lenders with less than $10 billion in assets issued nearly 39 percent of the second round of PPP loans, according to the U.S. Small Business Administration[3]. In total, the amount of credit disbursed to Americans by smaller lenders exceeds $55 billion.

However, community FIs lack the robust compliance and risk budgets that have become the industry standard for bulge-bracket banks in the aftermath of the post-crisis Dodd Frank Act. In fact, more than 80 percent of community FIs have previously reported a five-percent increase in compliance costs as a result of this regulatory reform[4].

Still reeling from the ripple effects of Dodd Frank's restrictions on capital, smaller banks continue to find reduced opportunities to generate fee income. The struggle to remain competitive means that community FIs are more like to cut corners, especially in compliance, an area that doesn't bring in any dollars.

With many banks possessing less resources to spend on the latest anti-fraud and customer-screening technologies, their onboarding and monitoring filters are more vulnerable to scammers, who know all too well how to game the system.

[2] https://www.sba.gov/sites/default/files/2020-05/PPP2%20Data%2005012020.pdf
[3] https://www.bankdirector.com/issues/cutting-compliance-costs-regtech/
[4] https://blogs.wsj.com/riskandcompliance/2015/05/12/more-regulation-leading-to-more-enforcement-against-community-banks/

Given the amount of PPP funds were loaned out by the SBA during second round of small business stimulus, it follows that some not-insignificant percentage of these loans were misappropriated by fraudsters.

The Department of Justice announced in May that they are cracking down hard on fraud in the government's emergency lending program[5]. Specifically, the Treasury Department has said it plans to audit cases where small businesses received $2 million in PPP funds, and to conduct "spot" checks for smaller loans[6].

Also, the Federal Bureau of Investigation testified before the Senate Judiciary Committee in June and said they formed a PPP Fraud Working Group in coordination with the Justice Department's Fraud Section and the SBA's Office of Inspector General. So far, the working group has initiated 100 investigations, "with over $42 million in potential fraud identified and over $900,000 recovered.[7]"

Lastly, organizations should also be on alert for heightened fraud risks related to economic injury disaster loans (EIDLs). A recent joint report issued by the SBA and government watchdog, the Office of Inspector General, cited "more than 5,000 instances of suspected fraud from financial institutions receiving economic injury loan deposits[8]."

Among active investigations cited by the SBA, a federal credit union reported to the Criminal Division of the DOJ, that it had flagged 59 percent of some $15 million in recent SBA EIDL deposits for fraud[9].

[5] https://www.wsj.com/articles/justice-department-eyes-fraud-in-lending-program-for-small-businesses-hit-by-coronavirus-crisis-11588716487#

CYBER RISKS

4 Quadrants of Pandemic Risk

A recent study by threat intelligence firm VMware Carbon Black attributed business disruption caused by the pandemic to a "238% surge in cyberattacks against banks[9]"
The increase in remote working, the use of virtual private networks, and the expanding digital attack surface in general, has only compounded the problem.

What's more is, just like regulatory technology (regtech), compliance costs related to Dodd Frank reform legislation have similarly placed community FIs out of the market for leading-edge cybersecurity platforms.

Thus, as attacks against community FIs continue to escalate, boards must reinforce the importance of cybersecurity and cyber-related operational resilience concerns to their management teams.

Industry trade organization Independent Community Bankers of America notes that, during the pandemic, three types of attacks have proliferated against smaller FIs. As such, management teams should anticipate the persistent threat of these attacks to their institutions.

The attack vectors highlighted by the ICBA include[10]:

- Phishing attempts using COVID-19-related issues as lures
- Advance -fee scams requiring up-front payment for products that do not exist
- Attacks on technologies required for remote work – like video chat apps and virtual private networks

[6] https://www.wsj.com/articles/justice-department-eyes-fraud-in-lending-program-for-small-businesses-hit-by-coronavirus-crisis-11588716487#
[7] https://www.wsj.com/articles/sba-to-face-big-challenges-ensuring-coronavirus-loans-arent-misspent-11588094140?mod=article_inline
[8] https://www.fbi.gov/news/testimony/covid-19-fraud-law-enforcements-response-to-those-exploiting-the-pandemic[9] https://www.zdnet.com/article/covid-19-blamed-for-238-surge-in-cyberattacks-against-banks/

The FBI identified two cases of BEC fraud that directly impacted FIs in their June Senate testimony. In the first case, an FI received an email, "allegedly from the CEO of a company, who had previously scheduled a transfer of $1 million, requesting that the transfer date be moved up and the recipient account be changed 'due to the Coronavirus outbreak.' The scammers' email address was nearly identical to the CEO's, except, save for one letter[8].

In the second case cited by the FBI, "a fraudster spoofed the email address of a CEO who had been approved for a PPP loan, contacted the financial institution facilitating the loan and requested that the PPP funds be transferred to a new account at a different institution[8]." To help community banks navigate the COVID-19 threat landscape, ICBA has created a resource page that assists bankers in mitigating cyber risk[8].

{9] https://www.zdnet.com/article/covid-19-blamed-for-238-surge-in-cyberattacks-against-banks/
[10] https://www.icba.org/news/blog-details/main-street-matters---innovation/2020/06/01/cybersecurity-in-the-time-of-covid-19

In the rush to alleviate borrowers' liquidity pains, community FIs are increasingly overlooking traditional AML safeguards and banking riskier clients, with reduced diligence. President Trump himself even signed an Executive Order in May, urging regulators - including bank watchdogs – to "address this economic emergency by rescinding, modifying, waiving, or providing exemptions from regulations and other requirements that may inhibit economic recovery[11]."

For money launderers, the current regulatory chaos thus represents the optimal environment to exploit relaxed customer screening and transaction-monitoring loopholes. The most pressing AML threat to community FIs right now is likely money mules, according to the FBI.

The Bureau told the Senate that, "with the U.S. unemployment rate soaring and large numbers of people being secluded at home, fraudsters are increasingly targeting individuals through 'work from home' opportunities or dating websites to use as money mules[8]."

To clean their illicit proceeds, scammers "frequently scam other people, known as money mules, into moving this illicit money for them," testified the FBI. Mules "are asked to receive funds in their personal bank account and then "process" or "transfer" funds via wire transfer, ACH, mail, or money service businesses," like Western Union or MoneyGram[8].

[11] https://www.whitehouse.gov/presidential-actions/executive-order-regulatory-relief-support-economic-recovery/

Are Payments The Cure?

Grappling with unprecedented credit risks, PPP loan scams, proliferating cyberattacks, and AML threats, community FIs and credit unions need to innovate new fee models to properly capitalize their compliance operations. As such, partnering with emerging mobile peer-to-peer (P2P) payments platforms might help them capture desperately needed revenue streams that have so far eluded them.

But in order to do so, independent FIs must overcome their cumbersome technological debt, invest in innovation, and provision for the additional risk exposures that mobile p2p platforms inevitably portend. According to PYMNTS, “it's a widespread view that many community banks cannot offer that technological edge that so many customers, both consumer and corporate, demand.[12]”

PYMNTS cautions that as new payment rails emerge, small banks must onboard these services to survive. These technology stacks must be interoperable so customers can transact across their various payment networks without losing the convenience of real-time transaction processing. It follows that in this unprecedented crisis, next-gen mobile P2P platforms may be the vaccine that immunizes community FIs from the contagion of compliance risk, if not total insolvency.

In conclusion, to cap off our analysis of the current risk environment, bank boards and senior management have been proactive and responsive to the needs of employees and customers during this health crisis. But the work is not over. Leaders are encouraged to be creative in their strategic planning. This entails embracing change and responding nimbly to rapidly changing business conditions.

[12] https://www.pymnts.com/news/b2b-payments/2020/community-banks-embrace-faster-payments-competitive-edge/

CONCLUSION

4 Quadrants of Pandemic Risk

Now is the time to review all products, services, and lines of business to determine which ones are no longer suitable for the current business environment. With the pandemic accelerating the migration of consumer purchasing behavior almost exclusively into the online realm, it's critical to reevaluate your customer's preferred transactional experience. It may even help to send out a survey or two, incentivizing customers with financial promotions.

Following last week's ABA Conference, and the general social zeitgeist over the last few months, diversity and inclusion are additional themes that should be on the agendas of bank leadership. Boards are encouraged to consider opportunities to diversify by adding members with varying expertise and viewpoints. Lastly, the message from ABA and our industry experts remains consistent: The timely and accurate reporting of compliance risks and trends is vital for institutions.

If your community financial institution is seeking guidance on how to build a more sustainable compliance organization and transform the risk-management cost center into a revenue driver, RADD LLC is here to help.

Thank you.

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