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OCC Highlights Key Risk Trends For Banks in Semi-Annual Report

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The Office of the Comptroller of the Currency (the “OCC”) recently issued the agency's semi-annual perspective on key risks facing banks in 2024 with a special focus on potential threats to safety and soundness. The OCC provided an overall assessment of the operating environment for banks, noting that the general condition of the federal banking system is sound and that banks are operating in an economy that has outperformed forecasts. However, the report notes emerging headwinds for banks, including the possibility of prolonged elevated interest rates and the need to manage funding costs, weaker loan growth and higher credit costs.

The report highlights four discrete areas of potential risk for banks in the current operating environment:

Credit Risk

The OCC report indicates that distress in certain commercial real estate (“CRE”) sectors, including the office sector and the multifamily property sector, will continue to expose banks to heightened commercial credit risk. Although CRE loan growth has slowed, the OCC cautions that concentrations in this sector continue to pose a heightened risk. The report notes that certain geographies, including New York and California, create greater exposure to CRE credit risk. From an operational perspective, the OCC is concerned that distress in the CRE sector could strain the credit risk review and workout functions at some banks where staffing with appropriate expertise in these areas has been an issue.

Although CRE exposure continues to challenge many banks, the OCC report is somewhat more sanguine about credit risk in the mortgage and retail credit sectors. Several factors explain the hopeful outlook for these sectors, including historically low levels of mortgage loan and retail credit delinquency and loss rates that are moderating to long-term averages. But there are headwinds that could change the trajectory for both sectors. Higher than projected inflation rates, increasing payment levels for homeowners, and loans with weaker loan-to-value ratios will all be considerations for banks as they manage credit risk. Banks are urged to maintain sound governance around the lending function and to maintain documentation of the assumptions and judgments that influence lending to ensure that loan loss allowances are adequate.

Market Risk

The OCC reports identifies continuing competition for deposits and increasing reliance on broker deposits as factors that could increase market risk for many banks. While noting that deposit rate acceleration and pressure on net interest margins “may be nearing a peak,” continuing uncertainty around the direction, timing and extent of interest rate shifts continue to challenge the way banks model and project deposit rates. The report warns that inaccurate deposit assumptions could result in unreliable internal modeling that distorts a bank’s true interest rate and liquidity risk.

Operational Risk

According to the OCC, managing operational risk continues to pose significant concerns in the banking sector. The report cites five specific areas that are accelerating operational risk:

- Banks are facing a cybersecurity environment where bad actors are becoming more sophisticated and pervasive.The report urges banks to maintain heightened threat monitoring and effective controls to safeguard against cyberattacks.According to the OCC, weak or poorly configured authentication systems are opening the door to cybersecurity incidents that create the potential for operational disruption, data compromise or financial loss.

- The report encourages banks to enhance their operational resilience to mitigate the effect of disruptive events like cybersecurity incidents.This caution includes a review of “contagion risk” from third party vendors.

- Many banks have pivoted their business plans to the adoption of new technology and the introduction of new products.The OCC risk report encourages banks to recognize that these innovations create a complex operating environment that requires effective pre-introduction due diligence and effective risk management processes.The report notes that, as banks increasingly consider artificial intelligence as means to create operational efficiencies, new challenges will emerge for the compliance and operational risk functions.The report also reminds banks that entry into crypto-asset markets and products requires prudent risk management and adherence to regulatory approval guidelines.

- The report includes a reminder that banks increasingly confront fraud schemes targeting the banks and their customers.The potential for fraud increases, the report notes, as bank adopt digital models that are outside of traditional payment channels such as checks and wire transfers.

- Banks are increasingly dependent on third-party relationships to deliver products and services.The report urges banks to maintain effective management and oversight of such relationships, particularly where they support high risk and critical activities.

Compliance Risk

The report identifies two areas of continuing concern in the compliance area:

- Deficiencies in BSA/AML and OFAC compliance are still a significant concern for the OCC.Banks are reminded to monitor staffing and in-house expertise levels in these areas to ensure adequate coverage of key process like customer identification and verification at all stages of the banking relationship.

- The report also includes a reminder of the compliance risks associated with the delivery of banking products and services to consumers, including adherence to the requirements of the Community Reinvestment Act.The OCC notes that banks are required to maintain a compliance risk management framework that cover all pertinent consumer-friendly statutes and regulations.In addition, banks are urged to proceed with caution as they introduce artificial intelligence and machine learning technologies into the customer service, underwriting, and lending functions to ensure that risk management adequately considers the impact on fair lending and the equitable provision of banking services.

The semi-annual risk OCC risk perspective report is an important window into the OCC's current thinking on areas that may receive special scrutiny through the supervisory process. Bankers are urged to benchmark their current operations against the report to ensure that consideration is given to key areas of regulatory concern that could become an issue during an exam.