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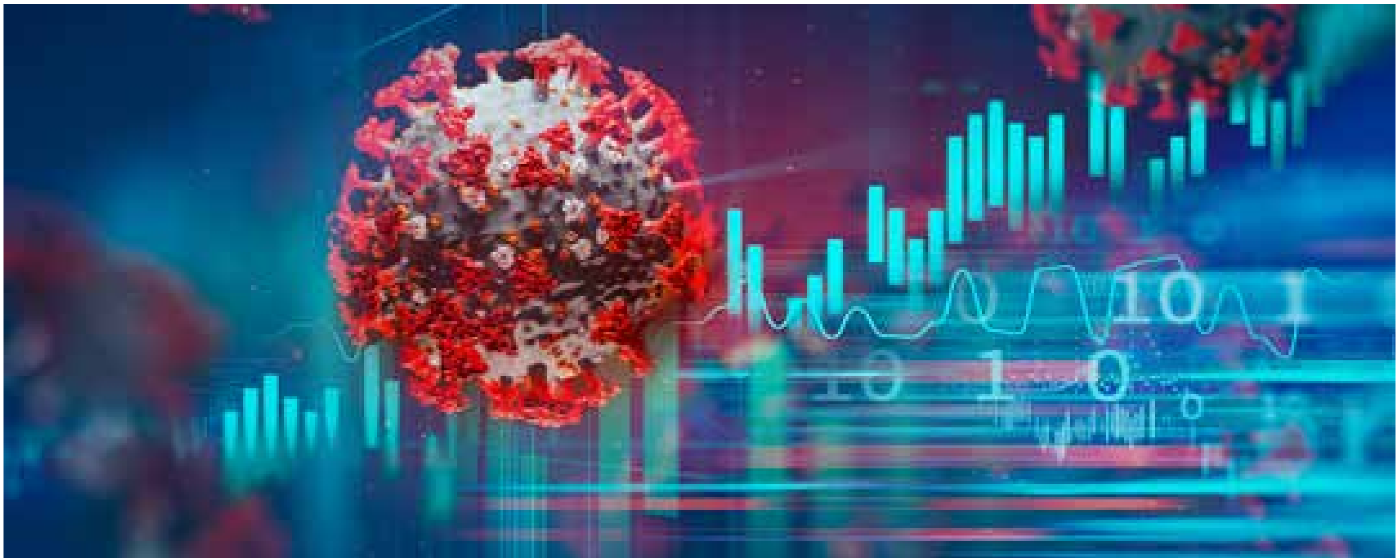

WHITE PAPER

March 2020

Coronavirus—Strategic Considerations for Financial Institutions and Their Boards

This *White Paper* discusses financial institution regulators' responses and requirements with respect to the novel coronavirus (COVID-19) pandemic, together with the planning and actions that financial institutions should consider.

We address the responsibilities of financial institution boards of directors and management to conduct business impact analysis and business continuity planning, and to maintain business resilience and recover from the effects of the pandemic. These include discussions of: employee protection, customers and counterparties, liquidity and capital actions, investors, and regulatory actions and relief.

The regulatory requirements build upon experience gained during the credit crisis, and the goals of the Dodd-Frank Act and the financial institution regulators, to ensure critical financial services during and following a pandemic or similar event of uncertain but potentially long duration.

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The worldwide novel coronavirus (COVID-19) pandemic is adversely affecting labor markets, supply chains, production and trade, and financial markets. Financial institutions have a crucial financial and economic role, and they need to provide continued services through potentially multiple waves of the pandemic, each of which may last two to three months, according to U.S. officials. Effective pandemic responses require clear identification of the risks, business continuity planning and management, strategic and risk management, and communication to financial institutions' multiple stakeholders.

The FFIEC[1] issued an "Interagency Statement on Pandemic Planning" on March 6, 2020 ("Interagency Statement"), which builds upon the regulators' experience with avian flu in 2007 and other disasters.[2] These provide useful insight on business interruptions greater in magnitude, complexity, duration, and geographic scope than ordinary disasters or emergencies. Planning and responding to coronavirus, and other similar health crises and disasters, are necessary parts of the business continuity management required of financial institutions.[3]

The Interagency Statement states that financial institution boards of directors are responsible for overseeing the development of a pandemic plan and ensuring that senior management is investing sufficient resources to implement such plans. Senior management is responsible for developing the pandemic plan and effecting it, as well as communicating the plan and keeping it up to date.

Earlier Federal Reserve supervisory letters also address the largest financial institutions and their need to maintain sufficient "capital and liquidity, and operational resilience by maintaining effective corporate governance, risk management and recovery planning," and boards of directors' responsibilities for planning and recovering from pandemics and similar events. Smaller institutions may find that these letters provide some useful guidance adaptable to their size and situation.[4]

BUSINESS IMPACT ANALYSIS

The process starts with business impact analyses and continuity management planning to maintain financial services through a pandemic. The business impact analysis and risk management should:

- Identify the most significant effects on the company's markets and its loan and deposit customers, and counterparties, as well as issuers of securities held. For example, customers that depend on long or complex supply chains may be especially affected by coronavirus.

  Stress testing should be adapted and conducted in light of the anticipated effects of coronavirus pandemic. Many customers may encounter reduced cash flows from operations and may draw on lines of credit or letters of credit, or be unable to meet their current obligations to their lenders. Therefore, banks may need greater liquidity to fund their credit commitments, while at the same time they may experience net deposit outflows as businesses and consumers have less cash flows to deposit and spend existing deposits.
- Identify legal and regulatory requirements to conduct business. For example, bank branches generally may not close without prior regulatory approval under Section 42 of the Federal Deposit Insurance Act.
- Estimate and minimize the downtime that may occur in business processes.
- Assess cross training and succession for key business positions, where absenteeism may be up to 40% in a severe pandemic. Who is the "next person up" if key persons or their families need to "self-isolate" as a result of contact with the virus?
- Evaluate and monitor service providers' and processors' business continuity plans and expectations for the pandemic, their ability to continue uninterrupted services at acceptable levels, and any issues they may begin to experience as a result of the virus.
- Determine remote access capabilities for employees and provide sufficient resources so that substantially larger than normal numbers of people can work effectively offsite.
- Evaluate potential changes in the size and composition of the organization's balance sheet.
- Evaluate maturing deposits and debt obligations, and consider how to replace these in stressed, volatile markets.

EMPLOYEE PROTECTION

Financial institutions should engage in preventative measures, including:

- Educate employees and service providers to prevent the spread of the virus using resources such as the Centers for Disease Control and the Department of Homeland Security for guidance.
- Limit travel and in-person meetings.
- Regular deep cleaning of work spaces.
- Telecommuting.

CUSTOMERS AND COUNTERPARTIES

Estimating the effects on customers, depositors, borrowers, and other counterparties are essential in a pandemic. Among other things, financial institutions should consider:

- The cash and liquidity needs of customers. Banks need sufficient liquidity to provide continuity of services to customers by making cash and access to existing credit and cash available conveniently. New credit should be extended prudently.
- The risks of customers affected by the coronavirus, including on their cash flows and ability to service debt or perform their obligations. The credit quality and grading of loans and securities should take into account the anticipated effects of coronavirus. Industry concentrations, as well as shared national credits and highly leveraged loans, may be especially vulnerable as a result of the pandemic.
- Market interest rates approaching zero may substantially change risks. For example, an extended period of declining rates and declining securities prices are likely to reduce pension plan funding levels and increase plan provider costs and risks.
- Evaluate the provision and allowance for loan losses, especially for public institutions utilizing new FASB ASU No. 2016-13 and its current expected credit losses methodology ("CECL") for a wide variety of financial instruments beginning January 1, 2020. The new CECL models may have to be adjusted, at least temporarily, in light of the pandemic and its effects upon borrowers and resulting expected losses. Consumer loans may be especially affected.
- Financial institutions should also evaluate how to remotely service customers and operate without in-person contact.
- Customer evaluations and risk assessments should be communicated throughout the organization as part of the disclosure controls for public financial institutions.

LIQUIDITY AND CAPITAL ACTIONS

Customers tend to use bank lines of credit more when their businesses and cash flows are stressed. Banks should maintain liquidity and funding sufficient to meet their obligations under lines of credit and credit commitments. Maturities of outstanding deposits and debt should be scheduled and plans prepared to replace such obligations. Reduced interest rates may make it easier for banks to obtain relatively low-cost deposit funding through the internet, reciprocal deposits, and brokered deposits. FDIC insured deposits should be especially attractive in a yield-challenged, risk-averse market.

The availability and continued availability of wholesale funding such as correspondent lines of credit, Federal Home Loan Bank advances, federal funds lines, repurchase agreements ("repos"), and brokered deposits should be confirmed and monitored. Continued volatility and disruptions in the repo markets, and related Federal Reserve intervention and support in the repo market, should be considered, together with the availability and costs of collateral required by the bank to support its obligations.

Public institutions should maintain universal shelf registration statements and stock repurchase programs. The shelf registration statements allow issuers to take advantage of potentially limited market windows to issue a broad range of debt and equity to raise capital or fund liquidity, as needed.

Stock repurchase programs allow issuers to buy back stock from time to time, especially when stock prices are depressed. Banking institutions should carefully consider existing or new stock repurchase programs in light of the pandemic and their anticipated earnings, existing dividend levels, and anticipated liquidity needs, as well as regulatory requirements. A repurchase program does not require immediate spending but provides the issuer with flexibility.

Bank and thrift holding companies are required to serve as a source of strength to their depository institution subsidiaries.[5] Bank holding companies must provide the Federal Reserve prior notice of the proposed net repurchase of their equity securities amounting to 10% or more of their net worth in any 12-month period.[6] Repurchases or redemptions of capital instruments should be coordinated with the Federal Reserve in advance.

Federal Reserve Supervisory Letter SR-09-4 (Feb. 24, 2009, rev'd. Dec. 21, 2015) applies to dividend payments, stock redemptions, and stock repurchases. Prior consultation with the Federal Reserve is required before:

- Redemptions or repurchases of capital instruments when the bank holding company is experiencing financial weakness; and
- Redemptions and purchases of common or perpetual preferred stock that would reduce Tier 1 capital at the end of the period compared to the beginning of the period.

Bank holding company directors must determine a dividend level that is prudent relative to maintaining a strong financial position and is not based on overly optimistic earnings scenarios. As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should consult with the Federal Reserve and eliminate, defer, or significantly reduce the bank holding company's dividends if:

- Its net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
- Its prospective rate of earnings retention is not consistent with its capital needs and overall current and prospective financial condition; or
- It will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Similar limitations apply to securities repurchases and redemptions. It is premature to generally suggest cutting dividends, since dividend policy is long term and dividend reduction cuts reduce investor confidence and have especially adverse market effects. Planning appropriately, however, is recommended to project capital and liquidity levels and requirements, and to protect shareholder value. Although share repurchase may provide substantial value at this time, financial institutions should consider and discuss with their regulators material planned share repurchases and their projected capital, liquidity, and earnings in light of the pandemic.

The Financial Services Forum, an association of the eight largest U.S. banking organizations, announced on March 15, 2020, that its members were temporarily suspending share buybacks through June 30, 2020:

> The COVID-19 pandemic is an unprecedented challenge for the world and the global economy and the largest U.S. banks have an unquestioned ability and commitment to supporting our customers, clients, and the nation.
>
> The decision on buybacks is consistent with our collective objective to use our significant capital and liquidity to provide maximum support to individuals, small businesses, and the broader economy through lending and other important services. The decision is consistent with actions by the Federal Reserve, the administration, and the Congress.

On the same day, the Federal Reserve stated that U.S. bank holding companies have substantial levels of capital and liquidity in excess of regulatory minimums and buffers and:

> These capital and liquidity buffers are designed to support the economy in adverse situations and allow banks to continue to serve households and businesses. The Federal Reserve supports firms that choose to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner.

On March 17, 2020, the OCC and the FDIC joined the Federal Reserve in issuing an interim rule changing the definition of "eligible retained earnings" to permit banking organizations to maintain continuity of their lending and financial intermediation through releases from their capital buffers. The agencies encouraged "banking organizations to make prudent decisions regarding capital distributions" during the current period of stress.

The current Basel III Capital Rules further limit permissible dividends, stock repurchases, and discretionary bonuses by banking organizations, unless these meet capital conservation buffer requirements. During the last period of financial stress, both the capital markets and the regulators emphasized institutions' tangible common equity as a measure of quality and safety. Tangible common equity and the Basel III "Common Equity Tier I Capital" ("CET1") should be considered in light of risks, peer ratios, and currently risk-averse capital markets.

INVESTORS

Institutions that are public, and to a lesser extent nonpublic financial institutions, need to consider their investor communications and disclosures. Such disclosures should accurately describe the anticipated effects of coronavirus on the institution and actions being taken by the institution, especially in light of volatile markets, changing monetary and regulatory actions, and low rates of interest. Investor communication is an important part of planning and implementing responses to the pandemic, maintaining public confidence and access to markets, and complying with applicable securities laws.

Among other things, public financial institutions should consider:

- Describing the effects of monetary policy, lower market interest rates, and the shape of the yield curve on their net interest income, net interest margin, and net income.
- Describing credit risks and trends, including delinquencies and "troubled debt restructurings" and changes in credit quality and the allowance for possible loan losses. Loan concentrations by industry, shared national credits, and highly leveraged loan exposures warrant careful attention and potential disclosure. Changes in the provision for loan losses arising from the pandemic and CECL should be described.
- Considering the adequacy of the allowance for possible loan losses in light of the pandemic's expected effects.
- Providing a management's discussion and analysis in SEC quarterly and annual reports and investor presentations that explains the organization's pandemic planning, asset/liability position, and anticipated balance sheet adjustments and derivative positions and strategies to compensate for reduced market rates, and the anticipated effects on profitability.
- Depending on a company's particular circumstances, it should consider whether it may need to revisit, refresh, or update previous disclosure to the extent that the information becomes materially inaccurate.
- Adding information regarding the anticipated effects of the pandemic to their risk factors and forward-looking statements.
- Adjusting funding and the balance sheet to maintain sufficient liquidity in volatile and uncertain markets, where customers may draw more heavily on their credit lines, which may require banks to maintain higher funding.
- Holding virtual shareholder meetings or otherwise discouraging personal attendance to the extent consistent with state, corporate law, applicable securities laws, and health emergency actions limiting the size of meetings.[7]
- Seeking delays in SEC and bank regulatory reports in appropriate circumstances.[8]

REGULATORY ACTIONS AND RELIEF

Monetary Policy

The Federal Reserve stated on February 28, 2020, that it was closely monitoring coronavirus developments and their effects on the economic outlook, and would act appropriately to support the economy. On March 3, 2020, the Federal Reserve:

- Reduced the target federal funds rate by 50 basis points to 1.00% to 1.25%.
- Announced it was purchasing Treasury bills into the second quarter of 2020, conducting overnight repurchase agreement operations at least through April 2020, and continuing to reinvest amounts of principal received by the Federal Reserve on its portfolio of treasury and agency debt and mortgage-backed securities.
- Reduced the interest it pays on excess reserves from 1.60% to 1.10%.

Such reductions in interest rates have created volatility in the financial markets, including the repo markets, which may adversely affect systemic liquidity, and financial institutions' net interest income and margins and profitability. At the same time, these reduced potential costs of funding and liquidity.

On March 12, 2020, and continuing through April 13, 2020, the Federal Reserve Bank of New York's Open Market Trading Desk ("Desk") will offer at least $175 billion in daily overnight repo operations and at least $45 billion in two-week term repo operations twice per week over this period. In addition, the Desk will offer three one-month term repo operations, beginning March 12, 2020. The amount offered for each of these three operations will be at least $50 billion. On March 12, the three- and one-month repo program was expanded by $1.5 trillion, "to address highly unusual disruptions in Treasury financing markets associated with the coronavirus outbreak." One day later, the Desk announced $33 billion of immediate purchases of short- and long-term treasuries, as part of $80 billion of planned monthly securities purchases.

In addition to these earlier actions, and allowing banks to use their excess capital and liquidity to support their customers and the economy, the Federal Reserve took these further measures on March 15, 2020, to support employment and price stability in light of the pandemic's potential economic effects:

- Federal Reserve holdings of Treasury securities will be increased by at least $500 billion and agency mortgage-backed securities by at least $200 billion. The Committee will also reinvest all principal payments from the Federal Reserve's holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities.
- Reduced reserve requirement ratios to zero percent effective on March 26, 2020, the beginning of the next reserve maintenance period. This action eliminates reserve requirements for thousands of depository institutions.
- Encouraged banks to make greater use of the Federal Reserve discount window by reducing the primary credit rate by 150 basis points to 0.25 percent, effective March 16, 2020.
- Encouraged depository institutions to utilize intraday credit extended by Reserve Banks to support the provision of liquidity to households and businesses and the general smooth functioning of payment systems.
- Lowered the target federal funds rate by 1.00% to 0 -.25%.
- Directed the Desk to conduct overnight reverse repurchase operations (and reverse repurchase operations with maturities of more than one day when necessary to accommodate weekend, holiday, or similar trading conventions) at an offering rate of zero percent.

The Federal Reserve may provide additional liquidity through its intervention in the repo market, securities purchases, and other measures.

Other Regulatory Actions

On March 9, 2020, the state and federal depository institution regulators issued a joint press release "Agencies Encourage Financial Institutions to Meet Financial Needs of Customers and Members Affected by Coronavirus" ("March 9 Release"). The regulators encouraged financial institutions to work constructively with their borrowers and other customers in affected communities. "Prudent efforts that are consistent with safe and sound banking lending practices should not be subject to examiner criticism." Where staffing challenges exist, the regulators will consider requests to provide more convenient availability of services in affected communities and work with financial institutions in scheduling exams or inspections to minimize disruptions and burdens to the institutions. The "Interagency Supervisory Examiner Guidance for Institutions Affected by a Major Disaster" may also be useful.

Federal Reserve Supervisory Letter SR 13-6 "Supervisory Practices Regarding Banking Organizations and Their Borrowers and Other Customers Affected by a Major Disaster or Emergency" (March 29, 2013) focuses on major emergencies or disasters declared by the President, which was declared by the President on March 13, 2020.[9] However, the March 9 Release indicates regulatory flexibility. As a result of the emergency declaration, more extensive regulatory relief may be granted.

The bank regulators also could permit financial institutions to take actions similar to those permitted in disasters and emergencies such as:

- Providing accommodation services to customers to make cash available, waiving certain fees and early withdrawal penalties, permitting increased borrowing by creditworthy customers, waiving late fees, etc.
- Restructuring loans in a prudent matter. Bank examiners will take into account such measures in light of the circumstances, and banks will not be subject to criticism for engaging these efforts where restructure loans have weaknesses that result in adverse classifications or credit risk downgrades.
- CRA credit may be claimed for up to 36 months for emergency or disaster areas, with greater weight given to benefits provided to low-to-moderate income areas.

The current pandemic has caused approximately 39 states so far to declare states of emergency. State bank regulators are also taking action through the CSBS and individually. For example, the New York Department of Financial Services issued on March 10, 2020, "Guidance to New York

State Regulated Institutions and Request for Assurance of Operational Preparedness Relating to the Outbreak of the Novel Coronavirus and Guidance to New York State Regulated Banks, Credit Unions and Licensed Lenders Regarding Support for Businesses Impacted by the Novel Coronavirus." This guidance builds upon the Interagency and FFIEC guidance. Financial institutions should consider carefully state and local actions prompted by coronavirus in the states where they have offices or conduct business.

Financial institutions should communicate frequently with their regulators regarding their planned responses to coronavirus and actions they may take. Such communications should be made early with an understanding that the regulators may also be thinly staffed or working remotely, and that responses may be delayed. The regulators have worked with financial institutions in the event of disasters to provide continuity of service and economic recovery, and we expect them to continue this practice with the current pandemic.

CONCLUSION

Financial institutions serve an essential role in the economy and in the communities that they serve, and collectively they are systemically important. The Dodd-Frank Act and regulatory responses in the credit crisis emphasized maintaining the availability of bank credit and services to customers through major disruptions. Financial institutions need a similar focus on business continuity to successfully operate through the coronavirus pandemic.

The financial system is much more resilient with greater liquidity and capital since the credit crisis. Financial institutions are operating from strength and can best deal with pandemics through appropriate risk and continuity planning and actions throughout their businesses. These include keeping financial institution employees, customers, regulators, and investors informed and confident in the financial institutions' responses to coronavirus.

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ENDNOTES

1 The Federal Financial Institutions Examination Council currently includes the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), the National Credit Union Administration ("NCUA"), and the Consumer Financial Protection Bureau and the State Liaison Committee, including representatives from the Conference of State Bank Supervisors ("CSBS") and state thrift and credit union regulators.

2 *See* "Interagency Statement on Pandemic Planning" (Dec. 12, 2007); the OCC, Federal Reserve, and SEC "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System" (April 11, 2003); and the FDIC "Lessons Learned from Hurricane Katrina: Preparing Your Institution for a Catastrophic Event" (Apr. 1, 2008).

3 *See* the FFIEC *Information Technology Examination Handbook—Business Continuity Management* (Nov. 2019) and FDIC National Support Resources.

4 SR 14-8 "Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies" (Sept. 20, 2014); SR 14-1 "Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies—Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions" (Jan. 24, 2014); and SR 12-17 "Consolidated Supervision Framework for Large Financial Institutions" (Dec. 17, 2012).

5 Federal Deposit Insurance Act Section 38A and Federal Reserve Reg. Y §225.4(a).

6 Federal Reserve Reg. Y §225.4(b).

7 *See* SEC Press Rel. No. 2020-62 (Mar. 13, 2020) providing guidance relief for shareholder meetings in light of coronavirus and Press Rle. 2020-63 (Mar. 13, 2020) with respect to investment companies and investment advisers.

8 *See* SEC Rel. No. 34-88318 (Mar. 4, 2020) and Federal Reserve SR 13-6.

9 *See* 42 U.S.C. 5122, 5170, and 5191.