Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

5 Risk Areas For Banks One Year Into The COVID-19 Crisis

By **Jon Hill**

Law360 (March 12, 2021, 5:11 PM EST) -- The banking industry has weathered the initial shock of the coronavirus pandemic and is holding steady one year later, but financial institutions still face significant legal risks tied to borrower accommodations, small business relief lending and cybersecurity.

Thursday marked the one-year anniversary of the World Health Organization's declaration that COVID-19 was a pandemic, an announcement that came as the virus panicked financial markets and sent federal regulators scrambling to cushion the economic blow.

Even though the coronavirus has since left a devastating trail of lost lives and hardship in its wake, some of the worst initial fears of a banking sector meltdown haven't come to pass. Instead, banks of all sizes "have held up quite well," as Federal Reserve Chairman Jerome Powell told lawmakers last month, and the brightening U.S. economy could spur further recovery for the industry.

But financial services attorneys told Law360 that a variety of pandemic-related risks continue to loom for banks, particularly under the new, more enforcement-prone Biden administration taking shape in Washington.

"I do think that the one year mark is very significant in terms of compliance challenges and liability exposure for financial institutions," said Stroock & Stroock & Lavan LLP partner Quyen Truong.

Here, Law360 looks at five of the most pressing risks for the banking sector.

Forbearance 'Confusion'

When the pandemic struck last year and left millions out of work, federal regulators urged financial institutions to offer loan payment deferrals and other concessions to accommodate struggling borrowers, and Congress tucked federal mortgage and student loan forbearance provisions into its first pandemic relief package, the Coronavirus Aid, Relief and Economic Security Act.

The CARES Act also contained certain foreclosure protections that, when combined with numerous other restrictions that state authorities put in place on foreclosure and debt collection, promised to give borrowers additional breathing room.

But Kali Bracey, co-chair of the consumer law practice at Jenner & Block LLP, told Law360 there is still "a lot of confusion" about forbearance eligibility, options and the protections that come with them, particularly for mortgage loans.

That problem is already on the radar of regulators like the Consumer Financial Protection Bureau, whose acting Director Dave Uejio has issued statements in recent weeks putting industry on notice that the agency will be cracking down on noncompliance with the forbearance provisions and other borrower protections found in the CARES Act.

"This is definitely an area of legal risk for large institutions and small that do servicing," Bracey said. "They need to make sure that consumers have the correct information and are being treated fairly — for instance, not being told that they have to be in default and miss a mortgage payment in order to be put into forbearance."

How forbearances and other pandemic-related accommodations show up on borrowers' credit reports is another area where financial institutions can expect to see heightened CFPB scrutiny going forward, according to Bracey.

The CARES Act generally forbade banks and other creditors from negatively reporting such accommodations to the credit bureaus, but Uejio has said there have been instances of violations.

The agency has also seen a surge in consumer complaints about credit reporting since the start of the pandemic.

"Financial institutions should be monitoring consumer complaints," Bracey said. "Those are always the canary in the coal mine, because they let companies know where the problems may be."

Sticking the Forbearance Landing

Many loans that might have been in forbearance last year will be exiting those arrangements this year, as those measures were never meant to be permanent. That means the banks holding these debts will face the tricky task of figuring out next steps with their borrowers — a process fraught with additional potential legal risks.

"Financial institutions will have to walk a fine line and make a lot of judgment calls about how they will comply with both the letter and the spirit of the CARES Act, state executive orders and other legal requirements and guidance," said Stroock's Truong, a former CFPB assistant director.

For one, at the end of a forbearance period, a bank has to determine whether and when a borrower is able to begin catching up on missed payments as well as regular payments.

If some borrowers are consistently getting better workout plans than others, a bank could find itself on the receiving end of a fair lending enforcement action. Or if a bank lacks a solid customer communication program, it may not have enough information to know how to proceed post-forbearance without risking financial harm to the borrower.

And if the early stages of the forbearance process were mismanaged — for example, by failing to properly disclose what a borrower can expect as far as interest and missed payments — the conclusion of the forbearance period is when those problems can become apparent.

"The chickens can come home to roost with the end of forbearance arrangements in many cases," Truong said.

Relief Loan Hangovers

The CARES Act also established the Paycheck Protection Program, through which banks and other lenders have channeled roughly $690 billion in federal pandemic relief funding to more than 7.5 million small businesses since last spring. PPP funding takes the form of forgivable loans and comes with some strings, but the program was generally designed to pump out money quickly in hopes of saving as many jobs as possible.

But the program's easy access and rapid, often chaotic rollout also made it an attractive target for fraud. For instance, one preliminary estimate **produced last fall** by Democratic House staffers suggested that design and implementation flaws "may have led to billions of dollars being diverted to fraud, waste, and abuse."

Since last year, federal prosecutors have brought dozens of cases in which PPP borrowers are alleged to have claimed **fictitious small businesses**, inflated loan amounts or blown the money on **sports cars**, **pricey jewelry** and other improper expenses.

So far, banks have been acting as partners with the U.S. Department of Justice in investigating PPP fraud, said Covington & Burling LLP senior counsel Jean Veta, a longtime banking enforcement litigator.

"Indeed, the banks were victims in these frauds," Veta said. "However, it doesn't take much to imagine that down the road, the spotlight could turn on the banks themselves."

Veta said it's a distinct possibility in the months ahead that federal enforcement authorities could try to argue that some banks that got caught up in these PPP fraud cases either knowingly processed bogus loan applications or didn't have adequate controls and safeguards to keep bad actors from applying in the first place.

That could present the potential for liability under laws like the False Claims Act and Bank Secrecy Act, both of which have previously been used to costly effect against financial institutions.

"There are some assurances now out there about False Claims Act [liability], but I'm not sure that anybody is really hanging their hat on it," said Courtney Dankworth, a litigation partner at Debevoise & Plimpton LLP. "And we know that in a Democratic administration, False Claims Act cases can sometimes pick up in relation to other types of civil enforcement actions."

Still, Veta said she believes banks could have good defenses available to such claims. For one, PPP lenders were given wide berth at the outset of the program to rely on borrowers' own certifications at the initial application and later loan forgiveness stages, and are not expected to police borrowers' compliance with the program's rules more generally.

"People may forget that when the program started, banks were drinking from a firehose trying to get much-needed money out the door quickly with very little guidance, and often conflicting guidance," Veta said. "But there's a risk there."

Closing the Gate

Speeding up the pace of PPP lending was also a reason why a number of participating banks chose early on in the program to accept borrower applications only from established customers.

Financial institutions have said these so-called gating policies allowed them to manage intense demand and streamline the anti-fraud and anti-money laundering checks that could otherwise slow down application processing. But the policies have touched off litigation from would-be borrowers and may yet result in fair lending enforcement.

In September, for example, House lawmakers released an oversight report finding that limiting PPP eligibility to existing borrowers wound up excluding many minority- and woman-owned small businesses from the program.

Similarly, in January, the CFPB flagged examiner concerns that gating policies may not have been discriminatory by design, but nevertheless "may have a disproportionate negative impact on a prohibited basis and run a risk of violating [fair lending laws]."

The CFPB's Uejio has since highlighted that finding in explaining why he has moved to prioritize pandemic-related enforcement investigations. And with racial equity issues high on the Biden administration's agenda, fair lending cases are expected to be a renewed area of activity, Debevoise's Dankworth said.

"I think fair lending will be a focus of the regulators and of enforcement actions when it comes to the PPP," Dankworth told Law360. "I do expect we'll see more action there."

Banking From the Bedroom

Like many law firms and other office-based businesses, banks had to make an unprecedented shift to remote work last year when the pandemic turned indoor spaces and in-person operations into health hazards.

Although banks were generally able to manage this transition without major hiccups, Jeremy Newell of Covington & Burling said the widespread adoption of remote work on an open-ended basis has forced financial institutions to confront a host of risk management issues that aren't going away any time soon.

"Some of this shift to remote work will almost certainly be permanent," said Newell, who is a partner in Covington's financial services group. "That is going to pose real long-run challenges in terms of how banks adapt the real core of their processes and procedures to the complexities of large-scale remote work, and I expect that supervisors will want to understand and assess how banks are handling that."

One key focus that is already emerging is cybersecurity, as banks' pivot to virtual work environments and increased reliance on digital processes have created more opportunities for security lapses and other vulnerabilities that malicious actors could exploit.

"Banks' automated systems just weren't designed to focus on people working from home in their spare bedroom," Covington's Veta said.

Federal and state regulators are keenly aware of these cybersecurity challenges, and have urged banks to remain "vigilant" against cyberthreats as well as maintain "effective incident response controls and operational resilience capabilities," as the Office of the Comptroller of the Currency advised last fall.

But even as the arrival of effective COVID-19 vaccines has raised the prospect of returns to the office for many workers, financial institutions will continue to face heightened privacy and cyberrisks going forward — and can expect to be held accountable for it by their regulators and private litigants, according to Stroock's Truong.

That's a function partly of how commonplace remote work is likely to remain even after the virus has abated, Newell noted, as well as how bold and sophisticated cyberattackers have become.

There is also greater government attention on the issue, as shown by the proliferation of legislative, regulatory and litigation activities focused on cybersecurity and data privacy, Truong said.

"The sensitive data that financial institutions possess, the rise in online and mobile activity and the increase in digital data collection, use, access and sharing all heighten these risks," she said.

Cybersecurity breaches can trigger a host of reporting and notice requirements that banks can be penalized for not complying with properly, not to mention costly civil litigation from affected customers. And if regulators find cybersecurity weaknesses in a breach's aftermath, that, too, can turn into an enforcement action.

That's what happened **earlier this month** when New York's Department of Financial Services fined a state-licensed mortgage lender over a 2019 data breach that the agency said wasn't timely reported, among other things. Although that breach predated the pandemic, the case "shows the state's determination to enforce its rigorous cybersecurity rules," according to Veta.

"This [enforcement] risk is not just at the federal level, it's at the state level as well," she said.

--Editing by Alanna Weissman.