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CPAs & Advisors

COVID19 – Hot Topics In Loan Review

Presenter: Timothy Ogburn, Director, BKD Loan Review Services

TOPICS FOR TODAY

A. Credit Risk – Points to Consider
B. Monitoring of Borrowers with Approved Loan Modifications
C. Recommendations for Additional “COVID19” Credit Monitoring
D. TDR Designation vs. Appropriate Risk Rating
E. Interagency Guidance on Credit Risk Systems

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Credit Risk – Points to Consider

What is the long-term impact of this challenging credit environment on lending institutions

- Safety and soundness warrant a high level of attention
- Almost every segment of institutions' portfolios will experience issues related to COVID, some of them quite severe
- Long term, regardless of the source of risk, institutions are vulnerable to being placed under a Memorandum of Understanding agreement with regulators if classified loans reach around 45% to 60% of equity
- a Consent Agreement is likely if it reaches 60% to 80% of equity
- these are general ranges and there are several factors that will ultimately influence this

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Credit Risk – Points to Consider

What is the long-term impact of this challenging credit environment on lending institutions

- Currently, the median percent that BKD Loan Review has observed at institutions for pre-COVID classified credits is 15% of equity. This means that on average, our institutions cannot afford to have more than the equivalent of an additional 30% to 40% of equity migrate to their classified loan list to avoid adverse regulatory action
- This will vary greatly by institution, but in general, many of our institutions have total loan portfolios that equal 500% to 800% of equity. To keep migration of problems below 30% to 40% of equity, this equals movement of less than 5% to 8% of total loans (which seems like a low number given current events)
- To safely manage their institutions, it is imperative that institutions management proactively analyze credit risk, so they know where to focus their efforts to minimize migration to the classified loan report, and most importantly, to minimize losses

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Macro-economic Trends/Concerns and their impact on Credit Quality

- Industries Expected to Experience Largest Impact
  - Hospitality
  - Restaurants/Food Service
  - Travel related (airlines, rental cars, etc.)
  - Sporting industries, including gyms, spas, event spaces, etc.
  - Neighborhood Retail
  - 1-4 Family
  - Multi-Family
  - Other Services (e.g. home improvement, cleaning services, etc.)
  - Oil and Gas/Energy Sector
  - Houses of worship

Monitoring Affected Industries and Borrowers

- BKD Loan Review clients are monitoring borrowers from those industries identified as impacted (often where borrower has self-identified impact) or are expected to be impacted
- Monitoring methods include using 5300 Call Report codes and/or NAICS codes as usually can be tracked via core systems

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Monitoring Affected Industries and Borrowers

- In addition to monitoring borrowers from these industries via Call Report and/or NAICS data, many clients are maintaining separate PD and Watch List reports for these borrowers
- Alternatively, clients have also used a “COVID19” marker/designation of some type added to Watch Lists and PD Reports

Borrowers who have Requested Loan Modifications

- Many of our clients have approved modifications to I/O payments for up to 90 days; these short-term modifications have regularly been allowed without updated/interim financial information
- 180 day modification periods are allowed under current guidance

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Borrowers who have Requested Loan Modifications – Recommendations

- Once the initial 90-day period has ended, lenders are requiring updated 2019 year AND interim financial information from their borrower
- Lenders are also encouraged to require some type of capital plan, budget, etc., for the remainder of 2020 and, likely, for 2021 – we suggest that this should be a REQUIREMENT for any further approvals

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Borrowers who have Requested Loan Modifications – Recommendations

- Develop a COVID assessment questionnaire for each borrower to assess the risk. This should cover items such as 1) whether the business is open, 2) ability to carry the business and debt through this crisis, 3) amount of SBA assistance, 4) discussions with the borrower, etc.
- Have each lender go through their portfolio from the top down or by prioritizing higher risk industries/segments to maximize risk-based coverage.

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Borrowers who have Requested Loan Modifications – Other Recommendations

- In conjunction with the assessment above, rank your borrowers as low, moderate or high financial impact due to COVID
- Also, consider a COVID risk grade in policy. We all know that many lenders are reluctant to move their borrowers to the criticized loan list, but they may be more likely to move something to a "COVID bucket"
- All borrowers over a certain size receiving deferrals and/or PPP loans should be tracked and considered for this analysis

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Borrowers who have Requested Loan Modifications – Recommendations

- Develop a new or improved Stress Test – apply to your loan portfolio to see the impact of declines in revenue on borrowers' cash flow and potentially analyze their burn rate for cash or working capital
- While their assessment of a borrower's risk above may be largely subjective, the exercise of stressing will help add a more objective view of borrowers in need of closer attention
- <u>Guarantor resources should be considered but not heavily relied upon if multiple contingent liabilities exist</u>
- A deep dive into a borrower's contingent liabilities is warranted more than ever today
- In addition, if liquidity is the mitigating factor to other credit weaknesses, <u>the institution should be verifying that liquidity with more than a personal financial statement (i.e. obtain institution or brokerage statements, etc.)</u>
- <u>Understand the difference b/w Collected Balances and Ledger Balances</u>

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TDR Designation vs. Appropriate Risk Rating

TDR Decision

- Per current guidance, loans modified for up to 180 days due to COVID impacts are generally not expected to be designated as TDRs
- This is provided under the strict conditions that the borrower: (1) was affected by COVID19; (2) was current as to payments, and; (3) the modification is short-term (i.e. up to 180 days)
- 180 day extension allowed under current guidance for all loan types, collateral types, repayment schedules, etc.
- Also note, a loan already risk-rated substandard may be granted such an extension and not necessarily be designated as a TDR, as long as the borrower is current as to payments

TDR Designation vs. Appropriate Risk Rating

REMEMBER

- The guidance on TDRs does not exempt a lender from classifying credits appropriately, nor does it exempt them from having to evaluate impairment
- More importantly, if a lender wishes to minimize both the ultimate migration to classified status and losses, it needs to be in front of risk identification early, so it knows which borrowers need attention

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TDR Designation vs. Appropriate Risk Rating

Risk Rating Decision

- all loan modifications should be prudent and institutions should appropriately assess credit risk rating (i.e. the determination of a risk rating is a separate decision from designation as a TDR vs. risk rating
- Management is expected (required) to review credit risk rating of modified loans

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TDR Designation vs. Appropriate Risk Rating

SAMPLE DECISION DISCUSSION

- While the modification does not mean they need to automatically criticize or classify a loan, lenders need to consider the longer-term risk implications of the individual borrowers
- That is, even if the transaction is not reported as a TDR, it should still be appropriately risk graded as OAEM or Substandard if the institution's knowledge of current conditions and longer-term prospects warrant

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TDR Designation vs. Appropriate Risk Rating

SAMPLE DECISION DISCUSSION

- For example, borrower A has a loan on a retail shopping center where 50% of the tenants have physically moved out; conversely, borrower B has a similar loan, but this borrower's tenants have requested rent forbearance for a short period
- Both of these sample borrowers may have requested the same loan modification, but the risk profile of borrower A is clearly elevated more than the risk profile of borrower B, ceteris paribus
- The guidance on TDRs does not exempt an institution from classifying credits appropriately, nor does it exempt them from having to evaluate impairment
- More importantly though, if a lender wishes to minimize both the ultimate migration to classified status and losses, it needs to be in front of risk identification early, so it knows which borrowers need attention

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TDR Designation vs. Appropriate Risk Rating

Accrual Status

- Should the modified loans that are not accounted as TDRs as a result of the interagency statement be reported on nonaccrual status in regulatory reports?
- If they meet the criteria (of the guidance), then would generally not required to be on nonaccrual; lenders should rely on regulatory instructions for non-accrual matters
- If P&I is deferred, judgement should be used, whether ultimately full payment of amounts due is likely

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Interagency Guidance on Credit Risk Systems

See:

https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-50.html

SUMMARY: The OCC, the Board, the FDIC, and the NCUA (collectively, the agencies) are issuing final guidance for credit risk review (final guidance). This guidance is relevant to all institutions supervised by the agencies and replaces Attachment 1 of the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses. The final guidance discusses sound management of credit risk, a system of independent, ongoing credit review, and appropriate communication regarding the performance of the institution's loan portfolio to its management and board of directors.

Source:
Interagency Guidance on Credit Risk Review Systems (NCUA RIN 3133-AF05)

Interagency Guidance on Credit Risk Systems

an effective credit risk review system accomplishes the following objectives:

- Promptly identifies loans with actual and potential credit weaknesses so that timely action can be taken to strengthen credit quality and minimize losses.
- Appropriately validates and, if necessary, adjusts risk ratings, especially for those loans with potential or well-defined credit weaknesses that may jeopardize repayment.
- Identifies relevant trends that affect the quality of the loan portfolio and highlights segments of those portfolios that are potential problem areas.
- Assesses the adequacy of and adherence to internal credit policies and loan administration procedures and monitors compliance with applicable laws and regulations.
- Evaluates the activities of lending personnel and management, including compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- Provides management and the board of directors with an objective, independent, and timely assessment of the overall quality of the loan portfolio.
- Provides management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ACL or ALLL, as applicable.

Source: ***Interagency Guidance on Credit Risk Review Systems (NCUA RIN 3133-AF05)***

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Interagency Guidance on Credit Risk Systems

For further information, contact:

NCUA: Vincent H. Vieten, Senior Credit Specialist (703) 518-6618; Uduak Essien, Director (703) 518-6399, Division of Credit Markets; or Ian Marenna, Associate General Counsel (703) 518-6554, Office of General Counsel

Source:
Interagency Guidance on Credit Risk Review Systems (NCUA RIN 3133-AF05

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Questions?

Timothy M. Ogburn, RMA-CRC
Director | Loan Review Services | BKD
201 N. Illinois, Suite 700
Indianapolis, IN 46204
togburn@bkd.com
317.383.5462 Direct
317.850.6850 Mobile

Thank You!

bkd.com | @bkdllp

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