Consultants to the Financial Industry
Young & Associates, Inc.

Loan Modifications: A Proactive Approach for Working with Borrowers Impacted by Coronavirus (COVID-19), Guided by Recently Issued Interagency Statement *(Updated April 8, 2020)*

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On March 22, 2020, the Federal banking regulators issued an interagency statement on loan modifications for customers affected by the Coronavirus Disease 2019 (also referred to as COVID-19). It has been subsequently updated and re-issued on April 7, 2020 due to provisions in the CARES Act (Section 4013) which provides further relief for financial institutions working with borrowers affected by the Covid-19 pandemic.

In a number of ways, it resembled historical statements issued in the wake of natural disasters. In keeping with previously issued statements following natural disasters the Federal regulators recognize that there can be an impact on borrowers and encourages banks “to work prudently” with those borrowers. However, given the sudden and significant impact of the rapidly spreading Coronavirus pandemic that has had a nationwide impact, the breadth of the statement was far more reaching than previous statements issued following natural disasters, which historically have been isolated to specific geographic regions. In the updated statement, the Federal regulators included the following provisions:

CARES Act – Section 4013

Under this section of the CARES Act, financial institutions may account for an ***eligible*** loan either under Section 4013 of the Act or in accordance with ASC 310-40 (Troubled Debt Restructuring).

CARES Act – Section 4013

- Defines a loan as ***eligible*** for modification without classification as a TDR based on a three part test:
  - Modification must be related to impact caused by Covid-19;
  - Loan was less than 30 days past due as of December 31, 2019; and
  - The modification must be executed between March 1, 2020 and the earlier of 60 days after the date of the termination of the National Emergency or December 31, 2020
- Modification can be for the life of the loan
- The financial institution ***should*** maintain a record of the volume of Section 4013 loans. There are reporting requirements from the FFIEC (ffiec.gov) that you should review.

ASC Subtopic 310-40

- Includes loans not eligible for Section 4013 (or if the financial institution chooses to apply ASC Subtopic 310-40). This may be a loan impacted by Covid-19, but the modification took place outside the timeframe allowed under Section 4013.
- To be eligible for treatment under this section, a loan must meet the following criteria:
  - It must be less than 30 days past due at the time of the modification
  - Modification must be related to impact caused by Covid-19
  - Modification must be short term (less than six months)

Other Provisions that do not Require TDR Status

- Loans subject to any government-mandated modification or deferral program (may be other Federal, state, or local programs). As an example, this may be a statewide program suspending mortgage payments for a period of time.

General Provisions

1. Borrowers granted a modification will not be "automatically adversely risk rated" by agencies' examiners. In fact, it is stated that agency examiners will use judgment in reviewing credits modified and 'regardless of whether modifications result in loans that are considered TDRs or are adversely classified, agency examiners will not criticize prudent efforts to modify the terms on existing loans to affected customers.'
2. Loans granted modifications will not be classified as past due if modified, unless they become past due per the terms of the modification.
3. During the temporary short term arrangements (as provided in the Interagency Statement) loans should not be reported as "non-accrual".
4. Loans subject to Section 4013 are eligible as collateral for the Discount Window
5. As information is gathered, if an adverse classification, non-accrual or charge-off is warranted, bank actions should follow existing guidance on the topics.

Young & Associates, Inc. Recommendations

- Section 4013 offers the most favorable terms. The modification can be for the life of the loan not just a short term period. Downside is that you need to track and report these loans;
- Develop a simple checklist to document eligibility.
  - One or two sentences about how the borrower was impacted by COVID-19 should do for meeting the first test.
  - System reports will document compliance with current status and modification dates.
  - We recommend the financial institution develop simple criteria for what types of modifications will be appropriate. These might be: length of interest only period, length of payment deferral, length of amortization etc. The regulators mention that modifications should still meet safe and sound lending practices to avoid criticism. As an example, several years of interest only would likely not meet the criteria of a safe and sound loan practice.

    - We recommend the loan officer or manager sign off on the modifications to indicate approval.
- Develop a simple report for tracking Section 4013 loans. Make this report a part of loan committee and board reports.
- When granting modifications, consider if there should be any new provisions added to the loan such as more frequent, timely financial reporting, additional collateral, limiting distributions to a level that leaves adequate debt service coverage.

Once the deferral decision has been made the real work begins. As mentioned above, this statement really provides banks with a near-term way to deal with an unknown impact while providing time to fully assess the actual impact on the borrower. Here are the steps we would recommend that banks take in response to the impact of COVID-19:

1. Make a list of borrowers most likely impacted by COVID-19. Hotels, restaurants, non-essential retailers, "Main Street business," some manufacturers, distributors, and especially non-owner occupied commercial real estate owners with tenants impacted by COVID-19 are examples of customers that are most vulnerable to the current health crisis.
2. Reach out to those borrowers to see how they are doing, how they have been impacted, and what they see as next steps for their business. Let your borrowers know that you are here to work with them as they navigate through the downturn, including taking pro-active steps to ensure the viability of their business. Let them know what you are doing in the community to help. This is the most important time to keep up communications with your customers. They may well be concerned about what might happen to them and a few kind words of support from their bank can go a long way to letting them know they are not alone.
3. Based on your initial analysis and conversations with potentially impacted borrowers you should derive a shorter list of borrowers for which deeper analysis is warranted. As you develop a forward-looking analysis, the following considerations should be made:
    a. Last year's tax return or financial statement may well be meaningless as a source of cash flow analysis if they have been significantly impacted by recent events.
    b. This is the time to work with these borrowers to develop honest, meaningful projections to help determine their ability to overcome any short-term cash flow impact.
    c. For CRE borrowers, a current rent roll with any concessions the owner has made to help tenants or identify tenants that may be at highest risk of defaulting on their lease should be included as part of the bank's analysis.
    d. It's also important to have a current balance sheet for any C&I borrowers. This can provide you with another method of assessing the borrower's financial strength and ability to withstand a downturn. Cash flow analysis alone cannot tell the whole story of a borrower's repayment ability. A strong balance sheet will include substantial liquidity and limited leverage beyond minimum policy requirements.
    e. Your analysis should be in writing and reviewed by the bank's loan committee and especially its board of directors to keep them informed about the level of risk to the bank.

f. For those borrowers where your analysis shows limited long-term problems, great news! Keep in touch to assure that things are actually going as expected.

g. The overall thrust of the analysis should be on a forward-looking basis in terms of the borrower's repayment ability, including a defined expectation for receiving frequent and timely financial information. Relying on a tax return, with financial information that could be aged up to 10 months following the borrower's year-end date could result in a false calculation of future repayment ability.

4. It is imperative that a proactive approach is taken by the institution in response to the impact of COVID-19. Sufficient human resources should be dedicated to the bank's response and outreach to impacted customers. If human resources are limited at the institution, the aforementioned list of borrowers should be prioritized based on factors developed by management, i.e., size of credit, borrower sensitivity to the impact of a downturn, and those businesses considered critical to the well-being of the community (large employers).

In addition to the bottom-up (customer level) analysis discussed above, we would recommend that the bank perform a comprehensive stress test of its loan portfolio to determine the level of impact, if any, on capital which should be addressed by the board and senior management. (This is a great time to update your capital plan as well.)

The next few months are likely to be a difficult period for many banks and their borrowers. As of today, we don't really know the actual impact on the economy from COVID-19. But, we can be sure it won't just be a quick blip and a return to normal for all borrowers. Take the time allowed by this unprecedented Interagency Statement and be proactive.

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About Young & Associates, Inc.

Young & Associates, Inc. has provided consulting, training, and practical products for financial institutions for over 41 years. We strive to provide the most up-to-date solutions for our clients' needs, while remaining true to our founding principles and goals – to make managing the bank easier, reduce the regulatory burden, improve the bank's bottom line, and increase shareholder value.