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

By: Bob Viering, Director of Lending, and Aaron Lewis, Director of Lending Education, Young & Associates, Inc.

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). 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 statement the Federal regulators included the following provisions:

1. The Federal regulators confirmed with the Financial Accounting Standards Board (FASB) that "…***short-term*** modifications made on a good faith basis in response to COVID-19 to borrowers who ***were current*** prior to any relief are not troubled debt restructurings (TDRs)."
2. ***"…short term (e.g., six months)…"*** modifications can include: payment deferrals, fee waivers, extension of payment terms or other delays in payments that are ***"insignificant."***
3. ***"Current"*** is defined as less than 30 days past due. If the credit is current at the time of the modification the borrower is deemed to not be experiencing financial difficulties.
4. Banks can choose to work with individual borrowers or as ***"part of a program."***
5. 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."
6. Loans granted modifications will not be classified as past due if modified, unless they become past due per the terms of the modification.
7. During the temporary short-term arrangements (as provided in the Interagency Statement), loans should not be reported as "non-accrual."
8. As information is gathered, if an adverse classification, non-accrual, or charge-off is warranted, bank actions should follow existing guidance on the topics.

The best way to interpret the Interagency Statement is to consider it as providing banks breathing room while more information is developed that allows the bank to accurately assess the borrower's financial

strength. It is clear throughout the statement that any modifications must be temporary and short-term to not be classified as TDR. This guidance is in keeping with previous statements regarding TDR and relative impact to the credit. While there is no specific definition of what constitutes short-term or temporary, the mention of six months in the Interagency Statement should be a reasonable maximum to consider.

The statement mentions that working with either individual borrowers or as part of a program is acceptable. The term "individual borrowers" is fairly self-explanatory. A "program" for working with borrowers will require a bank to determine criteria to allow for a more automatic deferral decision. This would need to include checking that the borrower was not past due for reasons other than the impact of COVID-19, that the deferral meets the criteria as outlined in the Interagency Statement, and that the bank believes the borrower has been impacted by the Coronavirus. In the case of a program, the decision on granting deferrals may be made by a lender or manager close to the front lines.

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 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 pro-active 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.

For more information, contact Bob Viering, Director of Lending, at bviering@younginc.com or 330-422-3476, or Aaron Lewis at alewis@younginc.com or 330-422-3466.

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.