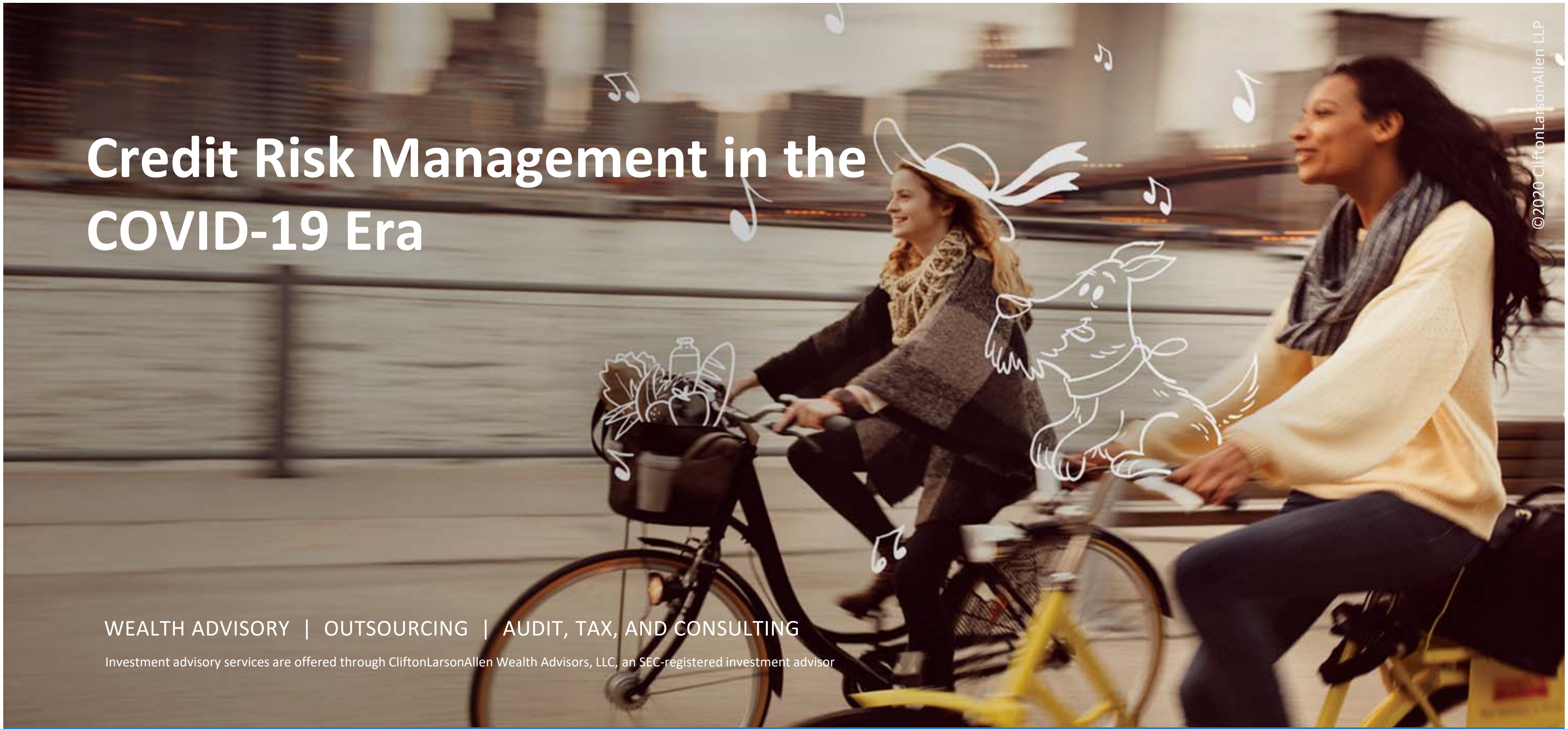
Credit Risk Management in the COVID-19 Era



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About CLA

Background and Knowledge

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Our promise

We promise to know you and help you.

Our purpose

CLA exists to create opportunities — for our clients, our people, and our communities.

CLA family culture

One family working together to create opportunities.

Strategic advantages

- Deep industry specialization
- Seamless, integrated capabilities
- Premier resource for private businesses and owners
- Inspired careers

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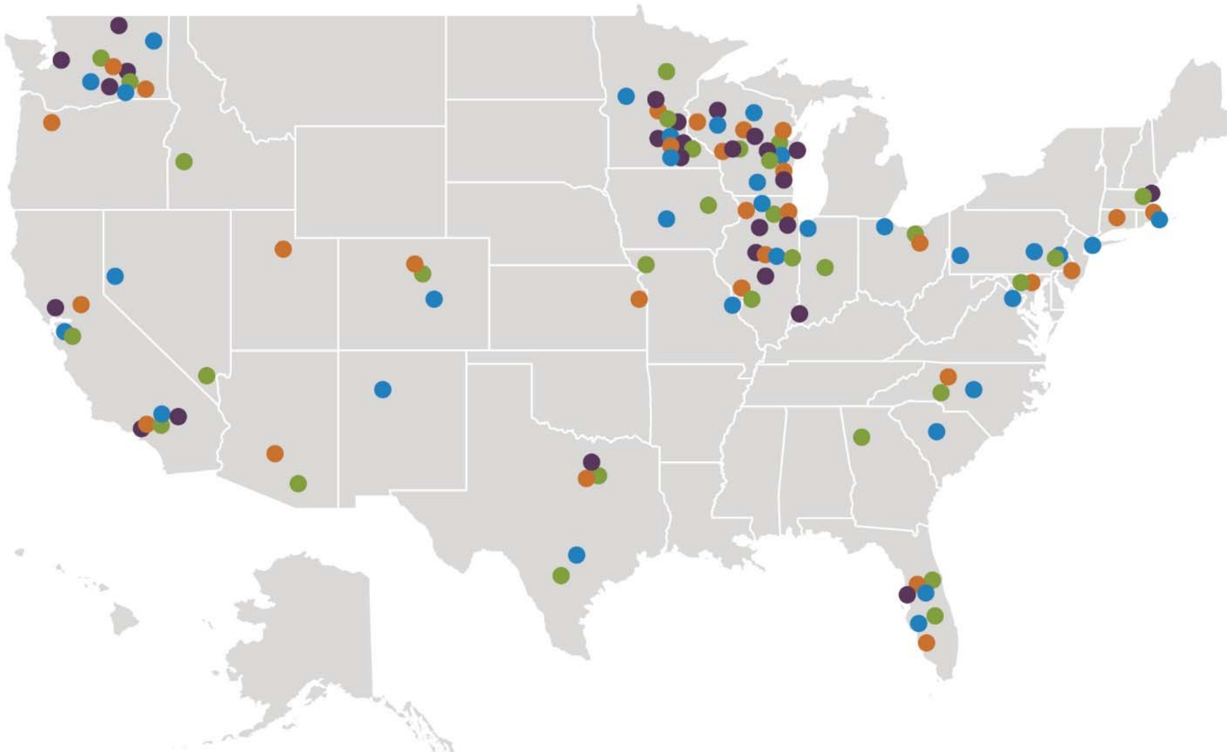
CLA creates opportunities for businesses, individuals, and communities through our wealth advisory, outsourcing, audit, tax and consulting services. With more than 6,200 people, 120 U.S. locations and a global affiliation, we promise to know you and help you. *Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC, an SEC-registered investment advisor.*

National and International Reach



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Today’s Session

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Your Presenters

Erica Crain is a former FDIC examiner and banker who currently serves as the national leader for CliftonLarsonAllen's Credit Risk Services. With over 20 years of experience, Erica utilizes her experience as former regulator, bank risk director, and commercial lender to lead the credit risk team and work with financial institutions across the country to assess the overall loan portfolio quality, evaluate credit risk identification procedures, and assess the overall effectiveness of credit administration practices.

Dean has more than 24 years of experience providing audit, internal audit, and consulting services to credit union and credit union related organizations. He has provided consulting services in the areas of business lending, bond claim preparation, product costing and profitability, and asset/liability management. He also has experience related to credit union 990 tax issues as well as unrelated business income tax issues. Dean has also worked as an internal auditor at IBM Mid America Employees Federal Credit Union. Dean has worked with a number of large credit unions on strategic issues such as board governance and enterprise risk management, as well as the role of internal audit and risk management, regulatory issues, and many accounting related topics.

Summary of Objectives

- Identify and monitor evolving risks in loan portfolios
- COVID-19 related loan modifications and identifying TDRs
- Credit risk monitoring during a problematic period
- Stress testing the loan portfolio
- Evaluating the adequacy of the ALLL
- Preparing for your next exam

Glossary of Acronyms Used

- **ALM** – Asset Liability Management
- **ALLL** – Allowance for Loan and Lease Losses
- **CARES Act** – Coronavirus Aid, Relief, and Economic Security Act
- **CFPB** – Consumer Financial Protection Bureau
- **FRB** – Federal Reserve Bank
- **GAAP** – Generally Accepted Accounting Principles
- **GDP** – Gross Domestic Product
- **IRR** – Interest Rate Risk
- **PPP** – Paycheck Protection Program
- **Q&E Factors** – Qualitative and Environmental Factors
- **ROA** – Return on Assets
- **SBA** - Small Business Administration
- **SFR** - single family residence
- **TDR** – Troubled Debt Restructuring

Identify and monitor evolving risks in loan portfolios

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Comparison of the Great Recession to the COVID-19 Pandemic – *Similarities*

The Great Recession And The COVID-19 Pandemic	NOO CRE and SFR valuation declines (COVID-19 not as deep)
	Narrowed interest margin as Fed reduced rates
	Low historical losses in ALLL models
	Reduced staffing
	Allowance for loan losses **should be** a focal point for management
	Delayed expansion of facilities and other cost reduction measures
	Increased efforts in consumer collection departments
	Volatile stock markets and government stimulus

Comparison of the Great Recession to the COVID-19 Pandemic – *Differences*

Great Recession	COVID-19 Pandemic
Consumers prioritized auto loans and credit card payments over home mortgages	Need for healthcare loans and auto & credit card loan assistance
High loan losses and more government oversight (i.e. CFPB)	Unknown level of loan losses due to unforeseeable end to pandemic and loan modification programs
Focus on consumer collection efforts	Increased focus on commercial loan workouts
Outsourced assistance to assess loss exposure on real estate portfolios	Outsourced assistance with various loan programs offered through SBA/Treasury and FRB

Comparison of the Great Recession to the COVID-19 Pandemic – *Differences*

Great Recession	COVID-19 Pandemic
Increased overdraft and credit card income	Decreased overdraft and credit card income from fee waivers
Negative ROAs	Currently unknown
Unemployment rate elevated but opportunities to find other work or retrain for a new vocation	Greater unemployment rate with unknown timeframe and inability to find employment opportunities due to continued closings of non-essential businesses in different parts of country
Reduced programs and/or services	Increased or virtual programs and/or services to help many
Delayed implementation of services	Acceleration of technology programs to offer more services virtually

COVID-19 related loan modifications and identifying TDRs

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Legislation and Guidance for COVID-19 Related Loan Modifications

- April 7, 2020 Interagency Statement seeks to provide further clarification between the interagency statement issued on March 22, 2020 and Section 4013 of the CARES Act

- **August 3, 2020 Joint Statement on Additional Loan Accommodations Related to COVID-19** seeks to stress the importance of lender and borrower communication, documentation and evaluation of additional loan accommodations.

Legislation & Guidance for COVID-19 Related Loan Modifications

- Financial institutions have the option to temporarily suspend certain requirements under GAAP related to TDRs for a limited period of time to account for the effects of COVID-19
- Three key points observed:
  1. Loan Modifications Under Section 4013
  2. Loan Modifications Not Under Section 4013
  3. Regulatory Reporting Considerations (see later slide)

Comparison of CARES to Regulatory Guidance

	Section 4013 of the CARES Act	Regulatory Guidance
Modifications terms allowed (safety and soundness principles still apply)	Applies only to the following modifications: forbearance agreements, interest rate modifications, repayment plans or other arrangements that defer/delay principal & interest payments	Applies only to the following modifications made to due to the COVID-19 pandemic: short-term modifications, such as payment deferrals, fee waivers, extensions of repayment terms, or delays in payment that are insignificant under ASC 310-40, government-mandated programs
Evaluation date of whether borrower was current (< 30 days past due)	May apply to borrowers not more than 30 days past due at December 31, 2019	Applies on the date which an FI implemented a modification program for borrowers less than 30 days past due
Time period of when the modification occurs	Applicable period began on March 1, 2020 and ends on the earlier of December 31, 2020, or 60 days after the termination date of the presidential national emergency	Applicable period not specified but is expected to be temporary in nature
Duration of non-TDR designation	Remaining life of the loan. Subsequent modifications must be evaluated if they are not also eligible under the criteria.	Remaining life of the loan. Subsequent modifications must be re-evaluated.

Legislation and Guidance for COVID-19 Related Loan Modifications

- August 3, 2020 Joint Statement stresses key points if additional accommodations are requested:
  1. Stresses prudent actions, applicable laws and regulations
  2. Active monitoring and management of modified loans
  3. Obtaining current and projected financial information
  4. Consistent application of accommodations
  5. Being cognizant of consumer protection aspects

Loan Modifications – Points of Consideration

- Establish consistent approach for handling loan modification requests and approved strategy for working with affected borrowers
    - Create a checklist for modifications as a best practice
- Create separate tracking for all loan modifications with consistent follow-up on continuing modifications
- Communicate regularly with lending & operational teams
- Be familiar with interagency guidance on loan modifications and the CARES Act

Loan Modifications – Points of Consideration

- What information is reviewed for continued loan modifications?
  - Current financial performance
  - Individual wherewithal vs. outside sources of cash flow
  - Existing collateral value/additional collateral availability
  - Additional “enhancements”
- What government subsidized programs support continued cash flow and for how long will existing support remain?
- What shifts, if any, have occurred in the last six months to the borrowers’ business model, delivery methods, and what does projected performance look like for the next six months and beyond?

Accounting for Loan Modifications

- The FASB[1] has provided two options related to recording interest during periods of payment deferment
  1. Interest income is recognized during the payment holiday period and applied prospectively for the remaining term.
  2. Interest income is not recognized during the payment holiday period and would resume recognizing interest income when the payment holiday ends.

[1]https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176174436194&pagename=FASB%2FFASBContent_C%2FActionAlertPage

Regulatory Reporting for COVID-19 Related Loan Modifications

- Management should recognize impact to the ALLL for these loans; however, impairment analysis is not required.
  - Management may want to consider pooling these loans and providing a separate Q&E factor for inclusion in ALLL
- The dollar amount and number of loans modified under Section 4013 are now reported on the call report (started with June 2020).
  - This information will not be made available to the public.

Regulatory Reporting for COVID-19 Related Loan Modifications

- Potential challenges that may arise:
  - Loan needs to be re-modified within the CARES Act window (see August 2020 Joint Statement)
  - Accrued interest considerations
  - Clarity of internal policies and procedures for re-modifying a loan
  - Ensuring lenders are informed

Troubled Debt Restructuring – GAAP Definition

- Current expectations are the majority of modifications during this period of time <u>will not</u> result in a TDR
- Due to the uncertainty, it is critical that lenders are proactive with borrowers throughout this period and as we reach the end of 6 month deferrals, etc.
- While there is *temporary* relief under Section 4013 of the CARES Act, accounting guidance for TDRs remains unchanged

Troubled Debt Restructuring – GAAP Definition

- A TDR is the result of restructuring debt if the creditor for economic or legal reasons related to the debtor's <u>financial</u> <u>difficulties</u> grants a <u>concession</u> to the debtor that it would not otherwise consider.
- To be a TDR the debtor must be experiencing financial difficulties **<u>and</u>** a concession is granted. <u>You must have both</u>.

Troubled Debt Restructuring: *Concessions*

Indicators of concessions that generally qualify a modified loan as a TDR:

1. Reduction in stated absolute or contingent interest rate, below market, for the remaining original life of the debt
2. Extension of maturity at a favorable interest rate
3. Reduction in the absolute or contingent face of maturity amount of the debt
4. Reduction in the absolute or contingent amount of accrued interest
5. Significant delay in payments (i.e. more than 6 months)

Credit risk monitoring during a period of uncertainty

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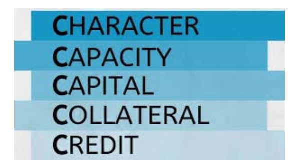
Credit Risk Monitoring: *A Period of Uncertainty*

- **Importance of the lender / borrower relationship**
  - Engaging regularly
  - Documenting financial and non-financial risks
    - Varying degrees of risk based on factors such as industry, geography, etc.
    - Documentation is key – update files with visits, communications, changes in the business or operation as they are occurring
  - Understanding current needs and anticipated needs
  - Structuring loan workouts or modifications that help the borrower and protect the credit union

Credit Risk Monitoring: *A Period of Uncertainty*

- **Back to the Basics**
  - Focus on the core principles of credit management
    - Evaluate the 5 C's of credit given current environment
    - *Conditions* – economic impact facing borrowers
      - Industry, supply chain, geographic location, etc.
    - *Credit* – consider PPP loans; number of loan mods



- **Ongoing Portfolio Management**
    - More risk = more frequent monitoring
    - Timely collection of financial and collateral documentation is essential

Problem Loan Management

- **Policy Guidance & Expertise**
  - Review credit union policies for inclusion of problem loan management program and responsible parties
  - Assess necessary expertise of lending staff to manage the problem loan portfolio
  - Evaluate additional parties involved in the process (examiners, auditors, etc.)

Problem Loan Management (continued)

- Action Plans
  - Documented action plans should include detailed description of actions to take in order to continue collection efforts
- Management should take a holistic view of its loan portfolio and assess the overall risk in the portfolio
  - Top Down vs. Bottom Up approach
  - Concentration Monitoring
- Obtain an independent loan review

Problem Loan Considerations

- Historical performance, trend analysis
- Carryover debt (with inadequate collateral and lack of repayment capacity)
- Collateral coverage, volatile or declining values
- Projected performance
- Risk rating migration analysis
- Increased delinquencies and chapter 12 bankruptcy filings

Risk Rating Considerations

- Impact of COVID-19 on Credit Risk Ratings
- Will there be a massive increase in problem or adversely classified credits?
- Temporary vs. Permanent Impact
- Not everything that is criticized or classified is impaired

Credit Risk Review

Renewed Emphasis of Significance

On May 8, 2020, the final ***Interagency Guidance on Credit Risk Review Systems*** was released by federal regulators.

FIL-55-2020: Credit Risk Review Systems

- Critical aspects of credit risk review systems include:
  - 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 ALLL, as applicable.
    - Credit review helps in determination of the ALLL but is NOT the only reason for a review
  - Supports trend analysis to highlight the quality of the loan portfolio and segments of those portfolios that are potential problem areas.
  - Evaluates quality of lending personnel including their loan approval, monitoring, and risk assessment.

Stress testing the loan portfolio

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Stress Testing

- Why stress testing?
  - Provides predictive & forward-looking information that will assist in identifying potential risks in a portfolio & resulting impact on capital
  - Quantifies potential impact of various scenarios on pools or loan segments
  - Clearly identify events causing stress (assumptions) to determine impact on portfolio performance & establish remedial action
    - Commodity prices, interest rates, unemployment rates, market rents, vacancy rates, or other variable specific to the type of credit
  - How often? At least annual (portfolio level); with each approval, renewal, or modification (transaction level)

Stress Testing Considerations

Identify what loan segments are most vulnerable or "at risk"

- Segmentation may include various factors such as: industry type (particularly where concentrations are present), geographic location, type of loan
- Examples of COVID-19 related considerations include:
  - Geographies with high level of outbreak or impact, extended travel bans, shelter in place considerations
  - Concentrations or exposure to segments such as food supply, exporting, hospitality, retail (including restaurants), multi-family residential, warehouses, office space, student housing
  - Loan types including lines of credit such as home equity lines, credit cards, and commercial lines of credit and the related unfunded exposure that may be funded in the near future

After the Stress Test – *Next Steps*

Take Action

- Utilize the information gathered to work with borrowers and sectors that evidence weakening according to the stress test results
- Formulate further relief measures for targeted groups
- Revise risk management strategy, capital planning initiatives, liquidity impact, and earnings outlook accordingly.

After the Stress Test – *Next Steps*

Evaluate Impact to Allowance for Loan Losses

- Apply current macroeconomic projections based on current market data (i.e. unemployment rate; bankruptcy filings)
- Incorporate findings from portfolio stress test with updated probability of default and expected losses
- Consider adjusting qualitative factors for increased risks identified in each loan segment

Evaluating the adequacy of the ALLL

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Estimating ALLL in Accordance with GAAP

- ALLL represents probable inherent credit loss
  - *Inherent – existing in someone or something as a permanent and inseparable element, quality or attribute*
- ALLL is complex and requires judgement
- Management should review and consider a range of estimated losses

Estimating ALLL in Accordance with GAAP

- Consider all available information as of the financial statement or call report date and subsequent events through filing dates
- Utilize loss estimation models or other estimation tools that conform to GAAP
- Document historical loss estimates for groups of loans using similar characteristics

Estimating ALLL in Accordance with GAAP

- Directional consistency should be observed
- Ensure your charge-off policy is updated
- Perform a deeper review of impaired loans and TDRs
- Document and expand Q&E factors

Q&E Factors in the ALLL

- Q&E Factors will be in the spotlight for 2020 reporting
  - Times of uncertainty are the reason <u>for</u> these factors
  - Recent earnings announcements from large publicly traded financial institutions indicate increases in their ALLL due to COVID-19
- Documentation of Q&E factors will be critical to support your ALLL

Q&E Factors in the ALLL

Seven factors should be present[1]

Factor	Comments
Portfolio Trends	Changes to portfolio that introduce risk
Portfolio Concentrations	Related customers, industry, geography, etc.
Economic and Market Trends	Trends in GDP, unemployment, etc.
Changes in Lending Practices	Changes in procedures, staffing, etc.

Factor	Comments
Changes in Loan Review System	Quality of loan review
Geographical Considerations	Unique matters – i.e. major employer closing
Other Factors	National emergencies, etc.

[1] Per the July 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses

Q&E Factors in the ALLL

- Consider adjusting Q&E factors, appropriately, for different portfolio segments or risk profile of the credit union
- Establish ranges that can be adjusted as the economic situation evolves
- Utilize data available that supports trends in your portfolio
  - Federal Reserve's Beige Book, U.S. Bureau of Labor Statistics Reports, local economic reports

ALLL – ***Good Controls are Critical***

- Compliance with a well-defined lending and ALLL policy
- Strong procedures and process for the calculation, understanding and review of the ALLL.
- Adequate reporting including watch lists and delinquent loan reports
- Strong oversight by senior management and board of director review of past due, watch, and classified loan reports.
- Existence of an objective credit review function

Preparing for your next exam

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June 2020 Interagency Examiner Guidance

- Interagency examiner guidance issued to advise on key areas of focus in upcoming regulatory exams (link to guidance)
- Management and governance teams should be highly engaged during this period of time
- Documentation, now more than ever, is critical to support management decisions and to provide to examiners in virtual exam settings.

Supervisory Rating Systems

Management and Governance

- Should be well-versed in the supervisory rating system;
- Should weigh each rating with equal importance;
- Should enhance regulatory relationships to understand regulatory areas of focus

There are other rating systems but today's session will focus on CAMELS.

CAMELS: Asset Quality & Capital

Asset Quality

- Objectivity is critical
- Documentation of updates to policies/procedures
- Problem loan management, credit modifications and risk rating assignments

Capital

- Review capital plan
- Assess impact of PPP, loss in impacted industries
- Strategize to address risk

CAMELS: Management & Earnings Performance

Management

- Higher level of communication
- Assess external factors and those in management's control
- Assess various areas of risk in the entity

Earnings Performance

- Impact to 2020, 2021 Plans
- More frequent financial projections
- Assess impact of asset quality, operational expenses, trend analysis

CAMELS: Liquidity & Sensitivity to Market Risk

Liquidity

- Review liquidity plan
- Analyze current inflows, potential future outflows
- Third party funding sources

Sensitivity to Market Risk

- ALM assumptions should be reviewed and adjusted
- Assess temporary and longer-term impacts on IRR profile
- ALM models are tools

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Read our blog series or listen to our recording on the recent guidance on safety and soundness examinations.