MOSSADAMS

Internal Control and Compliance Considerations over Lending in 2020

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Presentation Objectives

- Internal control considerations in PPP lending
- Regulation compliance considerations
- Loan forbearance/modification considerations
- Common findings in 2020

Polling Question 1

How difficult was the PPP lending program for your Credit Union?

A. As bad as 2020

B. Difficult, but nothing to cry over

C. I hope we do this every year

D. What is PPP?

Internal Control Considerations

- What is the tone?
  - Ethical tenor starts at top management and trickles down
  - Code of conduct
  - Lending Committees

- Credit Union can control “opportunities” for fraud

Internal Control Considerations

- Internal controls can be preventative or detective in nature.
  - Preventative controls are designed to keep errors or irregularities from occurring in the first place.
  - Detective controls are designed to detect errors or irregularities that may have occurred.
  - Are processes in place to correct errors or irregularities that have been detected.

Internal Control Considerations

- Lending function can be broadly divided into the following categories:

  - Program development and sales
  - Origination and disbursement
  - Ongoing maintenance and reporting
  - Credit supervision and monitoring

Paycheck Protection Program Lending

- Paycheck Protection Program (PPP) process includes four main phases:
  - Application
  - Processing
  - Funding
  - Forgiveness

Paycheck Protection Program Lending

Risk and compliance issues:

- Lenders must maintain compliance with all applicable regulations
  - Equal Credit Opportunity Act
  - Community Reinvestment Act
  - Fair Lending and Redlining Requirements
  - Bank Secrecy Act and anti-money laundering

Paycheck Protection Program Lending

Fraud concerns – lender:

- Internal fraud risks from lender staff could include:
  - Charging of prohibited loan fees or prepayment penalties by loan agent
  - Fraudulent approval of incomplete or ineligible applications, either in collusion with borrowers or in response to management pressure to meet sales objectives
  - Fictitious loan creation or presentation of multiple applications for same borrower
  - Falsification of loan documents to meet requirements or increase processing fee revenue

Paycheck Protection Program Lending

Fraud concerns – borrower:

- Fraud risks borrowers might present include:
  - Falsification of information in the PPP application process, including false certification
  - Multiple PPP loans for same borrower, which is not allowed
  - Falsification of documents at the time of application or in the forgiveness requests, including use of funds for ineligible purposes or misrepresenting payroll amounts

Paycheck Protection Program Lending

Internal control considerations:

- Development of new policies and procedures regarding the customized criteria of the SBA 7(a) Paycheck Protection Program
- Loan staff training on specific qualifications and underwriting criteria
- Identify various methods in which applications can be received and develop processes to record receipt of the submissions
- Utilization of tracking form to document receipt, analysis, and acceptance of records
- Controls to address consumer protection & BSA/AML considerations

Paycheck Protection Program Lending

PPP internal audit considerations:

- Identify and assess risk in the PPP loan portfolio
- Develop a course based on risk and SBA guidance
- Execute on the audit plan
- Evaluate the results of the internal audit
- Communicate and continue ongoing audits

Loan Modifications

Polling Question 2

What percentage of loans has your Credit Union modified?

A. less than 1%

B. less than 5%

C. greater than 5%

D. Unsure

Loan Modifications – Interagency Guidance

- Issued March 22, 2020, prior to the signing of the CARES act, in response to the COVID-19 pandemic
- FASB issued a statement of agreement with the interagency guidance
- Encourages working with borrowers to modify loans
- Includes detailed examples of modifications along with regulatory expectations
- Guidance refers to modifications of up to 6 months potentially not being considered troubled debt restructurings (TDRs) if pandemic related
- Delinquency reporting eased in this area
- https://mossadams.com/articles/2020/03/financial-institution-guidance-covid-19

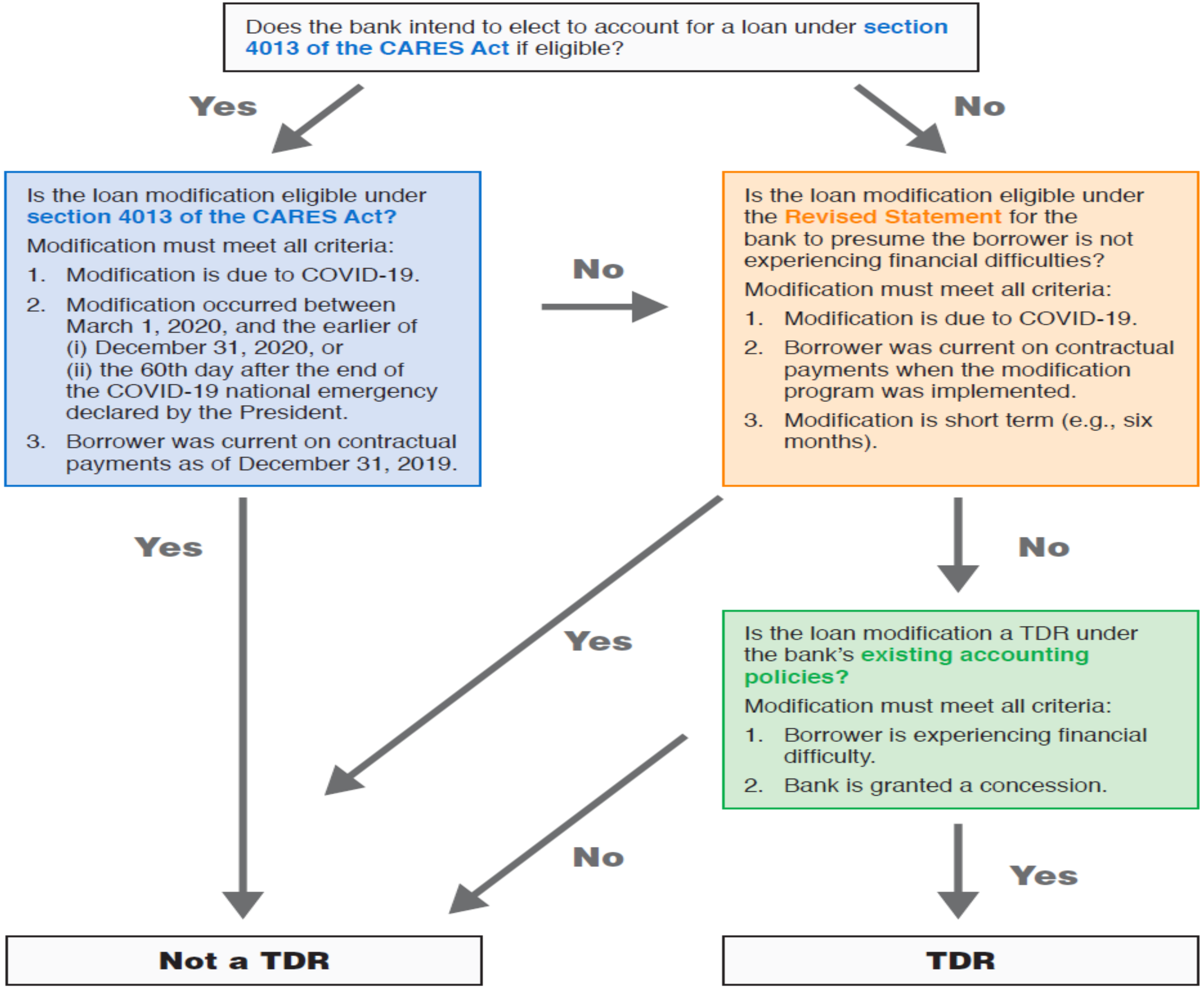
Loan Modifications – CARES Act

- Option to suspend requirements under US GAAP for loan modifications related to the pandemic that potentially would have otherwise been considered troubled debt restructurings.
- Must be current at December 31, 2019 (under 30 days past due) and the modification performed due to the pandemic to qualify.
- Includes modifications such as forbearance agreements, interest-rate modifications, repayment plans, or other arrangements that defer principal and interest payments.
- Election may begin on March 1, 2020 and last no later than the earlier of December 31, 2020 or 60 days after lifting of the coronavirus national health emergency.
- https://mossadams.com/articles/2020/03/cares-act-includes-cecl-and-tdr-relief

	Section 4013 of the CARES Act	Non-Section 4013 Loan Modifications (Revised Statement)
Evaluation date of whether borrower was current (< 30 days past due)	December 31, 2019	No earlier than when the modification program is implemented
Modifications terms allowed (safety and soundness principles still apply)	Any modification	Short term (e.g., six months)
Time period of when the modification occurs	Between March 1, 2020, and the earlier of (i) December 31, 2020, or (ii) the 60th day after the end of the COVID-19 national emergency declared by the President.	Management should use judgment to determine if the modification is related to COVID-19.
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.
Why is it not a TDR?	By law, the bank is not required to designate the loan as a TDR.	The bank may presume that the borrower is not experiencing financial difficulty.

If neither section 4013 of the CARES Act nor the Revised Statement criteria are met, the bank should follow its existing accounting policies to determine whether the modification should be accounted for as a TDR.

Is the COVID-19 Loan Modification a TDR?



Modification Considerations

- What are the controls in place to ensure proper documentation and classification of the modifications under policy, Interagency guidance or CARES ACT?
- What are the flagging/tracking mechanisms in place? Are they automatic or manual given multiple loan systems in play?
- Will regulators be critical if modifications are outside the six month deferral period as mentioned in the Interagency guidance?
- What documentation will be required to prove modifications are pandemic related?
- How will the Credit Union prepare for processing additional modifications?
- How should we be treating interest recognition (accrue or not) given varying modification programs?
- Loan Payment Deferral Accounting Considerations During COVID-19

Regulatory Compliance Considerations

Polling Question 3

Has the number of forbearances your Credit Union has granted during COVID cause you concern?

A. Yes, significantly concerned for the economy as a whole

B. Yes, but not overly concerned

C. No concern at all

D. What is a forbearance?

Regulatory Compliance Considerations/Relief

- On March 27, 2020 the CARES Act was signed into law.
    - If a borrower request and affirms that the borrower is experiencing a financial hardship during the COVID-19 emergency, servicers MUST provide a forbearance that allows borrowers to defer their mortgage payments up to 180 days and possibly longer. Must be without any fees, penalties, or interest (beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the terms of the mortgage contract).
    - Servicers can provide multiple sequential short-term payment forbearance programs under the Regulation X mortgage servicing rules. For example, under the CARES Act, the borrower may request another forbearance of up to 180 days in addition to the initial forbearance and the servicer must extend the forbearance.
    - Servicers **MAY NOT** require any additional information form the borrower before granting a CARES Act forbearance. Servicers do not have to obtain a complete loss mitigation application (as defined in Regulation X) from a borrower before offering a short-term loss mitigation option as defined in the rules, such as the CARES Act forbearance. A borrower does not need to submit additional documentation to qualify other than the claim to have a pandemic-related financial hardship.
    - For forbearance or other mortgage relief options provided to borrowers, provide borrower written documentation to the borrower confirming the details of the terms and agreement. ***This is not a requirement but a best practice***.

Regulatory Compliance Considerations/Relief

- Mortgage Servicing Rules (Regulation X)
  - As of April 3, 2020, and until further notice, in evaluating compliance with Regulation X, 12 CFR 1024, if a mortgage servicer offers or provides a short term option, including a CARES Act forbearance, the agencies do not intend to take supervisory or enforcement action against servicers for the following:
    - Delays in sending the loss mitigation-related notices
    - Delays in establishing or making good faith efforts to establish live contact with delinquent borrowers
    - Delays in sending the written early intervention notice to delinquent borrowers
    - Delays in sending the annual escrow statement

Regulatory Compliance Considerations/Relief

Additional Mortgage Servicing Considerations

1. As of August 27, 2020 the Federal Housing Finance Agency announced that Fannie Mae and Freddie Mac will extend the moratorium on single-family foreclosures and real estate owner (REO) evictions until at least December 31, 2020 (originally set to expire on August 31, 2020).

2. The foreclosure moratorium applies to Fannie Mae and Freddie Mac backed, single-family mortgages only.

Regulatory Compliance Considerations/Relief

- Appraisal and Evaluations for Real Estate Financial Transactions
  - Flexibility for Physical Property Inspections
    - Appraiser can determine characteristics of the interior condition of a property without performing an interior inspection (must follow certain criteria)
  - Appraisal Flexibility for FNMA/FHLMC Loans
    - Exterior-only and desktop appraisals are acceptable for qualified loans.
  - Appraisal or Evaluation Deferrals
    - Can now be deferred up to 120 days from the date of closing (will be in effect until December 31, 2020)

Regulatory Compliance Considerations/Relief

- Appraisal and Evaluations for Real Estate Financial Transactions (additional considerations)

  - Note that deferrals apply to both residential and commercial real estate-related financial transactions, BUT excludes transactions for acquisition, development, and construction of real estate.

  - Regulated institutions may close a real estate loan without a contemporaneous appraisal or evaluation, subject to a requirement that institutions obtain the appraisal or evaluation, as would have been required under the appraisal regulations without the deferral, within a grace period of 120 days after closing of the transaction.

  - The agencies expect institutions to use best efforts and available information to develop a well-informed estimate of the collateral value of the subject property. The agencies also expect institutions to develop an appropriate risk mitigation strategy if the appraisal or evaluation ultimately reveals a market value significantly lower than the expected market value. An institution’s risk mitigation strategy should consider safety and soundness risk to the institution, balanced with mitigation of financial harm to COVID-19-affected borrowers.

Regulatory Compliance Considerations/Relief

FCRA

Furnishing of Consumer Information Impacted by COVID-19: The CARES Act includes provisions addressing consumer reporting requirements. Many furnishers are or will be offering consumers affected by COVID-19 various forms of payment flexibility, including allowing consumers to defer or skip payments, as required by the CARES Act or voluntarily. <u>Such payment accommodations will avoid the reporting of delinquencies resulting from the effects of COVID-19.</u>

Regulatory Compliance Considerations/Relief

FCRA (continued)

Consumer Disputes Impacted by COVID-19: The FCRA generally requires that consumer reporting agencies and furnishers investigate disputes within 30 days of receipt of the consumer's dispute. The 30-day period may be extended to 45 days if the consumer provides additional information that is relevant to the investigation during the 30-day period. In evaluating compliance with the FCRA as a result of the pandemic, the CFPB has stated that they will consider a consumer reporting agency's or furnisher's individual circumstances and does not intend to cite in an examination or bring an enforcement action against a consumer reporting agency or furnisher making good faith efforts to investigate disputes as quickly as possible, even if dispute investigations take longer than the statutory timeframe.

Common Findings in 2020

Polling Question 4

How has working remotely (or a portion of your employees working remotely) impacted your institution?

A. Change has brought upon cost saving measures that has been great for our bottom line

B. We are less efficient and overall our institution is in a worse position because of it

C. No change and no impact

D. Unsure

Common Findings in 2020

1. Policy fails to document the timeline utilized to monitor the completion of annual reviews. Establishing and documenting a formal timeline enables consistency in conducting and completing annual reviews.

2. Consistency in loan write-ups; both structure and detail. Evidence of thoroughly understanding entity relationships and required documentation.

3. Due diligence of approved appraisers. Does not document the date the appraiser was added or the date of license expiration.

4. Not performing reviews of appraisals in accordance with policy/procedures

5. Policy provides guidance for annual reviews, which requires annual reviews for individual loans above $500,000. We recommend the policy be enhanced to provide an aggregate credit exposure guideline for relationships over $500,000.

6. Past due on Annual Reviews

Common Findings in 2020 (continued)

1. Management does not consistently prepare quarterly problem loan reports. Such reports typically provide background on the borrower, current workout plan, next steps, and updates on a quarterly basis. Such reports are generally briefer than an annual review and are intended to document the Institution's and borrowers ongoing efforts to resolve higher risk loans. This documentation is important as it evidences to third-parties (i.e., SBA, USDA, etc.) the Institution's diligence and activities to collect and protect guarantees.

2. Covenant compliance and getting updated financials from Lead Leader/Agent Bank.

3. PPP loans payroll calculation issues that include an employee's annual salary that was more than the allowable threshold or incorrect loan amount calculations.

THANK YOU