the CREDIT PULSE

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COVID Shockwaves and Aftereffects

In this issue of the *Credit Pulse*, we provide a U.S. bank supervisory update, spotlight commercial real estate (CRE) risks and shifting consumer payment priorities, and offer suggested actions related to credit risk modeling that financial institution leaders can take.

As COVID-19's shockwaves continue, credit portfolio managers are finding that an advanced degree in behavioral psychology might come in handy. Economic indicators affecting the strength of credit portfolios hinge on:

- An interrelated collection of underlying decisions and behaviors by federal legislators, banking supervisors and borrowers;
- Continually evolving perceptions about health risks; and
- Corresponding recommendations from healthcare professionals and governments about virus containment measures.

Two major provisions of the Coronavirus Aid, Relief, and Economic Security (CARES) Act — enhanced unemployment benefits and the Paycheck Protection Program (PPP) — have ended as of the publishing of this piece, and U.S. legislative leaders are still debating a further stimulus package after approving approximately $3 trillion worth of fiscal stimulus earlier this year. It also remains to be seen the extent to which recent presidential executive orders concerning unemployment benefits extensions, an eviction moratorium for renters and student-loan payment deferrals, along with a deferral on payroll tax collection to the end of this year, will provide meaningful relief.

The actions of federal and state government officials clearly affect the behaviors of companies and consumers. When forbearance measures expire, loan delinquency rates may spike and repayment priorities are likely to reshuffle for many borrowers. Government-mandated payment deferrals and loan forgiveness must be considered in assessing credit quality. Yet, performing this evaluation is challenging given the sheer magnitude of deferrals. While it is as important as ever for financial institution leaders to focus on capital adequacy, management capability, earnings and liquidity, they must be more sensitive to an expanding set of credit-related risks as well as to changes in borrower behavior.

Among the risks to consider:

- Cash flow challenges and increases in forbearance requests
- Increased unemployment claims
- Shifting customer payment priorities
- Highly leveraged borrowers at greater risk
- Defaults in the commercial real estate sector forecasted to be on par with the 2008–2009 recession
- Decline in discretionary spending
- Forecasted U.S. bankruptcies at a potential 10-year high[1]

In addition to finding new ways to identify, measure and mitigate these risks, financial institution leaders need to support distressed borrowers and, in many cases, reevaluate how they engage with borrowers.

Key Credit Metrics

	Recent	6/30/2020	3/31/2020	12/31/2019
Delinquency rates	1.51% (Q2)	1.51% (Q2)	1.52% (Q1)	1.47% (Q4)
Leveraged loan default rate	4.08% (August 31, 2020)	3.23% (June 2020)	1.84% (March 2020)	1.39% (December 2019)
U.S. Bureau of Labor Statistics unemployment rate	8.4% (August 2020)	11.1% (June 2020)	4.4% (March 2020)	3.5% (December 2019)
Conference Board Leading Economic Index (LEI)	104.4 (July 2020)	102.0 (June 2020)	104.2 (March 2020)	111.2 (December 2019)
Conference Board Consumer Confidence Index	84.8 (August 2020)	85.2 (June 2020)	120 (March 2020)	126.5 (December 2019)
CBOE Volatility Index (VIX)	25.59 (September 15, 2020)	30.43 (June 30, 2020)	53.54 (March 31, 2020)	13.78 (December 31, 2019)
S&P 500	3,385.49 (September 16, 2020)	3,100.29 (June 30, 2020)	2,584.59 (March 31, 2020)	3,230.78 (December 31, 2019)
Comment	• The overall economic outlook continues to be volatile given the uncertainty surrounding COVID-19 and political gridlock around potential legislative action and fiscal stimulus. • Lenders continue to await clarity on potential relief related to required documentation to assess PPP loan forgiveness (specifically, any potential relief beyond the Small Business Administration's $50,000 streamlined application requirements). • Forward indicators continue to point to increased default activity as temporary COVID-19 relief expires and various industry segments continue to be challenged while others are holding up well. • Numerous updates have been made to credit-related supervisory guidance and more are anticipated on topics such as loan portfolio management and Troubled Debt Restructurings (TDRs). • Interest rates are expected to remain low for an extended period, resulting in increased demand for certain products (such as residential mortgages origination and refinancing) and interest margin compression.			

[1] "US Bankruptcies Are on Track to Hit a 10-Year High as the Coronavirus Pandemic Continues to Slam Businesses," Carmen Reinicke, Markets Insider, August 11, 2020: https://markets.businessinsider.com/news/stocks/us-bankruptcies-track-hit-decade-year-high-coronavirus-crisis-businesses-2020-8-1029492702#.

Supervisory Aftershocks Continue

It's no surprise that guidance aimed at economic stabilization continued to evolve through the spring and summer, with more anticipated guidance to come. Highlighted below are a few key actions that have occurred since April that warrant special attention.

June Interagency Examiner Guidance

In June, the federal financial institution regulatory agencies — the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC) and the National Credit Union Administration (NCUA) — along with the state bank and credit union regulators, issued guidance "for assessing the safety and soundness of financial institutions given the ongoing impact of the COVID-19 pandemic."[2]

The 11-page document asserts it is "essential that examiners maintain a clear understanding of the financial condition of each institution and the effectiveness of each institution's risk assessment and response to the economic changes." This means that examination scopes will likely be adjusted to reflect the significance of affected loan and investment portfolios. Examiners will continue to assess credit in line with existing interagency credit classification standards. The guidance detailed how examiners will address important areas and considerations, including the following:

- Classification of credits
- Credit risk review
- New loans
- The Paycheck Protection Program (PPP)
- Credit modifications
- Nonaccrual
- Allowances for loan and lease losses (ALLL) and Current Expected Credit Loss (CECL)
- Real estate values
- Appraisal and evaluation delays
- The effectiveness of the institution's assessment of risk

July Senate Banking Committee Chairman Letter

On July 31, Senate Banking Committee Chairman Mike Crapo sent a letter to financial regulatory agency leaders applauding their injections of liquidity into the marketplace during the COVID-19 crisis and exhorting them to "remain diligent and continue to provide relief in light of a pandemic and economic conditions that continue to evolve."[3] Chairman Crapo specified several sets of recommendations, including:

- Extending relief provided under certain CARES Act provisions, including extending temporary relief related to:
  - Capital relief for smaller banks in the form of a reduction in the Community Bank Leverage Ratio from 9% to 8% by extending it to December 31, 2021
  - TDRs classification of loans with COVID-19-related modifications (forbearance, interest and/or principal deferrals, repayment plans, etc.) by extending relief to January 1, 2022
  - CECL methodology implementation by extending it to January 1, 2023 (while clarifying and minimizing unintended effects of midyear adoption)

[2] Federal Reserve Board, "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions," June 2020: www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200623a1.pdf.

[3] Letter from Mike Crapo, chairman of the Senate Banking Committee, to leaders of federal regulatory agencies, July 31, 2020: www.banking.senate.gov/imo/media/doc/Chairman Crapo Letter to Regulators_7.31.20.pdf.

- Taking additional steps to strengthen minority depository institutions (MDIs) and promote their economic activity by:
  - Codifying the federal Minority Bank Deposit Program
  - Strengthening partnerships between MDIs and the U.S. Treasury Department
  - Simplifying requirements for MDIs to raise capital
  - Clarifying the regulatory treatment of troubled loans and capital requirements for Community Development Financial Institutions and MDIs
- Extending looming deadlines for the following:
  - The Housing and Urban Development and Federal Housing Finance Agency single-family foreclosure and eviction moratorium
  - The maximum duration of multifamily mortgage forbearance for loans backed by Fannie Mae and Freddie Mac, beyond the current period of six months

August FFIEC Statement

On August 3, the Federal Financial Institutions Examination Council (FFIEC) issued a statement laying out prudent risk management and consumer protection principles for financial institutions to consider while working with borrowers as loans near the end of initial loan accommodation periods during the COVID-19 pandemic. The guidance, which applies to retail and commercial loan accommodations, defines "additional loan accommodations" as "the options a financial institution may provide to the borrower after the initial accommodation, which may include an additional accommodation, an agreement to repay any amounts deferred as a result of the initial accommodation, or an agreement to change the terms of the loan agreement to improve the long-term sustainability and affordability of the loan."[4]

The guidance specifies actions and deliberations to consider performing within five areas. For example, regarding prudent risk management practices, the FFIEC recommends:

- Identifying, measuring and monitoring the credit risk of loans that receive accommodations
- Applying appropriate loan risk ratings or grades and making appropriate accrual status decisions on loans affected by COVID-19
- Utilizing management information systems and reporting
- Providing clear, accurate and timely information to borrowers and guarantors regarding the accommodation

Recommendations are also itemized for well-structured and sustainable accommodations, consumer protection, accounting and regulatory reporting, and internal control systems.

While these actions are noteworthy, additional guidance, statements and announcements continue to appear. In late July, for example, Chairman Crapo also sent a letter to Treasury Secretary Steven Mnuchin and Fed Chairman Jerome Powell, encouraging them to allocate still-available funds under the CARES Act to expand the Main Street Lending Program by establishing an asset-based commercial lending program and a new commercial real estate program.[5] More broadly, in late September, Mnuchin and Powell stated that nearly $400

[4] Federal Financial Institutions Examination Council, "Joint Statement on Additional Loan Accommodations Related to COVID-19," August 3, 2020: www.ffiec.gov/press/PDF/Statement_for_Loans_Nearing_the_End_of_Relief_Period.pdf?source=govdelivery.

[5] Letter from Mike Crapo, chairman of the Senate Banking Committee, to Steven Mnuchin and Jerome Powell, July 31, 2020: www.banking.senate.gov/imo/media/doc/Chairman Crapo Letter to Treasury_Fed _7.31.20.pdf.

million in unused funds from the CARES Act was still available and could be diverted to provide further relief for individuals and businesses.[6]

Leaders in financial institutions should remain vigilant regarding the fluid regulatory and policy-making landscape.

Commercial and Consumer Credit Updates

As financial institution leaders strive to improve their identification of risk and weakening commercial and consumer loan portfolios, crucial questions affecting the precision of those evaluations loom large:

- Will additional sweeping or targeted COVID-19 stimulus package(s) appear?
- Will forbearances, modifications, maturity extensions and other forms of relief assistance under existing COVID-19 relief be extended when they expire?
- What if borrowers cannot provide timely or accurate financial information?
- Will delinquencies surge, and if so, when?
- What tools can be used to address the historically high portion of covenant-lite leveraged loans as those borrowers continue to struggle?
- How will the November elections affect current and future economic relief efforts?
- Which borrowers or industries may not see recovery in the near term or at all?

While answers to these questions are still to be determined, the uncertainty does not preclude lenders from improving their ability to target and manage risk amid difficult conditions. This requires accessing new information from borrowers to update credit risk assessments — at least quarterly, if not more frequently. The ability to obtain these updates affects evaluation of expected losses, which in turn affects how much capital needs to be held.

While a similarly cascading set of challenges exists in both commercial and consumer credit, we're spotlighting two issues, commercial real estate and changing consumer payment priorities, that reflect the credit risk modeling challenges financial institutions confront.

In August, the Standard & Poor's Leveraged Commentary & Data (LCD) leveraged loan default rate surpassed 4%, which is twice the level seen in January and the highest reported since September 2010. Retailers broke the sector-level default rate record in May, and the oil and gas industry did so in July, with the latter contributing to 29% of all defaults in 2020. The largest number of leveraged loans that were considered by S&P as the "weakest links" (rating of B- or lower) were related to the technology, healthcare and business equipment/services sectors, which collectively comprise 34% of the institutional lending market (S&P/Loan Syndications & Trading Association Leveraged Loan Index).

Covenant lite, or "cov-lite," leveraged loans, and the collateralized loan obligations (CLO) through which these loans are packaged and sold, continue to raise industry concern.[7] As events continue to unfold, default and recovery rates and how these highly diversified CLO structures will weather the storm are uncertain, but the risks related to the leveraged lending market continue to be an area of concern and closely monitored within organizations and in the marketplace.

[6] "Mnuchin, Powell say some $380 billion in unused aid could help U.S. economy," Ann Saphir, Howard Schneider, Reuters, September 24, 2020: www.reuters.com/article/us-health-coronavirus-usa-fed/mnuchin-powell-say-some-380-billion-in-unused-aid-could-help-u-s-economy-idUSKCN26F2QA.

[7] For more information on cov-lite loans, read the April 2020 edition of the *Credit Pulse* from Protiviti: www.protiviti.com/US-en/risk-compliance/credit-risk.

Commercial Real Estate: Mixed Messages

After soaring in May and June, the default rate for commercial mortgages declined significantly in July. That hardly means that financial institutions with sizeable commercial real estate (CRE) holdings are breathing sighs of relief. Trepp's U.S. commercial mortgage-backed securities (CMBS) delinquency rate, which measures loans 30 days or more past due, reached a near all-time high of 10.32% in June (two basis points shy of the index's all-time high in July 2012). July's 9.6% CMBS delinquency rate— a decline of 72 basis points — should be considered in context. (The delinquency rate was 2.14% in January.)[8]

Evercore ISI indicates that CRE loans comprise an estimated 22% of banks' loan portfolio. Yet, banks' allowances for those loans equate to approximately one-third of the Federal Reserve's forecast losses in the 2020 stress test.[9] Recent analyst calls suggest that bank-owned CRE loans are holding up better than CMBS, which may be a result of federal relief actions; however, this raises questions about the extent to which bank-owned loan delinquencies may increase as deferrals expire.

Given these mixed signals, it is important for financial institutions to:

- **Differentiate among subsectors:** Certain segments, such as lodging and retail, are anticipating prolonged challenges. However, some of the world's largest technology companies appear eager to invest in more office space. Facebook announced plans to lease 730,000 square feet in New York, and Amazon purchased a nearby building that could hold approximately 4,000 employees.[10]
- **Enhance portfolio analytics:** To stay informed of portfolio changes and deteriorations, use of enhanced analytics is paramount. These analytics should include aspects such as concentration assessment, stress-testing scenarios that correspond to potential simulations, potential impact of risk rating migrations, etc.
- **Update loss forecasting models:** Models may fail due to negative economic impacts or scenarios that were not envisioned when they were constructed. As extreme macroeconomic factors become the actual data used for modeling and back-testing, models will need to be updated.
- **Forecast more scenarios:** As economic indicators deteriorate, financial services companies need to develop multiple scenarios — baseline, adverse and severely adverse — to determine possible outcomes amid volatile and uncertain conditions going forward. CECL models may have vastly different results in Q3 compared to Q1 as economic conditions continue to evolve and various industry and borrower segments are impacted differently.
- **Look ahead:** Getting an early view of portfolio impacts and then developing action plans driven by related scenario analyses can help minimize credit losses while maintaining liquidity and financial strength.
- **Gauge government responses:** Government actions such as the PPP and moratoriums on evictions (which impact multifamily CRE holdings) must be considered in estimating credit quality, which is difficult given that there are few, if any, behavioral precedents for these programs and the numerous programs that have been initiated continue to change.

[8] Trepp, "CMBS Delinquency Rate Sees Biggest Drop in More Than Four Years," August 2020: https://info.trepp.com/hubfs/Trepp%20July%202020%20Delinquency%20Report.pdf.

[9] Telis Demos, "Commercial Real-Estate Bank Loans Are About to Get Real," *Wall Street Journal*, August 7, 2020: www.wsj.com/articles/commercial-real-estate-bank-loans-are-about-to-get-real-11596798001.

[10] Sebastian Herrera, "Amazon Bets on Office-Based Work With Expansion in Major Cities," *Wall Street Journal*, August 18, 2020: www.wsj.com/articles/amazon-bets-on-office-based-work-with-expansion-in-major-cities-11597741203.

- **Work with individual borrowers:** While some segments will produce much higher numbers of delinquencies than others, banks should assess risk at the individual borrower level. When it comes to managing troubled loans, the most prudent approach is to work through each individually. Given the large number of borrowers in many institutions' portfolios, prioritization of borrowers is key to ensuring that adequate resources are allocated in a timely manner to address problem credits. Examples of prioritization may include borrowers that requested relief due to COVID, facilities that are highly dependent on tenants that are known to have financial difficulties or have filed bankruptcy, and borrowers whose liquidity has significantly decreased.

Small Business and Consumer Credit Risk: New Payment Priorities

This summer, a group of economists and researchers at the Federal Reserve Bank of New York conducted a comprehensive analysis of the financial health of U.S. consumers who do not have a mortgage or a student loan. The purpose of the exercise was to assess the ability of consumers who are ineligible for the debt relief provisions of the CARES Act to manage financial distress. The deep-dive analysis churned through data on ZIP codes, age, income, race, credit score, credit card debt and other factors — and concluded that a significant swath of this population (especially those with already-delinquent credit card accounts) would be well served by continuing government programs providing unemployment coverage and stimulus checks.[11]

This conclusion may not have been earth-shattering, but the nature of the analysis is instructive for leaders with financial institutions seeking to gain a clearer picture of consumer credit risks. The need to generate clarity amid the fog of uncertainty is increasing attention on consumer payment priorities. When it comes to prioritizing which loan and bill payments individuals are willing to pay and which they opt to defer, consumers are behaving differently during the COVID-19 economic crisis than they did in the previous recession. Government stimulus actions appear to be playing a role in this behavioral shift.

According to a recent survey by *The Wall Street Journal*, consumers this year are more likely to delay payment on rent, utilities and auto loans and less likely to delay payment on life, health and dental insurance.[12] Healthcare concerns amid a global pandemic, the CARES Act eviction moratorium, high unemployment rates, remote working and stay-at-home requirements appear to have a significant influence on consumer behavior and payment priorities. Although that survey did not ask participants about credit card payments, credit card debt and delinquencies have been decreasing and are lower in the COVID-19 crisis than trends during previous financial crises.[13] In addition, according to a recent Consumer Financial Protection Bureau (CFPB) study, people have not loaded up on credit card debt as a means of staying afloat.[14]

When addressing all areas of commercial and consumer credit risk, lenders should continue to pursue the actions we identified in our last issue of the *Credit Pulse*.[15] This involves addressing resource shortages and realignment needs,

[11] Rajashri Chakrabarti et al., "Debt Relief and the CARES Act: Which Borrowers Face the Most Financial Strain?" Federal Reserve Bank of New York, August 19, 2020: https://libertystreeteconomics.newyorkfed.org/2020/08/debt-relief-and-the-cares-act-which-borrowers-face-the-most-financial-strain.html.

[12] "Americans Skip Millions of Loan Payments as Coronavirus Takes Economic Toll," AnnaMaria Andriotis, ***The Wall Street Journal***, June 18, 2020: www.wsj.com/articles/americans-skip-millions-of-loan-payments-as-coronavirus-takes-economic-toll-11592472601.

[13] Matthew Dalton and AnnaMaria Andriotis, "Consumers, Flush With Stimulus Money, Shun Credit-Card Debt," ***Wall Street Journal***, August 2, 2020: www.wsj.com/articles/consumers-flush-with-stimulus-money-shun-credit-card-debt-11596373201.

[14] ***The Early Effects of the COVID-19 Pandemic on Consumer Credit***, CFPB Office of Research Special Issue Brief, Consumer Financial Protection Bureau, August 2020: https://files.consumerfinance.gov/f/documents/cfpb_early-effects-covid-19-consumer-credit_issue-brief.pdf.

[15] "COVID-19 — A Global Shockwave to the Financial System," ***Credit Pulse***, Protiviti, April 2020: www.protiviti.com/US-en/insights/whitepaper-covid-19-global-shockwave-financial-system.

responding quickly to regulatory changes, and enhancing data collection activities and credit documentation, among other steps. Given all that has transpired during the past several months, institutions can further support their borrowers while mitigating credit risk by considering these steps:

- **Upgrade communications:** Consistent and proactive communication with borrowers is a baseline requirement. Institutions should utilize this challenge as an opportunity to ensure they have a holistic view of their customers that integrates information from all engagement channels. This can be done by leveraging email, text, phone, chat or another channel. In addition, any collections communication for consumer debts across these channels should consider requirements for the proposed changes by the CFPB to Regulation F, including controls for opt-out disclosures and use of employer -provided emails.
- **Leverage technology to address resource challenges:** Customer service expertise is in high demand across the industry. Related support functions, such as appraisal and legal, are also being called on with greater frequency. Organizations should have a well-defined approach to considering requests for additional borrower relief. In addition to hiring for these areas and reassigning current staff, organizations are leveraging technology to streamline processes in ways that enable them to enrich their communications with high-risk portfolio segments and individual customers.
- **Get granular:** While certain industries and portfolio segments represent higher default risk than others, institutions are best served by generating highly granular assessments of credit risk. Restaurants face different COVID-19 challenges than retailers with e-commerce capabilities. Mom-and-pop restaurants differ from chain restaurants, as sole proprietor eateries in certain geographies may be thriving, while those in other markets may not. Loan-by-loan analyses can help determine if a high-risk bucket contains 10 borrowers or 10,000 and the potential value at risk, which could have a significant impact on the approach taken to manage this risk (e.g., the number of skilled resources that are needed for workout activities, segmentation strategies, use of technology).
- **Consider COVID-19-specific risk assessments:** In addition to traditional risk-rating scales and frameworks, more financial institutions are developing COVID-19-specific assessments to help them pinpoint which borrowers are most likely to experience ongoing challenges and constraints in the current economic environment. Among the advantages, this may allow institutions to distinguish risk level across similar loan types within the same portfolio (e.g., single tenant CRE leased to a publicly traded pharmacy versus single tenant property leased to a movie theater). In addition, leaders with financial institutions should recognize that some borrowers may have loan obligations that are stressed, yet this and their ability to pay back loans are not showing in their FICO scores due to the prevalence of available loan accommodation and lending programs.
- **Expect growing regulatory scrutiny and fraud risk assessments:** As instances of PPP fraud and abuse are publicized, regulatory scrutiny is intensifying. Some of the missteps that have attracted regulatory scrutiny involve claims of discrimination, such as intentional misuse of government funds.

While the Department of Justice took the lead in identifying and addressing PPP-related fraud, other regulators are following suit, and their focus is likely to center on lenders' efforts to identify and address fraudulent activity. Lenders that self-discovered frauds, as opposed to being discovered by law enforcement or through regulatory examinations, will fare much better with regulators, so lenders should take steps to:

- Ensure that all components of the lender's PPP program are documented.
- Reexamine the Know Your Customer information collected on borrowers.
- Analyze their incentive programs and payouts for any signs of potential insider wrongdoing.
- Ensure that PPP loans have been incorporated into Bank Secrecy Act/anti-money laundering transaction monitoring and fraud monitoring programs.
- Be prepared to assess eligibility for forgiveness based on a comparison of information provided at the time of an application with that included with the forgiveness application.

In Closing

As many states are experiencing increases in COVID-19 infection and mortality rates and as previous stimulus programs expire, consumer confidence and incomes are likely to decrease and loan delinquencies could multiply. A decrease in COVID-19 infection rates and additional government stimulus would blunt the impacts of those negative consequences, but financial institutions cannot count on either form of relief to materialize over the short term or remain indefinitely. Instead, organizations should continue to sharpen their focus on actions they can take to measure and manage credit risks within their portfolios, while keeping an eye on the legislative and supervisory horizon.

At this point, it appears the only certainty is that there will continue to be uncertainty related to things institutions cannot control, such as the path of the virus, potential government support, the availability and efficacy of a vaccine, or further regulatory actions. As such, it is imperative that leaders with financial institutions continue to take action diligently to assess changes in risk within their portfolios and act accordingly.

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