Risk Ratings and Restructuring

COVID-19 continues to evolve with unimaginable ramifications to individuals and businesses around the world. The outbreak has caused increasing global business and economic disruptions. The spread of this disease and its resulting economic impact is unprecedented.

Most certainly loan portfolios have been both directly and indirectly impacted with increasing risk based on the current impact of COVID-19. Programs such as PPP, EIDL and the various forms of loan modifications and payment deferrals have provided either some level of working capital or cash flow relief to many borrowers. These programs may keep borrower's from going into default in the near term. Unfortunately, COVID-19 is currently too unpredictable, and these conditions may persist for some time.

Employment levels may be one key factor to help risk managers appreciate the potential impact of COVID-19. The result of legislative actions has triggered an unparalleled and extraordinary rise in unemployment. The March 23, 2020 "On the Economy Blog" titled Back-of-the-Envelope Estimates of Next Quarter's Unemployment Rate, by Miguel Faria-e-Castro, Economist, provides some insights into the potential outcomes for unemployment for the 2nd quarter of 2020. The paper identifies 66.8 million people that are employed in occupations that are at high risk of layoff and another group of 27.3 million workers with occupations identified as high personal contact intensity. Through these two groups, the author estimates a potential unemployment rate of 32.1% in the second quarter of 2020. This includes an estimated 47.05 million people laid-off during the second quarter plus the existing 5.76 million existing unemployed.

These numbers are staggering and truly hard to imagine. Unemployment will continue to be impacted by the speed and depth of state's restrictions on non-essential jobs. However as recent as April 9, 2020 economists were still anticipating an unemployment rate of 25%. To put this into context, the unemployment rate peaked at 10% during the Great Recession.

The Five C's of Credit include Character, Capacity, Capital, Collateral and Conditions. Currently, the C in Conditions is heavily influenced by the other new C, the C in COVID-19. Conditions not only include interest rate, loan amount and repayment terms, but also include factors outside of the borrower's direct control such as the state of the economy, industry trends or pending legislative changes. Conditions outside of the borrower's control have had an immediate outsized impact on borrowers. In addition, current Conditions have significantly influenced three of the remaining 4 C's of Credit: Capacity, Capital and Collateral in various ways and to various degrees. Conditions may also provide a greater insight into the Character of borrowers.

Bank regulatory agencies (agencies) have communicated they, "will not criticize institutions for working with borrowers in a safe and sound manner". Additionally, the Financial Accounting Standards Board (FASB) in coordination with the agencies has indicated payment modifications under Section 4013 of the CARES Act will not constitute a Troubled Debt Restructure (TDR) under ASC 310-40. FASB specifically excluded government-mandated modification or deferral programs related to COVID-19. The non-inclusion of modifications under the CARES Act provides bankers an opportunity to work with borrower's without immediately impacting Call Report requirements. The non-inclusion of TDR requirements for Call Reporting purposes does not mean risk has not increased within the loan portfolio. It should be clear a determination of TDR status and risk ratings remain two separate decisions.

The current economic downturn was not anticipated in terms of both the timing and the broad nature of the impact. Risk in loan portfolios has increased and continues to increase each day we are restricted from our conventional business operations. A great deal of uncertainty remains regarding the length, severity of the impact of COVID-19 along with the shape of the subsequent recovery. Loan portfolio risk identification and management should continue to be fluid and best represent the current risk in the loan portfolio. Regulators will continue to expect appropriate risk identification within the loan portfolio. Risk ratings should be accurate and timely with a dynamic approach for ratings to change as the risk changes. Risk rating methodologies should provide for early identification of problem credits, form the basis for the ALLL and provide for loan portfolio management. Bankers will need to continue to appropriately monitor and adjust risk ratings on a case-by-case basis to provide a timely assessment of risk within the loan portfolio.

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