LOAN REVIEW DURING THE PANDEMIC:

MONITORING AND REPORTING IN A “WHAT IF?” WORLD

BY STEVE WERT AND DEV STRISCHEK

Introduction: Welcome to Our New Work-Around World

Tom Edison was fond of saying, "I haven't failed—I've just found 10,000 ways that won't work." Unfortunately, most of us do not have Mr. Edison's time or money to test 10,000 possible solutions to this pandemic crisis when so many bankers are trying to figure out what to do first to cope with its threat to portfolio credit quality. What if the pandemic takes longer to run its course? What if recent governmental remedial actions must be extended? Loan review has always played a vital role in assessing both current impact as well as future consequences for asset quality in disaster scenarios, e.g., floods, hurricanes, earthquakes, fires, and COVID-19 has certainly been as devastating as some of our nation's past natural disasters. Expectations for loan review's role in this pandemic might start with sorting through recent regulatory actions and legislation.

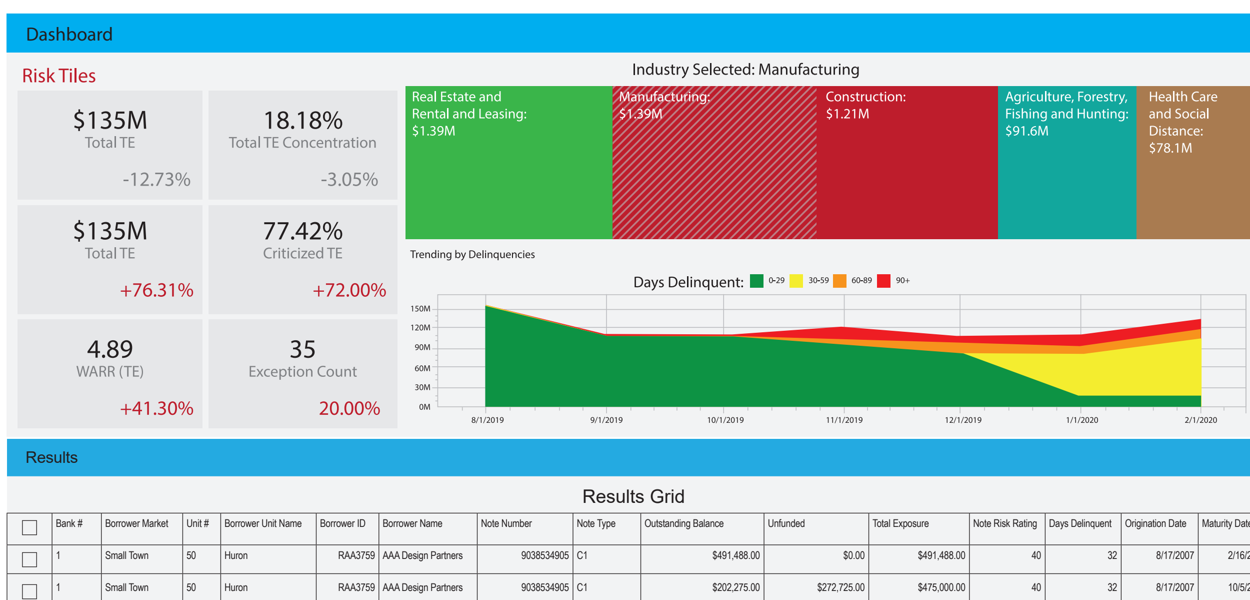
Governmental Responses to the Pandemic: Easy Does It?

Recent regulatory changes extended the bank exam cycle from one year to 18 months and raised the bank asset size limit from $1 billion up to $3 billion. Less frequent regulatory exams will mean more reliance on loan review to police portfolios. In addition, the $2 trillion CARES Act package will provide TDR relief, delay CECL, permit a lower leverage ratio, and waive lending limits. All of these measures will allow banks to better serve the credit needs of their customers, but they also increase the inherent risk in loan portfolios. For example, the TDR relief measure provides temporary relief from troubled debt restructurings beginning March 1, 2020, and extends 60 days after the end of the COVID-19 emergency. How does a bank monitor and report this measure? The aggregated impact of this and other temporary emergency measures will be less stringent underwriting of less creditworthy borrowers as bankers are asked to carry them through this difficult period by permitting lower debt service coverage ratios and higher loan-to-value ratios, and accepting marginal guarantors. Updated appraisals of real estate collateral value will certainly reflect shrinkage as lease and rental income declines and cap rates rise.

Combine the weaker underwriting with the easing of controls over borrowers, and financial organizations will have to monitor and manage a "pass" portfolio that contains borrowers on or over the edge into "criticized/classified" territory. While demonstrating their willingness to work with clients through the pandemic, bankers must also track their most vulnerable borrowers as well as others susceptible to longer-term effects of the pandemic, e.g., malls with closed tenants, office buildings with bankrupt lessees, manufacturers reliant on failed suppliers, etc. All of these adverse consequences need to be evaluated, monitored, and reported so that when the regulatory community advises the banking industry to return to business as usual, the banks can begin the arduous process of problem-asset resolution.

Besides TDR relief, what will the delay in CECL and higher bank leverage mean for asset quality in existing and new loan growth? Which borrowers and industries are most vulnerable to COVID-19, and which borrowers are less vulnerable? What geographies have been hit the hardest?

These kinds of reporting and analytical demands require adjusting for various time scenarios, e.g., the 60-day end to



☐	Bank #	Borrower Market	Unit #	Borrower Unit Name	Borrower ID	Borrower Name	Note Number	Note Type	Outstanding Balance	Unfunded	Total Exposure	Note Risk Rating	Days Delinquent	Origination Date	Maturity Date
☐	1	Small Town	50	Huron	RAA3759	AAA Design Partners	9038534905	C1	$491,488.00	$0.00	$491,488.00	40	32	8/17/2007	2/16/20
☐	1	Small Town	50	Huron	RAA3759	AAA Design Partners	9038534905	C1	$202,275.00	$272,725.00	$475,000.00	40	32	8/17/2007	10/5/20

Figure 1

Source: DiCOM

TDR relief after the unpredictable declaration date for the end of the COVID-19 emergency.

The pandemic has made critical the ability to easily analyze risk by industry, geography, or virtually any data attribute to find risk not necessarily visible in the portfolio. Figure 1 offers some insight into what technology can do for risk managers charged with spotting latent risk before it erodes asset quality – risk tiles and trend graphs to provide quick visibility to the emerging risk in each concentration. We suggest portfolio information should be filtered and evaluated for any risk factors present in the data as banks grapple with tracking credit risk not yet visible in traditional analysis due to delayed classifications and deferment of other regulatory requirements.

Yet another suggestion is the use of trend graphics, such as the illustration in Figure 2 analyzing delinquent loans; this graph depicts the volume and severity of delinquencies for a particular concentration over time.

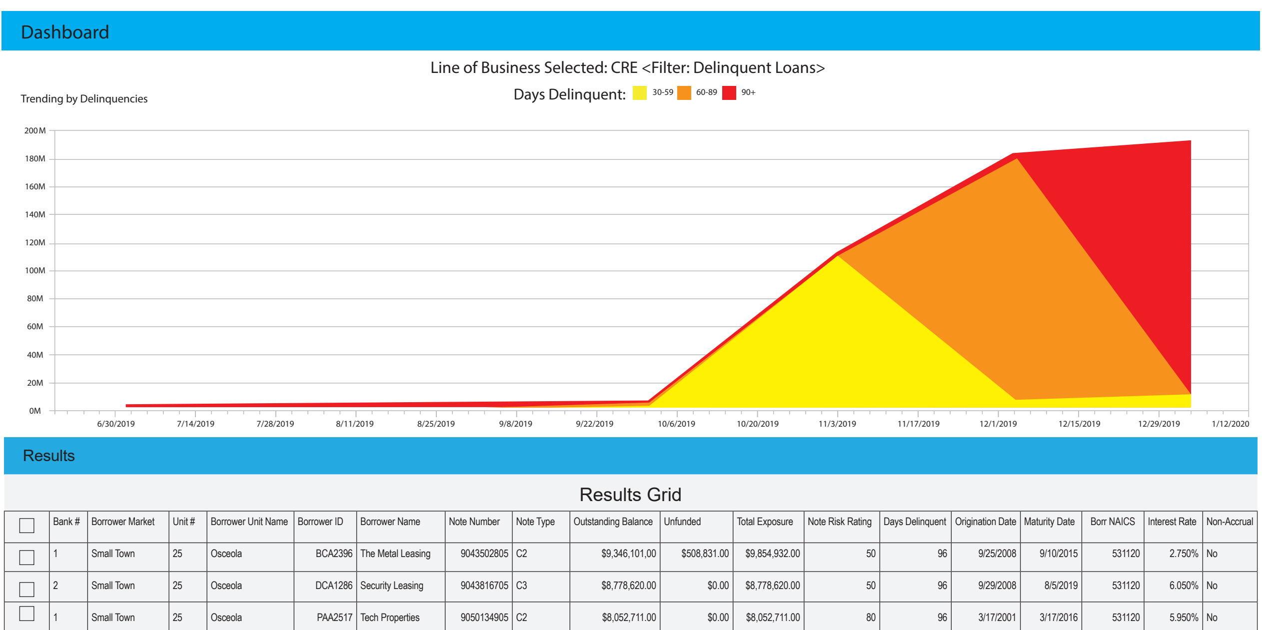
Another tip is to monitor trends in loan covenant ratios. Instead of waiting for a DTI, DSCR, or a leverage ratio to breach the covenant limit, trend analysis of these ratios reveals downward trends to flag weakening credits. Current measures enacted such as forbearance and payment deferrals may help support the economy, but they may also create growing blind spots of emerging risk. Leveraging leading indicators will help banks better adapt to the economic uncertainty and proactively manage growing credit risk

There is a growing criticality for real-time integration of portfolio analysis with the credit review process. Portfolio analysis must feed directly into the loan review workflow engine and auto-populate reports with the results of the portfolio analysis and the credit review findings. It streamlines the process, allowing more time for experienced staff to identify root cause and hidden risk. Targeted reviews can be easily performed to stay on top of dynamic economic conditions. Regardless of the vendor, the loan review function must move from ex post facto commentary on current problems to a more predictive and preventive role.

FFIEC's Guidance on Pandemics: Be Careful Out There[1]

Fans of "Hill Street Blues" may remember Sargeant Phil Esterhaus warning his cops after their morning roll call and briefing, "Let's be careful out there." Well, our regulatory cops did much the same in March 2020. The Federal Financial Institutions Examination Council (FFIEC), on behalf of its member agencies, issued guidance on pandemics by updating a 2007 Interagency Statement on Pandemic Planning. It also updated "Interagency Advisory on Influenza Pandemic Preparedness," originally issued in 2006 by the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, as well as the "Letter to Credit Union 06CU-06 - Influenza Pandemic Preparedness" issued by the National Credit Union Administration in March 2006. The revised document offers some direction by reminding financial institutions that business continuity plans should address the threat of a pandemic outbreak and its potential impact on the delivery of critical financial services.

The potential effects of a pandemic should be a part of the financial institution's overall business continuity management business impact analysis (BIA). One of the analytical tasks listed is to "identify the potential impact of a pandemic on customers: those that could be most affected and those that could



Results Grid

	Bank #	Borrower Market	Unit #	Borrower Unit Name	Borrower ID	Borrower Name	Note Number	Note Type	Outstanding Balance	Unfunded	Total Exposure	Note Risk Rating	Days Delinquent	Origination Date	Maturity Date	Borr NAICS	Interest Rate	Non-Accrual
☐	1	Small Town	25	Osceola	BCA2396	The Metal Leasing	9043502805	C2	$9,346,101,00	$508,831.00	$9,854,932.00	50	96	9/25/2008	9/10/2015	531120	2.750%	No
☐	2	Small Town	25	Osceola	DCA1286	Security Leasing	9043816705	C3	$8,778,620.00	$0.00	$8,778,620.00	50	96	9/29/2008	8/5/2019	531120	6.050%	No
☐	1	Small Town	25	Osceola	PAA2517	Tech Properties	9050134905	C2	$8,052,711.00	$0.00	$8,052,711.00	80	96	3/17/2001	3/17/2016	531120	5.950%	No

Figure 2 Source: DiCOM

Concentrations by Industry (Top 5)
Data Effective Date: 4/7/20

Industry	Outstanding Balance	% of Total OS	% Criticized	% Classified	% Downgraded*
Real Estate and Rental Leasing	$130,024,496	22%	27%	17%	12%
Maufacturing	$104,231,944	17%	21%	12%	6%
Construction	$98,150,759	16%	18%	11%	7%
Agriculture, Forestry, Fishing and Hunting	$73,187,363	12%	22%	9%	11%
Health Care and Social Assistance	$63,820,381	11%	5%	3%	1%

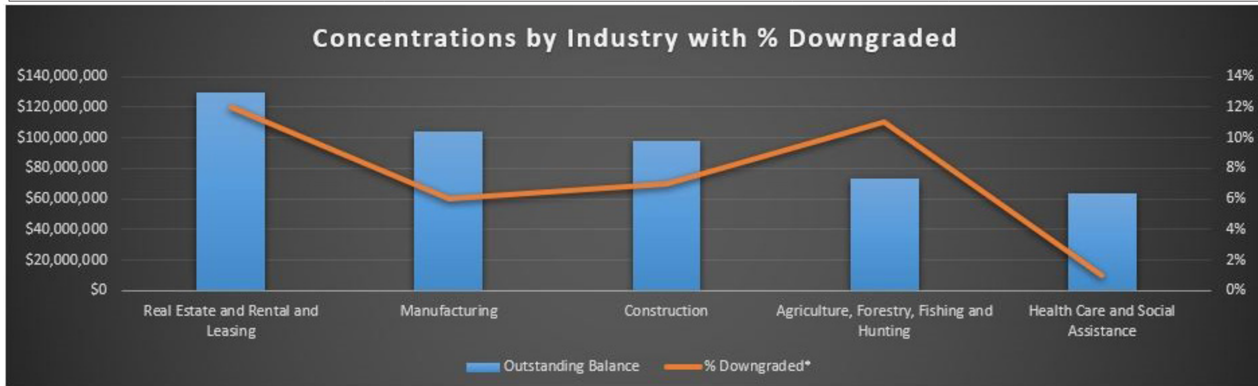


Figure 3 Source: DiCOM

have the greatest impact on the (local) economy."[2] So how does the organization identify customers most vulnerable to the pandemic and most impactful on the local economy?

We recommend that banks maintain extensive risk-reporting capabilities and the ability to access critical data for ad-hoc analytics. It will likely be very helpful to examine risky concentrations that existed at the beginning of the pandemic and continually monitor movement throughout the crisis. To effectively track the hardest-hit industries, capability should also include the ability to monitor growth in past dues, track businesses asking for payment relief (forbearance), and look at loans with loosened underwriting standards due to market pressure.

As we emerge from the crisis, loan review will need to track modified loans. Were they correctly modified, or was there faulty execution? Were they restored to P&I and paying as agreed, or are these borrowers asking for more forbearance? Are these loans appropriately classified, or are risk ratings not being updated? Are real estate-secured loans approved without updated appraisals and evaluations being identified for future remediation? The sample report in Figure 3 shows one way to display concentrations by industry along with percentages for criticized, classified, and downgraded.

Closing and Summary: Eternal Vigilance?

To paraphrase a quote attributed to Tom Jefferson, "The price of liquidity is eternal vigilance." The COVID-19 pandemic is going to require some eternal vigilance by our loan review units to monitor and report asset quality in a much more complex way because it will have to track borrowers who have been granted credit concessions in a volatile economic environment. The pandemic gives bankers the push they need to implement more forward-looking processes in monitoring, managing, and reporting credit risk. We have suggested some ways to evaluate vulnerable borrowers and some examples of reports that can help loan review units to cope with this responsibility. As Tom Edison observed, "Our greatest weakness lies in giving up. The most certain way to succeed is always to try just one more time." Try some of our recommendations some time. ®

Notes

1. Interagency Statement on Pandemic Planning, https://www.ffiec.gov/press/PDF/FFIEC%20Statement%20on%20Pandemic%20Planning.pdf (04/02/2020)
2. Ibid.

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