the CREDIT PULSE

April 2020

A financial institution's ability to maintain profitability through times of economic certainty or uncertainty is undoubtedly impacted by its careful management of the credit portfolio. Protiviti's Credit Pulse is intended to provide a summary and analysis of economic indicators impacting financial institutions and the strength of their credit portfolio while providing industry-leading insights and pragmatic recommendations to address areas of weakness.

COVID-19 — A Global Shockwave to the Financial System

It seems so long ago now. As recently as February, the Federal Reserve indicated that the near-term economic outlook remained favorable across the Unites States, supported by low unemployment rates and modest growth in consumer spending. With the country enjoying one of the longest positive economic cycles in its history, many financial institutions had taken great care to position their organizations for tougher times. Leading organizations developed downturn readiness playbooks and implemented governance and structure designed to enable them to identify deteriorating credit conditions on the horizon and take proactive actions to withstand a downturn. However, few organizations, if any, foresaw a shift as sudden and powerful as that brought on by the COVID-19 global pandemic.

The sizeable impacts of COVID-19 are only beginning to surface. China's retail sales of consumer goods declined 20% in the first 2 months of 2020 due to China's COVID-19 response.[1] As COVID-19 continues to spread, countries have responded by implementing social distancing and stay-at-home/in-place

[1] www.stats.gov.cn/english/PressRelease/202003/t20200317_1732694.html; www.nasdaq.com/articles/an-overview-of-chinas-economy-and-how-coronavirus-affected-it-2020-03-27.

measures, resulting in stalled economies and uncertainty in the financial markets. Moody's has estimated that compared to the first week of March, the U.S. daily output (as of April 6) has dropped 29% due to lockdown orders throughout the country, devastating the U.S. economy.[2] In addition, a record number of people — nearly 10 million — filed for unemployment benefits in the United States for the two weeks ending March 28, 2020. This is estimated to be higher than at any point since the Great Depression.[3]

We are in uncharted territory and there is limited visibility into the future, especially given the nature of this pandemic; however, by staying abreast of actions taken by governments and regulators, remaining current with the evolution of challenges, and taking action to understand borrower conditions, financial institutions can monitor credit risk exposures effectively and take appropriate action to best support borrowers, while maintaining the safety and soundness of their credit portfolios.

Seismic Actions from Governments and Regulatory Authorities

As news of the COVID-19 pandemic spread, supervisors and government leaders quickly mobilized, taking action in an attempt to stabilize and resuscitate the economy. The tone of policy makers has been markedly different than that expressed during the global financial crisis in 2007-2008, with the primary focus on providing economic relief to consumers and businesses most impacted by COVID-19. Following are a few highlights of recent policy changes that impact financial services customers.

Banking Supervisory Response[4]

- In early March, banking supervisors released several joint statements related to pandemic planning and encouraged financial institutions to meet the needs of customers and members affected by COVID-19.
- Interagency guidance was released encouraging institutions to work constructively with borrowers affected by COVID-19, including offering responsible small-dollar loans to consumer and small businesses.[5] In addition, any short-term loan modifications (payment deferrals, fee waivers, extensions of repayment terms, or other payment delays) made on a good faith basis for customers who are current prior to any relief are not to be considered as Troubled Debt Restructures. Also, loans with deferrals are not expected to be designated and reported as past due, or as nonaccrual.

[2] www.wsj.com/articles/state-coronavirus-shutdowns-have-taken-29-of-u-s-economy-offline-11586079001.

[3] www.wsj.com/articles/another-3-1-million-americans-likely-sought-unemployment-benefits-last-week-11585819800.

[4] Sources: Joint Release, "Agencies Encourage Financial Institutions to Meet Financial Needs of Customers and Members Affected by Coronavirus" (March 9, 2020); Joint Statement, "Pandemic Planning: Joint Statement on CRA Consideration for Activities in Response to COVID-19" (March 19, 2020); Joint Statement Encouraging Responsible Small-Dollar Lending in Response to COVID-19 (March 26, 2020; Interagency Statement on Loan Modifications by Financial Institutions Working with Customers Affected by the Coronavirus (March 22, 2020).

[5] "Treasury Department Issues Guidelines for Small Business Paycheck Protection Program," Protiviti Flash Report, April 1, 2020, www.protiviti.com/US-en/insights/flash-report-treasury-dept-issues-guidelines-small-business-paycheck-protection-program.

Government Response

- On March 15, the Fed cut short-term interest rates to zero to encourage lending to households and businesses. Due to this, many financial institutions began to see a surge in mortgage refinances, creating operational challenges at the same time many banks were transitioning to a remote workforce.
- On March 27, the President signed into law the CARES Act, a $2.2 trillion stimulus relief package that had been passed by the House and Senate to help U.S. families and businesses during the COVID-19 pandemic.
- Borrowers with mortgage loans under Fannie Mae and Freddie Mac that are experiencing financial hardship due to COVID-19 can request forbearance on their payments for up to six months. Interest will still accrue during the mortgage forbearance period; however, additional fees, penalties or extra interest cannot be added to mortgages. In addition, landlords cannot evict tenants or charge any late fees, penalties or other charges for past-due rent payments.
- Certain jurisdictions have also placed eviction and foreclosure moratoria. Although these actions help borrowers, the downstream impact of these actions on mortgage-backed security holders and other investors has not been addressed.
- The U.S. Department of Education directed borrowers to contact their student loan servicers and request forbearance. The stimulus package approved suspended payments and interest accrual for six months.
- The stimulus package also approved a $350 billion small business (SBA) loan fund. The loans are federally guaranteed and tax-free. All loan payments are deferred for six months and many will qualify to be forgiven.

Significant Fault Lines Remain

While the United States is spending vast sums of money to breathe life into a stalled economy and is focusing on regulatory flexibility, significant challenges remain for financial institutions related to the management of lending portfolios. As time continues to pass and rent, mortgage payments, corporate payroll, and other loan and investor payments come due, borrowers will be further challenged with regard to which obligations to pay or delay, resulting in increased impairments and delinquencies. This will also complicate each institution's ability to evaluate the credit quality of their portfolio, accuracy of risk ratings, and reserves, especially considering the implementation of CECL, which requires a life of loan evaluation of losses. At this point, it seems possible that every asset class will be impacted. Examples of vulnerabilities include:

Leveraged Loans

The COVID-19 crisis will shed further light on why covenants in leveraged loans are critically important. The Fed's data shows that more than 80% of leveraged loans are covenant lite. "Cov-lite" loans do not contain stipulations that require commercial borrowers to meet agreed-upon financial metrics, which serve as a form of protection for financial institutions. With cov-lite loans, as borrowers struggle, lenders will have fewer tools to manage their exposure and influence how borrowers utilize available cash.

As of January 2019, the Bank of England estimated there to be more than US$2.2 trillion in leveraged loans outstanding worldwide, as compared to US$1.4 trillion in 2018. It is estimated that nearly 45% of leveraged loans worldwide in 2018 were in collateralized loan obligation (CLO) investments. Corporations and sovereigns are being downgraded at a furious rate due to the COVID-19 crisis. As of March 31, Standard & Poor's reported 682 downgrades related to COVID-19, as compared to 583 rating actions for nine months ending 9/30/19.[6] S&P had reported 140 rating actions where it either downgraded a CLO tranche or put it on a negative credit watch; 10% of CLO assets have been downgraded and downgrades are likely to increase.[7] Such a prodigious level of downgrades could restrict CLOs' ability to reinvest, which is important to stabilize the credit market.

Organizations should scrutinize all potential exposure to leveraged lending. This involves evaluating both indirect and direct loans in the portfolio as well as investments in CLOs, among other areas. Speaking at a conference in Florida last spring, Fed Chairman Jerome Powell acknowledged that the riskiest form of corporate debt — leveraged loans — poses a concern in large part because a significant portion of this lending is financed outside of the regulated banking system. Leveraged loans also make up substantial components of closed funds, open-ended funds, and insurance and pension funds. A significant increase in leveraged loan defaults is projected to occur and will have a broad impact on financial services institutions, investors and consumers.

Lines of Credit

Corporations and consumers are beginning to draw on revolving lines of credit (LOCs) to shore up liquidity and combat expense and payment obligations. Financial institutions are already beginning to alter policies and revise existing lending programs (e.g., payment deferrals, increasing credit limits, reducing rates, fee waivers) to help consumers and small businesses weather this crisis.

It is imperative for financial institutions to ensure they have appropriate oversight and controls around these LOCs and appropriately consider how to balance borrower needs with the level of risk they are willing to assume.

Staffing Challenges

Given the combination of low interest rates and the velocity at which this crisis has developed, institutions are universally challenged with staffing. Many institutions were already seeing a surge in refinance and lending requests prior to the crisis taking hold, which has only been exacerbated by the volume of borrowers, both commercial and consumer, facing uncertainty or challenges. This will likely continue as a wave of loss mitigation and deferral requests flood call centers and commercial lenders. Additionally, given the nature of this crisis, this is all occurring as operations facilities and lending offices are shutting down, operating with reduced staffing, or transitioning to a distributed workforce (something for which many institutions may not have been prepared). It appears institutions will continue to face this challenge for an extended period.

[6] www.spglobal.com/ratings/en/research/articles/200318-covid-19-coronavirus-related-public-rating-actions-on-non-financial-corporations-to-date-11393186; www.spglobal.com/ratings/en/research/articles/191113-credit-trends-downgrade-prospects-are-growing-across-global-credit-markets-11233852.

[7] www.forbes.com/sites/mayrarodriguezvalladares/2020/03/27/distress-in-the-leveraged-loan-and-clo-markets-will-significantly-hurt-lenders-and-investors/#50fa336d7e10.

How to Respond

Many financial institutions are already in high-gear, taking action to respond to borrower inquiries, modifying policies to focus on customers impacted by COVID-19, and providing credit relief to their borrowers where they can. Although the path ahead will no doubt be fraught with further challenges, there are immediate actions institutions can take to continue to support their borrowers and mitigate credit risk.

- **Remove barriers for resources.** Assess what resource skillsets are needed, such as legal and compliance knowledge, special assets and problem loan workout experience, and customer service. Swiftly inventorying these skillsets across your organization and identifying personnel that can be cross-trained will help support areas with the greatest need and identify shortfalls to be addressed. For many organizations, consideration may include temporarily repurposing resources from the second and third lines of defense or bringing on temporary resources.
- **Keep abreast of changes.** Create a COVID-19 task force focused on credit risk management strategies. Ensure your institution has a process in place to assess and react swiftly to the rapidly evolving regulatory landscape, including considerations on policies and procedures and communication to responsible individuals, as well as potential further action taken by regulators and the government.
- **Reevaluate borrower communication.** Re-examine how the institution communicates with borrowers. Enact self-service models which incorporate technology that empowers customers to message, share documentation, contact or text via a mobile app or website. Analyze concerns of borrowers and look for trends that could potentially result in further policy changes.
- **Recalibrate credit risk rating models.** In this global crisis, rating models used to calculate probability of default (PD) and loss given default (LGD) may have lost their predictive capabilities. There is a need to consider recalibration of model inputs and assumptions to align with today's environment. Institutions maybe consider establishing an additional temporary COVID-19 risk rating.
- **Enhance data collection.** Institutions should continue enhancing data collection and ensure that the data collected during this time period is complete and can be relied on to provide deeper insights into credit risk on a go-forward basis. Establish COVID-19 system indicators or flags to help with ongoing monitoring and reporting. In addition, many institutions are well on their way with CECL implementation, but the timetable and priority for these efforts likely has shifted. Within the $2.2 trillion stimulus relief package signed into law is a provision that no insured depository institution, bank holding company, or any affiliate thereof shall be required to comply with the CECL standard during the period beginning on the date of enactment of the legislation and ending on the earlier of (a) the date on which the national coronavirus emergency declared by the President on March 13, 2020, under the National Emergencies Act terminates, or (b) December 31, 2020.[8] In short, affected financial institutions may have more time to transition to CECL, and while they likely will not stop their

[8] "CECL Deferred for Banks Due to the Impact of the COVID-19 Pandemic," Protiviti Flash Report, March 26, 2020, www.protiviti.com/US-en/insights/flash-report-cecl-deferred-due-covid-19.

transition activities altogether, much of the data exercise performed to prepare for CECL could be leveraged to perform sensitivity analysis on expected losses.

- **Focus on credit documentation.** Review credit legal documentation to understand your areas of greatest credit risk. Consider implementing optical character recognition (OCR) technology to automate tasks that would otherwise be performed manually. Perform keyword searches to help identify portfolios that lack appropriate or protective language and create strategies around these portfolio exposures.
- **Reassess concentration analysis.** Reassess how credit concentrations are aggregated and reported and modify them to align with the ongoing COVID-19 pandemic. Consider putting a different lens on your portfolio by evaluating professions, geographies, rating agency downgrades, etc.

In Closing

The COVID-19 global pandemic continues to evolve at a seemingly incomprehensible pace, and there is no reason to believe that will slow in the foreseeable future. We cannot lose sight that this crisis has been brought on by a health crisis and we will not be able to move past the economic challenges until the global health of the population is restored. As governments worldwide take steps to stem the tide of the pandemic and flatten the curve, financial institutions should take action to understand borrowers' current conditions, express empathy with the circumstances all of us are experiencing, and move swiftly to support borrowers while protecting the condition of the institution.

How Protiviti Can Help

Protiviti helps organizations maximize their returns by assessing, designing and implementing efficient and effective credit risk operations. Our professionals leverage experience as former lenders, regulators and risk managers to identify root causes, optimize operations and improve practices. Our credit risk management services cover the entire credit lifecycle ranging from risk appetite, policies and procedures, underwriting and originations, ongoing monitoring, problem loan management, credit and loan review, regulatory and financial reporting requirements (e.g., CECL, Basel, etc.), lender and portfolio due diligence, ongoing monitoring and reporting, and restructuring and litigation services.

CONTACTS

Bill Byrnes
Managing Director
+1.312.476.6387
bill.byrnes@protiviti.com

Matthew Moore
Managing Director
+1.704.972.9615
matthew.moore@protiviti.com

Michael Brauneis
Managing Director
+1.312.476.6327
michael.brauneis@protiviti.com

Ariste Reno
Managing Director
+1.312.476.6398
ariste.reno@protiviti.com

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