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Credit remade by COVID-19 crisis: Impact on loan modifications

Recent legislative and regulatory actions in response to the COVID-19 pandemic have resulted in an increase in loan modification requests[1]—such as deferrals and forbearances—placing pressure on banks to evaluate and service these requests in a timely manner.[2] With the initial wave of modifications expiring, banks may now be facing a second wave of requests while operating under significant pressure. However, banks can view this second wave as an opportunity to collect critical data to inform risk management decisioning and address certain operational and data challenges posed by a continuance of these payment holidays.

In April 2020, the Center for Regulatory Strategy analyzed[3] the Federal Reserve's credit facilities and several relief provisions within the Coronavirus Aid, Relief, and Economic Security Act [4] (CARES Act), which aim to more directly support the flow of credit to households and businesses.[5] With this support in place, banks moved rapidly to provide impacted communities and customers with access to loan relief.[6] Under the CARES Act, lenders are prevented from reporting deferred payments as late resulting in credit data that in many cases does not accurately reflect the level of risk. In response, many lenders have proactively increased the stringency of underwriting requirements and have begun to re-examine supporting models.[7] Given the potential for additional Congressional action on the horizon and the likely protracted duration of the economic recession, banks should remain mindful of the longer-term implications of government support,[8] especially as the temporary relief across sectors are set to expire.[9]

Examples of loan deferrals and forbearance

Loan Deferrals	Loan Forbearance
• Lender agrees to freeze payments for a period of time ('payment holiday') during which interest and fees are not accrued corresponding to an extension to the end of the loan • Deferred payment amount and term is added to the end of the loan • Initial deferrals (typical for a period of 90 days) were granted in March/April across the financial services industry with little to no data collection • Second round of deferral requests likely in July once the initial 90-day deferral period expires	• Lender agrees to accept reduced or no payment for a period of time ('payment holiday') during which interest and fees are accrued • When the period ends, the borrower restarts with regularly scheduled payments and must pay the amount accrued during the payment holiday (as a lump sum or installments) • Second wave of forbearance requests anticipated in line with related additional deferral requests timeline

With a focus on the challenges ahead in this environment, banks should a adopt 'strategic view' of how the ongoing crisis will impact corporate, small business, and consumer behaviors.[10] For example, with increased charge offs for universal, regional, and global banks in the first quarter and anticipated further credit deterioration in the third and fourth quarters of this year, banks should continually evaluate credit risk exposure in order to forecast their liquidity position, determine the impact to their portfolios, and the effect on capital.[11] Maintaining effective risk management and compliance programs during this period of changing regulatory guidance remains critical, necessitating robust analytics capabilities in order to make informed decisions when managing these potential downstream impacts.

Legislative and regulatory context

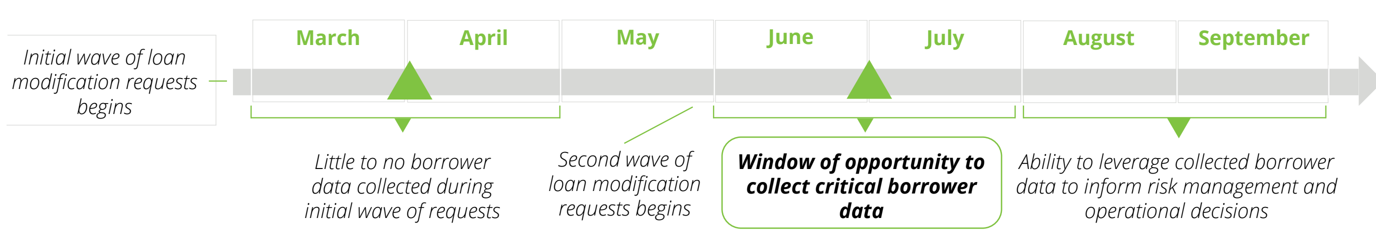
The uncertain economic conditions—especially if prolonged—may cause corporations, small businesses, and consumers to experience financial difficulties, preventing them from meeting their debt obligations, such as corporate/small business lending, leveraged loans, commercial real estate, as well as residential mortgages, personal loans, and outstanding credit card balances.[12] Amidst this ongoing financial difficulty, loan deferrals and forbearances have served as a source of relief for many.

The CARES Act provides consumers the right to forbearance for federally-backed mortgages, which about 70% of homeowners have,[13] and for the nearly 43 million who have federal student loans.[14] It also protects the credit histories of consumers with forbearance agreements.[15] In addition, the CARES Act offers both consumer and corporate loans relief from Troubled Debt Restructurings.[16] Financial regulators have issued guidance to encourage banks to provide options for helping distressed borrowers stay current with their loan payments and avoid default.[17] Loan modifications, for instance, allow the borrower, whether as an individual or a corporation, to renegotiate a contract with the financial institution in which the borrower can seek concessions (e.g., principal balance reductions, interest rate reductions, and term to maturity extensions). Most institutions granted these 'payment holidays' at the borrower's request, with minimal or no documentation required.

Beyond the CARES Act and initial regulatory actions, financial regulatory agencies have taken additional steps to respond to the crisis by encouraging loan forbearance and other financial relief options for affected borrowers and their banks, including:

Encouraging banks to work constructively with borrowers impacted by the pandemic	On April 7, 2020, the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the National Credit Union Administration (NCUA), and the Consumer Financial Protection Bureau (CFPB)—in consultation with state financial regulators—issued an interagency statement encouraging banks to work constructively with borrowers impacted by the pandemic. The agencies noted that they "view prudent loan modification programs to financial institution customers affected by COVID-19 as positive actions that can effectively manage or mitigate adverse impacts on borrowers due to COVID-19, and lead to improved loan performance and reduced credit risk."[18]
Issuing lending principles to encourage supervised banks, savings associations, and credit unions to offer responsible small-dollar loans for both consumer and small business purposes	On May 20, 2020, the FRB, FDIC, and the OCC, and the NCUA issued lending principles to encourage supervised banks, savings associations, and credit unions to offer responsible small-dollar loans to customers for both consumer and small business purposes.[19] The agencies recognize the important role that responsibly offered small-dollar loans can play in helping customers meet their ongoing needs for credit due to temporary cash-flow imbalances, unexpected expenses, and income shortfalls during periods of economic stress, national emergencies, or disaster recoveries.
Issuing interagency examiner guidance outlining the supervisory principles for assessing the safety and soundness of institution given the ongoing impact of the pandemic	On June 26, 2020, the FRB, FDIC, OCC, NCUA, and state financial regulators noted that, among other topics related to credit, examiners "should apply appropriate credit classification and charge-off standards in cases where the information indicates a loan will not be repaid under reasonable terms. Examiners should also assess the reasonableness of management's plans for workouts and pursuing foreclosure of collateral on nonperforming assets" [20].

Operational and data challenges



Initial deferrals and forbearances (typically for a period of 90 days) were granted in March/April across the financial services industry with little to no data collected from customers when making these loan modification requests. A second wave of loan modification requests is anticipated, which presents operational challenges to banks to continue to service, evaluate, and action these requests in a timely manner. However, these requests can also serve as an opportunity to collect critical data from borrowers to anticipate loan performance going forward as well as inform risk management activities, such as rating and ranking of loan portfolios and refinement of models and stress tests.

Relevant borrower attributes that could be collected and analyzed include specific factors contributing to their financial strain (e.g., industry negatively impacted, decreased revenue from business, temporary vs. permanent job loss). Geographic and industry specific information, such the states with slow re-openings and availability of outdoor seating at restaurants owned by customers, could also be assessed as performance may likely be different depending on what location and sectors of the economy their credit exposure is in.[21] If economic conditions were to further deteriorate or become protracted, this would make it more challenging for banks to provide loan forbearances and other credit relief to distressed borrowers over the longer term.

Retail and hospitality, as well as sales and consumer driven businesses more broadly, are likely to continue to be the most negatively impacted industries hardest hit by mandated lockdowns. In addition, the energy sector may experience continued financial strain as the demand for fuel to run businesses and industrial operations decreases. Ultimately, a specific challenge for banks remains predicting the performance of loans across different borrower segments to inform the rate at which deferrals are likely to translate into losses. The Deloitte Center for Financial Services has analyzed[22] the impacts on specific financial services sectors and the different paths for financial firms' performance.

Additionally, a pause on loan payments across different credit portfolios may result in downstream impacts, such as revenue losses, deteriorating asset quality, and need for increased loan loss provisions for banks. Understanding and predicting these impacts should also be considered as decisions are made to extend deferrals and forbearances.

The loss mitigations and forbearance programs provided to borrowers in reaction to government and regulatory actions may also create data risk if firms do not have automated capabilities or existing business processes to adjust for loan modifications or the payment status of loans on their underlying loan servicing platforms. When manual processes exist, these processes often cause data challenges in relation to regulatory, accounting, and risk data. Some banks, for instance, are using different types of "work arounds" to better manage borrower information in the current environment. These measures include leaving timeliness fields blank (e.g., on-time vs late) and applying codes to profiles that indicate COVID-19-related loan modifications.[23]

The different types of forbearance and tracking payment status amplifies the difficulties. For example, firms should have the capability to segregate whether loss mitigation or forbearance was done under Section 4013 of the Cares Act (which is already a regulatory reporting requirement) or under the April 17, 2020, Interagency Policy Statement. This is also true for tracking payment status adjustments needed so that loans that have received accommodations related to performance are disclosed correctly and the impact on interest accrual status is accounted for correctly.

Strategic view

The systems of banks are not typically set up to apply payment deferrals on a mass-scale. Banks should seek the means to efficiently capture, process, and analyze call center data and other data provided by relationship managers, as this can help them make more informed decisions.

Utilizing artificial intelligence, machine learning, natural language processing and other technologies can be particularly useful in data collection to inform risk management and operational decisions. These capabilities can help enable insight for banks into customer responses, which may be efficiently captured using predefined credit data questions. Customer experience and brand management serve as crucial considerations, along with legal and compliance implications relating to borrower data collection and reporting.

Any tactical processes to accomplish these adjustments should have the appropriate level of controls to ensure the quality of the data at the loan level. Business processes, risk assessments, and data lineage should be well documented. Where appropriate, the adjustments should be integrated into the attestation process for reporting.

Considerations and implications

Banks should consider the following actions:

- Developing the capability for accurately, efficiently, and consistently gathering customer data when loan modification requests are made as a means of evaluating the likelihood of repayment and informing risk management decisioning, while complying with applicable laws, rules, and regulations
- Monitoring regulatory posture going forward towards banks' servicing of these loan modification requests to inform the degree of flexibility that banks have over granting versus denying these requests
- Formulating clear evaluation criteria for making decisions on loan modification requests and providing sufficient rationale and evidence in anticipation of regulatory scrutiny, including analyzing borrower, geographic and industry-specific attributes
- Developing a strategy for reporting on impacted/modified loans through established and new regulatory reporting channels to meet business-as-usual and ad-hoc requests
- Implementing infrastructure and technology enhancements needed to service potentially large number of loan modifications and plan for downstream system implications
- Developing an operating model needed to support these loans over the course of the loan lifecycle

Conclusion

First quarter earnings releases already indicate higher allowances for loan losses and increased charge offs.[24] With a deteriorated economic outlook, many banks have contributed substantially to loan-loss provisions in the first quarter. With the economic outlook remaining uncertain, increased provisioning and continued reserve padding along with elevated charge-offs is anticipated in the second, third, and fourth quarters of 2020, and potentially into 2021. In some cases, these decisions are driven by proactive downgrades for modified and at-risk loans.

With credit conditions expected to remain strained, banks should evaluate their current operating models to proactively identify and implement any necessary changes. When doing so, banks should take a strategic view to managing the COVID-19 impact on their credit portfolios and businesses and meeting existing and anticipated regulatory reporting requirements.

As we move into 2021 and beyond, advancing further down the path toward economic recovery,[25] it is important for banks to consider a range of possible implications for how individuals, small businesses and large corporations will be affected in the longer-term and how behavior regarding accessing credit may change.

This is part of a series of insights from the Center for Regulatory Strategy on the implications of the CARES Act on the financial services industry. We—like you—are closely monitoring any developments that may emerge with the enactment of the law, including interpretive guidance from the Federal Reserve and federal banking agencies. Please visit our CARES Act financial services summary page here for more information on the impact to the financial services industry.

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Endnotes

1 TransUnion reported deferred debt payments on more than 100 million American accounts from March 1, 2020 through May 31, 2020.
2 As of May 31, for instance, around 4.3 million mortgages were in forbearance, representing 8.53 percent of the total outstanding mortgages. See: Kathy Orton, "Homeowners stopped paying mortgages in record numbers in April," The Washington Post, accessed on June 22, 2020.
3 Deloitte, "Addressing the credit impact of the current environment," accessed on June 10, 2020.
4 U.S. Congress, "H.R. 748 U.S. CARES Act.," accessed on April 9, 2020.
5 Deloitte, "Addressing the credit impact of the current environment," accessed on June 10, 2020.
6 FRB, "Federal Reserve Supervision and Regulation Report, accessed on June 22, 2020.
7 Wall Street Journal, "Flying Blind Into a Credit Storm': Widespread Deferrals Mean Banks Can't Tell Who's Creditworthy," accessed on June 29, 2020.
8 For example, on May 15, 2020, the House passed H.R.6800 (the "HEROES "Act), which would expand consumer rights to loan forbearance and other payment relief beyond federally backed mortgages and federal student loans. See Chairwoman Maxine Waters, "The Heroes Act Division K: The Covid–19 Housing, Economic Recovery and Oversight Act Of 2020 Section-By-Section," accessed June 11, 2020.
9 U.S. Congress, "H.R. 748 U.S. CARES Act.," accessed on April 9, 2020.
10 Deloitte, "Addressing the credit impact of the current environment," accessed on June 10, 2020.
11 FRB, Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions," accessed on June 22, 2020.
12 Wall Street Journal, "Consumers Seeking Debt Relief Amid Coronavirus Face Jammed Phone Lines, Overwhelmed Lenders," accessed on June 10, 2020.
13 Per the CARES Act, the borrower must attest to pandemic-related hardship, but no additional documentation is required. Mortgage servicers must grant forbearance for up to 180 days and must extend the forbearance up to an additional 180 days at the borrower's request. For homeowner statistics, please see: US Government Accountability Office Watch Blog, "CARES Act provides relief to some homeowners during coronavirus outbreak," accessed on June 26, 2020.
14 Right to request forbearance and no interest accrued through September 30, 2020; lender is to report on-time payment history. For federal student loan statistics, please see: US Department of Education, "Federal Student Loan Portfolio," accessed on June 26, 2020.
15 The covered period for this section starts on January 31, 2020 and extends to the later of 120 days after enactment or 120 days after the national emergency declared by the President on March 13, 2020, terminates.
16 This relief expires the earlier of 60 days after the public health emergency declaration is lifted or December 31, 2020.
17 Board of Governors of the Federal Reserve, "Revised Interagency Statement on Loan Modifications by Banks Working with Customers Affected by the Coronavirus," accessed on June 11, 2020.
18 *Ibid.*
19 OCC, "Small-Dollar Lending: Interagency Lending Principles for Offering Responsible Small-Dollar Loans," accessed on June 11, 2020.
20 FRB, Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions," accessed on June 22, 2020.
21 For additional insight on the impact on mortgage services and the housing finance market, please see: Deloitte Center for Financial Services, "The path ahead: Navigating financial services sector performance post-COVID-19," accessed on June 25, 2020.
22 *Ibid.*
23 Wall Street Journal, "Flying Blind Into a Credit Storm': Widespread Deferrals Mean Banks Can't Tell Who's Creditworthy," accessed on June 29, 2020.
24 Federal Reserve Bank of Atlanta, "Banks' Accumulated Credit Losses in the First Quarter," accessed on June 26, 2020.
25 New York Times, "Fed Leaves Rates Unchanged and Projects Years of High Unemployment," accessed on June 26, 2020.