CFO Perspective: A Few Observations on Loan Payment Deferrals and the March 31, 2020 ALLL Calculation

by Paul Allen, CPA

As you should have already seen by now, we have received very useful guidance from regulators and from FASB in the past few days regarding how to treat loan payment deferrals related to COVID-19 economic conditions.

If you haven't seen that, please refer to the FDIC FIL-22-2020 "Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus" issued on March 22, 2020. The same day, the FASB issued a statement that they concur with the approach set forth in the Interagency Statement.

The regulatory agencies have been consistently sending a message to encourage financial institutions to work with their customers during this unusual and stressful time, and the Interagency Statement went further into an accounting and regulatory issue that many management teams were increasingly concerned about. That issue was, if a financial institution worked with a loan customer affected by COVID-19, and offered a loan payment deferral, would that represent a modification that would automatically trigger Troubled Debt Restructuring (TDR) treatment. The accounting guidance provides for loan modifications that do not result in TDR treatment, such as "temporary delays" in loan repayments; however, in the past, the temporary delay was usually defined or interpreted as relatively short, such as 30 days after the contractual due date. If a modification was treated as a TDR, management teams were concerned that their NPA metrics could increase dramatically, the TDR may have to be placed on nonaccrual for a period of time, and that they would face regulatory criticism.

The Interagency Statement provides that a modification made on a good faith basis in response to COVID-19 to borrowers who were current prior to any such payment relief would not be considered TDRs. That would include short term (up to 6 months) modifications such as payment deferrals, fee waivers, extensions of payment terms, or other such payment delays.

We encourage you to consider your customer base, and proactively decide whether to offer such loan modification programs to your customers. Note; that the Statement implies such modifications are offered to "customers in good standing", so we would caution that loan modifications to customers who are already in nonaccrual or have pre-existing credit issues will likely need to be treated differently.

The probable action steps for most community banks might include:

1. Meet with your senior credit team and determine which, if any, customer groups are most likely candidates for such action (note, you may need to have several options, depending on the loan type, term and collateral types; one size may not "fit all").

2. Consider the proposed action against your existing loan policy and underwriting guidelines – we recommend the Board review and approve the proposed COVID-19 loan modification programs, and that you consider any compliance issues (such as modification fees and fair lending considerations).
3. Consider consulting your legal counsel on the proposed language of the loan modifications.
4. Include your marketing and compliance staff in determining the best method of communicating that your institution will be open to working with affected customers; consider also your social media channels.
5. Update and train your loan processing staff to ensure the loan modifications are booked correctly and promptly.

While no one knows the depth, timing and extent of this current crisis, we do encourage you to proactively move quickly. We have already noted the largest banks announcing such programs, and you will want to make sure your current customers are aware of options, as they are grappling with their own projections of cash flow needs over the next few months.

Moving forward, the March 31 Call Report and quarterly close procedures will be on top of us very quickly. Please consider that the ALLL analysis will require a bit of thoughtful preparation compared to prior quarters. Unless you are a public company that is already dealing with the first quarter under CECL, you will not have to deal with adopting the new accounting standard, but you will need to consider that the ALLL factors and the economic conditions have changed considerably since December 31.

We've been talking to CFO's in the past few days, and here is our suggestion for approaching the March 31 ALLL analysis:

1. Revisit the qualitative factors, especially the economic conditions factor or factors. Obviously, the economic outlook has changed since the beginning of the year, so one would expect the factors to go up (that is, move adversely); however, we would note that COVID-19 is not likely to have an equally adverse impact on all loan categories. We would recommend you go through each collateral and loan type, identifying ones that will likely have a more adverse and immediate impact (such as hotels or restaurants) and those that would have a more significant increase in the economic conditions loss factor, but all or most loan types may have some increase. You may need to further segment the loan categories in order to fully analyze this.
2. Revisit the estimated loss on impaired loans calculations, as conditions and fair values may have decreased since the beginning of the year, and the present value of cash flows may need to be revisited.
3. Recommend you review loans that have higher (more adverse) loan grades, but were not previously identified as impaired, to consider if any of those loans "on the bubble" may need to be reconsidered for impairment, due to the worsening economic conditions.
4. Lastly, we would suggest a brief memo setting forth Management's approach, to accompany the normal ALLL reporting to the Board, to document and acknowledge that the ALLL analysis appropriately considered the changing economic conditions and potential adverse impact due to COVID-19.

We fully recognize the uncertainty and additional pressure on management during this time and welcome the opportunity to be a sounding board to assist you through this crisis. Please contact us if you have questions and continue to check our COVID-19 RESOURCE HUB website for sources of information and updates.

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