Supervisory and Accounting Considerations for Loan Accommodations Related to COVID-19

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Lara Lylozian and Allen North

Carl White: Good afternoon, everyone and welcome to another *Ask the Fed*® session. My name is Carl White. I'm Senior Vice President of the Supervision Division at the St. Louis Fed. Today we're coming together for a session on supervisory and accounting considerations on additional loan accommodations related to COVID-19. The best experience is if you're joining us through the webinar and through webinar audio. Some of you, you may be calling in via phone and then maybe watching the webinar on a screen. You may notice just a slight delay; one suggestion is to download the presentation and then go through it as you hear the speakers advance the slides.

So, let me welcome our presenter's today. We have Lara Lylozian, she's the Chief Accountant and Deputy Associate Director at the Board of Governors, and we also have Allen North, Vice President at the Federal Reserve Bank of St. Louis. So, before we turn the call over to them, I'd like to cover just a few logistics, which you'll see on Slide 2.

First, please note that you can access the presentation slides in the webinar tool under materials or at our website, www.askthefed.org. As always, we do record every *Ask the Fed*® call and you can get the recording from any *Ask the Fed*® session right at that same website, askthefed.org. We have received several questions already but you can still submit questions. You can do that two ways: one, you can hit the 'Ask Question' button in the webinar or shoot us an email at questions@askthefed.org. And, as a reminder, the opinions expressed in the presentations are statements of the speaker's opinion, are intended only for informational purposes, and are not formal opinions of nor binding on the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve System. So, let's get going, let's jump to Slide 3, we're going to get started. So, Lara, I'm going to turn it over to you.

Lara Lylozian: Okay, thank you Carl and thank you to everyone for taking the time to join us this afternoon. At the Federal Reserve we prioritize outreach; it is such an important aspect of my role and I know that holds true for Allen as well. And we collectively have noted, from our outreach efforts, from the conversations we've had with examiners, bankers, audit firms, and trade groups all across the system, that there are a number of recurring questions around making additional loan accommodations. Especially those that are nearing the end of their initial accommodation period. These recurring questions relate primarily to how to account for them, how to report them, are they TDR and, just as importantly, how are

our examiners going to look at them? When we hear that bankers want the ability to continue modifying the loans after initial accommodation periods have ended without having to classify as TDR's.

So, our goals today are to help clarify our expectations, to help you better understand our supervision and examination approach to banks, working with borrowers affected by COVID-19, particularly those nearing the end of accommodation. Help you better understand the relief options available, specifically those in Section 4013 of the CARES Act. As well as the related accounting and reporting considerations so that financial institutions are more informed, have the clarity they need to better plan for year end and 2021. And I also hope this *Ask the Fed*® session, through it I hope Allen and I can help clear up some of the confusion we hear around this topic and alleviate some of the angst too. We are not introducing any new guidance here this afternoon. Think of this session as a follow-up that reinforces certain key messages from the August 3 FFIEC Joint Statement on Additional Loan Accommodations and the June 23 Interagency Examiner Guidance for assessing safety and soundness considering the effect of the COVID-19 pandemic on institutions. So, with that, Allen, walk us through the agenda on Slide 4.

Allen North: Sure. Thanks, Lara. So, on Slide 4 is our agenda and today I'll provide some background information, discuss loan accommodations related to COVID-19, review the nature of TDR relief provided by the Section 4013 of the CARES Act, and cover supervisory and accounting considerations on several topics. And hopefully we can provide some insight in our supervisory approach and finally, we'll have a Q&A session at the end.

Now, I want to say, since the onset of the pandemic, I've had numerous conversations with bankers regarding TDR's and loan modifications. This has been utmost in bankers' minds since the very start and certainly March and April and May I was on the phone every day, pretty much all day talking about TDR's and certainly how banks are working with their borrowers. So, hopefully today we can dispel some of the common supervisory myths and relax some concerns. I think, Lara, you said angst, I think that's something we really want to try to do today is relax some of the concerns there and then, really focus where we think bankers should be thinking today. And I want to provide as much as I can about the agency's approach to supervision in this time of uncertainty and really the flexibility examiners will try to apply. And then, hopefully, we can provide some additional practical information that will improve your overall risk management practices during the pandemic. Lara, I'll turn it back over to you.

Lara Lylozian: Thanks, Allen. I think before we get into all that, I just do want to spend a few minutes just to level set and give some additional context and background as to why all these conversations are happening right now. That if we go back you know that any response to the market volatility and the instability resulting from the COVID-19 pandemic, Congress passed the CARES Act to provide several forms of relief to businesses and borrowers. And early on, financial institutions recognized the severity of the situation and with encouragement from us, from the supervisors, banks have been working actively with

their customers to provide a variety of credit accommodations and had agreed to grant forbearance to millions of borrowers.

Institutions are using a wide range of accommodation programs with varying terms and conditions because the pandemic has affected borrowers very differently across industries, loan product types, and even by geographical location. And the timeline and the path to recovery is uncertain. Chair Powell said, "The recovery will depend heavily on the course of the pandemic. We must therefore recognize that progress toward a full recovery in economic activity may well be slow and uneven." So, as borrowers have begun reaching the end of their initial accommodation periods that Allen talked about, you know, back in March and April everyone was making these accommodations. As we reached the end of those initial accommodation periods, some borrowers are able to resume contractual payments while others continue to be negatively affected by COVID-19. Between the volume of loan accommodations and the unprecedented uncertainty caused by COVID-19, I think it makes it really difficult for financial institutions to determine how best to treat borrowers depending on each borrower's individual financial situation. And we do want banks to work with borrowers; we view working with borrowers as positive action. You'll hear Allen and I say that repeatedly today because we know from experience that when institutions are proactive and working with borrowers or customers, it better serves the long-term interests of the institution, of the communities it serves, and ultimately the economy.

That said, banks do have tough calls to make ahead of them on how exactly to do that, how to continue to work with their borrowers. And I think all of us are trying to figure out that balance even as supervisors, how do we balance temporary relief and flexibility with safety and soundness principle? Now, Allen, given your role, it would be great for everyone to hear what are you seeing in the field. And if you have any additional context or insight to share in terms of background as to why we're having the conversations we're having today.

Allen North: Sure, you know, I think all of the Reserve Banks and, for that matter, all of the agencies have spent quite a bit of time and outreach during this pandemic to try to get information out to the bankers in a timely fashion, something that they can use. Because, let's face it, no one could have possibly seen all this coming, I know we didn't. President Bullard of the St. Louis Federal Reserve has mentioned several times in public that this is really an episode unlike any other in that this was a health crisis that brought about an economic crisis. And that we really shut down to invest in our health, which is something that hasn't happened in a very, very long time, certainly nothing that any of us could have seen coming.

So, what we did see an awful lot of in the spring was bankers were doing everything they could do to help borrowers. Which you can imagine was incredibly difficult at the time, given the operational issues that they were dealing with in terms of getting staff to the bank offices, people working remotely, all those sorts of things just like that we've had to deal with. And their main concern during that time, were working with their borrowers, so, of course, the agencies did everything we could to encourage that. And I think what would be interesting to this audience is that, as we think about the loan accommodations that were granted, what we saw initially were the bankers were generally doing 90-day deferrals. And

being honest with you, a lot of regulators felt like that most bankers would use the relief provided by the Interagency Guidance, which would consider short-term accommodation as up to six months. But most of our bankers took a more conservative approach and went with a 90-day deferral or an interest only so that they could react and possibly change course at the end of those 90 days. And what we saw, really, across the country is that levels of modifications range from bank to bank and as you can imagine, by communities, by how heavily impacted they were by the virus and how much their communities actually shut down. And what we saw were some banks in very rural areas that were relatively isolated, very few accommodations were made. But we also saw on the other end that, when aggregated there were many banks that had made accommodations up to 25% of the banks' total loan portfolio.

Recent system data shows that ag banks made very few, and commercial real estate banks that were fairly heavy concentrated made more and that seems to be fairly intuitive. The good news is that the level of borrowers needing additional accommodations has really gone down. And those borrowers needing additional flexibility are generally in the hospitality, travel, and leisure industries, it's probably no surprise to anybody on this call. And my district bankers have predominately asked questions regarding hotel and restaurant loans. But several of my counterparts elsewhere in the system have mentioned the meeting and convention venues have also been heavily impacted and they've received questions regarding those types of loans.

So, if we could go to Slide 6. The Federal Reserve's perspective on loan accommodations has been consistent throughout, it's not changed since the onset of the pandemic. We continue to encourage institutions to work with their borrowers in prudent ways consistent with safe and sound standards. This recurring theme and many public statements we've made, including the Interagency Pandemic Examiner Guidance that was issued in June, as well as the FFIEC Joint Statement on Additional Loan Accommodations issued in August. This messaging has been consistent to both examiners and bankers. The agencies view loan accommodations, when done appropriately, as a way to mitigate adverse effects on borrowers affected by the pandemic. Really regulators and bankers want the same thing here, we want borrowers to be in the best position to make it through to the other side so the bank is ultimately paid back and customers remain the going concern. Lara, I'll turn it over to you to talk a little bit about relief from TDR designations.

Lara Lylozian: Yeah, thanks, Allen. I'll jump in here as the accounting voice, the voice of accounting, that release of TDR designation is currently and continues to be available under the CARES Act. And we know that bankers want the ability to continue modifying loans after initial deferral periods have expired without having to classify as TDR's. And questions around TDR designations have come up enough that we feel the need to reiterate that as we sit here today, TDR relief is currently and continues to be available under the CARES Act.

Which takes us to Slide 7 for an overview of COVID accommodations. So, this table on Slide 7 summarizes the accounting and reporting implications of any accommodations that an institution may offer borrowers. And I know there's a lot in this table but there is no new

guidance here, it is a summary of what has been previously provided. So, here we visually depict how the CARES Act, Interagency Statements, and traditional U.S. GAAP interact, each of which are represented by their own separate column. The rows of the tables represent accounting and reporting implications when an accommodation is extended to a borrower under each of these columns, or what I'll refer to as loan categories.

The merged cells that cross multiple columns indicate that the accounting and reporting treatment is the same across each loan category. Now, if you look at the first and second column, the CARES Act and Interagency Statements are separate and distinct paths, and they do not contradict each other. And if you haven't been following all of this closely, I can see how all the different options available to account and report modification—I can see how it would be confusing, I was confused initially. So, for me, this summary has been my saving grace, we refer to it internally—you know, it's part of a larger document—we refer to that larger document as the COVID-19 Road Map. And it has helped me keep all the different paths that one could go down straight. So, please, print this slide out and take notes on it, have it handy, use it as a cheat sheet. I have mine pinned on the board so I can easily refer to it to help me answer questions. And I know that there's a lot here, our focus in today's session is on Section 4013 in the CARES Act under which relief remains available. And if you can see, the highlighted portion of this table, that's what Allen and I are going to walk you through this afternoon.

Moving onto Slide 9, let's start first with a refresher of Section 4013 of the CARES Act and TDR relief. Financial institutions have the option to not apply TDR accounting to qualifying loans or report them as TDR's in regulatory reports. To qualify, all of the following criteria must be met: the accommodation granted is related to COVID-19, the loan was current as of December 31, 2019, and the accommodation must be executed between March 1, 2020 and the earlier of 60 days after the national emergency ends or December 31, 2020. And given that today is October 29, 2020, I think it's safe to say that the national emergency will not end prior to 60 days before December 31, 2020. So, we'll use December 31, 2020 as the cut-off date, which means there's still about two months left in this window to make accommodations and have them qualify under the CARES Act.

You look at the bottom of the slide, I have just a few more reminders that I wanted to spend some time on. The first is, there is no limit to the length of the modification and as long as it meets the criteria outlined above. In other words, modifications can be longer than six months. Now, those banks typically enter into short-term modifications to help borrowers that are experiencing short-term financial difficulties, the CARES Act does not restrict the term or length of the modification. So, a loan could conceivably be modified with a term well beyond six months and still qualify relief from designation as a TDR.

The second reminder here is that there is no limit on the number of modifications that can be granted to a single borrower. As long as the criteria continue to be met in totality, multiple payment deferrals can be granted to the same borrower and the lender can continue to have the option to not classify as a TDR. So, for instance, each payment deferral granted to a borrower would have to meet that criteria, it would have to be due to COVID-19 and occur

between March 1, 2020 and December 31, 2020. So, modifications can be made until December 31, 2020 and still qualify under the CARES Act.

Lastly, the third reminder here is that Section 4013 can still be used for subsequent modifications even if it wasn't used for the initial modification, again, assuming all criteria remain met. So, this one's actually a common example, a question that we get is that back in March or April an institution may have extended a short-term, six-month payment deferral to a borrower at the beginning of all this, at the onset of COVID-19. And concluded that this modification did not result in a TDR based on the interpretation provided in the Interagency Statement. And when you fast forward six months, to the fall period right now, you know, after we're coming out of this initial six-month deferral period, some borrowers are still struggling due to COVID-19. And so, the institution has a choice, they can grant an additional deferral and it could be six months, it could be longer, it could be whatever they want, and still elect to not report this loan as a TDR if it qualifies for relief provided by Section 4013 of the CARES Act. Meaning, it had to have been current as of 12-31-19, the modification had to be related to COVID-19, and it has to be executed in that window we talked about, sometime between March 1, 2020 and December 31, 2020.

So, I really just wanted to go through those reminders because this is where a lot of the questions are coming in on. And Allen, I'll turn to you to see, what are you seeing in the field in terms of length of modifications or number of modifications? Like, are you seeing multiple accommodations granted in the district? You know, what does that look like?

Allen North: Sure, and I think we're seeing some but as I mentioned earlier, it's where the industries that have been heavily impacted by COVID-19. And the example that comes to mind, I recently was contacted by a banker that was looking at modifying a loan again, a hotel loan, for 12 months, interest only, and was wanting to know if they executed before December 31, 2020, would that be acceptable to get TDR relief. And, of course, everything is facts specific, right, but based on the information I received that seemed that it would receive relief, but I did caution him on a couple of things. One is, when you go that long, you're still going to need to monitor how that loan is performing and try to get updated information. As we all know right now, there's a tremendous amount of uncertainty that's still out there and without updated information, it's very difficult to make a call. Of course, we're going to go into a lot more detail later in the presentation about that, but what I advised the banker to do was to execute a modification where they could, within six months, revisit and maybe change course and that seemed to be an acceptable answer to the banker, he appreciated that. And I think his plan was a very conservative approach anyhow where they would continue ongoing monitoring. But I guess that example really does, I think, spell out what you have here, Lara, in terms of the extent to which relief can be granted.

Lara Lylozian: Okay great, thanks, Allen. Okay, why don't we move to Slide 10 because there's a yin to every yang. We hear that bankers are concerned about the TDR designation, that label, and we just walked everyone through the TDR relief that is currently available under the CARES Act. But we would be remiss if we didn't also remind you that TDR relief is not relief from other existing accounting and regulatory reporting requirements.

So, notwithstanding TDR designation, institutions are still required to appropriately risk rate the loans receiving and accommodation, maintain an appropriate allowance for all loan modifications, place loans on nonaccrual status when full payment of principal and interest is not expected, and charge off loans when appropriate. I strongly encourage everyone to go back and read the accounting and regulatory reporting section of the August 3 Joint Statement on Additional Loan Accommodations, because it importantly reminds institutions that even if they elect to not apply TDR accounting, they must continue to follow other existing accounting and reporting requirements. So, Allen, let's move to Slide 11, and you can start us off with a discussion around risk management and regulatory risk ratings.

Allen North: Sure. So, I think it's helpful to maybe provide everyone some perspective here. While I certainly understand the concern, bankers have raised over TDR's and I'm certainly glad there's been relief provided, really understanding how the examiner's use TDR's and then, the additional risk management that we're getting ready to discuss, I think it's really critical. And that was really the conversation that I had with bankers early on to try to, in some ways, relax some of their concerns and really get them focused on what's important. You know, as with everything in banking, we want you to comply with all the appropriate standards and, certainly, accounting is a big one. But when we're doing our loan review, whether a particular loan should be designated to TDR is not one of our first questions we ask ourselves. Rather, we're focused on accurate risk identification and whether the loan is risk rated accurately and is a credit administration appropriate for the risk of the borrower? And finally, does management have a strong understanding of the borrower's current financial condition? So, that's really the perspective the examiners bring when they start to do their loan review. And certainly, we want you to comply with accounting standards typically, but the TDR question is definitely not one of our first concerns when we're reviewing credits.

So, on Slide 11, I think the key here is that, having that accurate risk rating for loans is really our primary concern. And as you think about the risk rating and whether a loan is a TDR, they are separate and distinct decisions but those processes are related, there's no doubt they are. However, TDR designation means the loan is impaired for accounting purposes but it doesn't automatically result in an adverse classification. Examiners will exercise judgment in reviewing loan modifications, including TDR's, and will not automatically adversely risk rate credits that are affected by COVID-19.

I'll talk more about what it looks like in a couple of slides but existing guidance does not change regarding regulatory risk ratings. Bankers should really still use traditional underwriting practices for determining creditworthiness of the borrowers. And importantly, agency examiners will not criticize management where prudent efforts to modify terms of the loan are used and are in the best interest of the borrower. I'll turn it back over to you, Lara, to start talking about some of the accounting reporting considerations.

Lara Lylozian: Okay. Yeah, let's turn to Slide 12, because another important area is related to the allowance. So, for allowances specifically, our Joint Statement on Additional Loan Accommodations reminded institutions that in accordance with the U.S. GAAP, when they are calculating the allowance, either under the Incurred Loss Methodology or CECL,

institutions are required to maintain an appropriate allowance for modified loans. And when determining the allowance to such loans, either under the Incurred Loss Methodology or CECL, an institution should consider all relevant and available information. And this includes changes as a result of COVID-19 and a borrower's financial condition, collateral values, the institutions lending policies and practices, and economic conditions.

Of course, looking at the Incurred Loss Methodology specifically, even though these loans are not designated as TDR's, the institution may need to segment these loans in a separate pool and estimate the appropriate allowances by applying a loss rate derived from historical performance of similar loans and/or by applying appropriate qualitive factors. In other words, you can't ignore increased credit risk. Under CECL, very similar to the Incurred Loss Methodology and in accordance with U.S. GAAP, institutions should consider segmenting loans that have received an accommodation into pools that share similar risk characteristics for purposes of determining expected credit losses. Also, in accordance with the U.S. GAAP, management should ensure the measurement of expected credit losses includes forward-looking information, such as reasonable and supportable forecasts, and considers the implications of that information on the underlying risk profile of the financial asset.

And Vice Chair Quarles spoke to this, in a recent speech he acknowledged that banks have been working actively with their customers and at the same time, banks have recognized that the credit quality of many loans has deteriorated, some considerably. And that banks have made sizeable provisions to prepare for expected loan losses. And I know that there is a lot of uncertainty around a borrower's financial condition and their long-term ability to repay loans, as well as an institution's ability to access the value of underlying collateral and that people might need more time to determine the effects of COVID-19. But as information becomes available, we do expect management to evaluate and to adjust the effects of COVID-19 in its allowance estimation processes in accordance with U.S. GAAP and regulatory reporting requirements. Allen, what are your teams looking for during examination on this?

Allen North: Well, I think you really hit the nail on the head with these points. We wanted to see the bankers are fully considering the level of reserve in light of the risk present in the loan portfolios. There's a great deal of uncertainty out there but, you know, in this environment reserves should be going up in our view. As you mentioned, accounting rules do give us quite a bit of flexibility whether you're still using the Incurred Loss Method or you've adopted CECL. And we've mentioned several times today, we expect significant uncertainty for certain borrowers, and we fully understand that management doesn't have a crystal ball or a complete picture at this point. But what we'd like to see is management's using the information available and incorporate it into the reserving methodology. Management needs to be actively managing the affected borrowers when uncertainty exists and when they get information to act on, they need to make those decisions and make adjustments accordingly. In my view, in this time of uncertainty, increasing reserves just makes sense.

Lara Lylozian: Right, thanks, Allen. Let's turn to Slide 13 and talk about past-due reporting. And this one should be so easy to talk about but I feel like because of all the

accommodations it's gotten a little complicated. But if you look at a Joint Statement, our Joint Statement on Additional Loan Accommodations reminded institutions that a loans payment date is governed by the due date stipulated in the loan agreement. Meaning that the past-due status reported in regulatory reports should be determined in accordance with the contractual terms of the loan. Therefore, for past-due reporting in regulatory reports, that's a call where institutions need to evaluate whether the contractual terms of the loan have been revised as part of the accommodation provided. Has to evaluate whether the terms have been revised and agreed to with the individual borrower or provided across the board to all affected borrowers as part of the accommodation or whether the terms have, in fact, remained the same. And so, judgment may need to be used to determine whether the contractual terms of the loan have been modified. The institutions, I think, do a pretty good job of this, they typically have developed policies documenting their process to determine past-due status and apply those policies consistently.

Now, this is where it gets a little tricky. For some accommodations, the past-due status of that loan may be frozen during the accommodation period. For others, institutions may continue to advance the delinquency during the accommodation period. It is just so important to evaluate and to understand the terms of the accommodation offered, as well as what was disclosed to the borrower to determine whether it is appropriate to freeze the past-due status during the deferral period or to continue to advance delinquency. And in cases where there are no contractual changes to the loan, management may decide to advance delinquency during the deferral period. So, for example, if a consumer loan was 60 days past due on the date of a COVID-related accommodation and no payment was due during the accommodation period, management could, based on its own internal policy, continue to report the loan in its regulatory reports as 60 days past due during the accommodation period. Now, the revised contractual terms of the loan will really drive the path forward on past-due status and delinquency coming out of that deferral period. Payments that were previously met or would have been due during the deferment period may be restructured and not contractually due until a later date.

All right, let's turn to Slide 14 to talk about nonaccrual status and charge-off, which is so related to past-due status reporting. So, with regards to accrual status, an institution should continue to refer to the applicable regulatory reporting instructions, as well as an institution's own internal accounting policies. To determine whether to report loans to affected borrowers with accommodations as nonaccrual assets in the regulatory reports. Again, judgment is needed, it's required, to determine whether the loan should be placed on nonaccrual or not. And typically, this is done when full payment of principal and interest is not expected, which may occur during or after the accommodation period. And I know, operationally, some institutions, based on their own internal accounting policies put certain loans on nonaccrual once a certain date's past-due status is reached, such as at 90 days or 120 days past due. And I know for some the past-due status is also a key assumption or a key input into the allowance calculation but the reality is that some of these mechanical triggers may no longer be appropriate. We all know that the delinquency data today is a bit muddied up because institutions are granting different types of loan accommodations and also tracking them

differently. And because of this, there is some degree of diversity in practice in terms of how banks are tracking and reporting delinquency status, and I think it's probably okay given where we are, provided that institutions have a sensible and reasonable policy that they are following consistently. And institutions are evaluating facts and circumstances of the accommodations granted to determine how to appropriately report the past-due status in the regulatory reports.

So, if you're currently relying primarily on some sort of mechanical trigger, whether it be the TDR designation or delinquency status to ensure an adequate allowance or to place the loan on nonaccrual, you should probably evaluate to determine if your existing processes are still appropriate in the current circumstances. And like I said, a loan should be placed, you know, according to the rules, on nonaccrual if full collection of principal and interest is not expected, notwithstanding the number of days past due being recorded. Institutions do need to take into account that the past-due status of the loans may be temporarily frozen as a result of contractual changes to minimum monthly payments.

So, I know sitting here all this is very easy for me to say and very hard to implement, you know, very hard to do in practice for institutions. Allen, what are you seeing on the nonaccrual funds? What expectations do your teams have for institutions to be placing loans on nonaccrual status at this point?

Allen North: Sure, that's a great question and at this point we haven't really seen a material increase in loans being put on nonaccrual, either by the bankers or examiners through routine exams. You know, in many cases we don't have enough new information that would indicate whether we're going to receive full principal or interest. And, as you mentioned, the mechanical triggers, they're not going to be as effective as they normally are. And so, we're really going to be trying to look at known facts and not assumptions on what we think might occur. So, as I said, with not a whole lot of new information, there haven't been a lot of loans put on nonaccrual. The examiners are going to be looking for concrete information and at this point there just doesn't seem to be a whole lot of new information that would indicate loans need to be on nonaccrual. Now, having said that, as we go into next year, circumstances may change and we should be able to get some updated information and at that point hopefully bankers will have enough to make the call.

So, let's go to Slide 15, and I wanted to provide some perspective of what bankers should be thinking and kind of, really, what are some best practices that you guys ought to be doing right now. The first thing is something that we've said since the onset of the pandemic is, how important it is to track the modifications and provide regular reporting to the Board of Directors so that they know what kind of risk the bank's facing. And those tracking modifications, it's really important that it's kept up to date. As I mentioned early on, banks made a fairly good number of modifications, and now bankers are making a lot fewer modifications but they're usually concentrated in those industries that we've mentioned before that are highly impacted. So, along with that tracking we want you to enhance the monitoring efforts for all loan categories that are going to be heavily impacted by the pandemic. And to the extent possible, obtain updated financial information and it's important

to not only get updated financial information on the business itself but also the guarantors. Because as we saw during the financial crisis, guarantors do come into play and frankly, when we're calculating a global cash flow on some of these relationships, those guarantors are going to come in to play. And some credits will not be downgraded because of the strength of the guarantors and their ability to keep the credit going.

When individual circumstances warrant and material witnesses are identified, bankers need to go ahead and internally classify those loans and place loans on nonaccrual when appropriate. And then, one thing that we haven't talked a lot about, you mentioned it briefly when we were talking about the ALLL and the Incurred Loss Methodology, you know, we still need to test loans for impairment. So, if we have information that suggest that we will not get full principal and interest then we need to test for impairment using the normal methods that we use for incurred loss. And lastly, we're recommending that bankers really fully consider all the alternatives for borrowers that are out there, which might include other loan programs at government-provided facilities.

So, let's go to Slide 16, and I want to provide a little perspective of how examiners are going to go about their work. And again, we've said a lot on this call but we understand bankers are not going to have a crystal ball, and what we want to see is that bankers have reacted and are doing the best they can to mitigate the risks that are present. And it's been my experience that bankers really just want a full understanding of the regulatory expectations and they'll strive to meet those. And likewise, as regulators, we want to avoid the 'got you' during exams. So, in order to provide transparency to the industry and promote consistency across the agencies, we issued an Interagency Examiner Guidance back in June to provide directions to examiners on assessing financial condition and management of an institution while taking into consideration all the uncertainty in borrower conditions and where the economic recovery may be and the ongoing work from banks to work with borrowers.

For state member banks, that guidance is in SR Letter 20-15 and it provides the additional information. So, I also wanted to provide basically the big picture risk management factors their examiners are going to assess when they come in at this point. And they're going to look at whether the modifications are prudent and consistent with the CARES Act. And more importantly, they're going to assess, what are the plans to return these borrowers to more prudent terms? And then, how are they going to adjust these terms as events take place and it becomes evident that they can adjust the terms? And we're going to assess the degree to which active credit monitoring and communication with borrowers in this environment. You know, we really want bankers to step up their ongoing communication with borrowers and especially those industries most impacted that we've mentioned so far.

We'll want to see that bankers are actively following TRANs note and financial information. Again, we're trying to assess where a borrower is maybe without complete information. I'm going to use our hotel as our example but there's information—several of my banks that have hotel loans that talked about how they're getting regular reports on occupancy rates and what those nightly rates are. So that they can get some kind of indication of what that cashflow may be going forward and their ability to service debt. Again, that kind

of applies to the next bullet here where we talk about future cashflow projections. You know, when we can get that information, we want to try to analyze that and see where we may come out. And then, I guess, probably the most important thing that we're going to assess—and this is very consistent with how we manage examinations in normal times is, we focus on the integrity of that internal loan grading. We really, from a supervisory perspective, the accuracy of that risk identification gives us confidence that internal classifications are indicative of the risk level of the portfolio. And that goes without saying with any economic time or any examination, when we have confidence that the bank is doing a good job of identifying the risk and appropriately classifying loans, that gives us a real good indication of what we think the risk of the portfolio is like and how well the bank's doing.

So, let's move to Slide 17, and Slide 17 is really, in my view, the principles that we'll be following as we do our examination work. So first off, I want to talk about credit modifications and how examiners will think about this. And most of this comes directly out of the Guidance for Examiners. But we're not automatically going to criticize institutions for working with borrowers as part of a risk mitigation strategy. You know, obviously, the restructured loans, they may or have developed weaknesses but they're not going to be classified simply because they're a loan modification. We will not automatically adversely risk rate credits because they're modified. You know, again, we're going to determine whether management's applying appropriate risk rates, that's key and really core to what we do in an examination.

And as we think about classification of credits, we're really going to focus on known facts and not make assumptions about future prospects. So, what I mean here is, I'm going to use the past financial crisis as an example and many of you know this, examiners will have a tendency to, using known facts and then saying, "Okay, what are the future prospects for a credit? And we can be fairly aggressive." During the last financial crisis, I think examiners were fairly aggressive in downgrading credits. And this episode is different and we really want to give banks flexibility to work with those borrowers and to do everything we can do to keep the flow of credit. So, we're going to really focus on known facts and try to avoid making assumptions. We're also not going to adversely classify a loan solely because the value of the underlying collateral is declined, as long as the borrower still has the ability to repay. But we're going to apply classification charge-off standards pretty much as we always have. The key here is we have information that we're not making any assumptions.

And then, finally, we want to see bankers developing and executing reasonable workout and foreclosure plans for nonperforming loans. Here what we're saying is, we want to make sure the bankers have a firm understanding of the problem loans and have workout plans developed in case things get worse, and we're really thinking through what might be a good alternative so that the bank's in the best position to be repaid. So, with that, I'm going to turn it over to Carl, that's the end of our slides, and I'll turn it over to Carl for our Q&A session.

Carl White: Thanks, Allen and Lara and on Slide 18, once again, just a reminder of how you can submit questions. You can use the chat feature in the webinar, just his the 'Ask

Question' button, you can email us, or use the ask a question feature on the *Ask the Fed*®
website. As I said at the beginning, we have received quite a few questions already so, we're going to get through as many as we can with our remaining time. And, Lara, I did take your advice, I printed off the chart and I took very copious notes and I'm going to keep this right by my side, so that's a great piece of advice.

So, the first question, Lara, this is about multiple accommodations and I think you covered this but let's go ahead and take the question. Is there a limit on the number of modifications a lender can offer to a borrower and still qualify for TDR relief under Section 4013 of the CARES Act? Will exam teams have a negative view of multiple accommodations offered to the same borrower? And what kind of credit analysis is expected?

Lara Lylozian: Okay, thanks Carl. I'll start us off but then I'm going to turn to Allen for help on the second part of that question. But you're right, I did cover this but I think this question is probably the question that has come up the most in the last few weeks. So, the answer is, you know, no, Section 4013 has no limit on the number or length of modifications that can qualify for TDR relief, provided that all the criteria are met. And so, yeah, if you've got Slide 7 in front of you, go to the criteria and you have to be able to show that the borrower is current as of 12-31-19, that the modification was granted prior to 12-31-20, and that the modification was related to COVID.

Now, I think Allen probably touched on this as well earlier, that there are other considerations beyond just what is allowed in the CARES Act. We've heard some banks say that further extensions of up to two years may be needed, perhaps even longer. And so, I guess, Allen, I'll ask you to weigh in here from the safety and soundness perspective, how are you looking at subsequent modifications, particularly if there are multiple modifications to the same borrower?

Allen North: Sure. So, I'm going to echo Carl's comments and share with everyone on the call that the examiners are using that table as their guide too with respect to relief under Section 4013. And I guess, the comment I'll make is fairly consistent with what I've said before. When we're thinking about the financial impact and the financial issues that may occur with some of these borrowers, to continue to modify them is a good idea to work with the borrower. But we have to continue to monitor their progress and as we get new information, we need to make decisions. Are we getting to a point where being intellectually honest, should we downgrade the credit? Should the credit continue to be on accrual status? And, you know, right now as we've mentioned, there's so much uncertainty and we don't have concrete information necessarily to make those calls today. But as we make those modifications longer in term, you know, we may get some updated information, likely we will and at that time we're going to want to make some decisions. Because at the end of the day, we want to make sure that the loans are graded appropriately, we've reserved appropriately, and that we don't have loans on accrual that we don't expect to get full principal and interest.

So, one of my main concerns as we've been dealing with this pandemic is to really avoid what I'm calling a cliff effect. Where while we're providing the TDR relief, which is

incredibly important, and we continue to work with our borrowers which, again, is incredibly important, we're not tracking our loan classifications correctly so, we could get in a situation six months, nine months down the road where the level of classified assets go up substantially at a given bank. And I think if we're monitoring this on an ongoing basis, on a flow basis, management's going to have a much better indication of the risk they're facing and the actual financial condition of the bank as we progress through the pandemic.

Carl White: All right, thanks Lara and Allen. So, the next question, Lara, I'm going to kick it to you first, this is in the accounting realm tied to TDR's. So, if the institution did a short-term modification in Q2, 2020 and concluded it was not a TDR in accordance with the criteria laid out in the revised Interagency Statement but then subsequently modified the loan during Q3, could it then elect treatment under Section 4013 and not consider it a TDR?

Lara Lylozian: Yes. This is also another of my frequently asked questions. We get question related to this scenario a lot. And so, yes, assuming that the modifications were all COVID-19 related, that the borrower was current as of 12-31-19, and that the modifications were all granted within the time frame specified, you know that window that we talked about between March 1, 2020 and December 31, 2020. Then yes, an institution could apply Section 4013 to the subsequent modification and not designate the loan as a TDR. And I guess, I don't know, just an observation, as I talk to my accounting colleagues across the system and with my counterparts at the other agencies, well, we're just a bit surprised by how much focus, how much attention, how many questions are coming in related to TDR identification. I heard Allen say earlier that that's not the primary focus of examiners. Allen, can you just repeat it again or confirm, is the identification of TDR's the primary focus for examiners?

Allen North: Sure, absolutely. I'm going to quote one of my FDIC counterparts. I was on an interagency call early on in the pandemic, I think it was March or April, and obviously all the questions from the bankers were concern about TDR's. And they were so concerned they couldn't work with their borrowers because of the TDR designation and his comment was, "You know, I've never heard an examiner say, 'Here are the level of TDR's in relation to capital and reserves.'" And you know, when we think about assessing asset quality, we're focused on that level of classified asset and nonperforming assets. And just because a loan is a TDR doesn't automatically mean that it's classified or that it's nonperforming. So, to answer your question, I think the real focus here, while I understand the concern bankers have, really should be focused on the credit quality and the ongoing credit quality of those loans.

Carl White: Great, thanks. So, Lara, this kind of expands on the last question and you kind of touched on it a little bit, Allen, regarding risk ratings. But if banks are using either the CARES Act or the Interagency Statement to avoid designating loan modifications as TDR's, they are often treating these loans under a unique credit or risk grade. Can you provide a clarification on how they should approach these loans regarding downgrade classification, nonaccrual, or even possible impairment?

Allen North: Lara, I guess I can tackle that one. So, the regulatory agencies issued a Joint Statement to the FFIEC in August and it really does discuss this topic in detail. It really reiterates that relief from TDR designation not be extrapolated to relief or other accounting and regulatory requirements. As we've said quite a bit today, you know, those loan ratings really need to reflect the borrower's ability to repay and contemplate any credit accommodations that have been granted. So, you know, really what we're focused on here is the fact that I think we should be monitoring these loans separately so we understand the risks that may be present at some point in time. But just because they are modified doesn't mean they automatically should be classified or placed on nonaccrual. Those decisions are going to be fact specific and, you know, our recommendation is that bankers continue to monitor those things on an ongoing basis and try to get updated information as it's available and then make those determinations appropriately.

Carl White: All right, great, thanks Allen. This next question also covers TDR's, I think you just covered it so I'm going to skip that one. Looking at our time, we want to get through a few more here. So, Allen, this one's regarding the Loan Loss Reserve and I know we covered this but I think it would be good for you to reemphasize some of these points. So, the question is, in the midst of all the TDR relief and the economic uncertainty, what specific things will examiners be looking for when addressing the overall allowance? Are there specific methods, segmentation issues, qualitative adjustments, or other analysis that might be expected?

Allen North: Sure. So, you know, everyone saw in the first quarter that many of the regional banks took some pretty hefty reserves as they were adopting CECL. And part of that was because the unemployment rate had jumped so dramatically and that was a big factor in a lot of these models. But the majority of community banks are still on the Incurred Loss Method and really what they should be focused on, first of all, is the qualitative adjustments that should be made. And that's really a tough one because a lot of the factors that are built in under these methodologies, they're based on local economic conditions and in some cases those conditions haven't worsened. Particularly in the rural areas that maybe have not been that greatly impacted by COVID. But what we would recommend is that bankers take a hard look at those qualitative adjustments and say, "You know, what's reasonable? What could we expect? Maybe not what's the worst possible outcome but what could we expect?" And I think that's certainly justifiable in this environment.

Second of all, Lara had mentioned this about the segmentation of loans and how you may want to create what I would call a different bucket of loans as you do your analysis for loss rate. And that's another way to get into this idea that you do have some increased risk here, although I will say that the loss rates are going to be hard to come up with. What we're typically seeing is bankers are adjusting those qualitative adjustments to really the predictive aspect of the Reserve Methodology to get at, how are we going to increase our reserves at this time.

Carl White: All right, thanks Allen. I think we have time for one more question and Allen I'm going to give you the last one. So, another one that we've kind of covered but

maybe you can add a little bit more detail behind this regarding credit analysis and what's expected. So, let's say a loan is coming off its six-month deferral period and the borrower says it needs more deferral time, can you discuss what kind of credit analysis you might expect, considering both whether collateral values have generally been strong and whether they have declined?

Allen North: Sure. So, the primary focus is going to be what it normally is for all examiners. We're looking at cashflow to repay the debt and really the fundamental characteristics of collectability of that particular credit. So, right off the bat I have to acknowledge that supporting documentation may be limited and cashflow projections are going to be highly uncertain. So, examiners will review management's assessment of the borrower's repayment ability and financial conditions to the best of their ability based on available information. And, you know, I think importantly, for this audience, examiners will not subject a renewed, extended, or modified loan to an adverse classification solely because the value of the collateral is declined. Really, what we're going to focus on is the borrower's ability to repay in this time. And, you know, when you think about it, when we get to the collateral values, we're really talking about a secondary source of repayment. And what we all need to be concerned with is the primary source, which is the borrower's ability to service that debt.

Carl White: Great, thanks Allen. So, we're going to wrap things up. One thing I want to note on Slide 19, there is reference specifically to the SR letter that Allen and Lara mentioned, so, you can use that as reference material. Thanks for all your questions, we got through as many as we could. We have received quite a few more questions and I will tell you, very similar to other *Ask the Fed*® sessions that we've had, we continue to get a lot of questions about other topics. Specifically, related to the PPP program, to the Economic Injury Disaster Loan program, that's the SBA's program. So, we're not ignoring you but those are different topics, so we encourage you to work with your SBA representative on those questions and they certainly have a lot of information, FAQs, etc., that's out on their site. And then, if you have very fact-specific questions, we strongly encourage you to reach out to your local Reserve Bank, talk to your examiners, your local supervisors regarding those questions, and they can give you the most appropriate feedback for those non-specific situations.

Okay, so, we're going to wrap up. So, thanks once again for everyone who attended, we have lots of folks who joined on this very important topic. First, I'd like to thank Lara and Allen for all their work on today's session. And a reminder that all sessions are archived on our *Ask the Fed*® site so you can review the materials and listen to the sessions at your leisure. And that will be out there just shortly, probably sometime this afternoon. Finally, *Ask the Fed*® is a program of the Federal Reserve Bank of St. Louis, it's intended only for informational purposes. The views are not formal opinions of nor binding on the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve System. This *Ask the Fed*® session is eligible for continuing education units, all you need to do is first of all, make sure you're registered for today's session, that one's easy. And two, complete the last section of the online survey, which we'll be sending out to you any minute now. I do want to

note that the survey will be coming from a new domain so, if you've been at different *Ask the Fed*® sessions, we have changed that. It's called Alchemer so you may want to be on the lookout for that, so that will be coming out very soon. Thanks so much for joining us today and we'll talk to you next time.

(END OF RECORDING)