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Loan Modifications and Other Guidance Related to COVID-19

Bank regulators recognized and addressed the current business disruptions and challenges that affect banks, credit unions, businesses, borrowers, and the economy on March 22, 2020, when they issued the *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus.*

The agencies encouraged institutions to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the effects of COVID-19. Given the unique challenges facing institutions, the agencies view loan modification programs as positive actions that can mitigate adverse effects on borrowers due to COVID-19. These proactive actions are in the best interest of institutions and their borrowers and the economy. Summarized below are the key takeaways from the interagency statement:

Troubled Debt Restructuring (TDR) Determination

- Loan term modifications do not automatically result in TDRs.
- Short-term modifications made on a good-faith basis in response to COVID-19 to borrowers who were classified as current prior to any relief are not TDRs.
    - This includes short-term (e.g., six months) modifications, such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant.
    - Borrowers considered current are those who are <u>less than 30 days past due on their contractual payments at the time a modification</u> program is implemented.
- The restructuring of loans that do not meet the criteria above should follow an institution's normal process regarding TDR determination, past-due reporting, and nonaccrual determination.
    - As part of that determination, financial institutions should consider the accounting rules in Accounting Standards Codification (ASC) 310-40-15-17 to 19 and the illustrations in ASC 310-40-55-16 to 25 in assessing whether the modifications are significant to the overall loan terms.
    - See Appendix A for additional guidance on accounting for loans modified in a TDR.

Past-Due Status

- Financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral.
    - Borrowers who were classified as current prior to becoming affected by COVID-19 and then receive payment accommodations as a result of the effects of COVID-19 generally would not be reported as past due.

- For loans subject to a payment deferral program on which payments were past due prior to the borrower being affected by COVID-19, it is the Federal Deposit Insurance Corporation's position that the delinquency status of the loan may be adjusted back to the status that existed at the date of the borrower becoming affected, essentially being frozen for the duration of the payment deferral period.
    - For example, if a borrower was 60 days past due at the time the borrower became affected by COVID-19 and requested a payment deferral under the COVID-19 program, that loan would continue to be reported by an institution as 60 days past due throughout the deferral period.

Credit Risk Grade or Classification

- An assessment of the credit risk grade or classification for restructurings occurring in response to COVID-19 to borrowers who were classified as current prior to any relief is not required.
    - As information becomes available that indicates a specific loan will not be repaid, institutions should consider whether changes in the loan's risk rating are necessary on a case-by-case basis.
- The restructuring of loans that are not the result of the COVID-19 program would require an assessment to determine the appropriate credit risk grade. All relevant factors, including the extent of a borrower's financial difficulty, should be considered when making the risk-rating assessment, similar to an institution's historical practice.
- See Appendix A for additional information on determining the appropriate credit risk grade or classification of a loan.

Accrual of Interest

- Restructurings, including short-term arrangements in response to COVID-19, generally should not be reported as nonaccrual.
- During the deferral period, institutions can continue to recognize interest income and report the accumulated balance in accrued interest receivable.
- Once the deferral period has concluded and the borrower is scheduled to resume regular loan payments, if the borrower is unable to make regular payments according to the terms of the modification agreement, an institution should make an assessment of collectability based on the circumstances of the loan and may be required to place the loan on nonaccrual status at that time, reversing previously recognized interest.
- Consultation with core providers is recommended for restructurings that include payment deferrals in order to fully understand how the system will apply the future payments at the end of the deferral period. Considerations may include:
    - How will the system apply the split of principal and interest after the deferral period?
        - Will all payments be applied to accrued interest until collected or will the accrued interest be recuperated at the end of the loan term?

- Will the system automatically place the loan on nonaccrual status if it surpasses 90 days without a payment?
- Will the system capitalize the deferred payments to the principal balance of the loan? (Institutions may need to take action to avoid this treatment.)
- At the loan's maturity, will the system report the remaining balance as due in a balloon, or reamortize the loan to the original maturity date?
  - An institution may consider adding these criteria to the modification agreement to ensure that all parties agree to the new repayment terms.

- On March 25, 2020, Fannie Mae also issued individual guidance to servicers of Fannie Mae loans that outlines additional criteria for qualifying modifications as well as specific treatment for principal and interest on serviced loans during the deferral period. Under Fannie Mae's approach, principal and interest during the deferral should be segregated and carried separately in a noninterest-bearing account until the maturity of the loan, at which time it should be collected. See reference to Fannie Mae guidance in Appendix B.
- As information becomes available that indicates a specific loan will not be repaid, institutions should reassess accrual status on affected credits.
- See Appendix A for additional information on determining the accrual status of a loan.

Fees and Costs for Restructured Loans

- Financial institutions are working with borrowers and in many instances not charging fees.
- When a restructuring constitutes a TDR, institutions should:
  - Expense the appraisal and other direct costs associated with the TDR when incurred
  - Apply the fee received in connection with the TDR to reduce the recorded investment in the loan. Thus, an institution should defer recognition of the fee income associated with the TDR
- See Appendix A for additional information on fees and costs associated with restructured loans.

Impact on the Allowance for Loan and Lease Losses (ALLL)

- Each institution should maintain an appropriate ALLL for these loans, considering all information available about their collectability.
- Certain economic data will lag and not provide for a full analysis of the impact of COVID-19 on qualitative factors.
- Institutions should assess the adequacy of qualitative factors related to:
  - the impact to national, state, and local economies,
  - concentrations of credits within industries affected by COVID-19, and
  - other external factors/COVID-19 qualitative factor (e.g., supply chains, property values, labor markets, interest rates).

Documentation

- Institutions should consider updating current loan modification evaluations to include an assessment of whether the restructuring met COVID-19 criteria.
    - Auditors and regulators will still want to see documentation supporting the restructuring.
- Ensure that any modifications to internal controls, particularly review controls, are appropriate.
- Review and update policies and procedures as appropriate.
- Determine any management or board monitoring reporting requirements.
- Consider policies and procedures if there is a prolonged impact.

Appendix A

The determination of whether a restructured loan is a TDR requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a restructuring is a TDR. An overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean that a borrower is *experiencing financial difficulties*. Accordingly, lenders should use judgment in evaluating whether a modification is a TDR.

Determining Whether a Borrower Is Experiencing Financial Difficulties

In determining whether a borrower is experiencing financial difficulties, an institution generally should perform and document a current credit analysis. This analysis should include an evaluation of a borrower's willingness and ability to meet the loan terms assuming no modification takes place and the loan resets to the higher payment.

The list of indicators below is not intended to include all indicators of a borrower's financial difficulties, but such indicators should be assessed at the time of modification.

- The borrower is currently in payment default on any debts or it is probable the borrower would be in default on any debts in the foreseeable future without the modification. (ASC 310-40-15-20a)
- The borrower has declared or is in the process of declaring bankruptcy. (ASC 310-40-15-20b)
- There is substantial doubt as to whether the borrower will continue to be a going concern. (ASC 310-40-15-20c)
- The borrower has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange. (ASC 310-40-15-20d)
- On the basis of estimates that encompass only the borrower's current capabilities, the institution forecasts that the borrower's entity-specific cash flows will be insufficient to service any debts (both principal and interest) under the existing agreement's contractual terms for the foreseeable future. (ASC 310-40-15-20e)
- Without the current modification, the borrower cannot borrow from sources other than the existing institution at a market rate of interest for similar debt for a nontroubled borrower. (ASC 310-40-15-20f)

If a borrower is experiencing financial difficulties, an institution should also assess and document whether it has granted a concession to the borrower.

Determining Whether a Creditor Has Granted a Concession

Determining whether a modification of a loan should be considered a concession is just as difficult as establishing borrower financial difficulty.

- As a result of the restructuring, the creditor does not expect to collect all amounts due, including interest accrued at the original contract rate. (ASC 310-40-15-13)

- If a creditor receives additional collateral or guarantees in exchange for a restructuring, the creditor has granted a concession if the additional collateral or guarantees are not adequate compensation for other terms of the restructuring. (ASC 310-40-15-14)
- A temporary or permanent increase in the interest rate may be a concession if the new interest rate on the restructured loan is still below a market rate or new loans with similar risk characteristics. (ASC 310-40-15-16)
- If a borrower does not otherwise have access to funds at a market rate for loans with similar risk as the restructured loan, it is assumed to be at a below-market rate and is likely a concession. However, if a market rate is not available (e.g., due to contracted markets), this alone may not be a concession. (ASC 310-40-15-15)

A restructuring that results in only a delay in payment that is insignificant is not a concession. The following, when considered together (including the effect of cumulative past restructurings), may reflect an insignificant delay that would not be a concession:

- The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
- The delay in timing of the restructured payment period is insignificant relative to any one of the following:
    - The frequency of payments due
    - The loan's original contractual maturity
    - The loan's original expected duration

Determining Accrual Status

The determination of accrual status is a separate process dependent upon several factors, which requires a current, well-documented credit evaluation of a borrower's financial condition and prospects for repayment. The evaluation must assess the likelihood that all principal and interest payments required under the terms of the modified agreement will be collected in full. In determining accrual versus nonaccrual, the assessment should consider the following:

- *Status prior to modification accrual*
    - If accrual was appropriate prior to modification,
    - The borrower had demonstrated sustained historical performance (usually six months), and
    - The borrower's capacity to continue to perform completely is evaluated as such, then it is likely that the loan should remain on accrual.
- *Status prior to modification nonaccrual*
    - If the loan was placed on nonaccrual, then the evaluation should demonstrate the capacity to meet the modified terms and
    - The borrower should demonstrate sustained performance (usually six months) after modification before returning to accrual status.

Determining Credit Risk Grade or Classification

A modified loan's credit risk grade or classification and its TDR analysis are separate and distinct decisions, but the processes are related. A TDR designation means the loan is impaired for accounting purposes, but it does not automatically result in an adverse classification or credit risk grade. However, at the time of the modification, an assessment of the credit risk grade or classification should be made. All relevant factors, including the extent of the borrower's financial difficulty, should be considered when making the risk-rating assessment.

Further, a TDR designation does not automatically mean that a loan should remain adversely risk graded or classified for its remaining life if it already was or becomes adversely risk graded or classified at the time of the modification. A TDR loan should be adversely risk graded or classified if the loan, as modified, is inadequately protected by the current sound worth and paying capacity of the borrower or the collateral pledged, if any. In determining the credit risk grade or classification of a TDR loan at the time of a modification or at a subsequent evaluation date, a well-documented assessment of the cash flows available to service the modified loan and the extent of any collateral protection and guarantor support should be performed to form the basis for determining whether an adverse credit risk grade or classification is warranted.

Fees and Costs in Refinancing or Restructuring

If the terms of the new loan resulting from a loan refinancing or restructuring other than a TDR are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan should be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans. Any unamortized net fees or costs and any prepayment penalties from the original loan should be recognized in interest income when the new loan is granted.

If the refinancing or restructuring does not meet the condition set forth in the preceding paragraph or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties should be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan should consist of the remaining net investment in the original loan, any additional amounts loaned, any fees received, and direct loan origination costs associated with the refinancing or restructuring.

A modification of a debt should be considered more than minor under the preceding paragraph if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the difference between the present value of the cash flows under the terms of the new debt instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10 percent, a creditor should evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification.

Fees received in connection with a modification of terms of a TDR should be applied as a reduction of the recorded investment in the loan. All related costs, including direct loan origination costs, should be charged to expense as incurred.

Appendix B

Guidance Overview

The available guidance on TDRs consists of both accounting and regulatory standards.

The Financial Accounting Standards Board's ASC Topic 310 provides the basis for identifying TDRs and treating TDRs as impaired loans when estimating allocations to the ALLL. In this regard, ASC Subtopic 310-40 addresses receivables that are TDRs from a lending institution's standpoint.

From a regulatory standpoint, the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* from December 2006 (FIL-105-2006) set many of the initial standards on the definition of a TDR.

Regulatory bodies issued subsequent standards to provide more clarity to creditors, specifically the *Interagency Policy Statement on Prudent Commercial Loan Workouts* (FIL-61-2009) as well as the October 2013 *Troubled Debt Restructurings Interagency Supervisory Guidance* (FIL-50-2013). The latter provides definitions around risk grading, measuring impairment for TDR loans, and expanded definitions related to collateral-dependent loans.

Considering the recent economic disturbances related to the spread of COVID-19, regulatory agencies issued an interagency statement to recognize and address these concerns in a white paper titled *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus* as well as a frequently asked questions guide for financial institutions affected by the novel coronavirus disease.

Links to these sources can be found below:

Interagency Policy Statement on the Allowance for Loan and Lease Losses
https://www.fdic.gov/news/news/financial/2006/fil06105.html

Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts
https://www.fdic.gov/news/news/financial/2009/fil09061.html

Troubled Debt Restructurings Interagency Supervisory Guidance
https://www.fdic.gov/news/news/financial/2013/fil13050.html

Regulatory Relief: Working with Customers Affected by the Coronavirus
https://www.fdic.gov/news/news/financial/2020/fil20017.html

Frequently Asked Questions for Financial Institutions and Consumers Affected by the Coronavirus
https://www.fdic.gov/news/news/financial/2020/fil20018.html

Joint Statement on CRA Consideration for Activities in Response to the COVID-19
https://www.fdic.gov/news/news/financial/2020/fil20019.html

Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus
https://www.fdic.gov/news/news/financial/2020/fil20022.html

Interagency Webinar on the Statement on Loan Modifications and Reporting for Institutions Working with Customers Affected by the Coronavirus
https://www.fdic.gov/news/news/financial/2020/fil20024.html

Fannie Mae's Approach to COVID-19
https://www.fanniemae.com/portal/covid-19.html