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GUIDELINES FOR RISK RATING LOANS IN THE COVID-19 PERIOD

JUNE 2020

EXECUTIVE SUMMARY

The pandemic associated with COVID-19 has caused an unprecedented reduction of economic activity. Unlike past recessions, wars and other economic shocks, the current crisis has impacted virtually every human being in the modern world.

The suddenness, scale and duration of the economic shutdown caused by stay-at-home orders has made the impact on credit quality difficult to measure. The timing of the shutdown - spanning a quarter end - has rendered the last two periods of borrowers' financial information minimally useful as an indicator of future performance. At the same time, the safe and sound functioning of the banking industry depends upon accurate and reliable credit risk ratings. This will require the gathering and analysis of alternative information to ensure that the industry can make sound credit judgments and continue supporting the economic recovery and the North American consumer.

Thirteen North American financial institutions, organized and supported by The Risk Management Association, contributed their insights for this paper. In the context of the current pandemic, this paper will identify information sources that can provide insights into credit risk for commercial borrowers impacted by COVID-19, suggest methods of incorporating individual borrower circumstances and access to special payment programs into the analysis, and discuss how triage efforts can aid in differentiating risk in the portfolio for early prioritization and action.

In later sections, this paper surveys bank practices regarding incorporation of alternative information and expert judgment into risk ratings determination, provides guidance on use of risk rating migration triggers, and explores how the pandemic may impact the use of risk ratings models.

I. Alternative Information

The banking industry needs to ensure that loan risk ratings accurately reflect risk and repayment ability. However, reliance on historical financial information will be of limited help during the current period. In concert with the application of expert judgment, alternative information must be analyzed in order to inform the final risk rating. The key attributes of commercial credit risk are well understood, and these underpin the choice of information to be gathered and the method of analysis.

In the **Appendix** we present a survey of key attributes of credit risk - both Business as Usual (BAU) characteristics and those providing more insight in the COVID-19 context. A review of those attributes by the reader will provide the foundation for the discussion that follows.

Types and Sources of Information

Banks cited a variety of sources for the alternative information they are gathering to make near-term risk ratings as responsive as possible to actual risk. Among them are:

- Specific information on the borrower, gathered from the customer and/or deal sponsor(s)
- Account officers' knowledge of the company, its industry, strength of management, history of past performance, customer base, and the competitive landscape.
- The credit underwriting/portfolio management team, senior credit officers, and Credit Review provide perspective and expert judgment from their broader view of the portfolio, exposure to current credit issues, and long experience.
- Bank departments such as portfolio management, industry analysis, credit analytics, stress testing, credit risk grading, corporate banking, industry verticals, and capital markets bring their industry expertise to bear on industry outlook. Other departments bring insights into collateral values, including real estate appraisal, asset-based lending, field audit, the equipment valuation team and credit review.
- Guidance from primary regulator
- Economic information, models, and forecasts, from the bank economics department or vendor sources
- Publicly available information on key industries

Gathering Information from the Borrower

The ability to accurately determine credit risk attributes of a borrower depends on skillful collection of information from the commercial customer. Bank methods of collecting information include use of checklists, deployment of customer surveys, and open conversation. Most banks did not report using a fixed template for account officers to conduct the customer discussions. Most took a principles-based rather than a rules-based approach for their information gathering guidelines. Some believe surveys and checklists promoted better consistency of reporting. In one case, a third-party vendor was engaged to administer the surveys. One bank reported using a risk rating aid form as a tool, to help the banker organize the information, including survey results, and promote consistency across the bank. Key information to gather includes:

- Revenue Impact
  - Comparison of current period revenues to trends pre-COVID, including sources of revenue that may have ceased – either temporarily or permanently - and impact on the borrower's business model
  - Revenue versus comparable previous period revenues, as a percentage change
  - Revenue projections or range of possibilities for the current quarter and subsequent quarters
  - Disruptions in their clients' business, to assess flow-through impact on revenue
  - Tertiary data that could be a proxy for customer's current revenue. For example, if a bank lends to auto dealerships on a floor plan basis, it may also be purchasing their retail paper. The retail paper flow would provide a proxy for the dealership's overall level of business.
  - Volumes associated with other bank products and services that are provided to the borrower; treasury management activity, wire activities, letter of credit requests, or employee benefit activity, where a slowdown in other service volumes may mean a slowdown in business activity that will eventually show up in the financials
  - For large borrowers or industry sectors, projections may be shocked to provide a range of outcomes
- Cash flow
  - 13-week cash flow projection
  - Monitoring deposit accounts for cash inflow and outflow, as a reasonable proxy for cash flow (for sole-bank relationships or certain ABL clients)
  - Projected monthly cash budget
- Commercial Real Estate
  - Rent rolls that are comprehensive and identify pay rate of tenant (past due or partial), if deferment has been granted, and if tenant has given notice of intent to vacate or not renew
  - Net Operating Income
  - Occupancy projections
  - Effective rent projections
  - Local government actions which reduce rental income or limit eviction
- Other
  - Updated guarantor personal financial statement and liquidity statement
  - Updated information on sponsor's ability to support
  - Interim financial statements, if available, for most recent 30-45 days
  - Simply asking the borrower for the best numbers they can give you, on a monthly basis
  - Accounts payable turnover and trends, terms with creditors
  - Recent inventory audits
  - Capital expenditures, and any change
  - Hedging activity and status of hedges, if applicable for the industry
  - Contingency plans for any further or unforeseen challenges

Special Note on Projections

Given the unprecedented and rapid change in the economic environment, projections may be a better source for assessing risk ratings than historical financial information. When using projections, one bank stresses the importance of discussing company prepared projections with company management; incorporating the bank's independent assessment into the analysis; updating the assessment regularly upon receipt of material financial information; and comparing projections to plan, to assess company performance to plan. The greater the reliance on projections to support a pass grade, the tighter the trigger would be set for negative performance versus plan.

Shocking projections based upon available industry information to provide a range of possible outcomes will be important to providing greater insights into the potential risk.

Incorporation of Individual Circumstances

Despite strong correlations among companies in the same industry, individual and company-specific factors can be determinative in terms of credit risk and survivability. Effectiveness in developing and using this knowledge in credit risk assessment depends on the banker's abilities and familiarity with the customer. Banks cited the 'art versus the science' of lending as an important tool. Nearly every contributing bank reported focusing on unique issues and reviewing individual credits as opposed to downgrading an entire segment or industry. In addition to the general attributes cited above, banks recommended looking closely at:

- Financial health, leverage, liquidity and performance compared with industry peers, using RMA Annual Statement Studies
- Competitive position and market share dominance compared with peers
- Comparative strength of company management

Triage and Bucketing

Assessing and categorizing the level of COVID-19 impact will be an important component of the risk ratings response, with size, capital structure, and available liquidity, among others, being key differentiators of risk.

Many banks are performing early triage by placing borrowers into 3 buckets: Significant Impact by COVID (shutdown, production interruption); Medium Impact (revenue decline, not complete shutdown); and Low/Minimal/Unknown Impact. The initial credit focus is Significant Impact borrowers and larger borrowers. Other common differentiators cited are: liquidity, cash flow, open/closed status, ability to raise money, perceived resiliency, Paycheck Protection Program loan access, loan modification request, employment status, reserves, cost control ability, material business disruption (for example greater than 50% of revenue), accounts already on watch list, serious COVID impact on tenants/customers/key suppliers, how far the borrower was off their plan or had marginal credit quality going into the crisis.

Special factors for CRE loans include segment (hotel, retail, restaurant real estate), plans for tenants to re-open, local opening guidelines, percent of tenants paying rent, and lease modifications requested/granted.

In summary, liquidity (creating and sustaining) plus subjective factors were cited as the most important elements of bank triage and bucketing efforts, both for purposes of addressing credit issues and for reviewing risk ratings.

Consideration of Paycheck Protection Program Loans and Loan Deferrals

Practices vary, but among the contributing institutions, most are considering a borrower's access of an SBA Paycheck Protection Program loan or granting of a loan payment deferral, on a case by case basis. Many believe it is too early to draw conclusions, since many borrowers took deferrals - and in some cases PPP loans - out of abundance of caution. Most banks granted the first payment deferral without a change in risk rating grade, though some went to Pass Watch or Criticized, depending on the overall credit quality of the loan prior to COVID. Most banks report they plan to review the risk grade if a second deferral is requested, particularly if the credit is on the lower boundary of its assigned risk rating, and thus, close to a more adverse rating. Some banks are not certain of how to regard PPP loans until more clarity is available on how much of the loan will be forgiven. In some cases, PPP is viewed as free bridge equity. Main Street Program loan structures, on the other hand, do not provide debt forgiveness, so banks intend to view them as debt.

II. *Risk Rating Practices*

Incorporating New Information into the Risk Ratings Process

A borrower's financial profile and performance is typically a component of most risk rating models in determining probability of default. It is unlikely financial statements for periods through 3/31/20 will evidence significant shifts in a borrower's historical financial profile or performance relative to current exogenous events (pandemic/COVID-19, civil unrest). The current challenge is to take alternative information discussed in this paper to layer in an additional 'forward looking' adjustment (or override) for these known, but yet unquantified events which are expected to materially affect borrower financial profiles/performance and apply such adjustments consistently across the institution.

Among the participating institutions, the risk rating is generally set by the Deal Teams: Account Officer, Underwriter/Portfolio Manager, Credit Officer, and Senior Manager. Credit Review typically provides independent, sample-based assurance on risk rating accuracy, generally having authority on final risk rating dispositions for sampled loans.

Banks have been providing interim guidance to the risk raters for help in risk grading loans and in reconciling the model output with the "intuitive risk grade". In many cases, this guidance represents reinforcement of previous guidance rather than any significant departures from practices to allow for COVID impact. The goal is ensuring consistency of practices.

Many banks report having regular portfolio meetings, including the deal team and sometimes attendance by Credit Review, to monitor any developments regarding the customer or to incorporate any new information, internal or external, into the risk analysis. If the risk profile is determined to have changed, a review of the risk rating may result from this process.

Most banks did not report using a special "COVID Risk Grade" or account identifier. However, several banks are adding a designation that the risk rating is COVID-impacted, while continuing to use the bank's standard risk rating scale. One bank reported having established a special temporary low pass risk rating for accounts impacted by COVID-19. These special ratings or identifiers are reserved for companies that were healthy before the pandemic and have significant mitigants (liquidity, management strength, guarantor support) that may help them sustain operations until conditions stabilize. The temporary rating allows the credit team to gather information to assess the full impact on operations and allow an appropriate risk grade to be assigned. These credits will be closely monitored by the credit team.

Some banks report plans to "re-underwrite" most of the portfolio on a phased basis over the year, with the highest perceived risk credits given the priority. This is being undertaken independently of the regular credit renewal process and separate from the ongoing commitment to ensuring the risk ratings are accurate and timely.

One bank cited the use of Early Warning Factors (EWF) to differentiate risk. An adverse EWF could impact the credit negatively by one notch; multiple adverse EWFs could result in a multiple level downgrade. For example, adverse findings could result from a known negative cash flow impact from operating closures (C&I) or tenant/hotel receipts (CRE); longer term, fundamental changes to the firm's business model; receipt of a qualified financial statement; expectation of COVID-19 outlasting the borrower's liquidity; or loss/bankruptcy of a major tenant, in the case of CRE.

Some Credit Review leaders discussed continuously monitoring risk rating adjustments by the line, which may lead to an adjustment in Credit Review's sampling. Other banks reported tracking borrowers that obtained COVID-19 related loans modifications, deferrals, and forbearance; borrowers that obtained loans under the SBA PPP program; and loans obtained under the Main Street Lending Program.

Notably, no bank reported plans to fundamentally change their overall risk ratings process or approach based solely on the current pandemic, including the focus on PD, LGD and their underpinnings.

Using Risk Migration and Risk Rating Triggers

When the risk rating is graded higher based on a strong mitigant (e.g. high level of liquidity or performance to plan status), banks emphasized the importance of putting triggers in place to guard against the degradation of that mitigant over time.

Triggers are only actionable when they are measurable, timebound and specific. Some banks favored triggers that can be monitored using current servicing information; others viewed triggers as related to unique circumstances, requiring separate monitoring of the data the trigger is based upon.

While generally only considered in certain circumstances, liquidity was cited as a primary factor in differentiating a credit between Pass and Criticized during the pandemic. One bank suggested requesting bank statements to monitor cash inflows and outflows. For other triggers, information flow or audit requirements should be put in place so the bank can get timely notice of an adverse movement. Reliance on liquidity to support a stronger rating would also prompt a tighter trigger on performance versus plan.

Banks advised avoiding over-reliance on any one trigger. Two or more triggers could be considered when measuring different aspects of the same attribute, but vague triggers should be avoided. In general, the closer a credit is to the cusp of a lower rating, the tighter the trigger would need to be set.

A borrower's long-term capacity to repay is an essential requirement to maintain a Pass rating. How close a borrower may be to breaching a minimum capacity to repay, particularly when based on projection assumptions, i.e. vulnerability to falling below minimum repay test levels, determines the level of attention merited.

Using Risk Ratings in the Ecosystem

Risk ratings are a key component in several critical bank processes including portfolio management, reserves, and capital calculation - what one bank referred to as the 'Ecosystem'. We posed the question of whether the dearth of indicative financial information as a component of the risk rating process would cause a temporary or permanent change in how banks use current risk ratings. No bank currently plans to use risk ratings differently in these processes because of any impact of COVID-19 on the nature or perceived quality of the ratings. Rather, banks expressed a commitment to ensuring that risk ratings are as accurate and as indicative as possible of the actual credit position of the loan.

Banks that have not been able to re-rate their entire loan book given the rapid rate of deterioration may implement interim qualitative factors into their allowance process to account for potential unaccounted for portfolio or model under-prediction risk.

Risk Rating Models

Depending on the size and complexity of the bank, risk rating models are typically used as a guideline or starting point in determining a risk rating, in conjunction with human intervention, which contributes subjective elements into the analysis.

Most of the economic impact of the COVID-19 shutdowns occurred in late March. Thus, as one bank expressed it, "the quantitative portion of risk rating models is not expected to be a significant differentiator of forward-looking risk". Risk rating models are expected to show unintuitive results for much of 2020, so banks are regarding the output of risk rating models with great care. Many banks expect heavy overrides of the PD model output until conditions stabilize and more meaningful financial data is available. The expert judgment of the 'rater' or deal team may play a larger role than usual. However, banks caution that overrides, though expected, should be consistently applied, and their rationale needs to be well documented. Banks plan to closely monitor model performance and check model output for reasonableness. Some report plans to use liquidity and cash burn rate as a way to gauge 'how far' to override an unintuitive model output. One bank ties its estimate of a borrower's cash-burn 'runway' with specific risk ratings. In that example, the greater the length of expected firm survival, the stronger the indicated risk rating, based on predetermined guidelines.

Banks do not expect that March financial data will be helpful. June data will be the first that will indicate the impact of COVID-19. Most do not plan to build June data into the risk rating models until 2021. By that time there will be more subsequent data, for example, 12 months of trailing information. However, some caution that "the truth is in the data", advising care to be taken before data is entirely excluded from the model in response to COVID-19.

Due to disruption of collateral resale markets that could affect loan recoveries, some banks plan to monitor the components of Loss Given Default carefully to ensure than expected loss measures are still reasonable under these market conditions. This dynamic may also be factored into loan structure (tightening borrowing bases, for example) in addition to scrutinizing the LGD basis.

FINAL NOTES

The COVID-19 pandemic has presented the financial services industry with an unprecedented set of challenges, impacting bank operations, financial reporting, credit quality, and the operation of markets. The crucial function of differentiating risk through the risk ratings process has been uniquely impacted. Obtaining current financial information from borrowers will be critical. However, reliance on historical financials (particularly income statement and cash flow measures) for borrowers significantly impacted by COVID-19 will be greatly reduced in the near to intermediate term for purposes of determining the final risk rating. As such, gathering and analyzing alternative information (13-week cash flow, forecasts, projections, available liquidity) will likely play a greater role in determining the final rating over the period of impact. Expert judgement (the "art" versus the "science "of credit) will also play a key role.

Providing COVID-19 specific interim guidance while reinforcing existing risk ratings practices and procedures will be important in maintaining consistency.

THANK YOU TO THE CONTRIBUTORS

RMA would like to thank the members of the Risk Ratings Working Group for their contributions to this paper. The Risk Ratings Working Group is made up of 13 RMA member institutions ranging from $25 billion to $450 billion in assets. The bank representatives in the group are senior executives from the underwriting and portfolio management, credit risk grading, credit review and credit modeling disciplines of their banks, as well as several Chief Credit Officers.

The members gave generously of their expertise, which was notable given the challenges they faced during an unusually demanding time for their firms. The group will turn its attention next to other impacts of the current crisis on the risk ratings process, including its interaction with the loan allowance process, and implications for credit risk modeling. A range of practice survey is planned.

APPENDIX

Attributes of Commercial Credit Risk

These qualitative and quantitative attributes of commercial borrowers have been cited by member banks as being helpful in differentiating risk in the credit portfolio. Some are more timeless or "Business as Usual"; others are more focused on the COVID-19 environment. During this period banks gather data indicative of these attributes in addition to traditional financial reporting, to assess individual loan credit quality as well as to assist in assigning risk ratings.

Environmental/Economy/Industry

- Mandatory capacity constraints (restaurants, casinos, theaters)
- Supply chain problems, upstream and downstream
- Vulnerability to global supply chains
- Perceived outlook for speed and strength of borrower's industry to rebound
- Possibility of government bailout of the industry
- "Essentialness" of the business (e.g. electric utility versus entertainment focused)
- COVID-19 impact on related or interdependent industries
- Trend of the rebound, week by week, as the country re-opens in stages

Operational/Competitive

- Operational Impacts
  - o Degree to which the borrower is operating, when it plans to re-open, at what percent of capacity
  - o Ability to source and fill orders
  - o Ability to maintain an adequate, healthy workforce, or shrink that workforce as demand dictates
  - o Status of suppliers, including any change in supplier terms or discounts offered
  - o Potential to restructure the borrower's operations to become viable or adapt the business model (for example serve alternative markets) until conditions stabilize
  - o Adequacy of operating plan, and status of having begun executing the plan
  - o Extent of contractual commitments which limit flexibility (e.g. take-or-pay contracts)

- Management/Strategic
  - o Quality of company management, including demonstrated prudence, judgment, industry knowledge, planning ability, past behavior in a crisis, resourcefulness, talent depth, ethics, succession planning, commitment, outside interests, quality of outside advice (legal, accounting, consultants), and reaction to company's current situation
  - o Speed of company's actions in response to a loss of revenue
  - o Business plan revisions and forecast
  - o Management ability to answer questions about plans, and how well the bank can "size" their ability to perform

- Customer and Competitive Impacts
  - o Impact on the customer's customers due to COVID-19 or the broader downturn and outlook for their rebound
  - o Location of customers in hotspot locations or areas under quarantine
  - o Customer concentrations, diversity of revenues, and ability to survive loss of a key customer
  - o Percent of revenues that are dependent on consumer discretionary spending
  - o Market position and vulnerability to competitive threats

Financial

- Financial Reporting
  - o Quality and availability of financial information provided by the borrower
  - o Borrower's ability and willingness to provide more frequent financial information if requested

- Balance Sheet Strength
  - o Balance sheet health immediately prior to the COVID downturn
  - o Amount and quality of capital
  - o Leverage and CTR after the impact of COVID-19, including the addition of any anticipated bridge debt

- Profitability and Cash Flow
  - o Profitability history immediately prior to the COVID-19 event
  - o Sufficiency of cash flow to maintain operations
  - o Degree of dependency of cash budget on a sales improvement
  - o Accounts receivable turnover and trend, changes in terms being requested

- Solvency and Financial Flexibility
  - o Fixed charges – can the company meet them? Can it repay any bridge debt?
  - o Rent concessions or deferrals available/granted from landlords or local governments, with consideration to how deferrals must be repaid
  - o Off balance sheet commitments to support subsidiaries
  - o Expectations of making timely payments on all scheduled debt obligations
  - o Other lenders' commitments and their status
  - o Size and utilization of credit lines
  - o Cross defaults and limitation on future liens – impact on future restructure or financing
  - o Degree to which expenses have been or can be reduced
  - o Loan deferrals granted (by banks or other financial providers)
  - o Covenant relief sought/secured
  - o Access to PPP or other government sponsored loan programs, and their responsiveness to the borrower's situation
- Liquidity (as a consideration for a short-term and defined disruption, not as a mitigant to non-pass in the case of a protracted downturn)
  - o Availability of liquidity, sources of liquidity
  - o Cash burn rate. How many months' survival at current liquidity and burn rate.
  - o Can available cash (or other liquidity, capital or borrowing sources) carry the company (pay for cash operating needs and required debt payments) until the environment stabilizes or until it can raise more cash?
  - o Cash on hand and expected point of cash depletion
  - o Alternative liquidity (ability to liquidate short term assets easily)
  - o "Excess cash" resulting from precautionary line drawdowns or capital markets raises

- Secondary Sources of Repayment
  - o Collateral (Factors impacting both repayment ability and LGD)
    - Nature and adequacy of collateral
    - Degree to which collateral can support additional borrowings
    - Projected outlook for collateral value
    - Collateral ranking and any need to share with other creditors
    - Degree to which collateral has realizable value and can be controlled
  - o Access to capital markets or private equity support
  - o Guarantors' and investors' ability to support (and existence of other contingent liabilities)