

Update: The Risk of 'People Helping People'

The Summer 2020 edition of Pipeline magazine included an article titled "The Risk of People Helping People"¹ that discussed the potential elevated credit risk due to credit unions granting payment deferrals to millions of members impacted by Covid-19.

That article discussed the results of a nationwide study, known as the Forbearance Risk Assessment (FRA) that FHN Financial Capital Assets began in March to assess the potential risk associated with increases in payment deferrals. The FRA tracked variables such as the number of members entering a payment deferral plan, the characteristics of the deferred loans, including their risk profile, and a variety of other variables as granular as the industry in which the member worked.

At the time of publication, the FRA data indicated that the degree of elevated credit risk was very manageable, but also warned that the risk profile could change depending on future developments. Dozens of credit unions around the country are participating in the FRA study, allowing Capital Assets to continue to track payment deferral and forbearance activity, and to receive feedback from many different credit union managers.

This article provides readers with an update of the FRA study data, including emerging trends since June 2020.

By Rachael Leamon
FHN Financial Capital Assets

As reported midyear in 2020, credit unions helping members in need is not a new concept. What was new, and continues to be since the Covid pandemic began, is the large number of members who have reached out for payment assistance.

Anytime a borrower requests a deferral of their loan payment, there is the potential for elevated credit risk.

The original midyear 2020 data set was made up of 161,655 residential mortgages for a total balance of \$35 billion. The loans in the initial data set were located across 49 states, representing a good diversity as to the regional impact of the pandemic on mortgage payment deferrals.

Throughout the summer and into the third quarter, the FRA data set has continued to grow, doubling in size and adding another \$45 billion in loans, placing the total data set at \$80 billion and containing loans from all 50 states.

JUNE TO SEPTEMBER CHANGES

One of the key variables being tracked within the FRA study is the percentage of Covid-19 payment deferrals on owned loans, and the percentage of forbearances on sold loans out of the total residential loan portfolio.

Deferral rates are tracked two ways: 1) percentage by loan count, which identifies the number of instances of deferment in the portfolio, and 2) percentage by dollar balances. The balance

distinction is important because we've found through three quarters of FRA analytics, loans requesting payment deferrals are typically larger balance loans.

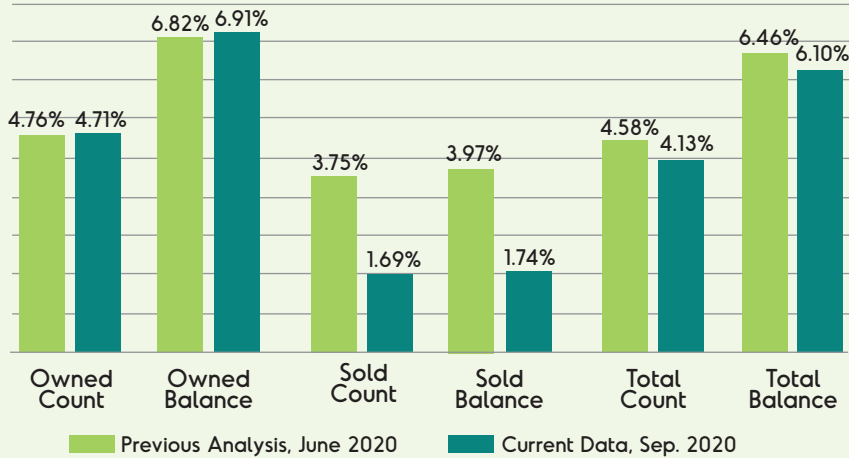
The trends indicate that most credit unions are experiencing a small number of new payment deferral requests. We can't say that we are totally out of the woods, but it appears that the likelihood of a material increase is low, barring some major change that would cause a nationwide Covid-19 lockdown.

Owned portfolios have maintained a stable level of payment deferrals since June, up slightly from 6.82% to 6.91%. The largest change has come from the portfolio of sold loans.

In the second quarter 2020, roughly

DEFERMENT PERCENTAGE OF LOANS ANALYZED

By Loan Count vs By Current Balance



Source: FHN Financial Capital Assets Corp.

3.97% of the sold loans being serviced had requested forbearance. At the end of the third quarter, the sold loan portfolio declined to 1.74%.

Credit unions continue to have far better performance on their sold loans compared to Fannie Mae and Freddie Mac's overall portfolio, whose most recent updated figures are around 3%.

In addition to monitoring the declining rate of payment deferrals, we also looked for changes in the underlying characteristics of payment deferral loans since June. Below is a snapshot of the composition of payment deferrals/forbearances within mortgage portfolios as of June vs. September.

As we found in June, loans that have entered a payment deferral plan have a slightly higher risk profile compared to the remaining portfolio. With few exceptions, the deferral loans had a higher balance, lower credit score, lower liquidity grade, poorer credit risk-layering, and slower historic pay histories "before" March.

The good news is that the updated LTV of these loans continues to be conservative—around 70%, although we are seeing a slight increase in loans with an LTV greater than 80%.

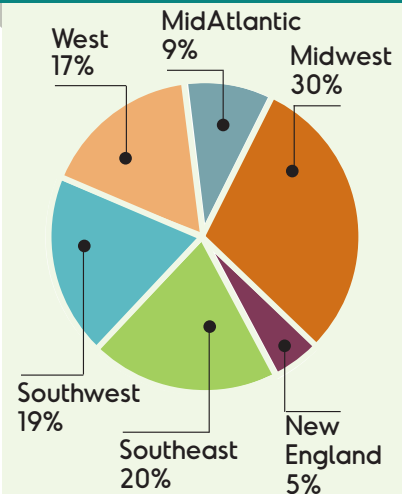
Deferment loans also continue to be

slightly older at 41 months compared to non-deferment loans, which average about 35 months of seasoning. (Note: The average age of all mortgage portfolios is shortening rapidly due to the very high instance of refinancing that continues to occur.)

REGIONAL DEEP DIVE

In addition to the aggregate data, we've looked at some breakouts by geographic region. The data set from portfolios we have reviewed has the largest number of payment deferrals in the Midwest, followed by the Southeast and Southwest.

DEFERRED LOANS BY REGION



Source: FHN Financial Capital Assets Corp.

When taking a closer look inside each region's data, we see that the West has the highest level of payment deferrals by both loan count and balance, at 5.88% and 7.84% respectively. The Mid-Atlantic has the lowest levels for both at 4.15% and 5.38%.

While there is some variance by region, there aren't any significant differences.

PERCENTAGE OF DEFERMENTS WITHIN PORTFOLIOS

Region	By Loan Count	By Loan Balance
Nationwide	4.71%	6.91%
Midwest	4.88%	7.14%
Southwest	4.71%	6.56%
Southeast	4.25%	7.20%
West	5.88%	7.84%
Mid-Atlantic	4.15%	5.38%
New England	5.39%	6.46%

Source: FHN Financial Capital Assets Corp.

PAYMENT DEFERRAL LOANS

Composition of payment deferrals/forbearances within mortgage portfolios as of June vs. September

Product Type	%Of Total	Loan-To-Value*			Seasoning		Balance		
		Amort. Avg.	Orig. Avg.	Amort. 80%+	Avg.in Mos.	%Below 3 Years	Curr Average	% Over \$510,400 Orig	% Over \$1.5M Curr
JUNE DEFER	6.46%	69%	76%	22%	40	54%	317,019	55%	8%
SEPT DEFER	6.10%	70%	77%	25%	41	54%	311,128	55%	9%

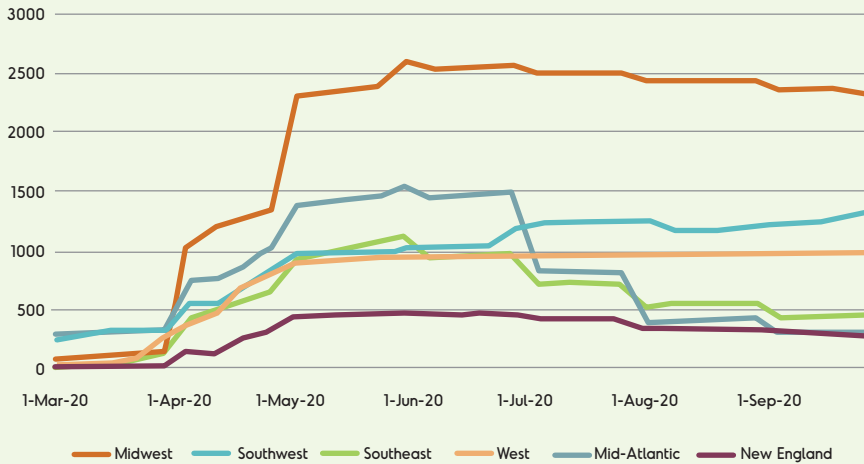
Product Type	Current/Historical DQ		Occupancy			Credit Score*			Purpose Code				
	0	30+	0/0	2ND	NOO	% With Score	%< 620	%> 700	Avg Score	Purch	Refi-Cash	Other-Not Out	Coded
JUNE DEFER	90%	10%	93%	3%	3%	92%	3%	24%	739	54%	18%	27%	18%
SEPT DEFER	82%	18%	93%	4%	3%	76%	3%	75%	737	56%	19%	24%	0%

Source: FHN Financial Capital Assets Corp.

The “run rate” illustrates the trend over time in active payment deferrals and forbearances.

The Midwest saw the quickest spike in payment deferral loans and continues to have the highest current active level. The New England region has had the lowest ongoing payment deferral levels, while the Mid-Atlantic has experienced the quickest drop in active deferrals loans.

PAYMENT DEFERMENTS RUN RATE BY REGION



Source : FHN Financial Capital Assets Corp.

A profile of the composition of deferred loans within each region is included below.

Once again, there are not any dramatic differences between regions, but some of the data points are interesting.

Deferred loans in the New England and Mid-Atlantic regions represent the most seasoned loans and have the lowest average balance. The West region has the highest average balance at \$450,053. The Southeast has a high percentage of historically delinquent loans at 34%. The credit scores are well clustered in the low-to-mid 700s.

DEFERRED LOANS BY REGIONS

Region	Amort LTV	Age in Mos.	Curr Avg	Hist DQ	Avg Score	CRLA Score
Nationwide	70%	41	311,128	18%	737	0.51
Midwest	74%	39	301,231	12%	738	0.56
Southwest	64%	43	352,859	20%	741	0.41
Southeast	76%	33	399,213	34%	733	0.80
West	66%	34	450,359	9%	737	0.46
Mid-Atlantic	66%	64	163,275	12%	734	0.36
New England	71%	52	206,473	31%	725	0.42

Source: FHN Financial Capital Assets Corp.

INITIAL DEFERMENTS VS. EXTENSIONS

Of the Covid-19 payment deferral loans that were part of our study, almost half of them entered their deferment period in April. A three-month grace period was the most common payment relief structure.

FRA study participants provide Capital Assets an updated loan database each quarter, which now includes information on extensions.

Not all study participants have reported third-quarter 2020 deferral extensions, but based on the roughly two-thirds that have, approximately 30% to 35% of initial borrowers under a payment deferral plan have been granted an extension. The lowest instance of extensions reported for a single study participant was 6% and the highest was 72%.

We will closely monitor fourth-quarter 2020 activity to track new payment deferral and extension requests to see if these relatively high instances of extensions continue.

CREDIT PROFILE OF INITIAL FORBEARANCES VS. EXTENSIONS

As the initial payment deferral loans reached the term of the agreement, we begin to focus on the characteristics of the extension loans to determine how they differ from payment deferral loans that did not request an extension.

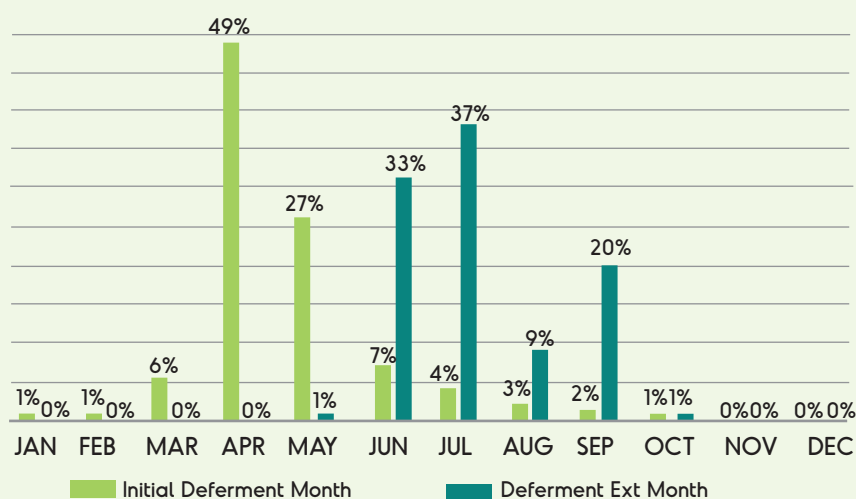
Payment deferral loans are a subset of the total portfolio. Deferral extensions are a subset of that subset.

An analysis of the extension loans revealed that they have a higher current LTV, a larger average balance, more instances of historical delinquency pre-pandemic, and a lower credit score as compared to payment deferral loans that did not request an extension. All those variables roll up to give deferral extensions a slightly higher Credit Risk Layering score of 0.72 vs. the 0.51 score of a loan that did not request an extension.

POTENTIAL CREDIT LOSSES

As mentioned in the Summer 2020 Pipeline, Capital Assets has decades of

TIMING OF DEFERMENTS



Source: FHN Financial Capital Assets Corp.

DEFERRED LOANS INITIAL REQUESTS vs EXTENSIONS

	Amort LTV	Age in Mos.	Curr Avg	Hist DQ	Avg Score	CRLA Score
Nationwide	70%	41	311,128	18%	737	0.51
Initial Defer Only	70%	41	323,972	17%	737	0.51
Extended	72%	35	333,878	41%	718	0.72

Source: FHN Financial Capital Assets Corp.

experience conducting loan analysis, but until March, zero experience estimating losses due to a pandemic. As the data set has grown larger and more diverse and we have more experience tracking Covid-19 deferral behavior—

including feedback from FRA study participants—we have been able to calibrate the models to produce what we believe to be a more realistic estimate of credit losses.

The two main drivers when predict-

ing credit losses are the number of loans that will go into default and the loss severity if a default should occur. For loss severity, we reference data from RealtyTrac, which tracks foreclosure discounts nationally. For default probability, we segment loans based on quality.

Capital Assets' credit models have historically segmented loans into six liquidity grades, A-F, based on liquidity and credit characteristics. We have applied that same approach to the data below. To date, the credit quality of most deferral loans within portfolios remains very strong with 65% of the loans as of September being either A or B grades.

During the initial phase of the FRA study, we assumed liquidity grades A-C would have a 5% probability of default, which is the default rate we would assign for a C grade loan in a normal world. As we have tracked the behavior of Covid-19 induced payment deferral loans, we found the risk profile of A and B grades was considerably better than originally assumed.

For example, a material number of the loans in the A and B liquidity grades continued to make regularly scheduled payments even though the borrower had the option to skip payments.

Property values overall have remained very strong, as well as the overall credit characteristics of that subset.

LIQUIDITY GRADE

	A	B	C	D	E	F	TOTAL
JUNE							
% of Deferred Total	27%	47%	17%	0%	7%	2%	100%
Default Assumption	5.00%	5.00%	5.00%	15.00%	35.00%	100.00%	9.00%
Loss Severity	-7.28	-12.67%	17.60%	-54.92%	-11.58%	-13.16%	-12.04%
Est. Lifetime Net Losses	-0.77%	-1.00%	-2.24%	-15.98%	-7.62%	9.49%	-1.81%
SEPTEMBER							
% of Deferred Total	21%	44%	33%	0%	1%	0%	100%
Default Assumption	1.00%	2.00%	5.00%	15.00%	35.00%	100.00%	3.63%
Loss Severity	-6.73%	-10.77%	-14.83%	-59.28%	-11.51%	-11.98%	-11.38%
Est. Lifetime Net Losses	-0.16%	-0.37%	-2.10%	-13.80%	-7.94%	-10.07%	-1.06%

Source: FHN Financial Capital Assets Corp.

For these reasons, we reduced the default assumption to the levels in the chart above, which has led to lower estimated losses.

WHERE THE NEEDLE IS POINTING

With nine months of activity under our belt, we can draw some conclusions as to where the needle is pointing:

- First, it appears the instance of new payment deferrals is near peak. New requests for deferrals will likely continue to trickle in, but absent a major shelter-in-place lockdown being implemented again, the majority of Covid-19 induced payment deferrals has already occurred.
- Second, payment deferral loans continue to have a slightly weaker credit risk profile before the pandemic compared to the loans that never requested a deferral.
- Third, the payment deferral loans that have requested an extension have a slightly weaker credit risk profile compared to the payment deferrals that did not request an extension.
- Fourth, the loans most likely to become a problematic credit will be some subset of the payment deferrals requesting an extension. Early indications are this segment is near one-third of total payment deferrals.
- Lastly, the risk associated with extended-deferment loans continues to be very manageable due to their relatively strong credit risk profile, which is additionally mitigated by a strong housing market.

Capital Assets will continue the FRA study until this issue is clearly in the tail lights, which we estimate will be around mid-2021.

REGULATORY DEVELOPMENTS

An additional development since June has been the ever-increasing focus of regulators on deferred loans. In August, the regulatory agencies issued Interagency Guidance on prudent risk

management and consumer protection principals when dealing with Covid-19 deferment loans (August 3, 2020, “Joint Statement on Additional Loan Accommodations Related to Covid-19”).²

The guidance instructs institutions to put in place effective tools for monitoring and managing loans that receive Covid-19 accommodations. Below is a list of significant guidelines in the advisory:

Page 3: “Effective management information systems and reporting helps to ensure that management understands the scope of loans that received an accommodation ... when the accommodation period ends, and the credit risk of potential higher-risk segments ...”

Page 4: “When a financial institution considers whether to offer additional accommodation options to a borrower ... assess each loan based on the fundamental risk characteristics of that particular credit.”

Page 3: “Sound credit risk management includes applying appropriate loan risk ratings or grades and making appropriate accrual status decisions ...”

Page 5: “According to GAAP, loans are to be segmented into a separate portfolio when they share similar risk characteristics for the purposes of estimating credit losses ...”

The FRA has proved to be an insightful research tool that not only provides important industry trends for all participants, but gives each credit union meaningful data for managing credit decisions and documenting risk management strategies related to payment deferral/forbearance requests and extensions.

CONCLUSION

As vaccines begin to be approved and distributed, the impact of Covid-19 should subside in 2021 and subsequent years. However, if 2020 has taught us anything, it is that “anything” can happen.

That is why we believe it is prudent to continue to track, monitor and estab-

lish programs to manage and minimize the exposure to the loan portfolio from the impact of Covid-19. It is imperative that you document what you are doing and how you are doing it, and have a plan in place to manage any loans that go into default.

For now, at least, the exposure to the credit union industry continues to be very manageable. And, with careful attention to trends and changes, as well as having a multitude of potential strategies in place to address any shortfalls, credit unions can effectively mitigate the risk of “People Helping People” and continue to serve their members. ▲

As part of the Capital Assets team for more than 10 years, Rachael Leamon serves as Lead Analyst for the Advisory Services Group. She focuses on loan portfolio analytics for depository institutions, as well as M&A valuations for whole bank acquisitions. Leamon also assists with strategic planning and balance sheet analytics for financial institution clients. She received an MBA, and Master's and Bachelor's Degrees in finance from the University of Memphis.



Rachael Leamon

CREDIT UNIONS CAN JOIN STUDY

- The Forbearance Risk Assessment (FRA) was begun by FHN Financial Capital Assets in March 2020 to assess the potential risk associated with increases in payment deferrals.

Any credit union that wishes to join the study is welcome to participate. There is no cost, and individual data is never shared. However, we require that your data be merged with the total database. Info: www.fhnfinancial.com/contact.

The larger and more diverse the database becomes the better results we will have to share with everyone.

Footnotes

¹ http://acuma.org.s3-us-west-2.amazonaws.com/pipeline/202007-pipeline/s12_RiskMgt.pdf

² <https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-72.html>