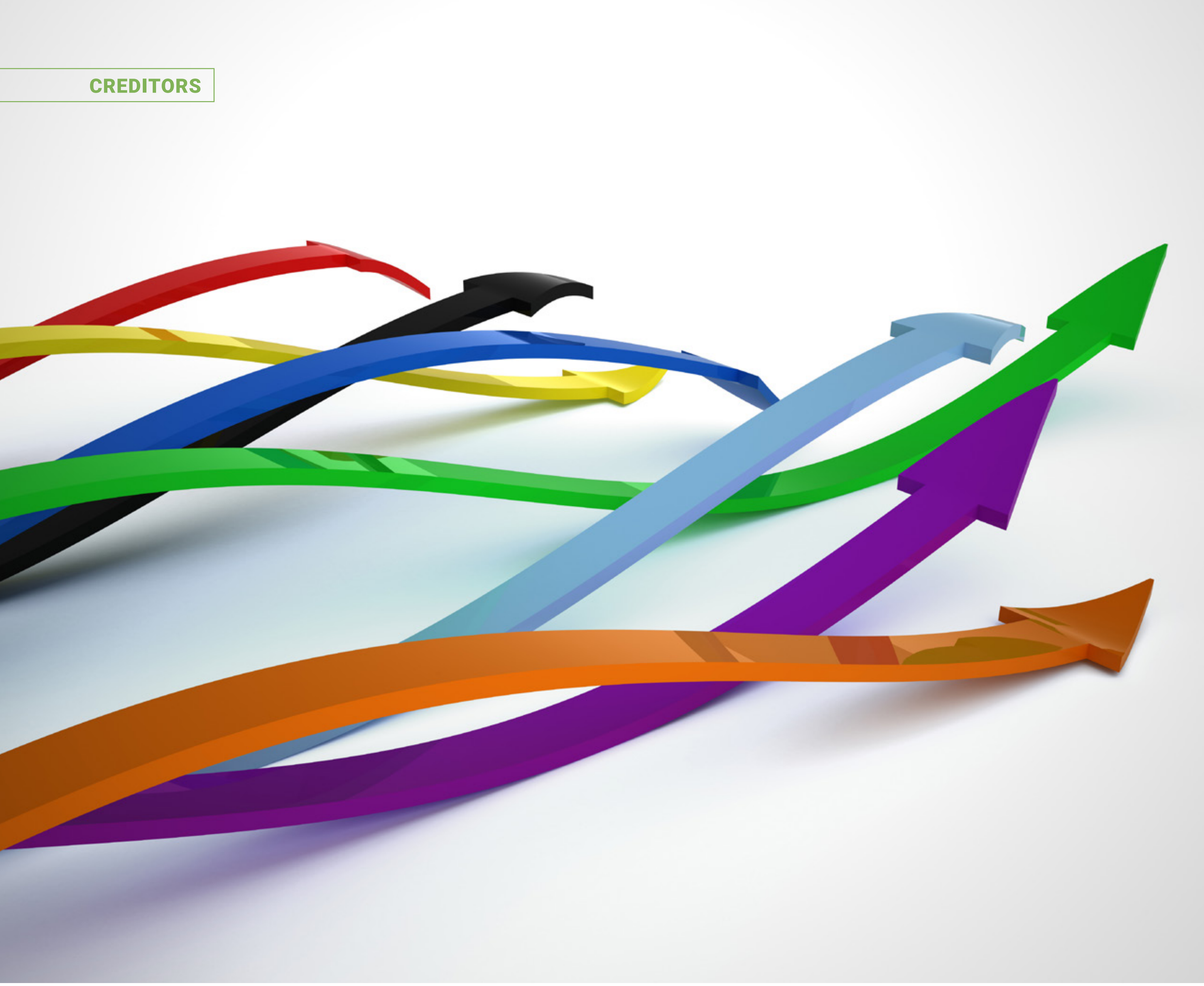

Understanding How COVID-19 Will Affect Loan Defaults

Financial companies are gearing up for an acceleration of defaults in the second quarter of 2021.

By Betsy Clarke

Professionals across the financial services industry have struggled to forecast economic trends as the disruption caused by the COVID-19 pandemic spreads into 2021. In December 2020, law firm Barnes & Thornburg in Minneapolis hosted a webinar on "Understanding How COVID-19 Will Affect Loan Defaults," a topic central to the work of creditors, collectors and asset buyers.

The panel featured moderator Connie Lahn, partner at Barnes & Thornburg who practices in the areas of bankruptcy and insolvency; Mike Cavallaro, partner at Barnes & Thornburg who practices in the area of default; and Violeta Zdravkovic, CPA and managing director at O'Keefe, a consultant in litigation for fraud, forensic accounting and bankruptcy.

Economic conditions in 2020 involved numerous unexpected directions. Because many lenders proactively offered borrowers short-term loss mitigation and payment deferral assistance, there were positive trends in consumer credit card and auto lending compared to the initial downward trend early in the pandemic.

Surprisingly, when these programs ended, many borrowers who relied on these options continued to stay current. The industry hopes charge-off rates will stay well below the historic rates of the Great Recession due to proactive industry and government approaches.

Here are some highlights from the panel's discussion, which have been edited for clarity and brevity.

Lahn: We are talking about the future of loan defaults. Let's start by discussing what is different in this economic downturn.

Zdravkovic: The differences between this situation and prior downturns arise from the following drivers:

- COVID-19 happened quickly and led to a sharp economic downturn.
- While we had significant market volatility at the beginning of this downturn, the markets are now doing well.
- The federal government pumped money into the economy, offering a $2 trillion stimulus package.
- Because of the pandemic, the hardest hit areas were entertainment, restaurant, hospitality, leisure and the retail sector.

Lahn: Have we seen an increase in bankruptcies? Where are the trends heading?

Cavallaro: While total bankruptcy filings in 2020 decreased by almost 40% compared to 2019, as of November 2020, Chapter 11 filings increased by 46% from 2019. We also expect an increase for small businesses.

Creditors need to respond within 60 days of the filing to review the process. It could create a significant burden if bankruptcy volumes go up.

One other point I want to bring up is that the default rates on home mortgages have gone up; I think this was the largest single quarter increase the Mortgage Bankers Association has tracked, yet foreclosure volumes were down 97%. We are talking about compressing the future timeline for what is going to happen in the courts when the floodgates open.

Lahn: Mike, are you seeing other enforcement actions such as assignment for benefit of creditor? How aggressive are lenders or creditors right now?

Cavallaro: This is a tricky question because we have both federal laws and individual state requirements, with each state doing things a little differently. While that has required large, national lenders to paint with a broad brush and not be so aggressive, we do expect to see assignments for benefit of creditors.

We saw the first wave of defaults impact consumers living paycheck to paycheck, but we are also concerned about six to nine months from now when we see impacts from the larger commercial entities.

Do we need to start liquidating? Most large financial institutions are afraid to be the first mover. I have some clients with major customers that were in default for three or four months before COVID-19, but these financial institutions are afraid to take action, even if they are legally allowed to do so, because they don't want the reputational damage. Everyone is waiting, but at a certain point they must go collect their debts.

Lahn: Is threat of foreclosure still a viable option in the negotiation of a defaulted loan?

Cavallaro: I think it is. This pause will not last forever; it may only last for a few months. The banking system wouldn't survive if it weren't able to collect on your debts. Everything just takes longer than it did before March.

Lahn: How are lenders documenting changes of payment terms? Any suggestions?

Panelists

Connie Lahn, partner at Barnes & Thornburg, practices in the areas of bankruptcy and insolvency.

Mike Cavallaro, partner at Barnes & Thornburg, practices in the area of default, including the consumer regulatory side and commercial work outs.

Violeta Zdravkovic, CPA and managing director at O'Keefe, a consultant in litigation for fraud, forensic accounting and bankruptcy.

Cavallaro: Because there is a lot of variation in these new loan terms, you must look at the underlying paper and break down all the nuances such as whether you have a two-year versus a five-year Paycheck Protection Program (PPP) loan. This creates the need for a lot of manual intervention.

Lahn: How long will another round of the PPP delay the inevitable enforcement actions?

Zdravkovic: The new PPP loans will help the hardest hit industries, but financial companies are gearing up for an acceleration of defaults in Q2 2021 and going into 2022. Government stimulus is helpful, however the solution is getting employees back to work and restarting commerce in a safe way.

Cavallaro: A six- to nine-month window gets us to where things start to change. The government put a Band-Aid on a broken arm, and we will start to see another wave of events shake out in Q2 or Q3 of 2021.

ACA'S TAKE

The financial services industry has taken lessons learned from the Great Recession and applied them to the economic distress that accompanied the pandemic. Bankers and creditors have striven to meet their customers' changing needs, offering PPP loans to businesses, fee waivers, reduced or deferred payments, loan modifications and extensions, as well as foreclosure and eviction relief. Most banks and creditors also voluntarily paused litigation and held back on repossession efforts. The focus within the industry has been to take broad, proactive actions to help meet the needs of customers and limit economic damage to help grow the recovery.

There is no clear path forward given the multiple variables impacting the upcoming timing and volume of defaults. Supporting consumers with good communication and creative payment options will help reduce the tide of defaults and bankruptcies, but creditors and collectors need to be prepared to ride out the upcoming wave of defaults that will ripple through the entire financial services industry.

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