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THE BANK REGULATORS' NEW GUIDANCE ON MANAGEMENT OF IRR AND CRE LOAN WORKOUTS

The new interest rate risk guidance sets out in greater detail than before the bank regulators' view on effective techniques and practices for monitoring and mitigating risks from adverse moves in interest rates. The commercial real estate loan statement addresses loan workout arrangements and allows additional flexibility in dealing with troubled credits to avoid unnecessary write-downs or charge-offs. Both sets of guidance are intended to help banking institutions navigate emerging risks along the path to economic recovery.

By Bradley K. Sabel and Gregg L. Rozansky *

U.S. bank examiners are expected to be especially vigilant and thorough in “safety and soundness” reviews that they will conduct this year. During reviews, examiners will likely place particular focus on large exposures that many banks have to potential increases in interest rates and still-struggling commercial real estate (“CRE”) loan portfolios. Given the vulnerability of many institutions in these areas, the U.S. federal bank, and thrift and credit union regulatory agencies have recently issued statements clarifying regulatory expectations relating to each of (i) interest rate risk (“IRR”) management, and (ii) credit risk management with respect to CRE loan workouts.¹ The “Advisory on

Interest Rate Risk Management” (Jan. 6, 2010) (the “IRR Advisory”) and the “Policy Statement on Prudent Commercial Real Estate Loan Workouts” (Oct. 30, 2009) (the “CRE Statement”) each highlights practices, policies, and controls intended to help U.S. depository institutions navigate the complex economic landscape that has emerged from the most acute stages of the financial crisis.

Risk-management and compliance personnel along with bank senior management should take steps as necessary to refine their institutions’ policies and procedures in order to take into account the guidance set out in the IRR Advisory and CRE Statement. This need may become even more urgent in light of the Federal Reserve’s move to increase its discount rate by one-quarter percent. Even though the Federal Reserve did not increase its target federal funds rate, it seems likely that the discount rate increase, and possible future increases, could put upward pressure on market interest

¹ For purposes of this article, the term “U.S. federal banking agencies” is used to refer to: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

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rates to an even greater extent as the economy gradually improves.²

This article summarizes the important points of the IRR Advisory and the CRE Statement and provides suggestions on how to check that an institution's policies and procedures appropriately address them.

THE IRR ADVISORY

The IRR Advisory describes selected IRR management techniques used by effective risk managers and clarifies existing IRR-related guidance.³ The U.S. federal banking agencies believe that the adoption and maintenance of these techniques will make banks better equipped to manage IRR-related challenges presented by different interest rate environments.

The Current Interest Rate Environment

For more than a year, the gap between short- and long-term interest rates has been unusually wide from a historical standpoint. This market condition has presented opportunities for many banks to earn profits by borrowing on a short-term basis at very low rates and acquiring long-term assets at higher rates.

While the specific movement of future interest rates – including the “slope” of the “yield curve” (*i.e.*, the relation between short-term and long-term rates) – is, at best, difficult to forecast, regulators and many industry analysts believe that the current interest rate environment may not persist for much longer, particularly if the economy continues to recover. This belief stems from several factors that could place upward pressure on rates, including increased competition for low-cost deposits, the U.S. federal budget deficit, and the need for the U.S. federal government to continue unwinding large scale credit and asset purchase programs (*e.g.*, programs to purchase large quantities of

mortgage-backed securities) introduced during the financial crisis.⁴

Future changes in interest rates will have varying effects on institutions depending upon a number of factors, such as the repricing and maturity mismatches found in the institution's assets, liabilities, and off-balance-sheet positions.⁵ In general, however, there appears to be a particular concern that higher interest rates could pose challenges for a number of institutions given popular strategies that many banks have employed to take advantage of the current interest rate environment.⁶ These strategies have included investing

⁴ Within the past few months, the Federal Reserve increased its “discount rate” slightly – the rate that it charges banks for short-term loans – and terminated several emergency lending programs. Some analysts believe that these moves may set the stage for higher rates. For a discussion of issues relating to the future path of interest rates, *see* speech by Federal Reserve Governor Donald L. Kohn, “Focusing on Bank Interest Rate Risk Exposure,” January 29, 2010; *Semiannual Monetary Policy Report to the Congress: Hearing before the Committee on Financial Services*, 111th Cong., 2d Sess., Feb. 24, 2010 (testimony of Chairman Ben S. Bernanke); *see also Working Without a Standard Playbook, the Fed Plans Its Moves on Rates*, THE NEW YORK TIMES, Feb. 20, 2010.

⁵ Changes in interest rates affect a bank's earnings by changing its net interest income and the level of other interest-sensitive income and operating expenses. Changes in interest rates also affect the underlying economic value of the bank's assets, liabilities, and off-balance-sheet items. Moreover, banks are subject to different types of interest rate-related risks. These include: (i) repricing risks (*i.e.*, risks presented by timing/maturity differences for assets, liabilities and off-balance-sheet instruments); (ii) “yield curve” risk (*i.e.*, exposures to changes in the relationship between short-term and long-term interest rates); (iii) basis risks (*i.e.*, risks due to repricing mismatches for assets, liabilities, and off-balance-sheet instruments – for example, prime-based loan rates may change by only 25 basis points, while LIBOR-based deposit rates may change by 60 basis points during the same period); and (iv) option risks (*i.e.*, risks posed by a future decision that could be made by a bank counterparty, such as an option offered to borrowers to prepay a mortgage).

⁶ According to Sandra L. Thompson, Director of the Division of Supervision and Consumer Protection of the FDIC, “Historically

² *See* Federal Reserve press release, Feb. 18, 2010.

³ The IRR Advisory is available at <http://www.fdic.gov/news/news/press/2010/pr1002.pdf>.

in longer-term mortgage assets (e.g., those maturing or repricing in three or more years), which could increase bank exposure to rising interest rates. In this regard, George French, the deputy director of policy in the FDIC's Division of Supervision and Consumer Protection, recently indicated that the current type of bank exposure is not unprecedented, "but we are in a fairly unusual position with short-term rates being as low as they are . . . That elevates the attention that needs to be given to this issue".⁷

Against this backdrop of concerns and considerations, the U.S. federal banking agencies issued the IRR Advisory in order to reemphasize the need for both large and small institutions to employ policies, systems, and controls as necessary and appropriate to ensure that key personnel fully understand, and can adequately manage, IRR – particularly in an environment of rising interest rates.

Features of IRR Risk Management

IRR has been defined by the U.S. federal banking agencies as the exposure of a bank's financial condition to adverse movements in interest rates. Exposure to IRR – which is a form of market risk – is an inherent part of the banking business. However, where exposures become too great, there may well be an enhanced risk of bank insolvency.

The U.S. federal banking agencies have for several years highlighted the importance of using sound practices for managing IRR exposures. The IRR Advisory clarifies and supplements various elements of previously issued guidance addressing supervisory expectations for U.S. bank holding companies, banks, thrifts, industrial loan companies, and credit unions (generically referred to below as "banks" or

"institutions") in this area.⁸ In this regard, the IRR Advisory describes in greater detail than previous interagency guidance effective techniques for measuring IRR. In addition, the Advisory suggests that banks should regularly assess exposures to interest rate movements beyond the typical industry convention of +/- 200 basis points (or 2 percentage points) that has developed in view of previous guidance in the area.

The important features of IRR risk management described in the IRR Advisory and summarized below include:

- **corporate governance**, including active involvement by the boards of directors and management;
- **policies, procedures, and limits** to govern the bank's IRR management process;
- **measurement and reporting systems** focusing on stress testing of both alternative interest rate scenarios and key assumptions driving the bank's IRR analysis;
- **risk mitigation** to ensure that any positions that exceed appropriate risk tolerances receive prompt management attention; and
- **internal controls** designed to ensure the integrity of all aspects of IRR management.

Feature 1. Corporate Governance. According to the IRR Advisory, active involvement by the board of directors and senior management of banks is critical to effective IRR management.

The board of directors (or its delegated committee of board members) should oversee the establishment,

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low short-term interest rates create an incentive for some banks to play the yield curve by funding longer-term assets with shorter-term liabilities." See FDIC: SUPERVISORY INSIGHTS, Winter 2009 (which describes how banks are becoming more liability sensitive and vulnerable to increases in short-term rates). Very generally speaking and everything else being equal, banks with liabilities such as deposits that "reprice" faster (i.e., have a shorter duration) than their assets may be negatively impacted by a rise in rates.

⁷ See *Rate Risk a Threat, But How Large?*, THE AMERICAN BANKER, Jan. 28, 2010. For a discussion of how interest rate increases may impact banks, see also *Bank Execs Counter the Red Flag on Interest Rate Risks: companies cite defensive moves ahead of rate rise*, THE AMERICAN BANKER, Feb. 3, 2010.

⁸ The IRR Advisory reiterates many basic principles codified in existing guidance. Interagency guidance on IRR management, issued by the U.S. federal banking agencies in 1996 (the "1996 Interagency Guidance"), remains a primary supervisory tool for assessing an institution's IRR management framework. The 1996 Interagency Guidance, which was issued under the title *Joint Policy Statement on Interest Rate Risk*, is available at <http://www.fdic.gov/regulations/laws/rules/5000-4200.html>. The IRR Advisory also provides citations to other relevant IRR-related guidance.

The Federal Reserve recently revised its *Bank Holding Company Supervision Manual* to take into account the IRR Advisory (see Section 2127). According to the Federal Reserve, the basic principles and supervisory expectations set out in the IRR Advisory are to be applied to U.S. bank holding companies.

approval, implementation, and annual review of IRR management strategies, policies, procedures, and limits or “risk tolerances”.⁹ Management is responsible for ensuring that board-approved strategies, policies, and procedures are appropriately executed, and for maintaining the following:

- appropriate policies, procedures, and internal controls addressing IRR management, including limits and controls over risk-taking to stay within board-approved tolerances;
- comprehensive systems and standards for measuring IRR, valuing positions, and assessing performance, including procedures for updating IRR measurement scenarios and key underlying assumptions driving the institution’s IRR analysis; and
- sufficiently detailed reporting processes to inform senior management and the board of the level of IRR exposure.

IRR reports distributed to senior management and the board should provide sufficient detail to enable them to assess (i) the sensitivity of the bank to changes in interest rates, and (ii) important assumptions underlying the measurement methods used.¹⁰

Feature 2. Policies and Procedures. Banks are expected to have comprehensive policies and procedures governing all aspects of their IRR management process and ensuring that assessment of IRR is integrated effectively with firm-wide risk-management efforts. An institution’s policies and procedures should: (i) ensure that the IRR implications of significant new strategies, products, and businesses are integrated into the IRR management process; (ii) provide for controls over permissible hedging strategies and hedging instruments (to the extent utilized); and (iii) document IRR tolerances from both long-term and short-term perspectives.

Well-managed institutions generally specify IRR tolerances in the context of scenarios of potential changes in market interest rates and a target or range for performance. Tolerances/limits should be neither so

high that they are never breached nor so low that exceeding the limits is considered routine and not worthy of action.

Feature 3. Measurement and Monitoring of IRR.

Banks are expected to have robust IRR measurement processes and systems to assess exposures relative to established risk tolerances. The type of systems appropriate for a particular institution depends on – and should be commensurate with – the size and complexity of the institution.

Banks are encouraged to use a variety of measurement methods to assess their IRR profile. Techniques currently being used include both (i) simple maturity “gap analysis” for assessing the impact of changes in market rates on earnings (which may continue to be the principal measurement technique used by small institutions with less complex IRR profiles);¹¹ and (ii) simulation models, which measure the degree to which earnings and/or the value of a bank’s positions change over a chosen period of time under different interest rate scenarios. The IRR Advisory clarifies that well-managed institutions use measurement methods to evaluate the impact of changing rates on both their earnings and economic value (*i.e.*, the net present value of assets or bank “capital”).

Key principles relating to measurement methodologies include the following:

- *Earnings simulation models* project the effects that interest rate changes will have on interest income or net income. When using earnings simulation models, IRR exposures should be projected over at least a two-year period. To fully assess the impact of certain products with embedded options (*e.g.*, mortgage-backed securities, callable bonds, structured notes, mortgage loans, trust preferred securities, etc.), longer time horizons of five to seven years are typically needed.¹²
- *Economic value-of-equity models* (or “EVE” models) may be used to evaluate the effect of a

⁹ For example, earnings-based tolerance limits may include volatility restrictions on: (i) net interest margin; (ii) net operating income; and (iii) net income. Capital-based risk tolerance limits may include volatility restrictions on: (i) economic value of equity; and (ii) regulatory capital.

¹⁰ Institutions with an Asset/Liability Committee (“ALCO”), or similar senior management committee, should ensure the Committee actively monitors and can influence the IRR profile.

¹¹ Maturity gap analysis measures the difference between the dollar value of assets and liabilities maturing or repricing during a given time period. When multiplied by a hypothetical change in interest rates, the dollar maturity gap gives a rough estimate of the effect of such a rate change on net interest income.

¹² On the asset side, the most prevalent embedded option is a prepayment option. For example, models need to account for the fact that when rates decline borrowers are more likely to refinance and exercise prepayment options.

change in interest rates on the net present value of the bank's assets, liabilities, and off-balance-sheet cash flows. These models generally provide insights into a bank's longer-term IRR position.

- *Static* simulation models are based on current exposures and assume a constant balance sheet with no new growth. In contrast, *dynamic* simulation models rely on detailed assumptions regarding changes in existing business lines, new business, and changes in management and customer behavior. When performing dynamic simulations, institutions should also run static simulations to provide the ALCO or senior management a complete and comparative description of the institution's IRR exposure.

According to the IRR Advisory, *stress testing* is an integral tool for IRR management.¹³ In general, stress tests assist in the evaluation of how a bank would perform under a range of future interest rate scenarios that are severe but plausible (so-called "scenario analysis"). Depending on an institution's IRR profile and complexity, stress scenarios should include but not be limited to hypothetical (i) instantaneous rate shocks,¹⁴ (ii) prolonged rate shocks, (iii) changes in the relationships between key market rates, and (iv) changes in the slope and the shape of the yield curve. Well-managed institutions compare stress test results against approved IRR tolerance limits.

The 1996 Interagency Guidance requires that management consider "meaningful stress situations" when modeling IRR – which, according to the Guidance, may include a 200 basis point (or 2 percentage point) rate change over a period of one year.¹⁵ Many institutions have now adopted this scenario as the basis for stress testing. According to the IRR Advisory, however, banks should regularly assess IRR exposures *beyond* 2 percentage points, including changes in rates of greater magnitude (e.g., up and down 300 and 400 basis points, or 3 and 4 percentage points, respectively).

¹³ The Basel Committee on Banking Supervision has released principles for sound stress testing practices and supervision. See Basel Committee on Banking Supervision, *Principles for Sound Stress Testing Practices and Supervision*, May 2009.

¹⁴ Interest rate shocks of sufficient magnitude should be run regardless of a bank's size or complexity.

¹⁵ See also Basel Committee on Banking Supervision, *Principles for the Management and Supervision of Interest Rate Risk*, July 2004 (suggesting that, in many cases, institutions consider the impact on their economic value of a proposed rate "shock" of upward and downward of 200 basis points).

In this regard, it is noteworthy that interest rates changed by more than 200 basis points in approximately 30 percent of the one-year periods between 1955 and 2008.¹⁶

Banks should regularly assess, by performing both historical (or "back-testing") and forward-looking analyses, the reasonableness of assumptions that underlie an institution's IRR exposure estimates. (In one way of using "back-testing," the bank compares model-predicted to actually observed changes in bank earnings and economic value due to interest rate movements.)¹⁷ Key assumptions used in IRR measurement models – as well as changes in such assumptions and the effects of such changes – should be documented, monitored, and regularly updated.¹⁸ Assumptions about customer behavior, including the "decay rate" of nonmaturity deposits (e.g., the average life of checking and savings accounts), are especially critical, particularly in the current market in which customer behavior may not reflect long-term economic fundamentals.

Feature 4. Risk-Mitigating Steps. Banks should take appropriate steps to mitigate IRR risks when exposures exceed designated risk limits or where earnings or capital are insufficient to hold up against adverse interest rate changes.

Approaches to mitigate IRR exposures include (i) adjusting the balance sheet mix of assets and liabilities, and (ii) using derivative instruments as part of a hedging strategy. Very generally, the "balance sheet" approach involves achieving an appropriate distribution

¹⁶ See FDIC: SUPERVISORY INSIGHTS, Winter 2009 (citing to this statistic which is based on the Fed Funds rate as set out in Federal Reserve H.15 data).

¹⁷ Model validation may involve (i) independent review of the logical and conceptual soundness of the model, (ii) comparison against other models, and (iii) comparison of model predictions against subsequent real-world events. The depth and extent of the model validation process should be consistent with the materiality and complexity of the risk being managed.

Institutions that use vendor-supplied models are not required to test the mechanics and mathematics of the measurement model. However, the vendor should provide documentation showing a credible independent third party has performed such a function. Large and complex institutions, or those with significant IRR exposures, may need to perform more in-depth validation procedures of the underlying mathematics.

¹⁸ According to the IRR Guidance, stress tests should be used on a periodic basis to determine the implications of key assumptions used in IRR measurement models (i.e., so-called "sensitivity analysis").

of asset maturities or repricing structures in order to avoid the potential for severe maturity or duration mismatches between assets and liabilities. This approach is the most commonly used risk mitigation method but frequently takes some time to fully implement. The objective of a “derivatives approach” is to limit downside earnings exposure or manage income or economic value-of-equity volatility.

If, for example, a bank is exposed to rising interest rates (*e.g.*, because asset maturities are relatively longer than liability maturities), it may enter into derivatives transactions to (i) effectively shorten the duration of a commercial loan or other asset portfolio, and/or (ii) effectively lengthen the duration of floating-rate liabilities (*e.g.*, by exchanging a floating-rate stream of payments for a fixed-rate stream under the terms of a fixed-for-floating rate swap). While several exchange-traded and “over-the-counter” hedging options are currently available to banks, use of derivatives to mitigate IRR may or may not be appropriate for a given bank depending upon the specific type of derivatives instrument(s) at issue and the level of experience of that bank with derivatives products.¹⁹

Feature 5. Internal Controls and Validation. The U.S. federal banking agencies expect banks to have an adequate system of internal controls to ensure the integrity and effectiveness of all elements of their IRR management process. An internal control system should ensure: (i) the adequacy of corporate governance (including follow-up procedures to monitor management’s corrective actions as and when necessary); (ii) compliance with policies and procedures; (iii) comprehensiveness of IRR measurement and management information systems; (iv) IRR measurement model validation; and (v) independent review of IRR management (through the internal and/or external audit functions or, in appropriate cases, through qualified staff independent of the IRR process).²⁰

Observations Relating to the IRR Advisory

While the IRR Advisory is largely written in technical terms for an audience of compliance and market-risk specialists, senior management and other decision-

makers at banks should be mindful of the following important principles being communicated by the Advisory and by senior representatives of the U.S. federal banking agencies in recent statements.

First, the effectiveness of an institution’s IRR management process and the level of its IRR exposure are critical components of a bank’s enterprise-wide risk identification and analysis process. These factors will continue to be taken into account by bank examiners in determining a bank’s overall supervisory (or “CAMELS”) rating, the adequacy of its level of capital, and whether or not corrective action is required.²¹

Second, while the U.S. federal banking agencies do not insist upon a “one size fits all” approach to IRR management, even smaller institutions are expected to have in place strategies, policies, procedures, and limits approved by the bank’s board of directors (or a committee thereof) that generally correspond to those described in the IRR Advisory and other relevant agency guidance. An effective IRR management process should (i) include systems and techniques (commensurate with the bank’s complexity, business model, risk profile, and scope of operations) to assess the impact of a change in interest rates on bank financial statements, (ii) provide a means to effectively communicate IRR-related risks to appropriate personnel within the bank, and (iii) foster prudent decision-making relating to business strategy and risk management.

Third, senior management of banks – and especially of those institutions with higher current levels of short-term liabilities and long-term assets – should proactively take steps to monitor and mitigate IRR. Given the current environment of a historically steep yield curve and likely increases in interest rates, the U.S. federal banking agencies are suggesting that for many banks this is an appropriate time to reassess current funding and investment strategies, especially given the lead time that

²¹ The term “CAMELS” stands for capital, assets, management, earnings, liquidity, and sensitivity to market risk. IRR is assessed under the “S” (“sensitivity to market risk”) component of the CAMELS rating.

¹⁹ Swaps and forwards are commonly used to hedge IRR, but futures, forwards, cap options, floor options, collars, and swaptions could also be possibilities. As noted previously, banks that use derivatives as part of a hedging strategy should have appropriate policies, procedures, and controls in place.

²⁰ For example, the parties involved in IRR management review should be independent of any operational responsibility for the measurement system.

Material weaknesses in risk-management processes or high levels of IRR exposure relative to capital will require corrective action. Such actions could include recommendations by examiners, or administrative directives, to (i) raise additional capital, (ii) reduce levels of IRR exposure, (iii) strengthen IRR management expertise, (iv) improve IRR management information and measurement systems, or (v) take other measures or some combination of actions, depending on the facts and circumstances of the individual bank.

it could take to appropriately change an institution's asset/liability mix or raise capital.

In preparing to be examined for compliance with the IRR Advisory, and generally to determine that an institution is conforming to what the agencies consider best practices, perhaps the best advice is to perform a time-series overview of the adjustments that the institution has made during the past two years to either cope with or take advantage of the interest rate environment. How has the institution changed the assets and liabilities that factor into IRR management? Has the institution shortened the maturity of its liabilities and of its assets in broad terms, or shortened or lengthened one or the other? Have the types of assets changed? Any changes that have been made from some period such as two years ago should be reviewed to determine how internal practices have changed in light of the asset-liability mix differences. This should help to focus on any particular elements of the IRR Advisory that might catch the agencies' attention.

THE CRE STATEMENT

The CRE Statement provides guidance for examiners and for banks working with CRE borrowers in the face of the struggling CRE market.²² The guidance specifically addresses bank practices, policies, and controls related to CRE loan workout arrangements – *i.e.*, mutual agreements by the bank and the borrower to restructure or renew a loan – under circumstances where the CRE borrower is experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties.

The CRE Statement reflects the U.S. federal banking agencies' view that loan workouts often benefit both CRE borrowers and bank lenders, particularly during challenging economic environments when collateral values and a borrower's cash flows may be temporarily depressed.²³ For example, loan workouts may improve a bank's prospects for repayment on a CRE loan and provide a CRE borrower with continued access to credit. Indeed, the Statement appears designed to encourage many banks to restructure CRE loans in certain cases, such as where the underlying fundamentals and income generated from the CRE could support a somewhat

lower payment than is called for under the original loan, rather than to pursue other possible options such as foreclosure. At the same time, however, the U.S. federal banking agencies emphasize that loan workouts may not be utilized as a means to conceal inevitable loan losses.

The Current Downturn in the CRE Market

The recent financial crisis has considerably weakened the CRE market in the United States. CRE property values have fallen as a growing amount of office and retail space has become vacant and cash flows derived from remaining tenants have diminished.²⁴ As a consequence of falling property values, nearly half of all CRE loans that will reach the end of their terms between now and 2014 are currently "underwater" (*i.e.*, the borrower owes more than the underlying property is currently worth).²⁵

According to recent reports, about \$1.7 trillion of outstanding debt associated with CRE is held on the books of banks and thrifts.²⁶ Community banks, in particular, tend to have very large CRE exposures relative to their size. CRE loans often account for as much as 40% of bank assets for smaller banks.²⁷ Meanwhile, according to figures reported by a senior

²⁴ See Congressional Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability* February 2010 (the "Congressional Oversight Report"), which is available at <http://cop.senate.gov/reports/library/report-021110-cop.cfm>.

According to the Congressional Oversight Panel – which was created by Congress in 2008 to review the current state of financial markets and the regulatory system – commercial property values have fallen more than 40% from the beginning of 2007 to February 2010.

²⁵ See the Congressional Oversight Report, *supra* note 24; see also letter from Congressman Paul E. Kanjorski (D-PA), Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, and Congressman Ken Calvert (R-CA) to Treasury Secretary Timothy Geithner and Federal Reserve Chairman Ben Bernanke regarding the growing concerns over deteriorating conditions in the CRE market, dated February 17, 2010.

²⁶ See Statement of Jon D. Greenlee, Associate Director, Division of Bank Supervision and Regulation, Federal Reserve, before the Congressional Oversight Panel Field Hearing, Atlanta, Georgia (January 27, 2010).

²⁷ See *CRE Losses Could Pass \$150 Billion Next Year*, THE AMERICAN BANKER, Feb. 8, 2010 (indicating that, according to Moody's Investors Service, the percentage is closer to 15% for larger banks).

²² The CRE Statement is available at <http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf>.

²³ Especially under these circumstances, CRE borrowers with loans about to mature may have difficulty obtaining a new loan to finance their continued ownership of the underlying property (*e.g.*, a shopping center, office, apartment building).

Federal Reserve official, more than \$500 billion of CRE loans will mature over the next few years, a significant amount of which is currently held by banks.

These figures, coupled with a general lack of available financing for CRE borrowers, foretell very large numbers of CRE borrowers that will be unable to meet loan repayment terms.²⁸ Given these conditions – and the fact that a significant percentage of the approximately 140 bank failures in 2009 were attributable, at least in part, to significant losses in CRE portfolios – loan workout policies, practices, and controls of banks have become, and are expected to remain, an important area of supervisory focus.

Principles Set Out in the CRE Statement

The CRE Statement updates supervisory guidance for banks relating to CRE loan workout programs, CRE loan workout arrangements, classification of CRE loans, and related regulatory reporting and accounting considerations.²⁹ In part, it also appears to constitute an effort by the agencies to rein in their own examiners, who may be worried about being criticized themselves for not being strict enough when deciding whether to require write-downs in light of conditions in the CRE market.

The CRE Statement applies to CRE loans – a category defined for this purpose to include loans that are secured by multifamily property, and nonfarm nonresidential property (*i.e.*, commercial properties such as office buildings) where the primary source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property. The CRE loan definition also applies to land development and construction loans (including 1- to 4-family residential and commercial construction loans), other land loans, loans to real estate investment trusts, and unsecured loans to developers.

Key topics addressed in the CRE Statement are summarized below.³⁰

Loan Workout Arrangements

A basic premise of the CRE Statement is that a loan renewal or restructuring may take many forms but must always be designed to improve the bank's prospect for repayment. These forms may include a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions on principal/interest. Starting from that premise, the CRE Statement clarifies the following two points regarding regulatory expectations with respect to loan workout arrangements:

- Restructured CRE loans for borrowers with an ability to repay under the modified terms will *not* be subject to adverse classification, even if the value of the collateral falls below the outstanding loan value; and
- A bank will *not* be subject to supervisory criticism for entering into restructurings that result in an adverse classification so long as management has each of the following:
 - A prudent workout policy that establishes appropriate loan terms and permits the modification of the workout plan if the borrower no longer sustains repayments or if collateral values do not stabilize. (The elements of such a policy are outlined below.)
 - An individual workout plan that analyzes the current financial information on each borrower and that supports the collection of principal and interest. The key elements of a workout plan should include:³¹ (i) updated and comprehensive financial information on the borrower, real estate project, and any guarantor; (ii) current valuations of the collateral; (iii) analysis of appropriate loan structure, covenants, or other requirements; and (iv) appropriate legal documentation for any changes to loan terms.

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Interagency Audio Conference on Prudent Commercial Real Estate Loan Workouts) – to clarify some of the principles set out in the CRE Statement. The transcript of the audio conference, which took place on December 2, 2009, is available at: <http://www.fdic.gov/news/news/financial/2009/fil09068a2.pdf>.

- ³¹ The CRE Statement provides in-depth guidance on analytical processes and approaches to (i) assessments of the borrower's ability to repay the CRE loan, and (ii) collateral and guarantee assessments.

²⁸ The Congressional Oversight Panel estimates losses at banks alone could range between \$200 and \$300 billion.

²⁹ The CRE Statement replaces the *Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans*, November 1991, and *Review and Classification of Real Estate Loans*, June 1993.

³⁰ Since the issuance of the CRE Statement, the FDIC and the other U.S. federal banking agencies have taken various steps – such as hosting a conference call on the Statement (the

- An analysis of the borrower’s global debt service (*i.e.*, aggregate financial obligations).
- The ability to monitor the ongoing performance of the borrower and any guarantor under the terms of the workout.
- An internal loan grading system that reflects the risk of the workout.
- An allowance for loan and lease losses (“ALLL”) methodology that covers estimated credit losses in the restructured loan, measured in accordance with generally accepted accounting principles (“GAAP”), and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate.

Risk-Management Elements for Loan Workout Programs

According to the CRE Statement, appropriate risk-management practices for reviewing and restructuring (*i.e.*, formally modifying) CRE loans may vary in accordance with the complexity and nature of the bank’s lending activity. The basic elements of a bank risk-management program, however, should include the following: (i) management infrastructure to manage workouts; (ii) documentation standards; (iii) adequacy of management information systems and internal controls; (iv) ensuring reports meet regulatory requirements; (v) effectiveness of loan collection procedures; (vi) adherence to lending limits; (vii) collateral administration to ensure proper lien perfection; and (viii) an ongoing credit review function.

Classification of Loans

The CRE Statement provides banks with a certain degree of flexibility in terms of loan classification practices. It clarifies that the following circumstances should *not* necessarily lead to an adverse classification (*e.g.*, “substandard assets,” “doubtful assets,” or “loss assets”) by examiners:³² (i) the borrower’s association with a particular industry that is experiencing financial difficulties; (ii) a decline in the value of the collateral to an amount that is less than the outstanding loan balance;³³ or (iii) a decision to renew or restructure a

loan; however, restructured loans typically represent elevated credit risk and may warrant close monitoring by the institution.

On the other hand, adverse classification of a loan may be appropriate where a well-defined weakness exists that will jeopardize repayment. In this regard, the CRE Statement reminds institutions that in certain situations the fact that a borrower may be contractually current on payments can at times be misleading as to underlying credit risk. For example, this can occur when the loan’s underwriting structure or the liberal use of extensions and renewals (*e.g.*, deferred repayment of loan principal) mask credit weaknesses and obscure a borrower’s inability to meet reasonable repayment terms due to an inability to refinance.

One particularly controversial aspect of the CRE Statement is the fact that it permits banks to essentially split loans into two parts – a performing part and a nonperforming part. Significantly, this should allow banks to only adversely classify – and eventually take losses against – the nonperforming part of the loan (rather than on the whole loan). The flexibility of this approach may also have the potential benefit for banks of reducing required regulatory capital and loan reserves associated with a CRE loan. Under this “bifurcation” approach, lenders would fix a realistic debt amount (in the “good” loan) which the collateral (the property) can support, and isolate the troubled piece in the “bad” loan.

Regulatory Reporting and Accounting Considerations

While the CRE Statement does not change existing regulatory reporting or accounting guidance or standards, it reinforces longstanding guidance in these areas. For example, the following considerations are highlighted:

- Institution management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements and supervisory guidance.
- Decisions related to loan workouts may affect regulatory reporting.

³² Loan classifications aid institutions and examiners in supervising and monitoring credit risk. How loans are classified also has an impact on required write-downs (banks are required to write-down or charge-off certain adversely classified loans) and bank capital.

³³ Particularly given the tremendously large volume of outstanding CRE loans where the loan amount exceeds the

footnote continued from previous column...

value of the underlying property, the flexibility granted by the CRE Statement in this regard may well lead to a significant amount of CRE loan reclassifications from nonaccrual to accrual status. *See Banks Hasten to Adopt New Loans*, WALL ST. J, Nov. 11, 2009.

- It is the responsibility of management to ensure that workout decisions are appropriately communicated internally to accounting and regulatory reporting staff in order to ensure the accuracy of regulatory reports.
- For a restructured loan that is not already in nonaccrual status before the restructuring, the institution needs to consider whether the loan should be placed in nonaccrual status to ensure that income is not materially overstated.³⁴
- All restructured loans should be evaluated to determine whether the loan should be reported as a TDR (troubled debt restructuring).³⁵
- Institutions are required to estimate credit losses based on a loan-by-loan assessment for certain loans and on a group basis for the remaining loans in the held-for-investment loan portfolio (all loans that are reported as TDR are deemed to be “impaired” from an accounting perspective – which will require the bank to make adequate loan loss provisions – and generally evaluated on an individual loan basis).
- For an individually evaluated impaired *collateral dependent* loan, the regulators require that if the recorded amount of the loan exceeds the fair value of the collateral (less costs to sell in many cases), this excess is included when estimating the ALLL.

³⁴ When a loan is on “accrual” status, the interest accruing on that loan may be credited as income for the institution. If a loan is on nonaccrual status, interest can not be recognized as income of the financial institution until it has actually been received. Very generally, loans may be placed on nonaccrual status (i) because of deterioration in the financial condition of the borrower, (ii) payment in full of principal or interest is not expected, or (iii) principal or interest has been in default for a period of 90 days or more unless the asset is both well-secured and in the process of collection.

For detailed criteria about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, see the instructions in FFIEC Call Report (for banks), TFR (for thrifts), and NCUA 5300 Call Reports (for credit unions).

³⁵ Very generally, a TDR is a restructuring in which a bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession (*e.g.*, reduction in principal) to the borrower that it would not otherwise consider (although a loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk may not be considered a TDR). For guidance on reporting TDRs, *see* the instructions in FFIEC Call Report (for banks), TFR (for thrifts), and NCUA 5300 Call Reports (for credit unions).

Illustrations and Examples

The CRE Statement includes several examples of CRE loan workouts demonstrating application of the CRE Statement to credit classification, determination of accrual versus nonaccrual status, and identification and reporting of TDRs. According to the U.S. federal banking agencies, the examples are provided for illustrative purposes only, and reflect examiners’ analytical processes.

Observations Relating to the CRE Statement

Although not overtly raised in the CRE Statement, it is important to keep in mind that the preponderance of CRE loans are nonrecourse loans to single purpose entities holding the commercial real estate. Thus, the “credit” of the borrower is solely the mortgaged property. As a result, while the CRE Statement is replete with references to the credit of the borrower and to credit enhancements such as a guarantor of the loan, in reality, banks will frequently make credit decisions based upon the effects of the current and projected rental markets on the prospects for the mortgaged property. In that light, the CRE Statement may be intended to tell banks and examiners that they should give less weight to possible deterioration of CRE collateral than they might otherwise do and they should not be subject to criticism as a consequence of doing so.

The CRE Statement reflects the U.S. federal banking agencies’ view on the appropriate balance between meeting the credit needs of CRE borrowers and maintaining prudent credit practices. Several industry experts, however, have questioned whether the guidelines are too forgiving in the sense that, in certain cases, they would appear to provide banks with new alternatives (*e.g.*, adopting a “good” loan, “bad” loan approach) to potentially reduce write-downs and the amount of capital reserved on account of troubled CRE loans.³⁶ For their own part, regulators have responded to these assertions by suggesting that bank examiners will take a tough approach to any bank attempting to use restructurings to improperly avoid CRE loan losses.

Although some in the CRE community have dubbed the current workout process “Extend and Pretend,” the CRE Statement does provide more flexibility and encouragement to banks in dealing with the significant

³⁶ The CRE Statement is generally expected to benefit many institutions with CRE loan portfolios including regional and small banks that, as noted above, tend to have very large CRE exposures relative to their size (*e.g.*, by allowing them to avoid write-downs in certain situations).

amount of maturing CRE loans for which there do not appear to be alternative capital sources to refinance. In determining whether and how to pursue a CRE loan workout, bank management should take into account several factors, including the historically low interest rate environment and the degree to which future increases in interest rates may affect the value of a restructured loan.³⁷ For example, a loan with an interest rate reduction could become much less valuable to a bank when interest rates begin to rise. A term extension – rather than a rate reduction – does not leave the institution with a lower yielding asset. On the other hand, a term extension may not be a viable option under circumstances where the CRE borrower is unable (or unwilling) to continue to pay its debt service at current rates. Principal reductions may be costly to a lender but may create positive equity for the CRE borrower, thus reducing the likelihood of a default on a loan.

It appears to still be too early to determine whether the CRE Statement has made (or will make) a contribution towards stabilizing the CRE sector and minimizing bank losses on CRE loans – key goals of the Statement.³⁸ While it is difficult to draw many conclusions regarding the workout strategies being pursued by banks based on publicly available information, it does appear that additional banks have been restructuring troubled CRE loans.³⁹ One key question is whether the restructured loans will continue to be repaid in accordance with their new terms if the economy does not improve relatively quickly. Indeed, the broader economic environment will undoubtedly play a significant role in determining whether or not the CRE Statement does, in fact, ultimately minimize bank losses from CRE loans or only push losses and write-downs into the future.

³⁷ Other important issues to consider include U.S. tax-related implications of loan modifications and whether the workout will adequately remove incentives for a borrower that is underwater to default on the loan.

³⁸ On February 22, 2010, the Chairman of the Senate Banking Committee, Senator Chris Dodd (D-Conn.), wrote a letter to the U.S. federal banking agencies asking them to provide an update on how the CRE Statement is helping to stabilize the CRE market.

³⁹ See *Banks buy time restructuring loans, for the moment*, Feb. 22, 2010 on the MarketWatch Web site.

CONCLUSION

The financial crisis has shown the critical importance of banks and the U.S. federal banking agencies working together to uncover and address emerging risks as early as possible. With the experience of the past few years still fresh in the minds of the public and Congress, the U.S. federal banking agencies are under pressure to demonstrate that they are proactively working to stabilize markets that are still struggling and to identify the next set of risks emerging on the horizon. In issuing each of the IRR Advisory and the CRE Statement, the agencies have communicated that they are focused on these objectives and encourage the banking industry to act proactively as well.⁴⁰

The IRR Advisory highlights techniques intended to reduce the likelihood that widely used bank strategies will lead to additional distress for banks as interest rates trend higher. Meanwhile, the CRE Statement is intended to help banks and examiners deal with a challenging situation where there are no easy solutions. Both sets of guidance are intended to help bridge a gap between our current economic and market conditions to a healthier and more stable economic environment. To this end, they both seek to encourage bank management and risk professionals to implement a risk-management approach based on rigorous analysis and testing, as well as carefully designed policies and controls. The ultimate usefulness and effectiveness of the guidance may rest, in part, in how well bank decision-making reflects this overall approach. ■

⁴⁰ In this regard, it warrants mention that the U.S. federal banking agencies have also issued guidance on liquidity risk management, an area where – as exposed by the financial crisis – many institutions are in need of improvement. The final guidance, issued on March 17, 2010, summarizes the principles of sound liquidity risk management that the agencies have previously issued and aligns such guidance with the “Principles for Sound Liquidity Risk Management and Supervision” issued by the Basel Committee on Banking Supervision in September 2008. The guidance warns institutions that they should not base their liquidity strategies on the belief that temporary government liquidity programs will remain in place indefinitely and emphasizes the importance of cash flow projections, diversified funding sources, stress testing, maintaining a cushion of liquid assets, and a formal well-developed contingency funding plan, as primary tools for measuring and managing liquidity risks.

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