Financial Institutions Advisory, Financial Regulatory Group & Property Group | November 13, 2009

U.S. Federal Banking Agencies Issue a Policy Statement on Commercial Real Estate Loan Workouts

There is a projected $400 billion of commercial real estate ("CRE") mortgage loans per year maturing over the next three years in the United States, a majority of which is held by banks. Moreover, according to estimates, greater than $500 billion of bank CRE loans maturing between now and 2014 are underwater. 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. Given these conditions, loan workout policies, practices and controls of banks have become, and are expected to remain, an important area of supervisory focus.

On October 30, 2009, the member agencies of the Federal Financial Institutions Examination Council ("FFIEC"), adopted guidance entitled the "Policy Statement on Prudent Commercial Real Estate Loan Workouts" (the "Policy Statement"). The member agencies of the FFIEC that jointly released the Policy Statement are the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Policy 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. Significantly, the Statement – which reflects the agencies' view that loan workouts often benefit both CRE borrowers and bank lenders particularly during challenging economic environments – is expected to encourage many banks to restructure CRE loans on their books in order to restore at least a portion of the loans from non-accrual to accrual status.

It 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, or realistic, in light of conditions in the CRE market.

Overview

The Policy Statement provides guidance for examiners of FFIEC agencies, and for banks, thrifts and credit unions (generically referred below to as "banks") that are working with CRE borrowers who are experiencing diminished operating cash flows, diminished collateral values, or prolonged delays in selling or renting commercial properties.[1]

The Policy 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

[1] The Policy Statement is available at http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf. It 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).

(that is, loans for which 50 percent or more of the source of repayment comes from third-party non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. It 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.

The impetus for issuance of the Policy Statement was the very high number of bank failures (approximately 100 out of 120) this year attributable in part to significant losses in CRE portfolios as well as the recent increase in CRE loan workouts. The Policy Statement is generally expected to benefit many institutions with CRE loan portfolios including regional and small banks that tend to have very large CRE exposures relative to their size.

Key topics addressed in the Policy Statement are summarized below.

Loan Workout Arrangements

A basic premise of the Policy Statement is that a loan renewal or restructuring may take many forms but must always be designed to improve the financial institution's prospect for repayment. Starting from that premise, the Policy 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 financial institution 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:[2]
    - updated and comprehensive financial information on the borrower, real estate project, and any guarantor;
    - current valuations of the collateral;
    - analysis of appropriate loan structure, covenants, or other requirements; and
    - appropriate legal documentation for any changes to loan terms.
  - 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 GAAP, and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate.

Risk Management Elements for Loan Workout Programs

[2] The Policy 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.

According to the Policy Statement, appropriate risk management practices for reviewing and restructuring (i.e., a formal modification in a loan's terms) 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:

- management infrastructure to manage workouts;
- documentation standards;
- adequacy of management information systems and internal controls;
- ensuring reports meet regulatory requirements;
- effectiveness of loan collection procedures;
- adherence to lending limits;
- collateral administration to ensure proper lien perfection; and
- an ongoing credit review function.

Classification of Loans

The Policy 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 (e.g., "substandard assets", "doubtful assets", or "loss assets") classification:

- the borrower's association with a particular industry that is experiencing financial difficulties,
- a decline in the value of the collateral to an amount that is less than the outstanding loan balance, [3] or
- a decision to renew or restructure a loan (however, restructured loans typically represent elevated credit risk and may warrant close monitoring by the financial 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 Policy 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 Policy Statement is the fact that it permits banks to essentially split loans into two parts – a performing part and a non-performing part. Significantly, this would allow banks to only adversely classify – and eventually take losses against – the non-performing part of the loan (i.e., 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 (i.e., the property) can support, and isolate the troubled piece in the "bad" loan. A question is how quickly banks that adopt this approach should write down the "bad" loans. The answer to this question may well determine how quickly the availability of credit (and, thus, liquidity) will return to the real estate market.

Regulatory Reporting and Accounting Considerations

While the Policy 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:

[3] Particularly given the tremendously large volume of outstanding CRE loans where the loan amount exceeds the value of the underlying property, the flexibility granted by the Policy Statement in this regard may well lead to a significant amount of CRE loan reclassifications (e.g., over $100 billion) from non-accrual to accrual status. See, e.g.,Wall. St. J., Nov. 11, 2009, "Banks Hasten to Adopt New Loan Rules".

- 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.
- 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 non-accrual status before the restructuring, the institution needs to consider whether the loan should be placed in non-accrual status to ensure that income is not materially overstated.[4]
- All restructured loans should be evaluated to determine whether the loan should be reported as a TDR (troubled debt restructuring).[5]
- 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 and generally be 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.

Illustrations and Examples

The Policy Statement includes several examples of CRE loan workouts demonstrating application of the Policy Statement to credit classification, determination of accrual versus non-accrual status, and identification and reporting of troubled debt restructurings. According to the FFIEC, the examples are provided for illustrative purposes only, and reflect examiners' analytical processes.

Observation

Although not overtly raised in the Policy Statement, it is important to keep in mind that the preponderance of CRE loans will be non-recourse 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 Policy 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 Policy 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.

Conclusion

The Policy Statement reflects the FFIEC's 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 reduce the amount of capital reserved on account of troubled CRE loans. 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 the commercial real estate community has dubbed the current workout process "Extend and Pretend", the Policy Statement does provide more flexibility and

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

[5] For guidance on reporting TDRs, see the FFIEC Call Report (for banks), TFR (for thrifts), and NCUA 5300 Call Reports (for credit unions) instructions.

encouragement to banks in dealing with the significant amount of maturing CRE loans for which there does not appear to be an alternative capital source to refinance.

The debate over the wisdom of the Policy Statement will surely continue until the impact of the guidance on the availability of CRE credit and the financial condition of banks with significant CRE exposures become more apparent.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Lisa M. Brill
New York
+1.212.848.4571
lbrill@shearman.com

Lee A. Kuntz
New York
+1.212.848.7392
lkuntz@shearman.com

Malcolm K. Montgomery
New York
+1.212.848.7587
mmontgomery@shearman.com

John L. Opar
New York
+1.212.848.7697
jopar@shearman.com

Barnabas W.B. Reynolds
London
+44.20.7655.5528
breynolds@shearman.com

Bradley K. Sabel
New York
+1.212.848.8410
bsabel@shearman.com

Steven E. Sherman
San Francisco
+1.415.616.1260
sesherman@shearman.com

Chris M. Smith
New York
+1.212.848.8238
csmith@shearman.com

Robert W.Fagiola
New York
+1.212.848.7606
rfagiola@shearman.com

Gregg L. Rozansky
New York
+1.212.848.4055
grozansky@shearman.com

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069 | WWW.SHEARMAN.COM

©2009 Shearman & Sterling LLP. As used herein, "Shearman & Sterling" refers to Shearman & Sterling LLP, a limited liability partnership organized under the laws of the State of Delaware.