

**Summary and Analysis of Federal Banking Regulators' Policy
Statement on Prudent Commercial Real Estate Loan Workouts
Released October 30, 2009**

Overview

The federal banking regulators have issued new guidance with the objective of encouraging institutions to pursue workouts on troubled commercial real estate (CRE) loans, a category that includes residential land acquisition, development and construction (AD&C) loans. Their stated intent is to ensure that supervisory policies and actions do not impair the flow of credit to viable borrowers and projects. The statement says that financial institutions that implement prudent CRE workouts will not be subject to criticism for engaging in such efforts and loans should not be subject to adverse classification solely because the value of the underlying collateral has declined.

The policy statement is a positive step in encouraging workouts as a preferred course of action and in directing examiners to make balanced assessments of institutions' workout efforts. The direction provided on allowing institutions to avoid using liquidation values when assessing collateral and on bifurcation of loans should be helpful to builders and developers. In general, however, the criteria specified for prudent loan workouts will allow institutions fairly limited ability to structure workouts for AD&C borrowers. Since AD&C loans are collateral-dependent with no internal cash flows to service principal and interest, borrowers on these loans will have to demonstrate other sources of loan repayment, provide additional collateral and/or make principal repayments in order to satisfy the criteria for prudent workouts. Many AD&C borrowers are not in a position to meet such requirements. In addition, the higher likelihood of a reclassification of a restructured AD&C loan as a troubled debt restructuring likely will discourage institutions from pursuing workouts on AD&C loans.

Background

On October 30, 2009, the federal banking regulators, consisting of the Board of Governors of the Federal Reserve System (FRB); Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA); Office of Thrift Supervision (OTS); Office of the Comptroller of the Currency (OCC); and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee, issued a new policy statement on prudent commercial real estate loan workouts. The new policy replaces previous guidance issued in 1991 and 1993.

Commercial real estate (CRE) loans include those that secure multifamily properties and nonfarm nonresidential property 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. CRE loans also include land development and construction loans (including one-to four-family residential and commercial construction loans), other land loans, loans to real estate investment trusts (REITs), and unsecured loans to developers.

Purpose

The purpose of the statement is to update and replace existing supervisory guidance to assist examiners in evaluating financial institutions' efforts to renew or restructure loans to creditworthy CRE borrowers. The policy is intended to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. The financial regulators recognize that CRE borrowers currently are experiencing diminished cash flows, depreciated collateral values and/or prolonged sales and rental absorption periods. Although CRE borrowers may experience deterioration in their financial condition, they may also continue to be creditworthy and have the capacity to repay their loans.

The regulators state that prudent CRE loan workouts can be in the best interests of the financial institution and the borrower. The examiners are directed to take a balanced approach in assessing financial institutions' workout activity. Of importance, the regulators state that financial institutions that implement prudent CRE workouts will not be subject to criticism for engaging in these efforts, even if the restructured loans have weaknesses that result in adverse credit classifications. Further, financial institution CRE loans will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

The policy statement covers the following areas: (1) risk management elements for loan workout programs; (2) loan workout arrangements (which includes analysis of the repayment capacity of the borrower, evaluating guarantors and assessing collateral values); (3) the classification of loans; and (4) regulatory reporting and accounting considerations. The policy statement also includes an appendix which provides examples of CRE loan workouts under different scenarios to help demonstrate the analytical approach examiners should take in identifying the appropriate loan classification.

Analysis of Builder/Developer Issues

Beneficial Elements

The stated objective of the policy statement is helpful to home builders and developers because it reinforces the position that loan workouts can be in the best interests of both the financial institution and the borrower. There are two areas addressed in the policy statement that are particularly beneficial to the home building industry:

Assessing Collateral Values

In the current economic environment where property values have declined, in some cases significantly, the assessment of the collateral value becomes critically important to the ability of the borrower to obtain a loan workout. The policy statement makes clear that commercial properties typically have more than one value conclusion and could include an "as is" market value, a prospective "as complete" market value and a prospective "as stabilized" market value. Thus, a financial institution should use the market value conclusion (and not the fair value

conclusion, which is used in an impairment assessment) that corresponds to the workout plan and the loan commitment. In other words, financial institutions are not required to use “as is” liquidation market values. The statement provides an example of a situation where, since the institution intends to work with the borrower to get a project to stabilized occupancy, it is appropriate to utilize the “as stabilized” market value in its collateral assessment for credit risk grading. This approach provides more flexibility in valuing the property.

Treatment of Restructured Loans with a Partial Charge-off

The policy statement notes that there may be cases that involve a multiple note structure wherein a troubled loan is restructured into two notes. Lenders may separate a portion of the current outstanding debt into a new note that is reasonably assured of repayment and performance. Because the note is expected to perform, the bank may return it to accrual status for classification purposes. The portion of the debt that is not reasonably assured of repayment is adversely classified and charged off as appropriate. This bifurcation of the loan is an alternative to foreclosing on the entire loan for both the institution and the borrower.

Areas of Concern

Unfortunately, the extent of flexibility that financial institutions have in approaching loan workouts will be limited depending on the type of property and loan. In most cases, to achieve a successful workout, borrowers will have to demonstrate that the properties continue to provide cash flow, (even if at reduced levels), additional collateral can be provided and that the restructured loan payments can be made. Loan workouts will continue to be difficult for acquisition, development and construction (AD&C) loans, however, because there is no cash flow associated with these properties and borrowers may have less access to additional collateral or cash resources.

Troubled Debt Restructurings

A significant potential problem area for AD&C borrowers is the criteria for classification of restructurings as troubled. The policy statement indicates that all restructured loans should be evaluated to determine whether the loan should be reported as a “troubled debt restructuring” (TDR). A restructured loan is considered a TDR if the institution, for economic or legal reasons related to a borrower’s financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the institution would otherwise not consider. Thus, the borrower must be experiencing financial difficulties and have been granted a concession on the loan by the institution in order for the loan to be classified a TDR. The policy statement emphasizes that no one single factor is determinative of whether a restructuring is a TDR. Significantly, the regulators stress that a general decline in the economy or some deterioration in a borrower’s financial condition would not automatically mean that the borrower is experiencing financial difficulty.

However, because of the collateral-dependent nature of AD&C loans, it is possible that more of these types of loans will be classified as TDRs if lenders pursue workout arrangements. Without cash flow, additional collateral or access to other cash resources, institutions may find that below

market rate interest and/or deferred payments on principal and interest are the only way to restructure such loans, which would trigger a TDR classification. Since TDR classification of a loan has adverse regulatory and accounting consequences for a lender, institutions may be less willing to pursue workouts on AD&C loans since they are more prone to such a reclassification.