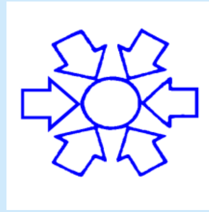

Financial Services Management

Commercial Real Estate Workouts

CFO	Risk Management Action Item

Cite

FRB, FDIC, OCC, OTS, NCUA
Policy Statement on Prudent Commercial Real Estate Loan Workouts

Recommended Distribution

CFO, Real Estate, Risk Management, Audit/Examination, Legal, Government Relations

Website

http://www.federalreserve.gov/boarddocs/srletters/2009/sr0907a1.pdf

Overview

Bank regulators have instructed examiners to take a "balanced" view of troubled commercial real estate (CRE) loans, noting that some workouts that do not involve stringent action against the borrower may be in the long-term best interest of both borrowers and lenders. Financial institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms 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. However, even as the guidance was issued, regulators repeated CRE concerns and made clear that banks will need to use strict processes to avoid criticism from their examiners.

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Impact

This guidance is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions and ensure that supervisors do not inadvertently curtail the availability of credit to sound borrowers. It builds on 2006 CRE guidance[1] that imposed concentration and other restraints in this area that, while hotly protested by many in the industry at the time, did not materially change practice before the current crisis.

As a result, many banks – especially small and mid-sized ones – have large CRE concentrations that, under current market conditions, pose significant concerns. Banks have protested that examiners are now taking so stringent a view of these loans – especially with regard to residential real-estate development – that high reserves, charge-offs and other costs are threatening the viability of feasible projects and, often, the bank itself. Regulators have countered that delaying loss recognition only exacerbates risk and increases the FDIC's resolution costs. However, also recognizing that some criticized projects may be viable over time, the agencies have decided to issue guidance that – like prior statements on residential mortgages – facilitates loan modification when borrowers are most likely to be able to meet new terms.

As noted, the guidance adopts what the agencies call a "balanced" approach. As a result, it includes an array of conditions and internal controls banks must adopt to take advantage of the new flexibility. Banks with significant CRE exposures and those contesting examiner decisions in this area will need quickly to review these conditions and institute appropriate controls to prevent adverse classification of CRE obligations. In some cases, the new standards will lead banks to data that may challenge their own assumptions about CRE loans – for example, the guidance makes clear that borrowers and guarantors must be assessed on a "global" debt capacity, not with regard to obligations on a single project funded by the bank. Further, collateral valuations must be done in a disciplined manner that, while differentiated by supervisors from accounting rules, still may require banks to write-down or otherwise classify loans they hope to keep on their books as performing obligations.

Also reflecting the agencies' balancing act, the guidance reiterates and does not change current policy regarding when the allowance for loan and lease losses (ALLL) must be increased for CRE obligations. When the guidance was released, senior officials at the FRB and OCC emphasized the need for discipline in this area, making clear that examiners may allow modifications even as they demand increased reserves to offset any resulting increased risk. Any such reserving requirements will add to the capital pressure at banks with large CRE portfolios, albeit also providing the bank with a larger cushion to bear losses in this high-risk sector.

[1] See Client Report **REALESTATE16**, *Financial Services Management*, December 26, 2006.

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What's Next

The guidance was issued in final form without any prior opportunity to comment on October 30.

Analysis

This statement replaces prior supervisory guidance on CRE classification, but not current reporting requirements. As in the current concentration guidance, CRE loans include those secured by multifamily property and non-farm nonresidential property where the primary source of repayment is derived from rental income (that is, loans for which fifty percent or more of the source of repayment comes from third-party rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. CRE loans also include land development and construction loans (including 1- to 4-family residential and commercial construction loans), other land loans, loans to real estate investment trusts (REITs), and unsecured loans to developers.

A. Risk Management

This should include:

- management infrastructure to govern the volume and complexity of workouts;
- documentation standards to verify borrower information and collateral values;
- adequate information systems and internal controls;
- management oversight to ensure that reports comply with regulatory requirements;
- effective loan-selection procedures;
- adherence to all applicable loan limits;
- collateral administration; and
- ongoing credit review.

B. Loan Workouts

A renewal or restructuring should improve the lender's prospects for repayment of principal and interest and be consistent with sound banking, supervisory, and accounting practices. Institutions should consider loan

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workouts after analyzing a borrower's repayment capacity, the support provided by guarantors, and the value of the collateral. Loan workout arrangements need to ensure that the institution maximizes its recovery potential. Renewed or restructured loans to borrowers who have the ability to repay their debts under reasonable modified terms 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.

To avoid adverse classification of loan workouts, banks must have:

- a prudent workout policy with appropriate limitations. This may permit further loan modification if the initial plan is not met; and
- current and forward-looking credit analytics for the borrower and/or guarantor.

Key components of each of these criteria are detailed in the guidance. Importantly, the guidance stipulates analysis of "global" debt-service obligations and capacity, not just that related to a CRE project. Loan-loss reserves must be set to reflect estimated losses in the restructured loan and recognize losses in a timely manner. Internal grades must be assigned to the loan and adjusted as required.

C. Collateral Valuation

The guidance also details appropriate collateral-valuation practices, requiring policies that ensure current and ongoing collateral valuation conducted under stringent standards. Workout collateral valuations must reflect factors related to the workout, not the prior loan, and reflect factors such as recent and likely market deterioration. A new appraisal may not be necessary if the institution itself fully considers current factors.

Collateral valuations of commercial properties typically contain 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. The institution should use the market value conclusion (and not the fair value) that corresponds to the workout plan and the loan commitment. For example, if the institution intends to work with the borrower to get a project to stabilized occupancy, then the institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading after reviewing the reasonableness of the appraisal's assumptions and conclusions. Conversely, if the institution intends to foreclose, then the institution should use the fair value (less costs to sell) of the property in its current "as is" condition in its collateral assessment. Examiners will analyze collateral values based on the institution's original appraisal or internal evaluation, any subsequent updates, additional information, and relevant market conditions. An examiner should review the appropriateness of the major facts, assumptions, and valuation approaches in the collateral valuation and in the institution's internal credit review. If institutions do not correct valuations following examiner requests, then examiners will make their own valuations, but Examiners generally are

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not expected to challenge the underlying valuation assumptions, including discount and capitalization rates, used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral.

D. Examiner Review

Examiners will assess workouts, reserves and related decisions based on borrower willingness and capacity to repay under reasonable terms. The guidance details how this should be done and also how collateral values and cash flow should be estimated to evaluate reserves and similar bank decisions. The guidance also details how examiners are to determine if guarantors are responsible and adequately funded; importantly, a guarantor's global debt position and the degree to which any prior claims had to be enforced, instead of met voluntarily will be evaluated.

E. Loss Recognition

1. Classification

Loans that are adequately protected by the current net worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not adversely classified. Similarly, loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards should not be adversely classified or criticized unless well-defined weaknesses exist that jeopardize repayment. Further, loans should not be adversely classified solely because the borrower is associated with a particular industry that is experiencing financial difficulties. When an institution's restructurings are not supported by adequate analysis and documentation, examiners are expected to exercise reasonable judgment in reviewing and determining loan classifications until such time as the institution is able to provide information to support management's conclusions and internal loan grades.

The guidance notes that just because a borrower is current on all principal and interest payments does not mean the loan is not risky because renewals, extensions or other modifications may mask weakness. Loans structured with up-front interest reserves may be particularly problematic despite borrower performance. Adverse classification may thus be appropriate. Loans restructured due to a borrower's inability to obtain replacement funding may also require adverse classification based on the specifics of each case, with the guidance stating that adverse classification should occur if a restructured loan has identified weaknesses.

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As a general classification principle, for a troubled CRE loan that is dependent on the sale of the collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the market value of the real estate collateral less the costs to sell should be classified "loss." This principle applies when repayment of the debt will be provided solely by the sale of the underlying real estate collateral and there are no other available and reliable sources of repayment, with the guidance detailing how to classify specific portions of such loans.

2. Charge-Off

An assessment may indicate that a credit has well-defined weaknesses that jeopardize collection in full and may result in a partial charge off as part of a restructuring. When well-defined weaknesses exist, and a partial charge-off has been taken, the remaining recorded balance for the restructured loan generally should be classified no more severely than "substandard." In contrast, for impairment measurement purposes under GAAP, a loan is collateral dependent if repayment of the loan is expected to be provided solely by sale or operation of the underlying collateral. A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined. If loans are restructured, a first note may be taken off non-accrual if certain conditions are met. Certain loans may be taken off non-accrual and charge-offs can be reversed before full repayment of the charged-off amounts.

F. Regulatory Reporting and Accounting

Decisions related to loan workout arrangements may affect regulatory reporting, particularly interest accruals, troubled debt restructuring treatment, and credit loss estimates. Management should ensure that loan workout staff appropriately communicate with the accounting and regulatory reporting staff concerning the institution's loan restructurings and that the reporting consequences of restructurings are presented accurately in regulatory reports. In addition to evaluating credit risk management processes and validating the accuracy of internal credit grades, examiners are responsible for reviewing management's processes related to accounting and regulatory reporting.

While similar data are used for credit risk monitoring, accounting, and reporting systems, this information does not necessarily produce identical outcomes. For example, loss classifications may not be equivalent to impairment measurements. The charged-off amount should not be reversed or re-booked when the loan is returned to accrual status. The guidance reiterates key regulatory and accounting requirements in all of these areas, instructing examiners on appropriate procedures.

G. Reserves

Institutions should recognize in other liabilities an allowance for estimated credit losses on off-balance sheet credit exposures related to restructured loans (e.g., loan commitments) and should reverse interest accruals on loans

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that are deemed uncollectible. Although accounting rules require recognition as a troubled debt when collateral values fall, supervisors will not necessarily require a reserve in such cases if the loan is otherwise performing.

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