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New CRE Loan Workout Rules Provide Relief and Pitfalls

By: Peter G. Weinstock

On October 30, 2009, all of the federal regulatory agencies issued a new policy statement on commercial real estate ("CRE") loan workouts. The policy statement does offer opportunities for financial institutions ("FI") to reduce the amount of charge-offs on CRE loans, return restructured loans to a performing status faster and generally work with customers on mutually beneficial workouts. Nonetheless, the policy statement does present challenges before FIs can achieve such results, especially for those management teams seeking to "kick the can down the road" to await better days. Notably, however, the policy statement does not change regulatory reporting guidelines or the accounting requirements under generally accepted accounting principles ("GAAP").

I. Credit Administration

Before an FI can take advantage of the policy statement, it must demonstrate a robust credit administration function, principally prudent risk mitigation practices related to renewing and restructuring CRE loans. At a minimum, the FI must demonstrate that its risk management practices address:

- an infrastructure sufficient to assess and manage the level and types of loan workouts. Bankers should consider hiring a loan workout officer or elevating such a position to a senior level;
- receipt and review of appropriate documentation in order to evaluate the borrower's financial condition and collateral values;
- management information systems and internal controls to test borrower performance and evaluate areas of risk, including from CRE concentrations;
- compliance with regulatory reporting obligations and supervisory guidance;
- procedures for collection of loans; and
- ongoing, well-functioning credit review processes.

Specifically, the credit administration function will need to include a loan policy revised to address loan workouts. The policy will need to set forth appropriate loan terms and amortization schedules. The policy will also need to provide for changes to workout plans if loans do not perform as intended or in the event collateral values continue to suffer. The loan workout plans themselves must be based on the following:

- current and comprehensive information on all of: (i) borrower, (ii) the CRE and (iii) any applicable guarantors. This means that the FI will need to have current collateral values. The collateral values need not necessarily be based on new appraisals. Instead, an internally prepared evaluation may update original assumptions to new realities and provide an estimate of fair value for impairment tests. For most FIs, however, the latter requirement will mean an updated appraisal. There still would need to be a well-functioning appraisal review process.
- FIs will be required to maintain policies and procedures dictating when collateral values need to be updated as part of either a review of a credit, in light of market conditions, or as a borrower's cash flow and other financial resources deteriorate. In short, the examiners will hold bankers' feet to the fire to comply with their own policies regarding updated appraisals.
- written explanation and justification for revisions for loan terms and amortization schedules, covenants, etc.
- revised agreements and instruments incorporating such changes.
- an analysis of the "global debt service" obligations of the borrower and all guarantors. The assessment of the "global debt service" obligations should include all of the contingent claims that may arise against the borrower or the guarantors. Moreover, examiners are specifically instructed by the policy statement to evaluate (i) whether a guarantor has demonstrated a willingness to comply with current and past obligations, (ii) whether it has upside in the project for performing on a guarantee and (iii) whether the guarantor has significant equity already invested in the project. Significantly, examiners will determine whether guarantors have a history of seeking to "walk" their guarantee. If a guarantor previously did perform, but was forced to do so by legal process, that would be a negative factor as well.

The FI must have the ability to monitor the borrower's compliance with the revised loan terms and the accuracy of the FI's internal loan grading methodologies. In addition, the allowance and lease loss methodology must accurately evaluate the inherent exposure in the restructured credit in accordance with GAAP or other key components of the overall workout process.

II. Minimizing Charge-offs and Classifications

The new policy statement provides that a loan will not be classified "solely" because the underlying collateral is less than the principal balance of the loan. As can be seen from the discussion set forth above, to take advantage of the opportunities presented by the policy statement requires a FI to develop and document a significant body of information. In short, the policy statement offers a carrot and a stick. FIs that seek to defer judgments by refraining from obtaining information will see management ratings fall and classification levels actually increase. On the other hand, FIs that have a robust credit function that obtains the requisite information will be able to take advantage of the policy statement. They will, at a minimum, have a better basis for arguing CRE loan grades. Ideally, the policy statement will provide such FIs more deferential treatment by examiners. At least that is how it is supposed to work.

The market value of collateral[1] should contain more than one value. There would be an "as is" market value, a prospective value for the project "as complete" and a prospective "as stabilized" value. The value used would then be based on the workout plan. For instance, if the FI is working with the customer to help the project reach a stabilized level of occupancy, then the "as stabilized" market value can be used. If the FI intends to foreclose, however, then it must use the "as is" value. Regardless of the value used, the FI must again have an appraisal review function that tests the assumptions used and conclusions reached.

In the current environment, the examiners will simply write down CRE loans when they differ regarding valuation. Under the policy statement, the examiners need to note the weaknesses in the FI's information or review process and ask the FI to correct those weaknesses. If the FI does so in a timely manner, then the examiners will consider this new information. Otherwise, "examiners will have to assess the degree of protection that the collateral affords

[1] The policy statement notes that the market value in a collateral valuation may be different from the fair value in an impairment analysis. This would result in different valuations for regulatory reporting purposes.

in analyzing and classifying a credit. This may result in examiners making adjustments, if applicable, to the collateral's value to reflect current market conditions and events." In other words, if the weakness is not addressed, the credit will be written down.

III. Classification

A. Loan Performance Assessment for Classification Purposes

The policy statement's central tenet behind the stick approach is relayed by the following:

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.

Again, from the standpoint of the carrot, the policy statement provides that "examiners should not adversely classify or require the recognition of a partial charge-off on a performing commercial loan *solely* because the value of the underlying collateral has declined to an amount that is less than the loan balance" (italics added).

The regulators specifically address the impact of interest reserves with regard to gauging the performance of loans. Bank examiners have long believed that interest reserves mask declining performance in a bad economy. Specifically, a FI will either loan funds to a developer or cause a developer to post, upon loan origination, interest reserves. The interest reserves keep the loan current even if the project itself may have stalled or become impracticable. The FI even continues to earn income on the loan. The policy statement specifically advises that examiners may classify such credits even if the loan is otherwise current.

Interest reserves may have been entirely appropriate when CRE loans were originated. Now, however, the loans need to be restructured to make them amortizing. It is not just the interest reserves, however, that are targeted by the examiners. Specifically, the policy statement provides that "when the loan's underwriting structure or the liberal use of extensions and renewals mask credit weaknesses and obscure borrower's inability to meet reasonable repayment terms," then classification may be appropriate. In essence, the policy statement is specifically taking issue with the banking alteration of the well-known Bob Dylan song "a rolling loan gathers no loss."

The policy statement recognizes that CRE loans oftentimes were originally structured with short maturities and other terms that need to be restructured in the current environment. The policy statement provides that such changes of terms for maturing loans will not be adversely classified if the borrowers have the ability to repay on "reasonable" terms. Instead, such loans would be treated as other assets especially mentioned and should be reflected on the FI's watchlist.

B. Classification of Troubled CRE Loans Dependent on Sale of Collateral for Repayment

Generally, when the collateral for a CRE loan is the source of repayment of the loan, the FI should write off as a loss the amount by which the value of the collateral (less selling costs) is less than the principal amount of the loan. This assumes that there are no other reliable sources of repayment other than liquidation of the real estate. The remaining portion of the loan balance should be treated as "substandard." The policy statement does provide for a doubtful classification instead of loss in the event there are mitigating factors or when a loss is expected, but the amount of the loss cannot be reasonably calculated. In such circumstances, the examiners can treat the entire loan as doubtful, but the policy statement provides that such classifications should be infrequent.

C. Classification and Accrual Treatment of Restructured Loans with a Partial Charge-off

Similarly, when a loan is restructured, and there is a partial charge-off, the remaining portion of the loan should be classified no worse than substandard. A doubtful classification also may be appropriate when the loss exposure cannot be reasonably determined.

The policy statement also brings the multiple note structure out of hibernation. A loan may be separated into a new note that has reasonable prospects for repayment. This note may be returned to accrual status when there is sustained payment performance. The policy statement allows a FI to take into account historical payment performance for a reasonable time *prior* to the restructuring, provided the determination is made by "a current, well-documented credit assessment." Six months still is considered the general time period for whether a restructured loan can be rebooked.

The second note, the one that lacks prospects for repayment, would

be charged off. Oddly, the policy statement provides that if, instead of two notes, the FI merely internally recognizes a partial charge-off, then the entire loan would remain on nonaccrual status. The policy statement once again encourages proactive conduct.

IV. Regulatory Reporting and Accounting Considerations

A. Reporting Restructured Loans

The policy statement makes clear that not every modified or restructured loan should be reported as a troubled debt restructuring ("TDR"). A TDR arises when the FI for:

[E]conomic 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 not otherwise consider. To make this determination, the lender assesses whether (a) the borrower is *experiencing financial difficulties*, ***and*** (b) the lender has granted a *concession*. (italics and underscoring in original text)

In contrast, circumstances that impact borrowers uniformly, such as declines in the economy, will not lead to a finding of a TDR. Most notably, the policy statement says that "some deterioration in a borrower's financial condition does not automatically mean that the borrower is *experiencing financial difficulties*" (italics in original text). Thus, the policy statement provides lenders with room to argue TDR treatment.

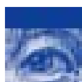
B. Allowance for Loan and Lease Losses

TDRs are deemed to be impaired loans and, accordingly, would be subject to write-down under FASB § ASC 310-10-35-2 through 30 (the former FASB statement no. 114). Generally, when the principal amount of an impaired loan is more than the discount at expected future cash flows, the excess is a valuation allowance. This assumes that the loan is not collaterally dependent.[2] For these purposes, the discount rate is deemed to be the loan's effective interest rate. The use of the loan rate as the discount rate is significant.

In contrast, for income-producing real estate, the policy statement provides that the discount rate should be the rate that market participants will require for that specific type of property. When market information exists for yields required by investors, then such information can be used. The policy statement recognizes that the discount rates used will vary with the risk associated with the particular property. In addition, it will vary based upon the type of the real estate in question as well as local market conditions. The policy statement notes that in most markets, there will be a fairly narrow range between the discount rate and the cap rates used in income analysis. Hopefully, the policy statement will temper the across-the-board and extraordinarily high discount rates some examiners have been applying.

The policy statement provides welcome relief to FIs experiencing this troubled CRE environment. FIs, however, must be proactive to take advantage of the relief afforded. Unfortunately, the policy statement no longer allows FIs to hide from information to the extent they ever could do so. Now, the FIs must obtain the information, analyze and act on it in order to be in a position to argue with the examiners after the fact.

[2] For collaterally dependent loans, the excess of the principal amount over the value of the collateral less costs would be included in the estimated allowance. Reductions in collateral values would also impact the general allowance methodology for comparable collaterally backed credits.



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