Feds Issue Policy Statement Encouraging Real Estate Loan Workouts Over Foreclosures

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In an effort to encourage commercial loan workouts over foreclosures, the FDIC along with five other federal regulatory agencies on Oct. 30 issued a joint policy setting forth examples of what the agencies expect to see in a "prudent commercial real estate loan workout."

Most notably, the statement promises that "performing loans made to creditworthy borrowers will not be subject to adverse classification solely because the value of the underlying collateral has declined."

This policy statement is quick to note that the statement does not change any aspect of regulatory reporting guidance provided in statements by the various regulatory agencies; nor does its change any aspect of accounting requirements under the U.S. Generally Accepted Accounting Principles (GAAP). And although the statement's title makes it seemingly apply to only commercial real estate loan workouts, the "general principles also could apply to commercial loans that are secured by real property or other business assets of a commercial borrower."

This policy statement provides guidance on a significant problem for many banks going forward. Many commercial real estate loans that come up for renewal are able to cover their agreed-upon principal and interest payments. But, unfortunately, the value of the loan's collateral has declined such that the loan, unless additional equity is brought in, would become a non-performing asset, or Troubled Debt Restructuring (TDR).

For example, a particular loan might have a 1.1 debt service coverage ratio, but have a 100 percent loan to value ratio (LTV). To avoid becoming a TDR, the loan would need to be at an 80 percent LTV. The newly-issued statement makes clear that the regulatory agencies will not classify these performing loans as TDRs, as long as the principal and interest payments remain current. Therefore, in addition to the value of the collateral, an institution should also take into consideration the borrower's repayment capacity and support provided by guarantors.

The statement's practical advice sets forth the essential elements of a "prudent workout plan." The regulators assure institutions that they will not be criticized for engaging in a loan workout as long as that particular institution has a "well-conceived and prudent workout plan" that analyzes the current financial state and creditworthiness of both the borrower and any guarantors. Specifically, the statement sets forth the following key elements of any workout plan:

- Updated and comprehensive financial information on the borrower, real estate project and any guarantor;
- Current valuations of the collateral supporting the loan and the workout plan;
- Analysis and determination of appropriate loan structure, curtailment, covenants or re-margining requirements; and
- Appropriate legal documentation for any changes to loan terms

Moreover, an institution will not be criticized for engaging in loan workout arrangements so long as the institution's management has engaged in:

An analysis of the borrower's global debt service[1] that reflects a realistic projection of the borrower's and guarantors' expenses

- The ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout
- An internal loan grading system that accurately and consistently reflects the risk in the workout arrangement
- An Allowance for Loan and Lease Losses (ALLL) methodology that covers estimated credit losses in the restructured loan, measured in accordance with the U.S. GAAP, and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate

Another noteworthy section of the agencies' statement is the sanctioning of the multiple-note structure for troubled loans. The statements provide that "[l]enders may separate a portion of the current outstanding debt into a new legally enforceable note that is reasonably assured of repayment and performance according to prudently modified terms." This "good note" may then be placed back onto accrual status in certain situations. Unfortunately, the agencies do not clarify what these "certain situations" are. The note representing the portion of the debt that is not reasonably assured of repayment (the "bad note") should be adversely classified and charged-off. If, however, the loan remains on the books without being split and the institution internally recognizes a partial charge-off, the loan needs to remain on nonaccrual.

The policy statement also briefly discusses classification of construction loans with interest reserves. Where a construction loan is contractually current because interest payments are being made from the interest reserve, the loan may require an adverse classification. For example, a development project may stall and the management of the institution may fail to properly evaluate the collectibility of the loan. In such a situation the lending institution will continue to recognize interest income from the reserve and capitalized into the loan balance despite the fact that the project is not generating sufficient cash flows to repay the principal. Here, adverse classification of the loan may be appropriate.

The policy statement does not show evidence of an enormous change in the various agencies' views on loan workouts; but it does recognize that the current economic situation makes it difficult for borrowers to obtain credit when the value of their collateral continues to decline. The agencies recognize that "financial institutions and borrowers may find it mutually beneficial to work constructively together." The statement's broad policies, outlines and numerous examples of troubled loans is a useful guide for the many institutions that choose commercial workout plans in order to meet the needs of troubled borrowers.

Should you have any questions about the Policy Statement on Prudent Commercial Real Estate Loan Workouts or about loan workouts in general, please feel free to contact any member of Plunkett Cooney's Banking, Bankruptcy & Creditors' Rights Group. Click here to review the practice group directory.

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[1] Global Debt represents the aggregate of a borrower's or guarantor's financial obligations, including contingent obligations.