HUSCH BLACKWELL

THOUGHT LEADERSHIP

LEGAL UPDATES

PUBLISHED: NOVEMBER 3, 2009

New Federal Policy Statement on Prudent Commercial Real Estate Loan Workouts

On October 30, 2009, the federal regulators of financial institutions[1] issued a new policy statement regarding prudent commercial real estate (CRE) loan workouts. The regulators recognize that financial institutions and borrowers face significant challenges when dealing with diminished operating cash flows, depreciated collateral values, or prolonged sales and rental absorption periods. The purpose of the statement is to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies do not inadvertently curtail the availability of credit to sound borrowers. The statement includes several examples of CRE loan workouts illustrating application of the statement to credit classification, determination of accrual versus nonaccrual status, and identification and reporting of troubled debt restructurings (TDRs).

CRE Loan Workout Arrangements

Institutions that implement prudent CRE loan workouts 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. 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. Even if a loan is adversely classified, an institution will not be criticized so long as management has:

A prudent workout policy that establishes appropriate loan terms and amortization schedules

A well-conceived and prudent workout plan for an individual credit that analyzes the current financial information on the borrower or guarantor and that supports the ultimate collection of principal and interest

An analysis of the borrower's global debt service that reflects a realistic projection of the borrower's and guarantor's 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 GAAP, and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate

Classification of Loans

Examiners will not adversely classify or criticize loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards unless well-defined weaknesses exist that jeopardize repayment. In addition, loans should not be adversely classified solely because the borrower is associated with a particular industry that is experiencing financial difficulty. The statement addresses the following four areas:

Loan Performance Assessment for Classification Purposes – 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 is less than the amount of the loan.

Classification of Renewals or Restructurings of Maturing Loans – Renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not be subject to adverse classification unless well-defined weaknesses exist that jeopardize repayment under the modified terms.

Classification of Troubled CRE Loans Dependent on Sale of Collateral for Repayment – Any portion of the loan balance that (i) exceeds the amount that is adequately secured by the market value of the real estate less the costs to sell should be classified as a "loss;" (ii) is adequately secured by the fair value of the real estate less the costs to sell should be classified no worse than "substandard;" and

(iii) is in excess of fair value of the real estate can be classified as "doubtful" if the potential for full loss can be mitigated by pending events, but such classification will be used sparingly and for a limited time.

Classification and Accrual Treatment of Restructured Loans with a Partial Charge-off – When well-defined weaknesses result in a partial charge-off as a part of a CRE loan workout, the remaining balance for the restructured loan should be classified no more severely than "substandard," unless the loss exposure cannot be reasonably determined. A restructuring involving a multiple note structure may be placed back on accrual status in certain situations but the portion of debt not reasonably assured of repayment should be adversely classified and charged-off as appropriate. If a multiple note structure is not employed and the loan is in part internally charged off, a loan should remain or be placed on nonaccrual status but may return to accrual status if the full amount contractually due, including the charge-off, is expected to be paid and the contractual loan has been brought current.

Regulatory Reporting and Accounting Considerations

The statement provides guidance for both institutions and examiners with respect to compliance regulatory reporting and accounting requirements, specifically addressing (i) implications for interest accrual status, (ii) TDR reporting, and (iii) ALLL reporting requirements.

What This Means to You

This is good news for both lenders and borrowers. The federal regulators formally recognize that given the current decline in the commercial real estate market, prudent CRE loan workouts are often in the best interest of the financial institution and CRE borrowers. The statement provides guidance on how financial institutions can craft a CRE loan workout program. This statement should allow more financial institutions to restructure or renew performing loans made to creditworthy borrowers with less trepidation that the regulators will criticize management and adversely classify CRE loans and modifications.

Contact Info

If you have any questions about this or any other Real Estate and Development matters, please contact your Husch Blackwell attorney.

[1]The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Financial Institutions Examination Council (FFIEC).

Husch Blackwell Sanders LLP regularly publishes updates on industry trends and new developments in the law for our clients and friends. Please contact us if you would like to receive updates and newsletters, or request a printed copy.

Husch Blackwell Sanders encourages you to reprint this material. Please include the statement, "Reprinted with permission from Husch Blackwell Sanders, copyright 2010, www.huschblackwell.com." at the end of any reprints. Please also email info@huschblackwell.com to tell us of your reprint.

This information is intended only to provide general information in summary form on legal and business topics of the day. The contents hereof do not constitute legal advice and should not be relied on as such. Specific legal advice should be sought in particular matters.