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New Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts

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Federal banking regulators have issued a final Policy Statement for Prudent Commercial Real Estate Loan Accommodations and Workouts (the "Policy Statement") that calls for financial institutions to work prudently and constructively with creditworthy borrowers during times of financial stress. The Policy Statement updates and replaces guidance issued in 2009 (the "2009 Statement") and includes a new provision on short-term loan accommodations.

The Policy Statement was issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the "Agencies"), in consultation with state-level bank and credit union regulators.

The Policy Statement reaffirms two key principles from the 2009 Statement:

1. Financial institutions that implement prudent commercial real estate ("CRE") loan accommodation and 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 these arrangements result in modified loans with weaknesses that result in adverse classification; and
2. Modified loans to borrowers who have the ability to repay their debts according to reasonable 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 outstanding loan balance.

I. The Policy Statement

The Policy Statement discusses the importance of financial institutions working constructively with CRE borrowers who are experiencing financial difficulty and addresses supervisory expectations with respect to a financial institution's handling of loan accommodations and workouts on matters including (1) risk management, (2) classification of loans, (3) regulatory reporting, and (4) accounting considerations.

Short-Term Loan Accommodations

One new topic addressed by the Agencies is short-term loan accommodations. The Policy Statement encourages financial institutions to work proactively and prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress. Such actions may entail loan accommodations

that are generally short-term or temporary in nature and occur before a loan reaches a workout scenario.

The Policy Statement states that when entering into an accommodation with a borrower, a financial institution should employ prudent risk management practices and appropriate internal controls over such accommodations. Prudent risk management practices include developing and maintaining appropriate policies and procedures, updating and assessing financial and collateral information, maintaining an appropriate risk rating (or grading) framework, and ensuring proper tracking and accounting for loan accommodations. Further, prudent internal controls related to loan accommodations include comprehensive policies and practices, proper management approvals, an ongoing credit risk review function, and timely and accurate reporting and communication.

Loan Workout Programs

The Policy Statement also provides that when short-term accommodation measures are not sufficient in addressing credit problems, financial institutions could proceed into longer-term or more complex loan arrangements with borrowers under a formal workout program. Loan workout arrangements can take many forms, including, but not limited to:

- Renewing or extending loan terms;
- Granting additional credit to improve prospects for overall repayment; or
- Restructuring the loan with or without concessions.

Additionally, a financial institution's risk management practices for implementing workout arrangements should be appropriate for the scope, complexity, and nature of the financial institution's lending activity. These practices should be consistent with safe and sound lending policies and supervisory guidance, real estate lending standards and requirements, and relevant regulatory reporting requirements. The Policy Statement provides a list of items examiners will use to evaluate the effectiveness of a financial institution's practices.

Long-Term Loan Workout Arrangements

An effective loan workout arrangement should improve the lender's prospects for repayment of principal and interest, be consistent with sound banking and accounting practices, and comply with applicable laws and regulations. The Policy Statement further states that consistent with safety and soundness standards, examiners will not criticize a financial institution for engaging in loan workout arrangements, even though such loans may be adversely classified, so long as management has for each loan:

- Developed a well-conceived and prudent workout plan that supports the ultimate collection of principal and interest (consistent with the Policy Statement);
- Analyzed the borrower's global debt service coverage, including realistic projections of the borrower's cash flow, as well as the availability, continuity, and accessibility of repayment sources;
- Analyzed the available cash flow of guarantors;
- Demonstrated the willingness and ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout arrangement;
- Maintained an internal risk rating or loan grading system that accurately and consistently reflects the risk in the workout arrangement; and

- Maintained an allowance methodology that calculates (or measures) an allowance, in accordance with U.S. generally accepted accounting principles ("GAAP") for loans that have undergone a workout arrangement and recognizes loan losses in a timely manner through provision expense and recording appropriate charge-offs.

a. *Supervisory Assessment of Repayment Ability of Commercial Borrowers*

The primary focus of an examiner's review of a CRE loan is an assessment of the borrower's ability to repay the loan. The major factors that influence this analysis are the borrower's willingness and ability to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business. When analyzing a commercial borrower's repayment ability, the factors examiners consider should include the following:

- The borrower's character, overall financial condition, resources, and payment history;
- The nature and degree of protection provided by the cash flow from business operations or the underlying collateral on a global basis that considers the borrower's and guarantor's total debt obligations;
- Relevant market conditions, particularly those on a state and local level, that may influence repayment prospects and the cash flow potential of the business operations or the underlying collateral; and
- The prospects for repayment support from guarantors.

b. *Supervisory Assessment of Guarantees and Sponsorships*

Examiners will review the financial attributes of guarantees and sponsorships in considering the loan classification and the financial attributes and economic incentives of sponsors that support a loan.

The Agencies believe financial institutions that have sufficient information on the guarantor's global financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) are better able to determine the guarantor's financial ability to fulfill its obligation. An effective assessment includes consideration of whether the guarantor has the financial ability to fulfill the total number and amount of guarantees currently extended by the guarantor. A similar analysis should be made for any material sponsors that support the loan.

c. *Supervisory Assessment of Collateral Values*

Examiners will analyze real estate collateral values based on the financial institution's original appraisal or evaluation, any subsequent updates, additional pertinent information (e.g., recent inspection results), and relevant market conditions. Examiners will assess the major facts, assumptions, and valuation approaches in the collateral valuation and their influence in the financial institution's credit and allowance analyses.

The Agencies' appraisal regulations require financial institutions to review appraisals for compliance with the Uniform Standards of Professional Appraisal Practice. As part of that process, and when reviewing collateral valuations, financial institutions should ensure that assumptions and conclusions used are reasonable. Further, financial institutions typically have policies and procedures that dictate when collateral valuations should be updated as part of financial institutions' ongoing credit risk reviews and monitoring processes, as relevant market conditions change, or as a borrower's financial condition deteriorates.

The Policy Statement provides for when a financial institution should consider the current project plans and market conditions in a new or updated appraisal or evaluation, as appropriate.

Classification of Loans

Pursuant to the Policy Statement, loans that are adequately protected by the current sound worth and debt service ability of the borrower, guarantor, or the underlying collateral generally are not adversely classified. Similarly, loans to sound borrowers that are modified in accordance with prudent underwriting standards should not be adversely classified by examiners unless well-defined weaknesses exist that jeopardize repayment. However, such loans could be flagged for management's attention or for inclusion in designated "watch lists" of loans that management is more closely monitoring.

a. *Loan Performance Assessment for Classification Purposes*

A loan's record of performance to date should be one of several considerations when determining whether a loan should be adversely classified.

One perspective on loan performance is based upon an assessment of whether the borrower is contractually current on principal or interest payments. For many loans, the assessment of payment status is sufficient to arrive at a loan's classification. In other cases, being contractually current on payments can be misleading as to the credit risk embedded in the loan.

A second perspective for assessing a loan's classification is to consider the borrower's expected performance and ability to meet its obligations in accordance with the modified terms over the remaining life of the loan. Therefore, the loan classification is meant to measure risk over the term of the loan rather than just reflecting the loan's payment history.

b*. Classification of Renewals or Restructurings of Maturing Loans*

When there has been deterioration in collateral values, a borrower with a maturing loan amid an economic downturn may have difficulty obtaining short-term financing or adequate sources of long-term credit. In such cases, financial institutions may determine that the most appropriate course is to restructure or renew the loan.

In general, renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not automatically be subject to adverse classification by examiners. However, such loans should be identified in the financial institution's internal credit grading system and may warrant close monitoring. Adverse classification of a renewed or restructured loan would be appropriate if, despite the renewal or restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan pursuant to reasonable modified terms.

c. *Classification of Problem CRE Loans Dependent on the Sale of Collateral for Repayment*

The Policy Statement provides that as a general classification principle for a problem 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 fair value of the real estate collateral less the costs to sell should be classified "loss." The Policy Statement also provides further details on when applicable portions of such loans could be categorized by examiners as "substandard" or "doubtful."

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

An assessment may indicate that a loan has well-defined weaknesses that jeopardize collection in full of all amounts contractually due and may result in a partial charge-off as part of a restructuring. The Policy Statement provides that when well-defined weaknesses exist and a partial charge-off has been taken, the remaining recorded balance for the restructured loan should be classified no more severely than "substandard," but that a more severe classification may be appropriate if the loss exposure cannot be determined.

The Policy Statement further provides for when a restructuring may involve a multiple note structure and how lenders may restructure a collateral-dependent loan using a multiple note structure.

Regulatory Reporting and Accounting Considerations

The Policy Statement provides that a financial institution's management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements. Management is also responsible for establishing and maintaining an appropriate governance and internal control structure over the preparation of regulatory reports. Therefore, it is important that loan workout staff appropriately communicate with the accounting and regulatory reporting staff concerning the financial institution's loan restructurings and that the consequences of restructurings are presented accurately in regulatory reports.

a. ***Allowance for Credit Losses***

The Policy Statement states that examiners need to have a clear understanding of the differences between credit risk management and accounting and regulatory reporting concepts when assessing the adequacy of the financial institution's reporting practices for on- and off-balance sheet credit exposures.

b. ***Implications for Interest Accrual***

The Policy Statement states that a financial institution needs to consider whether a loan that was accruing interest prior to the loan restructuring should be placed in nonaccrual status at the time of modification to ensure that income is not materially overstated. For a loan to remain in accrual status, the restructuring and any charge-off taken on the loan must be supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must be placed in nonaccrual status.

Appendices

Please note that the Policy Statement includes the following appendices:

1. Examples of CRE Loan Workout Arrangements

2. Selected Rules, Supervisory Guidance, and Authoritative Accounting Guidance
3. Valuation Concepts for Income Producing Real Estate
4. Special Mention and Adverse Classification Definitions
5. Accounting – Current Expected Credit Losses Methodology ("CECL")

II. Conclusion

The Agencies have found that prudent CRE loan accommodations and workouts are often in the best interest of the financial institution and the borrower. Therefore, financial institutions should consider the principles explained in the Policy Statement when engaging with CRE borrowers experiencing financial difficulties.

This advisory is a general overview of the Policy Statement and is not intended as legal advice. The Policy Statement is very detailed and should be reviewed in its totality.

If you have any questions about the Policy Statement, please feel free to contact Joseph D. Simon at (516) 357-3710 or via email at **jsimon@cullenllp.com**, Kevin Patterson at (516) 296-9196 or via email at **kpatterson@cullenllp.com**, Elizabeth A. Murphy at (516) 296-9154, or via email at **emurphy@cullenllp.com**, or Gabriela Morales at (516) 357-3850 or via email at **gmorales@cullenllp.com**.

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