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New Policy Statement on Commercial Real Estate Loan Workouts – Providing Welcomed Flexibility

When as a child we received a long-awaited toy that required assembly, so often we would rush to throw it together without even glancing at the thick instruction manual left sitting in the box, believing we could rely on past experience and instinct to get it right – that is, until we got towards the end and discovered that a critical piece could not be inserted without unwinding many of the prior steps. In a few cases, the error was irreversible, and the toy was ruined. The hard lesson learned was to take the time to follow the instruction manual in order to enjoy the gift both immediately and into the future.

On October 30, 2009, the agencies of the Federal Financial Institutions Examination Council[1] issued a Policy Statement on Prudent Commercial Real Estate Loan Workouts (the "Policy Statement"). Although the Policy Statement does not provide a "step-by-step manual" on how to structure workouts of commercial real estate loans, it does provide a broad overview of what factors the financial regulators will consider in determining whether a loan workout is conducted prudently, and it includes numerous practical examples of both successful and unfavorable strategies. Knowing how the financial regulators are likely to view a restructured loan provides (a) real estate borrowers with a realistic expectation of whether their loan workout proposals might be acceptable to their lenders and (b) real estate lenders with a road map to a restructuring that will avoid adverse regulatory treatment. Although the Policy Statement does in some instances require that lenders recognize losses for all or part of loans that are not reasonably assured of repayment, notably it also expressly states that an undercollateralized mortgage loan will not be adversely classified solely because the value of the real estate has declined to less than the loan balance—as long as the borrower has the ability to repay the restructured debt on reasonable terms. As a result, lenders now have new breathing room and may be permitted to retain billions of dollars of undersecured commercial real estate loans without having to write down these assets. The investors who have been waiting on the sidelines thinking that this recession might present a new opportunity to pluck out investments for pennies on the dollar and reap the type of bonanzas they saw during the RTC days will have to keep waiting.

[1] The Policy Statement was issued on behalf of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Financial Institutions Examination Council State Liaison Committee.

The Council's statement may be found at: http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf. The purpose of the Policy Statement is to instruct the examiners working for the various financial regulators on how loan workouts should be classified on the balance sheets of the institutions. The Policy Statement provides numerous examples of how the drafters of the Policy Statement believe those loans should be classified.

The Policy Statement applies to federally regulated financial institutions such as banks and savings and loans institutions and to loans held for investment by those institutions. It does not expressly provide guidance to servicers and special servicers of loans in pools supporting commercial mortgage backed securities. In those instances, the servicer's and the special servicer's actions are governed first and foremost by the terms and conditions of applicable pooling and servicing agreements and by the tax limitations generally applicable to Real Estate Mortgage Investment Conduits ("REMICs") (recent modifications to some of these limitations that bear on commercial mortgage loan workouts were discussed in our Distressed Real Estate and Tax Alert, "New REMIC Rules May Provide More Room to Modify Commercial Real Estate Loans," which can be viewed at: http://www.klgates.com/newsstand/Detail.aspx?publication=5953. However, given that nothing as clear and detailed as the Policy Statement has been issued in the past in any forum, that the guidance provided by the Policy Statement with respect to evaluating loan structures is of general applicability and is not specific to regulated banking institutions, and that pooling and servicing agreements typically do not provide the level of guidance to special servicers as that found in the Policy Statement[2], we believe that the principles of the Policy Statement will be adopted broadly and will find their way in some fashion into securitized structures.

Categorization of Loans

How loans are categorized directly affects how banks and savings and loans report income, recognize losses and must maintain reserves. These regulated lenders will be less inclined to approve loan workouts that require them to recognize losses or increase their reserves or those that result in such lenders not being able to recognize interest income.

The Policy Statement focuses on three aspects of the loan categorization system in connection with commercial real estate loan workouts. The basic classification system sorts loans based on the likelihood of full repayment. The highest classification is referred to as "Pass." A loan is classified as "Pass" if it is performing, and the bank does not perceive any specific potential weakness that might jeopardize its repayment. The next classification is "Special Mention." Loans that are classified as "Special Mention" are performing loans that have a recognized potential weakness that deserve close attention by the lender and that, if left uncorrected, could result in a risk of prepayment. The next level down is a "Substandard" loan, which means that the loan is not adequately collateralized, or the paying capacity of the borrower is considered inadequate. A substandard loan has some well-defined weakness that jeopardizes the repayment of the debt in full.

Below substandard loans are "Doubtful" loans. These are substandard loans where the identified weakness makes repayment in full highly questionable and improbable. Finally, the lowest category is a "Loss" classification. Loans classified as "Loss" are considered uncollectible.
When the Policy Statement refers to a loan having a "weakness," it means anything that increases the risk that the loan will not be repaid in full on time. A weakness could be a drop in the value of collateral, an adverse change in the financial condition of the borrower or the guarantor, market conditions that depress rents or sales activities, the bankruptcy of a large anchor tenant, a rise in rent payment delinquencies, the lack of refinancing options or combinations of any of these factors or others.

[2] A typical pooling and servicing agreement will not offer the servicer or special servicer as much guidance as the Policy Statement, but will contain restrictions on the servicer's or special servicer's ability to conduct certain workout activities, which may be circumscribed by, among other things, REMIC limitations, requirements for rating agency confirmations, and consent or purchase rights of holders of junior classes of certificates or subordinate or mezzanine debt interests. However, in all cases, servicers and special servicers are generally required to conduct their activities in accordance with a "Servicing Standard." That usually is defined by reference in some manner to a paradigm such as "the customary and usual standards of practice of prudent institutional commercial mortgage lenders servicing their own loans." The Policy Statement likely will provide a handy benchmark for what those "customary and usual standards" entail.

The second type of categorization conducted by bank management and regulators is whether the loan should be considered on "Accrual" or "Non-accrual" status. When a loan is on "Accrual" status, the interest accruing on that loan may be booked as income for the financial institution. If a loan is on "Non-accrual" status, the interest accruing on that loan is not recognized as part of the income of the financial institution.

The final type of categorization addressed in the Policy Statement deals with so-called "Troubled Debt Restructures" or "TDRs." A loan workout is considered to be a TDR if the borrower is experiencing financial difficulties and the terms of the workout provide a "concession" to the borrower. If a loan is classified as a TDR, then that loan must be assessed individually in accordance with appropriate accounting standards and will be deemed to be an impaired asset on the books of the lender, which will require the value of the loan to be reduced on the lender's books to then market value.

The Policy Statement is realistic in acknowledging that many restructurings will result in loans having an adverse classification (that is, anything below a "Pass") and provides that entering into a workout will not be criticized by the regulators so long as management of the financial institution enters into the workout:

- Pursuant to a "prudent workout policy" that establishes appropriate loan terms and amortization schedules and allows the institution to modify a particular loan workout if the first attempt does not result in sustained performance;
- Pursuant to a "prudent workout plan" for each loan that takes into account current financial information of the borrower and any guarantor and that supports the ultimate collection of principal and interest; the key components of a prudent workout plan would include:
    - review and analysis of an updated and comprehensive financial information regarding the borrower, the guarantor and the real estate collateral;
    - procurement and review of current valuations of the collateral, which may or may not require a new formal appraisal;
    - determination and analysis of an appropriate loan structure; and
    - preparation of appropriate legal documentation for any changes to the loan terms.
- After a thorough analysis of a borrower's and guarantor's entire debt service capacities, not just as to the particular loan in question (referred to as its "global" debt); and
- With the ability to monitor performance under the terms of the workout plan.

The most interesting aspect of the Policy Statement is a series of six different examples, each of which presents multiple alternative scenarios involving hypothetical loan restructures. These hypothetical restructures are then critiqued using the categories described above (e.g., pass, special mention, etc., accrual or non-accrual and whether the restructure is a TDR). While space does not permit an analysis of these examples, there are two principles worth pointing out:

Extensions Will Be Easier

The first principle relates to the loan's maturity date. In reviewing the Policy Statement, one sees that the regulators' primary focus is on the "ultimate repayment" of principal and interest, not necessarily on the "on time" repayment of principal and interest. Many loans held by banks and savings and loans are considered troubled not because of an existing payment default but because the maturity dates of these loans have come and gone without any refinancing available in the market (while the borrowers have continued to make their monthly payments of principal and interest timely, although the value of the real estate securing these loans might have fallen below the balloon payment amounts). A reasonable extension of such a loan's maturity date which does not alter the monthly payment amount should be a restructuring that, absent some other glaring weakness in the loan or the financial status of the borrower or guarantor, poses little or no regulatory concerns to the lenders.

The Policy Statement also contemplates more complicated scenarios with different outcomes.

Be Prepared to Create a Good Loan and a Bad Loan

The Policy Statement makes it clear that a lender can benefit by severing a single distressed loan into a "good" loan and a "bad" loan: one of which will receive a pass grade, stay on an accrual basis and not be considered a TDR, and the other of which will receive a grade of some level below pass, be treated as non-accrual and be considered a TDR. The bank will come out ahead in terms of regulatory results when compared to a workout that keeps the distressed loan on the bank's books as a single loan. If the loan remains evidenced by a single note secured by a single set of security documents, then the entire loan may be classified in one of the lower classifications, considered non-accrual or considered to be a TDR. A "good note/bad note" structure has the benefit of preserving at least a portion of the loan on the bank's books as a performing asset without any financial impairment.

It is not realistic for borrowers or lenders to believe that they will be able to create a restructured loan in all scenarios that will avoid adverse regulatory outcomes. There are many severely impaired commercial mortgage loans being carried today, and many inevitably will result in foreclosures and losses. However, many distressed loans held under the cloud of uncertainty that has hung over the commercial real estate finance sector for more than the last year now can be restructured in a way that will avoid or minimize losses to the lenders while allowing borrowers to retain control of their properties on reasonable terms. Lenders will be better motivated now to clean up their balance sheets by implementing a "prudent workout policy" within the parameters set forth in the Policy Statement. Likewise, from the borrowers' perspective, knowing the areas of concern for the financial regulators and working to minimize outcomes that would cause the lenders to come under scrutiny will make it easier for lending institutions to accept workout proposals. Borrowers need to understand the regulatory constraints that lenders are operating under and be prepared to deliver updated financial information and collateral values, to permit ongoing monitoring, and fundamentally to set their expectations of what might be achieved in a loan workout realistically.

The Policy Statement will likely have the effect of reducing the number of loans, particularly those with "hidden" value, that find their way onto the secondary market, and it may curtail the flood of distressed loans that investors have been hoping to see. The Policy Statement may not be the perfect instruction manual, but it's a good beginning to getting restructured deals assembled properly.