

You Can "Extend and Pretend," "Delay and Pray," or "Pay and Pray" and Not Get Criticized... Sort Of

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Regulated financial institutions should not now be criticized by bank examiners for working out commercial real estate loans, so long as they follow new and relaxed guidelines. On October 30, 2009, a collection of federal regulators issued an official policy statement setting forth "safe harbor" guidelines for financial institutions to follow to conduct prudent commercial real estate loan workouts to *"creditworthy borrowers who have the willingness and capacity to repay their debts"* and not *"inadvertently curtail the availability of credit to sound borrowers."* The policy statement includes a collection of workout deal "templates" or examples that pass muster and should not be criticized by examiners.

These so-called "prudent" loan workouts will not be subject to criticism even if the restructured loans have weaknesses that result in adverse credit reclassification; moreover, restructured loans to borrowers who can repay their debts according to reasonable modified terms will not be subject to an adverse loan reclassification solely because the value of the underlying property has declined to an amount that is less than the loan.

Part of the policy requirements is that the financial institution's risk management practices should be consistent with safe and sound lending practices and relevant reporting requirements. A financial institution must show that its risk management practice satisfy several criteria, including, a "management infrastructure to identify, control, and manage the volume and complexity of the workout activity."

Under the policy, the elements of a non-criticized loan workout arrangements are:

- A financial institution's prudent loan workout policy
- A well-conceived and prudent workout plan for an individual credit that includes:
 - Update and comprehensive financial information on the borrower, the real estate project, and any guarantor
 - Current valuations of the collateral
 - Analysis and determination of appropriate loan structure
 - Appropriate legal documentation for any changes to loan terms
- An analysis of the borrower's global debt service
- 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 ALLL (Allowance for Loan and Lease Losses) methodology that covers estimated credit losses

The policy statement states that prudent loan workouts are in the best interest of both financial institutions and borrowers. Aimed at the hundreds of billions of dollars worth of loans that are about to mature and cannot be refinanced, this policy may be viewed as helping financial institutions avoid large current losses. Critics, however, may say that the policy statement is just an approval by federal regulators of a common lender's practice known as "extending and pretending," where lenders extend the maturity of problem real estate with the hope that the borrower may be able to repay sometime in the future.

Despite the critic's view, the policy statement appears to be positive guidelines from federal regulators promoting restructuring of troubled commercial real estate loans in an effort to help financial institutions avoid current large losses. The concrete examples the policy statement provides of acceptable workout structures will help lenders and borrowers alike increase the likelihood of successfully consummating commercial loan workouts.

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