



Finance Legal Update

New Federal Guidance for Lenders Supports Workouts over Foreclosures

On October 30, 2009, the Board of Governors of the Federal Reserve System, together with the Federal Deposit Insurance Corporation, the National Credit Union Association, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, adopted a new Policy Statement on prudent commercial loans workouts. The Policy Statement was issued with the intent to promote prudent and realistic commercial real estate (CRE) loan workouts at regulated financial institutions. It reflects the Federal Reserve's recognition that workouts, as opposed to foreclosures or other enforcement actions, may be in the best interest of both borrowers and lenders based on the current state of the economy.

This new guidance replaces the previous Interagency Policy Statements issued in 1991 and 1993.

Purpose

The Policy Statement sets out new standards for evaluating business practices as related to risk management, workout arrangements, credit classification, and regulatory reporting. The intent is to promote supervisory consistency, enhance the transparency of workout transactions and, to the extent possible, limit the possibility that supervisory policies lessen the availability of credit to stable borrowers.

Scope of the Policy

The policy applies to loans secured by properties classified as CRE under SR Letter 07-1, Interagency Guidance on Concentration in Commercial Real Estate Lending, Sound Risk Management Practices. These loans include loans secured by multifamily properties; nonfarm nonresidential properties, with the primary source of repayment derived from the property's rental revenue, or from the sale, refinancing, or permanent financing of the property; loans for land development; all construction loans and loans to real estate investment trusts (REIT); and unsecured loans to developers.

Key Points of the New Policy

The new Policy Statement is designed to ease the tension felt by financial intuitions to reconcile the need to continue to make loans with the need to meet regulatory underwriting standards.

In that connection the following applies:

- Performing loans, including renewed and restructured loans, to creditworthy borrowers will not be adversely classified based solely on a decline in the value of the underlying collateral.
- Financial institutions will not be subject to criticism when a restructured loan is classified as "adverse," provided that the process used to analyze the restructured loan was based on sound business practices and a proper analysis of the totality of the circumstances of the individual borrower, its guarantors, and the current market.

Risk Management Elements for Loan Workout Programs

A financial institution must have risk management practices for renewing and restructuring CRE loans that are consistent with sound lending practices and relevant regulatory reporting requirements. A risk management plan should address these elements:

- Appropriate management infrastructure to identify, control, and manage the volume and complexity of the workout activity
- Proper documentation standards to verify borrowers' finances and evaluate the value of proposed collateral
- Sound collateral administration procedures
- The sufficiency of the institutions' information system to identify, control and track risk
- Compliance with GAAP and other regulatory requirements
- Effective loan collection procedures and policy

Loan Workout Arrangements

The objective of a loan workout (i.e., the renewing or restructuring of a loan) should be to improve the lender's prospects for collection of principal and interest in a manner consistent with sound banking, supervisory, and accounting practices.

The Policy Statement specifically provides that renewed or restructured loans to borrowers who have the ability to repay their debts under 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. Further, institutions that enter into restructures with borrowers that result in an adverse classification will not be criticized for engaging in loan workout arrangements as long as management had a prudent workout policy that allowed for individualized workout plans based on the circumstances of a particular borrower.

The Policy Statement provides that a workout plan should include the following:

- Updated and comprehensive financial information on the borrower and any guarantor
- Current valuations of the collateral supporting the workout plan
- An analysis and determination of the appropriate loan structure
- Appropriate legal documentation for any changes to loan terms
- An allowance for loan and lease loss (ALLL) that comports with GAAP and recognizes losses in a timely manner

Adverse Classification

The Policy Statement also addresses situations w a performing loan will be classified as adverse.

For example, constructions loans with an "interest reserve" are technically contractually current even w the borrower has made no payment because the payments are made from the interest reserve. In such a case, an adverse classification by the examiner would be appropriate if the borrower's current financial status raises doubts about the borrower's ability to repay the loan upon maturity.

When a troubled CRE loan is dependent on the sale of the collateral for repayment, general classification principles dictate that any loan amounts over the market value of the collateral be classified as a loss. This policy applies w t are no alternative reliable sources of repayment other than the collateral. The portion of the loan secured by the value of the collateral should be classified as no worse than "substandard." If the anticipated loss is unknown, the entire loan can receive a classification of "doubtful."

While the substandard classification applies to restructured loans with a partial charge-off, a more severe classification is appropriate only w the loss exposure cannot be reasonably determined, such as w the borrower is in bankruptcy or the collateral is subject to environmental hazards.

Regulatory Reporting and Accounting Considerations

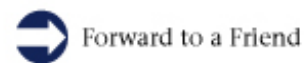
Institutions are responsible for complying with regulatory requirements and preparing reports in accordance with GAAP. Decisions regarding loan workouts may affect the regulatory requirements, especially as related to interest accruals and troubled debt restructuring (TDR).

All restructured loans should be evaluated to determine whether the loan should be reported as a TDR. A loan should be reported as a TDR when the institution, for economic or legal reasons, related to the borrower's financial difficulties, grants a concession to the borrower that the lender would not otherwise consider. Significantly, an overall decline in the economy and a partial deterioration of the borrower's financial condition does not give rise the assumption that the borrower is experiencing financial difficulties.

For more information on this Finance Law Update, we invite you to reach out to your personal contact at Robinson & Cole, Norman H. Roos at nroos@rc.com or James R. Kinyon at jkinyon@rc.com.

If you have any questions about the Policy Statement or about commercial real estate loan workouts, please do not hesitate to contact any member of [Robinson & Cole's Business Finance Group](#).

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