



November 3, 2009



CRE Workout Guidance – Pray and Delay No Longer Works

Author: [Harold P. Reichwald](#)

For the last several months the markets have been anticipating a wave of defaults by commercial real estate borrowers and the likely effect those defaults would have on bank balance sheets and on commercial mortgage-backed securities. With this expected wave in mind, lenders have been engaged in various attempts to work with borrowers in an effort to ameliorate the adverse effect of having to carry these loans as criticized or non-performing loans. Some observers caustically have called this a “pray and delay” strategy, while more charitable commentators refer to this as merely an “amend and extend” program.

Whatever name is applied, the federal banking regulators have seen fit to issue a Policy Statement on Prudent Commercial Real Estate Loan Workouts. However benign the title appears to be, the Policy Statement really is a warning to lenders that bank examiners will be closely examining CRE workout and restructuring arrangements to see if they truly meet supervisory expectations for prudence and realism.

In summary, the CRE Guidance requires that a lender carefully and meticulously document several elements in order that the bank examiners can pass the workout arrangement without further regulatory criticism. First and foremost, the workout arrangement must improve the lender’s prospects for the repayment of principal and interest consistent with safe and sound practices and accounting practices. In other words, merely restructuring the loan without more analysis will not pass muster.

Furthermore, the workout plan must demonstrate that the borrower has ability to repay the loan after restructuring. This calls for an analysis of not only the borrower’s capacity to pay but also its willingness to pay as exemplified by the borrower’s payment record with respect to the loan in question and its other outstanding loans. This analysis must

Newsletter Editors

[Katerina Hertzog Bohannon](#)
Partner
kbohannon@manatt.com
650.812.1364

[Harold P. Reichwald](#)
Partner
hreichwald@manatt.com
310.312.4148

Our Practice

Manatt was founded with a special emphasis on advising banking and financial services clients. Today we are one of the leading banking law firms in the United States, representing numerous banks, holding companies, foreign banks, savings institutions, mortgage lenders, finance lenders, credit card issuers, acquirers and processors and industrial loan companies ... [more](#)

[Practice Group Overview](#)
[Practice Group Members](#)

Info & Resources

[Subscribe](#)
[Unsubscribe](#)
[Newsletter Disclaimer](#)
[Manatt.com](#)

take into account the borrower's global debt, not only the outstanding debt on the loan in question, overall financial condition, market conditions and the realistic cash flow potential of the collateral or the underlying business enterprise.

If the loan being restructured is supported by a guarantee, the analysis must show the extent of the guarantor's financial ability and economic incentive to pay, taking into account the guarantee's financial adequacy in relation to the loan and the guarantor's capacity and willingness to honor the guaranty. The guarantor's other commitments must be documented so as to present a global picture of the creditworthiness of the guaranty. Outstanding questions about the enforceability of the guaranty must be adequately resolved.

Adequate collateral is a secondary source of repayment for almost all CRE loans. Thus, any workout program has to be documented with a clear assessment of the value of the collateral. The CRE Guidance makes it clear that the examiners will be looking closely at appraisals to determine if the assumptions and analysis adequately take into account the state of the project supported by the loan and its performance, geographic considerations and market conditions, variances from the original project assumptions and any loss of significant repayment support such as a take-out commitment, lease arrangement or pre-sales. Ordinarily, this collateral assessment would be accomplished by a new or updated appraisal unless the lender feels comfortable that its own internal evaluations accurately reflect market and project conditions. In any event, examiners will be seeking whether the assessment accurately indicates the collateral's "as is" condition taking into account the property's highest and best use.

The CRE Guidance also sets out the standards that examiners will be using in determining whether a restructured loan should be adversely classified. If the restructuring is accomplished in a prudent manner that is reflected by sound worth and debt service capacity of the parties and the collateral, the mere fact of the restructuring should not lead to criticism or adverse classification. However, if the analysis presented is insufficient to meet the standards set forth in the CRE Guidance, examiners are likely to be critical.

It is interesting to note that the CRE Guidance makes it clear that just because a borrower is contractually current may not be sufficient for the loan to escape examiner criticism. This could occur if there are embedded and well-defined risks inherent in the loan performance or in the collateral that are being masked by the borrower being current, such as if interest payments are coming out of an interest reserve.

Finally, the CRE Guidance addresses regulatory reporting and accounting considerations, including when a loan can be removed from non-accrual status, and the effect of a restructuring on the lender's allowance for loan and lease losses. The CRE Guidance concludes with a series of CRE loan workout arrangements that lenders would do well to examine carefully in determining how best to approach a CRE restructuring.

In testimony before a Congressional committee after the CRE Guidance was released, a senior official of the Federal Reserve Board made it clear that bank supervisors have a

view that lenders may not have been realistic in assessing loss potential in their CRE portfolios. He urged portfolio-level stress testing, improved management systems to capture adverse trends and loan performance and more robust appraisal practices. These concerns are likely to find their way into the examination of lenders and their CRE portfolios in the near future.

The CRE Guidance purports to be a guide for bank examiners. Banks should expect that these subjects will be raised in examinations. Therefore, it will be important not only to follow the policies articulated in the CRE Guidance but also to retain records that will demonstrate this, when a loan file is reviewed against these standards.

Click [here](#) to read more about this issue.

[back to top](#)

For additional information on this issue, contact:



[Harold P. Reichwald](#) Mr. Reichwald is a highly experienced banking and finance attorney whose career encompasses domestic and international matters for banks and specialty finance institutions. His experience comprises a broad range of matters including: governance matters, sophisticated financial transactions such as asset securitization, LBOs, project finance, corporate lending and restructuring; representation of a variety of domestic and foreign financial institutions before the FDIC, Comptroller of the Currency, the Federal Reserve Board and other bank regulatory agencies in connection with new product development, chartering new banks and branches, issues arising out of the bank examination process and enforcement actions demanded by regulatory authorities.

ATTORNEY ADVERTISING pursuant to New York DR 2-101(f)

Albany | Los Angeles | New York | Orange County | Palo Alto | Sacramento | San Francisco | Washington, D.C.

© 2009 Manatt, Phelps & Phillips, LLP. All rights reserved.