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November 2009

Real Estate & Environmental Bulletin

FEDERAL BANKING REGULATORS ISSUE COMMERCIAL REAL ESTATE GUIDELINES

Overview

On Friday, October 30, 2009, Federal banking regulators, including the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve, and the Office of the Comptroller of the Currency, issued a Policy Statement on Prudent Commercial Real Estate Loan Workouts (the "Guidelines"), intended to provide guidance to bank examiners and to financial institutions working with commercial real estate borrowers who are "experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties."

The Guidelines provide that restructured loans to borrowers who have the ability to repay the outstanding debt 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." For example, if a developer owns a shopping center that is performing well enough to service the mortgage debt, but which has recently been reappraised or otherwise revalued to an amount below the outstanding loan amount, then the lender is encouraged to work with the developer to adjust the loan in a reasonable way to promote the ultimate success of the project rather than simply classifying the loan as a "non-performing" asset.

The impetus behind the release of the Guidelines is the amount of commercial real estate debt currently "underwater," a term used to describe a scenario where the loan amount exceeds the value of the property securing the loan. Matthew Anderson, a partner at Foresight Analytics, estimates that about $520 Billion Dollars of commercial real estate debt that will come due between now and 2014 is currently underwater. The policy and guidance set forth in the Guidelines may serve to stabilize about $130 Billion Dollars of those loans by allowing lenders greater flexibility to workout troubled loans, provided that the workout is done prudently. The Guidelines should provide clearer guidance to lending institutions as to parameters for negotiating loan workouts.

Guidelines

The Guidelines allow lending institutions to restructure debt, even if the restructuring results in an adverse classification of the subject loan, provided that the lending institution has or implements the following:

1. "A prudent work-out policy that establishes appropriate loan terms and amortization schedules and that permits the institution to modify the work-out plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize."

2. "A well conceived and prudent work-out plan for individual credit that analyzes the current financial information of the borrower or guarantor and that supports the ultimate collection of principal and interest."

3. "An analysis of the borrower's global debt service that reflects a realistic projection of the borrower's and guarantor's expenses."

4. "The ability to monitor the ongoing performance of the borrower and guarantor under the terms of the work-out."

5. "An internal loan grading system that accurately and consistently reflects the risk and the work-out arrangement."

6. "An ALLL methodology that covers estimated credit losses in the restructured loan, measured in accordance with GAAP, and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate."

For the full version of the Guidelines, please visit http://www.fdic.gov/news/news/press/2009/pr09194.html. The bottom of the web page contains a link to a full PDF version of the Guidelines.

Effect on the Commercial Real Estate Market

The Guidelines should provide some assistance to a commercial real estate industry grappling with the effects of a severe recession, limited access to financing and erosion of property values. Under the Guidelines, lending institutions may have greater flexibility to implement workout strategies that will allow a borrower to retain ownership of its property and repay the mortgage debt, although under terms that are different than those of the original loan. Instead of being forced to classify a troubled mortgage loan as a "non-performing asset," the lender can evaluate that loan to determine whether there is a realistic possibly of "saving" the loan through some prudent restructuring or loan modification. The hope is that encouraging successful workouts will help stabilize the commercial real estate market by reducing the number of distressed commercial properties flooding the market, as well as reducing the number of foreclosures and real estate-related bankruptcies.

However, there is also opposition to the Guidelines. Some believe that lending institutions will use them to avoid writing off bad mortgages and making new loans, thus further delaying the national economic recovery. Others add that the Guidelines will allow borrowers to retain troubled assets that should otherwise be sold at a discount on the open market today, thus inhibiting the potential acquisition of properties across the country by distressed debt purchasers.

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