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Banks Get Guidance on Commercial Mortgage Workouts

Federal regulators say financial institutions can extend or modify loans without automatic downgrade from examiners

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Borrowers and lenders may cheer new guidelines for commercial mortgage workouts, but the boos heard in the background is from investors who hoped to buy troubled loans.

The Federal Reserve System and other regulators adopted a policy statement on Oct. 30 supporting prudent commercial real estate loan workouts, providing some assurance that bank examiners will not adversely classify mortgages for which financial institutions agree to extend or amend loan terms.

Opportunistic investors see the guidance as reinforcing banks' decisions to "extend and pretend" - extending or revising loan terms in anticipation that the real estate market will improve before the borrower can default. Modifying those loans could prevent the process of foreclosing on assets and selling them at discounts to investors that have set aside funds to buy distressed loans.

The policy statement adopted by the Federal Reserve, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision and the Federal Financial Institutions Examination Council's State Liaison Committee provides guidance for financial institutions working with borrowers experiencing diminished cash flows, depreciated collateral values or delays in selling or renting commercial properties.

Loan workouts can take many forms, including renewals or extensions of current loan terms, extension of additional credit or restructured terms with or without new concessions on the part of the borrower.

No matter the solution, the strategy should increase the lender's prospects for repayment after the financial institution has analyzed the borrower's repayment capacity, evaluated the support provided by guarantors and assessed the value of the collateral.

Modified loans will not be subject to adverse classifications by bank examiners just because the value of the collateral has declined or because the underlying property's value is lower than the amount of money owed on the loan.

The new guidance does not mandate a particular type of valuation method for determining the value of any borrower's collateral. The discount rate and net present value approach is acceptable, as well as determinations of capitalization rates and value at stabilization of the real estate asset, though banks must be able to justify their valuation methods for each property to bank examiners.

Jon D. Greenlee, associate director of the Division of Banking Supervision and Regulation at the Federal Reserve, said in testimony before the House Subcommittee on Domestic Policy on Nov. 2 that banks have raised concerns that examiners do not always take a balanced approach to assessing commercial mortgage restructurings. Greenlee also noted that examiners have observed that some banks are slow to acknowledge declines in cash flows and collateral values in their assessments of potential loan repayment.

"The [commercial real estate] guidance reiterates that classification of a loan should not be based solely on a decline in collateral value, in the absence of other adverse factors, and that loan restructurings are often in the best interest of both the financial institution and the borrower," Greenlee said. "The expectation is that banks should restructure [commercial real estate] loans in a prudent manner, recognizing the associated credit risk, and not simply renew a loan in an effort to delay loss recognition."

Work It Out

Regulators wanted to provide a means for salvaging loans that could be worked out with minimal risk to financial institutions in anticipation that commercial mortgage defaults will continue to rise.

Oakland-based **Foresight Analytics** projected last month that delinquency rates for construction lending would rise from 16.3 percent in the second quarter to 18.2 percent in the third quarter, with residential construction loans leading the delinquencies and commercial and multifamily construction loans helping to drive the numbers higher.

Foresight Analytics estimated that the commercial mortgage delinquency rate, excluding construction loans, was estimated to hit 4.7 percent for the third quarter, up from 4.1 percent in the second quarter and more than double the 2.1 percent figure from third-quarter 2008.

"If the examiners follow this, which they should, then Christmas, Hanukkah, Kwanzaa or whatever you celebrate came early," said Jess Bressi, partner in the Irvine office of law firm **Luce Forward**.

The policy statement was anticipated, but the fact that the guidelines for commercial mortgage workouts are user-friendly and specific was unexpected.

Bressi said it will help banks that are trying to protect their balance sheets, but it will make it more difficult for banks that are trying to acquire other banks while determining the true value of the assets on their books.

"If the process is price discovery in the marketplace on what these loans are really worth, then this slows price discovery," he said. "This will regrettably continue the process of 'amend and pretend,' 'extend and pretend' or 'pay and pray.'"

The reaction to the policy statement from Bressi's clients has been mixed. On one hand, investors who were hoping to buy distressed loans from banks fear that these new guidelines for working out commercial mortgages will slow the process of banks foreclosing and selling assets. On the other hand, borrowers or banks in the midst of restructuring loans are happy to have the guidance that they've been waiting for.

Steve Orchard, senior vice president at Los Angeles-based **George Smith Partners**, said the policy statement on commercial mortgage workouts should provide clarity to banks as they consider restructuring loans.

"The document talks about using your discretion and judgment and regulators reserving the right to disagree as to whether you're using your good sense," Orchard said. "The document doesn't call for a house cleaning. It's almost a 'don't ask, don't tell' policy. It's a blessing for the pretend-and-extend stance the banks have taken."

No More Denying Declining Values

Orchard said the capital markets and the economy should benefit from rules for working out commercial real estate loans, but it's disastrous for investors that acquired, financed and sold properties responsibly so that they could build up capital to buy distressed assets from banks at a discount when the market and property values declined.

However, Orchard said there have been some indications that regulators are forcing financial institutions to clear up their balance sheets as 2009 draws to a close, that banks plan to increase foreclosures by up to

four times current levels and that lenders are becoming more willing to negotiate with investors willing to buy distressed assets.

While Gregg Loubier, partner in the Los Angeles office of **Allen Matkins Leck Gamble Mallory & Natsis LLP**, acknowledged concerns that financial institutions are denying the decreased values of assets on their balance sheets, he countered that lenders are not necessarily in denial but said they have problems that take time to flesh out and can't be fixed in an ideal way.

The ability to put a value on properties in a declining market has stymied banks' attempts to work out loans. Lenders are being criticized for using prospective values or pro forma estimates to underwrite loans when the commercial real estate market was booming.

"This guidance says if you're going to improve the loan, restructure the debt so it performs at a certain level as it improves, then that's OK to look at the stabilized value," Loubier said. "That's an important statement as well. I have a project that's on its fifth appraisal this year. We're looking at how to get value out of it for everyone."

While there was a structure - the Resolution Trust Corp. - to move assets off bank balance sheets and sell them in the real estate market at new values in the 1990s, he said the strategy this time around seems to be focused on working loans out so that the mortgages can realize as much value as possible for both borrowers and lenders.

There is a focus in the federal regulators' policy statement on borrowers who have demonstrated a willingness to continue to pay their debts and whose loans may be current but are maturing without a source of refinancing.

"There are many of those loans out there where an extension could solve the largest problem, which is this refinance risk that is looming and the borrower is otherwise able to pay under similar or new loan terms," Loubier said.

Breaking the Bank Logjam

Andrew Raines, founder of **Raines Law Group LLP** in Beverly Hills, said the market was waiting for a while for federal regulators to issue some guidance on restructuring commercial mortgages.

"I think that it will break the logjam and allow banks to function more like banks to either extend loans that are coming due or recognize the fact that the value of the assets has declined but the borrower is creditworthy," Raines said.

Raines said the new guidance should give some breathing room to community banks that tried to compete with larger banks by lending in the commercial real estate arena, but the workouts will only pay off for those smaller institutions if the market cooperates and properties improve so that borrowers can pay down their debts.

Lenders are likely to come up with their own criteria for working out loans that also will require borrowers to pay down some of their debt or put up a guaranty where there wasn't one before. If that is the case, not all borrowers will be able to work out their loans because they won't have the capital to put more equity into their assets or they won't have the credit needed to supply a guaranty.

Bob Baradaran, chair of the real estate group at **Greenberg Glusker Fields Claman & Machtinger LLP** and partner in the firm's Los Angeles office, said the new guidance from federal bank regulators will be most helpful for borrowers with short-term or bridge loans, construction loans or other loans placed in the last two or three years that are maturing between 2009 and 2011.

"These loans were meant to be relatively short," Baradaran said. "Everybody assumed financing, mostly [commercial mortgage-backed securities], would be available before these loans matured."

The recent policy statement has the potential to delay the foreclosure and sale of assets, but he said that could work out for banks and the economy if financial institutions are healthier in two or three years when the restructured loans mature.

"If the economy is doing great and the only sector that's not is commercial real estate, then it will be a storm we can all weather and it won't drag down the rest of the economy," Baradaran said.

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