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WORKOUTS FOR ACQUIRED COMMERCIAL REAL ESTATE SHARED-LOSS LOANS

Summary: The FDIC recognizes that prudent workouts for acquired commercial real estate (CRE) loans generally are in the best interest of financial institutions and creditworthy borrowers. Further, Commercial Shared-Loss Agreements (CSLAs) require Assuming Institutions (AIs) to exercise their best business judgment to manage and administer Shared-Loss Assets, and maximize recoveries and collections in doing so. This process may be facilitated by engaging in prudent workouts for covered CRE loans that are performing, but do not meet all of the AI's current underwriting and credit guidelines. The CSLA requires AIs to engage in prudent workouts and extensions of covered CRE loans that maximize the recovery on the debt regardless of the expiration of shared-loss coverage.

Distribution:

Assuming Institutions
RSAM Specialists and Managers
Oversight Managers
Compliance Monitoring Contractors

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Related Topics:

- *FDIC 12 CFR part 323 and 365; OCC 12 CFR part 34*
- *Interagency Policy Statement on Prudent Commercial Real Estate Workouts (October 2009)*
- *Interagency Statement on Meeting the Needs of Creditworthy Borrowers (February 2010)*
- *Interagency Appraisal and Evaluation Guidelines (December 2010)*
- *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (December 2010)*
- *OCC Bank Accounting Advisory Series, (June 2012)*
- *ASC Topic 310-10, Receivables, and ASC Topic 310-40, and*
- *Call Report FFIEC 031 and 041, Glossary*

Highlights:

- CSLAs require AIs to apply prudent business and banking practices, adhere to examination criteria, and maximize recoveries. Prudent workouts for covered CRE loans are often in the best interest of the AI and creditworthy borrowers, and are permissible under the terms of the CSLAs.
- AIs should consider prudent workouts for covered CRE loans after analyzing the borrower's repayment capacity, evaluating the support provided by guarantors, and assessing the value of the collateral pledged on the debt. When considered, workouts for covered CRE loans should be designed to maximize the recovery potential on the debt.
- The required resolution of loss-share assets is the course of action that provides the AI and FDIC with the highest net present value (NPV) return on shared-loss CRE loans, notwithstanding the expiration of the shared-loss coverage. Analyzing the NPV of all viable disposition alternatives provides the economic justification for selecting between these alternatives, including the decision whether or not to enter into a workout.
- Workouts can extend the term of a Shared-Loss Loan Commitment or Shared-Loss Loan beyond the end of the final Shared-Loss Quarter. Any such extension does not extend shared-loss coverage beyond the final Shared-Loss Quarter.
- AIs should adequately document and support the facts and circumstances analyzed for each workout or extension, and the selection of the workout chosen as the best course of action to maximize the recovery on the loan.
- An increase in the default rate of covered CRE loans, especially those without a prudent workout, could result in increased scrutiny, including targeted reviews and denial of covered claims submitted for reimbursement if resolution strategies do not maximize recoveries.

WORKOUTS FOR COVERED COMMERCIAL REAL ESTATE SHARED-LOSS LOANS

PURPOSE

To promote Assuming Institutions' (AIs) consideration and use of prudent workouts for covered commercial real estate (CRE) Shared-Loss Loans as an alternative to foreclosure, and clarify that AIs are required by the Commercial Shared-Loss Agreement (CSLA) to select the disposition strategy that provides the AI and FDIC the highest NPV return.

STATEMENT

The FDIC recognizes that AIs face significant challenges when working with CRE borrowers that are experiencing diminished cash flows, declining collateral values, and/or prolonged sales and rental absorption periods. In spite of these conditions, many CRE borrowers are creditworthy customers who have the willingness and capacity to repay their debts.

The CSLA provides loss sharing coverage¹ to specified CRE loans and permits AIs to amend, modify, renew/extend, and waive terms/rights/remedies on Shared-Loss Loans.

Article 3.2 requires AIs to exercise their best business judgment in managing and administering Shared-Loss Assets, and to use their best efforts in maximizing collections. The CSLA further allows for the reimbursement of losses (such as "Charge-Offs") incurred by AIs when CRE loan modifications (referenced as CRE loan workouts throughout this document) are classified as loss by the AI's primary regulator (i.e., "Chartering Authority") or by the AI itself according to Examination Criteria.

CSLAs prior to November 1, 2011 did not allow an AI to extend the maturity of the debt beyond the end of the final Shared-Loss Quarter. The FDIC eliminated this restriction in CSLAs after November 1, 2011, to encourage sustainable loan restructurings and made this provision retroactive to older agreements effective as of December 14, 2011. AIs can engage in CRE loan workouts that extend the term of a Shared-Loss Loan Commitment or Shared-Loss Loan beyond the end of the final Shared-Loss Quarter. Any extension of loan terms does not extend shared-loss coverage beyond the final Shared-Loss Quarter.

CRE Loan Workouts as an Alternative to Foreclosure

Financial regulators² recognize that prudent CRE loan workouts are often in the best interest of financial institutions and creditworthy borrowers, and have instructed examiners that renewed or

¹ See Exhibit 4.15B, with references to the terms of coverage in Article 2 ("Permitted Amendments") and Article 3 (Duties of the Acquiring Institutions).

This information is provided for general guidance and clarity on the matters contained therein. The information is not intended to modify, or otherwise supplant, any provisions or definitions contained within the applicable Shared-Loss Agreements. The Assuming Institution is strongly encouraged to seek appropriate legal counsel for a comprehensive analysis and understanding of the matters contained within Shared-Loss Agreements.

restructured loans to such borrowers under reasonable modified terms should not be subject to adverse classification.^{3,4} The FDIC has a direct interest in prudent workouts that maximize recoveries through its shared-loss provisions in CSLAs, and the CSLA requires an AI to consider the feasibility of prudent CRE loan workouts before taking legal action or filing a foreclosure.

When considering a CRE loan workout, AIs should analyze the borrower's repayment capacity, evaluate the support provided by guarantors, and assess the value of the collateral pledged on the debt per legal⁵ and AI policy requirements. CRE loan workouts can take many forms, and should improve the prospects for repayment of principal and interest. Prudent workouts could include, but are not limited to, a reduction in accrued interest, interest rate adjustments, changes in repayment amounts, changes in maturity date, releases of collateral, additions or amendments to a guarantee, or other adjustments that are consistent with the borrower's ability to service the debt and maximize the recovery potential on the loan. Prudent CRE loan workouts to borrowers who have the ability to repay their debt under reasonably modified terms generally will not be subject to adverse classification solely because the underlying collateral has declined to an amount less than the CRE loan balance.

AIs are required to consider CRE loan workouts and extensions where practical as a least loss alternative to foreclosure without regard to the expiration of shared-loss coverage. Compliance monitoring teams will sample loan workouts and extensions. An increase in the default rate of covered CRE loans, especially those without a prudent workout arrangement, as loss-share coverage nears expiration may result in targeted reviews and denial of covered claims submitted for reimbursement if resolution strategies do not maximize recoveries.

Selecting the Disposition Strategy Providing the Highest NPV

When a borrower is unable to meet the terms of the original note, a creditor (such as an AI) has available a number of courses of action: loan workout, short-sale, deed-in-lieu, foreclosure, and litigation. The required resolution of Shared-Loss Assets is the course of action that provides the AI and FDIC the highest NPV return.

Analyzing the NPV of all viable disposition alternatives provides the economic justification for selecting between these alternatives, including the decision to enter into a CRE loan workout. CRE loan workouts with a NPV equal to or greater than other recovery alternatives are the

² The financial regulators consist of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee (collectively, the regulators).

³ See the regulators' Policy Statement on Prudent Commercial Real Estate Loan Workouts (FIL-61-2009) at <http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf>.

⁴ See the Interagency Statement on Meeting the Needs of Creditworthy Small Business Borrowers (FIL-5-2010) issued by the federal financial institutions regulatory agencies and the state supervisors (represented through the Conference of State Supervisors).

⁵ See OCC: 12 CFR part 34, FDIC: 12 CFR part 323 and 365, and Interagency Appraisal and Evaluation Guidelines

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required resolution, as such a course of action provides the AI and FDIC the maximum recovery potential while creating the least amount of hardship to borrowers and their communities.

As previously cited, CRE loan workouts are among the disposition alternatives allowed in the CSLA. The CSLA allows for the reimbursement of losses incurred by AIs when the workouts are classified by the AI's primary regulator or by the AI itself based on Examination Criteria. Accordingly, covered losses will be reimbursed under the CSLA providing:

- (a) the underlying workout arrangement:
 - is taken in good faith and compliance with the CSLA
 - is in accord with the existing credit policies of the AI
 - does not increase the principal amount of the debt
- (b) the loss has been calculated in accordance with regulatory guidance after proper consideration of the borrower's repayment capacity, support provided by guarantors, and assessing the value of the collateral pledged to the debt
- (c) the workout has a NPV equal to or greater than other recovery alternatives
- (d) adequate documentation is maintained by the AI to support:
 - selection of a CRE loan workout as the course of action that will best maximize the recovery on the CRE loan
 - the calculation of fair value loss.

References

Further information is available from:

- FDIC [12 CFR part 323](#) and [365](#); OCC [12 CFR part 34](#)
- *Interagency Policy Statement on Prudent Commercial Real Estate Workouts* (October 2009)
 - <http://www.fdic.gov/news/news/financial/2009/fil09061.html>
 - <http://www.occ.gov/news-issuances/bulletins/2009/bulletin-2009-128a.pdf>
- *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* (February 2010)
 - <http://www.fdic.gov/news/news/financial/2010/fil10005.html>
 - [OCC: Interagency Statement on Meeting the Needs of Creditworthy Borrowers](#)
- *Interagency Appraisal and Evaluation Guidelines* (December 2010)

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- *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (December 2010);
- *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (December 2006)
- *Frequently Asked Questions on Residential Tract Development Lending and FAQs on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions* (September 8, 2005). FDIC: FIL-20-2005: Frequently Asked Questions;
- *OCC Bank Accounting Advisory Series*, (June 2012)
- *ASC Topic 310-10, Receivables, ASC Topic 310-40, Receivables – Troubled Debt Restructuring by Creditors, and ASC 825-10, Fair Value Measurements and Disclosures*
- *Call Report FFIEC 031 and 041, Glossary*

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