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Bank Regulators Just Might Make Loan Workouts A Little Easier

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Maybe loan workouts will be a little easier. GETTY

Federally regulated lenders, such as banks, still play a major role in commercial real estate financing. As commercial real estate encounters headwinds, borrowers will often need relief from those

lenders, but regulated lenders typically cower in fear about doing anything that might cause regulators to raise their eyebrows or ask difficult questions. This mentality often leads regulated lenders to behave with a level of flexibility, creativity, cooperation, and speed reminiscent of the Internal Revenue Service. Result: workout negotiations can become difficult or impossible. Sometimes a loan that might have been "saved" if given more time and TLC instead goes into default and foreclosure.

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The federal bank regulators may have tried a bit to change that dynamic when they recently issued a joint policy statement on commercial real estate loan accommodations and workouts. Whether anything has actually changed will, of course, remain to be seen.

The policy statement opens by recognizing "the importance of financial institutions working constructively with CRE borrowers who are experiencing financial difficulty." It refers to a policy statement issued in 2009, another time when commercial real estate also faced problems. Today's policy statement doesn't purport to revolutionize bank regulation, but it does reaffirm that lenders should exercise some flexibility and judgment in dealing with borrowers in trouble. It restates two general principles from the 2009 guidance:

(1) Financial institutions that implement prudent CRE loan accommodation and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans with weaknesses that result in adverse classification.

(2) Modified loans to borrowers who have the ability to repay their debts according to reasonable 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 outstanding loan balance.

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Those general principles sound pretty good, if regulated lenders dare to apply them. The regulators' guidance also encourages use of short-term measures to help borrowers through rough patches, rather than declaring those borrowers in default. Short-term or temporary accommodations "can mitigate long-term adverse effects on borrowers by allowing them to address the issues affecting repayment ability and are often in the best interest of financial institutions and their borrowers," according to the regulators.

As always, valuation matters. The regulators want lenders to think hard about value, but value might depend on context. For example, if a lender intends to work with its borrower so a project can achieve stabilized occupancy, then the lender can consider "as stabilized" market value in assessing the collateral – provided that the appraisal's assumptions and conclusions are reasonable. On the other hand, if the lender expects to foreclose, then it would need to consider in its analysis a lower "fair value" analysis of the collateral. As is so often true, "value" involves a judgment call rather than

something fixed, immutable, scientific, and objectively determinable. (Letitia James might disagree.)

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The regulators want to look past temporary "financial difficulties" associated with a borrower's industry, before a lender needs to classify a loan as nonperforming.

The regulators' stated principles do seem to give federally regulated commercial real estate lenders some room to "kick the can down the road." That strategy worked out rather well after 2009 and the Great Financial Crisis.

It may be different this time, though. In 2009, commercial real estate distress seemed driven by overall panic in the financial system. After a while, the panic faded. Then commercial real estate recovered and did just fine. In contrast, today's distress comes mostly from a huge increase in interest rates driven by inflation. No one expects rates to go down soon. Today's rates generally track historical rates as they existed for decades before the Great Financial Crisis ushered in a decade and a half of artificially cheap money. They may merely reflect a return to the norm. If so, rates seem less likely to go down and take the pressure off commercial real estate borrowers that need to refinance. Borrowers, lenders, and the regulators will eventually have to figure out how to deal with that. In the meantime, some breathing room can't hurt.

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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books

on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals.

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