



SUPERVISORY MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

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To: All Examining Personnel

From: Timothy W. Long, Senior Deputy Comptroller and Chief National Bank Examiner

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Subject: Examiner Guidance for Appropriate Restructure and Risk Rating of Problem Real Estate Loans

As a result of the sharp and prolonged downturn that has occurred in residential real estate markets across the country, many banks have residential lot development loans where the underlying project has significantly slowed or stalled. In other cases, banks have loans for unsold condominium (condo) and single family residential (SFR) projects where those projects are now being converted to rentals. In the vast majority of these situations, a bank will need to develop a sound workout program for these credits and, in many cases, continue to classify the loan. This memo provides internal guidance to examiners on factors they should consider when evaluating banks' workout programs and risk ratings for such loans.

Elements of an Effective Workout/Restructure Program

Loan workouts can take a number of forms including: simple renewal or extension of the loan terms; extension of additional credit; formal restructuring of the loan terms with or without concessions; and, foreclosure on underlying collateral. Banks have flexibility in choosing the alternative that will maximize the bank's recovery on each troubled loan. Accordingly, bank management should not be criticized for continuing to carry workout loans as long as they have

- A well-conceived and effective workout plan for the borrower;
- Effective internal controls to manage the level of such loans;
- Properly risk rated the loan; and,
- Properly considered the loans when determining the level of the ALLL.

Key elements of an effective workout plan include:

- Current valuations of the collateral supporting the loan and proposed workout plan;
- Updated and comprehensive financial information on the borrower/project and any guarantor that is being relied upon;
- Analysis and determination of appropriate curtailment or re-margining requirements, as well as loan tenors and amortization schedules for any loan restructure; and
- Appropriate legal documentation for any changes to loan terms.

Factors that examiners should consider in evaluating each of these elements are described below.

Collateral Valuation – A current valuation of the collateral supporting the workout plan is an essential element in determining the reasonableness of the plan and in assigning an accurate risk rating. Depending on legal (12 CFR 34) and bank policy requirements, the updated valuation that a bank uses may be either an appraisal or an evaluation. A bank generally will want this valuation estimate to consider not only the current value, but also the highest and best use of the property, as the workout plan will generally be based on the highest and best use determination, with the restructure terms set accordingly.

Banks should have policies that guide them to when an appraisal is required versus when alternative valuation methods may be used. Factors that would point to the need for a new appraisal include: significant large-dollar loans, loans secured by complex or specialized properties, nonresidential real estate construction loans, out-of-area real estate loans, or significant changes in the business or economic environment.

A bank's policies should also provide guidance on the appraisal methodologies to be used for various types of real estate projects. In the case of a land development loan where the project is complete (i.e., horizontal improvements such as roads, water, sewer, utilities, etc., have been installed), an appraisal using the subdivision (tract) development approach to value may be appropriate. In this case, the appraisal should include well-supported demand and absorption assumptions and appropriate deductions and discounts if the project is expected to sell out in more than 12 months. Where there is no market demand for completed lots, or if the project is undeveloped (i.e., still raw land), the preferred valuation methodology is typically the sales comparison approach for similar raw land parcels. For loans for condo and SFR that have been converted to rental properties, the properties should be appraised as rental units. Accordingly, this income property valuation needs to specifically include deductions to net operating income (NOI) for vacancy, management fees, leasing commissions, taxes, insurance, and general maintenance reserves.

The appropriate frequency for re-appraisals/evaluations is case-specific. Prudent guidelines might require (especially in cases where the property is still marketed for sale) obtaining annual updated valuations for the first couple of years. Then, if the borrower has performed and project equity continues to grow, updated valuations may be required less frequently or even become unnecessary.

Financial Information – For any loan that is being worked out or restructured, a bank should have comprehensive financial information on the borrower/project and any guarantor who is being relied upon as part of the workout strategy. Since most loans that require restructuring have underlying projects that are underperforming, financial and performance projections are vitally important. Lenders should stress these projections to determine the ability of the borrower, project, and guarantor to perform under various scenarios.

In most restructured loans, increased reliance will be placed on the guarantor for repayment. The bank's analysis of the guarantor's cash flow and liquidity needs to consider both actual and contingent liabilities. Further, an analysis of the guarantor's global cash flow should consider

inflows, as well as both required and discretionary cash outflows from all activities. This may involve integrating multiple partnership and corporate tax returns, business financial statements, K-1 schedules, and individual tax filings. The analysis needs to specifically focus on “recurring” cash flow, including projections of anticipated capital gains income when historical data reflects income to be capital-gain dependent. Anything short of a comprehensive global cash flow analysis diminishes confidence in the assessment of guarantor strength.

Global debt service analysis needs to include realistic projections of borrower/guarantor living expenses, including personal mortgage debt payments, real estate property taxes, state and federal income tax payments, other consumer debt payments and normal living expenses.

Curtailement/Re-Margin – A sound workout program will generally require as part of any loan restructure, a curtailment or re-margining of the loan to bring it within the bank’s LTV policies for the property in its present state (e.g., raw land, developed land, etc.). The preferred method for this re-margining is a cash payment, but additional collateral support via liens on other appraised and unencumbered property would also satisfy the requirements of a reasonable restructure. Typically, junior liens on encumbered property provide less tangible support, but could still have value when senior liens are relatively small compared to the equity being provided. A bank taking junior liens should not be criticized when no other cash or collateral support is available and the bank is taking the liens, after proper due diligence, to reduce its loss potential.

Loan Tenor and Maximum Amortization – A bank’s workout policies should provide guidance on appropriate tenors and amortization schedules for restructured loans. These may vary, depending on the nature of the underlying loan project and collateral. OCC policy does not dictate minimum loan tenors or maximum amortization schedules for restructured real estate loans. In both instances, we expect bank management to employ reasonable terms that provide an expectation that the borrower can perform, but at the same time protects the bank’s ability to take additional mitigating action should the borrower or underlying project continue to deteriorate. In this regard, banks should be encouraged to maintain short tenors on their restructured loans (e.g., annual) during the first few years of the workout when collateral values may not have stabilized, and sustained payment performance has not yet been demonstrated. Banks also should ensure that loan terms provide for the periodic re-appraisal/evaluation of the property and that re-margin requirements to a stated LTV be required in the event that collateral values continue to erode. Once property values stabilize or begin to rebound, longer-term renewals could be appropriate and re-valuation could be less frequent. In general, banks should avoid locking into multi-year restructures with no re-appraisal and re-margining rights during a time of unstable values. They should also avoid restructures that have extended “interest only” terms or balloon payments that could mask or obscure a borrower’s repayment capacity or the underlying performance of the project.

The amortization for restructured real estate loans should also be reasonable and reflective of the underlying risk of the project. Much of the determination of what is “reasonable” will depend on an evaluation of facts such as the anticipated absorption period of the individual project. For a SFR development loan where the project is slow but sales continue, and the guarantor has the

ability to supplement payment through annual re-margining of the credit, an amortization period of up to 10 years may be appropriate. Conversely, for higher risk projects to more volatile and less substantial borrowers, an amortization of 10 years may not be acceptable. For example, for a project that has completely stalled and has no guarantor who can reliably supplement principal payments, a 10- year amortization is too long. The workout plan for a loan like this should include repayment terms more similar to those for the purchase of raw land.

For condo and SFR properties that are converted to rentals, amortization periods of less than 20 years would be reasonable for most projects. Again, much of the determination of what is reasonable will depend on an evaluation of the facts of the individual project. Using similar examples to those above, more stable situations with less risk could support a longer amortization, but, in any case, not longer than 20 years. Some banks are restructuring these types of loans as “mortgage” loans in the developer’s name. Banks making such loans should have well-defined, board-approved policies for rental properties, and these loans should fit into those underwriting parameters.

Legal Documentation – Banks should be encouraged to use formal loan agreements to document the terms and conditions of any loan restructure. The loan agreement should spell out specific issues such as re-appraisal and re-margin rights, financial reporting requirements, recurring information on the property, and disposition of any property sale proceeds.

Banks should maintain current rent rolls on condo and SFR rental units and should also maintain copies of all leases disclosing full rental terms. If leases represent contracts for deed or lease purchase options, full lease terms and rental applications (including current credit reports) should be obtained on renters/end-buyers. Banks should be expected to recapture full sales proceeds from collateral until such time as adequate collateral margins are obtained.

Effects of Restructuring on Risk Rating Considerations – Consistent with OCC policy, credits with well-defined weaknesses in the primary source of repayment should be risk rated accordingly. For land development projects, material negative deviations from planned absorption generally represent a well-defined weakness that likely justifies at least a substandard classification. Examiner judgment is required to determine material negative deviations. “For Sale” condo units and SFR “spec” construction loans that have been actively marketed but gone unsold for more than six months also generally represent well-defined weaknesses that likely justify at least a substandard classification, especially where repayment is solely collateral-dependent.

In many of the cases described above, lenders have restructured the loans and are now relying on a different source of repayment than what was contemplated in the initial underwriting. Examiner judgment is required in these cases to properly evaluate this new source of repayment and to determine how much performance is required before the risk rating could be adjusted. The period of performance needed before a restructured loan becomes eligible for a pass rating depends on a variety of factors. Generally speaking, a loan with well defined weaknesses should be classified until the basis for criticism is eliminated. The only existing guidance regarding the length of time necessary to consider an upgrade is related to Troubled Debt Restructurings

(TDR). The TDR guidance indicates that six months of performance (for monthly pay loans) is generally expected before a change to the rating could be *considered*. In determining whether an upgrade to pass should be considered, bankers and examiners should evaluate the following two essential elements: (1) the source of borrower/guarantor funds providing repayment; and (2) the demonstrated recurring capacity of the borrower/guarantor to continue meeting the contractual terms.

While no bright lines can be drawn, and every loan will possess unique circumstances, slow or stalled residential lot development loans and loans for unsold condo and SFR properties that are being converted to rentals will generally need to demonstrate performance through a sufficient series of consecutive, uninterrupted payments before an upgrade to pass should be considered. Where monthly payments are required, a minimum of 6 to 12 months may provide a sufficient time horizon. When the payment schedule is less frequent than monthly, a longer time horizon will be needed. When making such assessments, bankers and examiners should also analyze the appropriate cash flow margins (or debt service coverage). Factors to consider include: reasonableness of debt service requirements, existing collateral margin (LTV), source and reliability of cash flow, and the bank's own underwriting criteria (if reasonable).

The following examples illustrate the importance of assessing these elements.

Example A

Consider the case of a residential development where lot sales did not materialize or have completely stalled. In this case, the bank was able to restructure the loan into a five-year fully amortizing term loan with quarterly P&I payments. The guarantor's liquidity and income sources are not reliant on the sale or rental of the pledged assets. In a case such as this, an upgrade to pass could be considered after four to six consecutive quarterly payments. Before upgrading such a loan, the bank (or examiner) would want to ensure that the market has not deteriorated further, current collateral valuations show solid equity levels, and the guarantor shows the capacity to continue servicing the payments.

Example B

Consider the same case presented above, but with a guarantor who is a highly leveraged builder or contractor whose cash flows are dependent on the sale and/or rental of the pledged property and who does not reflect verified liquidity or stable recurring historical cash flow. In this case, historical cash flow may have been capital-gains dependent and future sales are now uncertain. Given the same repayment terms presented above, it would be prudent in this case to expect a longer period of performance before upgrading the loan to pass.

In both cases, examiners should keep in mind that these loans represent examples where the borrower was expected to perform to the original terms of the loan. It is unlikely that the original terms in these cases provided for an amortizing term loan. As such, these loans are restructured workouts, exhibiting well-defined weaknesses, and will likely warrant classification

(generally substandard or worse) for a period of time until the borrower/guarantor sufficiently demonstrates the willingness and ability to perform on the restructured terms.

There are also cases where a project has slowed or stalled, the guarantor is providing some support, but the loan has not been restructured. In these cases, unless the guarantor is providing support of principal payments sufficient to retire the debt under reasonable terms, a substandard classification is typically warranted. If the guarantor is keeping interest payments current, and shows the documented capacity to do so on a “going-forward” basis, and collateral values protect against loss, the loan should generally be left on accrual. This level of support, however, does not fully mitigate the well-defined weaknesses in the credit and does not preclude a substandard classification.

For additional information on the topics discussed in this guidance document, refer to the troubled debt section (Appendix F) of the CRE and Construction Handbook. If you have additional questions, you should contact your ADC/EIC or the Lead Credit Expert.