Interagency Audio Conference on
Prudent Commercial Real Estate Loan Workouts

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Coordinator: Welcome and thank you for standing by. At this time all participants are in a listen only mode. Today's conference is being recorded. If you have any objections, you may disconnect at this time. Now I would like to introduce Mr. Daniel Bean.

Daniel Bean: Thank you. Good afternoon everyone. Welcome to today's Risk Analysis Center presentation entitled Interagency Audio conference call on Prudent CRE Loan Workouts. There will be a discussion by our presenters followed by concluding remarks by Mindy West, Chief Policy and Program Development from the Division of Supervision and Consumer Protection. I would like now to turn this call over to Sandra Thompson, the Director of the FDIC Division of Supervision and Consumer Protection.

Sandra Thompson: Thank you Dan for the introduction. I’d like to welcome everyone to this interagency presentation on Prudent CRE Loan Workout Guidance. We are pleased to have a timely discussion of this important topic as many bankers are proactively engaging in a wide range of commercial loan workout activities for credit worthy commercial borrowers.

The agencies have found that Prudent Commercial Loan Workouts are often in the best interest of the bank and the borrower. The agencies have encouraged and will continue to encourage bankers not only to extend new credit to credit worthy borrowers, but also to work in a prudent manner with commercial borrowers who may be facing financial difficulties. Much of the guidance being discussed today reiterates existing guidelines and incorporates the components of effective workout programs. The guidance also provides some real world illustrations for the classification, non-accrual and troubled debt restructuring or (TDR) treatment of restructured loans.

These examples reinforce and are consistent with long-standing policies regarding loan classification and accounting requirements. The illustrations also will promote greater transparency and consistency among the regulatory agencies regarding how we define appropriate risk management and loan classification criteria for workout arrangements. We appreciate your taking the time from your busy schedules to join us today. At this time, I'd like to turn the presentation over to Mindy West. Thank you.

Mindy West: Thank you Sandra for providing those opening remarks. I also want to extend our appreciation to our regulatory panel members for participating in today's call to discuss this important guidance and answer some of the questions that have been raised relative to the loan workout guidance. I also want to thank the audience who have sent in many questions in response to the FDIC's request. We may unfortunately not be able to answer all of these questions, but we will certainly try to address all the topics or most of the topics that you've raised in your questions.

Let me discuss the format we will be using for this call. After I introduce our four regulatory panelists, we will hear some brief remarks from each. Then we will address a number of the questions we received. We won't be able to delve into specific factual tactical type questions or issues. For this reason, I have a disclaimer that I want to make regarding today's call in that the discussion and views offered by today's participants from the regulatory agencies should be considered in the context of the overall presentation.

It's also important to recognize that the loan workout guidance is intended to provide an illustration of the use of judgment based on certain examples within specific facts and circumstances. Institutions and examiners should use caution when applying these examples to real life situations because all facts and circumstances should be considered and judgment should be exercised before reaching a conclusion related to credit classifications and reporting and accounting requirements. Institutions should contact their primary federal regulator with specific questions about the application of loan workout guidance to specific situations.

For today's audio conference, we are joined by Bob Walker who is the Senior Supervisory Analyst for the Board of Governors of the Federal Reserve System; Mary Garvin who is the Senior Policy Accountant at the Office of Thrift Supervision; Suzy Gardner who is a Senior Examination Specialist in FDIC's Policy Section; and Darrin Benhart who is Direct of Commercial Credit at the Office of the Controller of the Currency. I'd like to turn this now over to Bob to lead off the discussion.

Robert Walker: Thank you Mindy. The federal agencies appreciate having this opportunity to discuss our policy statement on Prudent Commercial Real Estate Loan Workouts, which was issued on October 30th. This policy statement, which was adopted by each of the financial regulators and released by the FFIEC, provides guidance to examiners on evaluating financial institution's efforts to renew and restructure loans to credit worthy borrowers who are experiencing diminished operating cash flows, depreciated collateral values or prolonged delays in selling or renting commercial properties.

The regulators issued this policy statement to update longstanding guidance regarding the workout of commercial real estate loans, especially in light of recent increases in such workouts. This statement is based on guidance issued by the agencies in the last downturn in the commercial real estate market of the early 1990s. Institutions have raised concerns that supervisory policies and actions may be curtailing the availability of credit to sound borrowers. Given the lessons learned from the 1990s downturn, the agencies want to ensure that our examiners have a good understanding of risk management expectations for loan workouts and, in turn, have the tools necessary to appropriately and consistently assess institutions workout activities.

The statement promotes Prudent Commercial Real Estate Loan Workouts at institutions and to ensure examiners take a balanced and consistent approach in reviewing these workout activities. Institutions that implement prudent loan workout arrangements after performing comprehensive reviews of their borrowers' financial conditions would not be subject to criticism for engaging in these activities even if the restructured loans have weaknesses that result in adverse credit classifications. Further, renewed or restructured loans to credit worthy borrowers on reasonable terms would not be subject to adverse classification solely because of the value of the underlying collateral has declined. As detailed in the policy statement, an examiner's evaluation of a loan workout should be based upon the fundamentals of a particular loan. It considers the project's current and stabilized cash flows, debt service capacity, guarantor support and other factors relevant to the borrower's ability and willingness to repay the debt. I'd like to turn it over now to Mary Garvin with the Office of Thrift Supervision who will discuss our expectations for institutions' risk management practices related to a slowed workout activity.

Mary Garvin: Thank you Bob. Managing risk well is fundamental to the survival of any bank or thrift. Thus, management must be actively engaged in dealing with the heightened risk associated with the commercial real estate portfolio that is under stress. Managing the foreclosure process, dealing with collateral evaluation issues and ensuring the institution has a prudent, safe and sound workout process are critical risk management challenges. While dealing with troubled CRE loans requires many of the same skills and infrastructure as was involved in underwriting the CRE loans, it is important to recognize that they also require other enhanced skills such as legal, collection, asset evaluation and capability to perform appropriate cost benefit analysis to determine the best alternative in a difficult situation.

Independence of the loan disposition decision from the original underwriting decision is also important. The goal in a Prudent CRE Loan Workout is to maximize recovery versus maintaining a credit relationship. Given these considerations, the federal regulators expect financial institutions to have strong risk management practices that include a system of policies, procedures and internal controls to ensure that prudent loan disposition decisions are made, including those for engaging in workouts.

These policies and procedures should include, among others:

- a management infrastructure to manage the volume and complexity at the workout activity;
- document standards to verify borrower's financial condition and collateral value;
- adequate MIS systems and internal controls to track concentration, loan performance and risk;
- accurate regulatory reporting;
- effective loan collection;
- adherence to statutory, regulatory and internal lending limits;
- collateral administration to ensure proper lean perfection for both real and personal property; and
- an ongoing credit review function.

These practices should be commensurate with the size and complexity of the institution and its CRE portfolio as well as the nature of its own lending policies and practices. Now Suzy Gardner with the FDIC will discuss loan workout arrangements.

Suzy Gardner: Thank you Mary. As the guidance states, loan workouts can take many forms, including a renewal or extension of loan terms, an extension of additional credit or a restructuring with or without concessions. Prior to engaging in a loan workout, an institution needs to assess and borrowing financial condition so management can make an informed business decision as to whether or not it should consider a workout arrangement. This review should include obtaining and analyzing current and comprehensive financial information, including appropriate supporting schedules, on the borrower, any guarantors and on the commercial real estate project itself.

Management should use this information to perform a realistic assessment of a borrower's and guarantor's global debt service requirement and to determine the repayment capacity. Management also needs to obtain an updated understanding of the value of the collateral pledged on the loan.

Valuations of commercial properties typically contain more than one value conclusion. In assessing the collateral value, management should ascertain and document the collateral in its current “as is” condition. Management also should consider other relevant risk factors affecting its value and use the market value conclusion that corresponds to the workout plan and loan commitment. After performing an appropriate analysis of the borrower's financial capacity and considering market conditions, management should develop a well-conceived and prudent workout plan that's tailored for a borrower's specific fact pattern and financial circumstances.

The workout plan should result in a loan structure, including the loan terms such as the interest rate and amortization schedules, and provide for other requirements, such as curtailment, covenants or re-margining as appropriate, given the risk and the credit and the type of collateral. Well-conceived workout plans with credit worthy commercial borrowers should enable institutions to improve their repayment prospects during these difficult economic times.

During an examination, examiners will review an institution's workout activities. Examiners will consider the institution's analysis of the borrower’s or guarantor's repayment capacity in their assessment. Examiners also will evaluate an institution's collateral review and supporting documentation as well as the major factors, assumptions and valuation approaches used in the collateral valuation. In addition, examiners will assess the institution's internal loan grading system to ensure that it accurately and consistently reflects the risk in workout arrangements.

Examiners will not criticize institutions that engage in prudent loan workout activities after performing a comprehensive review of a borrower's financial condition, even if the restructured loans have weaknesses that result in adverse credit classification. Instead, examiners will take a balanced approach in assessing an institution's risk management practices for loan workout activities in light of the current economic circumstances and the realistic business alternatives that bank management is facing. With that, I will turn it to Darrin who's going to address loan classification issues.

Darrin Benhart: Thanks Suzy. I'm just going to touch on a few of the key topics in the classification of loans section. I want to emphasize that there's no change to the definition or the process for analyzing credit in determining the classification. This document is meant to provide some additional clarity and allow for more consistency as Bob indicated. We also have examples in Attachment 1 that hopefully will help you and provide some additional perspective.

The scenarios really are more illustrations to show some of the nuances within the rating process. Rating credits will always involve significant use of sound judgment. An analysis of credit should always start with a thorough understanding of all the relevant facts and circumstances surrounding the individual credit. Examiners will continue to complete this normal analysis, which will include looking at the debt service capacity and repayment capacity along with the collateral value in coming up with their ultimate credit rating.

As has been stated before, as a general principle, examiners are not going to classify loans solely because of the value of the underlying collateral has declined to amounts less than the loan balance. Hopefully, this hasn't been occurring even in the past. Examiners should always be taking a complete view of the credit. A loan's performance also is something that we've heard a lot of discussion about and is an important indicator or consideration in the credit analysis. But, you have to look through and understand really where that performance is coming from and the reasonableness of the continuation of that performance in looking at your loan classification process.

We've specifically pointed to situations where we've seen interest reserves being used to keep the loan current. Obviously, in those cases, you have to look through and understand the underlying performance of the project to really fully understand if that performance is going to continue.

In general, renewals or restructures of maturing loans to commercial borrowers who have the ability to pay, and again I want to stress that, it's about the ability to pay on reasonable terms will not be subject to adverse classification; a couple of the key operative words. Now, I'd like to talk a little bit about something that everyone seems to be very interested, which is the A and B note structure that we talk about. For many of you, hopefully this is not a new concept. But, I understand that for some of you it probably potentially is new. This concept has been out there for several years. It was actually originally brought up in some of our 1991 guidance that we put out. I want to make a few points here around the A and B note structure that I really want to be clear about. In a situation where the borrower is able to meet a certain level of debt service, but cannot meet the entire debt service requirements of the existing loan arrangement, we have some items that you need to consider when setting up the A and B note structure.

There are four of them. First of all, the bank restructures a loan by splitting it into a multiple not structure; in this case Note A and Note B. Second, the restructuring qualifies as a TDR as defined by FASB 15 where the borrower is experiencing financial difficulties and the institution grants a concession. Third, the ultimate collectibility of all amounts contractually due remaining on the books, specifically Note A, cannot be in doubt. Note A should be underwritten to the bank's customary underwriting standards. In our example, we had a 1.2 times debt service coverage ratio and an 80% LTV. These are not hard and fast rules that the agencies are establishing by any means. But, we are emphasizing that the note should be underwritten to the bank’s customary underwriting standards. Note B is charged off at or before the restructuring; again, another important factor.

Fourth, there is a period of satisfactory payment performance by the borrower before Note A is returned to accrual status. This period of performance should generally be a minimum of six consecutive months. Again, I want to stress, if any of these conditions are not met, the restructured loan should continue to be accounted for and reported as non-accrual.

We've also heard some discussion, about what if Note B is not charged off. In that case, the restructured loans will be evaluated together because they are supported by the same source of repayment. Doubt in this case would still probably exist as to the full collection of all loans that remain on the books. And, all loans would need to be reported as non-accrual. Generally, to remove that doubt, the bank would need to underwrite the A Note to their customary standards. Also simply reducing a loan's balance through partial charge off, which some bankers have indicated they were considering, will not allow a return to accrual and a pass rating. You still need to account for and classify the credit based on the contractual loan terms.

Last, I want to touch on the regulatory reporting and accounting considerations that this document has in it. This document primarily is a credit risk-related document. However, regulatory reporting and accounting considerations are always tied in together with safety and soundness issues. There are no new regulatory reporting or accounting requirements in this document. Attachment 2 and many of the footnotes highlight and provide a summary of some of the key accounting and reporting topics. But, again, as you look through, this is all information that was already out there either through GAAP or through the regulatory agencies. At this point, I'd like to turn it back over to Bob.

Robert Walker: Thanks Darrin. In conclusion, we encourage you to read the guidance and raise any further questions with your federal regulator. I also would note that there is good information in the four attachments to the narrative section, which include the illustrated examples which several of us have already referenced; supervisory and accounting guidance, valuation concepts for income producing real estate, and the classification definitions.

In closing, we would like to remind regulated institutions that the agencies support your efforts to work with commercial real estate borrowers. Institutions play a key role in providing credit to main street businesses.

In responding to the credit needs of their customers, institutions may need to consider restructuring or renewing a loan to provide credit to sound borrowers. The commercial real estate workout statement acknowledges this and reinforces sound risk management practices that are necessary to ensure an institution's workout activity is conducted in a safe and sound manner. Ultimately, prudent loan workouts are in the best interest of both institutions and borrowers, especially given current market conditions.

Mindy West: Thanks Bob. Now why don't we start addressing some of the questions that we've received? We've received several questions pertaining to the A and B Note structure specifically. If a financial institution bifurcates a problem loan into an A and B Note structure with cooperation from the borrower, can the loan amount allocated to the A note result in the A note being rated a pass using well substantiated pro forma operating statements such as lease projections? What are your thoughts Darrin?

Darrin Benhart: Thanks Mindy. I think the operative term here is the use of the word pro forma operating. I'm going to assume they're looking at and working with the A and B Note structure relative to the four items that I laid out just previously. But, to answer the question specifically, I would say it's not likely appropriate for a lender to use pro forma information to do the A and B Note structure. The lender probably should wait until there's actual evidence to properly size the A Note and ensure that they have a reasonable debt service coverage that is customary to their underwriting standards. Obviously, the A Note in this scenario may never attain the performance that is necessary to get to a pass rating if it's based on pro forma information.

I also want to reiterate the A Note should in all situations continue to be classified as substandard and remain on non-accrual until a minimum of six consecutive monthly payments are made. If the A Note does attain a pass rating in an A and B Note structure, I want to reiterate too that the bank should continue to monitor it and grade the loan appropriately. If deterioration occurs in the future, there's nothing to say that the A Note wouldn't necessarily have to go back to a substandard rating.

Mindy West: Okay. But, Darrin you mentioned that the A Note would need to remain on non-accrual. What if we assumed cash flows have been sufficient to make partial payments on a loan and the borrower has made that same partial payment each month for the last six months? After it is restructured, the payments on the new good loan or A Note are the same amount as what the borrower had been making previously. Is it possible for the bank to return the A Note to accrual at the time of the restructure?

Darrin Benhart: Thanks Mindy. This is again a very good question. And we specifically address this in Footnote 15 of the statement, which indicates in returning the asset to accrual status, sustained historical performance for a reasonable time prior to the restructuring may be taken into account. We want to emphasize that the level of the payments should be at least as much if not more than what is set up in the new A Note. So, you can look back at previous payments. In considering those, you need to look at and understand where those payments are coming from. Make sure there's good stability. And it needs to be based on a thorough credit analysis. But, you can look back as the statement indicates in Footnote 15.

Mindy West: Thank you Darrin. Mary, I've got a three-part question for you. First part, what is the relationship between a troubled debt restructure or TDR and an impaired loan? Does a TDR by definition need to be classified as impaired?

Mary Garvin: Thank you Mindy. Under GAAP, by definition all troubled debt restructurings are impaired loans. An impaired loan is actually defined as its probable that the lender will be unable to collect all amounts due, that's both principle and interest, in accordance with contractual terms of the loan. For TDRs, the lender has made a concession or concessions to the borrower, which confirms that they were unable to collect all amounts due in accordance with the borrower's original contractual loan terms. But, described and primarily related to the financial statement disclosure requirements, in certain circumstances however, it may or may not have an impact for the determination of the allowance valuation requirements.

I specifically want to refer to Scenario 3 in Example B for the shopping mall with the A and B Note structure that we've been discussing and Darrin described earlier. That A and B Note structure represents a TDR at the date of the restructuring and will be disclosed as a TDR in regulatory reports and financial statement footnotes in accordance with the respective requirements. Additionally, since the B Note was charged off, there has been a loss recognized on that restructuring. But, arguably, after the restructuring, the A Note represents a well-secured loan at a market rate of return, which would generally be considered to be a performing loan.

Mindy West: Thank you Mary. Can a TDR remain on accrual status?

Mary Garvin: Well, although it's not typical, there are situations where loans that go through a troubled debt restructuring can remain on accrual status. We'll use that same example, the A and B Note structure. If the loan was performing before the restructuring, then the prior performance could be used to demonstrate the borrower’s ability to meet the revised payments and the loan could remain on accrual. More common situations are where the loan that undergoes the restructuring was on non-accrual status prior to the restructuring. In order to return the restructuring loan to accrual status, a sustained period of performance evidenced by cash payments from the borrower is required.

Mindy West: Okay. And for the third part of the question, can a loan be impaired and remain on accrual status?

Mary Garvin: Yes. A loan may be deemed to meet the definition of impaired loan even though the loan may be current and performing in accordance with the contractual loan terms in which case the loan may continue to be on accrual status. Although these determinations are related, they're not always simultaneous.

Here's an example. You have a CRE loan to a borrower where payment terms are quarterly. Over the life of the loan, the borrower has been past due twice, but was always able to make the quarterly payment plus any late fees. At this time, the borrower is reported as being current. Recent financial statements on the CRE received from the borrower however show declining financial results. But, at least on these statements there appears to be a fair amount of cash reserve still available. That said, the market location of this CRE has incurred significant declines in value. This information may be enough to raise concerns about the borrower's ability to continue to pay all amounts due which may result in the loan being deemed an impaired loan. In this case, a measurement of impairment would need to be determined and if necessary, a valuation allowance established.

Mindy West: Thank you Mary. We've also received some questions on how to analyze an obligor's global cash flow for the purpose of projecting a cash flow surplus and deficit. Suzy, in particular, one banker asked whether the global cash flow analysis should adjust the projected net operating income or NOI for each project or property to reflect only the guarantor's percentage of ownership or should the full NOI be considered? Should the annual debt service be adjusted accordingly?

Suzy Gardner: Thank you Mindy. The key here is that management needs to perform a global cash flow analysis. The analysis should consider a borrower's or guarantor's overall financial resources, condition and payment record. It also should assess whether market conditions may influence the nature and degree of protection provided by the cash flow from business operations or the collateral relative to a borrower's or guarantor's total debt obligation. In response to the banker's specific question, after determining the net operating income or the cash flow expected from a borrower's or guarantor's business operation or collateral, management should adjust the projections to reflect the portion of the income stream that a borrower or guarantor is legally entitled to receive. So, the institution should adjust the projected net operating income based on the borrower's or guarantor's percentage of ownership and not include the full amount of expected cash flow in its analyses.

Mindy West: Suzy, you discussed the need for a global cash flow analysis. What about guarantors? For example, how should guarantors be evaluated and what criteria for payments should be considered?

Suzy Gardner: Guarantors can provide extremely valuable support to a credit facility. Institutions need to evaluate a guarantor's ability to support a credit by analyzing updated and comprehensive financial information. This information should include appropriate supporting schedules. Bankers can use this information to conduct a realistic assessment of a guarantor's global debt service requirement. This assessment should include the total number and amount of guarantees outstanding. After assessing a guarantor's ability to support a credit facility, institutions need to consider a guarantor's willingness to provide support for the credit through ongoing payments, curtailments or re-margining of the debt.

The first scenario in the shopping mall example illustrates that a guarantor's capacity and willingness to perform resulted in a restructured loan being passed. However, if the bank has to take legal action to force a guarantor to perform, then the guarantor generally will not be considered as willing to pay. In addition, situations where the guarantor has not been asked to perform when it would be prudent to do so generally could result in the guarantee being viewed as offering minimal support on the loan.

Mindy West: Thanks Suzy. Bob, we received several questions regarding market rates and below market rates of interest. The term market rate of interest repeats itself throughout the examples included in the policy statement. How exactly is a lender to determine and document a market rate of interest when renewing an extension of credit?

Robert Walker: Thanks Mindy. Unfortunately, there is no easy answer. Determining if an interest rate is a market rate of interest is more art than a science. There are a number of factors to consider when assessing whether the borrower is given a market rate of interest. The rate of interest should be reflective of the riskiness of the transaction. In determining the rate, the bank needs to look at the structure of the deal, the borrower’s financial condition, financial support of the guarantor and protection provided by the collateral.

Institutions can do their own comparison of rates offered to its other borrowers on similar properties to assess whether a rate offered on a loan modification is representative of market rates. Institutions also can get a sense of market rates by assessing what peer banks are charging on a similar type of transaction.

Mindy West: As a follow up to this question, most of the examples cited seem to clearly distinguish between a market rate of interested used and a restructure versus the use of a below market rate of interest. Is the use of the market rate and the borrower being able to service the loan at that rate one of the key determinants of the accrual status of a restructure?

Robert Walker: The rate of interest charged in the structuring is not the sole determinant of whether the loan can be placed in accrual status. If the institution could demonstrate to the borrower's historical performance that they have the ability to perform under the modified terms, either below or at a market rate of interest and full repayment is expected, the institution can place the loan on accrual status.

Mindy West: Thanks Bob. Darrin, is it the intent of the policy statement that any restructured non-accrual loan also be reported by the institution as a TDR?

Darrin Benhart: The simple answer to this is no. To qualify as a TDR, the borrower needs to be experiencing some financial difficulty and the bank needs to have granted a concession. In the case that you pointed out, the loan's already on non-accrual. So it seems to me the first criteria that their borrower is probably experiencing some type of financial difficulty has been met. Then, you would need to look at how the original credit and the new credit was restructured in order to consider if a concession was granted. If a concession was not granted, the loan would not be a TDR. Let me take a moment too and talk a little bit about concession. Concessions can take many forms, including a below market rate, a deferral of payments, preferential terms, extended maturities or extensions that would not ordinarily be granted by the institution. This isn't an all-inclusive list and you need to consider the facts and circumstances of each case, but this does provide a few examples of things that could be concessions.

Mindy West: Okay. For credit to be treated as a TDR Darrin, does there have to be a below market interest rate involved?

Darrin Benhart: Again, the simple answer here is no. There can be a number of other concessions that don't involve the interest rate that could trigger the TDR treatment.

Mindy West: Okay. Another follow up Darrin. Can a TDR have a market interest rate in place?

Darrin Benhart: I think we've hit this issue about every way that we can. But, I finally get to answer yes to a question. A TDR can have a market rate of interest, but you could have granted some type of other concession on the loan, so it would still qualify as a TDR.

Mindy West: Thank you Darrin. Mary, what if a non-performing loan went through bankruptcy and a portion of the debt was recognized as a loss? The loan is improving now partly due to concessions that were required by the bankruptcy judge, including changes in the amortization and interest rate. Should these be considered a concession?

Mary Garvin: Yes. The TDR definition is the lender for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. Modifications to a borrower's indebtedness that a lender is required to make as a result of the bankruptcy court requirements are definitely concessions granted due to legal reasons that the lender would not have otherwise considered.

Mindy West: Darrin, we received several questions related to credit classifications. The policy statement refers to renewals and restructurings in many places and emphasizes that borrowers who have the ability to repay on reasonable terms will not be subject to adverse classification, but should be identified in the institution's internal credit grading system and may warrant close monitoring. What does this mean? Does it mean that any renewed or restructured loan has to be maintained on an internal watch list?

Darrin Benhart: I think that this issue just gets back to many things that Mary talked about in the risk management section of the document. And again, it's just a sound process that we're trying to reemphasize here. Renewed or restructured loans in many times should be identified and may warrant closer monitoring. Some of the renewed loans are made under the same conditions that you would new loans, but others are obviously not.

Many of the restructured loans should be placed on the institution's internal watch list, depending on the extent and nature of the restructuring and the financial condition of the borrower. All borrowers are not necessarily created equal when you do a restructuring.

As time passes, you want to track whether restructured loans are performing under the modified terms. You also want to understand how you're doing and whether your restructuring program is resulting in effective workouts. So, those are the kind of reasons to keep track of the restructured loans and it's just sound risk management.

Mindy West: Okay. Well as a follow up, does substandard always mean non-accrual?

Darrin Benhart: I found this question interesting because as I looked back through our examples, I actually realized, and not intentionally by any means, but all of our substandard credits were non-accrual in the paper. This was not intentional. And the answer does substandard always mean non-accrual is no. The full definition of substandard is in Attachment 4 in the document. But, basically it really focuses on a well-defined weakness in the credit that jeopardizes the repayment of the debt.

Each agency also has guidance on non-accrual. But, again, basically a non-accrual decision deals with whether there is any doubt as to full collection of principal and interest. Obviously, a credit can have a well-defined weakness that jeopardizes repayment, but have other mitigants, generally excess collateral, that remove doubt as to full collection of the principle and interest. So again, the answer is no.

Mindy West: Okay. And Darrin, one more time. Can a financial institution reduce a loan's outstanding balance via a charge off to an amount which the borrower's existing or project cash flow covers the remaining on book balance after the charge off with cushion on an advertising basis at market rents and risk grade this portion a pass?

Darrin Benhart: That was kind of a complicated question, but really the answer is no. Again, this gets back to what my earlier comments were as far as just simply doing a partial charge off on a loan.

In substance, the bank has merely just charged down the existing loan leaving a remaining amount that should be accounted for and reported as a non-accrual loan. Just simply doing a partial charge off does not - or is not a sufficient basis by itself - for restoring the loan to accrual status. The charge off just simply recognizes the un-collectible portion of the loan and indicates that they're still concerned about the ultimate collectibility of the remaining loan balance. Payments should be recorded as principle reductions as long as there's any doubt to the collectibility. Again, you have to go back to the original terms of the loan. And just simply doing a partial charge off doesn’t mean you can't ignore the original terms of the loan.

Mindy West: Thank you Darrin. Bob, when would it be appropriate to use interest only terms in a restructuring?

Robert Walker: Thanks Mindy. The use of interest only terms might be appropriate as a short-term bridge to provide a period of time for a borrower's economic situation to stabilize. In fact, two of the illustrations in the attachment do include scenarios where the use of interest-only terms resulted in a pass rating for the credit. In these situations the borrowers or guarantors had demonstrated both the willingness and the capacity to supplement the project's cash flow and meet their global debt service requirements.

The borrowers or the guarantors also took other actions. These could include such things as providing curtailment or granting a lean on additional collateral to improve the bank's position. However, interest-only terms generally should be used in limited circumstances and on any subsequent loan terms should likely have a principle reduction component. I would like to talk about a related point where we've seen some other comments and those are dealing with whether interest income can be recognized by capitalizing the accrued interest to the loan balance provided that there is equity in the property.

Our feeling is that this generally would be considered an unsafe and unsound practice, as it does not accurately reflect the true financial strength of the borrower.

Mindy West: Thanks Bob. We've received several questions pertaining to collateral valuation issues. Suzy, the first question asks for more detail on when new appraisals should be obtained as part of the CRE Loan Workout process. Are appraisals absolutely required in all situations or are there some situations where examiners would consider existing appraisals to be valid? Are internal evaluations that supports value of the existing appraisal considered adequate by regulators as long as they include recent sales counts?

Suzy Gardner: Institutions should have established policies for monitoring collateral values. There are no bright line regulatory requirements regarding this particular issue. But, the expectation is that the banks policies should address the frequency, size and scope of getting updated valuations in the context of the risk profile of the collateral. A good portfolio management program may include a variety of relatively cheap market information to monitor valuation trends such as appraisals on similar properties, market trend data and other types of information. Obviously the larger and more complex the asset combined with a higher risk of possibly having to sell the collateral for loan repayment are key factors. Those conditions generally necessitate more comprehensive collateral valuation information, which ultimately is the key to good credit decision making.

Mindy West: And how often are you seeing properties that secure criticized assets being valued in generally; at least annually, quarterly?

Suzy Gardner: Again, there are no specific criteria for determining how often a new appraisal or evaluation is required. Such a decision is matter of professional judgment after consideration of a totality of the facts associated with a particular real state related transaction. If the loans are problem credits, an accurate, timely and specific collateral information will assist in institutions to make informed business decisions on the best way to maximize their recovery potential.

Mindy West: We received some questions pertaining to broker price opinions or BPOs. Suzy, are BPOs used at all for evaluation purposes for workouts or to support the validity of an existing appraisal? What type of documented evidence would you expect when an internal evaluation has been performed?

Suzy Gardner: BPOs can be a useful, quick and relative cheap tool that potentially could be used for monitoring portfolio quality or for workout situations. However, BPOs can vary widely in quality and tend to provide less comprehensive analytical information. BPOs shouldn't be overused, especially for larger and more complex assets, and their values should be reviewed over time to ensure their accuracy. In addition, BPOs could be used to supplement an appraisal or an evaluation.

As for documentation requirements for evaluation, evaluations should provide sufficient information to support the analysis, assumptions and a value conclusion. The interagency appraisal and evaluation guidelines provide additional guidance relative to the content for an evaluation.

Mindy West: Okay. Suzy, the last collateral valuation question we would like to address pertains to loan-to-value or (LTV) issues. Suppose an institution originated a CRE loan in 2006 and it matures in 2011. Should the institution be doing another appraisal at any time within the duration of the loan? If so, how do we handle LTVs that exceed the supervisory LTV requirements as a result of the latter appraisal?

Suzy Gardner: This question actually involves several different facets. The supervisory LTV threshold pertains to the LTV at the time the loan originated. For renewals, refinancings and restructurings, we need to consider whether there has been an advancement of new money, whether the loan was a high LTV loan at origination, and whether the renewal or refinancing is part of a workout situation. If the bank does not advance any new money, a renewal or refinancing or workout would be exempt from determining compliance with the supervisory LTV limits.

However, if the loan was a high LTV loan at origination and is still a high LTV loan at the time of the renewal, then the bank would have to keep the loan in the high LTV basket and count the loan against the capital limitations. Now, if there was an advancement of new money other than reasonable closing costs, it would typically not qualify for the exemption and the bank would have to re-determine compliance with the supervisory LTV limits. If the loan's LTV is above the supervisory threshold for the type of real property, the bank would have to report the loan as a high LTV loan and again count the loan against its capital limitations.

If the renewal or refinancing is in connection with a workout situation and there is an advancement of new money, the bank would not have to report the loan as a high LTV loan if the restructured loan now has an LTV above the supervisory LTV limits. To qualify for the exemption, the workout has to be consistent with safe and sound lending, achieve an orderly liquidation of the debt, reduce the risk of loss or maximize recovery on the loan as well as the loan being structured and have complied with the supervisory limits at the time of its original origination. For a loan with a high LTV before the workout, the bank would have to re-determine the LTV. If the loan's LTV is still above the supervisory LTV limits, then the bank would have to continue to report the loan as a high LTV loan and count it against its capital limitations.

Mindy West: Thanks Suzy. Mary, we received several questions pertaining to accounting related issues. The first question discusses how banks accommodate borrowers by reducing or deferring monthly payments for certain periods. Loan accounts should be classified as non-accrual when the payments are delinquent for over 90 days. When the bank allows the borrower payment deferment for three months of principal and interest and the borrower failed to make the first payment due after the deferment period, does the bank have to classify the account as non-accrual regardless of an eventual full collection possibility?

Mary Garvin: There are several significant aspects and considerations that are included in that question Mindy. Appropriate reporting determinations should always be based upon the specific facts and circumstances of the situation. In general, placing loans on non-accrual at 90 days past due is considered a reasonable threshold for determining that the continued accrual of interest income is no longer appropriate.

That said, whenever an institution determines that the collection on the loan in full is not probable, regardless of the payment performance status, it may be appropriate to place a loan on non-accrual. Banks may make accommodations to borrowers as an allowance for temporary reductions or deferrals for many reasons. Accommodations that have been more programmatic in nature have occurred when there have been significant natural disasters such as hurricane Katrina and the Northridge earthquake in southern California. Even though such accommodations may be granted, there is an expectation that institutions will continue to report loan performance in accordance with the contractual terms, the institution's policy and regulatory expectations.

Mindy West: Okay. Thanks Mary. The next couple of questions ask about interest-only payments. If the bank changed the terms to interest-only payments for six months from monthly P&I payments, and the borrower paid the interest as agreed for six months, does the bank have to place the loan on non-accrual because the borrower failed to make monthly payments according to the original contract?

Mary Garvin: So once again, specific facts and circumstances must be considered. When collection in full is not probable, a loan should be placed on non-accrual. The basis for the accommodation allowing the borrower to forego principle payments for the six-month period would have to be evaluated. If this accommodation raises questions as to collection in full, then it may have been appropriate to place it on non-accrual at the time of the interest-only payments were granted.

But, in general, whether this accommodation would require non-accrual reporting is dependent on whether there remains any expectations that the loan over its remaining term will be collected in full both principle and interest.

Mindy West: Okay. In addition, what if the bank allowed the borrower to make interest-only payments for the remaining loan terms? For example, two years. Should the bank place the account on non-accrual?

Mary Garvin: Once again, I'm going to refer back to the specific facts and circumstances for the particular situation. But, I would have to say with just the minimal information provided in this question that there would have to be sufficient support that collection in full, both principle and interest, was probable. Given that the accommodation was to allow interest-only payments for the remaining loan term, the level of support would have to be substantial Mindy. As a result, my opinion would be that non-accrual may likely be appropriate for this loan.

Mindy West: Well Bob, as a follow up to what Mary said, generally what are the limits to interest-only when the borrower can make those payments, but cannot cash flow P&I payments until occupancy of the project can be increased? In other words, must the loan be classified substandard or worse if the loan terms provide for interest-only payments after the project is completed and the borrower or guarantor has the ability to make the interest-only payments?

Robert Walker: Thanks Mindy. We touched slightly on this I think in an earlier question. But, I just want to reemphasize that all loans modified to interest-only payments are not necessarily classified substandard or worse. We have addressed some of these in the attachment, I think in particular dealing with the shopping mall loan. And as that discussion indicates, the factors to consider in the assessment of classification are the duration of the interest-only period and the likelihood that there will be improvement in the project's cash flow.

In this illustration in the attachment, the project was expected to continue to progress and to generate sufficient cash flows to support the interest payments. Further, there were other considerations including the ability and willingness of the guarantor to supplement the project's cash flow. Also, the example noted that any subsequent modifications should include a principle amortization component.

Mindy West: Okay. And Bob, we also received a few questions pertaining to equity investments. Specifically a banker noticed in a 10Q report recently where a community bank had transferred some non-performing loans into a real estate partnership with a third party as the bank's equity investment into the project. Is that a realistic option for disposing of non-performing assets?

Robert Walker: That's an interesting question Mindy. The guidance does not address the issues raised in this question. It would appear that the primary goal of these arrangements is to provide some type of capital relief. That being said, there are clear accounting, capital and regulatory reporting issues involved in this type of transaction. I would encourage anyone who is considering this type of activity to consult with their primary regulator before entering into such an arrangement.

Mindy West: Okay. Well thank you. That ends the question and answer session. Director Thompson would like to make some closing remarks.

Sandra Thompson: Thank you Mindy. I'd like to thank all of our speakers for taking the time to discuss this important and timely topic. I'd also like to thank everyone for calling into today's conference. We hope that the guidance and today's discussion will help maintain an ongoing dialog to talk about ways to work with credit worthy commercial borrowers who've experienced some decline in their financial condition due to the economic downturn.

I'd like to take this opportunity to reiterate that financial institutions that implement Prudent Commercial Loan 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 the restructured loans have weaknesses that result in adverse credit classification. I'd also like to thank everyone for their ongoing efforts. Your dedication will enable the banking industry to work through this current crisis and we'll emerge even stronger than before.

Mindy West: Thank you Sandra. And just to wrap this up, I hope that you found today's conference to be helpful. If you have additional questions or issues you would like to discuss further, we encourage you to discuss them with your designated point of contact with your primary regulator. The interagency working group who developed the guidance will continue to discuss the questions and issues that arise to ensure the guidance is implemented in a consistent manner across the regulatory agencies.

An audio recording or transcript of today's seminar will be posted on the FDIC's Web site shortly after it is received. Please check the FDIC's Web site at www.fdic.gov sometime after December 10th for this information. With that, I'd like to say goodbye to everyone and thank you all very much for your participation.

Coordinator: Thank you for joining today's conference. That does conclude the call at this time. Please disconnect.

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