

Commercial Lending Update

JANUARY 2010

FEDERAL REGULATORS ISSUE POLICY STATEMENT ON PRUDENT COMMERCIAL REAL ESTATE LOAN WORKOUTS

On October 30, 2009, the federal financial regulatory agencies adopted new guidance, entitled *The Policy Statement on Prudent Commercial Real Estate Loan Workouts* (“Policy Statement” or “Statement”). The Statement updates and replaces existing supervisory guidance to assist examiners in evaluating institutions’ efforts to renew or restructure loans to creditworthy commercial real estate (“CRE”) borrowers.

The Policy Statement addresses supervisory expectations for an institution’s risk management elements for loan workout programs, loan workout arrangements, classification of loans, and regulatory reporting and accounting considerations. The Statement also includes references and materials related to regulatory reporting. However, the Policy Statement does not change existing regulatory reporting guidance provided in relevant interagency statements issued by the regulators or accounting requirements under generally accepted accounting principles (GAAP). The Policy Statement notes that these general principles also could apply to commercial loans that are secured by real property or other business assets of a commercial borrower.

The Policy Statement addresses the challenges faced by institutions and borrowers when dealing with diminished operating cash flows, depreciated collateral values, or prolonged sale and rental absorption periods. It also notes that the financial regulators recognize that prudent CRE loan workouts are often in the best interests of the financial institution and its CRE borrowers.

Further, the Policy Statement provides that performing loans, including those renewed or restructured on reasonable modified terms, made to creditworthy borrowers, 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 loan balance. The Statement also explains that institutions that implement prudent CRE loan workouts 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 classification.

The agencies have noted that the Policy Statement is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. The Statement replaces the *Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans* (November 1991). The Policy Statement may be accessed through the FDIC’s website at: www.fdic.gov/news/news/financial/2009/fil09061.html.

FASB REDEFINES “PARTICIPATING INTERESTS”

The Financial Accounting Standards Board (FASB) issued in June 2009 a new Statement of Financial Accounting Standards No. 166 (SFAS 166) on accounting for transfers of financial assets. SFAS 166 is effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009.

SFAS 166 defines the term “participating interest” to establish specific conditions for reporting a transfer of a portion of a financial asset (such as a loan participation) as a true sale (as opposed to a secured borrowing). Under the new rule, a “participating interest” must meet the following requirements:

- From the date of the transfer, the participation interest must represent a pro-rata ownership interest in the entire loan.

- From the date of the transfer, all cash flows received from the entire loan are divided proportionally among the participants in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, must not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. **This requirement effectively eliminates the ability of institutions to enter into “first out-” or “last out-type” participations where one institution’s share of the principal gets repaid before the other participants.**
- The rights of each participant (including the transferor in its role as a participant) have the same priority, and no participant’s interest is subordinated to the interest of another participant. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participant. Participants have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than **standards representations and warranties**, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participant.
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

Institutions entering into loan participation agreements must consider this new rule when structuring the participation so as to ensure true sale

treatment of the participation interest. In addition, a transferor of a participation interest that fails to qualify as a true sale under SFAS 166 may not be able to exclude such participation interest for lending limits purposes.

NEW SHORT-SALES RULES EFFECTIVE JANUARY 1 ALSO APPLICABLE TO COMMERCIAL LOANS

Effective January 1, 2010, a new California law (SB 306) took effect requiring lenders to respond in a timely manner to short-sale requests. While the law was clearly intended to eliminate lender-caused delays in the residential context, it does not distinguish between residential or commercial real property, and therefore applies to commercial lenders as well.

Upon receiving a written short-pay request for a short-pay demand statement (that is, a short-sale package), institutions must respond within 21 days after receipt by either issuing the statement or decline the request in writing.

To be subject to this rule, the short-pay request must (1) be in writing, (2) be from an entitled person (generally, the trustor, competing lienholders or their agents), (3) include a copy of an existing contract to purchase the property for a determined amount, (4) include a copy of the short-pay agreement in the possession of the entitled person, and (5) contain information related to the release of any other liens on the property (if any).

If the terms of a short-pay agreement require additional approval by the lender of the closing statement or similar document prepared by the escrowholder, the lender must provide such approval or disapproval within four days of receipt of the closing statement, or the closing statement is automatically approved.

Lenders who fail to comply with these requirements are liable to the beneficiary for damages, plus the sum of \$300 per incident (regardless of whether damages were incurred).

FOR ADDITIONAL INFORMATION...

If you have questions, please contact Mark Aldrich or Eric Baron of Aldrich Bonnefin & Moore, PLC.