



Marcus & Millichap
Real Estate Investment Services

John J. Godwin
Vice President Investments
(248) 415-2618 Office
(248) 408-4015 Cell
John.godwin@marcusmillichap.com

hms
John T. Haarala
1500 Abbot Road, Suite 210
East Lansing, Michigan
877-791-0435 ext. 3705
Fax: 517-999-4028
Email: jhaarala@hms.com

Loan Workouts—Helping Your Client Manage the Commercial Real Estate Loan Renewal

A. The Problem Facing Commercial Real Estate Loan Renewals

Three years ago, Michigan's economic problems were an anomaly compared to the rest of the United States. Unfortunately for the rest of the United States, Michigan's economic problems only foreshadowed the coming problems for the rest of the country. We can only hope that Michigan will lead the way in ending the recession and returning the country to economic prosperity. But if the commercial real-estate market is any barometer, 2010 won't be the year for Michigan's rebound. In fact, the next three years may be especially difficult for a commercial real estate market that has seen falling prices, a shortfall of bank capital for refinancing, and a much tighter credit market. As outlined below, these factors will create a challenge for those borrowers with maturing commercial real estate loans.

1. Falling RE Values.

Across the country, commercial real estate values have fallen by over 40% since the October 2007 peak.¹ Harder hit areas of the country have seen even greater declines, with commercial real estate values dropping to almost half of its peak value.² This precipitous drop in value has eliminated significant amounts of equity that previously existed in commercial real estate.

2. Lack of Bank Capital.

Banks are finding it difficult to make new loans and renew existing loans because they lack adequate capital to do so. State and federal regulators require banks to maintain a certain level of internal capital to absorb the losses sustained when loans go bad.³ The number of delinquent and non-performing loans has risen drastically over the last 18 months. As a result, banks have had to tap into their capital reserves to cover losses. To make matters worse, bank regulators are requiring banks to increase their capital reserves to help weather this economic downturn. So at a time when banks are taking a big hit to their capital reserves, they are also being required to increase those reserves to an

even higher level. Money that banks would typically lend to borrowers must instead be used to replenish and build capital reserves.

3. Tightening credit guidelines.

Gone are the days of 95% loan-to-value lending. As bank losses on commercial real estate continue to mount, bank officers and directors are becoming much more conservative in their lending. And with good reason: bank regulators are placing an increased scrutiny on bank management, assessing civil money penalties and threatening criminal prosecution for those who head up failing banks.⁴ Lenders are expecting commercial borrowers to share more of the risk in commercial real estate transactions by injecting more equity into projects. In addition to bringing more money to the table, commercial borrowers will also face strict verification of their income and assets; more emphasis will be placed on other repayment sources as real estate collateral continues to decline in value.⁵

B. Proactive Steps to Help Your Client Manage the Commercial Loan Renewal

Commercial real estate owners are going to be presented with big challenges and difficult decisions over the next several months as they attempt to refinance their commercial real estate loans. As an attorney representing commercial real estate clients, there are steps that you can, and should, take to help your client manage the renewal process. It is estimated that at least \$1 trillion in commercial real estate financing will mature over the next three years.⁶ Many of these maturing loans were made when real estate values were at or near their peak. Up to 65% of these properties will fail to qualify for refinancing without a large equity infusion.⁷ With a proactive approach and early planning, a diligent attorney will be able to guide their client through a loan workout, or at the very least, position individual loan guarantors in such a way that they are not subject to overwhelming personal liability.

1. Alert your commercial real estate clients to potential renewal problems now.

A commercial borrower needs to begin the loan-renewal process early in order to head off potential problems. This is so even if the borrower has previously had a relaxed and informal renewal relationship with the lender. For past loan renewals, the borrower may have signed documents on the day of renewal or even several days after the renewal date. The borrower should not assume that this type of relationship will continue to exist under the current economic environment. Banks are under a tremendous amount of internal and external scrutiny. Waiting until the last minute to engage in the renewal process could jeopardize the renewal. An attorney representing commercial

real estate clients needs to be proactive in alerting their clients to the potential problems that might be encountered at renewal. By beginning early in the process, you will give your client a better chance to save their business or property.

2. Begin the renewal process 12 months before the loan matures.

Waiting until the day or week before a loan matures to engage in the renewal process will jeopardize your client's chance of obtaining a favorable renewal or workout for their commercial real estate loan. From the commercial borrower's perspective the renewal process should begin several months before the loan matures. Below is a timeline of activity that can be used as a guide to help prepare a commercial borrower for their renewal.

a. 6-12 Months before renewal

i. Gather and evaluate financial information

More so than at any other time in recent history, lenders are requiring borrowers to provide and verify their financial information at the time of loan renewal. Lenders are analyzing these figures for financial weakness or any other sign that could indicate that a borrower is an unacceptable risk. At least six months before renewal, a borrower should gather and assess their own financial condition so that they know and are prepared to address any potential financial weakness that may draw their lender's attention. Some relevant information to gather would include:

1. Updated personal financial statement for all borrowers and guarantors.
2. An appraisal, broker price opinion, or market analysis of the property.
3. Updated historical and projected financials for the business.
4. Last two years' tax returns.

ii. Meet with the lender

Once the borrower has gathered and analyzed its financial information, it should schedule a meeting with the lender. Going into the meeting, the borrower should have a clear and accurate picture of its financial position. Unless required by the lender, the borrower won't have to bring its current financial information to this early meeting. The borrower has an information advantage over the lender at this meeting: the borrower knows its precise, current financial condition and the lender does not. Now is the time for the

borrower to probe the lender to see if anything about the borrower's current financial situation will be a cause of concern for the lender when the renewal date approaches. The borrower should ask the following or similar questions:

1. What happens if the property does not appraise at renewal?
2. What if my business cash flow is insufficient to service the debt?
3. Can I extend maturity by 9-12-18 months without renewing the loan?
4. Would it be possible to enter into a forbearance agreement that lowers the monthly loan payment and extends maturity?

At this early stage, the borrower might choose not to bring its attorney to the meeting with the lender. Often, an attorney's involvement, especially when there hasn't been a history of attorney involvement in the past, could raise concerns for the lender. Even if not present at this meeting, an attorney can play an important role as the borrower's advisor and consultant.

iii. Approach other lenders

Several months before the loan matures, a commercial borrower should approach several other lenders about the possibility of refinancing the loan. The borrower's current lender may be unwilling or unable to renew the loan upon maturity. Or if the current lender does renew the loan, it may do so only with unfavorable terms. For these reasons, the borrower should shop several alternate sources of refinancing. Ideally, the borrower will obtain a competitive commitment to refinance the loan and use that as a tool to negotiate similar or better terms with its current lender. Alternatively, the borrower may find that it is unable to obtain any financing elsewhere. Knowing this early will help the borrower in its negotiations with its current lender: with no alternate source of financing, the current lender will have to renew or rework the original loan or else it will become nonperforming.

iv. Consider escrowing payments

After analyzing its finances and meeting with the lender, a borrower may reach the conclusion that there will be no way for it to obtain renewal or replacement financing for its commercial real estate loan. In that case, the borrower will need to consider whether it makes economic sense to continue paying interest, tax, and maintenance expenses on the property. The borrower may want to consider escrowing these payments until it can determine whether it will be able to remain in the property. The borrower should consult its attorney and financial advisors to fully understand the legal and financial ramifications of this decision.

b. 3 – 6 months before renewal

i. Meet again with the lender

At this stage of the game it is time to meet with the lender in order to determine if the loan will be renewed and under what terms. Just before this meeting, the borrower should provide the lender with the updated financial information that was previously compiled along with any additional information that may have been requested by the lender. When setting the meeting, the borrower should make it clear to the lender that it needs the bank's decision on whether it will renew the loan.

If the bank will not renew the loan and the borrower is unable to identify any other sources of financing, the borrower has to be prepared to discuss available alternatives with the lender. This is where the borrower's earlier questioning of the lender will prove helpful. One option to consider is extending the loan's maturity date rather than renewing the loan. Depending on the bank, it may be easier to extend the maturity date than it is to renew the loan for a new term. If the borrower is not delinquent on its payments and has sufficient projected cash flow to service the monthly debt obligations, it may be possible to obtain an extension even though the property value doesn't support a loan renewal.⁸ A lender can often justify extending a loan if doing so gives the borrower time to sell the building, obtain tenants, or raise capital for an equity injection.

If extending the loan is not an option, the borrower needs to bring up end-game alternatives. With no renewal, extension, or replacement financing, the borrower is very likely going to lose its property to the lender. If the property has declined in value to a point significantly below the outstanding debt, the borrower and loan guarantors may also face liability for any deficiency. As discussed below, two strategies for limiting deficiency liability include offering the lender a deed-in-lieu of foreclosure, and purchasing the note from the lender.

ii. Continue searching for alternative financing

The borrower should continue efforts to obtain financing from alternative sources. If the borrower has been unable to obtain financing from banks, it may want to consider private investors or other bank alternatives.

iii. Look for new property to purchase or lease

If no alternative sources of financing can be located, the borrower may need to consider purchasing or leasing a new facility to continue its operations.

By being proactive and taking action well before the renewal date, a borrower can be alerted to potential renewal problems and take steps to keep its business open. The borrower may be able to find a comparable property at a greatly reduced purchase price or lease rate that would allow the borrower to continue in business.

d. Begin taking steps to wind-up the business

For some commercial borrowers, the property is the business, and if there is no financing for the property, the business can't continue. For those borrowers, they may need to begin taking the steps necessary to wind up their business.

C. Limiting a Guarantor's Personal Liability

For risk management and financial planning purposes, most commercial real estate is owned by a business entity, whether that is a corporation, limited partnership, or limited liability company. In fact, the commercial property may consist of all or significantly all of the entity's assets. Lenders recognize that they have little recourse against such an entity other than going after the property pledged as collateral. As a result, most lenders require personal guarantees from one or more individuals before they make a loan to a business entity. The personal liability that attaches as a result of such a guarantee can be onerous if the value of the property securing the loan has dropped precipitously. Guarantors and individual borrowers should take steps to limit their liability to the lender if at all possible.

1. Deed-in-lieu of foreclosure: bargaining with time.

A borrower or guarantor may not have cash to bargain with if they have faced a recent reversal in the real estate market, but they do have time. It will take a lender several months to recover a property through the foreclosure process. During that time, the lender will not be receiving any payments on the loan and will be incurring significant property-related costs. Foreclosed borrowers have little incentive to pay taxes or other expenses related to maintaining the property. This means the lender will likely have to pay taxes and insure the property during the foreclosure process. Further, when the foreclosure is complete, the lender will likely have to pay significant deferred maintenance expenses before the property can be marketed for sale.

By offering the lender immediate possession and control of the property, a borrower or guarantor may be able to negotiate a concession with respect to any deficiency balance that may remain after a foreclosure sale. A

foreclosure deficiency balance is calculated by subtracting the lender's foreclosure bid from the remaining loan balance. If the loan balance is \$900,000 and the lender bids \$600,000 at the foreclosure sale, the borrower and guarantors face liability to the bank for a \$300,000 deficiency. The borrower can always defend a deficiency action by proving that, despite the amount of the lender's bid, the property sold was fairly worth the amount of the debt secured by it.⁹

It is important to remember that the deficiency balance will be established at the time of the foreclosure sale; as such, a lender can't pursue a borrower or guarantor for a decrease in the property value or expenses that occur after the foreclosure sale.¹⁰ A vacant and unmaintained building may lose significant value in the months following a foreclosure sale, especially in an already weak real estate market. A lender's actual loss on a foreclosed property can be far greater than the deficiency it would be able to recover from a guarantor. Prosecuting a deficiency action also costs the lender time and money.

A borrower or guarantor can provide substantial value to a lender by offering the lender immediate possession and control of the real estate through a deed-in-lieu of foreclosure. A deed-in-lieu gives the lender the property without the expense, time, or risk inherent in the foreclosure process. In exchange for the deed-in-lieu, the borrower or guarantor should be able to negotiate a complete or partial release from any deficiency action by the lender. And even if a guarantor can't negotiate a full release, they may be able to negotiate favorable terms for repaying a partial deficiency.

2. Guarantor note purchase

In some situations, a lender will be unwilling to negotiate a reduced deficiency balance in exchange for a deed-in-lieu. This will certainly be the case if a guarantor has a significant net worth or a high income. A lender will pursue a deficiency action following a foreclosure against a guarantor that it deems collectable. In such a situation, a guarantor with means to do so may want to consider purchasing the lender's interest in the note and security documents in order to control the liquidation of collateral and pursue its own recovery against the remaining guarantors.

A note is a negotiable instrument.¹¹ As such, a note is assignable, and a guarantor can purchase the note that it guaranteed from the lender. In doing so, the guarantor steps into the shoes of the lender and has the full right to enforce the note according to its terms. The assignment of a note also equates to an assignment of the security documents securing repayment of the note.¹²

So a guarantor purchasing a note also receives a right to enforce the mortgage securing that note.

An asset or income rich guarantor will be the primary target for a lender in a collection or deficiency action. If a guarantor has no real defense to a lender's claims under a note, purchasing the note puts a guarantor in the driver's seat. First, it gives the guarantor control over the collection process. Second, it gives the guarantor control over the collateral pledged as security. And finally, it gives the guarantor control over the borrower and other loan guarantors.

Purchasing the note gives the guarantor control over the collection process. The guarantor removes itself as a collection defendant, and, if it so chooses, can become the collection plaintiff. Once the guarantor steps into the shoes of the lender, it is often in a much better position to develop a flexible repayment plan with the borrower and remaining guarantors. Additionally, the guarantor can work with the borrower under a much more flexible timeline than a lender would be able to. Lenders are required by their policies and outside regulators to begin collection activities almost immediately after a default. On the other hand, a guarantor, free of bank or regulator influence, has the ability to wait months or years to pursue collection.

Lender liquidations rarely generate the best price for collateral. Asset sales by lenders attract bottom feeders and liquidation values. Often lenders sell collateral piecemeal through auction or liquidation companies. By doing so, lenders can quickly turn collateral into cash, but the amount of cash realized is often far less than would be realized if the assets were sold as part of a going concern. When a guarantor purchases a lender's interest in a note, the guarantor can exercise more control over how and to whom the collateral is sold. A guarantor can market the assets as a going concern, and can often solicit offers from industry partners or competitors that far exceed the liquidation values realized by the lender. By controlling the sale of collateral, a guarantor may be able to recoup the entire loan balance, whereas a lender would recover a fraction of that amount.

Finally, a guarantor that owns the note has greater control over the borrower and the remaining guarantors. The purchasing guarantor can pursue the borrower and remaining guarantors for any deficiency remaining after the sale of collateral. Or, if the purchasing guarantor does not want to pursue the remaining guarantors or borrower, its possession of the note may give the guarantor the leverage needed to gain control over the business operations and provide an opportunity to right the problems with the company.

Purchasing the lender's interest in a note may provide a high-net-worth guarantor with an opportunity to reduce or eliminate their exposure under the guaranty. At the very least, it gives the guarantor control over the collection process and provides an alternative to defending against a no-win lawsuit. A guarantor may even be able to negotiate a discounted purchase from the lender, which would allow it to pursue the full face value of the note and potentially turn a profit.

D. Conclusion

Commercial real estate has dropped significantly in value over the past three years. As a result, many banks have suffered loan losses on their commercial real estate portfolios. These losses, together with regulatory requirements to increase capital reserves, have created a shortage of funds available for banks to lend. The loss of equity in commercial property and shortage of bank capital will make it difficult for a commercial real estate borrower to obtain refinancing when its loan matures. An attorney advising a commercial real estate owner should prepare their client for this potential problem. By starting early in the renewal process and being aware of options to reduce or eliminate a borrower's or guarantor's liability, an attorney can help their client manage a commercial real estate crisis.

E. Exhibits

SBA Personal Financial Statement

Deed-In-Lieu of Foreclosure

Loan Assignment Agreement

¹ Moody's/REAL Commercial Property Price Indices, October 2009, p 4, available at <<http://www.reit.com/Portals/0/CPPI%20October%202009.pdf>>. Websites cited in this outline last accessed on January 26, 2010.

² Id.

³ 12 C.F.R. § 325.3

⁴ FinCriAdvisor, *Civil Money Penalties Against Bank Directors & Officers on the Rise* (December 13, 2009), <<http://www.fincriadvisor.com/2009-12-13/civilmoneypenalties>>.

⁵ FinCriAdvisor, *Appraisals, CRE Remain Focus of Examiners; New Guidelines Demand Strict Documentation* (November 8, 2009), < <http://www.fincriadvisor.com/2009-11-08/CREpolicy>>.

⁶ Deutsche Bank Securities, Inc., *The Future Refinancing Crisis in Commercial Real Estate* (April 23, 2009), p 7, available at <<http://cop.senate.gov/documents/report-042309-parkus.pdf>>.

⁷ *Id.* at 4.

⁸ Federal Financial Institutions Examination Council, *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (October 30, 2009) p 8, available at <<http://www.ffiec.gov/guidance/cre103009.pdf>>.

⁹ MCL 600.3280, See also *Chabut v Chabut*, 66 Mich App 440; 239 NW2d 401 (1976).

¹⁰ *Bank of Three Oaks v Lakefront Properties*, 178 Mich App 551, 558; 444 NW2d 217 (1989) (Holding that mortgagor is not liable to lender for post-foreclosure sale interest, taxes, or insurance costs).

¹¹ MCLA 440.3104.

¹² *Ginsberg v Capitol City Wrecking Co*, 300 Mich 712, 717; 2 NW2d 892 (1942).



PERSONAL FINANCIAL STATEMENT

U.S. SMALL BUSINESS ADMINISTRATION

As of _____, _____

Complete this form for: (1) each proprietor, or (2) each limited partner who owns 20% or more interest and each general partner, or (3) each stockholder owning 20% or more of voting stock, or (4) any person or entity providing a guaranty on the loan.

Name	Business Phone
Residence Address	Residence Phone
City, State, & Zip Code	
Business Name of Applicant/Borrower	

ASSETS		(Omit Cents)	LIABILITIES		(Omit Cents)
Cash on hand & in Banks	\$	_____	Accounts Payable	\$	_____
Savings Accounts	\$	_____	Notes Payable to Banks and Others	\$	_____
IRA or Other Retirement Account	\$	_____	(Describe in Section 2)		
Accounts & Notes Receivable	\$	_____	Installment Account (Auto)	\$	_____
Life Insurance-Cash Surrender Value Only	\$	_____	Mo. Payments \$ _____		
(Complete Section 8)			Installment Account (Other)	\$	_____
Stocks and Bonds	\$	_____	Mo. Payments \$ _____		
(Describe in Section 3)			Loan on Life Insurance	\$	_____
Real Estate	\$	_____	Mortgages on Real Estate	\$	_____
(Describe in Section 4)			(Describe in Section 4)		
Automobile-Present Value	\$	_____	Unpaid Taxes	\$	_____
Other Personal Property	\$	_____	(Describe in Section 6)		
(Describe in Section 5)			Other Liabilities	\$	_____
Other Assets	\$	_____	(Describe in Section 7)		
(Describe in Section 5)			Total Liabilities	\$	_____
Total	\$	_____	Net Worth	\$	_____
			Total	\$	_____

Section 1. Source of Income	Contingent Liabilities
Salary	As Endorser or Co-Maker
Net Investment Income	Legal Claims & Judgments
Real Estate Income	Provision for Federal Income Tax
Other Income (Describe below)*	Other Special Debt

Description of Other Income in Section 1.

*Alimony or child support payments need not be disclosed in "Other Income" unless it is desired to have such payments counted toward total income.

Section 2. Notes Payable to Banks and Others. (Use attachments if necessary. Each attachment must be identified as a part of this statement and signed.)

Name and Address of Noteholder(s)	Original Balance	Current Balance	Payment Amount	Frequency (monthly, etc.)	How Secured or Endorsed Type of Collateral

Section 3. Stocks and Bonds. (Use attachments if necessary. Each attachment must be identified as a part of this statement and signed).

Number of Shares	Name of Securities	Cost	Market Value Quotation/Exchange	Date of Quotation/Exchange	Total Value

Section 4. Real Estate Owned. (List each parcel separately. Use attachment if necessary. Each attachment must be identified as a part of this statement and signed.)

	Property A	Property B	Property C
Type of Property			
Address			
Date Purchased			
Original Cost			
Present Market Value			
Name & Address of Mortgage Holder			
Mortgage Account Number			
Mortgage Balance			
Amount of Payment per Month/Year			
Status of Mortgage			

Section 5. Other Personal Property and Other Assets. (Describe, and if any is pledged as security, state name and address of lien holder, amount of lien, terms of payment and if delinquent, describe delinquency)

Section 6. Unpaid Taxes. (Describe in detail, as to type, to whom payable, when due, amount, and to what property, if any, a tax lien attaches.)

Section 7. Other Liabilities. (Describe in detail.)

Section 8. Life Insurance Held. (Give face amount and cash surrender value of policies - name of insurance company and beneficiaries)

I authorize SBA/Lender to make inquiries as necessary to verify the accuracy of the statements made and to determine my creditworthiness. I certify the above and the statements contained in the attachments are true and accurate as of the stated date(s). These statements are made for the purpose of either obtaining a loan or guaranteeing a loan. I understand FALSE statements may result in forfeiture of benefits and possible prosecution by the U.S. Attorney General (Reference 18 U.S.C. 1001).

Signature: _____ Date: _____ Social Security Number: _____

Signature: _____ Date: _____ Social Security Number: _____

PLEASE NOTE: The estimated average burden hours for the completion of this form is 1.5 hours per response. If you have questions or comments concerning this estimate or any other aspect of this information, please contact Chief, Administrative Branch, U.S. Small Business Administration, Washington, D.C. 20416, and Clearance Officer, Paper Reduction Project (3245-0188), Office of Management and Budget, Washington, D.C. 20503. **PLEASE DO NOT SEND FORMS TO OMB.**

DEED IN LIEU OF FORECLOSURE

THIS DEED IN LIEU OF FORECLOSURE (“Deed”) is given this _____ day of March 2010, by Ben Borrower, a single man, whose address is 123 Apple Rd., Houghton, Michigan (“Grantor”), to Bankers Bank of Banking, whose address is 250 South Street, Lansing, MI (“Grantee”).

In exchange for \$1.00 (one dollar and 00/100), and other valuable consideration, including the forgiveness of and release from the debt secured by a mortgage on the property located at 3450 Douglass Avenue, Houghton, MI 49910, dated October 1, 2007, and recorded on October 10, 2007, in Liber 3781, Page 46, Houghton County Register of Deeds (“Mortgage”), Grantor grants to Grantee its interest in and to that property located in Houghton County, Michigan as legally described on the attached **Exhibit A** (“Property”).

The parties acknowledge and agree that the Grantor is in default under the terms of the Mortgage and has failed to cure a payment default on the obligation secured by the Mortgage. Grantor knowingly and voluntarily gives this deed in lieu of foreclosure of the Mortgage. This Deed is an absolute sale of the Property, and the parties agree that Grantor retains no right of redemption or possession to the Property. The parties further agree that this Deed will not result in a merger of Grantee’s title into the Mortgage. It is Grantee’s intent to preserve the Mortgage and the obligation secured by the Mortgage as against the Property.

This transaction is exempt from transfer taxation pursuant to MCL 207.526(a), (d), and (v) and MCL 207.505(a) & (d).

GRANTOR:

Ben Borrower, a single man

Acknowledged before me in Houghton County, Michigan, on March _____, 2010, by C. Ben Borrower, a single man.

, Notary Public
Houghton County, Michigan
Acting in Houghton County, Michigan
My Commission Expires: _____

Prepared by and after recording return to:
Able Attorney
123 Main Street
Houghton, MI 49910

AGREEMENT TO ASSIGN LOAN DOCUMENTS

THIS AGREEMENT to Assign Loan Documents is made on March __, 2010, between Banker's Bank of Banking, 123 N. East Street, Valley Hills, Michigan 48000 ("Assignor"), and Guarantor, LLC, 500 W. South Ave., Detroit, MI 4800("Assignee").

RECITALS

- A. Assignor is the holder of a Note dated October 1, 2007, given by Borrower Business, Inc. ("Borrower") in the original amount of \$1,500,000.00 ("Note"). A copy of the Note is attached as Exhibit A.
- B. Repayment of the Note is secured by a Mortgage on the property located 3450 Douglass Avenue, Houghton, MI 49910 ("Real Estate") according to a Mortgage dated October 1, 2007, recorded on October 10, 2007, in Liber 3781, Page 46, Houghton County Register of Deeds (the "Mortgage"). A copy of the Mortgage is attached as Exhibit B.
- C. Repayment of the Note is secured by a Commercial Guaranty dated October 1, 2007, executed by Bob Borrower in favor of Lender ("Guaranty"). A copy of the Guaranty is attached as Exhibit C.

The Note, Mortgage, and Guaranty are collectively referred to as the "Loan Documents."

AGREEMENT

The parties mutually agree as follows:

- 1. Assignment. Assignor assigns to Assignee, all of its interest in the Loan Documents. This Assignment is made without recourse. At closing, Assignor will sign and deliver to Assignee an endorsement of the Note and an assignment of the Mortgage.
- 2. Consideration. As consideration for this Assignment, Assignee will pay \$1,400,000.00 USD to the Assignor, payable in cash upon execution of this Agreement, which shall take place no later than April 1, 2010.
- 3. Assignee's Prior Due Diligence. Assignee is purchasing the Loan Documents after its independent examination and inspection of the Loan Documents. Assignee is relying on its own determination of the condition of the Loan Documents and the assets securing payment of the Note, and not on any information provided or to be provided by the Assignor. Assignee is not relying on any representations of Assignor with respect to:
 - a. the marketability, value, quality, or condition of the Loan Documents;
 - b. the validity, enforceability, or the collectability of the Loan Documents;
 - c. the validity, priority or perfection of any liens securing payment of the Note;

- d. Assignor's compliance with any and all applicable federal, state or local laws, rules, regulations or ordinances in any manner relating to the Loan; and
- e. any other matters pertaining to the Loan Documents or the assets securing payment of the Note.

Assignee has knowledge and experience of financial and business matters and is capable of evaluating the merits and risks relating to the Loan Documents and is making an informed purchase and investment decision in connection with this Agreement.

4. Miscellaneous. This Agreement is governed by Michigan law. This Agreement may only be amended by a written agreement signed by the parties. This Agreement shall inure to the benefit of and be binding upon the parties and their successors and assigns. This Agreement may be executed in one or more counterparts, each such counterpart being an original and all such counterparts taken together constituting one and the same instrument. The parties agree that a facsimile transmission of a counterpart signature page to this Agreement executed by the transmitting party shall have the same force and effect as delivery of an originally signed counterpart signature page of this Agreement and shall be binding upon the transmitting party.

BANKER'S BANK OF BANKING

By: Darren Helm
Its: President

GUARNATOR, LLC

By: Peter Borrower
Its: President

**Workouts That Work Better than Others
Or
Why Would the Bank Want to do That?**

David A. Handelsman
First Vice President
Associate General Counsel
5151 Corporate Drive
Stop S-700-4
Troy, MI 48098
Office: (248) 312-6008
Cell: (586) 744-9352
Fax: (877) 471-.5352
dhandelsman@flagstar.com
www.flagstar.com

Financial Institution Letters

Policy Statement on Prudent Commercial Real Estate Loan Workouts

FIL-61-2009
October 30, 2009

Summary: The financial regulators recognize that prudent commercial real estate (CRE) loan workouts are often in the best interest of financial institutions and creditworthy CRE borrowers. The attached guidance focuses on the elements of prudent workout programs. It also provides illustrations of the analytical review process to ensure the credit risk in a loan workout is accurately identified and the arrangements receive appropriate regulatory reporting and accounting treatment.

Highlights:

- Institutions and borrowers face significant challenges when dealing with diminished operating cash flows, depreciated collateral values, or prolonged sale and rental absorption periods.
- The financial regulators recognize that prudent CRE loan workouts are often in the best interest of the financial institution and CRE borrowers.
- 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.
- 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.
- Examiners will take a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity.
- The guidance includes a series of examples of CRE loan workouts, which are provided for illustrative purposes only.
- This guidance replaces the *Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans* (November 1991).

Distribution:

FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:

Chief Executive Officer
Chief Lending Officer

Related Topics:

Managing CRE Concentrations in a Challenging Environment ([FIL-22-2008](#))

Interagency Statement on Meeting the Needs of Creditworthy Borrowers ([FIL-128-2008](#))

Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices ([FIL-104-2006](#))

Attachment:

[Policy Statement on Prudent Commercial Real Estate Loan Workouts \(PDF Help\)](#)

Contact:

For supervisory issues:

Beverlea S. Gardner, Senior Examination Specialist, at BGardner@FDIC.gov or (202) 898 3640

For regulatory reporting and accounting issues:

FDIC Regional Accountant or Robert F. Storch, Chief Accountant, at RStorch@FDIC.gov or (202) 898 8906

Policy Statement on Prudent Commercial Real Estate Loan Workouts

The financial regulators¹ recognize that financial institutions face significant challenges when working with commercial real estate (CRE)² borrowers that are experiencing diminished operating cash flows, depreciated collateral values, or prolonged sales and rental absorption periods. While CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together.

The regulators have found that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower. Examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity. Financial institutions that implement prudent CRE 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. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified 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 loan balance.

I. Purpose

This statement updates and replaces existing supervisory guidance to assist examiners in evaluating institutions' efforts to renew or restructure loans to creditworthy CRE borrowers.³ It 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. This guidance 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.

¹ 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), the Office of Thrift Supervision (OTS), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee (collectively, the regulators).

² Consistent with the FRB, FDIC, and OCC joint guidance and the OTS guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (December 2006), CRE loans include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. CRE loans also include land development and construction loans (including 1- to 4-family residential and commercial construction loans), other land loans, loans to real estate investment trusts (REITs), and unsecured loans to developers. For credit unions, "commercial real estate loans" refers to "member business loans," as defined in Section 723.1 of the NCUA Rules and Regulations, secured by real estate.

³ This statement replaces the Interagency Policy Statements on *the Review and Classification of Commercial Real Estate Loans* (November 1991) and *Review and Classification of Commercial Real Estate Loans* (June 1993).

The statement also includes references and materials related to regulatory reporting,⁴ but it 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). These general principles also could apply to commercial loans that are secured by real property or other business assets of a commercial borrower.

Attachment 1 of this document contains examples of CRE loan workouts illustrating application of this statement to credit classification, determination of accrual versus nonaccrual status, and identification and reporting of troubled debt restructurings. Attachment 2 lists a summary of references to relevant supervisory and accounting guidance for real estate lending, appraisals, allowance for loan and lease losses (ALLL), restructured loans, fair value measurement, and regulatory reporting matters such as nonaccrual status. This statement should be used in conjunction with materials identified in Attachment 2 to reach appropriate conclusions regarding credit classification and regulatory reporting. Attachment 3 discusses valuation concepts for income producing real property.⁵ Attachment 4 provides the classification definitions.

II. Risk Management Elements for Loan Workout Programs

An institution's risk management practices for renewing and restructuring⁶ CRE loans should be appropriate for the complexity and nature of its lending activity and should be consistent with safe and sound lending practices and relevant regulatory reporting requirements. These practices should address:

- Management infrastructure to identify, control, and manage the volume and complexity of the workout activity
- Documentation standards to verify the borrower's financial condition and collateral values
- Adequacy of management information systems and internal controls to identify and track loan performance and risk, including concentration risk
- Management's responsibility to ensure that the regulatory reports of the institution are consistent with regulatory reporting requirements (including GAAP) and supervisory guidance
- Effectiveness of loan collection procedures
- Adherence to statutory, regulatory and internal lending limits

⁴ For banks, the FFIEC Consolidated Reports of Condition and Income (FFIEC Call Report); for savings associations, the Thrift Financial Report (TFR); and for credit unions, the NCUA 5300 Call Report.

⁵ Valuation concepts applied to regulatory reporting processes also should be consistent with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*.

⁶ A restructuring involves a formal modification in the loan's terms with written and legally enforceable documentation.

- Collateral administration to ensure proper lien perfection of the institution's collateral interests for both real and personal property
- An ongoing credit review function

III. Loan Workout Arrangements

Loan workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions. A renewal or restructuring should improve the lender's prospects for repayment of principal and interest and be consistent with sound banking, supervisory, and accounting practices. Institutions should consider loan workouts after analyzing a borrower's repayment capacity, evaluating the support provided by guarantors, and assessing the value of the collateral pledged on the debt. Loan workout arrangements need to be designed to help ensure that the institution maximizes its recovery potential. Further, renewed or restructured loans to borrowers who have the ability to repay their debts under reasonable modified 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 loan balance.

While institutions may enter into restructurings with borrowers that result in an adverse classification, an institution will not be criticized for engaging in loan workout arrangements so long as management has:

- A prudent workout policy that establishes appropriate loan terms and amortization schedules and that permits the institution to modify the workout plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize
- A well-conceived and prudent workout plan for an individual credit that analyzes the current financial information on the borrower or guarantor and that supports the ultimate collection of principal and interest. The key elements of a workout plan include:
 - Updated and comprehensive financial information on the borrower, real estate project, and any guarantor
 - Current valuations of the collateral supporting the loan and the workout plan
 - Analysis and determination of appropriate loan structure (e.g., term and amortization schedule), curtailment, covenants, or re-margining requirements
 - Appropriate legal documentation for any changes to loan terms
- An analysis of the borrower's global debt⁷ service that reflects a realistic projection of the borrower's and guarantor's expenses
- The ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout

⁷ Global debt represents the aggregate of a borrower's or guarantor's financial obligations, including contingent obligations.

- An internal loan grading system that accurately and consistently reflects the risk in the workout arrangement
- An ALLL methodology that covers estimated credit losses in the restructured loan, measured in accordance with GAAP, and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate⁸

A. Analyzing Repayment Capacity of the Borrower

The primary focus of an examiner's review of a commercial loan, including binding commitments, is an assessment of the borrower's ability to repay the loan. The major factors that influence this analysis are the borrower's willingness and capacity to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business. When analyzing a commercial borrower's repayment ability, examiners should consider the following factors:

- The character, overall financial condition, resources, and payment record of the borrower
- The nature and degree of protection provided by the cash flow from business operations or the collateral on a global basis that considers the borrower's total debt obligations
- Market conditions that may influence repayment prospects and the cash flow potential of the business operations or underlying collateral
- The prospects for repayment support from any financially responsible guarantors

B. Evaluating Guarantees

The support provided by guarantees is a consideration in determining the credit classification for a workout. The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation and may be sufficient to preclude classification or reduce the severity of classification. The attributes of a financially responsible guarantor include:

- The guarantor has both the financial capacity and willingness to provide support for the credit through ongoing payments, curtailments or re-margining
- The guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term
- The guarantee is written and legally enforceable

⁸ Additionally, if applicable, institutions should recognize in other liabilities an allowance for estimated credit losses on off-balance sheet credit exposures related to restructured loans (e.g., loan commitments) and should reverse interest accruals on loans that are deemed uncollectible.

The institution should have sufficient information on the guarantor's global financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. This assessment includes consideration of the total number and amount of guarantees currently extended by a guarantor in order to assess whether the guarantor has the financial capacity to fulfill the contingent claims that exist.

Examiners should consider whether a guarantor has demonstrated its willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee.

C. Assessing Collateral Values

As the primary sources of loan repayment decline, the importance of the collateral's value as a secondary repayment source increases in analyzing credit risk and developing an appropriate workout plan. The institution is responsible for reviewing current collateral valuations (i.e., an appraisal or evaluation) to ensure that their assumptions and conclusions are reasonable. Further, the institution should have policies and procedures that dictate when collateral valuations should be updated as part of its ongoing credit review, as market conditions change, or a borrower's financial condition deteriorates.

For CRE loans involved in a workout situation, a new or updated appraisal or evaluation, as appropriate, should address current project plans and market conditions that were considered in the development of the workout plan. The consideration should include whether there has been material deterioration in the following factors: the performance of the project; conditions for the geographic market and property type; variances between actual conditions and original appraisal assumptions; changes in project specifications (e.g., changing a planned condominium project to an apartment building); loss of a significant lease or a take-out commitment; or increases in pre-sales fallout. A new appraisal may not be necessary in instances where an internal evaluation by the institution appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value for impairment analysis.⁹

The market value in a collateral valuation and the fair value in an impairment analysis are based on similar valuation concepts. However, the market valuation may differ from the collateral's fair value for regulatory reporting purposes. For example, differences may result if the market value and the fair value estimates are determined as of different dates or the fair value estimate reflects different assumptions than those in the market valuation. Such situations may occur as a result of changes in market conditions and property use since the "as of" date of the appraisal.

⁹ According to the FASB ASC Master Glossary, "fair value" is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

The documentation on the collateral's market value should demonstrate a full understanding of the property's current "as is" condition (considering the property's highest and best use) and other relevant risk factors affecting value. Collateral valuations of commercial properties typically contain more than one value conclusion and could include an "as is" market value, a prospective "as complete" market value, and a prospective "as stabilized" market value.

The institution should use the market value conclusion (and not the fair value) that corresponds to the workout plan and the loan commitment. For example, if the institution intends to work with the borrower to get a project to stabilized occupancy, then the institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading after reviewing the reasonableness of the appraisal's assumptions and conclusions. Conversely, if the institution intends to foreclose, then the institution should use the fair value (less costs to sell) of the property in its current "as is" condition in its collateral assessment.

Examiners will analyze collateral values based on the institution's original appraisal or internal evaluation, any subsequent updates, additional information, and relevant market conditions. An examiner should review the appropriateness of the major facts, assumptions, and valuation approaches in the collateral valuation and in the institution's internal credit review and impairment analysis.

If weaknesses are noted in the institution's supporting documentation or appraisal or evaluation review process, examiners should direct the institution to address the weaknesses, which may require the institution to obtain a new collateral valuation. However, if the institution is unable or unwilling to address these deficiencies in a timely manner, examiners will have to assess the degree of protection that the collateral affords in analyzing and classifying a credit. This may result in examiners making adjustments, if applicable, to the collateral's value to reflect current market conditions and events. When reviewing the reasonableness of the facts and assumptions associated with the value of an income-producing property, examiners should evaluate:

- Current and projected vacancy and absorption rates
- Lease renewal trends and anticipated rents
- Effective rental rates or sale prices, considering sales and financing concessions
- Time frame for achieving stabilized occupancy or sellout
- Volume and trends in past due leases
- Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs
- Discount rates and direct capitalization rates (refer to Attachment 3 for more information)

Assumptions, when recently made by qualified appraisers (and, as appropriate, by the institution) and when consistent with the discussion above, should be given a reasonable amount of deference by examiners. Examiners also should use the appropriate market value conclusion in their collateral assessments. For example, when the institution plans to provide the resources to complete a project, examiners can consider the project's prospective market value and the committed loan amount in their analysis.

Examiners generally are not expected to challenge the underlying valuation assumptions, including discount rates and capitalization rates, used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate or can support alternative assumptions.

Many CRE borrowers may have other indebtedness secured by other business assets such as furniture, fixtures, equipment, inventory, and accounts receivable. For these commercial loans, the institution should have appropriate policies and practices for quantifying the value of such assets, determining the acceptability of the collateral, and perfecting its security interest. The institution also should have appropriate procedures for ongoing monitoring of the value of its collateral interests and security protection.

IV. Classification of Loans

Loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not adversely classified.¹⁰ Similarly, loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards should not be adversely classified or criticized unless well-defined weaknesses exist that jeopardize repayment.

Further, loans should not be adversely classified solely because the borrower is associated with a particular industry that is experiencing financial difficulties. When an institution's restructurings are not supported by adequate analysis and documentation, examiners are expected to exercise reasonable judgment in reviewing and determining loan classifications until such time as the institution is able to provide information to support management's conclusions and internal loan grades. Refer to Attachment 4 for the classification definitions.¹¹

¹⁰ For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system, i.e., those loans that tend to be included in the credit union's "watch lists."

¹¹ The NCUA does not require credit unions to adopt a uniform regulatory classification schematic of loss, doubtful, substandard or special mention. A credit union should apply an internal loan grade based on its evaluation of credit risk. The term "classify" within the credit union industry has typically meant "individually review to apply a percentage reserve" for ALLL purposes. As used in this statement, "classify" and "classification" in relation to a credit union's evaluation of a credit for risk mean "grade" and "assign a credit risk grade."

A. Loan Performance Assessment for Classification Purposes

The loan's record of performance to date should be considered when determining whether a loan should be classified. As a general principle, examiners should not adversely classify or require the recognition of a partial charge-off on a performing commercial loan solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it is appropriate to classify a performing loan when well-defined weaknesses exist that will jeopardize repayment.

One perspective of loan performance is based upon an assessment as to whether the borrower is contractually current on all principal and interest payments. In many cases, this definition is sufficient for a particular credit relationship and accurately portrays the status of the loan. In other cases, being contractually current on payments can be misleading as to the credit risk embedded in the loan. This situation can occur when the loan's underwriting structure or the liberal use of extensions and renewals mask credit weaknesses and obscure a borrower's inability to meet reasonable repayment terms.

For example, in many acquisition, development and constructions loans, it is common for a loan to be structured with an "interest reserve" for the construction phase of the project. The interest reserve is established at the time the loan is originated as a portion of the initial loan commitment. The lender recognizes interest income from the reserve during the construction phase. Proceeds from the sale of lots, homes, or buildings or permanent financing based on stabilized occupancy are used for the repayment of principal, which includes any draws from the interest reserve that have been capitalized into the loan balance.

However, if the development project stalls for any number of reasons and management fails to evaluate the collectibility of the loan, interest income will continue to be recognized from the initial interest reserve and capitalized into the loan balance even though the project is not generating sufficient cash flows to repay the principal. In such cases, the loan will be contractually current due to the interest payments being funded from the reserve, but the repayment of principal may be in jeopardy, especially when expected leases or sales have not occurred as projected and property values have dropped below the market value reported in the original collateral valuation. In these situations, adverse classification of the loan may be appropriate.

B. Classification of Renewals or Restructurings of Maturing Loans

Loans to commercial borrowers can have short maturities, including short-term working capital loans to businesses, financing for CRE construction projects, or loans to finance recently completed CRE projects for the period to achieve stabilized occupancy. Many borrowers whose loans mature in the midst of an economic crisis have difficulty obtaining short-term financing or adequate sources of long-term credit due to deterioration in collateral values despite their current ability to service the debt.

In such cases, institutions may determine that the most appropriate and prudent course is to restructure or renew loans to existing borrowers who have demonstrated an ability to pay their debts, but who may not be in a position, at the time of the loan's maturity, to obtain long-term financing. The regulators recognize that prudent loan workout agreements or restructurings are generally in the best interest of both the institution and the borrower.

Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. The assessment of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. In general, renewals or restructurings of maturing loans to commercial 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. However, adverse classification of a restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.

C. Classification of Troubled CRE Loans Dependent on the Sale of Collateral for Repayment

As a general classification principle, for a troubled CRE loan that is dependent on the sale of the collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the market value of the real estate collateral less the costs to sell should be classified "loss." This principle applies when repayment of the debt will be provided solely by the sale of the underlying real estate collateral and there are no other available and reliable sources of repayment.¹²

The portion of the loan balance that is adequately secured by the fair value of the real estate collateral less the costs to sell generally should be adversely classified no worse than "substandard." The amount of the loan balance in excess of the fair value of the real estate collateral, or portions thereof, should be adversely classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, examiners should use a "doubtful" classification infrequently and for a limited time period to permit the pending events to be resolved.

D. Classification and Accrual Treatment of Restructured Loans with a Partial Charge-off

Based on consideration of all relevant factors, an assessment may indicate that a credit has well-defined weaknesses that jeopardize collection in full and may result in a partial charge-off as part of a restructuring. When well-defined weaknesses exist, and a partial charge-off has been taken, the remaining recorded balance for the restructured loan generally should be classified no more severely than "substandard."

¹² In contrast, for impairment measurement purposes under GAAP, a loan is collateral dependent if repayment of the loan is expected to be provided solely by sale or operation of the underlying collateral. For further guidance on impairment measurement on impaired collateral dependent loans, see the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (December 2006).

A more severe classification than “substandard” for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined. Such situations may occur where significant risk exposures are perceived, such as a borrower’s bankruptcy or a loan collateralized by a property subject to environmental hazards.

A restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes. Lenders may separate a portion of the current outstanding debt into a new legally enforceable note (i.e., the first note) that is reasonably assured of repayment and performance according to prudently modified terms. This note may be placed back on accrual status in certain situations. In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account. The portion of the debt that is not reasonably assured of repayment (i.e., the second note) should be adversely classified and charged-off as appropriate.

In contrast, the loan should remain or be placed on nonaccrual status if the lender does not split the loan into separate notes, but internally recognizes a partial charge-off. A partial charge-off would indicate that the institution does not expect full repayment of the amounts contractually due. If facts change after the charge-off is taken such that the full amounts contractually due, including the amount charged-off, are expected to be collected and the loan has been brought contractually current, the remaining balance of the loan may be returned to accrual status without having to first receive payment of the charged-off amount.¹³ The institution should have well-documented support for its credit assessment of the borrower’s financial condition and the prospects for full repayment.

V. Regulatory Reporting and Accounting Considerations

Institution management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements and supervisory guidance. Management also is responsible for establishing and maintaining an appropriate governance and internal control structure over the preparation of regulatory reports. This structure includes written policies and procedures that provide clear guidelines on accounting matters. Accurate regulatory reports are critically important to enhancing the transparency of an institution’s risk profile and financial position and imperative for effective supervision. Decisions related to loan workout arrangements may affect regulatory reporting, particularly interest accruals, troubled debt restructuring treatment, and credit loss estimates. Management should ensure that loan workout staff appropriately communicate with the accounting and regulatory reporting staff concerning the institution’s loan restructurings and that the reporting consequences of restructurings are presented accurately in regulatory reports.

In addition to evaluating credit risk management processes and validating the accuracy of internal credit grades, examiners are responsible for reviewing management’s processes related to accounting and regulatory reporting. While similar data are used for credit risk monitoring, accounting, and reporting systems, this information does not necessarily produce identical outcomes. For example, loss classifications may not be equivalent to impairment measurements.

¹³ The charged-off amount should not be reversed or re-booked when the loan is returned to accrual status.

Examiners need to have a clear understanding of the differences between the credit risk management and accounting and regulatory reporting concepts (such as accrual status, restructurings, and the ALLL) when assessing the adequacy of the institution's reporting practices.¹⁴ The following sections provide a summary of these reporting topics. However, examiners should refer to regulatory reporting instructions and guidance and applicable GAAP for further information.

A. Implications for Interest Accrual

For a restructured loan that is not already in nonaccrual status before the restructuring, the institution needs to consider whether the loan should be placed in nonaccrual status to ensure that income is not materially overstated. A loan that has been restructured so as to be reasonably assured of repayment and of performance according to prudent modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the loan are supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must remain in nonaccrual status.

The assessment of accrual status should include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents.¹⁵ A restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule and does not relieve the institution from the responsibility to promptly charge off all identified losses. For more detailed criteria about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, see the FFIEC Call Report, TFR, and NCUA 5300 Call Report instructions.

B. Restructured Loans

The restructuring of a loan or other debt instrument should be undertaken in ways which improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. All restructured loans should be evaluated to determine whether the loan should be reported as a TDR. For reporting purposes, a restructured loan is considered a TDR when the institution, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the institution would not otherwise consider. To make this determination, the lender assesses whether (a) the borrower is *experiencing financial difficulties*, and (b) the lender has

¹⁴ These factors also apply when considering loss estimates for off-balance sheet credit exposures (e.g., loan commitments).

¹⁵ In returning a loan to an accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account.

granted a *concession*.¹⁶ Guidance on reporting TDRs, including characteristics of modifications, is included in the FFIEC Call Report, TFR, and NCUA 5300 Call Report instructions.

The determination of whether a restructured loan is a TDR requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a restructuring is a TDR. An overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean that the borrower is *experiencing financial difficulties*. Accordingly, lenders and examiners should use judgment in evaluating whether a modification is a TDR.

For more detailed information about determining whether a borrower is *experiencing financial difficulties* and the attributes of a *concession*, see the sources of relevant supervisory and accounting guidance listed in Attachment 2.

C. Allowance for Loan and Lease Losses (ALLL)

Guidance for the institution's estimate of loan losses and examiners' responsibilities to evaluate these estimates is presented in *Interagency Policy Statement on the Allowance for Loan and Lease Losses (December 2006)* and *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (July 2001)*.¹⁷

Institutions are required to estimate credit losses based on a loan-by-loan assessment for certain loans and on a group basis for the remaining loans in the held-for-investment loan portfolio. All loans that are reported as TDRs are deemed to be impaired and should generally be evaluated on an individual loan basis in accordance with FASB ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors*¹⁸ and FASB ASC 310-10-35-2 through 30, *Receivables - Overall - Subsequent Measurement - Impairment*.¹⁹ Generally, if the recorded amount of an individually assessed loan that is impaired, but is not collateral dependent, exceeds the present value of expected future cash flows, discounted at the original loan's effective interest rate, this excess is reported as a valuation allowance.

¹⁶ Refer to FASB ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors* and FASB ASC 470-60, *Debt - Troubled Debt Restructurings by Debtors* for the characteristics of "*experiencing financial difficulties*" and "*concession*."

¹⁷ Credit unions should follow interagency supervisory guidance relative to the ALLL in the financial and regulatory reporting of loans.

¹⁸ This guidance was formerly referred to as FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

¹⁹ This guidance was formerly referred to as FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.

For an individually evaluated impaired collateral dependent loan, the regulators require that if the recorded amount of the loan exceeds the fair value²⁰ of the collateral (less costs to sell if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan), this excess is included when estimating the ALLL. However, some or all of this difference may represent a confirmed loss, which should be charged against the ALLL in a timely manner.²¹ Institutions also should consider the need to recognize an allowance for estimated credit losses on off-balance sheet credit exposures, such as loan commitments, in other liabilities consistent with FASB ASC 825-10-35- 1 through 3, *Financial Instruments – Overall - Subsequent Measurement - Credit Losses on Financial Instruments with Off-Balance-Sheet Credit Risk*.²²

For performing CRE loans, supervisory policies do not require automatic increases in the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance. However, declines in collateral values should be considered when calculating loss rates for affected groups of loans when estimating loan losses under the FASB ASC 450-20, *Loss Contingencies*.²³

²⁰ The fair value of collateral should be measured in accordance with FASB ASC 820, *Fair Value Measurements and Disclosures*. For impairment analysis purposes, the fair value of collateral should reflect the current condition of the property, not the potential value of the collateral at some future date.

²¹ Purchased loans with evidence of deterioration in credit quality since the origination of the loan, loans held for sale, and loans accounted for under the fair value option are subject to different accounting rules than originated loans that are accounted for at their amortized cost. When reviewing these other types of loans, examiners should understand the implications of other accounting rules when determining whether a loan is a TDR, what amount should be reported as a TDR, and how to estimate an associated credit loss for a TDR.

²² This guidance was formerly included in American Institute of Certified Public Accountants Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*.

²³ This guidance was formerly referred to as FASB Statement No. 5, *Accounting for Contingencies*.

Attachment 1 Examples of CRE Loan Workouts

The following examples are provided for illustrative purposes only and are designed to demonstrate the examiner's analytical thought process to identify appropriate classification, implications for interest accrual, and whether a loan should be reported as a troubled debt restructuring (TDR) for regulatory reporting purposes.²⁴ Although not discussed in the illustrations below, examiners also need to consider the adequacy of the lender's supporting documentation, internal analysis, and business decision to enter into a loan workout arrangement and its effect on the allowance for loan and lease losses (ALLL), including any impairment measurements, and subsequent reporting requirements related to the loan.

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 conclusions related to credit classifications, accrual versus nonaccrual status, and TDR reporting.²⁵ The determination of whether a loan modification is a TDR requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a modification is a TDR. To make this determination, the lender assesses whether (a) the borrower is *experiencing financial difficulties*, and (b) the lender has granted a *concession*. For purposes of these examples, if the borrower was not *experiencing financial difficulties*, the example does not assess whether a *concession* was granted. However, in distressed markets, lenders may make *concessions* because borrowers are *experiencing financial difficulties*. Accordingly, lenders and examiners should exercise judgment in evaluating whether a restructuring is a TDR.

A. Income Producing Property – Office Building

BASE CASE: A lender originated a \$15 million loan for the purchase of an office building with monthly payments based on an amortization of 20 years and a balloon payment of \$13.6 million at the end of year three. At origination, the loan had a 75 percent loan-to-value (LTV) based on an appraisal reflecting a \$20 million market value on an "as stabilized" basis, a debt service coverage ratio of 1.35x, and a market interest rate. The lender expected to renew the loan when the balloon payment became due at the end of year three. The project's cash flow has declined, as the borrower granted rental concessions to existing tenants in order to retain the tenants and compete with other landlords in a weak economy.

SCENARIO 1: At maturity, the lender renewed the \$13.6 million loan at a market rate of interest that provides for the incremental credit risk and amortized the principal over the remaining 17 years. The borrower had not been delinquent on prior payments and has sufficient cash flow to service the market rate terms at a debt service coverage ratio of 1.12x.

²⁴ The regulators believe that the accrual and TDR treatments in these illustrations fall within the range of acceptable practices under GAAP.

²⁵ In addition, estimates of the fair value of collateral for regulatory reporting purposes require the use of judgment and should be consistent with FASB ASC 820, *Fair Value Measurements and Disclosures*; see Attachment 2.

A review of the leases reflects the majority of tenants are now stable occupants with long-term leases and sufficient cash flow to pay their rent. A recent appraisal reported an “as stabilized” market value of \$13.1 million for the property, reflecting an increase in market capitalization rates, which results in a 104 percent LTV.

Classification: The lender internally graded the loan pass and is monitoring the credit. The examiner agreed, as the borrower has the ability to continue making payments on reasonable terms despite a decline in cash flow and in the market value of the collateral.

Nonaccrual Treatment: The lender maintained the loan on an accrual status. The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower’s creditworthiness, cash flow appears sufficient to make these payments and full repayment of principal and interest is expected. The examiner concurred with the lender’s accrual treatment.

TDR Treatment: The lender determined that the renewed loan should not be reported as a TDR. While the borrower is experiencing some financial deterioration, the borrower has sufficient cash flow to service the debt and has no record of payment default; therefore, the borrower is not *experiencing financial difficulties*. The examiner concurred with the lender’s TDR treatment.

SCENARIO 2: At maturity, the lender renewed the \$13.6 million loan at a market rate of interest that provides for the incremental risk and amortized the principal over the remaining 17 years. The borrower had not been delinquent on prior payments. The building’s net operating income has decreased and current cash flow to service the new loan has declined, resulting in a debt service coverage ratio of 1.12x. Some of the leases are coming up for renewal and additional rental concessions may be necessary to keep the existing tenants in a weak economy. However, the project’s debt service coverage is not expected to drop below 1.05x. A current valuation has not been ordered. The lender estimates the property’s current “as stabilized” market value is \$14.5 million, which results in a 94 percent LTV. In addition, the lender has not asked the borrower to provide current financial statements to assess the borrower’s ability to service the debt with cash from other sources.

Classification: The lender internally graded the loan pass and is monitoring the credit. The examiner disagreed with the internal grade and listed the credit as special mention. While the borrower has the ability to continue to make payments, there has been a declining trend in the property’s income stream, continued potential rental concessions, and a reduced collateral margin. In addition, the lender’s failure to request current financial information and to obtain an updated collateral valuation represents administrative deficiencies.

Nonaccrual Treatment: The lender maintained the loan on an accrual status. The borrower has demonstrated the ability to make regularly scheduled payments and, even with the decline in the borrower’s creditworthiness, cash flow is sufficient at this time to make payments and full repayment of principal and interest are expected. The examiner concurred with the lender’s accrual treatment.

TDR Treatment: The lender determined that the renewed loan should not be reported as a TDR. While the borrower is experiencing some financial deterioration, the borrower is not *experiencing financial difficulties* as the borrower has sufficient cash flow to service the debt, and there was no history of default. The examiner concurred with the lender's TDR treatment.

SCENARIO 3: At maturity, the lender restructured the \$13.6 million loan on a 12-month interest-only basis at a below market rate of interest. The borrower has been sporadically delinquent on prior payments and projects a debt service coverage ratio of 1.12x based on the preferential terms. A review of the leases, which were available to the lender at the time of the restructuring, reflects the majority of tenants have short-term leases and that some were behind on their rental payments to the borrower. According to the lender, this situation has not improved since the restructuring. A recent appraisal reported a \$14.5 million "as stabilized" market value for the property, which results in a 94 percent LTV.

Classification: The lender internally graded the loan pass and is monitoring the credit. The examiner disagreed with the internal grade due to the borrower's limited ability to service a below market rate loan on an interest-only basis, sporadic delinquencies, and the reduced collateral position, and classified the loan substandard.

Nonaccrual Treatment: The lender maintained the loan on accrual status due to the positive cash flow and collateral margin. The examiner did not concur with this treatment because the loan was not restructured with reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced estimate of cash flow from the property indicates that full repayment of principal and interest is not reasonably assured.

TDR Treatment: The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*: the project's ability to generate sufficient cash flows to service the debt is questionable, the lease income from the tenants is declining, loan payments have been sporadic, and collateral values have declined. In addition, the lender granted a *concession* (i.e., reduced the interest rate to a below market level and deferred principal payments). The examiner concurred with the lender's TDR treatment.

B. Income Producing Property – Shopping Mall

BASE CASE: A lender originated a 36-month \$10 million loan for the construction of a shopping mall to occur over 24 months with a 12-month lease-up period to allow the borrower time to achieve stabilized occupancy before obtaining permanent financing. The loan had an interest reserve to cover interest payments over the three-year term of the credit. At the end of the third year, there is \$10 million outstanding on the loan, as the shopping mall has been built and the interest reserve, which has been covering interest payments, has been fully drawn.

At the time of origination, the appraisal reported an "as stabilized" market value of \$13.5 million for the property. In addition, the borrower had a take-out commitment that would provide permanent financing at maturity. A condition of the take-out lender was that the shopping mall had to achieve a 75 percent occupancy level.

Due to weak economic conditions, the property only reached a 55 percent occupancy level at the end of the 12-month lease up period and the original takeout commitment became void. Mainly due to a tightening of credit for these types of loans, the borrower is unable to obtain permanent financing elsewhere when the loan matured in February (i.e., due to market factors and not due to the borrower's financial condition).

SCENARIO 1: The lender renewed the loan for an additional year to allow for a higher lease-up rate and for the borrower to seek permanent financing. The extension is at a market rate that provides for the incremental credit risk and on an interest-only basis. While the property's historical cash flow was insufficient at 0.92x debt service ratio, recent improvements in the occupancy level now provides adequate coverage. Recent improvements include the signing of several new leases with other leases currently being negotiated.

In addition, current financial statements reflect that the builder, who personally guarantees the debt, has sufficient cash on deposit at the lender plus other liquid assets. These assets provide sufficient cash flow to service the borrower's global debt service requirements on a principal and interest basis, if necessary. The guarantor covered the initial cash flow shortfalls from the project and provided a good faith principal curtailment of \$200,000 at renewal. A recent appraisal on the shopping mall reports an "as is" market value of \$10 million and an "as stabilized" market value \$11 million.

Classification: The lender internally graded the loan as a pass and is monitoring the credit. The examiner agreed with the lender's internal loan grade. The examiner concluded that the project continues to progress and now cash flows the interest payments. The guarantor currently has the ability and demonstrated willingness to supplement the project's cash flow and service the borrower's global debt service requirements. The examiner concurred that the interest-only terms were reasonable because the renewal was short-term and the project and the guarantor have demonstrated repayment capacity. In addition, this type of loan structure is commonly used to allow a project to achieve stabilized occupancy, but any subsequent loan terms should likely have a principal amortization component. The examiner also agreed that the LTV should be based on the "as stabilized" market value as the lender is financing the project through the lease-up period.

Nonaccrual Treatment: The lender maintained the loan on accrual status as the guarantor has sufficient funds to cover the borrower's global debt service requirements over the one-year period of the renewed loan. Full repayment of principal and interest is reasonably assured from the project's and guarantor's cash flow despite a decline in the collateral margin. The examiner concurred with the lender's accrual treatment.

TDR Treatment: The lender concluded that while the borrower has been affected by declining economic conditions, the level of deterioration does not warrant TDR treatment. The borrower was not *experiencing financial difficulties* because the borrower and guarantor have the ability to service the renewed loan, which was prudently underwritten at a market rate of interest, plus the borrower's other obligations on a timely basis, and the lender's expectation to collect the full amount of principal and interest from the borrower's or guarantor's sources (i.e., not from interest reserves). The examiner concurred with the lender's rationale and TDR treatment.

SCENARIO 2: The lender restructured the loan on an interest-only basis at a below market rate for one year to provide additional time to increase the occupancy level and thereby enable the borrower to arrange permanent financing. The level of lease-up remains relatively unchanged at 55 percent and the shopping mall projects a debt service coverage ratio of 1.02x based on the preferential loan terms. At the time of the restructuring, the lender inappropriately based the selection of the below market interest rate on outdated financial information, which resulted in a positive cash flow projection even though file documentation available at the time of the restructuring reflected that the borrower anticipates the shopping mall's income stream will decline due to rent concessions, the loss of a tenant, and limited prospects for finding new tenants.

Current financial statements indicate the builder, who personally guarantees the debt, is highly leveraged, has limited cash or liquid assets, and has other projects with delinquent payments. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in a LTV ratio of 111 percent.

Classification: The lender internally graded the loan as substandard. The examiner disagreed with the internal grade and classified the amount not protected by the collateral value, \$1 million, as loss and required the lender to charge-off this amount. The examiner did not factor costs to sell into the loss classification analysis, as the source of repayment is not reliant on the sale of the collateral at this time. The examiner classified the remaining loan balance, based on the property's "as is" market value of \$9 million, as substandard given the borrower's uncertain repayment capacity and weak financial support.

Nonaccrual Treatment: The lender determined the loan did not warrant being placed on nonaccrual status. The examiner did not concur with this treatment because the partial charge-off is indicative that full collection of principal is not anticipated and the lender has continued exposure to additional loss due to the project's insufficient cash flow and reduced collateral margin, and the guarantor's limited ability to provide further support.

TDR Treatment: The lender reported the restructured loan as a TDR because (a) the borrower is *experiencing financial difficulties* as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe; and (b) the lender granted a *concession* as evidenced by the reduction in the interest rate to a below market rate. The examiner concurred with the lender's TDR treatment.

SCENARIO 3: Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this credit. The lender chose not to restructure the \$10 million loan into a new single amortizing note of \$10 million at a market rate of interest because the project's projected cash flow would only provide a 0.88x debt service coverage ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reported an "as is" market value of \$9 million, which results in a LTV of 111 percent.

Therefore, at the original loan's maturity in February, the lender restructured the \$10 million debt into two notes. The lender placed the first note of \$7.2 million (i.e., the A note) on monthly payments that amortize the debt over 20 years at a market rate of interest that provides for the incremental credit risk. The project's debt service coverage ratio equals 1.20x for the \$7.2 million loan based on the shopping mall's projected net operating income. The lender placed the second note of the remaining principal balance of \$2.8 million (i.e., the B note) into a 2 percent interest-only loan that is scheduled to reset in five years to an amortizing payment. The lender then charged-off the \$2.8 million note due to the project's lack of repayment capacity and to provide reasonable collateral protection for the remaining on-book loan of \$7.2 million. Since the restructuring, the borrower has made payments on both loans for more than six consecutive months.

Classification: The lender internally graded the on-book loan of \$7.2 million as a pass credit due to the fact that the borrower has demonstrated the ability to perform under the modified terms. The examiner agreed with the lender's grade as the lender restructured the original obligation into A and B notes, the lender charged off the B note, and the borrower has demonstrated the ability to repay the A note. Using this multiple note structure with the charge-off of the B note enables the lender to recognize interest income and limit the amount reported as a TDR in future periods. If the lender had restructured the loan into a single note, the credit classification and the nonaccrual and TDR treatments would have been different.

Nonaccrual Treatment: The lender restored the on-book loan of \$7.2 million to accrual status as the borrower has the ability to repay the loan, has a record of performing at the revised terms for more than six months, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment. Interest payments received on the off-book loan have been recorded as recoveries because, in this case, full recovery of principal and interest on this loan was not reasonably assured.

TDR Treatment: The lender reported the restructured on-book loan of \$7.2 million as a TDR. The lender determined that the on-book loan should be reported as a TDR, consistent with the regulatory reporting guidance because (a) the borrower is *experiencing financial difficulties* as evidenced by the borrower's high leverage, delinquent payments on other projects, and failure to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe and the unlikely collectibility of the charged-off loan; and (b) the lender granted a *concession*. The concessions included a below market interest rate and protracted payment requirements on the charged-off portion of the debt and extending the on-book loan beyond expected timeframes.

If the borrower continues to perform according to the modified terms of the restructured loan, the lender plans to stop reporting the on-book loan as a TDR after the regulatory reporting defined time period expires because it was restructured with a market rate of interest. For example, since the restructuring occurred in February, the \$7.2 million on-book loan should be reported as a TDR on the lender's March, June, September, and December regulatory reports. The TDR reporting could cease on the lender's following March regulatory report if the borrower continues to perform according to the modified terms. The examiner concurred with this planned treatment.

SCENARIO 4: Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this credit. The lender restructured the \$10 million loan into a new single note of \$10 million at a market rate of interest that provides for the incremental credit risk and is on an amortizing basis. The project's projected cash flow reflects a 0.88x debt service coverage ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in a LTV of 111 percent. Based on the property's current market value of \$9 million, the lender charged-off \$1 million immediately after the renewal.

Classification: The lender internally graded the remaining \$9 million on-book portion of the loan as a pass credit because the lender's analysis of the project's cash flow indicated a 1.05x debt service coverage ratio when just considering the on-book balance. The examiner disagreed with the internal grade and classified the \$9 million on-book balance as substandard due to the borrower's marginal financial condition, lack of guarantor support, and uncertainty over the source of repayment.

Nonaccrual Treatment: The lender maintained the remaining \$9 million on-book portion of the loan on accrual, as the borrower has the ability to repay the principal and interest on this balance. The examiner did not concur with this treatment. The examiner instructed the lender to place the loan on nonaccrual status. Because the lender restructured the debt into a single note and had charged-off a portion of the restructured loan, the repayment of the interest and principal contractually due on the entire debt is not reasonably assured.

The loan can be returned to accrual status if the lender can document that subsequent improvement in the borrower's financial condition has enabled the loan to be brought fully current with respect to principal and interest and the lender expects the contractual balance of the loan (including the partial charge-off) will be fully collected. In addition, interest income may be recognized on a cash basis for the partially charged-off portion of the loan when the remaining recorded balance is considered fully collectible. However, the partial charge-off cannot be reversed.

TDR Treatment: The lender reported the restructured loan as a TDR according to the requirements of its regulatory reports because (a) the borrower is *experiencing financial difficulties* as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the original exit strategy because the borrower was unable to lease the property in a reasonable timeframe; and (b) the lender granted a *concession* as evidenced by deferring payment beyond the repayment ability of the borrower. The charge-off indicates that the lender does not expect full repayment of principal and interest, yet the borrower remains obligated for the full amount of the debt and payments, which is at a level that is not consistent with the borrower's repayment capacity. Because the borrower is not expected to be able to comply with the loan's restructured terms, the lender would likely continue to report the loan as a TDR. The examiner concurs with reporting the renewed loan as a TDR.

C. Construction Loan – Single Family Residence

BASE CASE: The lender originated a \$400,000 construction loan on a single family “spec” residence with a 15-month maturity to allow for completion and sale of the property. The loan required monthly interest-only payments at a market rate and was based on a LTV of 70 percent at origination. During the original loan construction phase, the borrower made all interest payments from personal funds. At maturity, the home had not sold and the borrower was unable to find another lender willing to finance this property under similar terms.

SCENARIO 1: At maturity, the lender restructured the loan for one year on an interest-only basis at a below market rate to give the borrower more time to sell the “spec” home. Current financial information indicates the borrower has limited ability to continue to pay interest from personal funds. If the residence does not sell by the revised maturity date, the borrower plans to rent the home. In this event, the lender will consider modifying the debt into an amortizing loan with a 20-year maturity, which would be consistent with this type of income-producing investment property. Any shortfall between the net rental income and loan payments would be paid by the borrower. Due to declining home values, the LTV at the renewal date was 90 percent.

Classification: The lender internally graded the loan substandard and is monitoring the credit. The examiner agreed with the lender’s treatment due to the borrower’s diminished ongoing ability to make payments and the reduced collateral position.

Nonaccrual Treatment: The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments during the construction phase. The examiner did not concur with this treatment because the loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is questionable.

TDR Treatment: The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal payments, at a below market rate (compared to the rate charged on an investment property) for an additional year when the loan was no longer in the construction phase. The examiner concurred with the lender’s TDR treatment.

SCENARIO 2: At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market rate to give the borrower more time to sell the “spec” home. Eight months later, the borrower rented the property. At that time, the borrower and the lender agreed to restructure the loan again with monthly payments that amortize the debt over 20 years at a market rate for a residential investment property. Since the date of the second restructuring, the borrower has made all payments for over six consecutive months.

Classification: The lender internally graded the restructured loan substandard. The examiner agreed with the lender's initial substandard grade at the time of the restructuring, but now considered the loan as a pass due to the borrower's demonstrated ability to make payments according to the modified terms for over six consecutive months.

Nonaccrual Treatment: The lender initially maintained the loan on nonaccrual, but returned it to an accruing status after the borrower made six consecutive monthly payments. The lender expects full repayment of principal and interest from the rental income. The examiner concurred with the lender's accrual treatment.

TDR Treatment: The lender reported the first restructuring as a TDR. However, the second restructuring would not be reported as a TDR. The lender determined that the borrower is *experiencing financial difficulties* as indicated by depleted cash resources and a weak financial condition; however, the lender did not grant a *concession* on the second restructuring as the loan is at market rate and terms. The examiner concurred with the lender.

SCENARIO 3: The lender restructured the loan for one year on an interest-only basis at a below market rate to give the borrower more time to sell the "spec" home. The restructured loan has become 90+ days past due and the borrower has not been able to rent the property. Based on current financial information, the borrower does not have the capacity to service the debt. The lender considers repayment to be contingent upon the sale of the property. Current market data reflects few sales and similar new homes in this property's neighborhood are selling within a range of \$250,000 to \$300,000 with selling costs equaling 10 percent, resulting in anticipated net sales proceeds between \$225,000 and \$270,000.

Classification: The lender graded \$130,000 loss (\$400,000 loan balance less estimated net sales proceeds of \$270,000), \$45,000 doubtful based on the range in the anticipated net sales proceeds, and the remaining balance of \$225,000 substandard. The examiner agreed, as this classification treatment results in the recognition of the credit risk in the collateral dependent loan based on the property's value less costs to sell. The examiner instructed management to obtain a current valuation on the property.

Nonaccrual Treatment: The lender placed the loan on nonaccrual when it became 60 days past due (reversing all accrued but unpaid interest) because the lender determined that full repayment of principal and interest was not reasonably assured. The examiner concurred with the lender's nonaccrual treatment.

TDR Treatment: The lender plans to continue reporting this loan as a TDR until the lender forecloses on the property, and transfers the asset to the other real estate owned category. The lender determined that the borrower was continuing to *experience financial difficulties* as indicated by depleted cash resources, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. In addition, the lender granted a *concession* by reducing the interest rate to a below market level. The examiner concurred with the lender's TDR treatment.

SCENARIO 4: The lender committed an additional \$16,000 for an interest reserve and extended the \$400,000 loan for 12 months at a below market rate of interest with monthly interest-only payments. At the time of the examination, \$6,000 of the interest reserve had been added to the loan balance. Current financial information that the lender obtained at examiner request reflects the borrower has no other repayment sources and has not been able to sell or rent the property. An updated appraisal supports an “as is” value of \$317,650. Selling costs are estimated at 15 percent, resulting in anticipated net sales proceeds of \$270,000.

Classification: The lender internally graded the loan as pass and is monitoring the credit. The examiner disagreed with the internal grade and instructed the lender to reverse the \$6,000 interest capitalized out of the loan balance and interest income, and adversely classified the loan. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower has limited capacity to service the debt and the reduced collateral margin indicated that full repayment of principal and interest is not assured. The examiner classified \$130,000 loss based on the adjusted \$400,000 loan balance less estimated net sales proceeds of \$270,000, which was classified substandard. This classification treatment recognizes the credit risk in the collateral dependent loan based on the property’s market value less costs to sell. The examiner also criticized management for the inappropriate use of interest reserves. The remaining interest reserve of \$10,000 is not subject to adverse classification because the loan should be placed on nonaccrual.

Nonaccrual Treatment: The lender maintained the loan on accrual status. The examiner did not concur with this treatment. The loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is not assured. The examiner advised the lender that the loan should be placed on nonaccrual. The lender’s decision to advance a \$16,000 interest reserve was inappropriate given the borrower’s inability to repay it. The lender should reverse the capitalized interest in a manner consistent with regulatory reporting instructions and should not recognize any further interest income from the interest reserve.

TDR Treatment: The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal payments, at a below market rate (compared to investment property) for an additional year when the loan was no longer in the construction phase. The examiner concurred with the lender’s TDR treatment.

D. Construction Loan – Land Acquisition, Condominium Construction and Conversion

BASE CASE: The lender originally extended a \$50 million loan for the purchase of vacant land and the construction of a condominium project. The loan was interest-only and included an interest reserve to cover the monthly payments. The developer bought the land and began construction after obtaining purchase commitments for about a third of the planned units.

Many of these pending sales were with speculative buyers who committed to buy multiple units with minimal down payments. As the real estate market softened, most of the speculative buyers failed to perform on their purchase contracts and only a limited number of the other planned units have been pre-sold.

The developer subsequently determined it was in the best interest to halt construction with the property 80 percent complete. The loan balance was drawn to \$44 million to pay construction costs (including cost overruns) and interest and the borrower estimates another \$10 million is needed to complete construction. Current financial information reflects that the developer does not have sufficient cash flow to service the debt; and while the developer does have equity in other assets, there is a question about the borrower's ability to complete the project.

SCENARIO 1: The borrower agrees to grant the lender a second lien on certain assets, which provides about \$5 million in additional collateral support. In return, the lender advanced the borrower \$10 million to finish construction and the condominium was completed. The lender also agreed to extend the \$54 million loan for 12 months at a market rate of interest that provides for the incremental credit risk to give the borrower time to market the property. The borrower agreed to pay interest whenever a unit was sold with any outstanding balance due at maturity.

The lender obtained a recent appraisal on the condominium building that reported a prospective "as complete" market value of \$65 million, reflecting a 24-month sell-out period and projected selling costs of 15 percent. The \$65 million prospective "as complete" market value plus the \$5 million in other collateral results in a LTV of 77 percent. The lender used the prospective "as complete" market value in its analysis and decision to fund the completion and sale of the units, and to maximize its recovery on the loan.

Classification: The lender internally graded the \$54 million loan as substandard due to the project's limited ability to service the debt despite the 1.3x gross collateral margin. The examiner agreed with the lender's internal grade.

Nonaccrual Treatment: The lender maintained the loan on an accrual status due to the protection afforded by the collateral margin. The examiner did not concur with this treatment and determined the loan should be placed on nonaccrual due to the borrower's questionable ability to sell the units and service the debt, raising concerns as to the full repayment of principal and interest.

TDR Treatment: The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*, as demonstrated by the insufficient cash flow to service the debt, concerns about the project's viability, and the borrower's inability to obtain financing from other sources. In addition, the lender provided a *concession* by advancing additional funds to finish construction and deferring payments except from sold units until the maturity date when any remaining accrued interest plus principal are due. The examiner concurred with the lender's TDR treatment.

SCENARIO 2: A recent appraisal of the property reflects that the highest and best use would be conversion to an apartment building. The appraisal reports a prospective “as complete” market value of \$60 million upon conversion to an apartment building and a \$67 million prospective “as stabilized” market value upon the property reaching stabilized occupancy. The borrower agrees to grant the lender a second lien on certain assets, which provides about \$5 million in additional collateral support.

In return, the lender advanced the borrower \$10 million, which is needed to convert the project to an apartment complex and finish construction. The lender also agreed to extend the \$54 million loan for 12 months at a market rate of interest that provides for the incremental credit risk to give the borrower time to lease the apartments. The \$60 million “as complete” market value plus the \$5 million in other collateral results in a LTV of 83 percent. The prospective “as complete” market value is used because the loan is funding the construction of the apartment building. The lender may utilize the prospective “as stabilized” market value when funding is provided for the lease-up period.

Classification: The lender internally graded the \$54 million loan as substandard due to the project’s limited ability to service the debt despite the 1.2x gross collateral margin. The examiner agreed with the lender’s internal grade.

Nonaccrual Treatment: The lender determined the loan should be placed on nonaccrual due to the borrower’s untested ability to lease the units and service the debt, raising concerns as to the full repayment of principal and interest. The examiner concurred with the lender’s nonaccrual treatment.

TDR Treatment: The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*, as demonstrated by the insufficient cash flow to service the debt, concerns about the project’s viability, and the borrower’s inability to obtain financing from other sources. In addition, the lender provided a *concession* by advancing additional funds to finish construction and deferring payments until the maturity date without a defined exit strategy. The examiner concurred with the lender’s TDR treatment.

E. Commercial Operating Line of Credit in Connection with Owner Occupied Real Estate

BASE CASE: Two years ago, the lender originated a CRE loan at a market rate to a borrower whose business occupies the property. The loan was based on a 20-year amortization period with a balloon payment due in three years. The LTV equaled 70 percent at origination. A year ago, the lender financed a \$5 million interest-only operating line of credit for seasonal business operations at a market rate. The operating line of credit had a one-year maturity and was secured with a blanket lien on all the business assets. To better monitor the ongoing overall collateral position, the lender established a borrowing base reporting system, which included monthly accounts receivable aging reports. At maturity of the operating line of credit, the borrower’s accounts receivable aging report reflects a growing trend of delinquency, which is causing the borrower some temporary cash flow difficulties. The borrower has recently initiated more aggressive collection efforts.

SCENARIO 1: The lender renewed the \$5 million operating line of credit for another year, requiring monthly interest payments at a market rate of interest. The borrower's liquidity position has tightened but remains satisfactory, cash flow to service all debt is 1.2x, and both loans have been paid according to the contractual terms. The primary repayment source is from business operations, which remain satisfactory and an updated appraisal is not considered necessary.

Classification: The lender internally graded both loans as pass and is monitoring the credits. The examiner agreed with the lender's analysis and the internal grades with the understanding that the lender is monitoring the trend in the accounts receivables aging report, and the borrower's ongoing collection efforts.

Nonaccrual Treatment: The lender determined that both the real estate loan and the renewed operating line of credit may remain on accrual status as the borrower has demonstrated an ongoing ability to perform, has the financial capacity to pay a market rate of interest, and full repayment of principal and interest is reasonably assured. The examiner concurred with the lender's accrual treatment.

TDR Treatment: The lender concluded that while the borrower has been affected by declining economic conditions, the renewal of the operating line of credit did not result in a TDR because the borrower is not *experiencing financial difficulties* and has the ability to repay both loans (which represent most of its outstanding obligations) at a market rate of interest. The lender expects full collection of principal and interest from the borrower's operating income. The examiner concurred with the lender's rationale and TDR treatment.

SCENARIO 2: The lender reduced the operating line of credit to \$4 million and restructured the terms onto monthly interest-only payments at a below market rate. This action is expected to alleviate the business' cash flow problem. The borrower's company is still considered to be a going concern even though the borrower's financial performance has continued to deteriorate and sales and profitability are declining. The trend in delinquencies in accounts receivable is worsening and has resulted in reduced liquidity for the borrower.

Cash flow problems have resulted in sporadic delinquencies on the operating line of credit. The borrower's net operating income has declined, but reflects the capacity to generate a 1.08x debt service coverage ratio for both loans, based on the reduced rate of interest for the operating line of credit. The terms on the real estate loan remained unchanged. The lender internally updated the assumptions in the original appraisal and estimated the LTV on the real estate loan was 90 percent. The operating line of credit has an LTV of 80 percent with an overall LTV for the relationship of 85 percent for the relationship.

Classification: The lender internally graded both loans substandard due to deterioration in the borrower's business operations and insufficient cash flow to repay all debt. The examiner agreed with the lender's analysis and the internal grades with the understanding that the lender will monitor the trend in the business operations profitability and cash flow. The lender may need to order a new appraisal if the debt service coverage ratio continues to fall and the overall collateral margin further declines.

Nonaccrual Treatment: The lender reported both the restructured operating line of credit and the real estate loan on a nonaccrual basis. The operating line of credit was not renewed on market rate repayment terms, the borrower has an increasingly limited capacity to service the below market rate on an interest-only basis and there is insufficient support to demonstrate an ability to meet the new payment requirements. Since debt service for both loans is dependent on business operations, the borrower's ability to continue to perform on the real estate loan is not assured. In addition, the collateral margin indicates that full repayment of all of the borrower's indebtedness is questionable, particularly if the company fails to continue being a going concern. The examiner concurred with the lender's nonaccrual treatment.

TDR Treatment: The lender reported the restructured operating line of credit as a TDR because (a) the borrower is *experiencing financial difficulties* (as evidenced by the borrower's sporadic payment history, an increasing trend in accounts receivable delinquencies, and uncertain ability to repay the loans); and (b) the lender granted a *concession* on the line of credit through a below market interest rate. The lender concluded that the real estate loan should not be reported as TDR since that loan had not been restructured. The examiner concurred with the lender's TDR treatment.

F. Land Loan

BASE CASE: Three years ago, the lender originated a \$3.25 million loan to a borrower for the purchase of raw land that the borrower was seeking to have zoned for residential use. The loan had a three-year term and required monthly interest-only payments at a market rate that the borrower has paid from existing financial resources. An appraisal obtained at origination reflected an "as is" market value of \$5 million, which resulted in a 65 percent LTV. The borrower was successful in obtaining the zoning change and has been seeking construction financing for a townhouse development and to repay the land loan. At maturity, the borrower requested an extension to provide additional time to secure construction financing that would include repayment of the land loan.

SCENARIO 1: The borrower provided the lender with current financial information, demonstrating the ability to make principal and interest payments. Further, the borrower made a principal payment of \$250,000 in exchange for an extension of the maturity date of the loan. The borrower also pledged additional unencumbered collateral, granting the lender a first lien on an office building with an "as stabilized" market value of \$1 million. The financial information also demonstrates that cash flow from the borrower's personal assets and the office building generate sufficient stable cash flow to amortize the land loan over a reasonable period of time. A recent appraisal of the raw land reflects an "as is" market value of \$3 million, which results in a 75 percent LTV when combined with the additional collateral and the principal reduction. The lender restructured a \$3 million loan with monthly principal and interest payments for another year at a market rate that provides for the incremental credit risk.

Classification: The lender internally graded the loan as pass due to the adequate cash flow to pay principal and interest from the borrower's personal assets and the office building. Also the borrower provided a curtailment and additional collateral to maintain a reasonable LTV. The examiner agreed with the lender's internal grade.

Nonaccrual Treatment: The lender maintained the loan on accrual status, as the borrower has sufficient funds to cover the debt service requirements for the next year. Full repayment of principal and interest is reasonably assured from the collateral and the borrower's financial resources. The examiner concurred with the lender's accrual treatment.

TDR Treatment: The lender concluded that while the borrower has been affected by declining economic conditions, the level of deterioration does not warrant TDR treatment. The borrower was not *experiencing financial difficulties* because the borrower has the ability to service the renewed loan, which was prudently underwritten and has a market rate of interest. The examiner concurred with the lender's rationale and TDR treatment.

SCENARIO 2: The borrower provided the lender with current financial information that indicated the borrower is unable to continue to make interest-only payments. The borrower has been sporadically delinquent up to 60 days on payments. The borrower is still seeking a loan to finance construction of the townhouse development, but has not been able to obtain a takeout commitment. A recent appraisal of the property reflects an "as is" market value of \$3 million, which results in a 108 percent LTV. The lender extended a \$3.25 million loan at a market rate of interest for one year with principal and interest due at maturity.

Classification: The lender internally graded the loan as pass because the loan is currently not past due and at a market rate of interest. Also, the borrower is trying to obtain takeout construction financing. The examiner disagreed with the internal grade and adversely classified the loan. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower does not have the capacity to service the debt and full repayment of principal and interest is not assured. The examiner classified \$550,000 loss (\$3.25 million loan balance less \$2.7 million, based on the current appraisal of \$3 million less estimated cost to sell of 10 percent or \$300,000). The examiner classified the remaining \$2.7 million balance substandard. This classification treatment recognizes the credit risk in the collateral dependent loan based on the property's market value less costs to sell.

Nonaccrual Treatment: The lender maintained the loan on accrual status. The examiner did not concur with this treatment and advised the lender to place the loan on nonaccrual because the loan was not restructured on reasonable repayment terms, the borrower does not have the capacity to service the debt, and full repayment of principal and interest is not assured.

TDR Treatment: The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by the inability to refinance this debt and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal and interest payments for an additional year when the borrower was unable to obtain takeout financing. The examiner concurred with the lender's TDR treatment.

Attachment 2 Sources of Relevant Supervisory and Accounting Guidance

Supervisory Guidance

- Federal regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: FDIC: 12 CFR part 365 and appendix A; FRB: 12 CFR part 208 subpart E and appendix C; OCC: 12 CFR part 34, subpart D and appendix A; and OTS: 12 CFR Parts 545 and 563. For NCUA, refer to 12 CFR part 723 for member business loan regulation which addresses commercial real estate lending.
- Federal appraisal regulations: FDIC: 12 CFR part 323; FRB: 12 CFR part 208 subpart E and 12 CFR part 225 subpart G; OCC: 12 CFR part 34, subpart C; OTS: 12 CFR Part 564; and NCUA: 12 CFR part 722.
- *FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031 and FFIEC 041 Instructions); *Thrift Financial Report (TFR) Instruction Manual*; and *NCUA 5300 Call Report Instructions*.
- FRB, FDIC, and OCC joint guidance and the OTS guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 2006.
- *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, issued December 2006.
- *Interagency FAQs on Residential Tract Development Lending*, issued September 2005.
- *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, issued July 2001.²⁶
- *Interagency Appraisal and Evaluation Guidelines*, issued October 1994.²⁷

²⁶ The guidance in the July 2001 Policy Statement was substantially adopted by the NCUA through its Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions*, in May 2002.

²⁷ The October 1994 guidance was issued by NCUA through its Letter to Credit Unions No. 03-CU-17, *Independent Appraisal and Evaluation Functions for Real Estate-Related Transactions*, in November 2003.

Authoritative Accounting Guidance

New Accounting Standards Codification (ASC) References	Former References
FASB ASC 450-20, <i>Contingencies - Loss Contingencies</i>	FASB Statement No. 5, <i>Accounting for Contingencies</i>
FASB ASC 310-10-35-2 through 30, <i>Receivables – Overall - Subsequent Measurement – Impairment</i>	FASB Statement No. 114, <i>Accounting by Creditors for Impairment of a Loan</i>
FASB ASC 310-20-35, <i>Receivables – Nonrefundable Fees and Other Costs – Subsequent Measurement</i>	FASB Emerging Issues Task Force (EITF) No. 01-7, <i>Creditor’s Accounting for a Modification or Exchange of Debt Instruments</i>
FASB ASC 310-40, <i>Receivables - Troubled Debt Restructurings by Creditors</i>	FASB Statement No. 15, <i>Accounting by Debtors and Creditors for Troubled Debt Restructuring</i> ; and FASB Technical Bulletin No. 80-2 <i>Classification of Debt Restructurings by Debtors and Creditors</i>
FASB ASC 470-60, <i>Debt – Troubled Debt Restructurings by Debtors</i>	FASB Statement No. 15, <i>Accounting by Debtors and Creditors for Troubled Debt Restructurings</i> ; and FASB EITF No. 02-4, <i>Determining Whether a Debtor’s Modification or Exchange of Debt Instrument is within the Scope of FASB Statement No. 15</i>
FASB ASC 820, <i>Fair Value Measurements and Disclosures</i>	FASB Statement No. 157, <i>Fair Value Measurements</i>
FASB ASC 825-10-35-1 through 3, <i>Financial Instruments – Overall - Subsequent Measurement - Credit Losses on Financial Instruments with Off-Balance-Sheet Credit Risk</i>	American Institute of Certified Public Accountants (AICPA) Statement of Position 01-6, <i>Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others</i>

Non-authoritative Accounting Guidance

- In December 2008, the Center for Audit Quality, an affiliate of the AICPA, issued *Application of Statement 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructurings*

Attachment 3

Valuation Concepts for Income Producing Real Estate

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate and the Net Present Value Approach: The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for the specific type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.

The Direct Capitalization (“Cap” Rate) Technique: The use of “cap” rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a “cap” rate is used as a short cut for computing the discounted value of a property’s income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its “stabilized” annual income by a factor called a “cap” rate. Stabilized annual income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today’s actual market conditions. The “cap” rate, usually defined for each property type in a market area, is viewed by some analysts as the required rate of return stated in terms of current income. That is to say, the “cap” rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The “cap” rate also can be viewed as the number of cents per dollar of today’s purchase price investors would require annually over the life of the property to achieve their required rate of return.

The “cap” rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property’s selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized annual income or the “cap” rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, the net present value approach and the direct capitalization technique will yield the same results.

The direct capitalization technique is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A “terminal cap rate” is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

Differences between Discount and Cap Rates: When used for estimating real estate market values, discount and “cap” rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the “cap” rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than “cap” rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the “cap” rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the “cap” rate because the income generated by a property, in addition to providing the required return on investment, have to be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is the depreciation in any one year, hence, the smaller is the annual income required by the investor, and the lower is the “cap” rate. Differences in terms and the extent of debt financing and the related costs are also taken into account.

Selecting Discount and Cap Rates: The choice of the appropriate values for discount and “cap” rates is a key aspect of income analysis. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and “cap” rates used in an income analysis generally should fall within a fairly narrow range for comparable properties.

Holding Period versus Marketing Period: When the net present value approach is applied to troubled properties, the chosen time frame should reflect the period over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the “holding period.” The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate. The marketing period is the length of time that may be required to sell the property in an open market.

Attachment 4 Classification Definitions²⁸

The federal bank and thrift regulatory agencies utilize the following definitions for assets adversely classified for supervisory purposes as well as those assets listed as special mention:

Substandard Assets: A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets: An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets: Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Special Mention: A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

²⁸ The NCUA does not require credit unions to adopt a uniform regulatory classification schematic of loss, doubtful, substandard or special mention. A credit union should apply an internal loan grade based on its evaluation of credit risk. The term "classify" within the credit union industry has typically meant "individually review to apply a percentage reserve" for allowance for loan and lease losses ("ALLL") purposes. As used in this paper, "classify" and "classification" in relation a credit union's evaluation of a credit for risk mean "grade" and "assign a credit risk grade."



Marcus & Millichap

Real Estate Investment Services

John J. Godwin
Vice President Investments
(248) 415-2618 Office
(248) 408-4015 Cell
John.godwin@marcusmillichap.com

Marcus & Millichap
Real Estate Investment Services

Unique Characteristics

- **Singular focus on investment brokerage**
 - Unrivaled local market expertise by individual agents
 - Superior underwriting, property positioning for maximized value
 - The most extensive and influential investor relationships
- **Largest investment sales force in the U.S.**
 - Individual agents' expertise, relationships harnessed nationally
 - Consistent underwriting standards across all offices
 - Culture of information sharing backed by policy, powered by technology
- **Product type, client group segmentation**
 - Private market, institutional investors
- **Real-time property marketing system and proprietary tools**
 - Proactive marketing to select buyer pools locally, regionally, nationally
 - Movement of capital across the U.S. and through various product types
 - *Making a Market* for every property, not "waiting" for the market

© 2009 Marcus & Millichap

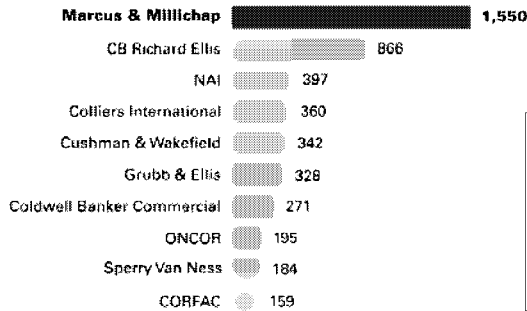
Investment Sales ♦ Financing ♦ Research ♦ Advisory Services

- **Unrivaled depth and breadth of private capital access**
 - Dominant brand and influential, long-term relationships among private investors in every market (high-net worth individuals, private funds and managers)
 - Real-time database of buyers' specific acquisition needs (Buyer Needs)
 - Real-time awareness of new buyer pools and active investors
- **Up-to-the-minute forward-looking pricing (property type, price range)**
 - Dominant volume of property analysis, valuations, investor dialogue captured locally and nationally, enhanced by industry-leading research
- **Relationships with still-active lenders; experienced financing experts**
- **Cycle-tested skill set among agents, management team**
 - Maximizing value by matching each property to the right buyer pool
 - Managing the buyer qualification and bidding process
 - Ensuring a successful closing as efficiently as possible

© 2009 Marcus & Millichap

Investment Sales ♦ Financing ♦ Research ♦ Advisory Services

NATIONAL RANKING OF BROKERAGE COMPANIES
Sales of Major Property Types \$1 Million and Greater
2Q 2008 – 2Q 2009



Marcus & Millichap 2008 Results

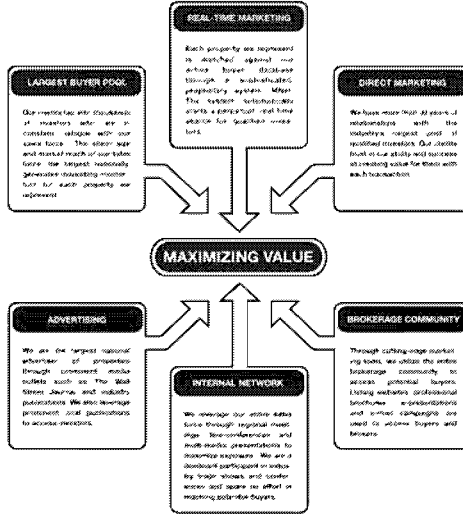
TOTAL SALES: \$13.1 BILLION

TOTAL TRANSACTIONS: 3,756

Includes apartment, industrial, office, retail for 12 markets ending 02/2009
Source: CoStar Group, Inc.

© 2009 Marcus & Millichap

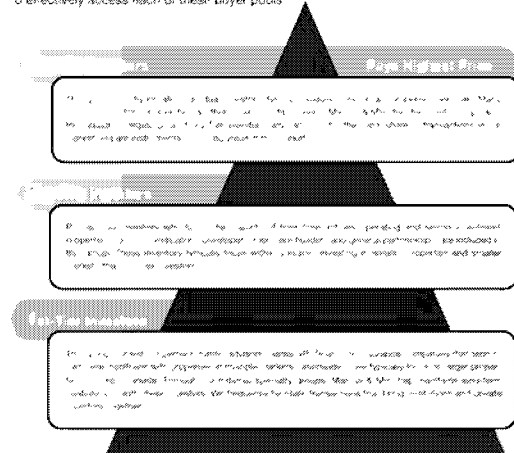
Investment Sales ♦ Financing ♦ Research ♦ Advisory Services



© 2009 Marcus & Millichap

Investment Sales ♦ Financing ♦ Research ♦ Advisory Services

There are three primary investor tiers in the marketplace and **Marcus & Millichap** has the track record and relationships to effectively access each of these buyer pools:

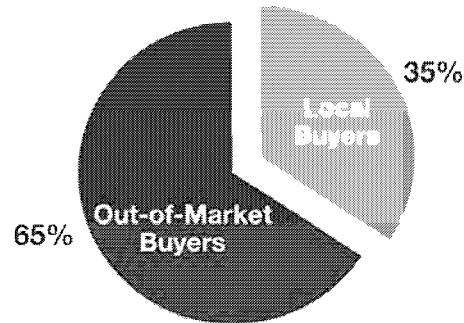


© 2009 Marcus & Millichap

Investment Sales ♦ Financing ♦ Research ♦ Advisory Services

**Maximizing Value By Accessing More
Out-of-Market Buyers Than Any Other Source**

In 2008, Marcus & Millichap's National Marketing System and Investor Relationships Secured Out-of-Market Buyers 65 Percent of the Time.



© 2009 Marcus & Millichap

Investment Sales ♦ Financing ♦ Research ♦ Advisory Services



- Hospitality
- Industrial
- Land
- Manufactured Housing
- Multi Housing
- Net-Leased Investments
- Office
- Retail
- Self-Storage
- Seniors Housing
- Special Assets

© 2009 Marcus & Millichap

Investment Sales ♦ Financing ♦ Research ♦ Advisory Services

Locally, Regionally, Nationally

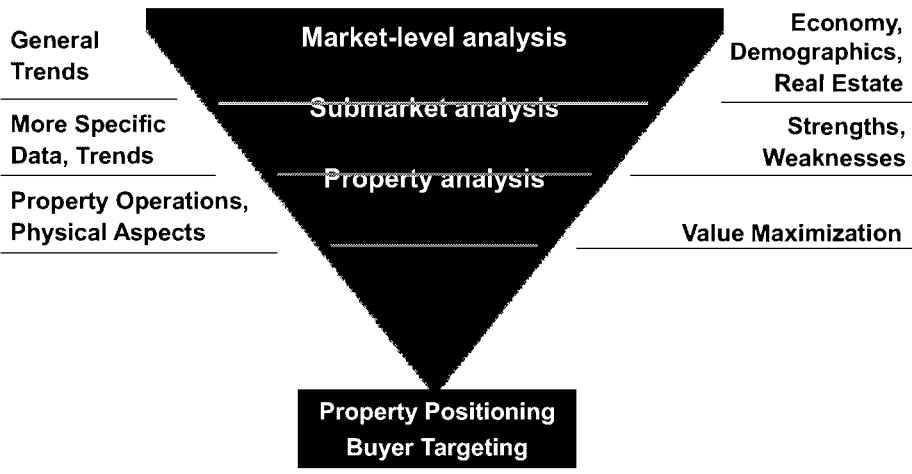
- Existing client relationships of the 1,300+ agents
- Electronic marketing system (MNet) links properties with agents' buyers real-time (Buyer Needs)
- Investor database - local similar property owners and active investors (systematic direct marketing, outreach)
- Active Starker lists (among the largest nationally)
- Classified advertising locally and nationally
- Brokerage community outreach
- Investor symposiums and trade shows
- The Internet

© 2009 Marcus & Millichap

Overview

- National Team, Local Market Expertise
 - Professional Real Estate Analysts
 - Senior Financial Analysts
 - Integrated approach
 - Macroeconomic, market conditions
 - Micro analysis (submarket, property-level)

© 2009 Marcus & Millichap

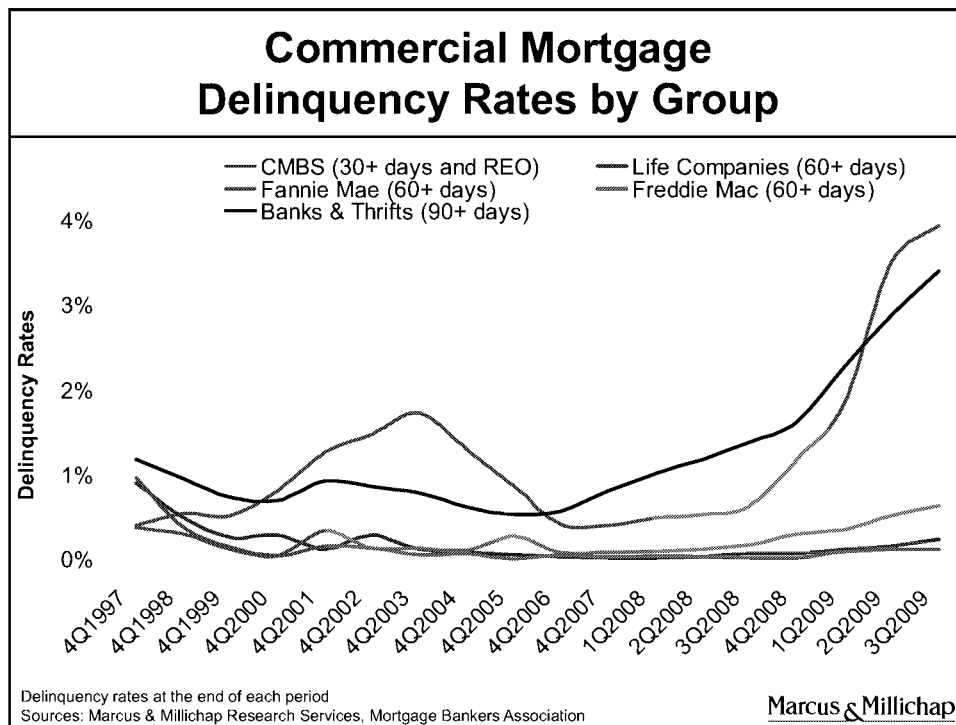


Factors Impacting Value

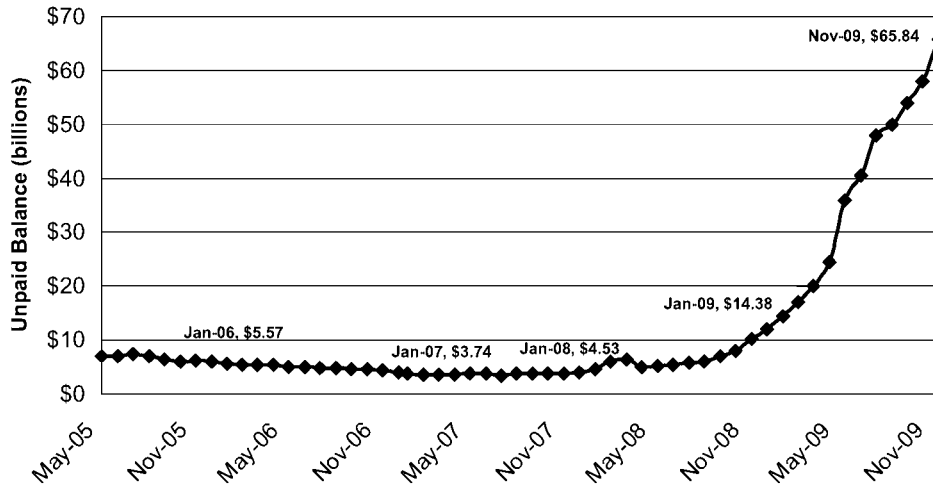
- New construction, future supply
- Traffic patterns, competition
- Proximity to jobs
- Demographic shifts
- Vacancy and rental trends
- Sales trends
- Current and future economic drivers

Delinquency

Marcus & Millichap



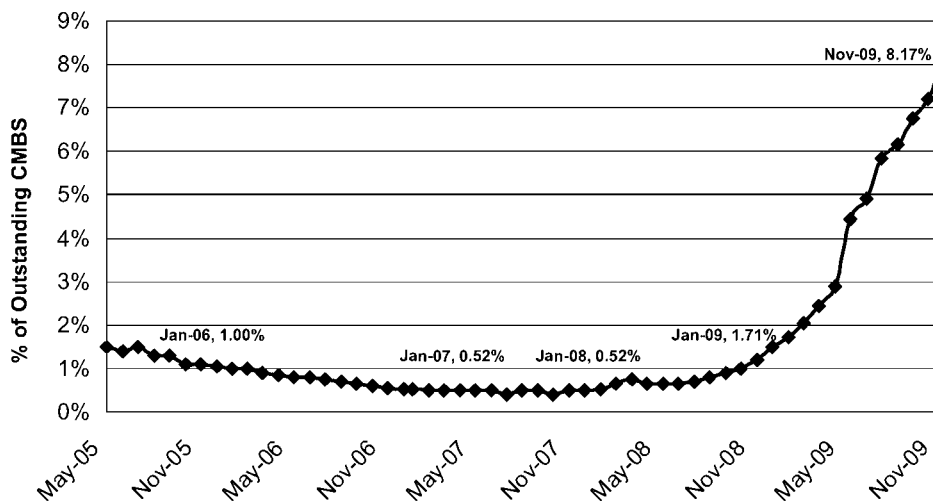
Trailing 12-Months Unpaid Balance of Specially Serviced CMBS Loans



Sources: Marcus & Millichap Research Services, Real Point

Marcus & Millichap

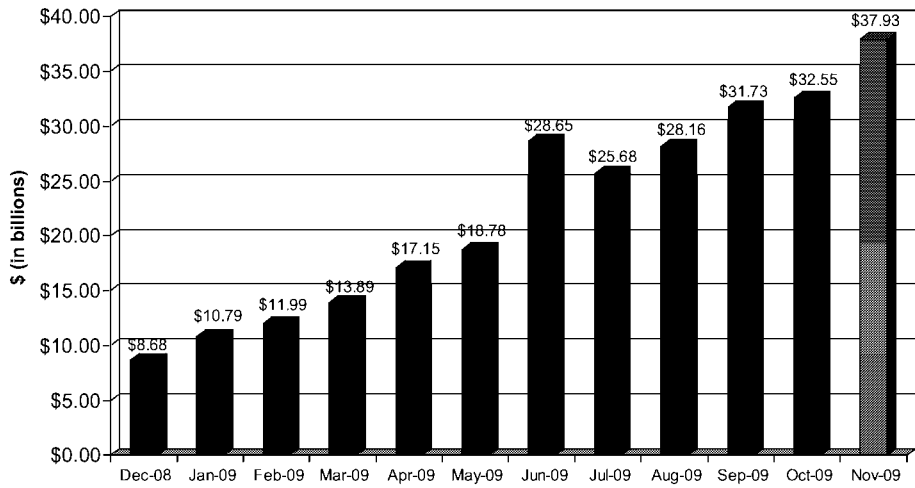
CMBS Special Servicing Exposure by Unpaid Balance Rising Significantly



Sources: Marcus & Millichap Research Services, Real Point

Marcus & Millichap

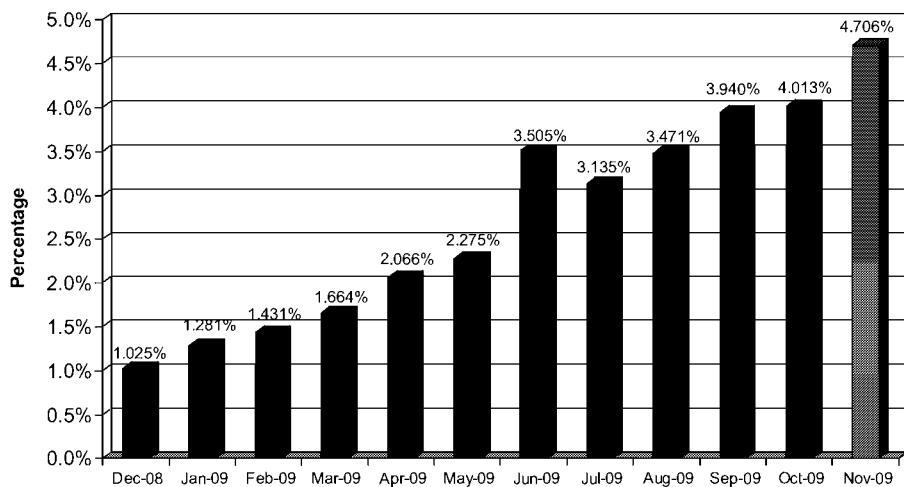
Monthly CMBS Delinquency



Sources: Marcus & Millichap Research Services, Realpoint

Marcus & Millichap

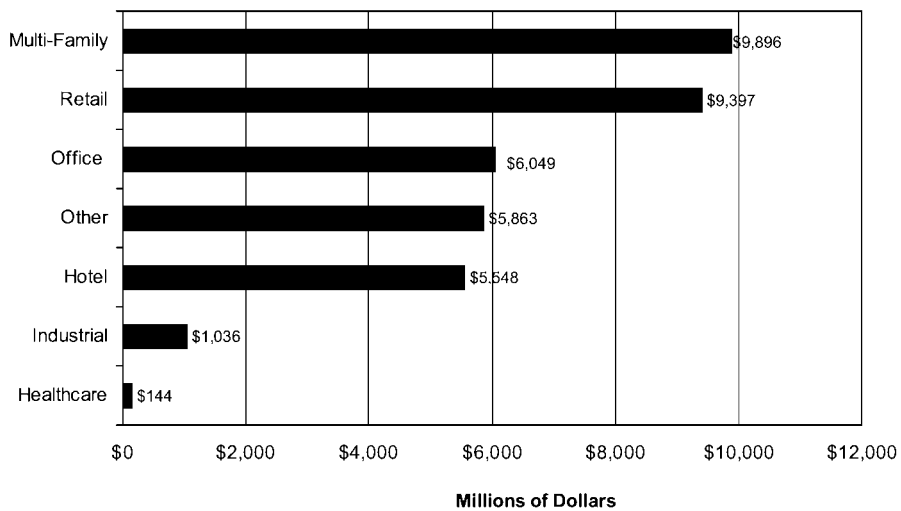
Monthly CMBS Delinquency



Sources: Marcus & Millichap Research Services, Realpoint

Marcus & Millichap

November 2009 Delinquent CMBS Loan Balance by Property Type



Sources: Marcus & Millichap Research Services, Realpoint

Marcus & Millichap

Distressed Assets

Marcus & Millichap

U.S. Estimated Distressed Assets Summary By Property Type

	Distressed	
	\$ in Bil.	# of props
Retail	\$38.5	1,804
Hotel	\$32.6	1,336
Office	\$31.8	1,025
Apartment	\$30.8	1,857
Development Site	\$27.5	1,108
Industrial	\$5.1	630
Other	\$3.8	324
Grand Total	\$170.1	8,084

* As of December 29, 2009

Note: Some portfolio deals may not be allocated to a single market

Sources: Marcus & Millichap Research Services, Real Capital Analytics

Marcus & Millichap

U.S. Estimated Distressed Assets Summary By Region

	Distressed	
	\$ in Bil.	# of props
West	\$53.4	2,164
Southeast	\$34.0	2,034
Northeast	\$26.3	814
Southwest	\$25.2	1,412
Midwest	\$18.9	1,198
Mid-Atlantic	\$12.3	462
Grand Total	\$170.1	8,084

* As of December 29, 2009

Note: Some portfolio deals may not be allocated to a single market

Sources: Marcus & Millichap Research Services, Real Capital Analytics

Marcus & Millichap

Estimated Distressed Assets Summary Major Midwest Markets

	Distressed	
	\$ in Mil.	# of props
Chicago	\$6,393.6	381
Detroit	\$2,952.5	132
Minneapolis	\$1,338.9	60
St Louis	\$1,119.6	50
Cincinnati	\$1,094.4	51
Cleveland	\$766.8	51
Indianapolis	\$644.2	48
Columbus	\$541.2	69
Kansas City	\$447.9	41
Milwaukee	\$328.7	31
Grand Total	\$18,937.1	1,198

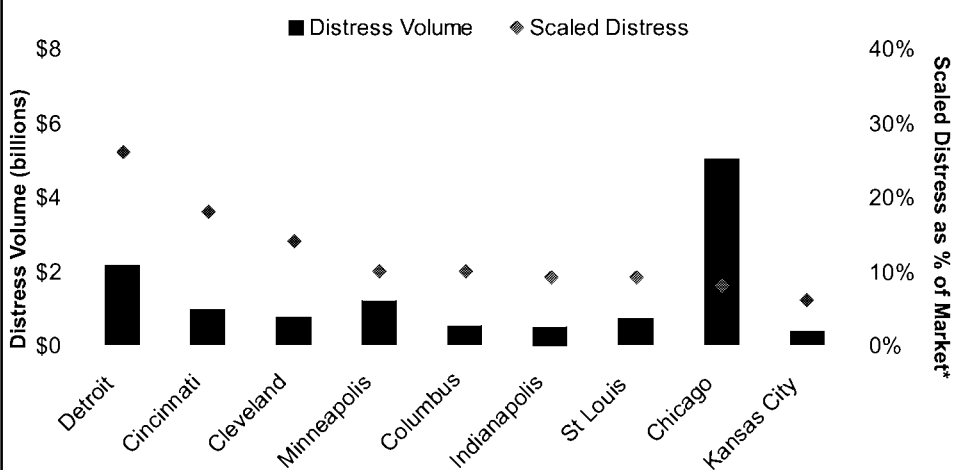
* As of December 29, 2009

Note: Some portfolio deals may not be allocated to a single market

Sources: Marcus & Millichap Research Services, Real Capital Analytics

Marcus & Millichap

Distress Scaled to Activity



* Distress volume as of Dec.29, 2009 as a % of total sales volume 2005-2008
Includes apartment, office, retail, industrial, and hotel properties (excluding casinos)
Sources: Marcus & Millichap Research Services, Real Capital Analytics

Marcus & Millichap