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New Fed Policy on Extend and Hold Bank Loans for Multi-Family Properties - Welcome Back to 2008

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A little over two months ago, the federal banking authorities (Feds) issued a new Policy Statement, a re-vamp and expansion of the 2008 “extend and hold” or “pretend and extend” policy that emerged from the 2008 Bank Liquidity Crisis.

Like 2008, the Feds recognize four huge factors:

1. A real estate financing crisis is beginning, and will significantly worsen in 2024 and 2025 when $4-5 Trillion in office loans will mature and need to be refinanced. This is due to Post Pandemic economic conditions in the real estate industry, especially office properties, where the national average vacancy rate is 18.2% and fair market values nationwide are down approximately 30%.

2. The above crisis in the office market will affect other real estate sectors, such as retail, hotels, multi-family properties, etc., as the effects of an office market collapse and a banking collapse will spread throughout the real estate and banking industries.

3. This problem is NOT the fault of over-development by property owners or lax lending oversight (like the 1980s S&L Crisis); instead, good, hard-working middle American and foreign companies were and are still caught in the effects of an unexpected, once in a century, pandemic. Literal enforcement of banking regulations would wipe out an incalculable number of large, middle, and small American and foreign companies, resulting in an industry collapse.

4. Even if the Feds were to disregard innocent property owners, they do not want to crash the banks, as happened in the 1980s S&L Crisis, when banks and savings and loans foreclosed on and ate the losses of the entire property market collapse. Therefore, if nothing else, to save the banks, the Feds have to relax literal compliance with current banking regulations.

The Policy Statement discusses how the Feds will view upcoming workouts and restructurings used to avert the aforementioned crises, including, various elements of a lender's review and analysis such as the future likelihood of debt service payments, the ability of guarantors and sponsors to assist in supporting repayment of the debt, assessment of collateral values, how certain workout arrangements would be classified by the bank's auditors, and whether such arrangements would be classified by the auditors as accrual or non-accrual. The Policy Statement also provides specific examples of different loan extension scenarios for office, retail, hotel, residential, construction of single family residences and commercial properties, owner occupied properties, land loans and multi-family, and how each scenario would be classified for loan grading and accrual or non-accrual purposes.

In the Policy Statement, the Feds explain that, even in cases where the fair market value of a property has actually fallen below the outstanding principal balance of the loan, i.e., the property is worth less than the debt, banks can still extend the term of the loan if the extension is made in circumstances where the borrower can show it can continue to pay debt service (preferably at current market interest rates) and prospects for repayment of the loan, "on reasonable terms," can be seen due to positive actions by the borrower, guarantor and/or sponsor to support the property.

The Policy Statement's overall first page introductory explanation is set forth below:

June 30, 2023

Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts

The agencies[1] recognize that financial institutions[2] face significant challenges when working with commercial real estate (CRE)[3] borrowers who are experiencing diminished operating cash flows, depreciated collateral values, prolonged sales and rental absorption periods, or other issues that may hinder repayment. While such borrowers may experience deterioration in their financial condition, many borrowers will continue to be creditworthy and have the willingness and ability to repay their debts. In such cases, financial institutions may find it beneficial to work constructively with borrowers. Such constructive efforts may involve loan accommodations[4] or more extensive loan workout arrangements.[5]

This statement provides a broad set of risk management principles relevant to CRE loan accommodations and workouts in all business cycles, particularly in challenging economic environments. A wide variety of factors can negatively affect CRE portfolios, including economic downturns, natural disasters, and local, national, and international events. This statement also describes the approach examiners will use to review CRE loan accommodation and workout arrangements and provides examples of CRE loan workout arrangements as well as useful references in the appendices.

The agencies have found that prudent CRE loan accommodations and workouts are often in the best interest of the financial institution and the borrower. The agencies expect their examiners to take a balanced approach in assessing the adequacy of a financial institution's risk management practices for loan accommodation and workout activities. Consistent with the *Interagency Guidelines Establishing Standards for Safety and Soundness*,[6] financial institutions that implement prudent CRE loan accommodation and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse classification. In addition, modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the outstanding loan balance.

Examples of CRE Loan Multi-Family Workout Arrangements

In addition to laying out the rationale and methodologies that banks and examiners should follow, the Policy Statement also provides examples of extended office property loans and how banks and examiners should classify each type of scenario. These examples are helpful when examining the pros and cons of your property and evaluating and planning your options and approach when you meet with your lender.

For examples of loan extension scenarios for multiple types of different properties, click here to read examples in their entirety with footnotes. As this piece focuses on multi-family properties, below are scenario examples provided in the Policy Statement covering multi-family properties.

Multi-Family Property

Base Case

The lender originated a $6.4 million loan for the purchase of a 25-unit apartment building. The loan maturity is five years, and principal and interest payments are based on a 30-year amortization at a market interest rate. The LTV was 75 percent (based on an $8.5 million value), and the DSC ratio was 1.50x at origination (based on a 30-year principal and interest amortization). Leases are typically 12-month terms with an additional 12-month renewal option. The property is 88 percent leased (22 of 25 units rented). Due to poor economic conditions, delinquencies have risen from two units to eight units, as tenants have struggled to make ends meet. Six of the eight units are 90 days past due, and these tenants are facing eviction.

Scenario 1:

At maturity, the lender renewed the $5.9 million loan balance on principal and interest payments for 12 months at a market interest rate that provides for the incremental risk. The borrower had not been delinquent on prior payments. Current financial information indicates that the DSC ratio dropped to 0.80x because of the rent payment delinquencies. Combining borrower and guarantor liquidity shows they can cover cash flow shortfall until maturity (including reasonable capital expenditures since the building was recently renovated). Borrower projections show a return to break-even within six months since the borrower plans to decrease rents to be more competitive and attract new tenants. The lender estimates that the property's current "as stabilized" market value is $7 million, resulting in an 84 percent LTV. A new appraisal has not been ordered; however, the lender noted in the file that, if the borrower does not meet current projections within six months of booking the renewed loan, the lender will obtain a new appraisal.

Classification:

The lender internally graded the renewed loan as pass and is monitoring the credit. The examiner disagreed with the lender's analysis and classified the loan as substandard. While the borrower and guarantor can cover the debt service shortfall in the near-term using additional guarantor liquidity, the duration of the support may be less than the lender anticipates if the leasing fails to materialize as projected. Economic conditions are poor, and the rent reduction may not be enough to improve the property's performance. Lastly, the lender failed to obtain an updated collateral valuation, which represents an administrative weakness.

Nonaccrual Treatment:

The lender maintained the loan in accrual status. The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, the borrower and guarantor appear to have sufficient cash resources to make these payments if projections are met, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

Scenario 2:

At maturity, the lender renewed the $5.9 million loan balance on a 12-month interest-only basis at a below market interest rate. In response to an event that caused severe economic conditions, the federal and state governments enacted moratoriums on all evictions. The borrower has been paying as agreed; however, cash flow has been severely impacted by the rent moratoriums. While the moratoriums do not forgive the rent (or unpaid fees), they do prevent evictions for unpaid rent and have been in effect for the past six months. As a result, the borrower's cash flow is severely stressed, and the borrower has asked for temporary relief of the interest payments. In addition, a review of the current rent roll indicates that five of the 25 units are now vacant. A recent appraisal values the property at $6 million (98 percent LTV). Updated borrower and guarantor financial statements indicate the continued ability to cover interest-only payments for the next 12 to 18 months at the reduced rate of interest. Updated projections that indicate below break-even performance over the next 12 months remain uncertain given that the end of the moratorium (previously extended) is a "soft" date and that tenant behaviors may not follow historical norms.

Classification:

The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the borrower's diminished ability to make interest payments (even at the reduced rate) and lack of principal reduction, the uncertainty surrounding the rent moratoriums, and the reduced and tight collateral position.

Nonaccrual Treatment:

The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make principal and interest payments and has some ability to make payments on the interest-only terms at a below market interest rate. The examiner did not concur with this treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash flow to amortize the debt, and the slim collateral margin indicates that full repayment of principal and interest may be in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

Scenario 3:

At maturity, the lender renewed the $5.9 million loan balance on a 12-month interest-only basis at a below market interest rate. The borrower has been sporadically delinquent on prior principal and interest payments. A review of the current rent roll indicates that 10 of the 25 units are vacant after tenant evictions. The vacated units were previously in an advanced state of disrepair, and the borrower and guarantors have exhausted their liquidity after repairing the units. The repaired units are expected to be rented at a lower rental rate. A post-renovation appraisal values the property at $5.5 million (107 percent LTV). Updated projections indicate the borrower will be below break-even performance for the next 12 months.

Classification:

The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's concerns due to the borrower's diminished ability to make principal or interest payments, the guarantor's limited ability to support the loan, and insufficient collateral protection. However, the examiner classified $900,000 loss ($5.9 million loan balance less $5 million (based on the current appraisal of $5.5 million less estimated cost to sell of 10 percent, or $500,000)). The examiner classified the remaining $5 million balance substandard. This classification treatment recognizes the collateral dependency.

Nonaccrual Treatment:

The lender maintained the loan on accrual basis because the borrower demonstrated a previous ability to make principal and interest payments. The examiner did not concur with the lender's treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash flow to service the debt at a below market interest rate on an interest-only basis, and the impairment of value indicates that full repayment of principal and interest is in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

While the Policy Statement does not govern CMBS loans, there is no doubt that CMBS has to consider the same issues and look at the same extension concepts. In facing the same market circumstances (and maybe even worse as CMBS loans often only use "bad-boy non-recourse guaranties instead of full repayment guaranties), CMBS should hopefully conclude that it will be best for its certificate holders not to crash the market with underwater foreclosed properties thereby killing the value of their certificates. Additionally, the above Fed standards should be used as arguments for borrowers when negotiating with CMBS as to what is reasonable in today’s market.

About the Author

Charles Aster has a diverse real estate practice which includes not only working closely on the development and financing of a number of premier stadiums and arenas across America, with over 40 years of experience in financing (both lending and borrowing), acquisition, ground leasing, construction, leasing and sales of major office buildings, hotel groups and hotel projects, apartment complexes and shopping centers throughout the United States.

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