New Fed Policy on Extend and Hold Bank Loans for Hotel Loans – 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:

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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 Office 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 hotel 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 hotel properties, below are scenario examples provided in the Policy Statement covering hotel properties.

Income Producing Property – Hotel

Base Case

A lender originated a $7.9 million loan to provide permanent financing for the acquisition of a stabilized 3-star hotel property. The borrower is a limited liability company with underlying ownership by two families who guarantee the loan. The loan term is five years, with payments based on a 25-year amortization and with a market interest rate. The LTV was 79 percent based on the hotel's appraised value of $10 million.

At the end of the five-year term, the borrower's annualized DSC ratio was 0.95x. Due to competition from a well-known 4-star hotel that recently opened within one mile of the property, occupancy rates have declined. The borrower progressively reduced room rates to maintain occupancy rates, but continued to lose daily bookings. Both occupancy and Revenue per Available Room (RevPAR)35 declined significantly over the past year. The borrower then began working on an initiative to make improvements to the property (i.e., automated key cards, carpeting, bedding, and lobby renovations) to increase competitiveness, and a marketing campaign is planned to announce the improvements and new price structure. The borrower had paid principal and interest as agreed throughout the first five years, and the principal balance had reduced to $7 million at the end of the five-year term.

Scenario 1:

At maturity, the lender renewed the loan for 12 months on an interest-only basis at a market interest rate that provides for the incremental risk. The extension was granted to enable the borrower to complete the planned renovations, launch the marketing campaign, and achieve the borrower's updated projections for sufficient cash flow to service the debt once the improvements are completed. (If the initiative is successful, the loan officer expects the loan to either be renewed on an amortizing basis or refinanced through another lending entity.) The borrower has a verified, pledged reserve account to cover the improvement expenses. Additionally, the guarantors' updated financial statements indicate that they have sufficient unencumbered liquid assets. Further, the guarantors expressed the willingness to cover any estimated cash flow shortfall through maturity. Based on this information, the lender's analysis indicates that, after deductions for personal obligations and realistic living expenses and verification that there are no contingent liabilities, the guarantors should be able to make interest payments. To date, interest payments have been timely. The lender estimates the property's current "as stabilized" market value at $9 million, which results in a 78 percent LTV.

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 borrower and guarantors have sufficient resources to support the interest payments; additionally, the borrower's reserve account is sufficient to complete the renovations as planned.

Nonaccrual Treatment:

The lender maintained the loan in accrual status as full repayment of principal and interest is reasonably assured from the hotel's and guarantors' cash flows, despite a decline in the borrower's cash flow due to competition. The examiner concurred with the lender's accrual treatment.

Scenario 2:

At maturity of the original loan, the lender restructured the loan on an interest-only basis at a below market interest rate for 12 months to provide the borrower time to complete its renovation and marketing efforts and increase occupancy levels. At the end of the 12-month period, the hotel's renovation and marketing efforts were completed but unsuccessful. The hotel continued to experience a decline in occupancy levels, resulting in a DSC ratio of 0.60x. The borrower does not have ability to offer additional incentives to lure customers from the competition. RevPAR has also declined. Current financial information indicates the borrower has limited ability to continue to make interest payments, and updated projections indicate that the borrower will be below break-even performance for the next 12 months. The borrower has been sporadically delinquent on prior interest payments. The guarantors are unable to support the loan as they have limited unencumbered liquid assets and are highly leveraged. The lender is in the process of renewing the loan again. The most recent hotel appraisal, dated as of the time of the first restructuring, reports an "as stabilized" appraised value of $7.2 million ($6.7 million for the real estate and $500,000 for the tangible personal property of furniture, fixtures, and equipment), resulting in an LTV of 97 percent. The appraisal does not account for the diminished occupancy, and its assumptions significantly differ from current projections. A new valuation is needed to ascertain the current value of the property.

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 ongoing ability to make payments, the guarantors' limited ability to support the loan, and the reduced collateral position. The lender is obtaining a new valuation and will adjust the internal classification, if necessary, based on the updated value.

Nonaccrual Treatment:

The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments. The examiner did not concur with this treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash resources to service the below market interest rate on an interest-only basis, and the collateral margin has narrowed and may be narrowed further with a new valuation, which collectively 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.

Scenario 3:

At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market interest rate to give the borrower additional time to complete renovations and increase marketing efforts. While the combined borrower/guarantors' liquidity indicated they could cover any cash flow shortfall until maturity of the restructured note, the borrower only had 50 percent of the funds to complete its renovations in reserve. Subsequently, the borrower attracted a sponsor to obtain the remaining funds necessary to complete the renovation plan and marketing campaign. Eight months later, the hotel experienced an increase in its occupancy and achieved a DSC ratio of 1.20x on an amortizing basis. Updated projections indicated the borrower would be at or above the 1.20x DSC ratio for the next 12 months, based on market terms and rate. The borrower and the lender then agreed to restructure the loan again with monthly payments that amortize the debt over 20 years, consistent with the current market terms and rates. Since the date of the second restructuring, the borrower has made all principal and interest payments as agreed for six consecutive months.

Classification:
The lender internally classified the most recent restructured loan substandard. The examiner agreed with the lender's initial substandard grade at the time of the subject restructuring, but now considers the loan as a pass as the borrower was no longer having financial difficulty and has demonstrated the ability to make payments according to the modified principal and interest terms for more than six consecutive months.

Nonaccrual Treatment:
The original restructured loan was placed in nonaccrual status. The lender initially maintained the most recent restructured loan in nonaccrual status as well, but returned it to an accruing status after the borrower made six consecutive monthly principal and interest payments. The lender expects full repayment of principal and interest. The examiner concurred with the lender's accrual treatment.

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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