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# New Fed Policy on Extend and Hold Bank Loans for Construction 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 gives 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 Construction Loan 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 construction loans, below are scenario examples provided in the Policy Statement covering land acquisitions, condominium construction and conversion.

## 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 luxury condominium project. The loan was interest-only and included an interest reserve to cover the monthly payments until construction was complete. The developer bought the land and began construction after obtaining purchase commitments for 1/3 of the 120 planned units, or 40 units. Many of these pending sales were speculative with buyers committing to buy multiple units with minimal down payments. The demand for luxury condominiums in general has declined since the borrower launched the project, and sales have slowed significantly over the past year. The lack of demand is attributed to a slowdown in the economy. As a result, 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 experienced cost overruns on the project and subsequently determined it was in the best interest to halt construction with the property 80 percent completed. The outstanding loan balance is $44 million with funds used to pay construction costs, including cost overruns and interest. The borrower estimates an additional $10 million is needed to complete construction. Current financial information reflects that the developer does not have sufficient cash flow to pay interest (the interest reserve has been depleted); and, while the developer does have equity in other assets, there is doubt about the borrower's ability to complete the project.

### Scenario 1:

The borrower agreed to grant the lender a second lien on an apartment project in its portfolio, which provides $5 million in additional collateral support. In return, the lender advanced the borrower $10 million to finish construction. The condominium project was completed shortly thereafter. The lender also agreed to extend the $54 million loan ($44 million outstanding balance plus $10 million in new money) for 12 months at a market interest rate that provides for the incremental risk, to give the borrower additional 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 of the sales price. Comparing the $54 million loan amount against the $65 million "as complete" market value plus the $5 million pledged in additional collateral (totaling $70 million) results in an 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 classified the $54 million loan as substandard due to the units not selling as planned and 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 in accrual status due to the protection afforded by the collateral margin. The examiner did not concur with this treatment due to the uncertainty about the borrower's ability to sell the units and service the debt, raising doubts as to the full repayment of principal and interest. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

**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 agreed to grant the lender a second lien on an apartment building in its portfolio, which provides $5 million in additional collateral support. In return, the lender advanced the borrower $10 million, which is needed to finish construction and convert the project to an apartment complex. The lender also agreed to extend the $54 million loan for 12 months at a market interest rate that provides for the incremental risk, to give the borrower time to lease the apartments. Interest payments are deferred. The $60 million "as complete" market value plus the $5 million in other collateral results in an LTV of 83 percent. The prospective "as complete" market value is primarily relied on as the loan is funding the conversion of the condominium to apartment building.

Classification:

The lender internally classified the $54 million loan as substandard due to the units not selling as planned and the project's limited ability to service the debt. The collateral coverage provides adequate support to the loan with a 1.2x gross collateral margin. The examiner agreed with the lender's internal grade.

Nonaccrual Treatment:

The lender determined the loan should be placed in nonaccrual status due to an oversupply of units in the project's submarket, and 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.

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 guarantees), 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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