Borrower, Have You Started Preparing for Your Meeting With Your Lender to Discuss a Loan Extension or Restructuring?

PART I - HOW WILL YOUR LENDER APPROACH THIS MEETING?

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As discussed in my previous blogs regarding the $4-5 Trillion of office mortgage loans maturing in 2024 and 2025, the Federal Banking Authorities (the “Feds”) have foreseen, in their new June 2023 Policy Statement (the "2023 Fed Policy Statement"), the potentially back-breaking strain this will place on the American banking system if banks strictly follow federal banking policies for commercial real estate (“CRE”) regarding loan refinancings, loan extensions and restructurings. Because of the significant nationwide decrease in office fair market values (approximately 30%) and historically high national vacancy rates (approximately 18.2%), a large portion of today's performing loans, even if all debt service is current, would not qualify for extensions of their maturity dates or new refinancing loans. This would result in foreclosure rates not seen since the late 1980s and early 1990s. The Feds have also foreseen that today's office market problems have, and will continue to, spread to other asset groups putting their loans and properties in similar jeopardy.

In trying to get ahead of the upcoming maturity crises, the 2023 Fed Policy Statement explains that: "*When there has been deterioration in collateral values, a borrower with a maturing loan amid an economic downturn may have difficulty obtaining short-term financing or adequate sources of long-term credit, despite the borrower's demonstrated and continued ability to service the debt. In such cases, financial institutions may determine that the most appropriate course is to restructure or renew the loan. Such actions, when done prudently, are often in the best interest of both the financial institution and the borrower.*" Further, “*Proactive engagement by the financial institution with the borrower often plays a key role in the success of the workout.*" (The immediately preceding quoted language and all quoted language in italics below are quoted from the 2023 Fed Policy Statement.)

This approach by the Feds applies to all CRE asset classes, office, retail, hotel, multifamily, owner-occupied, land loans, and construction loans. Hence, if you have a CRE loan maturing at the end of 2023 or in 2024 or 2025 which you wish to extend or restructure because your property will not qualify for a new refinancing due to adverse market conditions, you will need to meet with your lender as soon as practicable to convince them that such an extension or restructuring *"...should improve the lender's prospects for repayment of principal and interest...."*

Assume the Lender is Aware of Your Issue.

Assume the lender is aware that you may wish to seek an extension or restructuring. As explained to me by one bank's special assets negotiator, "We are already reviewing our loan files looking at loans which are close to maturity and may be in trouble as we want to get ahead of when our borrower walks in." Bankers are aware of what their borrowers are going through. Bankers watch fair market values and occupancy levels, talk to property appraisers and leasing brokers, study your monthly and quarterly financial reports and rent rolls, pull tax payment records to make sure your property taxes are current, and visit your property to see its condition.

You Need to Walk into the Meeting with a Plan that Gives the Lender Confidence in You.

In this market, your lender is expecting you to knock on their door. And when you do, the absolute worst thing you can do is walk into that meeting without a presentation and plan that will give the lender confidence that you (a) are aware of all of the issues facing your property, and (b) have a plan on how to extend or restructure the loan so that at the end of the new term, the bank has received reasonable interest payments and has reasonable chance of being repaid in full. The Feds and banks understand that the pandemic and worker reluctance to return to the office have created market upheaval. However, the last thing a bank wants to hear is a borrower who says they have no idea how to improve the situation. If the borrower cannot convince the lender that the property and lender are better with the borrower figuring out and overseeing the solution, then the lender will lose confidence in the borrower, view the borrower as an impediment to improvement, will not grant an extension or restructuring request, and will commence foreclosure proceedings.

Timing is Now:

Do not wait until two months before your loan matures to first meet with your lender, as negotiations can take multiple months. Present your lender your presentation and plan on how to proceed as well as property and financial information similar to what you presented when you first applied for the loan. This may necessitate a new appraisal. Your lender will pour over such information and your plan to confirm their decision to extend or restructure complies with the bank's internal policies and the 2023 Fed Policy Statement. This review takes time. Especially if the loan involves a CMBS lender, as a CMBS loan usually takes much more time dealing with the loan's special servicer. Therefore, if you have a loan maturing at the end of 2023 or in 2024, you need to meet with your lender as soon as you can put together your presentation, plan and other materials.

So now you are thinking, alright, what in particular is the lender looking for me to include in my presentation and plan?

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What the Lender and Bank Examiners are Looking For:

As explained in the 2023 Fed Policy Statement, the Lender will look for the Borrower to present, "…*a well-conceived and prudent workout plan that supports the ultimate collection of principal and interest….based on key elements such as*:

- *Updated and comprehensive financial information on the borrower, real estate project, and all guarantors and sponsors;*
- *Current valuations of the collateral supporting the loan and the workout plan;*
- *Appropriate loan structure (e.g., term and amortization schedule), covenants, and requirements for curtailment or re-margining; and*
- *Appropriate legal analyses and agreements, including those for changes to original or subsequent loan terms.*

With such plan, the borrower and guarantors should also provide the lender with:

- *the borrower's global debt service coverage, including realistic projections of the borrower's cash flow, as well as the availability, continuity, and accessibility of repayment sources; and*
- *the available cash flow of guarantors.*

In reviewing the proposed plan, the Lender will also closely and critically analyze the borrower's ability to repay the loan. "*The major factors that influence this analysis are the borrower's willingness and ability to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business*." The Lender will consider the following factors among others:

- "*The borrower's character, overall financial condition, resources, and payment history;*
- *The nature and degree of protection provided by the cash flow from business operations or the underlying collateral on a global basis that considers the borrower's and guarantor's total debt obligations;*
- *Relevant market conditions, particularly those on a state and local level, that may influence repayment prospects and the cash flow potential of the business operations or the underlying collateral; and*
- *The prospects for repayment support from guarantors*."

In analyzing the assistance a guarantor or sponsor/principal of the borrower might provide, the lender will consider "…*whether the guarantor has the financial ability to fulfill the total number and amount of guarantees currently extended by the guarantor. A similar analysis should be made for any material sponsors that support the loan."* This consideration should include *"…whether a guarantor has demonstrated the willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. An important consideration is whether any previous performance under its guarantee(s) was voluntary or the result of legal or other actions by the lender to enforce the guarantee(s).*"

In addition to analyzing the borrower's, guarantors' and sponsor/principals' assets and liabilities, the Lender will want updated value information on the property itself. This will require an analysis of the "*...real estate collateral values based on the financial institution's original appraisal or evaluation, any subsequent updates, additional pertinent information (e.g., recent inspection results), and relevant market conditions.... For a CRE loan in a workout arrangement, a financial institution should consider the current project plans and market conditions in a new or updated appraisal or evaluation, as appropriate. In determining whether to obtain a new appraisal or evaluation, a prudent financial institution considers 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-sale fallout*.

However, "*A new appraisal may not be necessary when an evaluation prepared by the financial institution appropriately updates the original appraisal assumptions to reflect current market conditions and provides a reasonable estimate of the underlying collateral's fair value.*"

Even if the current appraised value comes in significantly below the original appraisal when the loan was made, under the 2023 Fed Policy Statement, a property currently valued below the outstanding debt is not fatal to the request for an extension or restructuring. "*... 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.*"

To see if the property has the cash flow ability to service and repay the loan according to reasonable terms, the lender's analysis "*... will consider expected cash flow from the property, current or implied value, relevant market conditions, and the relevance of the facts and the reasonableness of assumptions used by the financial institution*. For an income-producing property, such an evaluation would include:

- *"Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs;*
- *Current and projected vacancy and absorption rates;*
- *Lease renewal trends and anticipated rents;*
- *Effective rental rates or sale prices, considering sales and financing concessions;*
- *Timeframe for achieving stabilized occupancy or sellout;*
- *Volume and trends in past due leases; and*
- *Discount rates and direct capitalization rates."*

It should be no surprise that the borrower's actual payment history and the likelihood of the borrower actually making future payments must be reviewed in addition to the actual cash flow available for payment. *"One perspective on loan performance is based upon an assessment as to whether the borrower is contractually current on principal or interest payments.... A second perspective .... is to consider the borrower's expected performance and ability to meet its obligations in accordance with the modified terms over the remaining life of the loan."*

The 2023 Fed Policy Statement often refers to the borrower extending or restructuring the loan and repaying it on "reasonable terms". One of the reasonable terms the 2023 Fed Policy Statement refers to throughout its scenarios of good and bad extensions is the conversion of the loan at the time of modification to a current market interest rate if the property's income will in any way support it. The Feds often state that the use of a current market rate by the bank "*provides for incremental risk*." It is not mandatory that a current market rate be used, and there are a number of scenarios in the 2023 Fed Policy Statement where the existing interest rate was extended into the new term. However, there is clearly a preference for the banks, in any extension or restructuring, to increase the loan's existing interest rate to current market rates so the banks do not suffer a loss on interest rates. As part of a borrower's preparation and planning, the borrower should explore what level of interest rate increase can be paid in exchange for the extension, if any. Just because the market value of the property has dipped in a nationwide downturn does not necessarily mean that the property's income has dipped and cannot support an increase in interest rates. Any increase near current market interest rates would go a long way toward making the extension or restructuring one that can be viewed as being repayable on "*reasonable terms*."

Finally, though not in the 2023 Fed Policy Statement, a borrower should not be surprised if the lender requires a pay down of the loan in consideration for the extension or restructuring. A pay down (a) lessens the lender's loan exposure, (b) proves to the lender that the borrower is not trying to place the entire burden of the extension or restructuring on the back of the lender and (c) provides the lender some amount of confidence that its borrower believes in the extension or restructuring or it would not invest new money in the deal.

None of the above lender considerations and issues for analysis should come as a surprise to borrowers. However, it would be reckless for a borrower to attempt to seriously discuss an extension or restructuring without being prepared to deliver the above information and materials. Yes, there might be a general meeting or two to discuss big-picture items, but at some point early in the process, the lender is going to need the above information, documents and agreements from the Borrower to confirm that it can tailor an extension or restructuring within the guidelines set by the 2023 Fed Policy Statement.

We at KRCL have extensive experience sitting on both sides of the table for the above meeting between borrowers and lenders. We understand the issues facing both sides thereby allowing us to assist in finding a common ground for the parties to proceed. Of course, some properties are so underwater that there is no reasonable path to full repayment of the loan. In such cases, KRCL's attorneys switch from their negotiating hats to their combat boots in order to protect their client. Whether you believe negotiations are a potential path or you need an attorney to protect your position, we can assist you in this endeavor.

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, but also over 40 years' experience in the 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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