Mackinac Credit + Compliance

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PREPARED BY: Tammy McDowell, President & Co-Founder ▪ 906-286-0808 ▪ tmcdowell@maccreditcomp.com
Brian Wawsczyk, VP Regulatory & Credit Services ▪ 906-373-3968 ▪ bwawsczyk@maccreditcomp.com

SUBJECT: Summary – 2023 Statement on Prudent Commercial Real Estate Accommodations and Workouts

Background

The 2023 Statement of Policy is meant to update the 2009 Statement considering several regulatory, accounting, and societal changes since its publication. However, the 2009 Statement remains "useful for the agencies' staff and financial institutions in understanding risk management and accounting practices for commercial real estate (CRE) loan workouts." In fact, large portions of the 2009 Statement are either directly or in spirit present in the 2023 Statement.

- It remains important for financial institutions to work constructively with CRE borrowers who are experiencing financial difficulty.
- Financial Institutions that implement prudent CRE loan accommodations and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism.
- 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 less than the outstanding balance.

What has Changed?

- **Section II Short-term Accommodations** (pg. 20) – The 2023 Statement adds a section encouraging banks to work proactively with borrowers experiencing financial stress, before the credit reaches renewal or deteriorates to a more formal workout program. The Risk Management Elements for Loan Workout Programs from Section II of the 2009 Statement remain within this section.

- **Section III Loan Workout Programs** (pg. 21) – The 2023 Statement adds the caveat that the granting of additional credit must improve the prospects of overall repayment.

    - **Subsections A, B, and C** shift the focus from prescribing the financial institution's actions to establishing how examiners will evaluate the Repayment Ability, Guarantees and Sponsorships, and Collateral Values.
    - **Subsection A** also clarifies that banks should use relevant market conditions, particularly state and local.

- **Section IV Long-Term Loan Workout Arrangements** (pg. 22) – Section IV of the 2009 Statement has been renamed to differentiate formal workout arrangements from the short-term concessions discussed in Section II.

- **Section V Classification of Loans** (pg. 31) – While consistent with the prior Statement that "loans to sound borrowers that are modified in accordance with prudent underwriting standards should not be adversely classified...," now adds a caveat that examiners may flag loans for management attention or inclusion in designated "watch lists" of loans that management is more closely monitoring.

- **Subsection A.** (1) Loan Performance Assessments for Classification purposes now differentiates accounting treatment between how proceeds from lot, home, or building sales are recognized, versus when the property has achieved stabilization and permanent financing amortizes the loan. (2) Subsection A also adds a second "perspective" that takes the borrower's expected performance and ability to meet its obligations in accordance with the modified terms over the remaining life of the loan.
- **Subsection D.** Adds clarifying language and granularity on the use of A and B Note structure for partial charge-offs. The Statement remains vague on returning the A portion back to accrual status, "This note may be placed back in 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."

- **Section VI Regulatory Reporting and Accounting Considerations** (pg. 37)
    - The Subsections have been reorganized to A. Allowance for Credit Losses and B. Implications for Interest Accrual. The Restructured Loans subsection has been removed.
    - The Allowance section has changed to layout applicable guidance and references Appendix 5, where the detail can be found.

- **Appendix 1:** (pg. 40)
    - **Income Producing Property – Retail Properties Scenario 1 (**pg. 40) **–** The facts of this scenario remain largely unchanged; however, the examiners noted that the guarantor could continue servicing principal and interest, if necessary, for the next 12 months. The 2009 Statement omitted "for the next 12 months."

        - **Classification** – The addition of the 12-month qualifier drove the ratings change in the 2023 Statement from "Pass" to "Special Mention" as cash flow only covers interest only payments and there remains significant uncertainty with permanent financing.

    - **Subsection C. Income Producing Property – Hotel** (pg. 50) is a new case added to the 2023 Statement.

        - This case highlights how a loan restructured on 12-month interest only at below market rate can move from "Substandard" to "Pass" if the loan is restructured into an amortizing loan on market terms and performed for at least six months.

    - **Subsection D. Acquisition, Development, and Construction – Residential** (pg. 56) is a new case added to the 2023 Statement. This case illustrates a 48-unit residential project structured under an ADC term loan and a construction revolver, including modifications to both acquisition financing, curtailments, release prices, and market absorption.

- **Subsection I. Multi-Family Property** (pg. 75) is a new case added to the 2023 Statement. This scenario highlights the impact of eviction moratoriums from the pandemic and how cash flow can be severely strained. The case also illustrates the inability to service debt at market interest rates as justification for nonaccrual treatment.

- **Appendix 5: Accounting – Current Expected Credit Losses Methodology (CECL)** (pg. 88)
  - Appendix 5 is new for the 2023 Statement, as the Allowance has changed since the 2009 issuance.

Where is it easier to be a banker?

- **Section VI Regulatory Reporting and Accounting Considerations** (pg. 37) – The 2023 Statement is less rigid in the interpretation of the internal control structure compared to the 2009 Statement. Specifically, the 2009 Statement says, "This structure includes written policies and procedures that provide clear guidelines on accounting matters." Whereas the 2023 Statement says, "The agencies observed this governance and control structure commonly includes policies and procedures that provide clear guidance on accounting matters."

  - **Subsection A. Allowance for Credit Losses** – Section moved from subsection C to subsection A. Now refer readers to appendix 5 where the Allowance for Credit Loss standards are imbedded.

  - **Subsection B. Implications for Interest Accrual** - The 2023 Statement allows institutions to include payment periods prior to restructuring when considering accrual status and sustained repayment performance.

  - The 2023 Statement reorganizes this section into Allowance for Credit Losses and Implications for Interest Accrual, while the 2009 guidance also had a Restructured Loans section.