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Matthew Bisanz, Andrew Olmem and Jeffrey P. Taft 507

Federal Reserve Updates Framework for Stablecoins, Digital Assets and Other New Tech Activities
Max Bonici, Christopher L. Boone and Connor J. Webb 516

Financial Promotion of Crypto Assets
James Tinworth and Jack Spence 521

The Commercial Activity Exception Stands Strong
Timothy E. Powers, Emily Fuller and Eric Worthington 526

NAV Facilities: A Potential Liquidity Solution?
Jennifer M. Morgan, Jeffrey Misher, Rachel Shepardson and Olivia Stewart 529

Regulators Replace Policy Statement on Troubled CRE Loans and Allow Short-Term Accommodations
Thomas R. Fileti, Jeremy R. Mandell, Alexa I. Tirse, Jason Shafer and Deana Gonzales 533

Analysis and Strategic Implications of *Consumer Financial Protection Bureau v. Brown*
Anthony E. DiResta and Diego J. Troncoso Breton 538

New York Enacts Disclosure Requirements for Commercial Financing Transactions
Brian H. Montgomery 543

Understanding and Interpreting Document Text of Letter of Credit from the Perspective of the Humei Case
Wang Dongtao 546

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Regulators Replace Policy Statement on Troubled CRE Loans and Allow Short-Term Accommodations

By Thomas R. Fileti, Jeremy R. Mandell, Alexa I. Tirse, Jason Shafer and Deana Gonzales*

The authors of this article discuss a joint Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts. The Statement provides guidance on how to handle loan accommodations and workouts in connection with risk management, loan classifications, regulatory reporting, and accounting considerations, and appears to signal that financial institutions will not be penalized as a regulatory matter when working with their troubled borrowers.

The Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, National Credit Union Administration, and Federal Deposit Insurance Corporation (collectively, the Agencies) issued a joint Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts (Statement),[1] which supersedes the 2009 Policy Statement on the same topic (2009 Statement).[2]

For financial institutions engaging with commercial real estate (CRE) borrowers experiencing financial difficulties, the Statement provides guidance on how to handle loan accommodations and workouts in connection with risk management, loan classifications, regulatory reporting, and accounting considerations, and appears to signal that financial institutions will not be penalized as a regulatory matter when working with their borrowers makes prudent sense. The Statement is generally consistent with the 2009 Statement, with a few main distinctions, discussed further in this article.

REAFFIRMATION OF THE 2009 STATEMENT

The Statement reaffirms the following key principles:

1. Financial institutions that perform prudent CRE loan accommodations and workouts (after conducting a diligent review of a borrower's financial condition) will not be subject to criticism for such efforts, even if the arrangements lead to weakened modified loans that become

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[1] https://www.fdic.gov/news/financial-institution-letters/2023/fil23034a.pdf.

[2] https://www.ffiec.gov/press/pr103009.htm.

adversely classified.

2. Modified loans to borrowers who can repay their debts under reasonable terms will not be subject to adverse classification solely because the underlying collateral value has been reduced to an amount that is less than the outstanding loan balance.

UPDATES FROM THE 2009 STATEMENT

The Statement includes three main updates:

1. Short-Term Loan Accommodations.

   The Agencies recognize that short-term and less complex loan accommodations may be warranted for borrowers experiencing financial stress. The Statement infuses principles consistent with existing accommodations guidance made during the COVID-19 Pandemic, when some properties faced temporary downturn.[3]

   When entering into an accommodation with a borrower, financial institutions should: (a) ensure the accommodation is consistent with applicable laws and regulations; (b) provide prompt and precise information about the arrangement to the borrower and guarantor; and (c) utilize prudent risk management practices and internal controls over accommodations to identify and manage risk.

   Prudent risk management practices include tracking for loan accommodations, assessing financial and collateral information, keeping a risk rating framework, and creating policies and procedures. Prudent internal controls include accurate reporting, continuous credit risk review function, and implementation of policies and protocols.

2. Changes in Accounting Principles.

   The Statement addresses the accounting changes since 2009, including:

   a. Implementation of current expected credit losses (CECL);

   b. Guidance on estimating loan losses for financial institutions that employ CECL; and

[3] See Joint Statement on Additional Loan Accommodations Related to COVID-19: SR Letter 20-18 (Board); FIL-74-2020 (FDIC); Bulletin 2020-72 (OCC); and Press Release, August 3, 2020 (NCUA). See also Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised): FIL-36-2020 (FDIC); Bulletin 2020-35 (OCC); Letter to Credit Unions 20-CU-13 (NCUA); and Joint Press Release, April 7, 2020 (Board).

c. Removal of references to troubled debt restructurings (TDRs) from the examples in Appendix 1 of the 2009 Statement, because the relevant TDRs' accounting standards will no longer be applicable after 2023.

The same CECL methodology used to estimate loans in a portfolio should also be used to estimate expected credit losses on modified or restructured loans. Loans should be evaluated collectively unless they have different risk characteristics from other loans. Certain changes will require revaluation to assess if the modified loan should be included in a different asset pool with similar risks for measuring expected credit losses, including borrower circumstances, credit risk, charge-offs recognition, or cash collections fully applied to principal.

3. Additions and Revisions to CRE Loan Workout Examples.

The Statement provides information about industry loan workout practices, including revisions of the 2009 Statement's CRE loan workout examples. The examples are intended to provide existing rule applications, nonaccrual treatment determinations, reporting instructions, and loan classification guidance.

While not discussed in the examples, examiners also consider a financial institution's internal analysis, choice to enter into a loan workout arrangement, and adequacy of supporting documentation.

ACTIONS BY FINANCIAL INSTITUTIONS

Examiners will not criticize financial institutions for engaging in loan workouts as long as management:

1. Has a well-developed workout plan for each loan that supports principal and interest collection that is based on elements such as:
    a. Comprehensive financial information on the borrower, guarantors, sponsors, and the real estate project,
    b. Current collateral valuations that support the workout plan and loan,
    c. Appropriate loan structure, covenants, and curtailment/re-margining requirements, and
    d. Documentation of legal analyses and agreements;
2. Determines guarantors' available cash flow;
3. Analyzes the borrower's: (a) cash flow, (b) global debt service coverage,

and (c) availability and accessibility of repayment sources;

4. Demonstrates the ability and willingness to continuously monitor performance of guarantor and borrower under the workout arrangement terms;
5. Keeps an internal risk rating or loan grading system that reflects the workout arrangement risk; and
6. Maintains an allowance methodology that measures an allowance, in accordance with GAAP, for loans that went through a workout arrangement and timely recognizes loan losses via provision expense and recording appropriate charge-offs.

ACTIONS BY BORROWERS

Borrowers should be cognizant of the documentation needed to demonstrate repayment ability. The Agencies agree that proactive engagement of the borrower often plays a key role in the success of a workout. The main focus of an examiner's review of a CRE loan is an evaluation of the borrower's ability to repay the loan, which will be assessed by the following factors:

1. Borrower's character, resources, payment history, and overall financial condition;
2. Guarantors' repayment support prospects;
3. Relevant market conditions that may affect repayment prospects and cash flow potential of the underlying collateral or business operations; and
4. Nature and degree of protection provided by (i) business operations' cash flow or (ii) underlying collateral on a global basis that considers total debt obligations of the borrower and guarantor.

CONCLUSION

In the Statement, the Agencies recognize that CRE loan accommodations and workouts are often sensible for both borrowers and financial institutions. Based on the Statement, borrowers should be forthcoming in providing the necessary documentation that will help financial institutions comply with the standards that regulators will be examining, and lenders should be diligent in their efforts to provide accommodations and consider the principles outlined in the Statement when working with CRE borrowers experiencing financial difficulties.

The Statement serves as a reminder for lenders to assess their internal controls, risk management policies, and regulatory reporting rules regarding loan workouts and accommodations. The reminder is especially relevant in the

current environment in which certain classes of real estate assets are particularly challenged by climbing interest rates, changes in modes of work and space utilization, supply chain disruptions and inflationary pressures.