



Interagency Policy Statement on  
Prudent Commercial Real Estate  
Loan Accommodations and  
Workouts



## Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts

Michael Umscheid, President and CEO of ARCSys

### Introduction

On June 29, 2023, the FDIC, Federal Reserve, NCUA, and OCC issued a final Policy Statement on commercial real estate loan accommodations and workouts. The purpose of the policy update is to expand upon existing guidance that calls for financial institutions to work “prudently and constructively with creditworthy borrowers during times of financial stress.” Additionally, it updates the current guidance on commercial real estate loan workouts and short-term loan accommodations.

ARCSys has been following and discussing the Commercial Real Estate price changes since September 2022. Over the past year, the overall commercial real estate price index has fallen approximately 15%.

This whitepaper will provide a brief overview of what you need to know about these updates. The full Policy Statement can be viewed here: [Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts](#).

### Highlights

- This Statement replaces the 2009 Policy Statement on Prudent Commercial Real Estate Loan Workouts
- The focus is the importance of working constructively with CRE borrowers that are experiencing financial difficulties
- This Statement includes information about the handling of loan accommodations and workouts for risk management, the classification of loans, regulatory reporting, and accounting considerations
- This updated Statement reaffirms the following from the 2009 Statement:
  - Financial institutions that undertake **prudent** commercial real estate (CRE) loan accommodation and workout arrangements, following a thorough assessment of a borrower's financial situation, will not face criticism for their involvement in these



initiatives. This remains the case even if such arrangements lead to **modified loans** with identified weaknesses that result in adverse classification.

- Borrowers with modified loans who possess the capacity to repay their debts under reasonable terms will not face adverse classification solely due to the decline in the value of the underlying collateral falling below the outstanding loan balance.
- The following changes are included in this Statement, compared with the 2009 Statement:
  - Addition of a new section on short-term loan accommodations
  - Information about changes in accounting principles since 2009
  - Revisions and additions to examples of CRE loan workouts

## Purpose

The revised statement aims to assist financial institutions in modifying commercial real estate (CRE) loans for borrowers who are facing difficulties in meeting their current payment obligations or fully repaying their debts. Its primary objectives are to promote consistency among examiners, increase transparency in CRE loan accommodations and workout arrangements, and support supervisory policies that ensure credit availability for creditworthy borrowers.

The statement focuses on promoting prudent risk management practices related to short-term loan accommodations, loan workout programs, long-term workout arrangements, loan classification, and regulatory reporting. Importantly, it does not modify existing regulatory reporting requirements or supervisory guidance provided in interagency statements or U.S. generally accepted accounting principles (GAAP). However, it offers valuable guidance specifically applicable to commercial loans secured by real property or other business assets. The statement is further supplemented by five appendices that provide additional information on various aspects.

## Short-Term Loan Accommodations

Financial institutions are encouraged to proactively assist borrowers facing financial difficulties by offering short-term loan accommodations and additionally references the short-term accommodations within the *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)*. These accommodations are temporary solutions provided before a loan reaches a long-term workout scenario, aiming to mitigate long-term adverse effects on borrowers and protect the interests of both the borrower and financial institutions.



For example, if the cumulative modifications for a loan are all COVID event related, in total represent short-term modifications (e.g., six months or less combined), the modification would be considered short-term. This accommodation is only for a short period and the borrower will return to normal loan status after a short term period, compared to a long-term where the entire loan agreement is modified for the remainder of the life of the loan.

When entering into such accommodations, institutions should provide clear and timely information to borrowers and guarantors. Prudent risk management practices and internal controls are crucial in this process to prevent potential risks and adverse impacts.

Effective risk management involves identifying, measuring, monitoring, and managing the credit risk associated with accommodated loans. Financial institutions should develop and maintain appropriate policies and procedures, regularly update financial and collateral information, establish risk rating frameworks, and ensure accurate tracking and accounting of loan accommodations. Internal controls should include comprehensive policies, management approvals, ongoing credit risk reviews, and timely reporting and communication.

Since December of 2022, the Troubled Debt Restructuring (TDR) concept has been replaced with the modified disclosure accounting requirements. The new modified disclosure guidance has a very broad definition of “borrowers experiencing financial difficulties”. Therefore, a borrower does not have to be past due to be defined as experiencing financial difficulties.

### **How ARCSys Can Help!**

ARCSys consultants can help create detailed reporting within the ARCSys Data Warehouse to support the monitoring process for loans that may require a short-term modification. These reports can contain credit risk information, modification codes, past due analysis, and other information.

## **Long-Term Loan Workout Programs**

Loan workout programs are formal arrangements between financial institutions and borrowers that aim to address credit problems that cannot be resolved through short-term accommodation measures. These programs involve longer-term or more complex loan arrangements, such as renewing or extending loan terms, granting additional credit, or restructuring the loan with or without concessions.

To effectively implement workout arrangements, financial institutions need to have appropriate risk management practices in place that are in line with their lending activity, policies, supervisory guidance, real estate lending standards, and regulatory reporting requirements. Examiners will assess the effectiveness of these practices, which typically include the following elements:



- Prudent loan workout policy
- Management infrastructure
- Documentation standards
- Management information systems and internal controls
- Regulatory reporting processes
- Loan collection procedures
- Adherence to lending limits
- Collateral administration
- Ongoing credit risk review function

By adhering to these practices, financial institutions can effectively manage their loan workout programs and mitigate the risks associated with distressed loans.

### **Arrangements for Long-Term Loan Workout Programs**

The goal of a successful loan workout arrangement should enhance the lender's chances of receiving repayment for both principal and interest, adhere to sound banking/accounting practices, and comply with relevant laws and regulations. Financial institutions typically initiate loan workout arrangements after conducting a thorough analysis of the borrower's repayment capacity, assessing the support provided by guarantors, and evaluating the value of any pledged collateral.

Examiners, in line with safety and soundness standards, will not criticize financial institutions for participating in loan workout arrangements, even if such loans are classified as adverse, as long as the management has taken certain steps, including:

- Developing a well-conceived and prudent workout plan for each loan, which includes key elements such as updated and comprehensive financial information on the borrower, real estate project, guarantors, and sponsors; current valuations of the collateral supporting the loan; appropriate loan structure, covenants, and curtailment requirements; and appropriate legal analyses and agreements for any changes to loan terms.
- Analyzing the borrower's overall debt service coverage
- Assessing the cash flow of guarantors.
- Monitoring actively the borrower and guarantor performances under the workout arrangement.
- Assessing risk linked to the workout arrangement through an internal risk rating or load grading system.
- Implementing a GAAP-compliant CECL allowance methodology, calculating an allowance for loans involved in workout arrangements and promptly recognizing loan losses through provision expense and appropriate charge-offs.



The Statement provides additional information about the supervisory assessments of repayment ability of commercial borrowers, guarantees and sponsorships, and collateral values.

### **How ARCSys Can Help!**

ARCSys consultants can help create detailed reporting within the ARCSys Data Warehouse to support the monitoring process for loans that may require a long-term workout program. These reports can contain credit risk information, modification codes, past due analysis, and other information.

Additionally, ARCSys can help an institution update their policies and procedures for the loan-workout programs for the institution.

### **Classification of Loans**

Loans that have sufficient protection through the borrower's current financial condition, debt service ability, or collateral are typically not classified as adverse. Likewise, loans made to creditworthy borrowers that are modified based on sound underwriting standards should not be classified adversely unless specific weaknesses jeopardize repayment. However, these loans may be flagged for closer monitoring by management or included in watch lists.

Examiners should not classify loans negatively solely due to a borrower's association with a struggling industry. In cases where loan modifications lack proper analysis and documentation, examiners are expected to use their judgment when reviewing and determining loan classifications until the financial institution provides sufficient information to support management's conclusions and internal loan grades.

The Statement provides more in-depth information about the following topics regarding the classification of loans:

- Loan performance assessment for classification purposes
- Classification of renewals or restructurings of maturing loans
- Classification of problem CRE loans dependent on the sale of collateral for repayment
- Classification and accrual treatment of restructured loans with a partial charge-off

### **How ARCSys Can Help!**

ARCSys consultants can prepare data analytics to track both short and long term modifications, including redefault, changes in risk ratings, and other credit quality factors through time. These detailed reports can help management understand the impacts of modified loans on their balance sheets and income statements.



## Regulatory Reporting and Accounting Considerations

Financial institution management holds the responsibility for preparing regulatory reports in line with GAAP and regulatory requirements, while also establishing a governance and internal control structure to ensure accurate and transparent regulatory reporting. Loan workout decisions can impact regulatory reporting, particularly in terms of interest accruals and loan loss estimates. Therefore, effective communication between loan workout staff and the accounting/regulatory reporting staff is essential to accurately present the consequences of loan restructurings in regulatory reports.

Examiners are tasked with evaluating credit risk management processes, validating internal loan grades' accuracy, and reviewing management's processes related to accounting and regulatory reporting. While loan risk monitoring, accounting, and reporting systems may use similar data, they can produce different outcomes. For instance, loss classifications may not always align with associated allowance measurements. Ensuring consistency and accuracy between these processes is vital for a comprehensive understanding of a financial institution's financial position and risk profile and for effective supervision.

In regards to Allowance for Credit Losses, examiners must differentiate between credit risk management and accounting/regulatory reporting concepts, such as accrual status and the allowance, to assess the adequacy of a financial institution's reporting practices for on- and off-balance sheet credit exposures.

Additionally, when a loan undergoes restructuring, a financial institution needs to first consider whether a loan that was accruing interest already should be placed in nonaccrual status at the time of modification to ensure that income is not materially overstated. If a loan has been appropriately restructured with reasonable assurance of repayment and adherence to prudent modified terms, it is not necessary to classify it as nonaccrual. However, for a loan to maintain its accrual status, the restructuring and any associated charge-offs must be supported by a current and well-documented credit assessment of the borrower's financial condition and their ability to repay under the revised terms. In the absence of such evidence, the restructured loan should be placed in nonaccrual status.

### **How ARCSys Can Help!**

ARCSys consultants can help institutions track overall losses, including principal, interest, deferred fees and costs, and premiums and discounts, through the Data Warehouse.

## Conclusions

The updated statement serves as a comprehensive resource for financial institutions, providing them with practical guidance and principles to follow when modifying CRE loans. By adhering to these



guidelines, institutions can effectively manage risks, ensure transparency, and support the availability of credit for deserving borrowers.