
EXAM COUNCIL GUIDANCE HOLDS OUT HOPE FOR CRE LENDING

Ed brings a seasoned eye to the regulators' new CRE guidance, and finds promise.

Plus a special banker alert

Bankers: See the special alert at the end of this column after you read Ed's analysis.

Several years ago, when I had a house for sale (as I do now), I received a card from a friend that said, "Your prayers are always answered. Sometimes the answer is 'no'."

Maybe some bankers have felt like this the last few months about their commercial real estate portfolios. And then, suddenly, there is a sign that maybe the answer to our prayers has shifted from "no" to "maybe."

This came in the form last week of guidance from the Federal Financial Institutions Examination Council "supporting prudent commercial real estate loan workouts." [For a copy, [click here.](#)]

Assessing the timing

The guidance, effective for virtually all insured lenders, appears to wipe away years of practice by supervisory authorities whereby they created a category of loans that bankers quickly labeled "performing non-performing loans." This described loans that the borrowers were faithfully servicing as to both principal and interest, but which examiners chose to define as "non-performing" because collateral values were underwater.

Examiners are charged with taking a conservative view of collateral and the servicing capacity of the borrower. As I've stated in past blogs, lenders comprise the credit sales forces of most banks, so it's probably not surprising that examiners are cautious.

In too many environments over the last generation, the examiners have been more right than we.

The way that they have gone about it at times may have left us scratching our heads but in hindsight, they were doing

what they were expected to do.

The “maybe” that we’re getting is coming at an important time.

There’s a virtual tidal wave of commercial real estate debt on the books of the banking system that will be under the microscope for various reasons, including the need to periodically reappraise collateral or the need to renew debt maturing according to its contractual terms.

Either way, it’s an anxious time for lenders. Under the old rubrics, a shortfall in collateral value would trigger a performing non-performing loan, and doubtlessly move substantial new debt into the non-performing category.

In a proportional sense, the biggest impact will be visited on the community and regional banks, as these components of the industry contain more significant and potentially much more serious concentrations of real estate credit.

The return of “forbearance”?

The announcement is also a potentially important development in terms of supervisory attitudes toward forbearance.

I say that not just from the point of view of working out individual credits.

Unfortunately, any bank with a significant burden of criticized assets is also the object of the workout. And in a macroeconomic sense, maybe it is the more important component.

Yes, we bankers are working out our troubled customers

but in a real way, many of us will be working out our own banks.

That’s why a discussion of forbearance is important in the light of this regulatory development on the handling of troubled real estate credit.

As we go about our business of fixing our criticized asset totals, real estate or otherwise, we have to acknowledge the fact that the principal driver of asset criticisms is performance.

We can, with borrower cooperation, fix structure, credit, and collateral exceptions and other examiner criticisms not relating to borrower performance or collateral values. The only way to fix those latter two is with the passage of time and

an improved local or regional economy.

There are encouraging signs that things are improving on a national level. Our heartburn comes from the realization that real estate problems relating to collateral values and performance lag the standard indicators such as GDP, consumer confidence, and the myriad of indicia relating more specifically to non-real estate related loans.

Recent press reports have noted leading authorities and economists (who by the way may have no better information than you, or I or the FDIC) predicting that the wave of real estate credit that must be dealt with in the next several quarters has the potential for causing failures of (pick a number) 500 or 800 or a thousand banks. A thousand banks are nearly 12% of the federally insured banking companies. The additional fact that such failures will impact a much smaller proportion of banking industry assets is scant comfort to banks, bankers, and their local communities that are dependent on them.

An appropriate remedy for the times

Philosophically, forbearance makes sense in a workout. The borrower very often wants something from us and forbearance can be an easy and prudent trade with which to fix documentation or structural criticisms.

But when what we and the customer need is time, then forbearance has a different dimension and assumes a different urgency.

What we're seeing here may be an honest effort of the supervisory agencies to cut some banks some slack—for want of any attractive, politically palatable alternatives. They have no magic wand, the Deposit Insurance Fund is not infinitely capitalized, and the FDIC closure crews have more than they can comfortably handle right now.

Safety and soundness of any insured institution cannot be compromised. Examiners have to do what they have to do when they see continued unsound or unsafe practices. But if we can demonstrate restraint and prudence over the coming quarters, many of our banks have better odds of weathering this very difficult period. No one wants to see the community and regional banking sectors decimated.

Maybe now we are seeing a life line that will help some banks endure the current trials.

Banker Alert: Tell us how your bank plans to utilize the new guidance, and tell us what experiences you have had with examiners regarding appraisals of commercial real estate. Executive Editor Steve Cocheo is working on an article and wants to hear from you. E-mail him at scocheo@sbsub.com. (Deadline Nov. 19.)

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

Order Ed O'Leary's two-hour "Improving Your Bank's Workout Function" CD