



## Shining a Light on the Policy Statement on Prudent Commercial Loan Workouts

*By Kevin K. Watson, AuditOne LLC*

The regulatory agencies released their latest interagency guidance on October 30, entitled "Policy Statement on Prudent Commercial Real Estate Loan Workouts". Sound risk management practices dictate careful consideration of this new policy statement since it clearly indicates the focus of future examination scrutiny. This column will shed some light on the implications of the new guidelines.

While the policy Statement is intended for use by examiners to promote examination consistency and ensure that regulatory policy does not unnecessarily deny credit to borrowers, it is also a useful document for bankers. First of all, it establishes the rules of the game. This is important because you can't win a game if you don't know the rules. Of course, the stakes are much higher in real life than in a game, but the concept is the same. The statement sets the expectations for a bank's 1) overall risk management program for loan workouts, 2) appropriate activities for individual loan workouts, 3) loan classification practices and 4) considerations for call report and financial statement reporting. There are some important takeaways for the Director's Loan Committee and for a bank's loan workout staff for each of these topics that comprise the first 13 pages of the statement. The remaining 17 pages are appendices and should also prove to be very useful as a source of reference for bankers and examiners alike. We certainly should expect increased consistency in the treatment of various lending situations across institutions. Also, as a byproduct of the goal of examination consistency, I expect the specific language from this document to show up in many examination reports. Bankers have always complained about inconsistent treatment and the new guidelines are a very good effort on the part of regulators toward achieving that. Of course, examiners, like umpires and referees are certainly human so we should not expect complete uniformity.

The first section of the document, "Risk Management Elements for Loan Workout Programs", is a general statement on the appropriate elements of a loan workout program such as management infrastructure, documentation standards and information systems. It would behoove you to consider how well your institution measures up to these elements, since the examiners will also be making that assessment.

The next section, "Loan Workout Arrangements", clearly lays out the expected actions to be taken and documented in loan files for all problem loans. Though the documentation process is time consuming it does contribute materially towards a systematic improvement process and can mean the difference between Pass/Watch and Substandard/Doubtful loan grades and the related loss reserve requirements. The key elements are the traditional and fundamental activities of obtaining updated financial statements, current collateral valuations, global debt service analysis of borrowers and guarantors, and documenting the monitoring of compliance with workout terms. The statement pays particular attention to assessing collateral values, and while a new appraisal is not always necessary, especially when there has not been a restructuring or renewal, importance is placed on the timeliness of the valuations. This is especially important when values are dropping as rapidly as they have in the past year and property valuations of six months ago may no longer be reliable. The statement also presents, in bullet format, seven elements of appraisals that examiners

should be scrutinizing, such as vacancy rates and capitalization rates. The examiners have been instructed well in appraisal review techniques and I expect an extremely high level of scrutiny over the next few years, especially if a bank is carrying little or no additional loan loss reserve against an impaired loan. Appraisals should be carefully reviewed by someone who is very well versed in these seven elements. This will reduce the risk that examiners discount or disregard the appraised values supporting your loans.

Section IV is entitled, "Classification of Loans". It includes useful discussion of loan performance as a determinant of the loan grade, how to handle a maturing loan, loans dependent on the sale of collateral for repayment, and the treatment of restructured loans with partial charge-offs. These concepts are also applied in a series of scenarios provided in the appendix of the Statement.

Section V, "Regulatory Reporting and Accounting Considerations", discusses non-accrual requirements, troubled debt restructurings, and the Allowance for Loan and Lease Losses (ALLL). The most irritating aspect of the guidelines is the adoption of the new Accounting Standards Codification (ASC) terminology. The Financial Accounting Standards Board (FASB) has re-codified all accounting standards by topic as opposed to FASB number. For example, FASB No. 5 is now ASC 450-20; FASB 114 is now ASC 310-10-35-2 through 30. I never thought I would miss my old favorites FASB No. 5 and No. 114, but I do now.

By far the most useful element of the Statement is the Appendices. These 17 pages contain case studies of different loan scenarios; each one varied by subsequent actions taken by the bank and borrower. The Appendix systematically notes the related loan classification, Troubled Debt Restructuring (TDR) treatment and non-accrual treatment for each scenario. Bank staff can map their own particularly tricky loan situations as near as possible to the examples provided to get a good idea of the appropriate treatment. There is substantial subjectivity involved, but the case studies can be used to reduce the risk of examination criticism.

This new statement includes all of the lending hot button issues and should be required reading for your loan workout managers. I strongly urge you to take advantage of this effort by the regulators to increase transparency and consistency and also to contribute favorably to the overall quality of bank loan portfolios.

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