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Regulatory Insights, Then and Now

By Sam Chandan

November 4, 2009 | 12:36 p.m



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In the face of rising defaults and increasing pressure on banks to modify problematic commercial mortgages, the Federal Financial Institutions Examination Council (FFIEC) released its anticipated Policy Statement on Prudent Commercial Real Estate Loan Workouts on Oct. 30. The new policy statement supersedes current guidance used by examiners in evaluating the steps taken by

banks in renewing and restructuring commercial mortgages. Encouraging prudent mortgage modifications; enhancing transparency in those modifications; and supporting the availability of credit to creditworthy borrowers are all among the stated goal of the FFIEC in releasing the new guidance.



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The FFIEC includes the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union

Administration, the Offices of the Comptroller of the Currency and of Thrift Supervision, and its own State Liaison Committee. (The text of the policy statement is available [from the F.D.I.C. here.](#))

Central to its policy statement, the FFIEC has

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indicated that banks that undertake prudent modifications of loan structures after thorough assessments of borrower conditions and capacities “will not be subject to criticism for engaging in these efforts.”

In a softening of the expected requirement that mortgage modifications should result in substantially lower default risks, the FFIEC absolves lenders of potential criticism “even if the restructured loans have weaknesses that result in adverse credit classifications.” As for mortgages that are performing—on a current and prospective basis—and that have been made to high-credit-quality borrowers, the mere fact of the underlying real estate’s drop in value will not in itself trigger a mandatory and adverse reclassification of the mortgage.

The new guidance follows a series of material loss reviews by the F.D.I.C.’s Office of Inspector General that have suggested a degree of laxity in the agency’s oversight of commercial mortgage risks. The reviews, undertaken subsequent to bank failures, have cited rapid growth in acquisition, development and construction financing and in commercial real estate exposures as causally related to the failure some banks. Acknowledging conflicts of incentives within some banks, one recent review also cites “an incentive compensation program that paid a commission to a senior lending official based on the volume of loans and fees that the official originated.” A number of the reviews describe how commercial real estate concentrations increased at specific lenders and how the F.D.I.C. did not respond as vigorously as it might have.

And yet, the policy statement is not the first major regulatory foray into commercial real estate during this cycle. In early 2006, a subset of the FFIEC agencies released proposed guidance, Concentrations in Commercial Real Estate Lending and Sound Risk Management Practices, in response to how commercial real estate exposures on the balance sheets of many banks had increased. In the 11 months that passed before the final concentration guidance was promulgated, regulators and policy makers had to contend with a sometimes-visceral response to the perceived interference.

At the time, the market was enjoying a seemingly perfect alignment of rising fundamentals and even more rapidly rising prices and transaction volumes. During the comment period, a letter from one of the industry’s leading associations stated that “the burden should be placed on the examining authority to demonstrate that the risk characteristics of a bank’s commercial real estate portfolio warrant enhanced risk-management practices or increased capital.” Following the promulgation of the final guidance, another leading association released a position statement stating that it “objects to banking agency restrictions that unnecessarily constrain CRE lending.”

The proposed Concentration Guidance elicited an unprecedented response from market participants. All told, the agencies received over 4,400 comment letters: “The vast majority of commenters expressed strong opposition to the proposed guidance and believe that the Agencies should address the issue of CRE



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concentration risk on a case-by-case basis as part of the examination process ...

Several commenters asserted that today's lending environment is significantly different than that of the late 1980s and early 1990s, when regulated financial institutions suffered losses from their real estate lending activities due to weak underwriting standards and risk management practices."

In 2006 and today, this view is dangerously naïve. It was certainly not shared by the full array of lending institutions. Conceding the limitations of the Concentration Guidance, many of those lenders that embraced its spirit are now in a far more enviable position than their peers.

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