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Federal Reserve Bank of Philadelphia

Prudent Measures for Commercial Real Estate Workouts

by Sharon D. Wells, Examiner

It's no surprise that nonperforming assets (NPAs) and other real estate owned (OREO) levels in the Third District and the nation continue to rise as of the third quarter of 2009. Actual classification levels at many institutions may be higher, and workout activities and their associated costs are also on the rise. In response to the need for more robust workout programs and to provide institutions with insight into regulatory concerns, interagency regulatory guidance was issued in October 2009—SR Letter 09-7, *Prudent Commercial Real Estate Loan Workouts* (the guidance).[1] This article discusses the highlights of the guidance, and an article will appear in the second quarter issue of *SRC Insights* to provide a more detailed discussion of strategic loan workouts.

Essential Elements of a Strong Workout Program

The guidance supports prudent workout activities that are designed to minimize losses and improve opportunities for recovery, identifies key risk management practices essential to a meaningful loan workout program, and provides expectations for loan restructuring activities. In addition, specific examples of workout situations, classification assignment, and regulatory reporting requirements are included as an aid to both bankers and examiners.

The guidance stresses that financial institutions that implement prudent loan workout arrangements after performing comprehensive reviews of borrowers' financial conditions will not be subject to criticism for engaging in these efforts, even if restructured loans have weaknesses that result in an adverse classification. In addition, examiners should evaluate a loan workout based on the fundamentals of the particular loan, taking into consideration the project's current and stabilized cash flows, debt service capacity, guarantor support, and other factors relevant to the borrower's ability and willingness to repay the debt.

[1] SR Letter 09-7, *Prudent Commercial Real Estate Loan Workouts*, is available on the Board of Governors' website at: <www.federalreserve.gov/boarddocs/srletters/>.

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FEDERAL RESERVE BANK OF PHILADELPHIA

Supervision Spotlight: Small Business Lending Conditions

by Michael E. Collins, Executive Vice President

The effect of the financial crisis and economic recession on small businesses remains a prominent concern for 2010. Small firms have traditionally played an important role in spurring new job growth and stimulating broader economic recovery, and community and regional banks continue to serve as the primary financial intermediary for their credit needs. The focus on credit availability for small businesses has heightened in recent months, and this issue has been addressed in several policy responses intended to rejuvenate lending activity. As a recent GAO report indicated, "due to turmoil in U.S. credit markets, many lenders have been reluctant to offer conventional loans—that is, loans not guaranteed by the federal government—to small businesses to finance their operations and capital needs."[1]

The Importance of Small Businesses

Small businesses play an important role in the economy. More than 99 percent of all U.S. employers are classified as "small businesses," and, as a group, small businesses employ about half of all private sector workers. Research indicates that small firms, defined as those with 1 to 499 employees, create about 64 percent of new jobs. During the 2001 recession, the very small businesses, those with 19 or fewer employees, lost fewer jobs and recovered faster than their larger counterparts.[2] In contrast, during the current recession, there has been more job loss on a percentage basis at smaller firms than at larger firms. This could indicate that small businesses have been hit particularly hard during this broad-based credit crunch.

Credit Conditions

The National Federation of Independent Business's monthly survey of small business economic trends reveals that obtaining loans is still a challenge for prospective borrowers, as a net 15 percent reported

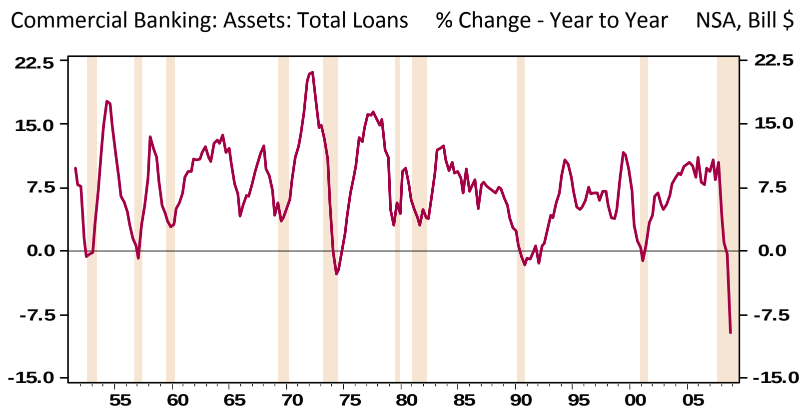
[1] GAO report, available at: <www.gao.gov/new.items/d10298r.pdf>.

[2] Helfand, Jessica; Sadeghi, Akbar; and Talan, David; "Employment Dynamics: Small and Large Firms over the Business Cycle," *Monthly Labor Review*, March 2007, available at: <www.bls.gov/opub/mlr/2007/03/art3full.pdf>

loans harder to get than in their last attempt. The report suggests that "many potentially good borrowers are simply on the sidelines, waiting for a good reason to make capital outlays and order inventory and take out the usual loans used to support these activities."[3]

Analysis of ratios derived from the Federal Reserve's flow of funds data indicates that small businesses have accumulated greater debt relative to net worth than large businesses. It is also known that small businesses have been relying more on credit cards to fund operations, in part because traditional lending sources contracted, and house price declines curtailed the funds available under home equity lines of credit.

Contradictions of Credit Common Around Recessionary Periods



Source: Federal Reserve Board /Haver Analytics

Source: Haver Analytics, Federal Reserve Board   Flow of Funds data through Q3 2009

Influences on Credit Availability

History shows that the economic cycle exerts influence on lending in the banking industry. Credit cycles and contractions and expansions in the availability of credit have been an inherent part of banking, largely due to the ways banks compete for borrowers. During good times, both borrowers and lenders are confident, and perhaps sometimes overconfident, about investment projects and the borrower's ability to repay. Credit tends to flow freely during these periods, with affordable rates and relaxed terms. As lender and borrower sentiment shifts, often preceding the actual recession, credit availability contracts, and loan growth slows. In fact, during the most recent recession, the speed with and extent to which total loan growth turned sharply negative was unprecedented.

Several factors influence the availability of credit and outstanding loans. On the supply side, we are seeing self-corrective actions to strengthen underwriting and reduce exposures. There is a greater tendency toward conservatism and tightening of credit standards as banks experience higher levels of nonperforming loans, increased provisions for loan losses, and declining collateral values. The Federal Reserve's January 2010 senior loan officer survey indicated that "commercial banks generally ceased tightening standards on many loan types in the fourth quarter of last year but have yet to unwind the considerable tightening that has occurred over the past two years."[4]

Compounding the reduced supply, borrowers generally demand less credit, as expansion plans are put on hold, business activity slows, and cash flows tighten.

Michael E. Collins, Senior Vice President

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[3] Dunkelberg, William C. and Wade, Holly, *Small Business Economic Trends*, NFIB, December 2009, available at: <www.nfib.com/Portals/0/PDF/sbet/sbet200912.pdf>.

[4] The January 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices, available at: <www.federalreserve.gov/boarddocs/SnLoanSurvey/201002/default.htm>.

[5] *Summary of Commentary on Current Economic Conditions by Federal Reserve District (Beige Book)*, January 2010, available at: <www.federalreserve.gov/FOMC/BeigeBook/2010/20100113/fullreport20100113.pdf>.

Third District bankers contacted for the *Beige Book* have indicated that "lending activity has been soft in nearly all major consumer and business credit categories, mainly due to slack demand."[5] Looking ahead, they see loan growth starting around mid-year as the economy recovers and loan demand picks up.

The Role of Community and Regional Banks

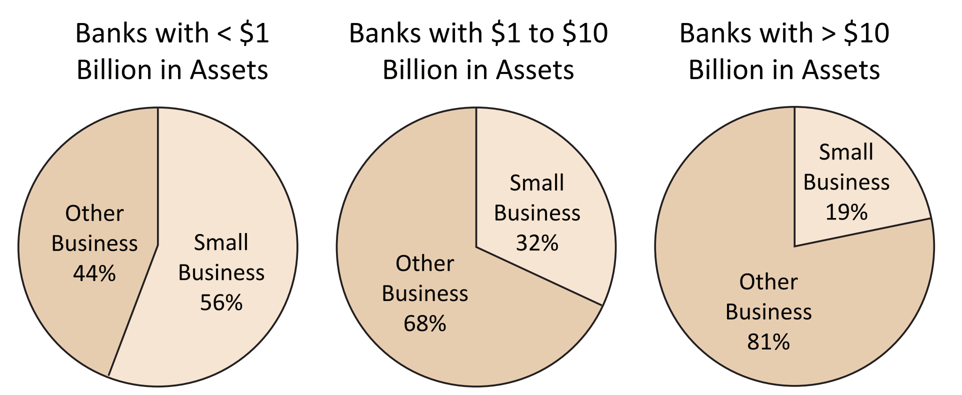
It is apparent that community and regional banks continue to be an important source of strength for the financial system and serve as the primary lender to small businesses. Their emphasis on personal service and relationship banking is highly sought after by small businesses. In Congressional testimony, Jon D. Greenlee, associate director, Division of Banking Supervision and Regulation at the Board of Governors, noted that "small businesses rely on banks for 90 percent of their financing needs, compared to large businesses, which use banks for only 30 percent of their financing."[6]

A review of data from the FDIC call reports as of June 2009 shows that banks with less than $10 billion in assets make a greater proportion of their business loans to small businesses than do larger banks. Over half of business loans made by banks with assets of less than $1 billion are small business loans, while about one-third of business loans made by mid-size banks with assets between $1 and $10 billion are small business loans.

Furthermore, U.S. Department of the Treasury reports show that the 22 largest banks that received TARP Capital Purchase Program (CPP) funds have decreased their small business portfolios. According to the Treasury data, these banks reduced small business loans outstanding by approximately $1 billion in November 2009, the seventh consecutive month of declines.

Third District banks continue to keep small business credit flowing, albeit at a slightly slower pace than in previous years. Anecdotal evidence obtained from bankers suggests that tightened credit and underwriting policies are commonplace. They generally report higher scoring cutoffs, tighter advance rates on collateral, and more conservative cash flow calculations. Bankers are often heard lamenting that demand is down, and creditworthy borrowers are harder to find.

Lending to Small Businesses by Bank Size



Note: Commercial loans under $1 million used as proxy for small business lending
Source: Democratic Policy Committee Report; FDIC data, June 2009

Third District small businesses continue to seek out community and regional banks for financing needs. For the year ended June 2009, the latest period for which these data are available, small and mid-size commercial banks in the District increased their outstanding loans to small businesses by $1.7 billion, while banks with more than $10 billion in assets reported declines in small business loans outstanding of $438 million.

[6] Greenlee, Jon D., *Small Business Lending Testimony Before the Subcommittee on Oversight and Investigations, Committee on Financial Services*, U.S. House Of Representatives, Southfield, Michigan, November 30, 2009, available at: <www.federalreserve.gov/newsevents/testimony/greenlee20091130a.htm>.

Third District Lending Snapshot

Small Business Lending June 2008 to June 2009		
	Total Change in (thousands)	% Change
Banks < $1B	$ 751,315	13.0%
Banks Bet $1B and $10B	$ 981,968	13.4%
Banks Bet $10B and $100B	($ 229,960)	-16.3%
Banks > $100B	($ 207,895)	-3.8%

Note: Commercial loans under $1 million used as proxy for small business lending
Source: Call Report

Pressure on some community banks is inhibiting their ability to lend to small businesses. Dennis Lockhart, the president of the Federal Reserve Bank of Atlanta, noted in a November 2009 speech that "small firms' reliance on banks with heavy commercial real estate (CRE) exposure is substantial. Banks with the highest CRE exposure (CRE loan books that are more than three times their tier 1 capital) account for almost 40 percent of all small business loans."[7] The economy's emergence from recession may be slowed if a negative feedback loop emerges under which small banks with disproportionately high CRE exposures reign in small business lending, hampering their capability to add employees, making obtaining tenants challenging, and placing further pressure on CRE.

Small Business Administration (SBA) Loans

The SBA lending programs enable participating financial institutions to make loans to small businesses while mitigating some of the risks. SBA lending volumes at both the local and national level declined throughout fiscal years 2008 and 2009, but rose recently due to program incentives associated with stimulus measures.

At the national level, the SBA's main 7(a) program backed 37 percent more loans in the latest quarter compared with the similar period one year ago.

Recently, small businesses have been benefitting from lower fees for SBA loans and increased credit availability. The Philadelphia SBA District Office reported that businesses in the Philadelphia five-county region saved more than $3 million in fees on loans issued in the first fiscal quarter of 2010. A comparison of the first quarter fiscal year of 2009 versus 2010 shows that Pennsylvania, Delaware, and New Jersey all experienced double-digit growth in SBA volumes.

Balanced Response by Regulators

Examiners are urging banks to make prudent decisions and continue lending to creditworthy borrowers. They are also encouraging banks to work constructively with customers who are having difficulty servicing loans.

Research conducted on previous credit crunches shows that while examiners sometimes depart from standards that they set during the previous phases of the cycle, this bias is not widespread or systematic. Research "provides modest support that supervisors got tougher on banks during the credit crunch period of 1989–92. However, all of the measured effects are small, with 1% or less of loans receiving harsher or easier classification, about 3% of banks receiving better or worse CAMEL ratings, and bank lending being changed by 1% or less of assets."[8] This and other studies suggest fairly small results in terms of economic significance.

[7] Lockhart, Dennis P., "Economic Recovery, Small Business, and the Challenge of Commercial Real Estate," speech given at Urban Land Institute's Emerging Trends in Real Estate Conference, Atlanta, Georgia, November 10, 2009, available at: <www.frbatlanta.org/news/speeches/lockhart_111009.cfm>.

[8] Berger, Allen N.; Kyle, Margaret K.; and Scalise, Joseph M.; "Did U.S. Bank Supervisors Get Tougher During the Credit Crunch? Did They Get Easier During the Banking Boom? Did It Matter to Bank Lending?," available at: <people.brandeis.edu/~cecchett/pdf/berger2000.pdf>.

The federal bank regulators have taken steps to help promote appropriate bank lending. In November 2008, interagency guidance was issued to encourage banks to meet the needs of creditworthy borrowers. The guidance urged banks to lend in a responsible manner consistent with safety and soundness, by taking a balanced approach in assessing a borrower's ability to repay and making realistic assessments of collateral valuations. Federal Reserve examiners have been directed to be mindful of the pro-cyclical effects of excessive credit tightening and to encourage banks to continue making economically viable loans.

Given the current economic and business climates, the challenge for bank supervisors is to apply examination guidance prudently, without being punitive. Most importantly, regulators must ensure that supervisory practices appropriately constrain risk-taking at financially weak institutions without impeding stronger institutions' extensions of credit to viable small businesses as these firms prepare for the eventual economic recovery.

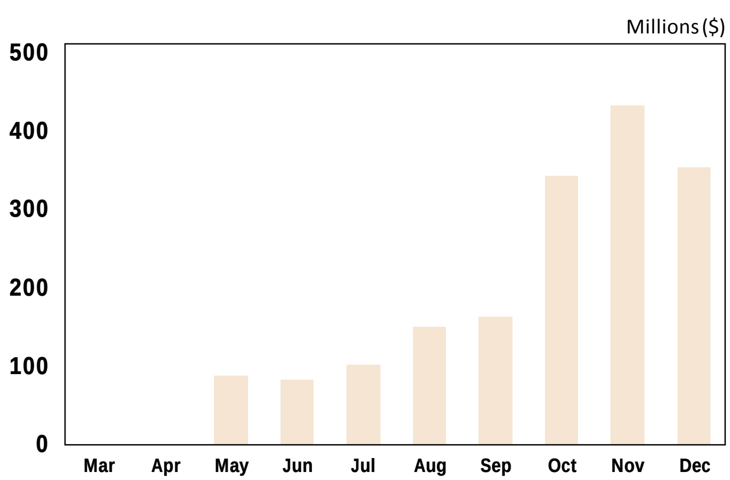
Policy Response

The Term Asset-Backed Securities Loan Facility, or TALF, facilitates the ability of lenders to originate new small business loans by providing confidence that secondary markets have ready buyers for those loans. The Federal Reserve and the Treasury created the TALF to help market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by various loan types, including loans guaranteed by the SBA. As the program matured throughout 2009, the volume of securitized small business loans rose sharply.

The American Recovery and Reinvestment Act of 2009 (Recovery Act) was signed into law on February 17, 2009. In part, it provided tax incentives and financing opportunities to help small businesses create jobs. Importantly, the Recovery Act provided the SBA with specific tools to make it easier and less expensive for small businesses to get loans, gave lenders new incentives to make more small business loans, and included provisions to boost liquidity and help unfreeze the secondary markets.

The America's Recovery Capital (ARC) loan program, a new SBA program formed under the Recovery Act and launched in June 2009, offers participating banks a 100 percent guarantee on loans made to viable but struggling businesses. Given the full guarantee, the SBA's eligibility guidelines are very restrictive. Among the main qualifications, firms must have been in business for at least two years, must have reported positive cash flow in one of the last two years, and must be able to demonstrate severe financial hardship in revenue streams. Finding stressed businesses that meet the borrowing qualifications has proved somewhat problematic. Nonetheless, ARC loans are being originated. By January, 2010, nearly 5,200 ARC loans had been approved, with a total value of $167 million, representing 65 percent of the $255 million of appropriated funds. Interestingly, the volume of ARC loans in

Term Asset-Backed Securities Loan Facility (TALF):
Small Business Loans Requested at Facility



Source: Federal Reserve Bank of New York

Delaware and New Jersey has been relatively low in comparison to other states.

In November 2009, the White House announced a series of initiatives to stimulate small business lending. These include providing lower cost capital to banks to increase small business lending; making lower cost capital available to community development financial institutions; increasing the maximum size of SBA loans; and convening a Treasury-SBA lending conference to work with regulators, lenders, and Congress to ensure that credit is readily available to small businesses.

Recently, the administration proposed legislation that will use $30 billion from TARP repayments to create a new separate program designed to provide capital to small and community banks. The proposal includes a carefully-designed incentive structure that improves the terms of the capital as a small bank expands lending to small business.

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Conclusion

Regionally, small business owners are cautiously optimistic. TD Bank asked small business owners across the Northeast, Mid-Atlantic, and Southeast regions how they think 2010 will compare to 2009. "Eighty-seven percent of small business owners felt their business performance will remain the same or improve during 2010. A remarkable 92 percent of small business owners are considering proactive strategies to prepare for an economic upswing, with 36 percent expecting to see their business grow in 2010."[9]

Despite recent signs of economic improvement, considerable challenges remain for small business owners in 2010. An August 2009 survey completed by the City Business Journals revealed that the U.S. economy—and not necessarily credit availability—topped small business owner concerns. Close behind was the rising cost of doing business. Furthermore, only 52 percent of those surveyed had a positive outlook about future business prospects. Clearly, demand for credit may remain soft in the near-term, as nationwide many small business owners remain apprehensive and lack the confidence needed to put plans for expanding or hiring into action.

The tepid optimism about the economy is also reflected in the National Federation of Independent Business's Index of Small Business Optimism. The NFIB Index lost 0.8 points in November 2009, falling to 88.3. It was the sixth quarter that the index was below 90 during this recession. In comparison, the index was below 90 in only one quarter during the 1980–82 recession period, and it quickly surged to a record high level in early 1983.

As we transition from recession to recovery, small businesses will again assume their prominent role in the economy, and banks will continue to be the providers of credit that drive the growth. ☐

[9] "TD Bank Small Business Survey Reveals Optimism Despite Negative Impact of U.S. Recession," available at: <www.prnewswire.com/news-releases/td-bank-small-business-survey-reveals-optimism-despite-negative-impact-of-us-recession-82057212.html>.

Prudent Measures for Commercial Real Estate Workouts

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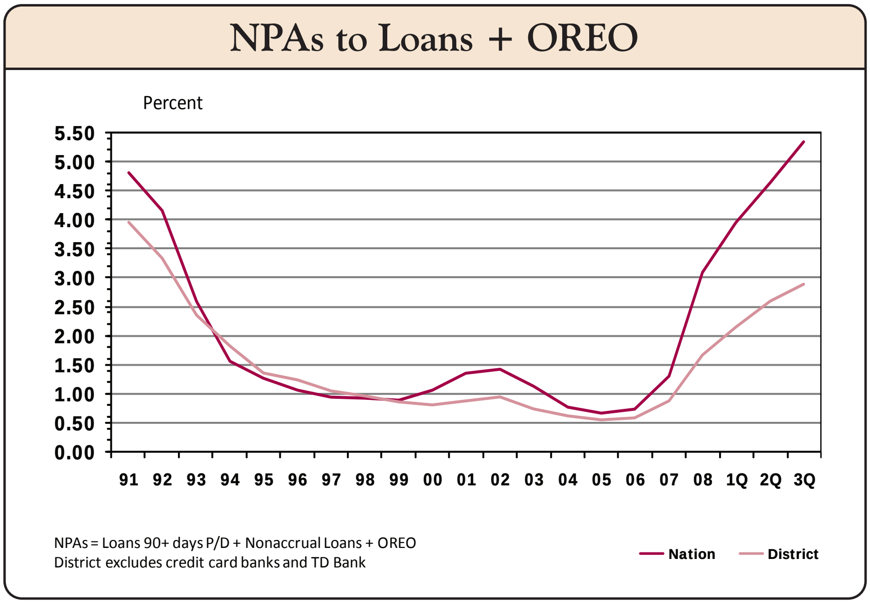

Management infrastructure. The management infrastructure of a workout department may vary. Most commonly, a special assets committee is appointed to periodically monitor and review the success of workout strategies and the level of problem assets and routinely reports the results to the board of directors. Generally, a specific team of individuals separate from the relationship management/business development activities is responsible for handling collection activities and problem loans. The benefits of this approach are as follows:

Essentially, the guidance reinforces the need for institutions to maintain an overall problem loan management program that is reflective of the nature of an organization's lending activities and identifies several essential risk management elements, including the following:

- An adequate management infrastructure to identify, control, and manage the volume and complexity of workout activities
- Documentation standards to verify the borrower's financial condition and collateral values
- Adequate management information systems (MIS) and internal controls to identify and track loan performance risk, including concentration risk and statutory, regulatory, and internal lending limits
- Sufficient management oversight to ensure that regulatory reports are compliant
- Effective loan collection procedures
- Adherence to statutory, regulatory, and internal lending limits
- Adequate collateral administration procedures to ensure proper lien perfection of collateral
- An ongoing credit review function

- It ensures objectivity in the loan disposition process.
- It eliminates any conflicts of interest.
- It provides a dedicated resource concerned only with loan collection.

Organizations that maintain a separate "watch" credit committee and staff experienced with workouts can anticipate future problems and implement loss mitigation strategies early in the process, potentially thwarting or reducing the velocity with which problem loans result in loss.

Financial and collateral documentation verification standards. A strong workout program will require a meaningful review of the financial condition of the borrower from a holistic perspective. This includes evaluating all affiliated relationships and exposures within the organization to determine the impact of these activities on the collectability of the loan as well as, when possible, the borrower's global exposure at other institutions. Comprehensive, current borrower financial information should be obtained.

Management information systems, internal controls, and regulatory reporting oversight. Management information systems should promote early detection of potential issues and ongoing tracking of delinquencies, problem loans, nonaccruals, ORE, property valuations, property taxes, insurances, occupancy changes, absorption rate changes, covenant compliance, LTV exceptions (Regulation H compliance), loan concentrations, etc., in order to monitor factors that affect the collectability of the loan (DCRs and LTVs), comply with regulatory guidance and statutory provisions (concentrations, LTVs, ORE), open up opportunities for negotiation of terms or acceleration of collections (covenant compliance), and ensure that collateral is perfected adequately.

Loan collection procedures. An institution that philosophically invests in collection procedures during the early stages of delinquency will have a better chance of reducing losses either through outright collection or early development of loss mitigation strategies. Emphasis should be placed clearly on those loans that represent the largest percentage of the institution's capital, with priorities highlighted within a written policy that reflects the economic benefits of the initiative levels. For smaller loans, an organization may determine that it is not economically advantageous to engage in collection procedures; in this instance, a charge-off strategy would prevail.

Collateral administration. Strong collateral administration practices are essential for institutions facing a high level of CRE loan delinquencies. Routine lien searches should be conducted, and mortgage recordings, UCC filings, and tax and insurance payment status for all problem loans should be evaluated and, if necessary, remedied as soon as possible. Institutions with high CRE concentrations should aggressively clear up any documentation deficiencies that may impact the institution's collateral position.

Ongoing loan review. An organization's first line of defense is a strong portfolio risk rating system and independent loan review function aimed at those lending sectors or markets where there are weaknesses or where the outlook is questionable. A system for downgrading or upgrading credits should be documented as part of any comprehensive policy and should include a control system that ensures that risk ratings are objective and accurately reflect the obvious or inherent weaknesses in the loan portfolio.

Restructuring Activities

Restructuring, modification, renewal, and/or extension activities are recognized as essential activities in the loan workout process, provided that they are designed to improve the prospect of repayment of principal and interest, and that they are "consistent with sound banking, supervisory and accounting practices." The guidance provides that these activities will not be criticized by regulators if the following supporting elements are in place and practiced effectively:

- A written workout policy
- A workout plan for each individual credit
- A global borrower and guarantor debt service analysis
- Loan terms that promote monitoring the borrower's performance against the restructured loan terms and expectations
- An accurate internal loan grading and classification system
- An ALLL methodology that estimates credit losses in restructured loans
- Timely allocation of loan loss provisioning and recognition of loan loss

Workout policies. Institutions should have policies and procedures for problem loan workout and loss mitigation. Policies and procedures should include, at a minimum, circumstances and requirements for:

- Terms for various workout programs, including extensions, re-aging, modifications, and re-writes
- Requirements for analysis of financial capacity and debt service ability under new loan terms (see individual workout plans below)
- Suggested and allowable loss mitigating strategies, including foreclosure
- Appropriate MIS to track and monitor the effectiveness of workout programs and the performance of all categories of workout loans, including delinquency and loss tracking

Individual workout plans. Individual workout plans, or "action plans," provide a mechanism to encourage, memorialize, and report strategies to minimize loss. Workout plans should outline future activities aimed at reducing loss. Workout plans should be reviewed by management periodically and guided by the limits established by the central workout policy.

Individual workout plans should be based on an evaluation of the most currently known financial condition and repayment capacity of the borrower, the project, and the guarantors, as well as current collateral information. The guidance places emphasis on the use of global cash flow analysis to determine the debt repayment capacity of the borrower and guarantor, primarily to ensure that all cash flow requirements are considered. If restructuring activities are part of the plan, justification for the most appropriate loan structure, including terms, covenants, curtailments, etc., should be included.

The accrual status of a restructured loan should be based on the borrower's sustained ability to demonstrate satisfactory repayment status.

Collateral documentation within the workout plan is necessary and should reflect the current "as-is" value of collateral based on its highest and best use and other factors that affect the value. Valuations utilized should be well supported and documented. Additionally, institutions should verify that discounts, or "haircuts," on appraised values should also be well supported and documented through market information and trends. Valuations that have been discounted and carried over for impairment analysis for provisioning or charge-off purposes must also be well supported.

Loan grading and classifications. In addition to these workout program considerations, the guidance also highlights classification parameters under general and restructured loan scenarios, but most importantly, the guidance serves as a reminder that "collateral deficiency alone does not warrant classification of a loan." Classification, first and foremost, should be predicated on well-defined weaknesses that jeopardize repayment of the loan. Most importantly, the guidance addresses the treatment of land acquisition and development (LAD) loans, where interest reserves have supported debt service on an otherwise stalled project. For these types of loans, fundamental weaknesses in the underlying source of repayment (i.e., lot sales) would warrant classification in the event that interest reserves prove insufficient and there are no alternative sources of repayment to be gathered under formal restructuring arrangements. Severity of the classification also depends on a guarantor's ability to carry debt service on a project over an extended period of time, including principal reduction if the perceived time horizon for sellout is materially protracted or uncertain.

Loans where maturities have been extended based on a borrower's inability to refinance at the time of original maturity should be evaluated on a case-by-case basis, considering whether defined weaknesses jeopardize the loan repayment. An absence of available credit in the market alone would not warrant classification if the borrower is financially sound and demonstrates the ability to repay under reasonable terms.

Loans that are dependent upon the sale of the underlying collateral for repayment require collateral shortfalls to be classified as loss, premised upon the market value of the real estate less costs to sell with the covered portion of the loan generally classified as no worse than substandard. In some instances where pending events may exist, a doubtful category can be assigned (e.g., as additional financial information, an appraisal, or environmental site assessment are being evaluated).

For loans with partial charge-offs or bifurcated into "A" and "B" facilities, with the "A" facility having adequate repayment sources to fulfill the obligation and the "B" facility representing the equivalent of a deficiency note, the classification for the "A" note is based upon the presence of well-defined weaknesses that jeopardize the repayment source. Typically, the entire loan would have been classified prior to the restructure into two notes. Generally, a sustained period of performance is required to declassify any loan, even if it is bifurcated. In any case, any upgrade from classified status should be well documented, supported, and implemented in a controlled environment (i.e., subject to review by a designated authority or authorities, such as senior management, the board, problem loan management committees, etc., and confirmed by an independent function, such as loan review).

ALLL methodology. Regulatory emphasis on the ALLL continues to remain high, with particular emphasis placed not only on the level of the ALLL, but also on the methodology's compliance with GAAP under FAS 5 and FAS 114 and related regulatory guidance. SR 09-7 confirms the regulatory guidance detailed in SR 06-17, *Interagency Policy Statement on the Allowance for Loan and Lease Losses,* and SR 01-17, *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.*[2] Lenders can also refer to Sections 2070.1 and 2072.1 in the *Commercial Bank Examinations Manual* (CBEM) for further information.[3]

The guidance further reminds lenders that a decline in collateral value below the loan balance for a loan that is *not* primarily collateral-dependent (i.e., reliant upon the sale of collateral for repayment) does not require an automatic increase in the ALLL.

Regulatory Reporting and Accounting

The guidance also emphasizes that institutions must comply with regulatory reporting requirements, GAAP, and supervisory guidance, and that an adequate governance and internal control structure must be in place. This structure should include written policies and procedures that provide clear guidelines on accounting matters. The guidance emphasizes the need for accurate reporting of nonaccruals, restructured loans, and charge-offs.

The accrual status of a restructured loan should be based on the borrower's sustained ability to demonstrate satisfactory repayment status. Loans on nonaccrual that have been restructured and are demonstrating adequate repayment histories and ability should maintain a sustained period of repayment performance (typically six months minimum).

All restructured loans should be evaluated to determine whether they should be classified as a troubled debt restructuring (TDR). Mechanisms to identify, monitor, and report TDRs should be incorporated into workout processes and procedures, and TDRs should be identified as part of any restructuring requests and should be accounted for and reported properly. An easy way to monitor TDRs is to add a simple checklist to all loan approval memorandums highlighting the four primary conditions identified in FAS 15 and the CEBM under Section 2040.1. A loan identified as a TDR on the loan approval document can be added to a centralized reporting system, preferably the loan accounting system, to ensure that it is accurately monitored and incorporated within the call report.

Finally, confirmed loan losses should be charged to the ALLL as soon as they are identified, recalling that the guidance emphasizes that a reduction in collateral value alone is not a reason for classifying it, determining impairment, or rendering a charge-off.

Summary

As problem loans and workout activities continue to increase, regulatory scrutiny over the adequacy and effectiveness of workout programs is on the rise. Lenders are encouraged to review the newly developed guidance to enhance current workout practices at their institutions and to gain insight into the supervisory and regulatory emphasis and expectations for examinations. A number of helpful examples and scenarios are provided to help illustrate the principles of the guidance under practical application.

Lenders who wish to review the subject guidance and other SR Letters can go to the Board of Governors' website at: <www.federalreserve.gov/boarddocs/srletters/>. If you have any questions on this guidance, please contact Sharon D. Wells (sharon.wells@phil.frb.org) at (215) 574-2548 or your assigned Third District portfolio manager. ☐

[2] Supervision and Regulation letters are available on the Board of Governors' website at: <www.federalreserve.gov/boarddocs/srletters/>.

[3] The current *Commercial Bank Examination Manual* is available at: <www.federalreserve.gov/boarddocs/supmanual/>.

SUPERVISION AND REGULATION LETTERS

SR 10-2, Interagency Statement on Meeting the Needs of Creditworthy Small Business Borrowers: Issued February 26, 2010

With SR 10-2, the federal financial institutions' regulatory agencies[1] and the Conference of State Bank Supervisors (the regulators) re-state and expand upon supervisory views regarding prudent lending to creditworthy small businesses. The regulators understand the role of small business in the economy and want to ensure that small businesses are not unduly harmed by excessive credit tightening. This interagency statement also discusses sound underwriting and risk management practices. Also, the Federal Reserve is delivering related training and communication initiatives to its examination staff in support of the interagency statement.

Please refer to the article, "Supervision Spotlight on Small Business Lending Conditions," in this issue of *SRC Insights* for additional information and commentary.

SR 10-1, Interagency Advisory on Interest Rate Risk: Issued January 11, 2010

SR 10-1 is an interagency advisory to reinforce the supervisory expectations on sound practices for managing interest rate risk (IRR). It does not set forth new guidance, but rather it reiterates the basic principles of sound IRR management that each of the banking regulators[1] has codified in its existing guidance and in the interagency guidance on IRR management issued by the banking agencies in 1996.[2] SR 10-1 stresses the need for active board and senior management oversight and a comprehensive risk management process that effectively measures, monitors, and controls IRR.

While the primary target audience of SR 10-1 is insured depository institutions, its principles and supervisory expectations also apply to bank holding companies, which are reminded to adhere to longstanding supervisory guidance, managing and controlling aggregate risk exposures on a consolidated basis.

[1] The other financial regulators include the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee (collectively, the regulators).

SR 09-7, Prudent Commercial Real Estate Loan Workouts: Issued October 30, 2009

SR 09-7 is an interagency policy statement to update longstanding guidance regarding the workout of commercial real estate (CRE) loans. The intent of SR 09-7 is to both promote prudent CRE loan workouts at regulated financial institutions and ensure that examiners use a balanced and consistent approach in reviewing institutions' workout activities.

Note: Please refer to this issue's full-length article on SR 09-7, "Prudent Measures for Commercial Real Estate Workouts," for more details on the SR 09-7 policy statement and guidance. A follow-up article on strategic CRE loan workouts will be published in the second quarter issue of *SRC Insights*.

All SR Letters are available on the Board of Governors' website at: <www.federalreserve.gov/boarddocs/srletters/>.

[2] See SR 96-13, *Joint Policy Statement on Interest Rate Risk*, issued May 23, 1996, available at: <www.federalreserve.gov/boarddocs/srletters/1996/sr9613.htm>.

REGULATORY NEWS

February 5, 2010: Regulators Issue Statement on Lending to Creditworthy Small Businesses. The federal banking agencies and the Conference of State Bank Supervisors have issued a statement on prudent lending to creditworthy small business borrowers. The statement emphasizes that financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial condition will not be subject to supervisory criticism for small business loans made on that basis. The statement builds upon existing guidance, including the *Interagency Statement on Meeting the Needs of Credit worthy Borrowers* issued in November 2008 and the *Policy Statement on Prudent Commercial Real Estate Loan Workouts* issued in October 2009.

January 25, 2010: The Federal Reserve Announces the Availability of Electronic Applications, or "E-Apps," a New Internet-Based System for Financial Institutions to Submit Regulatory Filings. E-Apps allows for online filing of regulatory applications, thereby eliminating the time and expense of printing, copying, and mailing the documents. Registered users can access the system at any time to upload additional documents or create new filings. There are no fees for using E-Apps, and it is designed to ensure the confidentiality of the data and the identity of individual filers. To sign up and access forms, go to: <www.federalreserve.gov/bankinforeg/eappssignup.htm>.

January 21, 2010: The Federal and Thrift Regulatory Agencies Announce the Final Risk-Based Capital Rule (the rule) Related to Statement of Financial Accounting Standard Nos. 166 and 167. The new accounting standards implement a change in how banking organizations account for, among other items, securitized assets. If affected by the new standards, a banking organization generally will be subject to higher risk-based regulatory capital requirements. The rule better aligns risk-based capital requirements with the actual risks of certain exposures. In addition, it provides an optional phase-in for four quarters of the impact on risk-weighted assets and tier 2 capital that result from implementation of the new accounting standards.

This rule is effective March 29, 2010. Banking organizations may choose to comply with the final rule as of the beginning of their first annual reporting period after November 15, 2009.

December 17, 2009: U.S. Regulators Encourage Comments to Basel Committee. The Basel Committee on Banking Supervision released for comment new proposals that aim to strengthen the resiliency of the banking sector through new capital and liquidity standards. Proposed changes include new standards for liquidity risk management, the addition of a leverage ratio to the Basel II framework, and strengthening of capital requirements for counterparty credit risk. With these recent changes and the July 2009 enhancements, the Basel Committee is continuing its ongoing effort to apply lessons learned from recent market events to enhance regulation, supervision, and risk management of global banks.

The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, which are members of the committee, encourage interested persons to review and comment on the proposals.

The proposals are available on the committee's website at: <www.bis.org/press/p091217.htm>. Responses are due by April 16, 2010.

Press releases related to banking and consumer regulatory policy are available on the Board of Governors' website at: <www.federalreserve.gov/newsevents/press/bcreg/2010bcreg.htm>.

Send Us Your Feedback!

What issues arise in your daily operations? What questions concern you in the course of business? What else would you like to see in an upcoming issue of *SRC Insights*?

With each issue of *SRC Insights*, we aim to highlight the supervisory and regulatory issues that affect you and your banking institution. We encourage you to contact us with any ideas for articles or any questions or concerns you may have so that we can continue to provide you with value-added information.

Please direct any comments and suggestions to our editor, Joanne M. Branigan (joanne.branigan@phil.frb.org) at (215) 574-3769.

Visit the **Federal Reserve System Publications Catalog** at <www.newyorkfed.org/publications/frame1.cfm> for all of your public information needs. A wide variety of materials are available for students, teachers, and the general public. Orders can be placed online for printed publications, and most documents can also be viewed online. Subscription service is available for certain publications.

SR and CA Letters Are Now Available Electronically

This is a reminder that Board of Governors' Supervision and Regulation (SR) and Consumer Affairs (CA) letters are available to Third District supervised institutions through the Federal Reserve Bank of Philadelphia's E-Mail Notification Service. These letters address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities.

We encourage you and other members of your organization to sign up for this service at <www. philadelphiafed.org/philscriber/user/dsp_content.cfm> as soon as possible. In addition to receiving e-mail notification for newly released SR and CA Letters, you can also elect to receive notification when publications, circular letters, news releases, and financial services information are added to our website.

Note: For technical questions related to the E-Mail Notification Service, please contact the Reserve Bank's web team through the link on the subscription page.

Who To Call

Your institution may need to contact an officer, manager, or staff member in the Supervision, Regulation, and Credit Department, but you may not know whom to contact. The following list should help you find the correct contact person to call. Financial institutions that have an appointed central point of contact should generally contact that individual directly. **Contact names appearing in bold are the primary contacts for their areas.**

Community and Regional Supervision

William W. Lang, SVP	215-574-7225
Elisabeth V. Levins, AVP	215-574-3438
Stephen J. Harter, Manager	**215-574-4385**
Jacqueline Fenton, Manager	**215-574-6234**
Cynthia L. Course, AVP	215-574-3760
Lorraine Lopez, Manager	**215-574-6596**
Adina A. Himes, Manager	**215-574-6443**
H. Robert Tillman, Special Advisor	215-574-4155

Capital Markets

William W. Lang, SVP	215-574-7225
Elisabeth V. Levins, AVP	**215-574-3438**

Consumer Compliance & CRA Examinations

William W. Lang, SVP	215-574-7225
Constance H. Wallgren, AVP	215-574-6217
Robin P. Myers, Manager	**215-574-4182**
David A. Center, Manager	**215-574-3457**
Robert Snarr, Manager	**215-574-3460**

Consumer Complaints

Federal Reserve Consumer Help Center	888-851-1920

Regulations Assistance

Regulations Assistance Line	**215-574-6568**

Enforcement

A. Reed Raymond, VP	215-574-6483
Eric A. Sonnheim, AVP	215-574-4116
Joseph J. Willcox, Manager	**215-574-4327**

Regulatory Applications

A. Reed Raymond, VP	215-574-6483
William L. Gaunt, AVP	215-574-6167
James D. DePowell, Manager	**215-574-4153**

Retail Risk Analysis

Christopher C. Henderson, Retail Risk Officer	**215-574-4139**

Discount Window and Reserve Analysis

Vish P. Viswanathan, VP	215-574-6403
Gail L. Todd, Credit Officer	**215-574-3886**

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