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Managing Workouts – Why Timing is Everything



The Clock is Ticking

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Analyzing your Bank's Portfolio for Unidentified Real Estate Problem Loans

- Provide your Lenders and Underwriters with training in the identification of potential problems.
- Set a policy that requires Lenders to perform a bi-annual review of their PASS Credits to detect issues that may need to be explored for possible deterioration, as well as a quarterly review of all loans graded "Watch" or below.
- Have them complete a worksheet that prompts them to review issues that might direct the Lender to understand the current status of the asset.
- Instill in your lending staff the need to take ownership and ask themselves what issues might be a problem for the Bank if it became the owner of the property through a foreclosure action.
- Items to consider are: taxes, insurance, interest reserve, leasing, mechanics liens, White Report and the Association, delinquent payments, tenant diversification, specific risks, set aside letters, construction progress. These are just a sample of issues how each type of creditor carries its own specific risks.
- Don't forget to: stress financial covenants, follow up on reporting requirements, maintain communication, identify problems with other Borrower projects.

Grading Your Loans and the PLR Review Process

- All Banks need to have a quarterly review process in place for monitoring all loans. Most Banks have a quarterly review prepared on each asset classified as Watch, Substandard, Doubtful or Loss. The reviews are commonly referred to as **“Problem Loan Reviews”**.
- The report should provide the reader with an understanding of what the loan was made for, the details of the loan itself, and the status.
- The report should also set forth the steps that will be taken in an effort to correct the problem, the actions should include duties in order to be pro active and maintain progress during the problem loan management.
- The loan grading classification system rates individual loans with respect to the likelihood of loss and the extent that the loss will be realized.
- Substandard- They have a well defined weakness that may jeopardize the collection of principal and interest. These weaknesses include inadequate net worth, paying capacity and collateral.
- Doubtful have the same weaknesses of a substandard asset plus the characterization that full collection is highly questionable and not likely. There will be some loss in the asset, but the amount is not yet known.
- Loss – Considered to be uncollectible and of so little value that maintaining them as a Bank asset is not warranted. Losses should be charged off at the time they are determined to be uncollectible.

FAS 114

- Once a quarter the Bank should review all impaired loans. (Sample Form Attached)
- Many community banks have loans on real estate that are considered to be collateral dependent.
- When you are determining the amount of actual impairment on a collateral dependent loan , institutions must base their determination on the fair market value of the collateral.
- Most institutions set a discount factor to be applied against the market value of the property for sales commissions, closing costs, etc. based on the type of collateral. The discount factors are generally updated on a quarterly basis.
- The Special Asset loan file should contain well documented information about the value that is being relied on. Copies of the individual FAS 114 review forms should be kept in the files as well.
- Any portion of the loan balance on a collateral dependent loan that exceeds the fair value of the collateral and is identified as uncollectible should generally be classified as LOSS and immediately charged off.

Now What?

- Establish a group to manage all problem loans, preferably people that were not involved in the origination of the loans. The employees in the Special Assets group bring greater objectivity, no previous emotional involvement with the borrower and will likely reduce any potential lender liability issues.
- Once the loan is transferred to the Special Assets group all other Bank personnel must cease communications with the Borrower and the Guarantors.
- Review your Bank policy and guidelines to make sure that this group has appropriate authority to handle issues as they arise. They need to be able to hire counsel, consultants, issue pre-negotiation agreements, file notice of defaults, etc.
- The group needs to have the full support of senior management. Interference can send a message to the borrower that weakens the effectiveness of the Bank's Special Assets Officer.

Analysis of the Loan Asset

- The Special Assets Officer should review all files on the borrower, the guarantors, the loan documents and the loan payment history.
- Review the file for current financial statements, tax returns and in the event that the property is income producing an income and expense statement along with a rent roll. The Officer should run an updated credit report on the borrower and the guarantors.
- In the event that the loan asset was a construction loan, make sure to review the draw file, the inspection reports, etc.
- It is imperative that the Account Officer get out and walk the property and the surrounding neighborhoods. There are some instances where the liabilities associated with the property would make it risky for the Lender to hold title through a foreclosure.
- Obtain a date down on title to determine if there are additional encumbrances on the property that the Bank is not aware of.
- It is recommended that the Officer transferring the loan to Special Assets meet and discuss the issues that need to be addressed immediately. I recommend that they prepare an updated PLR and a FASB 114 upon transfer.
- Call the borrower and guarantors and let them know that Special Asset is now handling their loan and request a meeting. Ask them to come in with a written plan and let them know you will be sending them a Pre-Negotiation Workout Agreement which will need to be signed.

Demand Letter

- Once a default occurs the Bank should ***immediately*** send out a demand letter.
- The letter should be addressed to the Borrower and all Guarantors.
- This action starts the clock on the obligation to perform.
- The demand letter should include a reservation of rights.
- The letter notifies all parties that the current commitment has been suspended or terminated.
- If you have other loans that are cross defaulted you should send out demand letters on those loans as well. This particular step can really motivate a borrower to do whatever it takes to perform.
- Before you start negotiating make sure that you have an executed Pre-Negotiation Workout Letter in file!

Pre-Negotiation Workout Agreement

- Before you start negotiating any workout negotiations with your borrowers, a Pre-Negotiation Agreement should be in place and executed by the borrowers, guarantors and the Lender.
- The agreement is designed to protect the Lender from any claims that may arise during the workout process itself.
- The agreement should cover the following points:
 - That the loan documents remain in full force and effect.
 - Acknowledgement of defaults by the borrower and the guarantors.
 - The agreement is to be confidential and neither party can speak to the media about the negotiations.
 - Acknowledge that no oral promises have any effect whatsoever and that all agreements must remain in full force and effect.
 - Acknowledge that neither party can sue the other for discussions held in the workout negotiation process.
 - This is also a good time to try and clean up any loan documentation issues.

Strategy

- Experience shows that the most successful Lenders are those that come up with a strategy and execute on it.
- Delay is not recommended.
- Once you let a deadline go by or do not carry out on a failed benchmark you will weaken your position in the borrower's eyes.
- Weigh all your options using the information obtained in your file review and the inspection of the property. Determine what the most likely exit strategy will be to pay off the loan or minimize loss.
- Consider some of the following:
 - Forbearance
 - Note Sale
 - Judicial or Non Judicial Foreclosure
 - Receivership
 - Litigation against Guarantors
- Analyze strategies that the borrower might utilize.
- Talk to your Bank or outside counsel.
- Execute and constantly monitor.

Is a Bankruptcy so Bad?

- What happens if I have a borrower that keeps threatening bankruptcy? Should I worry that the property will be tied up indefinitely?
- First of all never let yourself be forced into giving a borrower something they are not entitled to through fear.
- In many cases it can actually get the show on the road. The Federal Bankruptcy Code has specific timeframes for filing a plan.
- Now the Courts will require regular reporting. This is great since in many cases borrowers have ceased supplying the Bank with required reporting.
- They will be required to provide the Courts with a plan that makes sense if the BK is a reorganization.
- A bankruptcy can assist in facilitating a sale of the property.

Forbearance

- There may be situations where a forbearance might be a good solution.
- A forbearance does not act as a cure or a waiver of any existing defaults.
- It is used to document an agreed upon workout plan.
- The agreement should include the following:
 - Borrower /guarantors acknowledge the defaults and the amount of each of the debts in default.
 - It will outline the forbearance period and state exactly what the Bank is forbearing against.
 - All conditions required to occur prior to the forbearance.
 - Reaffirmation of Loan Obligations .
 - Conditions to continue forbearance .

Filing a Non-Judicial NOD, the Process and the Timing

- The time frame for a non-judicial California Foreclosure under a Deed of Trust is as follows. Prior to filing the Notice of Default the borrower and the guarantors will have been sent out the Demand Letter.
- Day 1 Record the Notice of Default.
- The borrower will be given a 90 day cure period until the Bank is able to publish for sale.
- At the end of 90 days the Bank can publish for sale.
- Posting of property and public place 20 days prior to sale.
- Bank submits their bid.
- Bidders are qualified at sale.
- Sale is conducted.

Judicial or Non-Judicial

- Non Judicial Foreclosures are the most common in California.
- They are processed without any court intervention.
- It takes approximately 180 days to complete a foreclosure in California.
- There is a new regulation regarding foreclosures on single family residences which I will discuss verbally.
- Judicial foreclosures are processed through the courts, beginning with the lender filing a complaint and recording a notice of Lis Pendens.
- This process can become very protracted and in the interim the property can deteriorate substantially.
- If the court finds the debt valid, and in default, it will issue a judgment for the total amount owed, including the cost of the foreclosure process.

What About a Deed in Lieu?

- Many borrowers will throw out a request for a Lender to take a deed in lieu. The borrower has given up and wants to give the property back and just get the whole problem over.
- By taking a property back the Bank is subject to any other liens that may be of record, additional loans. The Bank would need to pay those off in order to clear title.
- The Lender no longer has any ability to obtain a deficiency judgment. In some cases that might not be important if the borrowers/guarantors have no assets.
- This is not the preferred method for a Lender to obtain the property.
- This might be considered if the borrower is no longer able to maintain the property and it is diminishing in value as a result.
- The property must be free of all liens and or attachments.

Appraisals and Environmental

- Once the loan is transferred into the Special Assets Group check the date of the last appraisal in file. In most instances the appraisal will be outdated and a new one should be ordered in order to help the Bank understand the value of the collateral.
- In the event that the Lender decides to file an NOD and move through the foreclosure process a new appraisal (within 30 days of the Trustee Sale) should be ordered by and for your Legal Counsel. This way the Borrower has no access to the appraisal. The Lender can use the appraisal value less ten percent in establishing an opening bid for the Trustee Sale. This same appraisal can be used to help support a deficiency judgment.
- The regulators will require that the Bank use the fair market value less a percentage discount for closing and sales commissions when the property becomes OREO.
- Prior to foreclosing on a property (excluding single family –one to four) the Lender should order a Phase 1. You don't want your Bank to suddenly be liable for any type of contamination issues.
- Take advantage of brokers offering to send you free BPO's.

Note Sales

- If your Bank is trying to raise capital they can elect to try and sell their performing Notes or their non-performing Notes.
- Parties who are interested in viewing individual Notes should be pre-qualified to make sure that they have the ability to perform and they need to execute a Confidentiality Agreement.
- The Board should give guidance on the discount they would be willing to offer in order to achieve a sale within a specific period of time.
- Investors should not be allowed to view any financial information regarding the borrower and guarantors unless there is a strong indication that the purchase will occur.
- You might want to consider opening a virtual Sales Office that the Bank can use to allow qualified parties to review the files and loan tapes. This cuts down on the time consumed in taking calls and copying information.
- Make sure that the pricing of any bulk sales of a loan pool would not be dramatically affected by deleting any of the loans.
- Before spending a lot of time on a bulk sale ask for a potential top-end loan purchase level.

Summary

- Understand your collateral and your borrower.
- Be proactive.
- Look for a strategy that presents the best opportunity for the loan repayment.
- Seek the advice of counsel or other experts.
- Seek out the best Asset Managers when forming your group.
- Be aware of potential lender liability issues.
- Stay emotionally detached and professional.
- The work is difficult, the hours are long but the rewards through personal satisfaction are well worth it.