Credit Risk Ready Podcast

Host Linda Keith CPA With Gina Marotta

CRE Forbearance: The New ‘F’ Word in Banking. What About ‘J’?

Linda Keith:
Hi, this is Linda Keith CPA with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

Our guest today is Gina Marotta, an independent consultant and commercial real estate due diligence. She currently works directly with community, regional, and national financial institutions who need a CRE collateral subject matter expert for loan origination or for review. Her deep expertise comes from 30 years in this field and includes loan re-underwriting and due diligence on behalf of high-yield investors purchasing commercial real estate loans and assets. And then during the Great Recession, she was on a team that revalued CRE portfolios of banks that the FDIC had slated for closure. Add to that, Gina has worked with a major private equity firm building a distressed debt platform to invest in small business mortgage loans of failed community banks throughout the United States.

In this episode, she will help us with the issues and the approach to forbearance decisions.

Thanks for being back with me, Gina.

Gina Marotta:
Oh, you're welcome, Linda.

Linda Keith:
So, my listeners know I am a bit edgy, which is why we've identified forbearance as the new ‘F’ word. There is a way to do it right and I'm sure quite a few ways we can get it wrong.

So, Gina, can we talk first about forbearance in any environment before we jump into the way this pandemic and the recession changed the game?

Gina Marotta:
Thank you, Linda.

Yeah, certainly. Forbearance today has certainly taken on a very fast track. We went from a very healthy performing loan portfolio to, all of a sudden within 30 days, we're faced with a congressional document that grants people rights to request forbearance for residential and commercial loans.

For the majority of borrowers out there, forbearance is a new term for them. And it was a matter of educating them that forbearance does not mean forgiveness. That loan payments that a lender allows them to miss must be repaid. The challenge right now for lenders is: when does that repayment occur? And what is the term for the number of months within a forbearance? And what, more importantly, what do their investors allow, right? And for some of the lenders, when it comes to forbearance and their borrowers are actually requesting a forbearance of the loan, they're restricted on what they can do because of their servicing documents with their investors.

I will say that forbearance, as a new ‘F’ word, is very dependent on ‘J,’ that being judgment. The servicers reviewing the request for forbearance, and let's talk specifically about commercial real estate loans, it's incumbent upon them to apply judgment based on facts and reality as it relates to the borrower being able to repay the loan.

So, I'd mentioned earlier that lenders are being faced with how do they structure the forbearance? Do they move the missed payments to the end of the loan? Or do they require the borrower to double up on payments once the forbearance payment has ended? Or make a lump sum payment at the end of the forbearance period?

Indeed, this is a true test for the puzzle maker. Every case is different. I am seeing lenders… In the beginning I've seen lenders, for example, three-month commercial real estate lenders, which is what the CARES Act enunciates is forbearing three months of payments. So, they have granted forbearance for May, June, and July. These lenders are now either, what I've been seeing, is they're requiring all three months to be made up in August 2020 or they're requiring those three payments to be made up the following year. So, you're doubling up on payments in May, June, and July in 2021.

For me, the risk factor is the borrower's ability to have cash to make these extra payments during the loan term.

Linda Keith:
It makes sense to me. I actually didn't understand this concept that you would forbear it for three months and then make them pay it all. If the reason they need forbearance is that their businesses shut down or their tenants aren't paying or whatever, the idea that they would have all that money in three months, it defies my imagination.

Gina Marotta:
Well, and that's where a lender needs to be realistic in their structure. And one of the recommendations that I have is, when a lender is looking at a forbearance case, that they asked the borrower or the lender at analysis think through sources and uses of funds. Well, we know the use of funds is going to be the loan payment. Well, what are the sources? Are other sources going to be of a size that allows the borrower, number one, to resume paying their scheduled principal and interest payments, or PITI if

taxes and insurance are impounded, and will the borrower have a source of cash to be able to make up the payments that were forbeared? So, that is something that every lender needs to address.

My view is that lenders that have structured a doubling up of payments or lump sum payment after the end of the short-term forbearance period, they're just setting themselves up for further default or further forbearance requests. And that puts a burden on the lender’s already-stretched resources in their servicing department. Once again, they're having to redraft an amendment or modification of the loan documents or a letter between the borrower and lender setting forth the repayment terms.

Forbearance is not a new term, but it's become a very frequent dinner table term because of where we are. Forbearance agreements: they're not new. It's common. And I think every lender needs to think through their forbearance structure, which includes how those missed payments get repaid and when.

They also might want to think about a structure that may be an A/B Note structure, which is not uncommon. During the distressed debt period, we saw these A/B Note structures where the A Note is when the loan resumes to start paying. So things open up post pandemic, we resume our normalized loan payments under our promissory note, but those column A/B six or 12 months of missed payments go into a B Note. Put them at the end of your loan term. And maybe your balloon loan term is 11 years now rather than 10 years. Put them into a B Note. So that is a separate note that has a separate interest rate that might be a higher-risk note.

Again, it all depends on what you can do within the context of your financial institution. But it's really about structure. And I would really encourage your listeners to think about a forbearance agreement with your borrower that is realistic given the property type, the property location, and your borrower needs. Because what you don't want to do is create more of a burden on your already taxed servicing platform, because they're getting a lot of calls and requests for forbearance and loan modifications.

Linda Keith:
So, it seems like there's two pieces to this sticking with the A/B idea. One is if you forbear for three months, is it even realistic that they could resume their normal level at that point? And then for that other piece that they haven't paid, what's the more realistic way? Because you could stick that at the end of the beginning, right? You could set up the forbearance to say, “Alright, we're going to give you three months. Those three months are going to be pushed to the end of the deal.” But if in three months they still can't make their basic payment, again, you're back into the service department and your back into considering additional forbearance.

Gina Marotta:
Yeah, that's right. And that becomes very taxing on the servicer and for your borrower as well. And, of course, it’s lenders who want to maintain good relationships with our borrowing group.

Linda Keith:
Yeah. If you thought about what we knew in March and what we know now, you might very well have said in March, “Okay, from what everybody's telling us, you know, we're going to get control of this and and we'll just do the stay at home for a period of time. And then, in three months, we should be starting back up. People are talking about a V shape, you know, to the recession, and we would just bounce right back up.”

And so, the idea that any of us can predict with any certainty what's going to happen in three months, and whether a business would be in position, unless they didn't really need the forbearance in the first place and they were being defensive, which might still make sense. If you had somebody that came to you that actually could make the payments, but they're trying to take this opportunity to build up more of a cash liquidity cushion because we don't know what's coming, that to me could make sense as well.

But too many uncertainties to assume that we won't actually be right back at the table with this borrower in three months or six months. Now that we know how they're doing at that point and have to do something somewhat different.

Gina Marotta:
Yeah. And Linda, to that point, if you think that your borrower is asking for the forbearance to allow them time to build up a cash cushion, I would encourage a lender to ask that borrower to put that cash cushion in a bank account with a lender that serves as, you know, additional collateral for the loan or for some type of source of payments that has some assuredness to them.

Linda Keith:
Yup. I don't know if that's part of a loan covenant. We're getting out of my area of expertise, which is loan origination/cash flow calculations. Would that be a situation where those funds would be in an account at that bank and not available for general use? How does that work?

Gina Marotta:
It's all a function negotiation between the borrower and lender and needs to be documented as such. So, it goes back to structure and lenders thinking outside of the box. To structure around a forbearance scenario that gives them assuredness of repayment of the loan.

Linda Keith:
Well, I can imagine that if we are planning for, say three months forbearance, and then as soon as that time is up they have to give us all of those missed payments plus start again, then this idea that they could use it to build up cash as a cushion doesn't make as much sense as if we're actually putting it to the end of the loan. And so that cash build-up really is providing a backstop in case things continue poorly, they can't open as quickly as they thought, they open and have to close again… many of those things we just can't know right now.

Gina Marotta:
Yeah. And I would add when do lenders need to be careful of where their LTV is? Because if you're forgiving loan payments and you're adding them to your loan balance, your LTV is going up. Your today LTV is going up. Now, obviously, we're pushing them to the end of the loan. But I encourage lenders to always have that watchful eye. Where is your current LTV? And a lot of this is a function of how seasoned is your loan. Okay, a loan that's 10-year seasoned, so it's originated in 2010, even the 2010 to 2014 era, and your borrower has not done a cash-out refinance. You know, your leverage is good in that loan.

Linda Keith:
Yeah.

Gina Marotta:
But if it's a recent origination in the last 12-to-18 months, and especially if it was a cash-out refinance, that to me falls into a higher risk category. So, servicers' portfolio managers need to take into consideration some of their loan seasoning characteristics. Not only how seasoned is a loan, but when you originated it, where was your LTV? Where was the occupancy? Where's the debt service coverage ratio? Because some of these loans, if they've been in your books for a long time, your borrower just needs some help, it's kind of a no brainer: you don't have to go through as deep of a dive analysis. But if it's a recent origination, you do need to look at it a little closer.

I would also… lenders are probably aware of this, but I'll just enunciate it for keeping it fresh on people's thought process. But understand the relationship that you have. That borrower or guarantor key principle, or obligor is a term that is used, do they have other loans within your institution? And thus, it doesn't hurt for you to kind of compare notes with other departments. Do they have an auto loan? Do they have a business line of credit? A home loan? What other credits do they have with your institution? So, you can do more of a relationship review.

Linda Keith:
Yes, and compare notes. Because if some of the lenders are hearing a different story from this borrower than other departments, you know, that would be a huge red flag if they're getting different information.

I also might mention we've done an episode where we really zeroed-in on appraisals. And that can help you get your current sense of the value because LTV can be changing because you're extending the loan, but it also can be changing because that valuation is changing. So, if you've got a single-use kind of asset that isn't real marketable, at the same time that that borrower is showing some weakness, that's a different situation than if it's a strong borrower, normally the property is very saleable, and they need some short-term help.

Gina Marotta:
Yeah, and on the forbearance, too, Linda… In a few forbearance agreements that I have looked at the lender didn't recognize property tax and insurance payments. Not really hearing a lot in the industry. Lenders are talking about forbearance of principal and interest payments, but they're not including the tax and insurance component, which is so necessary and important for preservation of their collateral. So, remember that property tax you've got to pay. Those become senior liens to their deed of trust or mortgage. And property insurance is critical in any event there's a casualty. So, I would highly recommend that in the forbearance conversation and in the spirit of structure that they consider the source of funds for property taxes and insurance payments.

And I have seen in the past during the community bank crisis, when I saw loan files and when borrowers were getting behind on the principal and interest payments, lenders were actually funding the tax payments and the insurance and adding it to loan balance. So, something you can do but be careful of where you stand from a loan devalue perspective and also assess the borrower's ability to repay. Not only ability, but willingness to repay the loan. One of the biggest triggers of default, historically, has been cash-out refinances. So, a borrower that has had a recent cash-out refinance does risk factor. Now I think in this case, current era, this new era that we're in, in post-housing crisis, there's fewer cash-out refinances. Those have not been frequent and they have not have not been as deep in terms of cash out to the borrower above their basis.

Another thing to look at is what is the borrower's basis in the property? Basis is key. And you can get that off of the balance sheet in the tax return or the updated balance sheet from the borrower. And on that balance sheet that you get. I mean, it's not just looking at where is the property in terms of cash flow, but where is the balance sheet? Does the borrower actually have cash? When I refer to the borrower, I'm talking about a borrower entity. A lot of commercial real estate loans are held in entities, not in individual names. You know, they might be an individual name. So, then you look at the personal financial statement.

But we've got to look at the balance sheet. Because what you might see on that is a depletion of cash, which is because they've distributed out to partners or members, and an increase of liabilities, where there has been outside loans that have been secured that you don't know about unless you looked at the balance sheet. And those loans might **be** a breach of covenant in your loan documents now. Not that you want to put a loan in default. But it's important for you as the analyst to be aware that this borrower has taken on additional debt, but that may stress the ability of that borrower repaying your loan.

Linda Keith:
Now they've taken on additional debt, but it's second to your debt, is that as much of a concern?

Gina Marotta:
Thank you for that question. I'm not necessarily referring to debt that is a deed of trust or mortgage, because most first lien security agreements do not allow additional debt. Or if they do, it has to have first lien lender approval. The borrower's might have pledged their equity interests. There's issues out there that borrowers do with rescue capital, or angel capital, or hard money capital, that doesn't necessarily become a lien on your property. But it becomes an obligation to that borrower. And it's not discoverable unless you look at the balance sheet. And assuming they put it on the balance sheet.

Linda Keith:
Well and once it's there, what that diminishes is the borrower's ability to come to the table for capital calls and so forth if they also have all these other debts. So that's the danger, yeah?

Gina Marotta:
Well, I think it's important. Again, let's go back to the forbearance process. So, what should be collected by the analyst when a borrower comes and ask for forbearance? Well, most analysts know, you know, the routine documents that you collect for a loan review, you would do the same for forbearance. Ask for an updated personal financial statement and SREO. Ask for an updated balance sheet and profit loss statement for your property, as well as for your borrower.

I'd also ask for any current lease modifications or amendments. You know with COVID, borrower's - especially with retail, a little bit with office - tenants have been asking for rent forgiveness and repayment. You know, just as borrowers are asking for forbearance, tenants are asking for similar concessions to their rates.

What has the borrower been doing? So you want to understand so that you're underwriting today's lease terms. Also ask for an accounts receivable aging report to show 30-, 60-, 90-day past-due payments, rent, and expense escalation payments or dam recoveries. You know, it never hurts to get a

bank statement from your borrower to really validate: is what they're showing on the rent roll to be collected from tenants? Is that actually what they're collecting? You can validate bank statements, which are very easy to collect these days. Because all these statements are available electronically through online banking.

Linda Keith:
Well, you might need to get bank statements. Not just the most recent, but back some months, because that will show you in real time whether they are making arrangements with some of their tenants to pay less and so forth. So, if the rent rolls still say the same thing, but the bank statement shows they're getting a lot less money, then maybe they are offering some opportunities for their tenants for reduced payments or forbearance at that end.

Gina Marotta:
That's right, and it provides quantification to the story and quantification to the trend and need. It's necessary to document the forbearance terms.

Linda Keith:
Right. When someone's requesting forbearance, how do we tell whether this is someone that is suffering a short-term setback because of COVID or really someone who just is getting into trouble?

Gina Marotta:
Yeah, that's the art of the analysis. And a lot of it comes down to judgment, Linda, the "J" word. It's helpful to have an experienced analyst or a lot of common sense on something like this. And it's really have they lost their job or have tenants that vacated the property. It's case by case.

It's really hard to write a policy around this right now, for banks in servicing or a default management department to write a policy around how to handle forbearance for commercial real estate loans as they're so dynamic. They're so unique and particular. Every case is different. It really is a case-by-case analysis.

Now, I'll just give you an example. I looked at a loan where the borrower has owned the property for 35 years. It's a very well-located retail center in the San Fernando Valley of Los Angeles. The borrower had refinanced to cash out a couple of years ago and was asking for forbearance. And one of the tenants had some difficulty making payments. But the LTV on the property was 35% loan origination. Well, it didn't make sense. And this person had the cash. This borrower had the cash to make the payments as for three months of a forbearance. So, you know, maybe there were other factors beyond that. But that case, to me, compared to other cases out there, it would be a tough one to approve of forbearance on. If anything, I told my lender client, "You'd want to own this property all day long, because you'll make money on the loan if you have to sell the loan because the collateral support is so strong." So, it's really a case-by-case basis.

You really have to look at the story behind each applicant. It's a little bit like doing a socioeconomic, I don't want to use the word profile, but assessment of what's going on with the collateral that you depend on repaying your loan, and then the individual who may be your guarantor obligor. What's going on with them in their life that might be impairing their ability to fund the deficit associated with the principal and interest payment obligations? Because there might be things going on in their portfolio that is stressing their cash flow that isn't necessarily your collateral property.

I’ve seen borrowers go to certain lenders because it's easier for them to get a forbearance from a certain lender than it is another. It's another lender’s property that's causing the stress. So, it gets to be a little challenging and problematic for lenders to apply judgment.

But at the end of the day, what's important is the borrower has got to come to you with a plan. What is the existing situation? And what is causing your need to request forbearance? So, that's the plan, the existing situation, existing conditions. And then the second part of the plan is when you expect conditions to normalize or to resume to a level that will allow you to start making your principal and interest payments. And then the third point is how are you going to make up the gap that was missed? And sometimes that gap that was missed, that gap being the payments that were missed, can be made up because the borrower can refinance or sell the property at a level that will allow you to get the payoff of those deferred payments. Again, it depends on loan to value, depends on the fundamentals of the real estate, the tenancy, and the location of that property.

Linda Keith:
So, there's a lot of the “J” word here, a lot of judgment in play, and then documenting what you're thinking. And then if it's a three-month, you get to revisit it in three months and decide: was that a good idea? Is the plan still the same? Does it still make sense? Do we need to adjust further? Or do we need to somehow find a way to help this borrower unwind their position? Think it through?

Gina Marotta:
Yeah, I think it's important now more than ever that portfolio managers or risk management departments really assess the portfolio. I will tell your audience out there, there's a lot of capital out there that wants to chase after buying loan portfolios from banks. A lot of capital out there. So if you've got some good coupon on your portfolio and you think, rather than dealing with these individual borrowers, you might be better off just aggregating a pool of your loans and giving it to this many loan sale advisors out there and having them market your portfolio, don't hesitate doing that. I know lenders certainly don't want to have runoff on their portfolio as it relates to their net interest income. But you also don't want to stress your operating costs because of the time and resources, including legal fees, that might be generated because you're dealing with a problem loan portfolio. Get it on the books, get the cash on your books, and start fresh with capital on your balance sheet to put out there in loans, maybe other property types, or just wait until we’ve emerged from the COVID era.

I had a lender client that had a loan on its books. It was one of the largest loans and the borrower was, you know, threatening bankruptcy. It was a loan that had been coming out of construction and wasn't finalized. They had marked it down. They decided this one time to put it to a loan sale advisor to sell it and that loan sale advisor sold it at such a high rate that they booked a gain on the sale.

Linda Keith:
Wow. Somebody was happy with that decision, weren't they?

Gina Marotta:
So the point being is, it doesn't cost a risk management department anything to go to a loan sale advisor and give them an opinion on what level they could execute that portfolio out in terms of net sale proceeds back to the bank. Because you could make more money just doing that than trying to work it out yourself. Now, obviously, you want to keep the customers. You want to be careful when you sell

loans that you if you're not getting customers away to opportunity fund buyers that might not ever want to work with you again.

So, it's really a relationship and institutional judgment in terms of what loans are selected for sale, but consider that as an option as an exit strategy.

Linda Keith:
Exactly. At least it's out there on the table as a possibility.

Gina Marotta:
That's right.

Linda Keith:
Well, so we had the "F" word. We had the "J" word. Forbearance is certainly something that is happening a lot. It is a changing circumstance.

So, I want to just say that this is the last day of July. So by the time you listen to this particular podcast, something else may have been passed by Congress that gives us even more direction and more opportunities for how we can support our borrowers. So stay tuned.

But the things we've just talked about with regards to how to decide about forbearance; the way to think about it; the way to consider the structure and how it's coming out; and the kinds of questions to ask the borrower to understand what they think their problem is and what they think the solution will be in three months or six months is a critical piece of the puzzle.

Hey, Gina, thank you again for being with us and helping us find our way through the puzzle that is commercial real estate in the pandemic recession. Thank you so much.

Gina Marotta:
My pleasure, Linda. Thank you.

Linda Keith:
Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound.

Take care.

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CRE Forbearance: The New ‘F’ Word in Banking. What About ‘J’?

Resources

- *Do’s and Don’ts in CRE Loan Underwriting*: https://lindakeithcpa.com/wp-content/uploads/2020/10/Dos-and-Donts-in-Commercial-Real-Estate-Loan-Underwriting-Credit-Risk-Ready-Podcast.pdf
- *Do’s and Don’ts in CRE Loan Reviews*:

  https://lindakeithcpa.com/wp-content/uploads/2020/10/Dos-and-Donts-in-Commercial-Real-Estate-Loan-Reviews-Credit-Risk-Ready-Podcast.pdf
- Gina Marotta Loan Review Worksheet: https://lindakeithcpa.com/wp-content/uploads/2020/08/Gina-Marotta-CRE-Loan-Review-Checklist-3.xlsx
- Contact CRE Answers and Advisory for answers to questions or transaction-related support services related to commercial real estate: https://creanswersandadvisory.com/

About Gina Marotta

Ms. Marotta is a subject matter expert in mortgage finance, property ownership, and due diligence involving performing and non-performing commercial real estate loans and properties. In addition to structured finance transactions, she works with credit unions on the underwriting analysis of new loan participations and the completion of annual loan reviews, global cash flow analysis, and credit risk rating of commercial real estate loans.

Since 1995, she has held a variety of roles in pooled mortgage transactions that include the re-underwriting of some $70 billion in legacy CMBS loans under the US Treasury’s PPIP program; managing the securitization process of commercial real estate loans; and loan re-underwriting and due diligence on behalf of high-yield investors purchasing commercial real estate loans and assets. Between 2009 and 2012, Ms. Marotta worked with a major private equity firm in building a distressed debt platform to invest in small balance mortgage loans of failed community banks throughout the US.

Ms. Marotta has held various senior consultant roles in Latin America since 2004 that include: social interest housing securitization transactions, enterprise risk assessments of social interest housing mortgage companies, distressed small-balance mortgage loans, and operational assessments of regional mortgage and consumer finance companies.

In addition to her corporate and consultancy career in real estate investment transactions, she has been an investor in various commercial and multifamily properties in California and Michigan.

Ms. Marotta began her career in 1987 working in the urban mixed-use development group of the Santa Fe and South Pacific Railroad (Santa Fe Pacific Realty). She holds an MBA from the University of San Diego and an MA in international human rights from Columbia University. She is the founder of the non-profit Human Strategies for Human Rights, which she ran from 2001 through 2004, focusing on NGO capacity building, and held consultancy positions at the United Nations in 2000 and 2001. She maintains consultancy offices in Los Angeles and Detroit.

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About Linda Keith

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an Examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say "yes" to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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