Evaluations for Subsequent Transactions: An Under-Utilized Tool to Reduce Bank Costs

By George Mann, MAI, SRA, AI-GRS
and Randy Fuchs

Since 1992, financial institutions have been permitted to use an evaluation in lieu of a real estate appraisal for certain types of transactions. More than 25 years later, there still remains substantial ambiguity over the practical role and application for residential and commercial evaluations within the banking community. We argue that status quo appraisal practices and misinterpretation of the guidelines have led to overly conservative or suboptimal use of evaluations that, in turn, have restricted cost saving opportunities for many financially-regulated institutions.

EXEMPTIONS PRIMER

The Interagency Appraisal and Evaluation Guidelines (IAEG), promulgated in December, 2010, states that an appraisal is required for all real estate-related financial transactions except when an exemption applies. These exemptions include a transaction that:

1. Has a transaction value equal to or less than the appraisal threshold of $250,000.
2. Is a business loan with a transaction value equal to or less than $1 million and is not dependent on the sale of, or rental income derived from real estate as the primary source of repayment.
3. Involves an extension of an existing credit at the lending institution, provided that:
    - There has been no obvious and material change in market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or
    - There is no advancement of new monies other than funds necessary to cover reasonable closing costs.

The first two exemptions apply to new loans. The focus of this article is on the third exemption – and its consequences for banks – involving subsequent transactions such as renewal of an existing loan at time of maturity, refinancing of an existing loan prior to maturity and loan extensions (and/or modifications that exceed a limited change in terms). To this list, we also add periodic loan or credit reviews where evaluations are eligible. For convenience, we will henceforth refer to these transactions either as "loan renewals" or "subsequent transactions."

NO DE MINIMUS LEVEL

One of the common myths in the marketplace is that appraisals are required on loan renewals over $250,000 or $1,000,000. Those figures come from the two new loan exemptions. However, there is absolutely no loan amount threshold for renewals. As will be discussed further below, financial institutions that are exclusively ordering appraisals over these set loan amounts are missing out on a sizable opportunity to cut appraisal costs and, also, may be inadvertently placing their organization at a competitive disadvantage.

REQUIREMENTS

Although there is no de minimus level for loan renewals, the third exemption noted above does have a few requirements that must be met. First, note that the two sub-items listed under this last exemption are separated by an "or" – not an "and."

Let's carefully review the wording in each requirement:

(1) "...no obvious and material change in market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction."

The key word in this long phrase is "threaten." Threaten is not defined by the regulators. It is up to each financial institution to define it. Our experience is that most institutions use the Loan-to-Value (LTV) maximums set forth in the Federal Deposit Insurance Corporation Improvement Act (FDICIA). These limits, excerpted from the FDICIA, are as follows:

Loan Category	**LTV Limit (≤)**
Raw land	65%
Land development or improved lots	75%
Construction:	
Commercial, multifamily and other nonresidential	80%
One- to four-family residential	85%
Improved property—commercial, multifamily, and other nonresidential	85%
Owner-occupied one- to four-family and home equity	90%

Even so, we are aware that some commercial banks take a somewhat more risky or aggressive approach and set the LTV at 95%. That is, if the loan renewal results in an LTV over 95% then the exemption does not apply and an appraisal must be ordered.

As we know, real estate markets are cyclical, and property values will rise and fall – sometimes precipitously – over time. Take, for example, a loan originated three years ago for $200,000 on a property appraised at $500,000. Today, the loan is renewed for $180,000. An evaluation is performed and the value is $400,000. Although the property value has declined (and market conditions may have also), the resulting LTV is 45%. This does not "threaten" the bank's collateral protection. So, the exemption allowing an evaluation can be invoked.

(2) "...even with the advancement of new monies."

We have worked with many banks that require appraisals across the board for loan renewals that involve new monies (above normal closing costs). As noted by this wording, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) does not require appraisals even when new monies are involved. The key check is to make sure the collateral is not "threatened." Reverting to the example above, say the borrower asks for $60,000 above the loan balance of $180,000. Thus, after renewal, the loan amount would be $240,000. The resulting LTV is 60%, which is not threatening the bank's collateral protection. An evaluation is again acceptable.

(3) "There is no advancement of new monies other than funds necessary to cover reasonable closing costs."

With the "or" cited previously, this requirement stands on its own. Therefore, any loan renewal absent new monies qualifies for the evaluation option. It is likely the vast majority of subsequent transactions meet this requirement. However, many bank policies limit full use of this exemption by enforcing a dollar cap above which appraisals are required.

PRUDENT LIMITATION

Although the requirements for the above exemption have no dollar limits, the IAEG does set forth prudent suggestions for constraining the use of evaluations:

(4) "For example, an institution should consider obtaining an appraisal as an institution's portfolio risk increases or for higher risk real estate-related financial transactions, such as those involving:

- *Loans with combined loan-to-value ratios in excess of the supervisory loan-to-value limits.*
- *Atypical properties.*
- *Properties outside the institution's traditional lending market.*
- *Transactions involving existing extensions of credit with significant risk to the institution.*
- *Borrowers with high risk characteristics."*

For example, an evaluation could technically apply to a $20 million loan renewal on a $40 million retail shopping center. However, the size and complexity of the valuation would warrant an appraisal.

Moreover, what is a significant risk to one institution may not be to another. For example, a $2 million loan renewal on any property might be significant to a $200 million community bank. But it will be insignificant to a $500 billion bank. As with any policy, each institution needs to determine its own prudent practices and level of risk aversion.

While the IAEG outlined above offer some useful guideposts for navigating through the regulatory thicket for appraisals and evaluations, we believe that the guidance on subsequent transactions is a bit fuzzy and may have inadvertently curbed broader and practical use of evaluations.

STUDY CONFIRMS UNDER-UTILIZATION

Since the IAEG's release, commercial banks have given evaluations a mixed reception: some have fully embraced the evaluation option; and other institutions have shunned this tool for a variety of reasons including misinterpretation of the IAEG provisions and/or faithful adherence to status quo appraisal policies and procedures among other explanations.

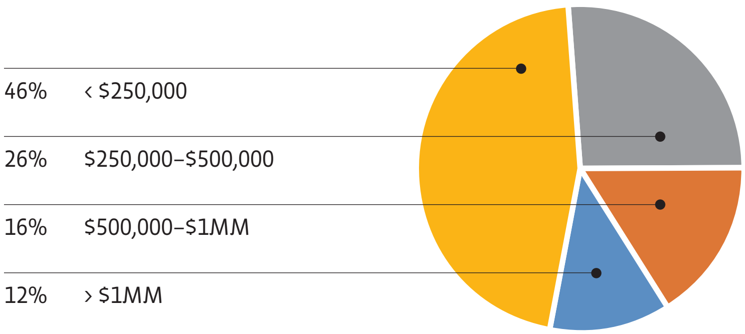
Whatever the case may be, it is our respective experience in the residential and commercial arenas that bankers that have yet to utilize evaluations are missing the boat. Moreover, it is our contention that particularly for lower-risk subsequent transactions commercial banks are paying hundreds – and in the commercial real estate arena – sometimes thousands of dollars more than necessary for a suitable property valuation.

This oversight is particularly costly to banks when considering the number of collateral valuation events that institutions are compelled to perform over the life of a portfolio loan, plus the fact that these periodic transactions frequently impose non-refundable expenses on the institutions.

Furthermore, these episodic needs by banks for valuations on subsequent transactions involving small loans determine that Credit and Appraisal departments not only rack up substantial internal expenses but, also, incur costs that are very high relative to the size and income produced by these small balance loans.

Boxwood's recent assessment of client commercial evaluation activity on its institutionally-oriented SmallBalance.com web site points to a disproportionate use of evaluations on very small loans when subsequent transactions arise. The study included 1,500 recent commercial evaluation reports completed on behalf of a cross-section of national, regional and local community banks where the stated valuation uses involved loan renewals, extensions and credit reviews. On this pool of evaluations, we reduced the concluded market value of the properties by 30% to estimate a 70% LTV reflecting the banks' possible debt level. As shown in the nearby graph, the study results showed that a plurality, or 46%, of the loans were for less than $250,000 in value and only a minority (12%) exceeded $1 million.

Study #1: Smallest Loans Predominate on Commercial Evaluations for Subsequent Transactions



Source: Boxwood Means, LLC

These findings underscore a strong preference or bias for use of evaluations on the smallest dollar loan values even when the intended use typically involves a lower-risk, subsequent transaction. It is possible that many banks programmatically use appraisals on loans above $1 million on renewals out of an abundance of caution. However, this explanation does not square with another finding of the study: i.e., that one-third of bank clients ordered evaluations one or more times for loans greater than $1 million. Instead, with nearly 50% of the evaluations reserved for estimated loans below $250,000 in value, it's more likely that bank staff simply default to the familiar IAEG thresholds that apply to financial transactions involving new monies. And therein lies the missed opportunity for financial institutions.

SIZING THE MARKET OPPORTUNITY

How large is this opportunity? Some market-level information provides some clues. According to third quarter, 2016 data from the FDIC, there were 1.27 million small business real estate (SBRE) loans under $1 million in value on the books of commercial banks with an aggregate, outstanding balance of $284.0 billion. The collateral for this large sum of SBRE loans is, with normal exceptions for complex and/or high LTV properties among other considerations, fully eligible under the IAEG for commercial evaluations involving subsequent transactions.

Furthermore, this SBRE debt is a mere fraction of the $1.98 trillion of total commercial and multi-family mortgage debt held by depository institutions according to the Federal Reserve Board. (This figure includes income-producing commercial/multifamily mortgages, construction loans, owner-occupied commercial debt and the aforementioned SBRE loans.) Based on Boxwood's small balance market research, a reasonable estimate of total small balance mortgage debt held by commercial banks and thrifts with a principal value under $5 million amounts to roughly 30% of that total amount, or an estimated $600 billion.

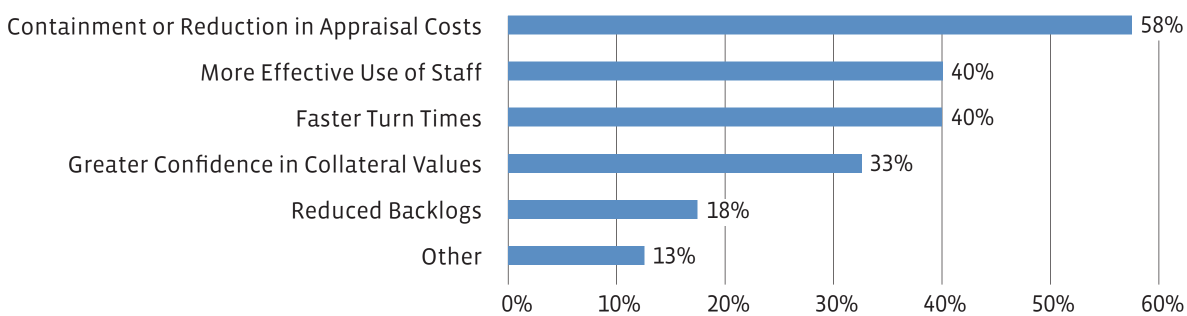
These financial institutions also hold $2.5 trillion of residential (one-to-four family) mortgage debt outstanding.

Our point is that the massive dollar volume of outstanding residential and small balance commercial/ multifamily debt held by commercial banks is largely suitable for evaluations when subsequent transactions take place. Yet by adhering to conservative appraisal policies and practices that limit the usage of evaluations, many institutions are missing tangible opportunities to streamline their internal operations and cut costs.

REAL-WORLD BENEFITS

That being said, as suggested earlier staunch proponents of evaluations do exist within the banking industry and, as a second Boxwood study determined, a substantial percentage of these institutions extract multiple tangible benefits from their employ. For example, as shown in the nearby graph a majority of respondents to Boxwood's recent client user survey involving the firm's FieldSmart-brand commercial evaluations reported they had successfully contained or reduced appraisal costs among other important rewards.

Study #2: A Payoff from Evaluations



Source: Boxwood Means, LLC

While these benefits may offer some encouragement to non-adopter institutions, the maximal benefits and cost savings that can be reaped from periodic valuations on the hundreds of billions of dollars of outstanding residential and commercial mortgage debt will be modest – even among current users – unless financial institutions are willing to expand the use of evaluations on subsequent transactions above the IAEG threshold limits.

As we enter the later stages of the credit cycle with all of the attendant pressures on banks to cut costs further, employ best practices available and increase competitiveness, staking out a more liberal policy on residential and commercial evaluations represents a sure-fire way to streamline appraisal operations and reduce expenses.

George Mann, MAI, SRA, AI-GRS is an appraisal reviewer with over 30 years of national and international experience including completion of more than 4,000 commercial real estate appraisal reviews. Previous positions include chief appraiser at two $100 Billion financial institutions. He can be reached at GeorgeRMann@aol.com.

Randy Fuchs is principal and co-founder of Boxwood Means, LLC. Randy is a CRE market analyst with 30 years of experience. Before starting Boxwood in 2003, he held senior managerial roles at two national real estate research firms. Randy pioneered research on the small commercial property and loan markets. His firm's research, data analytics and commercial property valuation services are available to clients on SmallBalance.com. He can be reached at randy.fuchs@boxwoodmeans.com.