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Assessing Collateral Values

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Last October's Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts (http://www.federalreserve.gov/boarddocs/srletters/2009/sr0907a1.pdf) provides regulatory guidance as to when and how commercial real estate loan collateral should be valued and re-valued. The following is a summary of the valuation guidance provided in Section C of the Policy Statement. Please refer to the Policy Statement itself for the complete text.

When Should Valuations be Updated?

Each institution should have its own policies and procedures that dictate when collateral valuations should be updated as part of their ongoing credit review. Consideration should be given to changes in market conditions or deterioration of a borrower's financial condition. Institutions are responsible for reviewing current collateral valuations (appraisals or evaluations) to ensure that their assumptions and conclusions are reasonable.

New appraisals may not be necessary when an internal evaluation: a) appropriately updates the original appraisal assumptions to reflect current market conditions, and b) provides an estimate of the collateral's Fair Value[1] for impairment analysis.

Market Value vs. Fair Value

Market Value in a collateral valuation and Fair Value in an impairment analysis are based on similar valuation concepts. They may differ however in various situations such as the following:

a. If they are based on different dates of value, and market conditions have changed since the initial date of value,

b. If the property use or physical characteristics have changed since the initial date of value, or

c. If they are based on different underlying assumptions.

What Should a New Valuation Address?

For CRE loan workouts, a new or updated appraisal or evaluation should address current project plans and market conditions. It should analyze whether there has been material deterioration in any of the following:

a. The performance of the project,

b. Market conditions for the location and property type,

c. Variances between current actual conditions and original appraisal assumptions,

d. Changes in project specifications (e.g., changing a planned condominium project to an apartment building),

e. Loss of a significant lease or take-out commitment, or

f. Increases in fallout of pre-sales.

Documentation for the Market Value of the collateral should demonstrate a full understanding of the property's current "As Is" condition (considering the property's Highest and Best Use) and other relevant risk factors affecting value.

CRE collateral valuations often contain more than one value conclusion and could include:

- "As Is" Market Value[2]
- Prospective[3] "As Complete" Market Value
- Prospective[3] "As Stabilized" Market Value

Which Value Conclusion to Use?
Institutions should use the Market Value conclusion (and not Fair Value) that corresponds to the workout plan and the loan commitment. For example, if an institution intends to work with the borrower to get a project to stabilized occupancy, then the institution can consider the Prospective "As Stabilized" Market Value in its collateral assessment for credit risk grading, after reviewing the reasonableness of the appraisal's assumptions and conclusions.

Conversely, if the institution intends to foreclose, then the institution should use the Fair Value (less costs to sell) of the property in its current "as is" condition in its collateral assessment.

What Do Examiners Look At?
Examiners will analyze collateral values based on the following:

a. An institution's original appraisal or internal evaluation,

b. Any subsequent updates,

c. Additional information, and

d. Relevant market conditions.

An examiner should review the appropriateness of the major facts, assumptions, and valuation approaches in the collateral valuation and in the institution's internal credit review and impairment analysis.

When reviewing the reasonableness of the facts and assumptions associated with the value of an income-producing property, examiners should evaluate:

a. Current and projected vacancy and absorption rates,

b. Lease renewal trends and anticipated rents,

c. Effective rental rates or sale prices, considering sales and financing concessions,

d. Timeframe for achieving stabilized occupancy or sellout,

e. Volume and trends in past-due leases,

f. Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs,

g. Discount rates and direct capitalization rates.

Examiners should give a reasonable amount of deference to assumptions that were recently made by qualified appraisers (and, as appropriate, by the institution) as long as they are consistent with the discussion above. Examiners also should use the appropriate Market Value conclusion in their collateral assessments. For example, when the institution plans to provide the resources to complete a project, examiners can consider the project's Prospective Market Value and the committed loan amount in their analysis.

What If the Examiners Find Weaknesses in the Valuation?
If weaknesses are noted in the institution's supporting documentation or appraisal or evaluation review process, then examiners should direct the institution to address the weaknesses, which may require the institution to obtain a new collateral valuation.

However, if the institution is unable or unwilling to address these deficiencies in a timely manner, then examiners will have to assess the degree of protection that the collateral affords in analyzing and classifying a credit. This may result in examiners making adjustments, if applicable, to the collateral's value to reflect current market conditions and events.

Should Examiners Challenge Valuation Assumptions?
Examiners are generally not expected to challenge the underlying valuation assumptions (including discount rates and capitalization rates) used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral under review.

The estimated value of the underlying collateral may however, be adjusted for credit analysis purposes when the examiners can establish that any underlying facts or assumptions are inappropriate or when they can support alternative assumptions.

Key Valuation Definitions and Concepts
The Policy Statement also provides definitions and discussions of the following key concepts for valuation of income producing real estate:

- The Discount Rate and the Net Present Value Approach
- The Direct Capitalization ("Cap" Rate) Technique
- Differences between Discount and Cap Rates
- Selecting Discount and Cap Rates
- Holding Period versus Marketing Period
- The full text of these can be found in Attachment 3 of the Policy Statement (see link above).

Planned Update to Interagency Appraisal and Evaluation Guidelines

The banking regulatory agencies intend to publish updated Interagency Appraisal and Evaluation Guidelines to replace the existing guidelines which were published in 1994. While no firm timeframe has been set, once the updated guidelines have been finalized and released, they will be reviewed and summarized in this column.

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[1] "**Fair Value**" is defined in the FASB ASC Master Glossary, is "*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*"

[2] "**As Is Market Value"** is defined in *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute), 2010 as: "*The estimate of the market value of real property in its current physical condition, use, and zoning as of the appraisal date."*

[3] "**Prospective Opinion of Value"** is defined in *The Dictionary of Real Estate Appraisal,* 5th ed. (Chicago: Appraisal Institute), 2010 as*: "A value opinion effective as of a specified future date. The term does not define a type of value. Instead, it identifies a value opinion as being effective at some specific future date. An opinion of value as of a prospective date is frequently sought in connection with projects that are proposed, under construction, or under conversion to a new use, or those that have not yet achieved sellout or a stabilized level of long-term occupancy."*

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