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Real Estate Solutions*

SPECIAL ASSETS

Appraisal Institute

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Douglas Potts, MAI, VP
Commerce Bank
St. Louis, MO

References

- **FASB ASC 820** – Fair Value Measurements & Disclosures
- **FAS 157** – Fair Value Standards
- **FAS 114** – Accounting for Impairment of a Loan
- **FASB ASC 310-10-35** – Receivables, Subsequent Measurement
- **FIL 61-2009** – Prudent CRE Loan Workouts
- **FDIC** – Regulatory Teleconference 10/21/10

Disclaimers

- Information is believed accurate and relevant, but participants should verify for themselves as desired.
- Information is presented for educational purposes only.
- Information presented is neither accounting nor legal advice.

“Don’t follow me, I may not know where I am going.”

Special Assets Topics

- Loan Classification
- Repayment Reliance
- Loan Impairment & ALLL
- Prudent Workouts & Troubled Debt Restructuring (TDR)
- Much ado about Fair Value
- Measuring Special Assets
- Appraisers Set Free



Loan Classification

- **How assured is full loan repayment?**
 - *Primary & Secondary repayment sources*
- **Sound loans (Pass)**
 - *Net worth & financial capacity are acceptable*
 - *Even in the face of sector weakness*
 - *Solely because RE Value < Loan Bal*
- **Classified Loans**
 - *Special Mention*
 - *Sub-standard*
 - *Non-Accrual*
 - *Loss*
- **Risk of loan loss**
 - *Increases as classification decreases*

Repayment Reliance

- **Non-Collateral Dependent Loans**
 - *Business loans are common (lines of credit, asset backed & borrowing base)*
 - *Typically owner-occupied RE*
 - *Loan language gets the bank RE in fee simple*
- **Collateral Dependent Loans**
 - *Repayment depends on rental or sales proceeds, even if credit is indirectly associated*
 - *Rental property*
 - *Spec land or improved property development*

Defining Impairment

- **FAS 114 = Impairment of a Loan**
 - *Amended by FASB ASC 310*
 - *Lender may not be able to collect all amounts due per the loan.*
 - *Resolution is in best interests of both lender & borrower*
- **Material deterioration:**
 - *Economic performance*
 - *Declined values in asset type*
 - *Declined values in market conditions*
 - *Physical condition (or not built to specs)*
- Requires current “Fair Value” for impairment analysis
- **Aids in establishing ALLL**
 - *Allowance for Loan or Lease Losses*
 - *Loan balance above the Fair Value subject to charge off*



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Prudent Loan Workout?



Split Loan Classification

- **Focus is on CRE loans**
 - *Depend on collateral sale for repayment and*
 - *Alternate repayment sources are not reliable*
- **Can be incorporated as part of a TDR**
 - *Not all impaired loans get Troubled Debt Restructure*
- **“A / B” Note Structure**
 - *Adjusted accrual v non-accrual for regulatory accounting*
- **Note A (rated Substandard)**
 - *Principal is expected to be collected.*
 - *Loan balance still protected by “FV” less sales costs*
- **Note B (rated Non-Accrual or Loss)**
 - *Loan balance exceeding “FV” less sales costs*
 - *Principal is expected to be lost.*

Much Ado About Fair Value

- **FAS 114 established 2 methods**
 - *PV of loan cash flows*
 - *“Observable market price,” where the loan is collateral dependent – a “practical expedient”*
 - *At foreclosure = as-is fair value less costs to sell*
- **FAS 157 clarified the definition**
 - *“Fair value 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.”*
- **ASC 820 adjusts the method**
 - *“Transaction costs should be excluded from all fair value measurements”*

FAS 114 v FAS 157

- **FAS 114 = Impairment of a Loan**
 - *Accounting procedures for impaired loans.*
- **FAS 157 = Fair Value Standard (effective Nov 2007)**
 - *Refines “fair value” definitions and guidance for GAAP*
 - *Aids consistency in definition, application, & disclosure.*
 - *Amended by FASB ASC 820*
- **RE collateral is covered by both standards**
- **Both cover many other non-RE assets**
 - *Financial instruments, including loans (w/ or w/o collateral)*
 - *Stocks & bonds*
 - *Derivatives*
 - *Other liabilities*

FAS 157 Clarifications

- Value in exchange
- Sale as of a hypothetical date
- Using observable market evidence
- In the most likely marketplace in which the asset would market / sell.
- Using assumptions that buyers/sellers would use to establish price.
- Orderly sale – not forced (not liquidation or distress)
- Non-related & knowledgeable parties (buyers and sellers are independent)
- Capacity & desire to perform the transaction
- Usual and customary exposure time on the market
- Asset is sold for its HBU
- In-use & in-exchange premises apply
 - going concerns as aggregations of assets
 - assets to likely be transferred “stand alone.”
- “Exit price” = is this net proceeds after deducting costs of sales?

Fair Value Challenges

- **Why exit price not entry price?**
 - *Not the same.*
 - *Seller's (i.e. lenders) perspective*
- **Should we establish net proceeds?**
 - *If so, what charges to deduct?*
- **Observable v Unobservable Market Inputs**
 - *Observable = assumptions based on independently observed market data (sales, leases, vacancies, etc.)*
 - *Unobservable = assumptions by the entity based on the best available data, esp when little data exists to form opinions.*
 - *Unobservable would not necessarily be known to buyers.*
- **Should Fair Value also consider other risks?**
 - *Restrictions on use of the asset after sale. (e.g. stocks)*

Fair Value - 3 Level Hierarchy

- **Level 1 (Best)**
 - *Prices obtained from active market (not adjusted prices)*
- **Level 2 (Next Best)**
 - *Prices obtained from inactively traded markets*
 - *Prices obtained from non-public markets (seller-seller)*
 - *Prices obtained from other market parameters from which pricing can be imputed / inferred.*
- **Level 3 (Least Reliable)**
 - *Seller-based pricing using seller assumptions*
 - *These are unobservable inputs*
 - *Buyers can't see all the information*

Fair Value - Techniques

- Valuation techniques should reflect what market participants would use
- FAS 157 recognizes standard techniques:
 - Cost
 - Sales
 - Income based
 - *Where sufficient information for each is available*

Measuring Special Assets

- **Institution should review current valuations**
 - *New appraisals “may not be necessary”*
 - *“updated appraisal or evaluation”*
 - *Internal evaluation update assumptions*
 - *Reflects current economic/market conditions*
- **Regulatory Considerations**
 - *Interagency Guidelines*
 - *FASB and IVS requirements*

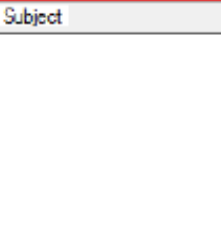






Measurement Challenges

- **What's our goal?**
 - *New market value opinion?*
 - *Validate or adjust the value already on file?*
 - *Stress test downside risks and worst case scenarios?*
- **What measurement techniques to apply?**
 - *Collateral dependent loans (e.g. CRE)*
 - *Loans that are not collateral dependent (e.g. business loans)*
- **Which product type?**
 - *Evaluation?*
 - *BPO? AVM?*
 - *Internal product?*
- **Who should do it?**
 - *Formal appraisal by qualified vendor?*
 - *Appraisers, brokers, assessors, etc.*
- **Is objective observable market data available?**
- **Risk-based considerations**
 - *Cost/benefit analysis v risk of loss v cost to determine*

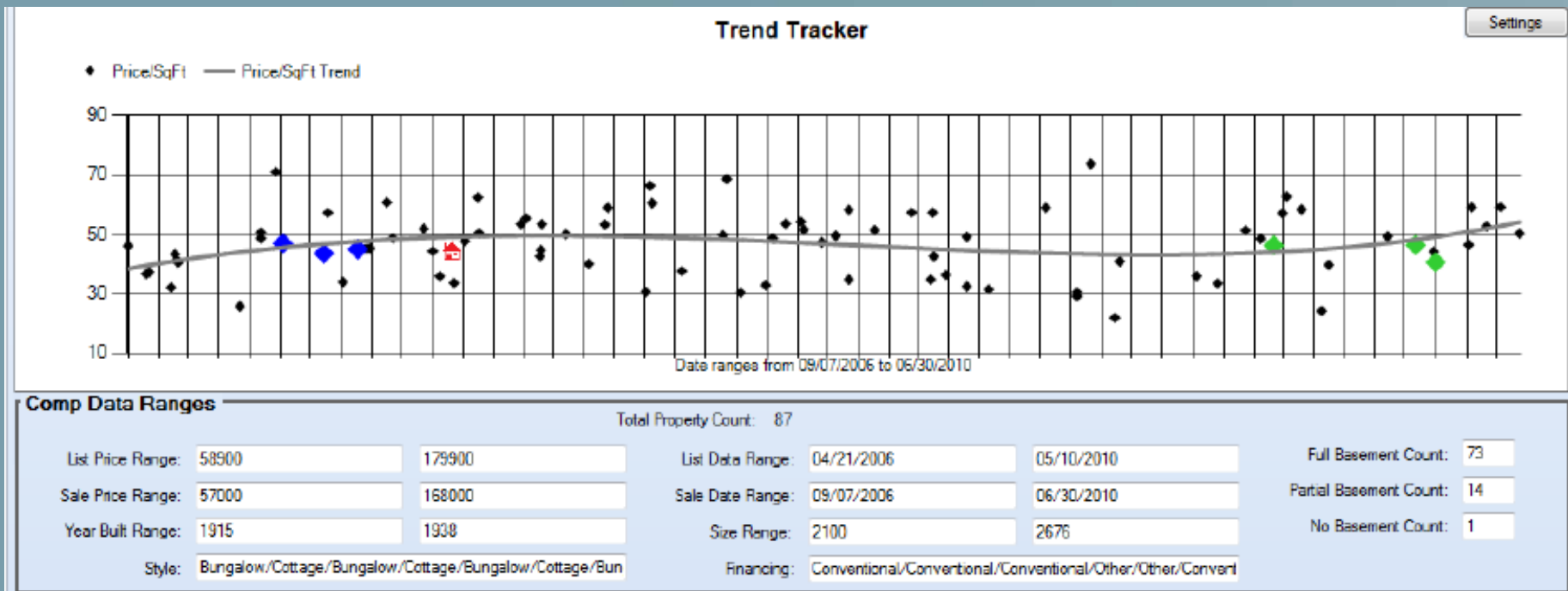
Measurement Options

- **Application**
 - *Deal by deal or at the portfolio level*
- **Sales based measurements**
 - *Sales-to-Sales trend measurements*
 - *Graphic time trend measurements*
- **Income based measurements**
 - *NOI-to-NOI trend measurements*
 - *OAR-to-OAR trend indexes*
 - *IRR-to-IRR trend indexes*
- **Stress modeling**
- **Fair Value Documentation**

Sales-to-Sales Trends

| Subject | | Historical Data | | | Current Data | | |
|---|---------------|---|---|--|---|---|---|
| | | Historic Comp 1 | Historic Comp 2 | Historic Comp 3 | Current Comp 1 | Current Comp 2 | Current Comp 3 |
|  | |  |  |  |  |  |  |
| Address | 780 28TH ST | 721 East 28TH ST | 2917 FOWLER AVE | 3560 ADAMS AVE | 985 East BINFORD ST | 2868 South ADAMS Ear | 2846 South QUINCY AV |
| City | Ogden | Ogden | Ogden | Ogden | Ogden | Ogden | Ogden |
| MLS# | 675304 | 661773 | 648552 | 670943 | 937195 | 943154 | 877928 |
| Style | Rambler/Ranch | Bungalow/Cottage | Bungalow/Cottage | Bungalow/Cottage | Rambler/Ranch | Rambler/Ranch | Rambler/Ranch |
| Year Built | 1923 | 1922 | 1922 | 1925 | 1917 | 1922 | 1933 |
| Size | 2400 | 2214 | 2218 | 2404 | 2466 | 2288 | 2380 |
| Basement | Full/1200 | Full/945 | Full/1000 | Full/1202 | Full/1233 | Full/1144 | Full/600 |
| Sold Date | 07/30/2007 | 03/22/2007 | 02/09/2007 | 04/25/2007 | 04/07/2010 | 03/18/2010 | 10/27/2009 |
| Price | 105000 | 96368 | 104000 | 108025 | 100000 | 106000 | 110000 |
| Financing | VA | Conventional | Conventional | Conventional | Conventional | FHA | FHA |
| Concessions | 0.00 | 6368.00 | 3617.00 | 2850.00 | 0.00 | 4500.00 | 3150.00 |
| Price/SqFt | 43.75 | 43.53 | 46.89 | 44.94 | 40.55 | 46.33 | 46.22 |
| Sale \$ / SF: <input type="text"/> | | Low: \$43.53 Median: \$44.94 | | | Low: \$40.55 Median: \$46.22 | | |
| Appraised \$ / SF: <input type="text"/> | | High: \$46.89 Mean: \$45.12 | | | High: \$46.33 Mean: \$44.37 | | |

Graphical Pricing Trends

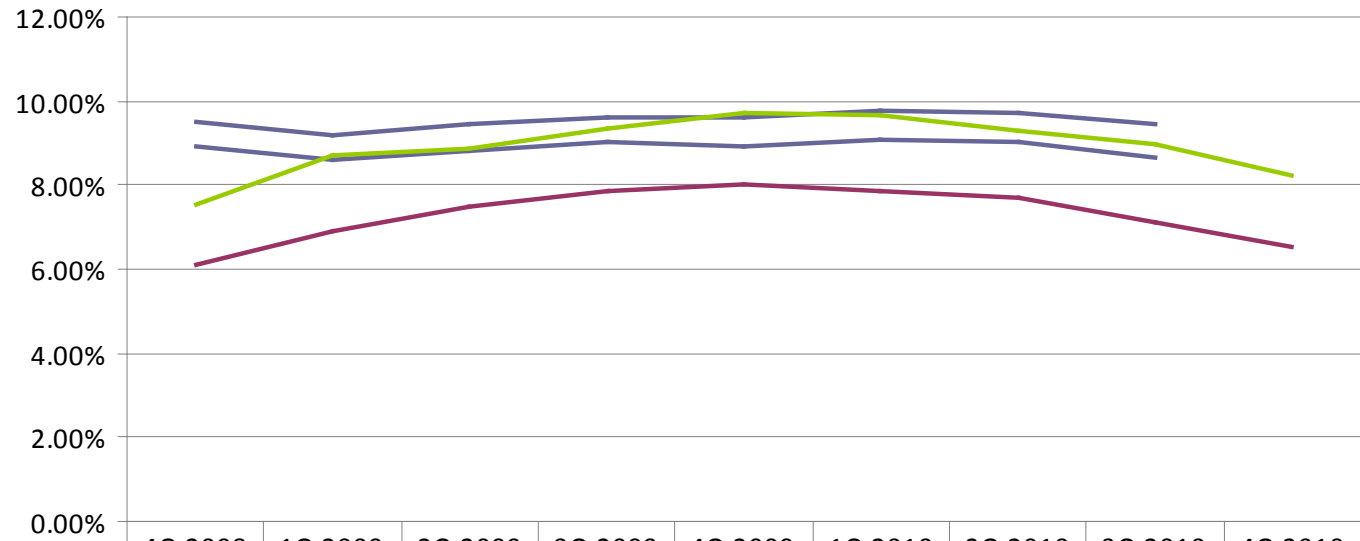


NOI-to-NOI Trends

| | | Appraisal Data in File | Prior Actual -- 2yrs ago | Prior Actual -- 1yr ago | ARG Proforma Current Fiscal Year | Comments | % Chg from Appr in File |
|---------------------------|------------------------------|---------------------------|-----------------------------|----------------------------|--|--|----------------------------|
| Concluded Value | | \$7,240,000 | | | | | |
| Income Comparisons | Year/Quarter | 1Q 2008 | YE 2009 | YE 2010 | | 2010 from borrower's CBRE appraisal | |
| | PGI | \$1,081,809 | | | \$1,063,059 | Rents adj to 2010 avg rents/unit type +\$10M other income | -2% |
| | Vacancy % | 4.1% | | | 4.0% | Current & Hist occ good (2-3%0. App indicated 5%, but effectively applied 4.1% | -3% |
| | EGI | \$1,037,124 | \$908,000 | \$967,105 | \$1,020,537 | | -2% |
| | Annual Expenses | \$548,112 | \$575,000 | \$525,245 | \$545,000 | Expenses estimated between 2009 & 2010 | -1% |
| | NOI | \$489,012 | \$333,000 | \$441,860 | \$475,537 | | -3% |
| OAR Comparisons | OAR Applied (File) | 7.3% | | | | | |
| | Applicable OAR by ARG Survey | 6.7% | | | 8.0% | Korpacz Nat'l Apt Avg Non-Instit OAR | |
| | OAR Index Spread | 0.6% | | | 0.6% | | |
| | | | | 8.6% | Index Calculated Proforma OAR | | |

OAR Index Trends

Apartment Cap Rates



| | 4Q 2008 | 1Q 2009 | 2Q 2009 | 3Q 2009 | 4Q 2009 | 1Q 2010 | 2Q 2010 | 3Q 2010 | 4Q 2010 |
|---------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| RR- APARTMENTS | 8.91% | 8.60% | 8.84% | 9.02% | 8.94% | 9.10% | 9.03% | 8.63% | |
| RR- SR HOUSING | 9.53% | 9.20% | 9.44% | 9.62% | 9.61% | 9.77% | 9.70% | 9.45% | |
| Korpacz Institutional | 6.13% | 6.88% | 7.49% | 7.84% | 8.03% | 7.85% | 7.68% | 7.12% | 6.51% |
| Korpacz Non-Institutional | 7.53% | 8.71% | 8.85% | 9.34% | 9.70% | 9.69% | 9.29% | 8.95% | 8.21% |

Fair Value Documentation

| FAIR VALUE CALCULATOR | | | | | |
|---|---------------------------------|---------------|-----------|-------------------|--------------------------|
| Brooks Kellogg | | | | | Comments |
| 209 W 5th, Hays, KS | | | | | |
| Appraised Value | | | | \$ 257,000 | 2011 appraisal |
| Additions | | Amount | | | |
| | List item description or NA | | NA | | |
| | List item description or NA | | NA | | |
| | List item description or NA | | NA | | |
| Deductions | | Amount | | | |
| | List item description or NA | | NA | | |
| | List item description or NA | | NA | | |
| | List item description or NA | | NA | | |
| | Subtotal | | \$ - | | |
| CBI Value | | | | \$ 257,000 | |
| Adjustments | | Amount | | | |
| | Foreclosure costs @ 2% | | \$ 5,100 | | |
| | Remarketing costs @ 6% | | \$ 15,400 | | |
| Required -- answer "In Appraisal" for each item -- Yes, No, NA | | | | | |
| | Cost to Cure | In Appraisal? | NA | NA | |
| | Cost to Complete | In Appraisal? | NA | NA | |
| | Unpaid / delinquent RE Taxes | In Appraisal? | NA | NA | |
| | Rental deposits & other escrows | In Appraisal? | NA | NA | |
| | Any other adjustments | In Appraisal? | NA | NA | |
| | Subtotal | | \$ 20,500 | | |
| Fair Value | | | | \$ 236,500 | Rounded to nearest \$100 |

Appraisers Set Free

- **Evaluations vs BPOs vs APOs v USPAP**
- **In the public interest?**
 - *protection vs availability; accuracy v risk*
 - *how much value precision is needed for low LTVs deals*
 - *risk spreading – note volume v portfolio \$ exposure*
- **Portfolio monitoring needs**
 - *3x as numerous as new loan volume.*
 - *special assets have special questions and needs*
 - *go beyond generic valuation techniques*
- **Appraisers need a chance to compete here**
 - *Prices not competitive because of USPAP fear*
 - *Need to be given latitude as banking regs permit*
 - *Bring superior expertise to a world dominated by inexperienced agents or automated remote-controlled systems*

Appraisers Need.....



A Chance to Compete