Disclaimer

The views and materials presented in this presentation are solely the opinions and views of the presenters, and do not represent the opinions of the author's employers or the Appraisal Institute. They are not endorsed or approved by the Appraisal Institute as policy unless adopted by the Board of Directors pursuant to the Bylaws of the Appraisal Institute.

While substantial care has been taken to provide accurate and current data and information, the Appraisal Institute does not warrant the accuracy or timeliness of the data and information contained herein. Further, any principles and conclusions presented in this webinar are subject to court decisions and to local, state, and federal laws and regulations and any revisions of such laws and regulations.

This webinar is presented for educational and informational purposes only with the understanding that the Appraisal Institute is not engaged in rendering legal, accounting, or other professional advice or services. Nothing in these materials is to be construed as the offering of such advice or services. If expert advice or services are required, readers are responsible for obtaining such advice or services from appropriate professionals. The materials presented in this seminar are for educational purposes only.
Welcome!  
Bienvenido!  
歡迎！

Bienvenue!  
Willkommen!  
환영!

Speaker Introductions

- Paula Konikoff
- Leslie Sellers
- Doug Potts
Abstract

Financial Institutions have a broad range of valuation needs, especially for portfolio monitoring, loan renewals, and modifications. Demand continues to shift from appraisals toward nontraditional products. Traditional point-value estimates – whether appraisals or evaluations – may not answer the key issues of banks, limiting the usefulness of traditional appraisal and valuation services.

Appraisers must adapt, and intercept banks' evolving needs in order to remain relevant.

The US real estate market is late in cycle, with growing concerns about price pressure in commercial real estate. At the same time, recent guidance released by regulators confirms a potential limitless useful life for appraisals and evaluations already in file. This convergence is likely to increase the demand for validations both near- and long-term. Appraisers are ideally positioned to innovate new valuation stress test products that can answer important needs, especially in a shifting economy.

Participants in this presentation will learn:

- Different regulatory and functional uses for valuations in loan production versus loan renewals and portfolio monitoring.
- Bank expectations for the useful life of appraisals and evaluations, and how validation processes and procedures can impact.
- Best practices for supporting innovative relational values in ways that offer trend insights while also complying with USPAP standards.
- How to marry appraisal review theory with relational value concepts that support validation processes.
Banking & Valuations – a Variety of Needs

- Loan Originations
- Subsequent Transactions
- Loan Monitoring
- Special Asset Management

Job Stratification by Function

- Appr NL: 60%
- Eval NL: 30%
- Valid: 10%

Where is Most of the Workload?
QBP - 2018 FYE

LOAN WORKLOAD v PROFITABILITY

NIM Earnings (M)

# of Notes (M)

Loan Size Bracket

- <$100M
- <$250M
- <$1MM
- > $1MM

82% of workload

6% of risk/profit

Current CRE Threshold

80% of risk/profit

±10% of workload*

*$ DP estimate; not reported

THE NEW FRONTIER - VALIDATION STRESS TESTING
Of Bubbles & Mean Reversions

FRB Z1 Sales Index 1952 - 2017Q2

- 18% peak to peak
- 59% trough to peak
Valuations Chasing Price Bubbles?

FRB Sales Price Index 2007-2017Q2

New Loans & Renewals – all get new valuations

- Loan renew 2016Q1; value @$160/sf; 55% LTV = loan $88/sf
- Loan renew 2013Q1; value @$120/sf; 60% LTV = loan $72/sf
- Loan origin 2010Q1; value @$100/sf; 60% LTV = loan $60/sf
Why It Matters – the Perfect Storm is Coming

- We are late in economic cycle
  - Real estate bubble appears mature?

- Problem loans will fester & grow
  - Decline in bank earnings / stock value

- Regulatory pressure
  - Preserve loan quality
  - Independent & consistent processes

- Business pressure
  - Portfolio loan management – preserve loan incumbency & retain borrowers
  - Extreme time & cost sensitivity in the face of appraiser shortages
Regulatory Expectations

- Appraisal Standards
  - USPAP
  - AI SVP

- Evaluations
  - Interagency Appraisal & Evaluation Guidelines

- Appraisals v Evaluations – what’s the difference?
What is an Evaluation?

“A valuation permitted by the Agencies’ appraisal regulations for transactions that qualify for the appraisal threshold exemption, business loan exemption, or subsequent transaction exemption.”

- SR 1016a1. Interagency Appraisal & Evaluation Guidelines, App. D.

State Law & Rules

- Some States allow evaluations – permits maximum SOW and reporting flexibility
- Some have other exemptions
- Some are very strict on Definitions & USPAP-only standards
Appraisals & Evaluations – Shelf Life

Appraisal Regulations FAQ (10/16/18) – Q 8 – Highlights (w/ highlights)

- “A financial institution may use an existing appraisal or evaluation when market value conclusion with the appraisal or evaluation remains valid.”

- “...there is no provision in the agencies’ appraisal regulations specifying the useful life of an appraisal or evaluation.”

- “appraisal regulations require an evaluation for transactions involving an existing extension of credit ... when either”
  - “There has been no obvious and material change ... that threaten the adequacy of collateral protection ... even with the advancement of new money”
  or
  - “There is no advancement of new money, other than ... to cover reasonable closing costs.”
Subsequent Transactions – the Bottom Line

- For loans secured by real estate – collateral value must be examined
  - New appraisals or evaluations are not automatically required
  - Even older appraisals or evaluations on file can be useful for subsequent transactions
- The concept of “validity” continues to evolve – no extensive guidance .... yet.
- Existing validation guidance is a risk-based & case-specific determination –
  - Whether there is or isn’t a loan advance (beyond closing costs)
  - Whether conditions have changed materially.
    - – does this mean even cannot have improved?
- “Material change that threatens the adequacy of real estate collateral protection.”

What is “threaten adequacy of collateral protection?”
Loan Renewal – No Loan Increase*

  - No
  - Yes
    - Favorable to Value/Marketability? Adverse to Value/Marketability?
      - Favorable
      - Adverse
        - Threatens Collateral LTV Protection?
          - No
          - Yes
            - New Evaluation Required (New Appraisal Optional)

*Beyond closing costs
Loan Renewal – Includes Loan Increase*

- Change in Physical Condition?
  - Market Conditions?
  - Economic Performance?
  - No
  - Yes

- Favorable to Value/Marketability?
  - Adverse to Value/Marketability?
    - Favorable
    - Adverse

- Threatens LTV Protection?
  - No
  - Yes

- NEW DOCUMENTATION NEEDED per Loan Threshold Requirements

*Beyond closing costs
How Can Appraisers Help Identify Change?

- Guidance is evolving away from new appraisals toward change ... that matters.
- Historically, appraisers identified change through a new appraisal or evaluation.
- Instead, the marketplace has aggressively embraced evaluations
  - Both for Loan originations and for Subsequent Transactions

Are current evaluations wise for the financial environment? Especially as market cycles turn?
“Why Use Evaluations to Validate Old Conclusions?”

- Aren’t “evaluations” diluted appraisal processes, at least as offered by most preparers?
- Evaluations don’t efficiently identify the most important aspects of change that matter.
- Very worrisome -- with abundant evidence of a real estate bubble ...
  - should we test adequacy of historic values using “point value” using arguably diluted processes?

Can appraisers provide a better product for loan monitoring?

Better than an evaluation?
Better than an appraisal?
Recalling the 3 Expressions of Valuation

Point Value  Range Value  Relationship Value

Identify Change
Property
Market
Performance

Which way is it going?
Leveraging Relationship -- Identifying Change

- Financial Investor Premise --
  - "Past performance is no guarantee of future results."
    - If later performance falls short, don’t we wish we had paid less?

- The Validation premise –
  - "Were the valuation’s past forecasts validated by subsequent actual performance?"
    - "If actual performance beats an old forecast – is that old valuation still likely ok?"
    - "If actual performance falls short of forecast – how much less should we have paid back then?"
Predicting the Predictor

- Do Validations Predict Value? Or …
  - Predict what an appraiser would likely opine about value?
  - If an appraisal was performed for the collateral?

- But How Can a Validator Predict a Predictor?
  - Relying on a different frame of reference than Point Value.
  - By focusing on stress testing key elements of a prior valuation
A Marriage Made in Heaven?

- Validations are a new twist in the valuation process
- Can we adapt it into a flexible new practice area?
  - Consulting & advising?
  - Evaluations where legal?
  - USPAP compliant structure where preferred/required?

Apply Appraisal & Evaluation Standards Creatively

- Evolving Body of Knowledge = opportunity for innovation & invention
- CAARR methods from AI Review Theory helps identify key issues
- Uses of Standards 3 & 4 continue to evolve – a New Frontier!
Life Boat in the Perfect Storm?

- Using tests to identify change, not value.
- Test a Pass/Fail change from the origination
- If the direction of change is positive...
  - Continue with the documentation and its results
- If the direction of change is adverse ..... 
  - Document a fail and recommend new valuation
  - Document a fail and independently opine a degree of adverse change
  - Document a fail and independently opine a new value
Control the Chase – a One-Way Filter

FRB Sales Price Index 2007-2017 Q2

Origination = appraisal
Renewals = stress validations

Prices inc 60%

Relationship Values

Loan origin 2010 Q1; value @$100/sf; 60% LTV = loan $60/sf

Loan renew 2013 Q1; value tests @$120/sf hold @ $100/sf

Loan renew 2016 Q1; value tests @$160/sf hold @ $100/sf
Control the Chase – Declining Market

FRB Z1 Sales Index 2007-2017Q2

2007Q1 to 2017Q1

-40% to 30%

-40% -30% -20% -10% 0% 10% 20% 30%

2007Q1 2009Q1 2011Q1 2013Q1 2015Q1 2017Q1

FRB Z1 Sales Index 2007-2017Q2

Loan originated 2007 Q4 value @ appraisal 3 yr renewals

Mkt shift during 3rd period to future 2017Q4 renewal shows growth beyond 2010 appraisal file value

File value governs risk @ all renewals unless new appraisal is obtained

Mkt shift covering 2nd 3 yr renewal shows more modest shift

2013Q4 renewal adjusts file value 3yrs recognizing only some mkt recovery

2010Q4 renewal adjusts file value 3yrs recognizing previous mkt declines

File value governs risk @ all renewals unless new appraisal is obtained

Mkt shift covering 2nd 3 yr renewal shows more modest shift

2013Q4 renewal adjusts file value 3yrs recognizing only some mkt recovery

2010Q4 renewal adjusts file value 3yrs recognizing previous mkt declines
Applications of the Body of Knowledge

- Appraisers need to understand where we are in the Chain of Commerce
- Need to answer the question to the Clients’ stated problem
- BOK can help solve client problems
- Use BOK to identify obvious and degree of change (since reference valuation)
  - Market conditions
  - Property conditions
  - Economic performance
Market changes

“To test the reasonableness of small area projections, comparisons should be made between the demographic data and the supply data collected in the specified market. Supply data may include building permits and market sales or absorption rates kept by public agencies such as building inspection, city planning, and public works departments.”

- The Appraisal of Real Estate 14th Ed. (Chicago: Appraisal Institute), 121

- The Appraisal of Real Estate 14th Ed. (Chicago: Appraisal Institute), 135
Market changes

“An appraiser gathers broad information about a market from its pattern of sales. Important market characteristics can be revealed by significant factors such as

- number of sales
- period of time covered by the sales
- availability of property for sale
- rate of absorption
- rate of turnover—i.e., volume of sales and level of activity
- characteristics and motivations of buyers and sellers
- terms and conditions of sale
- use of property before and after its sale”

- The Appraisal of Real Estate 14th Ed. (Chicago: Appraisal Institute), 121
Market Changes

“While analyzing data to establish comparability and select sales, an appraiser begins to form certain conclusions about the general market, the subject property, and the possible relationships between the data and the subject property. The appraiser identifies the following:

▪ market strengths and weaknesses
▪ the probable supply of, demand for, and marketability of properties similar to the property being appraised
▪ the variations and characteristics likely to have the greatest impact
▪ on the value of properties in the market”

- The Appraisal of Real Estate 14th Ed. (Chicago: Appraisal Institute), 123
Market Change – Forces that Influence Value & RE Mkts & Data

- Social Forces
- Economic Forces
- Governmental Forces
- Environmental Forces
  - The Appraisal of Real Estate 14th Ed. (Chicago: Appraisal Institute), 130
Property Changes

- Physical Changes – is there an inspection
- Changes in Highest & Best Use – should it be part of validation process
- Changes in Most Probable Purchaser
- Timing & Timelines
  - Where is it in the development & stabilization time line?
Economic Performance

- Changes in Supply & Demand
- Leases & lease quality
- Expense Change
- Ro Change
- Remaining balances of subsidies
  - Abatements
  - TIFF
  - LIHTC
  - Brownfields
  - HTC
What is this process?

- Are we validating an estimate from the past?
- Is this a value opinion? Or something else?
- Is it a relationship value?
- Or is it a confirmation of adequacy? Adequacy how?
What is a Stress Test?

- Valuation process/practice? -- No
- Test of reasonableness? -- No
- Stress test? -- Yes
  - Reliance on new facts.
  - Simple mathematic operations.
Valuation Process v Stress Tests

Stress tests are techniques – do not produce value opinions

- Historic inputs compared to current data
- No independent opinion of
  - Property characteristics
  - Problem identification
  - Scope of Work
  - Appropriate methods & techniques
  - Determination of what is a comparable
Valuation Process v Stress Test Techniques

Validators are determining

- Changes in physical features & condition
  - SOW – is a site visit involved?
  - Favorable change – new construction & renovation
  - Adverse change – portions sold/released; deterioration/damage

- Changes in economic characteristics
  - Occupancy
  - NOI
  - Market rent
  - Rates of return – Ro & Y

- Other Client-Identified Items
Reporting the Results - Compliance

Depends on the client needs & regulatory requirements?

- Does the client want a statement of threshold pass/fail only?
  - Consultation Memo/Report -- No Value Opinion
  - Does the client want a “new” value opinion?

Appraisal v Appraisal Review

- New opinion of value
  - Appraisal or evaluation
- Update of existing valuation
- Review existing valuation & provide own value opinion
Where Does Stress Testing Fit?

Valuation Services
Don’t Misrepresent

Appraisal Practice
(Acting as an Appraiser)

USPAP Obligations

Appraisal
Appraisal Review
Standards 1-10 Apply
Validations – Bringing It All Together

- Point values are always susceptible to tracking today’s “price” rather than the collateral’s “fundamental value.”
- Relying on historic values for the loan portfolio reduces exposure to “chasing price” and insulating the portfolio from speculative risk.
- Minimizes bubble inflation risk, while approaching a “fundamental” method.
- Can be an excellent source of consultation to bank customers in a mature market.

Unfamiliar techniques – (maybe a little frightening)
  - But all useful things were novel in the beginning

Appraisers are IDEALLY SKILLED to ADD VALUE HERE.
What’s in a Name? Branding Counts!

What’s the right thing to call this?

- Affirmation?
- Confirmation?
- Validation?
- Update?
- Review?
- Review & Affirmation?
- Review & Validation?

“You have a condition whose name is very hard to remember.”
The New Frontier

Thanks for Attending!

Paula Konikoff  JD MAI AI-GRS  Douglas Potts MAI AI-GRS  Leslie Seller MAI SRA AI-GRS