COMMERCIAL REAL ESTATE EVALUATIONS AND VALIDATIONS

In their April 2018 updated guidance the (The agencies) "encourage financial institutions to make use of the following exceptions" related to (the use of) Evaluations and Validations. **

Transactions That Require Evaluations: December 2010 and April 2018 Interagency FDIC appraisal guidelines permit an institution to obtain an appropriate evaluation of real property collateral in lieu of an appraisal for transactions that qualify for certain exemptions. These exemptions include a transaction that:

- Has a transaction value equal to or less than the appraisal threshold of $500,000.**
- Is a business loan with a transaction value equal to or less than the business loan threshold of $1 million, and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.*
- Involves an existing extension of 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.*

Evaluation guidelines require that a minimum of seven factors regarding the property and marketplace are included in an evaluation. ** Some of the factors that seem most problematic for analysts are:

- Identifying the correct square footage of a property (just think how using the incorrect square footage can misrepresent a property's value!).
- Utilizing the proper commercial real estate subscription sites to find, analyze, and adjust good sales comps. (how many times have you experienced "bad comps"?)

Evaluation and validation valuation methodology is based on the property type. To determine the market value of an owner-occupied property, the Evaluator / Validator should ask the question: "if this property were to be sold, who is the most likely buyer?" Typically, the answer would be another owner occupant. Therefore, the Sales Comparison Approach would be utilized to determine the market value.

To determine the market value of a single tenant (with an at market lease) or a multi-tenant, income producing property the Evaluator / Validator should ask the same question as above: "if this property were to be sold, who is the most likely buyer?" Typically, the answer would be an investor seeking an income stream. Therefore, the Income Approach supported by the Sales Approach would be utilized to determine the market value.

(The agencies) also allow institutions to use an existing appraisal or evaluation to support a subsequent transaction in certain circumstances. Therefore, an institution should establish criteria for assessing whether an existing appraisal or evaluation continues to "reflect the market value of the property" (that is, remains valid).

This is when an institution should refer to their existing policy of "shelf-life." Typically, shelf-life is a prior appraisal or evaluation that is three years (or newer). According to validation guidelines, a new appraisal or evaluation is necessary if the originally reported market value has changed due to 10 various "factors" regarding the property and the marketplace.

Unfortunately, here is where the guidelines are unclear, because the only way to know if the market value "has changed" is to value the property using one or both valuation methods above. Common sense would say that a market value, which is the same (or higher) than the previous appraised or evaluated value would mean that a new appraisal or a new evaluation is NOT necessary.

After 10 years of examining these guidelines and completing more than 800 evaluation and validation reports; I remind myself that these are "guidelines", not law, and therefore subject to interpretation. In business terms we might consider these guidelines "best practices" utilized as a roadmap for commercial real estate valuation policy, underwriting, and decision-making - based on overall good risk management.

Following the guidelines - with evaluation and validation tools that apply, common sense, reasonableness, innovativeness, at fair price-points (when engaging a 3rd party vendor) will enable community lenders to know and understand the market value of their borrower's property, while avoiding the "appraisal fatigue" pitfall that oftentimes comes from "doing another appraisal" - especially during these challenging times.

Please stay well and stay prudent.

*Financial Institution Letter FIL-82-2010, 12/2/2010. FDIC 1210 Interagency Guideline

**Financial Institution Letter FIL-14-2018, 4/2/2018. 422018 FDIC Threshold Increase to

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