



Testimony presented on behalf of the

Appraisal Institute

American Society of Appraisers

American Society of Farm Managers and Rural Appraisers

National Association of Independent Fee Appraisers

Before the

House Committee on Financial Services'

Subcommittee on Oversight and Investigations

On

"Commercial Real Estate:

A Chicago Perspective on Current Market Challenges and Possible Responses."

Presented by

Leslie Sellers, MAI, SRA

President

Appraisal Institute

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Chairman Moore and Ranking Member Biggert, and members of the Subcommittee, thank you for the opportunity to share the real estate appraisal profession's concerns regarding challenges and possible responses to today's market. My name is Leslie Sellers, MAI, SRA, and I am the 2010 president of the Appraisal Institute, an international association of real estate appraisers, the largest in the United States, headquartered here in Chicago. I am here today on behalf of the four largest professional organizations of appraisers, including the American Society of Appraisers, the American Society of Farm Managers and Rural Appraisers, and the National Association of Independent Fee Appraisers.

Today's commercial real estate market is facing severe and potentially crippling challenges. Underlying economic conditions are troubling, with high unemployment, minimal job creation and limited investment taking place. Private equity for investment is limited, and equity positions have been severely impaired and in some cases eliminated as a result of overall market declines. Hundreds of bank failures loom, vacancy rates remain high, and many commercial real estate loans are delinquent or facing foreclosure. By some estimates, there is several trillion dollars of commercial paper due to be refinanced in the coming years, with significant concerns relative to the ability to finance these maturing loans. Without debt capital, many of these loans will go into foreclosure, causing further economic hardship.

However, there is some good news. There are initial signs of bottoming in the market. If economic conditions stabilize and begin to improve, investors may return to the table. The concern, however, is that the next few years are vital and that demand for most commercial property uses now is anemic. We are here today to explain how professional real estate appraisers can assist in the economic recovery, and how we can avoid such situations in the future.

In speaking with our members in the Chicago real estate market, the biggest challenge today is the lack of available financing. While there is demand for new loans, a typical commercial real estate loan requires 30 percent equity, is likely a short-term loan and carries very high fees. As a result, financing is scarce. Within the market itself, many subsectors in Chicago have vacancy rates well above historical averages, and with unemployment remaining high, this is unlikely to change in the short term. Chicago, it seems, is like many real estate markets today.

#### Role of CRE Appraisals

As background, commercial real estate carries a great deal of risk, as it represents an illiquid asset and for the most part takes several years to develop a property. These risks can be mitigated by sound due diligence and risk management procedures conducted by financial institutions. Real estate appraisals are a central part of these systems, helping financial institutions make safe and sound loan decisions through fundamental market analysis.

Traditional lending theory centers on the "Three C's" – Credit, Capacity to repay and Collateral. Lender underwriters confirm that the borrower is creditworthy and has the capacity to repay the loan, and then hire professional real estate appraisers to provide professional opinions of value to understand the risk regarding the collateral offered for the mortgage. The same is generally true for the secondary commercial real estate markets, but unfortunately this analysis is all too often conducted in portfolio or in aggregate and not on a property specific basis.

Commercial real estate appraisals also are an important component to loan portfolio monitoring. Like all investments, commercial real estate is subject to market fluctuations. It is critical that financial institutions monitor these fluctuations to guard against risk. Real estate appraisals also are used in asset management, loss mitigation or property disposition, which are common situations in today's market. Here, lenders are facing a potential loss due to delinquency and foreclosure and use appraisal services to test collateral for loan workouts. Upon foreclosure, appraisals also can be used for accounting procedures and to help dispose of assets in an orderly fashion.

### Industry Concerns

We would like to dispel several myths about real estate appraisals that have surfaced in Congressional testimony and in the media.

Myth 1. *Real estate appraisals are backwards looking.*

Some have tried to argue that appraisals only look at recent comparable sales, and because of this, do not reflect the current market. This belief fails to recognize that real estate appraisers typically employ three approaches to value. While the sale comparison approach is important, other approaches may be more applicable, including the income capitalization approach and the cost approach. For income-producing properties, the income capitalization approach is typically the most applicable approach, relying on current market information obtained directly from the marketplace. This approach to value is based on the premise of future benefits accruing to the owner and therefore is better measured of anticipated future benefits. Simply put, the appraisal process requires an appraiser to view the property and the market from three perspectives – a look back to understand trends and behaviors of investors/users, a present view to understand supply and demand and the situation that investors/users face, and a forward view to measure the potential benefits of ownership.

Myth 2. *CRE properties are too hard to value.*

Some have also tried to argue that many properties are simply too hard to value. This leaves a false impression of real estate appraisals. While there are many hard-to-value properties, especially in today's market where few sales may be taking place, it is not an impossible task. Rather, highly trained real estate appraisers employ residual valuation techniques every day that value such properties with a high degree of confidence.

Myth 3. *There are not enough qualified appraisers to handle the distressed CRE workload.*

Members of our respective professional appraisal organizations have met rigorous education, experience, testing and peer review requirements. Our organizations offer training to tens of thousands of appraisers on valuing complex properties such as subdivisions, land and distressed commercial real estate. Combined, our organizations represent more than 35,000 professional appraisers, resulting in an ample supply of valuation expertise in virtually every market in the United States.

## Professional Appraisal Concerns

Our organizations have concerns with regard to current federal regulations, guidelines and practices within the regulatory sphere involving collateral valuation, which include but are not limited to the following:

1. *Securitization processes:* While securitization plays a critical role in providing liquidity to the marketplace, we believe greater due diligence, particularly in the area of collateral analysis, is long overdue. Unfortunately, the structures of the secondary market and the relatively long period of success it had in recent decades lulled many into believing that secondary market risks in commercial real estate were non-existent or unlikely. Here, as with any investment decision, due diligence and risk management – The Three C's – should be areas of primary importance.

In my capacity as president of the Appraisal Institute, I have had opportunity to travel internationally and discuss commercial real estate issues with government officials, investors and borrowers throughout the world. What I have learned from these conversations is that much of the world looks to the United States for guidance in establishing procedures of their own in mortgage lending and real estate finance. For instance, new emerging market economies in Eastern Europe, such as Ukraine, modeled much of their real estate valuation regulatory structure after ours here in the United States. The same is true for many other countries.

What has been striking in some of my recent conversations is the extent of concern that many foreign observers have with how the United States conducts due diligence in both the primary and secondary real estate markets. Many have expressed severe concern with the “wild west” attitude found in many quarters of the real estate industry. As a result, many foreign investors are reconsidering their investments in the United States. The recent action taken by China to divest itself of U.S. paper serves as one example of the importance of this issue.

For us, it seems clear that if we are going to retain and attract new investment, we must earn back the trust of investors worldwide. Put another way: we have an opportunity today to embark on a path that builds confidence in our financing systems, winning back investors and promoting economic growth. We firmly believe that enhanced due diligence that more closely examines collateral valuation is part of that effort to rebuild investor confidence.

While the secondary market may obtain appraisals and environmental site assessments as part of due diligence requirements, we believe that enhancements of these processes are essential. Appraisals should give full consideration to fundamental market considerations. The holy grail of instantly analyzing real estate is simply impossible to attain. Thoughtful underwriting requires adequate time or else “garbage in – garbage out” prevails.

The U.S. financial system has operated under an unlevel playing field – banks are required to comply with the sweeping changes of Title XI of FIRREA, but the securitized industry has not. This resulted in an unfair playing field for many financial institutions, and some may argue a weakening of the appraisal product produced for securitized products.

With participation loan packages, where a large number of properties are marketed to large number of banks, the complexity of the package may be beyond the capacity of the participant to analyze adequately. Our members report that detailed information on appraisals may be limited and the timeframe to make a loan decision may be short, hence comprehensive analysis may not be feasible.

This may result in participation based on reputation of “lead” financial institutions, and that likely does not adequately assess collateral risk.

Another problem is that requests for proposals (RFPs) for appraisal services are often premised on who offers the lowest bid. Emphasizing pricing over competency can result in lower quality appraisal services that do not adequately capture the complexity of the real property assignment. This can be compounded with appraisal reviews that are also based on similar low-bid arrangements.

In the end, we believe there are a number of areas that can be strengthened in collateral valuation in the secondary market. Appropriate guidelines and enforcement of those rules and regulations can enhance the confidence of investors. While lenders prefer portfolio analysis over appraisals of individual collateral property, both are needed; individual valuations provide a check on, and help build and strengthen, overall portfolio analysis.

2. *Inconsistent and inadequate regulatory agency oversight and enforcement:* We believe oversight of the real property collateral by the federal banking agencies is inadequate. Currently the federal agencies do not have sufficient qualified real property analysts to properly monitor and adequately enforce existing regulatory policies. Auditing teams typically do not contain licensed or certified real estate appraisers, yet having trained professionals would be a best practice in adequately assessing real estate collateral policies.

A recent review conducted by the Appraisal Institute indicates that two-thirds of failed banks from 2009 were previously cited for appraisal administration problems by federal bank regulators and that many of these issues remained unresolved at the time of the bank failure<sup>1</sup>. In other words, many financial institutions are not conducting sound collateral risk management, and while regulators are often citing the institutions, little action has actually occurred to resolve the issues found in the citation. This was illustrated very well by a recent Material Loss Report of IndyMac Bank, where that institution had been cited for appraisal administration shortcomings numerous times over a seven-year period leading up to the bank failure.

The concerns identified in the Material Loss Reports are consistent with concerns expressed by our members, who have reported a clear lack of consistency among bank examiners on real estate appraisal issues. This highlights a significant challenge – building appraisal capacity within the financial institutions themselves and within the federal bank regulatory agencies and the bank examiner community.

3. *Vague and confusing guidelines:* The bank regulators often have been cited for issuing guidelines that are not generally understood by financial institutions and the real estate community at large. This problem is extremely acute with regard to commercial real estate and real estate valuation issues, where there remain many questions unresolved from guidelines issued in the early 1990s. For example, when the Interagency Appraisal and Evaluation Guidelines were issued in 1994, they explained when appraisals are required in federally related transactions. They also permitted extensive exemptions from professional appraisal requirements. One exemption allows for an “evaluation” rather than an appraisal in loan renewal, refinancing and workout situations under certain conditions, including where no new monies are advanced and when there are “no material changes in market conditions.” The understanding of many appraisers and financial institutions is that where

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<sup>1</sup> Available at <http://www.appraisalinstitute.org/ano/archive.aspx?volume=11&numbr=3/4#9472>

material changes in market conditions have occurred a new appraisal is required in a loan renewal or workout situation. However, that term has not been defined within the guidelines themselves leading to varying degrees of debate over what constitutes a material change. Further, the responsibility for determining when a material change has occurred is not addressed at all.

Another example: the recent guidance issued on Prudent Commercial Real Estate Loan Workouts has not been understood by many financial institutions and industry participants. We have heard reports from our members that the guidelines are well-intended but not adequately descriptive, and as a result were not generally understood. Further, the new guidelines reference accounting standards that have been recently updated and changed, which themselves take time to study, understand and implement. Moving forward, we believe all facets of the commercial real estate industry must be involved in the development and implementation of clear guidelines that are essential to prudent decision making.

4. *Loan Production Objectives Over Risk Management:* Appraisal organizations have had a long-standing concern with how loan funding decisions are made within many financial institutions, in particular the propensity to place the interests of loan production ahead of appropriate due diligence and risk management. There are myriad reasons for this concern, but the most common is that many parties within an institution are incentivized to make almost any deals. Loan officers may be paid on commission. A key underlying fact is that financial institutions cannot make money unless they are making loans. Federal regulatory agencies and financial institution reserves are funded out of bank assessments. Some therefore argue that even bank regulators themselves have an interest in loan production.

Regardless of the potential incentives or conflicts of interest, we believe more emphasis must be placed on making safe and sound loans, rather than making lending decisions focused on achieving volume alone. As loan officers are incented to close loans because financial institution profits are indirectly generated by loan production, the temptation to make loans of marginal or dubious quality is great. Further, many loan committees are presented with very limited information about the underlying collateral and the appraisal report. In many cases, according to our members, the committee will be advised whether the appraisal was prepared in accordance with uniform appraisal standards, in addition to the loan-to-value information. In other words, the only information the committee has is the number provided on the front page of the appraisal report. Within the appraisal report, the appraiser could have advised that the property was in a highly volatile market, or it could have indicated a possible range of values. By not relying on the collateral as an essential form of security for loan repayment, many loan committees too often make their loan decisions today by looking at the revenue of the property and the creditworthiness of the commercial loan applicant, with not nearly enough attention to the underlying collateral.

We share similar concerns in the area of loan monitoring, which in many institutions is conducted by loan officers with limited training and expertise on valuation issues. Current regulatory bulletins advise loan officers to review loan performance on a regular basis, but this is typically done by simply reviewing cash flow and property information and often does not involve the appraisal department or those with professional valuation experience and training. Generally speaking, our members report that loan officer knowledge and expertise of real estate valuation issues is limited, as many loan officers specialize only in closing deals and making loans. However, if the security of the loan is based exclusively or mainly on credit and the borrower defaults, the institution only has the underlying

real estate, to make it whole. Here again, due diligence must be emphasized and play a more integral role.

5. *Disincentives for obtaining a credible appraisal:* There exist many disincentives to obtaining credible appraisals in loan origination, loan monitoring and property disposition. As previously discussed, loan production forces often outweigh risk management, and place a great deal of pressure to close the deal. However, such disincentives exist in loan monitoring as well. A current example of this: a bank president was found guilty of bank fraud for concealing the existence of several appraisals recently conducted by the bank in advance of an examination<sup>2</sup>. The appraisals did not report a pretty picture – significant declines in market value of the underlying assets held as security for several commercial real estate loans. The bank president apparently advised staff to make sure that the appraisals “did not see the light of day.”

According to press accounts, when examiners arrived, they conducted a thorough review and were about to give the bank a clean bill of health, when a staff person, or whistleblower, advised that the president had not been truthful with the examiners. Examiners were directed to look underneath a desk and in a box where they would find updated appraisals that had been concealed for the examination.

Of course, the effort undertaken by that bank president is extreme, but it does illustrate a common concern in many institutions today. Banks do not want to obtain updated appraisals because they may result in their having to increase their capital reserves. Many borrowers do not want updated appraisals because they may result in an “equity call.” These concerns can be compounded by the examination process itself, which can operate on a “don’t ask – don’t tell” arrangement. Our members report that access to the audit team is often restricted by senior bank management and is diligently monitored and scrutinized. Examinations can also be restricted by the size of the audit team as well as the time allocated to the audit. Further, during the examination, auditors typically only review a sampling of files in an effort to look for discrepancies. This can be tantamount to finding a needle in a haystack. We are not promoting write downs and equity calls. We believe that having adequate, timely information provides the opportunity for better solutions.

In our view, the function of the real estate appraisal is to provide parties with credible, timely and, most importantly, independent information to help with business decisions and to protect the public trust. However, the appraiser’s role must be protected, respected, and enhanced for it to be successful, as the various interests that exist can often overwhelm our role.

6. *Appraisal Competency:* Federal guidelines presently require residential loans higher than \$250,000 and commercial loans over \$ 1 million, are required to have a licensed or certified real estate appraiser (with complex commercial properties and those over \$1 million requiring a certified general appraiser). The licensing regulations were enacted to establish the “minimum” level for competency, and do not outline a hierarchy for experience and competency requirements for increased complexity of the real estate collateral.

Further, the federal agency guidelines do not require financial institutions to maintain an internal appraisal department to order or review the valuation of the collateral. Additionally, if an internal appraisal staff is maintained, reporting is often to loan production via the chief credit risk officer.

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<sup>2</sup> Available at [http://blog.oregonlive.com/frontporch/2010/02/former\\_bank\\_of\\_clark\\_county\\_ex.html](http://blog.oregonlive.com/frontporch/2010/02/former_bank_of_clark_county_ex.html)

While this is not commonplace in some of the larger lending institutions, it is known to occur in regional and smaller banking environments, where insufficient safeguards to protect appraiser independence may not been clearly instituted. The commercial loan officer whose client is the loan applicant is typically the only representative present at the decision-making committee. The minimum requirement for the real property securitization is an acceptable appraisal and appraisal review. A synopsis of the report utilized to underwrite the collateral as well as any comments in the appraisal review may not be included in the presentation, hence a comprehensive overview of the risk associated with the collateral may not be included in the decision making process. Again, financial institution profits are based on approving loans; therefore internal pressure to approve substandard appraisals as well as approve the overall loan is significant.

### Recommendations

We propose several recommendations to this Committee to address the concerns expressed above. For ease of understanding, we have divided these into two categories – 1) those to restore confidence in today's real estate market and 2) legislative suggestions.

#### *Restoring Confidence in the Market*

1. *Conduct Multi-Value Appraisals for Troubled CRE Assets:* Three value estimates (fair value, market value and liquidation value) are suggested to be made on all non-performing loans or problem potential loans to identify/quantify the entire spectrum of financial risk. Clear guidance on these value definitions is imperative for consistent applications.
2. *Implement Consistent and Robust CRE Monitoring Procedures:* Recently, the CFA Institute, an association of chief financial officers, adopted an updated version of the Global Investment Performance Standards, which are recognized globally for investment management, including commercial real estate investment<sup>3</sup>. GIPS 2010 recommends an increase in the frequency of external valuations conducted by qualified real estate appraisers from once every three years to annually. We believe such policies are sound and have applicability in other forms of commercial real estate lending, including that overseen by the federal bank regulators. Further, we are confident that we can develop scopes of work that will allow periodic valuations to be delivered in a timely and cost efficient manner.
3. *Strengthen Interagency Appraisal and Evaluation Guidelines:* The federal bank regulatory agencies have released proposed Interagency Appraisal and Evaluation Guidelines that are expected to be finalized this year. The agencies should revise the proposed guidelines, strengthening the importance of professional appraisals and appraiser competency (as opposed to reliance on highly unreliable valuation products), and providing specific definition to key terms such as “complex” appraisals and “material change in market conditions.” Further, the Guidelines should reinforce a recent Federal Reserve Board staff interpretation clarifying that commercial broker price opinions do not satisfy the definition of an “evaluation,” meaning more sophisticated valuation skills and due diligence are required than simply utilizing a commercial BPO where an evaluation is allowed.
4. *Promote Appraisal Independence:* Require an internal collateral risk assessment/real estate appraisal department reporting directly to compliance (to maintain independence) staffed with qualified real

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<sup>3</sup> Available at [http://www.gipsstandards.org/standards/current/2010\\_edition\\_gips.html](http://www.gipsstandards.org/standards/current/2010_edition_gips.html)

estate appraisers who have obtained the appropriate experience and competency to review appraisals for compliancy. Further, appraisal reviews on the collateral should be reported independently by the appraisal department directly to the commercial loan committee.

5. *Increase Appraisal Capacity:* Increase staffing within the federal agencies to include individuals with the appropriate qualifications, experience, and competency (i.e., real property analysts or real estate appraisers) to perform an adequate analysis of the appraisal policies and procedures as well as the collateral within the loan portfolio. Additionally, we repeat our recommendation, made previously, that each federal banking agency establish the office of Chief Appraiser, who would report only to the most senior management of the banking agencies

### Legislative Suggestions

1. *Enact the appraisal reform provisions found in H.R. 4173:* This legislation enhances appraiser oversight and enforcement and clarifies certain provisions applicable to commercial real estate.
2. *Support Financing to Small Business:* Specifically, support the Administration's request for an expanded SBA authorization for small business commercial real estate and working capital programs.<sup>4</sup> The plan proposes legislation to temporarily allow small businesses to refinance existing, qualified, owner-occupied small business commercial mortgages into SBA's 504 program, which provides guarantees supporting loans for the development of real estate and other fixed assets. Currently, 504 loans must be used for new development or construction — and can only include a limited amount of refinancing when businesses are expanding. The program promotes sound underwriting, including current market value real estate appraisals.
3. *Oppose increasing the appraisal threshold for Small Business Administration commercial real estate loans.* H.R. 3854, the Small Business Financing and Investment Act of 2009, introduced by Rep. Kurt Schrader (D-Ore.), passed the House of Representatives on October 29, 2009, and is currently pending in the Senate. Among other things, the bill raises the threshold for appraisals for commercial real estate backed by the Small Business Administration (SBA) loans from \$250,000 to \$400,000. In the last two years, the number of SBA loans that are more than 60 days past due, delinquent, or in liquidation has nearly doubled from 10 percent to 18 percent. Startlingly, more than 12 percent of SBA loans today stand in liquidation, *up from 6 percent in 2007. It is surprising that in today's financial climate, where bankruptcies are facing some of the biggest SBA lenders in the country, Congress would even consider loosening basic risk management and underwriting requirements.*

### Closing Remarks

Our organizations stand committed to working with Congress, federal agencies, and our real estate industry groups and clients to address problems and concerns in the commercial real estate market. Our profession represents a relatively small component in commercial real estate finance, but it is one that

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<sup>4</sup> Available at

[http://www.sba.gov/idc/groups/public/documents/sba\\_homepage/sba\\_rcvry\\_factsheet\\_cre\\_refi.pdf](http://www.sba.gov/idc/groups/public/documents/sba_homepage/sba_rcvry_factsheet_cre_refi.pdf)

carries a great deal of importance. We look forward to working with the Committee and others moving forward.

Thank you for the opportunity to appear before you today, and I am happy to answer any questions you may have.