

NEW INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES *Brief Review and SmallBalance.com Product Compliance*

INTRODUCTION

The Interagency Appraisal and Evaluation Guidelines issued by the federal banking agencies in late 2010 focused considerable attention on evaluation development, evaluation content and automated valuation models (AVMs), among other areas of concern.

Boxwood Means, Inc. is committed to delivering commercial evaluation report products on our SmallBalance.com web site that comply with the revised guidelines.

To that end, Boxwood has completed development of the *Property-Conditioned* Mercury PRO and a *Property-Conditioned* VALPRO reports that build on the foundation of the respective Mercury PRO and VALPRO reports. These additional SmallBalance.com reports now incorporate a field inspection of the subject property and, at the client's option, will either automatically modify or 'condition' the market value estimate if warranted, or leave the estimate unimpaired. Additional details about our products are described below, after a brief discussion of pertinent Guideline provisions as well as our own primary conclusions.

RELEVANT GUIDELINE PROVISIONS

As background, the five federal banking agencies issued their revision to the Guidelines in December, 2010. These guidelines apply to all real estate-related financial transactions originated or acquired by a regulated institution for its own portfolio or as assets held for sale. The document is in addition to the Federal Reserve Board's interim final rule on appraisal independence. Moreover, the Guidelines may be affected in the future via implementation of appraisal and valuation provisions of the Dodd-Frank Act.

The revised guidelines offer substantial direction on evaluation content, AVM use and valuation updates among other considerations. We excerpt below several important provisions of the Guidelines including portions of Appendix B (Evaluations Based on Analytical Methods or Technological Tools) that have a direct bearing on the applicability of Boxwood's report products. They are:

"The Agencies' appraisal regulations permit an institution to use an evaluation in lieu of an appraisal for certain transactions. An institution may use a variety of analytical methods and technological tools for developing an evaluation, provided the institution can demonstrate that the valuation method is consistent with safe and sound banking practices and these Guidelines."

“Institutions may employ AVMs for a variety of uses such as loan underwriting and portfolio monitoring. An institution may not rely solely on the results of an AVM to develop an evaluation unless the resulting evaluation is consistent with safe and sound banking practices and these Guidelines. For example, to be consistent with the standards for an evaluation, the results of an AVM would need to address a property’s actual physical condition, and therefore, could not be based on an unsupported assumption, such as a property is in “average” condition.”

“An evaluation should contain sufficient information detailing the analysis, assumptions, and conclusions to support the credit decision. An evaluation’s content should be documented in the credit file or reproducible.

“Consistent with the Agencies’ real estate lending regulations and guidelines, an institution should monitor collateral risk on a portfolio and on an individual credit basis. Therefore, an institution should have policies and procedures that address the need for obtaining current collateral valuation information to understand its collateral position over the life of a credit and effectively manage the risk in its real estate credit portfolios.”

“An institution should establish standards and procedures for independent and ongoing monitoring and model validation, including the testing of multiple AVMs, to ensure that results are credible...Validation can be performed internally or with the assistance of a third party, as long as the validation is conducted by qualified individuals that are independent of the model development or sales functions.”

KEY TAKEAWAYS

Our conclusions about these provisions and the Guidelines in general, which find support from federal regulators, include the following:

- 1. An AVM alone does not qualify as an evaluation. An AVM may qualify if it addresses or incorporates physical property condition and is further supported by safe and sound bank processes and the Guidelines.**
- 2. An evaluation based on an AVM that is supported by supplemental property-specific data, market data and the physical inspection unmistakably satisfies the Guidelines.**
- 3. Without the inspection, an AVM can be employed for certain non-transactional purposes such as portfolio monitoring, loan modification and reviews; as well as subsequent transactions that do not involve extension of new funds.**
- 4. With respect to monitoring the impact of collateral valuation trends on portfolio risk, banks may use various sources including but not limited to external market data and reviews of recent appraisals and evaluations.**

SMALLBALANCE.COM PRODUCT COMPLIANCE

Boxwood Means, Inc. has extended its product line to satisfy the revised guidelines pertaining to commercial evaluations.

The **Property-Conditioned Mercury PRO** represents our top-of-the-line report product and fully meets the evaluation requirements with the following content:

- Market value estimate and confidence score derived from our proprietary AVM system.
- Exterior property inspection or, alternatively, a combined exterior and interior inspection.

The inspection report includes details on the following sections: Site Description; Improvement Description; Interior Description (optional); Building Construction Type; Exterior Condition; Environment, Health or Safety Issues; Subject Leasing/For-Sale Activity; General Location and Neighborhood Information; plus a building sketch and a full series of photos.

In addition, we have independently integrated regional construction cost estimates, updated annually, into an algorithm that downwardly adjusts the AVM value based on the degree to which property condition is rated below “average” by the inspector. Below-average ratings are on a scale of 1-3 that correlate with increasing repair or cure costs. For resulting property conditions rated less than average, the conditioned Mercury PRO can be obtained either with the impaired market value or without.

- Selected public record and tax assessment data on the subject property.
- Neighborhood and market information correlated with subject property.

This information includes neighborhood rents and lease listings, rent trends, business vacancy trends, leasing days on market, closed property sales listings and listings of for-sale properties, and sales price trends.

- Subject property street maps and aerial-birds eye images.

The Property-Conditioned Mercury PRO is suggested for all possible uses of commercial evaluations including approved types/sizes of new loan transactions, loan refinances, loan reviews, subsequent transactions and portfolio monitoring.

The turnaround time for the Property-Conditioned Mercury PRO report with an exterior inspection is five days from the order date on SmallBalance.com. The turn time for the same report with combined exterior and interior inspections is 10 days.

The **Property-Conditioned VALPRO** report incorporates the following:

- Market value estimate and confidence score derived from our proprietary AVM system.
- Exterior property inspection or, alternatively, a combined exterior and interior inspection.
- Selected public record and tax assessment data on the subject property.
- Subject property street maps.

This conditioned VALPRO report can likewise be obtained with or without the automatic value impairment in cases of a below-average rating. Turn times for these reports are the same five and 10 days for exterior and combined exterior-interior inspections, respectively.

Use of the conditioned VALPRO report is suggested for loan reviews, subsequent transactions and portfolio monitoring. In addition, this report can be used in conjunction with other supporting material in order to comport with a commercial evaluation.

These two AVM-based report products are supported by an in-depth, annual **validation study** conducted by independent academicians and are available at no charge to SmallBalance.com subscribers. In addition to this third-party validation, Boxwood conducts its own validation studies on a quarterly basis and also disseminates them to clients.

ABOUT SMALLBALANCE.COM

SmallBalance.com is the subscription web site owned and operated by Boxwood Means, Inc. Founded in 2003, Boxwood is a leading provider of data, analytics and valuation models for participants in the small commercial property and loan markets.

Leading commercial lenders including 10 of the top 20 commercial bank holders of commercial real estate mortgages rely on SmallBalance.com for collateral valuation, loan origination and loan underwriting, loan review, market surveillance and portfolio risk monitoring.

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Boxwood Means, Inc.
Two Stamford Landing, Suite 100
68 Southfield Ave.
Stamford, CT 06902

T 203-653-4100
E info@boxwoodmeans.com

Websites:
BoxwoodMeans.com
SmallBalance.com