December, 2017

# Strong Support, Modest Regulatory Relief

## Client Survey on the Outlook for the Proposed Appraisal Exemption Increase

## 1. Introduction

**A Overview** This past summer the federal agencies collectively released their *Notice of Proposed Rulemaking and Request for Comment* report which, in pursuit of regulatory relief for commercial banks, recommended that the appraisal exemption be raised for the first time in over 20 years from $250,000 to $400,000. The anticipated regulatory relief is expected to be achieved through cost savings associated with the authorized and increased use of less costly and time-consuming commercial evaluations. This recommended, heavier reliance on commercial evaluations has sparked much debate within the commercial real estate/appraisal industry as the agencies continue their deliberations on the new rule to this day.

The fulcrum of this initiative is the small balance commercial lending space that generated massive loan volume exceeding $200 billion last year involving commercial and multifamily mortgages under $5 million in value. As a leading participant in this specific market as both a national research and commercial evaluation services provider, Boxwood is particularly interested in the reactions to and outlook for the proposed rule among banking officers charged with abiding by it.

To gather insights and also offer them back to the community at large, we devised a short online survey of commercial evaluation clients which we administered during November. This report describes the survey and its findings preceded by some additional background on both the small balance lending space and the appraisal exemption rule. Our conclusions are contained in the final section.

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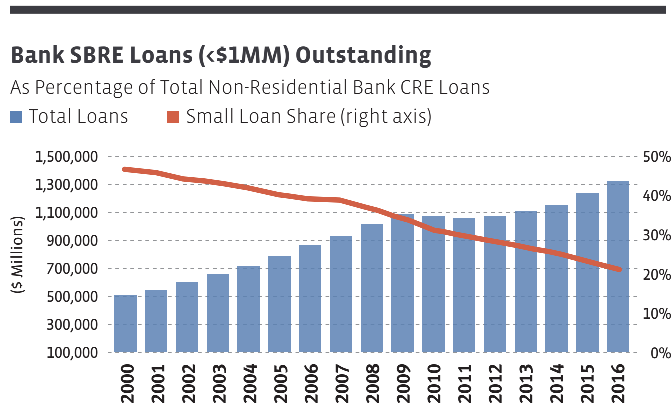
**B Bank Lending Challenges in the Small Balance Domain** Commercial banks face a number of challenges to successful small balance commercial real estate (CRE) lending. Perhaps first and foremost, financial institutions are increasingly vulnerable to non-bank entities such as CRE marketplace lenders, crowdsourcing funders and ubiquitous private lenders over the small balance loan (SBL) territory of loans under $5 million in value. Historically in this fragmented market, Boxwood's research indicates that the top 15 commercial banks have commanded roughly 20% of national SBL volume that in 2016 totaled more than $200 billion. Despite their higher origination fees, non-banks are gradually nibbling away at that market share with superior closing speed aided by technological innovation. Another turf grab by non-banks comes as depositories have grown progressively reluctant to fund riskier construction, development and other transitional loans because of their higher capital requirements.

Aside from market competition, commercial banks face an internal, operational challenge in maintaining efficient and profitable SBL production processes. Too frequently, a bank's effort spent on originating, underwriting and reviewing loans for small assets as diverse as an industrial condo unit, 10-unit apartment building or strip center can rival the resources leveled at a larger CRE credit facility valued at $10 million or more. Internal workflow processes can be overly complex and antiquated, producing friction that prolongs the time to close loans. Moreover, third-party fees such as appraisal, environmental and legal are often disproportionally large in comparison with the loan fees generated by a small property loan. These conditions hamper the profitability of small balance CRE lending for commercial banks.

These combined pressures explain at least in part, and offer striking illustration of the relentless decline in bank CRE lending in one corner of the SBL world, i.e., small business real estate loans.[1] As the nearby graph shows, the proportion of these small loans under $1 million in value held in bank portfolios has plummeted over the years by more than one-half, from 46.5% of the total dollar value of non-residential CRE loans in 2000 to 21.0% in 2016 according to FDIC data. This trend has unfolded even as the total value of non-residential CRE loans held by banks substantially increased.[2]

**Bank SBRE Loans (<$1MM) Outstanding**

As Percentage of Total Non-Residential Bank CRE Loans




Source: Boxwood Means, LLC

It's doubtful that commercial banks voluntarily walked away from this small business real estate lending business.[3] It's more likely that competitive flaws have eroded the volume over time. As a result, these and other market forces jeopardize the dominion over small balance lending that commercial banks have historically held. Thus it behooves financial institutions to seize reasonable opportunities that can sharpen their effectiveness, reduce operating costs and stabilize market share.

[1] These loans are technically real estate-secured business loans. The current exemption level for such transactions is $1 million.

[2] The "denominator effect" is not at play here. That is, the absolute *number* as well as percentage of small business real estate loans dropped dramatically over time. Since 2000, the total number of these portfolio loans declined by 17.0%. But the total number of these small loans dropped even more precipitously over the last decade, i.e., by 39.1% compared with the average number of outstanding loans during the previous peak period between 2006-2008. As a point of contrast, banks' aggregate number of commercial and industrial (C&I) loans under $1 million in value *increased* by 12.4% over the same time frame.

[3] At a total of $283 billion as of December, 2016, small business real estate loans under $1 million represent a sizable portion of the aggregate CRE balance sheet for commercial banks.

**C** **Appraisal Exemption Proposal** The federal oversight agencies proposed a regulatory change involving appraisals earlier this year that clears a pathway for commercial banks to boost their competitiveness in CRE lending generally and the SBL space in particular. The agencies' *Notice of Proposed Rulemaking and Request for Comment* (July, 2017) amends the Title XI[4] appraisal regulations reducing the requirement for appraisals on certain federally-related, commercial real estate transactions. Specifically, the proposal would increase the threshold level from $250,000 to $400,000 and, in so doing, allow financial institutions to obtain a commercial evaluation in lieu of an appraisal consistent with safe and sound banking practices.[5]

This proposal originated with the agencies' completion of the once-per-decade review of their own regulations pursuant to the Economic Growth and Regulatory Paperwork Reduction Act. Based on their supervisory experience, data and industry comment, the agencies developed a series of proposed initiatives that included a change to the appraisal threshold that has been fixed at $250,000 for over 20 years. The agencies' intent with the threshold change is to reduce the regulatory burden of financial institutions without imposing risks to the safety and soundness of the banks. This regulatory relief is expected to be realized principally in the form of time and cost savings, estimated by the agencies as potentially substantial for commercial banks. The action is also intended to mitigate partially the declining numbers of state certified and licensed appraisers primarily in rural areas.[6]

## 2. Survey

Boxwood is a leading national provider of commercial evaluations to financial institutions and, like other participants in this industry segment, has a keen interest in helping our bank clients realize the potential benefits of the threshold change.

Since Boxwood also has a specialization in research covering the small commercial property and loan space, we were motivated, too, by the opportunity to offer the general banking community some helpful, ground-level insights from industry peers on their outlook for the agencies' proposal.

In a brief online survey conducted during November involving roughly 100 banking officers in senior appraisal and credit administration roles, we received a 35% response rate from clients ranging from small community and regional banks to large national institutions.

[4] Title XI defined appraisal regulations in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.

[5] The monetary threshold specifically applies to the transaction value of new loans and extensions of credit. Transactions that involve an existing extension of credit such as a loan renewal are exempt from the Title XI appraisal requirements. Such non-financial transactions allow for commercial evaluations subject to some limiting conditions. For information on commercial evaluations, appraisal exemptions and related recommendations, see the agencies' *Interagency Appraisal and Evaluation Guidelines* (IAEG; November, 2010).

[6] The Appraisal Institute (AI) recently indicated that the number of licensed appraisers declined by 23% since 2007 at roughly a 3% annual clip, a rate that the AI suggests may increase over the next 5-10 years. The AI claims that the shortages primarily involve residential appraisers. Per the IAEG, commercial evaluations can be performed by either a bank employee or third party as long as s/he is competent and has relevant experience and knowledge about the market, location and property type.

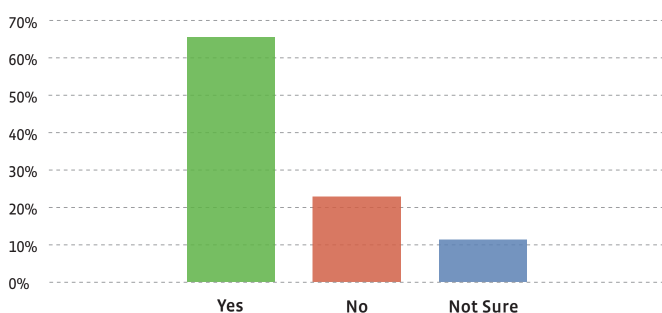
## 3. Survey Results

The agencies' intent with the proposed rule is to produce regulatory relief for financial institutions. Most of the survey participants believe this goal is achievable. The top-line survey findings are presented with illustrations below and are supplemented by some cross-tabulated results.

### ▸ Nearly two-thirds of bank officials support the new rulemaking.

A sizable majority (65.7%) backed the higher appraisal exemption while another 22.9% did not, and 11.4% were unsure.

**Supportive of the New Appraisal Exemption Amount?**

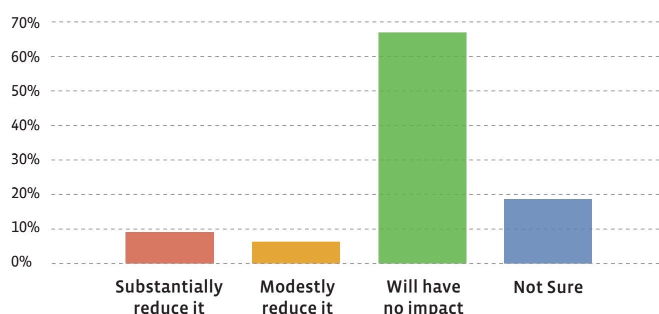



Source: Boxwood Means, LLC

Supporters of the new rule were much more likely to expect benefits and an upside than the minority who were opposed. In fact, nine of 10 advocates believe that some combination of borrower costs savings and an upturn in their SBL volume will transpire.[7]

Also noteworthy, bankers' tallies for and against the proposed rule were apparently not influenced by their opinions about the new threshold's potential impact on the reliability of commercial evaluations. Overall, two-thirds of all respondents (66.7%) indicated the proposed rule would have no bearing on reliability, with very narrow minorities suggesting dependability would be substantially reduced (9.1%) or modestly reduced (6.1%). A larger subset (18.2%) was undecided.

**Impact of Proposed Rule on Commercial Evaluation Reliability**




Source: Boxwood Means, LLC

In fact, a big majority (72.7%) of the supporters for the proposed rule claimed their increased reliance on commercial evaluations would not affect report reliability. This position contrasts with the small minority that opposed the increase, and who were evenly split between those that believed the new rule would substantially reduce report reliability and others that suggested it would have no impact at all.

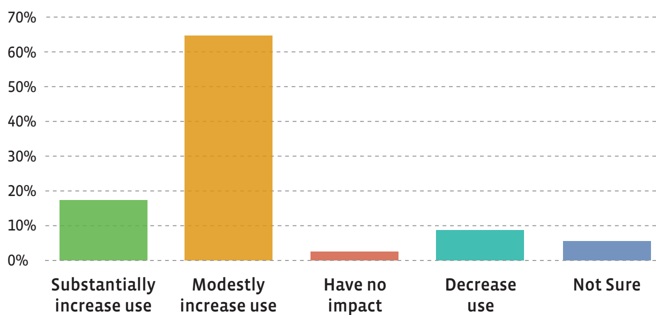
In any event, the essential finding that bankers are largely confident in commercial evaluations may serve as tonic for concerns and apprehension expressed in some quarters of the industry.

[7] Though not polled directly on this aspect, the declining relevance of a 20+ year-old threshold amount may have been influential for supporters, too. In its rationale for a higher level, the agencies' *Notice of Proposed Rulemaking* presented two analyses that arrived at similar results. One method simply adjusted the $250,000 value of a typical asset in 1994 for inflation and derived a valuation result ranging between $374,000 and $401,000 based on conventional inflation measures. The other approach imputed a new threshold amount from historical CRE price trends.Employing CoStar's sales price index, the agencies indicated that a commercial property that sold for $250,000 in 1994 would be valued at $423,000 at the cycle's March, 2010 nadir and, thereafter, would recover during the market's expansion to $830,000 by December, 2016. The agencies concluded that a revised threshold near the cycle's bottom would represent a conservative and reasonable amount, and this concluded $400,000 value also corresponded with the inflation-adjusted figures. Separately, state banking organizations and leading national banking organizations including but not limited to the American Bankers Association and the Independent Community Bankers Association may also have been influential with their backing of the proposed rule.

## ▸ An overwhelming percentage will increase use of commercial evaluations.

Despite the slim minority that voiced concern over the dependability of evaluation reports at the higher threshold, in the main respondents welcome the prospective pick-up in commercial evaluation use. A considerable 82.4% indicated they will procure more evaluation reports, including 17.7% and 64.7% that will substantially increase or modestly increase their use, respectively. The remainder (17.6%) indicated they were not sure, or either: (a) the new rule will have no impact on current use; or (b) will prompt less use.

**Impact of the Proposed Rule on Commercial Evaluation Use**




Source: Boxwood Means, LLC

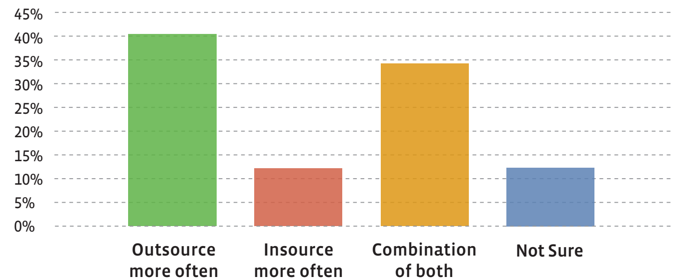
In particular, bank officers that support the new rule are more heavily committed to expanding commercial evaluations. Nine out of 10 advocates will either substantially (22.7%) or modestly (68.2%) increase their use. But in a loose example of the "if you can't beat them, join them" maxim, even the minority of bankers that oppose the initiative are more likely than not to expand usage of commercial evaluations.

## ▸ More of the extra commercial evaluation workload will be channeled to vendors than to internal staff.

Bankers will take slightly divergent paths to manage their expected, new commercial evaluation growth. A plurality (40.0%) of bank officials will obtain their extra evaluation reports from outside suppliers.

A comparable percentage of respondents (36.7%) intends to split the added work between vendors and in-house staff. Importantly, allocating the new valuation work exclusively to internal staff is not shaping up to be a preferred or viable option as only a slim minority (10.0%) indicated they would handle it by themselves.

**Impact of the Proposed Rule on Commercial Evaluation Procurement**




Source: Boxwood Means, LLC

The predisposition to outsource all or some of the added work likely reflects the sober reality that many commercial banks are cutting overhead costs, and not adding new staff or filling open slots at this late stage of the credit cycle. As added incentive to outsourcing, Boxwood's previous market research indicates that bank officers are generally very satisfied with the service quality and fees from their evaluation vendors. Supporters of the threshold change thus lean heavily (76.2%) towards outsourcing the added workload entirely or a share of it. Even the majority (50.0%) of opponents of the new rule picked outsourcing over the other options.

## ▸ Many banking officers are comfortable using commercial evaluations on bigger loan renewals.

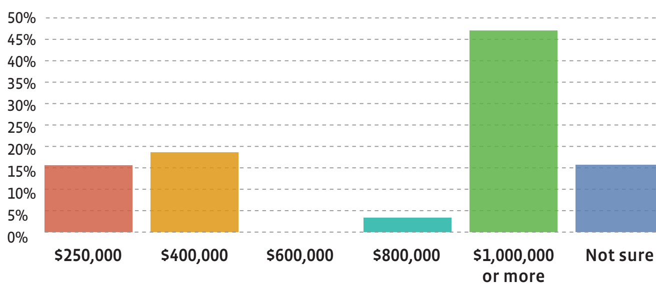
Whereas the present exemption level for originations involving extensions of credit is clear and unambiguous, bankers are left to their own devices (and policies) when interpreting the rule on where to draw the line with commercial evaluations on non-financial transactions such as loan renewals. Of course, regulatory guidance in this area is challenged by an expansive set of risk

factors including multiple CRE property types, variable loan terms, as well as widely different geographical markets, bank sizes and CRE loan concentrations, among other considerations. The Interagency Guidelines thus limit regulation to a series of prudent suggestions and conditions under which to employ commercial evaluations.

As a result, current bank policies are diverse, as are judgments on the appropriate dollar ceiling for employing commercial evaluations on loan renewal transactions.

This diversity of opinion was manifest when bank officers were asked to peg the loan amount with which they were comfortable using an evaluation for a renewal or extension on a typical property with relatively low credit risk. A plurality of bank officers (45.2%) expressed that they will use commercial evaluations on renewals at the top end of the range, i.e., involving loans of $1 million or more.

**Comfort Level for Using Commercial Evaluations on Renewal Loan Transactions**



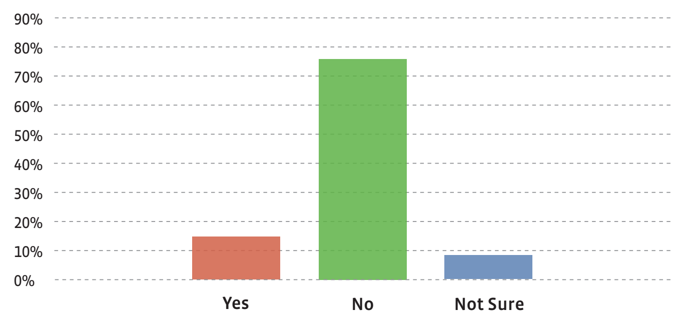

Source: Boxwood Means, LLC

The preference of this particular group to the highest dollar range could well originate with: (a) their embrace of the threshold increase (85.7%); and (b) their confidence that the new rule will not adversely impact the reliability of evaluation reports (73.3%).

The views about the dollar ceiling from a second (combined) group of respondents (35.5%) were far more conservative, and indicated they will restrict evaluations either at the existing exemption level ($250,000) or the proposed, higher amount ($400,000). Perhaps these bankers earmark appraisals for all non-financial transactions above these lower amounts out of an abundance of caution. Other risk-off considerations of the group might include their respective bank's mix of collateral types and/or overall quality of loans in portfolio, market conditions and regulator feedback, among other factors. One might also surmise that risk aversion for commercial evaluations at larger SBL sizes might contribute, but any linkage between bankers' specified loan renewal cap and concerns over the erosion in the dependability of commercial evaluations was not borne out by the survey.

At the end of the day, banking officials' choices for the loan renewal ceiling, whether high or low, seem to reflect the status quo. That is, the vast majority of bank officers (75.0%) indicated their quoted dollar maximum was consistent with current internal appraisal and evaluation policy. Only a minority (15.6%) claimed their desired loan amount would require a policy rewrite. The fact is that undertaking appraisal and evaluation policy revisions tend to be a big deal for bank managers, so it's not surprising that most respondents will stick with their current policy.

**Does Your Loan Renewal Cap Require a Policy Change?**

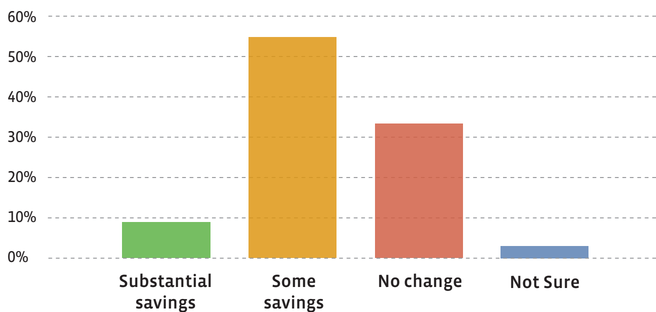



Source: Boxwood Means, LLC

## ▶ Bankers foresee modest cost savings from the new rule.

Despite the core finding that two-thirds of banking officers embrace the threshold change, there appears to be less enthusiasm over the level of internal cost savings that will accrue. A majority (54.6%) suggested that some cost savings will result from the replacement of appraisals, but only a minority (9.1%) expect substantial savings. Moreover, a sizable subset (33.3%) anticipated no net change in bank operational costs at all.[8]

**Expected Cost Savings with the Proposed Rule**




Source: Boxwood Means, LLC

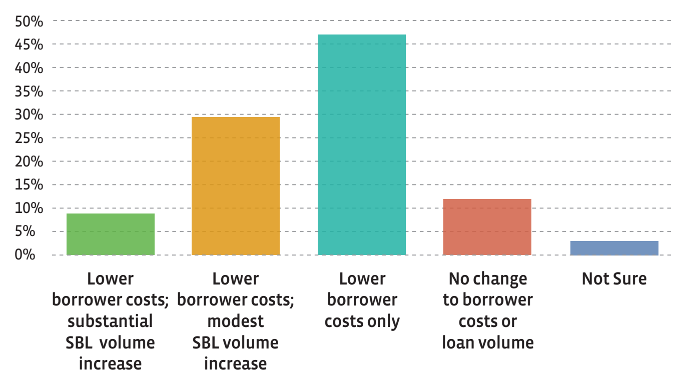
This measured viewpoint on cost savings stems from the fact that a majority (64.7%) of all respondents only see a modest rise in commercial evaluation use and not an upsurge. Yet the survey findings do indicate a couple of salient, if not obvious relationships concerning cost savings: first, bankers that intend to increase use of evaluations expect to realize lower costs; and second, respondents that were comfortable using commercial evaluations on renewals of $1 million or greater were also more likely to envision savings. However, overall the results do not suggest that bankers are expecting big dividends from the threshold change.

This sentiment contrasts sharply with the agencies' expectations for "significant" cost savings by financial institutions as described in their *Notice of Proposed Rulemaking*.[9] Note, however, that in addition to estimating an increase in the number of exempt transactions, the agencies also projected potential cost savings associated with a reduction in the amount of time to review an evaluation relative to an appraisal. This is an important consideration, and we agree that the lower documentation requirements of a commercial evaluation will require substantially less review time. This savings can take the form either of expanding the productive time of internal staff tasked with the reviews or reduce the fees incurred by banks for external reviews by contractors.

## ▶ Borrowers will be prime beneficiaries.

At 85.3%, respondents overwhelmingly believe that borrower costs will decline as a result of the new rule.[10] Only a very narrow minority (2.9%) think that borrowers will not benefit. Of the sizable majority that expect borrower cost savings, a solid portion (29.4%) also believes that the threshold increase will trigger a modest increase in SBL volume for their own institution. A more optimistic minority (11.8%) claim that they will see a substantial increase in SBL volume.

**Impact of the Proposed Rule on Lending Business**




Source: Boxwood Means, LLC

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[8] Inopportune phrasing of the survey question may have inadvertently led to more "no change" responses. Had participants understood that the question's intent was to probe expectations for overall cost reductions (via greater use of evaluations) rather than mere changes in the cost of appraisals themselves, it's conceivable that a greater number of respondents may have opted for a more positive financial payoff.

[9] The agencies estimated an 11% increase in the aggregate number of CRE transactions exempted by the new rule that, by qualifying for a commercial evaluation, would translate into an estimated savings of several hundred dollars per affected transaction. Moreover, the agencies suggested that since reviews of evaluations take less time than appraisal reviews (which the agencies estimated at a savings of 30 minutes of staff time per transaction), the aggregate impact of the new rule was deemed significant.

[10] The agencies' report suggested that small entities and borrowers could experience significant cost reductions on CRE transactions under the new rule.

Of course, bankers' individual assessments of the degree of financial payoff depends on numerous factors such as the bank's average CRE loan size, their production goals, health of the market, competition, etc. All things being equal, banks with a penchant for making small balance CRE loans are more likely to generate savings on collateral valuations performed on behalf of their borrowers. And, to some extent, property owners and investors may be better motivated by the lower closing costs on purchase and refinance loans, follow through on more deals and thereby generate more fee income for banks.[11]

## 4. Conclusions

There has been a fair amount of industry buzz about the status and implications of the agencies' *Notice of Proposed Rulemaking and Request for Comment* report since its release last summer. Boxwood's survey of commercial bank appraisers and credit officers generally confirmed the agencies' primary assertion that the higher threshold exemption will lower costs for financial institutions. Yet our finding of predominantly moderate increases in commercial evaluations will probably yield less robust financial benefits than the agencies projected. Thus by no stretch of the imagination can the survey's modest, concluded amount of regulatory relief be correlated with the industry hype the proposed rule has fostered.

We thought varying industry opinion about the reliability of commercial evaluations might also have explained some of the hype or debate surrounding the proposed rule. For that reason, we queried survey participants on the topic and found it essentially to be a non-factor. We don't expect this result to put the issue firmly to bed, but it may be reassuring to some parties involved.

Finally, there is little debate that commercial evaluations can reduce the cost of a suitable transaction by hundreds, if not thousands of dollars in some cases. We might think that opportunity would be ample incentive for financial institutions, following safe and sound banking practices, to try and maximize cost savings under either the prevailing or proposed exemption levels. And clearly from our vantage point, the largest opportunity and recurring stream of cost savings is for more banks to relax their exemption level on loan renewals. Yet while the findings showed a plurality of bankers will use commercial evaluations on loan renewals of $1 million or more (involving typical property types with relatively low credit risk), more than one-third of respondents will forgo the greater cost savings and, instead, apply the lowest exemption threshold for non-financial transactions.

Again, we understand from the survey findings that this conservatism is not caused by discomfiture over the reliability of commercial evaluations. So what prevents bankers from prudently taking advantage of higher appraisal exemption levels on loan renewals, especially when some of their banking peers are more profitably doing so? The findings hint at one possible reason: i.e., the propensity of some banks for inertia because of the major challenges managers face in altering internal policies.

We believe that financial institutions using any reasonable exemption threshold might be more apt to relax restraints on larger-sized renewal loans – and perhaps seize the magnitude of regulatory relief the agencies claim – were they to actually calculate for themselves the savings that could accrue. It may be well worth the effort.

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*Boxwood Means, LLC is a leading provider of property valuations and data analytics in the small commercial property and loan markets. Boxwood's technology-driven solutions including commercial evaluations, appraisals, CRE price indices and market research support the investment and risk management activities of 200 banks, non-bank lenders, financial services firms and investors in the U.S. and Canada.*

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[11] The agencies' report indicated the proposed rule could "marginally" increase lending activity because of lower loan origination fees.

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