

A Business Real Estate Appraisal Problem

BY KATHLEEN W. COLLINS and ZONNIE BRECKINRIDGE

When does "market value" not mean market value? When does the "value" as in "loan to value" mean something less than the bank thought it did? And how would your bank fare if the business value were stripped out of your market value appraisals during your next examination?

It appears that at least some of the federal banking agencies may be moving toward a formal position on appraisals that is sure to leave bankers aghast.

After first encountering the issue with our clients, we were pleased that a question on this point was asked during an excellent American Bankers Association program, "Appraising the Appraisal: Understanding the Appraisal Review Process," held jointly with the Appraisal Institute on Oct. 25.

Representatives of the Federal Reserve Board and the Office of the Comptroller of the Currency provided confirmation of a position that could fundamentally affect the market value of real estate used in business, including hotels, gas stations, convenience stores, bowling alleys, restaurants, and nursing homes.

If the appraisal for a real-estate-related financial transaction — such as the use of real property as security for a loan — reports the market value of the business as a component of that of the real property, examiners will expect the bank to exclude the business value from the collateral value.

These regulators say, for example, that in the case of a loan secured by a nursing home, the market value of the real estate — ignoring the business and the

income it produces — would be the value of the land and improvements alone. That is the value they want to be used in calculating supervisory loan-to-value limits.

This position has real impact. Supervisory LTV ratios are not numbers that sit idly in the file.

Regulations require that banks establish their own internal loan-to-value limits for real estate loans. These limits generally should not exceed those set by regulators; those that do must be identified in the bank's records and reported periodically to the board of directors. Failure to report these exceptions violates the regulations.

The regulations also limit the aggregate amount of loans in excess of supervisory LTV limits. Total loans in various categories are also limited — for example, nonconforming commercial loans to 30% of capital. As banks approach these limits, they are scrutinized more closely by their regulators.

In our experience most appraisers take the value of the business into account when determining real estate's market value. Moreover, many evidently believe they are compelled to break that out into components (including a business value component) even when submitting a "market value" appraisal — and even when the bank has not asked for anything more.

Some appraisers point to the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 for the proposition that the ongoing business produces a value that must be disclosed as a component of the property's overall value. Some point to the Uniform Standards of

Professional Appraisal Practices, promulgated by the Appraisal Foundation's Appraisal Standards Board.

But banks typically request a "market value" appraisal. That is what the regulations issued as a result of a FIRREA mandate for real-estate-related financial transactions entered into by banks. And neither FIRREA nor professional appraisal standards require allocating the market value of real estate into components.

But just try to convince your appraiser that this is so. And it is this allocation to business value that will get you into trouble.

"Market value" is defined in these regulations as "the most probable price" a property would bring in a "competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus."

Would a prudent buyer or seller ignore a high percentage of continuous occupancy in a nursing home, with a waiting list as long as the eye can see? Surely such a situation can be accommodated in the context of a market value appraisal. But many appraisers resist changing old habits and insist on allocating business value separately, unintentionally setting their bank clients up for a fall.

But all is not lost, the regulators say.

True, subtracting the allocated value of the business from the market value of the nursing home leaves the bank with an out-of-kilter LTV and puts it in violation of law.

However, said a regulator speaking on the program, the

bank can make a second, commercial loan — secured by cash flow supported by a "going concern" appraisal of the property or the "value attributed to the business housed within a piece of real property."

The regulators professed a strong preference for seeing two different loans and two different structures for real estate and commercial-industrial loans. That preference prompts the obvious question: What if different banks make different loans — one secured by real estate, the other by cash flow, furniture, and fixtures — and only one is in default?

There is presently no guidance about acceptable practices when making one or both of these dual loans, so the supposed solution to this "going concern" conundrum may well involve even more regulation.

We understand that an interagency group of bank regulators is considering issuing guidance that will attempt to address the business value issue. The agencies can issue new regulations if they take the position that principles of safe and sound banking require banks to comply with standards stricter than the Appraisal Standards Board's.

Going this route would seem to require that regulators first identify cases where errors related to inaccurate valuation resulted in

losses to insured banks.

If only some examiners and agencies are going to take this position (as now seems to be the case), perhaps the public process of issuing interagency guidance would vet the issue better — and at least provide uniformity in a very competitive market.

But more important than new regulation is the need for the industry to react now to the regulators' shot across its bow.

The point of FIRREA and the regulations, which became effective in 1990, was to set bank regulatory standards for the performance of appraisals and to require that they conform to the Appraisal Standards Board's.

But appraisals being written today that conform to those standards and provide the market value required by federal regulation are at risk of being disassembled and misunderstood by examiners.

Until a public rulemaking or similar process establishes that safety and soundness principles dictate stricter standards, regulators should leave the fine art of appraising to the appraisal industry.

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LETTER TO THE EDITOR

Debit Cards Still Have Logo Clutter

To the Editor:

Your Jan. 27 article "Another Network Logo No-Go, Now at B of A" [page 7], which reports on Bank of America's newest debit cards, accurately describes the long overdue but gradual elimination of a confusing array of regional brands and logos on bank debit cards.

But there's still a long way to go before these cards are proprietary to the issuing bank and a principal method of differentiation in an increasingly competitive retail banking market. For the debit or deposit access card is in effect the key to the bank and

customer relationship. For example, the new Bank of America card can aptly be described as just another Visa card. Although some confusion is eliminated, the powerful Visa (or MasterCard) brands simply overwhelm the position of any bank, large or small.

Fortunately, the incredible total of some 150 regional brands and logos which populated the American banking system is now history. But, in its place, we now have a three-way battle to brand our electronic banking system, with new combatants poised to enter the network-

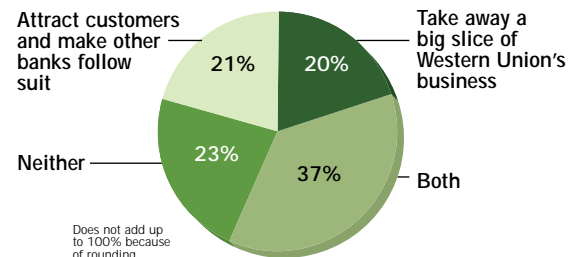
branding game. Although this transaction processing competition is most welcome, their brands are not.

The bank brand must take precedence over any network brand. And the only way to achieve this is by way of a true, common, universal bank acceptance mark with no brand pretensions of its own. A competitive yet efficient electronic banking system is finally in sight.

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