

July 5, 2017

MEMORANDUM TO: Board of Directors

FROM:

Doreen R. Eberley 
Director, Division of Risk Management Supervision

SUBJECT:

Notice of Proposed Rulemaking to Implement an Increase in the Appraisal Threshold for Commercial Real Estate Transactions

Summary of Recommendation

Staff recommends that the FDIC's Board of Directors approve the attached Notice of Proposed Rulemaking (NPRM), entitled *Real Estate Appraisals*, for publication in the *Federal Register* for a sixty-day comment period. The NPRM would amend regulations requiring appraisals of real estate for certain transactions. The proposed amendments would create a new definition of, and separate category for, commercial real estate (CRE) transactions and increase the threshold at which these transactions require an appraisal. CRE transactions with a value greater than \$400,000 would require an appraisal, as opposed to the current \$250,000 threshold. Evaluations would be required for CRE transactions with a value of \$400,000 or less. While the current \$1 million threshold for business loans is not increased in the NPRM, comment is requested regarding the appropriateness of increasing the threshold and for data and the industry's experience with such loans. If approved, the NPRM would be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System (Board) and the Office of the Comptroller of the Currency (OCC) (the Agencies).

SUPPLEMENTARY INFORMATION:

I. Background

Title XI Appraisal Requirements

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Title XI) requires the Agencies to adopt regulations prescribing standards for appraisals used in connection with federally related transactions within the jurisdiction of each agency. The purpose of Title XI is to protect federal financial and public policy interests in real estate-related transactions. Title XI directs the Agencies to prescribe appropriate standards for Title XI appraisals in connection with federally related transactions under the Agencies' respective jurisdictions. These rules, at a minimum, require that Title XI appraisals be: (1) performed in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP); (2) written, as defined by the statute; and (3) subject to appropriate review for compliance with USPAP.

Title XI appraisal regulations identify categories of real estate-related financial transactions that do not require appraisals by certified or licensed appraisers in order to protect federal financial and public policy interests or to satisfy principles of safe and sound banking. Transactions that are not required to have Title XI appraisals are not federally related transactions under the

statutory or regulatory definitions, because the definition only includes transactions that require the services of an appraiser. Title XI authorizes the Agencies to establish a threshold level below which an appraisal by a certified or licensed appraiser is not required if the Agencies determine in writing that the threshold does not represent a threat to the safety and soundness of financial institutions. Title XI further requires that the Agencies receive concurrence from the Bureau of Consumer Financial Protection (CFPB) that such threshold level provides reasonable protection for consumers who purchase 1-to-4 unit single-family residences.

Among transactions that do not require appraisals under Title XI appraisal regulations are those falling below specific monetary thresholds and thus are not federally related transactions. Under current thresholds, which were established by rulemaking in 1994, all real estate-related financial transactions with a transaction value of \$250,000 or less, as well as certain business loans (qualifying business loans) secured by real estate that are \$1 million or less, do not require appraisals. Qualifying business loans are business loans that are real estate-related financial transactions that are not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment. For these real estate-related financial transactions at or below the applicable thresholds and qualifying for the exemption, the Title XI appraisal regulations require financial institutions to obtain an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

EGRPRA Review

The Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) requires that, not less than once every ten years, the Federal Financial Institutions Examination Council (FFIEC), Board, OCC and FDIC conduct a review of their regulations to identify outdated or otherwise unnecessary regulatory requirements imposed on insured depository institutions. This review has been recently completed. During this review, the Agencies received comments related to the Title XI appraisal regulations from bankers, banking trade associations, associations of appraisers and others. Among the comments were recommendations to increase the thresholds at or below which an appraisal would not be required for real estate-related financial transactions.

The Agencies considered the EGRPRA comments and provided a report to Congress in March 2017 that identified potential initiatives to reduce regulatory burden (EGRPRA Report). In the EGRPRA Report, the Agencies addressed comments concerning the appraisal thresholds and stated that the Agencies would propose an increase to the threshold for commercial transactions from \$250,000 to \$400,000.¹

¹ The Agencies also addressed the current \$250,000 threshold for loans secured by residential real estate and whether it would be appropriate to increase the threshold for these transactions. The Agencies determined that an increase would not be appropriate at this time based on three considerations: 1) a threshold increase would have a limited impact on burden due to appraisals still being required under other rules (e.g., Fannie Mae/Freddie Mac requirements); 2) appraisals provide consumer protection by assuring that the property's value supports the mortgage amount; and 3) safety and soundness concerns in light of past imprudent residential mortgage lending. The NPRM would request comment on whether there are other factors that should be considered in evaluating the current threshold for 1-to-4 family residential transactions and whether the threshold can and should be raised, consistent with consumer protection, safety and soundness, and reduction of unnecessary regulatory burden. The Agencies will

Summary of the NPRM

Threshold Increase for Commercial Real Estate Transactions

The NPRM would amend the Agencies' Title XI appraisal regulations to establish a separate threshold for commercial real estate transactions at or below which a Title XI appraisal would not be required. The separate threshold would be set initially at \$400,000, which would represent an increase from the current threshold of \$250,000. In reaching the decision to make the proposal, the Agencies considered comments received through the EGRPRA process, specifically, whether changes to the threshold would be appropriate to reduce regulatory burden consistent with federal financial and public policy interests in real estate-related financial transactions and the safety and soundness of regulated institutions. The Agencies also considered supervisory and market factors.

Definition of Commercial Real Estate Transaction

The current regulations do not have a definition of "commercial real estate transaction." The Agencies propose to define "commercial real estate transaction" as a "real estate-related financial transaction that is not secured by an existing 1-to-4 family residential property." Under the proposed definition, a commercial real estate transaction would include any "real estate-related financial transaction," as defined in the Title XI appraisal regulations, including a loan for construction of buildings with 1-to-4 dwelling units, but excluding a transaction secured by an existing 1-to-4 family property. An existing 1-to-4 family property is a parcel of real property containing fewer than five completed individual dwelling units, including manufactured homes permanently affixed to the underlying property.

Threshold Increase

The NPRM would propose increasing the threshold in the Title XI appraisal regulations for commercial real estate transactions from \$250,000 to \$400,000. In determining the level of increase, the change in prices for commercial real estate was considered as measured by the Federal Reserve Commercial Real Estate Price Index ("CRE Index"). The CRE Index is a direct measure of the changes in commercial real estate prices in the United States. The data incorporated into this index cover properties across the country and across all price ranges, and extends to before 1994.

Review of the CRE Index shows that prices for commercial real estate have increased over time, resulting in an increased proportion of commercial real estate transactions being over the current threshold level than in 1994. Based on this change, a commercial property that sold for \$250,000 in 1994 would be expected to cost approximately \$812,000 today. The price of commercial real estate is particularly volatile, however. In the aftermath of the most recent financial crisis, commercial real estate prices declined sharply. For example, the CRE Index indicates that a commercial property that sold for \$250,000 in 1994 would have cost

continue to consider other possibilities for burden relief in connection with residential mortgage lending appraisals.

approximately \$423,000 in December 2004, \$696,000 in December 2007, and \$414,000 in May 2010, when commercial real estate prices were at their lowest point in the recent downturn.

The NPRM would raise the threshold to a level approximating prices at the low point of the recent cycle. This more conservative approach is appropriate for a one-time threshold change, as it takes into consideration the highly cyclical nature of the commercial real estate market and volatility in actual prices of commercial real estate over time. This figure is also consistent with general measures of inflation across the economy since the current threshold was set. The proposed threshold would provide burden relief, while not posing a threat to the safety and soundness of financial institutions.

Safety and Soundness Considerations for Increasing the Threshold for Commercial Real Estate Transactions

Preliminary analysis of supervisory experience and available data indicates that the proposed threshold level of \$400,000 for commercial real estate transactions would not pose a threat to the safety and soundness of financial institutions. The Agencies have had a \$250,000 threshold in place since 1994. Experience supervising financial institutions under the current threshold has produced no evidence suggesting that faulty estimates of value of real estate collateral securing commercial real estate transactions have been a material cause of losses in connection with transactions at or below \$250,000. Although many variables, including changing market conditions and various loan underwriting practices, may affect an institution's loss experience, supervisors have not identified a lack of appraisals as a significant cause of financial loss with respect to transactions at or below the current thresholds. Based on this supervisory experience, the Agencies have no evidence that an increase to \$400,000 for commercial real estate transactions would materially increase the risk of loss on such loans. Analysis of call report, charge off, and other data reported by insured depository institutions also supports this conclusion.

Use of Evaluations

The Title XI appraisal regulations require regulated institutions to obtain evaluations for three categories of real estate-related financial transactions that the Agencies have determined do not require a Title XI appraisal, including real-estate-related financial transactions within the \$250,000 threshold and business loans within the \$1,000,000 threshold. For commercial real estate transactions, the Agencies propose a corresponding change to the scope of this requirement, such that institutions entering into commercial real estate transactions within the proposed \$400,000 threshold would be required to obtain evaluations that are consistent with safe and sound banking practices on such transactions.

State Certified Appraiser Required

Currently, under the appraisal regulations, any federally related transaction with a transaction value of \$250,000 or more, and which does not involve an appraisal of a 1-to-4 family residential property (a nonresidential transaction), is required to have an appraisal performed by a State certified appraiser. In order to make this existing requirement consistent with these proposed

changes to the appraisal regulations, a change to the wording is proposed. The revised language would replace the wording that all federally related transactions require an appraisal prepared by a State certified appraiser “other than those involving appraisals of 1-4 family residential properties” and replace it with language using the new definition of “commercial real estate transaction” to state that commercial real estate transactions that are federally related transactions shall require an appraisal prepared by a State certified appraiser (if the transaction value is more than \$400,000). This would be a technical change to reword this existing requirement and would not change the substantive requirement.

Appraisal Threshold for Qualifying Business Loans

As previously noted, the Agencies have stated their intention to gather more information about the appropriateness of increasing the \$1 million threshold for qualifying business loans. No increase in the business loan threshold is proposed at this time due to the relatively high current dollar threshold. Based on data analysis, the Agencies believe that a significant percentage of qualifying business loans originated by regulated institutions is exempt under the current threshold. Approximately 62 percent of such transactions are already estimated to be exempt. An increase in the threshold proportionate to the proposed commercial real estate threshold increase would result in close to 77 percent of such transactions being exempt. The Agencies are concerned that an increase in this threshold could particularly increase risk to certain small institutions, for which an increased number of these loans may represent a high percentage of capital. The Agencies are therefore requesting information as part of this proposal.

CFPB Concurrence

Title XI authorizes the Agencies to establish a threshold level at or below which a Title XI appraisal is not required if concurrence is received from the CFPB that the threshold level provides reasonable protection for consumers who purchase 1-to-4 unit single-family residences. The Agencies are consulting with the CFPB regarding the NPRM.

Recommendation

Staff recommends the Board approve the attached Resolution to adopt and authorize the publication in the *Federal Register* of the attached NPRM for a sixty-day comment period.

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CONCUR:

A handwritten signature in black ink, appearing to be 'CY', written over a horizontal line.

Charles Yi
General Counsel
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Attachments