Decision of the

Supervision Appeals Review Committee

In the Matter of * * *

Case No. 2016-01

I. Summary of Findings

After consideration of the timely filed written submissions of the parties and the record of this case, and following the April 29, 2016 deliberative meeting of this Committee, we have granted the Bank's appeal. For the reasons set forth below, the Committee reverses the decision of the Director, Division of Risk Management Supervision, with respect to disputed supervisory determinations made during the * * *, 2014 examination and a related determination contained in a * * *, 2015 letter to the Bank.

II. Background and Procedural History

This appeal concerns material supervisory determinations arising from the examination of * * * ("Bank"), which began on * * *, 2014 and was conducted by the FDIC's * * * Regional Office ("Regional Office") concurrently with the [State banking authority] ("State"). The FDIC Report of Examination cited several apparent violations of law and regulations.[1] The Bank also was required to make specific allocations to its allowance for loan and lease losses ("ALLL") with respect to certain loan relationships.

In addition, the Regional Office required the Bank to obtain appraisals on six specific properties. The Regional Office subsequently reviewed these appraisals and in a letter to the Bank dated * * *, 2015, stated that the review disclosed weaknesses in five of the six appraisals, resulting in apparent violations of Part 323 and applicable standards set forth in the Uniform Standards of Professional Appraisal Practice.

The Bank submitted a response addressing the examination findings to the Regional Office and requested review of certain supervisory determinations set forth in the Report of Examination. In a letter dated * * *, 2015, the Regional Office informed the Bank that certain contested findings were amended or partially amended. A final revised Report of Examination ("Report") with CAMELS ratings of * * * was transmitted to the Bank on * * *, 2015.[2]

On October 12, 2015, the Bank filed a request for review with the Director of the Division of Risk Management Supervision, contesting the following material supervisory determinations:

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[1] The State issued its own Report of Examination.

[2] Capital "5," Asset Quality "5," Management "5," Earnings "5," Liquidity "3," Sensitivity to Risk "4," and Composite "5."

- Apparent violations of Section 24 of the Federal Deposit Insurance Act (“FDI Act”) and Part 362 of the FDIC’s regulations relating to the purchase of an office building in connection with a loan to [X];
- Apparent contraventions of the *Interagency Appraisal and Evaluation Guidelines*[3] (“*Interagency Guidelines*”) relating to certain evaluations of real estate prepared in connection with the [Y] and [Z] loan relationships;
- An apparent violation of Part 323 of the FDIC’s regulations relating to an appraisal prepared by an independent real estate appraiser with respect to the [Y] loan relationship; and
- Specific allocations to the ALLL relating to the [Y] and [Z] loan relationships.[4]

On December 30, 2015, the Division Director upheld the material supervisory determinations contained in the Report and the * * *, 2015 letter. The Division Director concluded that the contested determinations were appropriate and consistent with current guidance.

The Bank timely filed an appeal with the Supervision Appeals Review Committee by letter dated February 25, 2016, disputing material supervisory determinations relating to the [X], [Y], and [Z] loan relationships.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations*,[5] the Committee has reviewed the Bank’s appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of and support for the positions of the parties. The Committee met to consider the appeal and to hear oral presentation from the parties on April 29, 2016. The Committee has carefully considered the written submissions and oral presentations of the parties.

Under the *Guidelines for Appeals of Material Supervisory Determinations*, the burden of proof on all matters at issue rests with the institution. Further, the scope of the Committee’s review is limited to the facts and circumstances as they existed prior to or at the time the relevant material supervisory determinations were made. No consideration is given to any facts or circumstances that occur or corrective action taken after the determinations were made.

[3] The *Interagency Guidelines* were issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the Board of Governors of the Federal Reserve System. 75 Fed. Reg. 77,450 (Dec. 10, 2010).

[4] The Bank’s request for review also contested other determinations that were not included in the Bank’s appeal to this Committee, and therefore will not be addressed here.

[5] 77 Fed. Reg. 17,055 (Mar. 23, 2012) (available at: http:///www.fdic.gov/regulations/laws/sarc/sarcguidelines.html).

III. Analysis

A. Apparent Violations of Section 24 of the FDI Act and Part 362

Factual Background

In 2013, the Bank renewed a $1,500,000 loan to one of its former directors, [X]. [X] was the Chief Executive Officer of [Inc.], a corporation that owned one material asset – an office building in [city], [state] ("Building"). Another lender held a mortgage interest in the Building, and had required [Inc.] to enter into an agreement not to convey or encumber the building without prior consent until the mortgage loan was paid in full. The Bank's loan to [X] was secured by the total outstanding stock of [Inc.], of which [X] was the sole owner.

The mortgage loan became delinquent and the mortgagee began collecting the rental income from the Building. Without this rental income, [X] was unable to keep the Bank loan current. The tenant vacated the property and the mortgage loan servicer instituted foreclosure proceedings. [Inc.] also filed for bankruptcy protection.

With the collateral for the [X] loan – [Inc.] stock – likely worthless due to [Inc.]'s bankruptcy, the Bank began negotiating with the mortgage loan servicer to acquire the Building. The servicer scheduled a foreclosure sale of the property for * * *, 2014.

[One day before the foreclosure sale] the Bank's board of directors approved a bid of up to $2,600,000 for the Building. The next day, just prior to the foreclosure sale, the Bank's President and counsel for the servicer agreed to a sale price of $2,500,000. The servicer acquired the property at the foreclosure sale and later sold it to the Bank's subsidiary, * * *.

FDIC examiners determined that the purchase of the Building was an impermissible investment, in violation of Section 24 of the FDI Act and Part 362 of the FDIC's regulations. The Bank has noted that State examiners determined that the transaction violated [a state statute], which defines the investment powers and limitations of [state] banks.

Statutory and Regulatory Background

The legal framework governing the purchase of the Building includes state law, Section 24 of the FDI Act, and Part 362 of the FDIC's regulations. First, the purchase must be permissible under state law. Second, assuming the purchase is permissible under state law, it must also be permissible for a national bank; otherwise, an application to the FDIC is required.

Section 24 of the FDI Act limits FDIC-supervised banks' activities and equity investments (including real estate activities and investments) to those that are permissible for national banks, unless the FDIC has determined that the activity or investment would pose no significant risk to the Deposit Insurance Fund and the bank is in compliance with applicable capital standards.[6] Section 24 is implemented by Part 362 of the FDIC's regulations, which generally prohibits

[6] 12 U.S.C. § 1831a(a).

insured state banks from engaging in activities or investments that are impermissible for national banks, absent the FDIC's prior approval of a bank's application.[7]

An "activity permissible for a national bank" means any activity authorized for national banks under any statute, including the National Bank Act, as well as any activity recognized as permissible for a national bank in regulations, official circulars, bulletins, orders, or written interpretations issued by the Office of the Comptroller of the Currency ("OCC").[8]

The authority for national banks to obtain and hold real estate is set forth in Section 5137 of the Revised Statutes of the United States, which provides that a national bank may purchase, hold, or convey real estate only for four specific purposes, one of which is satisfaction of debts previously contracted ("DPC") in the course of its dealings.[9] National banks that have acquired real estate through their DPC authority may act in good faith with respect to that property as would any other prudent owner, subject to the requirement of disposal within specific time frames defined by statute and regulation.[10]

FDIC-supervised banks must satisfy the requirements of both state law and Part 362 of the FDIC's regulations. The following activities and investments are exempt from Part 362 and its application requirement:

(1) Activities conducted as agent for a customer or as a trustee;
(2) The acquisition of real estate for use in the conduct of the bank's business; and
(3) Equity investments acquired in connection with DPC if the bank does not hold the property for speculation and takes only such actions as would be permissible for a national bank's DPC.[11]

For any other real estate activity permitted by state law, an insured state bank must comply with Part 362 by meeting the applicable capital standards and applying for and obtaining the FDIC's prior written consent to engage in the activity. Consent is given only if the FDIC determines that the activity poses no significant risk to the Deposit Insurance Fund.[12]

RMS's Position

RMS concedes that the Bank might have been permitted to acquire the Building under its DPC authority, provided that the purchase was not speculative. However, RMS concludes that the purchase was speculative and thus required a prior application to the FDIC under Part 362. The Bank never filed such an application.

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[7] *See* 12 C.F.R. § 362.3(b).

[8] 12 C.F.R. § 362.1(a).

[9] 12 U.S.C. § 29.

[10] *See*, *e.g.*, OCC Interpretive Letter No. 1123 (Sep. 18, 2009).

[11] *See* 12 C.F.R. § 362.1(b).

[12] 12 C.F.R. § 362.3(b)(2).

RMS highlights two OCC Interpretive Letters that include an analysis of certain real estate transactions that were determined to be speculative and impermissible for a national bank.[13] RMS reasons that the Bank's purchase of the Building was similar to those transactions and should similarly be considered speculative.

RMS argues that neither the FDIC nor the OCC has defined the term "speculative," but consistent with OCC practice, the determination of whether a transaction is speculative should be made on a case-by-case basis. RMS argues that the purchase or production of real estate assets without an agreement with an end-user to purchase the property is speculative.

RMS asserts that the facts here support the conclusion that the purchase of the Building was speculative. The property had been vacant for two years and would require a stabilizing period to become profitable. RMS argues that the necessary mold remediation also would entail costs that were unknown at the time. The Bank failed to provide any evidence of a disposition plan that would result in the recovery of its investment. In addition, the minutes of the Bank's board meeting do not detail the board's deliberations concerning the purchase of the Building, and the Bank did not document the board's consideration of the ongoing management and operating expenses of the property.

Finally, RMS argues that state banks are not authorized to make investments that are prohibited under state law. Because the State concluded that the purchase of the Building was in violation of [a state statute], the transaction was impermissible.

The Bank's Position

The Bank argues that the purchase of the Building was within its DPC authority and was not speculative. Therefore, it argues, the transaction was permissible under Section 24 of the FDI Act and did not require an application under Part 362.

The Bank argues that the purchase was not speculative, as it was not motivated by an expectation that the property's value would increase. The purpose was to realize the property's appraised value to recover at least a portion of the balance of the [X] loan.

The Bank explains that the vacancy of the Building at the time of the purchase does not support the conclusion that the purchase was speculative. It argues that the building was vacant only because the mortgage servicer's rules did not allow for an agreement not to disturb tenants in the event of default or foreclosure. Absent such an agreement, prospective tenants were unwilling to enter into a lease. The Bank believed that its purchase of the property would remove this impediment, making the property attractive to prospective tenants.

The Bank also argues that it conducted extensive due diligence before the purchase, including obtaining an updated appraisal and cost estimates for repairs, cleaning, and mold remediation. The Bank's board of directors was informed of the necessary expenditures and plan for recovery

[13] OCC Interpretive Letter, 1990 WL 362126 (Feb. 13, 1990); OCC Interpretive Letter, 1983 WL 145782 (Jan. 21, 1983).

prior to authorizing the transaction. The Bank's President inspected the property before the transaction and reported to the board of directors on its condition. The Bank argues that given this due diligence, the purchase cannot be considered speculative.

The Committee's Findings

As explained below, the Committee cannot fully address the permissibility of the Bank's purchase of the Building, due to the State's determination that the transaction violated [state] law. However, the Committee will address whether the purchase was speculative, and thus, in violation of Section 24 and Part 362, assuming it was permissible under state law.

RMS has conceded that the purchase of the Building could have been permitted under the Bank's DPC authority if it were not speculative. RMS argues that the purchase was speculative due to the lack of an identified subsequent purchaser and inadequate due diligence.

Turning to the question of speculation, the Committee concludes that the OCC Interpretive Letters highlighted by RMS do not resolve the matter. Each of those Interpretive Letters involved a national bank that had previously acquired real estate under its DPC authority and sought to buy an adjacent parcel. In each case, the OCC explained that the national bank's DPC authority applied only to the acquisition of the first parcel and did not extend to the purchase of the adjacent parcel. Moreover, in each case, the OCC suggested that the national bank was able recoup its investment through the first parcel. Reliance on these cases to evaluate the Bank's purchase of the Building is inappropriate.[14] Here, the Bank was unable to recover any portion of the delinquent [X] loan because the existing collateral, the stock of bankrupt [Inc.], was worthless.

The Committee is not persuaded by the argument that it was speculative for the Bank, in this case, to use its DPC authority to acquire real estate absent an agreement with a subsequent purchaser. National banks generally have a period of five years to dispose of DPC property.[15] Because the law does not contemplate requiring an identified subsequent purchaser when acquiring DPC property, the lack of such a purchaser alone cannot indicate speculation. Moreover, DPC authority allows a bank to satisfy debts through the value of the equity in the property. As the equity has value, the acquisition of the property can be useful in satisfying the debt, regardless of whether the bank has identified a subsequent purchaser.

The Committee concludes that the Bank's purchase of the Building was not speculative. The Bank appears to have believed that the acquisition would mitigate the expected loss on the [X] loan, despite the property's condition at the time. The Bank obtained an appraisal in April 2014

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[14] For the same reason, SARC Decision 2012-01 (June 19, 2012) does not resolve this issue. In that case, a bank obtained several parcels of land in a subdivision through its DPC authority and argued that its subsequent purchase of additional parcels in the subdivision was not speculative. The Committee concluded that the purchase of the additional parcels was speculative.

[15] OCC Interpretive Letter No. 1007 (Sep. 7, 2004). [State] law also generally provides up to five years for state-chartered banks to dispose of real estate acquired through their DPC authority. [State statute].

that assigned an "as is" value of $3,300,000 to the property.[16] Although the appraisal report notes that this valuation did not account for mold remediation costs, the Bank obtained a separate cost estimate of $5,000 for mold remediation from a local contractor that had consulted with an environmental engineer.[17] The Bank could have reasonably concluded that it was likely to recover at least a portion of the delinquent [X] loan, given the $2,500,000 purchase price.

Furthermore, it appears that the Bank had reason to believe that it could obtain an even greater recovery by returning the Building to a stabilized condition; that is, by making necessary repairs and leasing the space to one or more tenants. The appraisal report assigned an "as stabilized" value of $4,320,000 to the property, based on typical vacancy rates for the market.[18] The report concluded that if the space was offered at a competitive lease rate, the building could achieve a stabilized level of occupancy within 24 months.[19] The report further estimated that a marketing period of 12 to 24 months would be necessary to dispose of the building.[20] Bank management concluded that stabilization of the building would result in a near complete recovery of the [X] loan.[21]

While stabilization would require tenants, the Bank had grounds for believing that it could obtain tenants for the Building, as several organizations had expressed interest in the property and had negotiated lease terms with [Inc.] prior to the foreclosure sale. The Bank was aware that in November 2012, a prospective tenant inspected the Building several times and requested a firm lease offer for occupancy beginning in February 2013.[22] The Bank also was aware that in September 2013, [Inc.] negotiated a lease with another prospective tenant for use of the building as a call center.[23] The Bank's classified loan action plans state that [X] and [Inc.] were negotiating with a number of other prospective tenants, including * * *, the * * *, a firm that was awarded a contract with * * *, and an unidentified operator of an international call center.[24]

The pending foreclosure sale appears to have been an obstacle to executing a lease. The Bank's classified loan action plan dated March 31, 2014 states: "A potential tenant is an international call center but the issues with the foreclosure prevent any lease from being executed."[25] Given

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[16] Exhibit L to the Bank's appeal. This valuation included a deduction of $310,000 for estimated expenses related to capital improvements necessary to lease the property, such as repainting and replacing carpets and ceiling tiles.

[17] Exhibit T to the Bank's appeal.

[18] Exhibit L to the Bank's appeal.

[19] Exhibit L to the Bank's appeal, p. 87.

[20] Exhibit L to the Bank's appeal, p. 18.

[21] *See* Exhibit O to the Bank's appeal, e-mail message from the Bank's President to its board of directors, dated July 24, 2014.

[22] *See* [Inc.] Historical (Composite) Exhibit to the Bank's appeal, e-mail message from * * * to the Bank's President, dated November 28, 2012.

[23] *See* [Inc.] Historical (Composite) Exhibit to the Bank's appeal, e-mail message from [X] to the Bank's President, dated September 24, 2013.

[24] [Inc.] Historical (Composite) Exhibit to the Bank's appeal, classified loan action plans dated December 31, 2012, March 31, 2013, March 31, 2014, and June 30, 2014.

[25] [Inc.] Historical (Composite) Exhibit to the Bank's appeal, classified loan action plan dated March 31, 2014.

prospective tenants' reluctance to enter into a lease in these circumstances, the Bank could have reasonably concluded that it would have greater success in marketing the property.

The Committee has reviewed the Bank's documentation of the due diligence it conducted prior to the purchase of the Building, but concludes that this documentation does not support a finding of speculation.[26] Bank management provided board members with detailed information on the Building prior to the meeting at which the purchase was approved, including the appraisal report for the property and cost estimates for repairs and mold remediation.[27] The appraisal report contains, among other information, detailed estimates for ongoing expenses and an analysis of the estimated marketing period for the property. The board meeting minutes state that several options were presented and, following considerable discussion of the Building, the board voted to approve the purchase.[28]

Considering the facts and information available to the Bank at the time of the transaction, the Committee concludes that the purchase of the Building was not speculative.

With respect to the cited violation of state law, the Committee notes that insured state banks may only engage in activities or investments that are permissible for national banks and are permissible under state law.[29]

The State determined that the Bank's purchase of the Building was an impermissible investment, in apparent violation of [a state statute]. The Committee makes no findings with respect to the State's determination, as the interpretation of the [state] statute is the province of the State.[30] The Committee determines only that the transaction was not speculative and would not otherwise be in violation of Section 24 and Part 362, absent the State's determination. Therefore, as long as the State's determination of a state law violation stands, the Committee cannot conclude that the purchase of the Building was permissible.

B. Apparent Contraventions of the Interagency Guidelines, Apparent Violations of Part 323, and Required Specific Allocations to the ALLL

Because the disputed material supervisory determinations relating to the [Y] and [Z] loan relationships share certain factual similarities and involve the same regulations and guidance, the Committee will address them together.

1. Factual Background

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[26] The Committee has previously considered a bank's due diligence, among other things, in evaluating whether a transaction was speculative for purposes of Part 362. *See* SARC Decision 2012-01 at p. 13 (June 19, 2012).

[27] *See* Exhibits L and O to the Bank's appeal.

[28] *See* Exhibit AC to the Bank's appeal.

[29] *See*, *e.g.*, FIL-54-2014 ("A State bank (or its subsidiary) generally may engage in an activity or investment . . . that is permissible for a national bank (or its subsidiary) and is also permissible under State law.").

[30] The record before the Committee also does not detail the specific reasoning underlying the State's determination.

[Y] Loan Relationship

The Bank originated loans totaling more than $9,500,000 to [Y] for the purchase of land and construction of a subdivision in [city], [state] known as [Development 1]. At the time of the examination, two of the loans to [Y] with a total outstanding balance of $7,667,000 were delinquent and in nonaccrual status. The Bank deemed the delinquent loans to be collateral dependent.

Examiners noted that the most recent independent appraisal of the property, from 2008, valued it at $11,000,000, assuming a bulk sale of the lots to one purchaser. In 2013, the Bank prepared an internal evaluation valuing the property at $9,500,000. Examiners reviewed this evaluation and determined that it failed to conform to the *Interagency Guidelines* in several respects:

- The evaluation relied upon lot sales that examiners concluded were not comparable.
- The evaluation did not state how long the comparable lots were on the market or if their characteristics were superior to, inferior to, or the same as lots at [Development 1].
- The evaluation did not employ a discounted cash flow approach supported by an absorption rate.

Examiners estimated the value of the property at $5,390,000, using a discounted cash flow approach over a 5-year absorption period and assuming a $25,000 per lot sales price, 4% selling costs, and a 10% discount rate. Considering another loan to [Y] that was current but was not supported by sufficient cash flow, examiners estimated that the Bank's total potential loss exposure to [Y] was $2,500,000. The Bank was required to make a specific allocation to the ALLL in this amount.

The Bank agreed to obtain an independent appraisal of the property. This appraisal, prepared by certified general real estate appraiser [A] ("[A] appraisal"), valued the property at $9,900,000. In its * * *, 2015 letter to the Bank, the Regional Office stated that the [A] appraisal did not comply with Part 323 of the FDIC's regulations. The Bank obtained two independent reviews of the [A] appraisal from state-certified general real estate appraisers. The first review, prepared by [B], concurred with the appraisal. The second review, prepared by [C], suggested three enhancements to the report but stated that the report satisfied the requirements of the Uniform Standards of Professional Appraisal Practice.

RMS upheld the apparent contravention of the *Interagency Guidelines*, the apparent violation of Part 323, and the required specific allocation of $2,500,000 to the ALLL. The Bank disputes all three of these determinations.

[Z] Loan Relationship

The Bank originated loans totaling more than $7,500,000 to [Z] for the purchase of land and construction of a multi-phase townhouse development in [city], [state] known as [Development 2]. At the time of the 2014 examination, a total balance of $6,360,000 was outstanding on the loans, which were in nonaccrual status and being serviced under a forbearance agreement.

Examiners noted that the most recent independent appraisal of the property, from 2008, resulted in a valuation of $5,200,000. In 2014, the Bank prepared an internal evaluation valuing the property at $5,424,000. Examiners reviewed the 2014 evaluation and determined that it failed to conform to the *Interagency Guidelines* for the following reasons:

- The evaluation lacked a discounted cash flow analysis, including a projected sales price and absorption rate, supported by anticipated demand based on market data.
- The evaluation used inappropriate comparable sales data, including outdated sales.

Examiners estimated the value of the property at $3,198,000. After accounting for additional supporting collateral, examiners estimated the Bank's potential loss exposure to [Z] was $1,725,000. The Bank was required to make a specific allocation to the ALLL in this amount.

In response to the initial examination findings, the Bank prepared a 2015 internal evaluation of the property valuing the property at $5,160,000. RMS considered this evaluation as part of the Bank's request for review and determined that the evaluation failed to conform to the *Interagency Guidelines*, as it used inappropriate comparable sales data and a three-year absorption period, raising concerns about its value conclusion.

RMS upheld the apparent contraventions of the *Interagency Guidelines* and the required specific allocation of $1,725,000 to the ALLL. The Bank disputes these determinations.

2. Statutory and Regulatory Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provides protection for federal financial and public policy interests in real estate related transactions by requiring real estate appraisals used in connection with federally related transactions to be performed in writing, in accordance with uniform standards, by appraisers whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.[31]

Part 323 of the FDIC's regulations implements the requirements of Title XI and applies to all federally related transactions entered into by the FDIC or institutions regulated by the FDIC. Real-estate related financial transactions generally require an appraisal, with certain exceptions.[32] For specific types of transactions that are exempt from the appraisal requirement, institutions must obtain an evaluation of the property that is consistent with safe and sound banking practices.[33]

Appraisals required by Part 323 must satisfy certain minimum standards, including conformance with generally accepted appraisal standards, as evidenced by the Uniform Standards of

[31] 12 U.S.C. §§ 3331-3351.

[32] 12 C.F.R. § 323.3(a).

[33] 12 C.F.R. § 323.3(b).

Professional Appraisal Practice ("USPAP").[34] Appraisals for tract developments also must analyze and report appropriate deductions and discounts.[35]

Evaluations should satisfy the standards set forth in the *Interagency Guidelines*, which clarify supervisory expectations concerning the development and content of evaluations. Evaluations are not subject to the same detailed requirements that apply to appraisals; rather, the *Interagency Guidelines* state that evaluations should provide a reliable estimate of the value of collateral and support the institution's decision to engage in the relevant transaction.[36] Evaluations also should contain sufficient information detailing the analysis, assumptions, and conclusions to support the credit decision.[37]

3. Apparent Contraventions of the Interagency Guidelines (Evaluations)

The Bank's Position

The Bank contends that the *Interagency Guidelines* do not prohibit the use of comparisons of bulk sales in preparing evaluations and do not require evaluations to employ a discounted cash flow analysis. The Bank argues that the methodology used in the disputed evaluations satisfies the criteria set forth in the *Interagency Guidelines*.

The Bank also argues that all three disputed internal evaluations were sound and complied with the *Interagency Guidelines*.

The Bank emphasizes that the 2013 evaluation relating to [Y] considered four actual bulk lot sales that occurred within a 20-minute drive of the property during the year prior to the evaluation date and included appropriate adjustments for lot size and location. The Bank asserts that because the comparable sales upon which the evaluation was based were bulk lot sales, the evaluation effectively incorporated the discount that would be required to sell the development's lots in one all-inclusive transaction.

The Bank contends that the 2014 internal evaluation relating to [Z] accounted for the minimal comparable sales. In such circumstances, it is appropriate to consider older sales in combination with active listing data.

The Bank argues that the 2015 evaluation relating to [Z] used appropriate comparable sales data and no adjustments were necessary. The Bank asserts that the evaluation properly considered local market sales data for the prior two years in estimating the absorption period.

RMS's Position

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[34] 12 C.F.R. § 323.4(a).

[35] 12 C.F.R. § 323.4(c).

[36] *Interagency Guidelines*, Section XII.

[37] *Interagency Guidelines*, Section XIII.

RMS argues that the *Interagency Guidelines* require evaluations to be consistent with safe and sound banking practices and provide a reliable estimate of the collateral's value. RMS contends that safety and soundness concerns warrant requiring evaluations of tract developments to use the same analysis that the *Interagency Guidelines* require for appraisals of tract developments; that is, a discounted cash flow analysis with appropriate deductions and discounts to reflect holding costs, marketing costs, and entrepreneurial profit. According to RMS, the existence of this requirement for appraisals indicates that a discounted cash flow analysis provides an effective means of determining a tract development's value.

RMS argues that the Bank's 2013 evaluation relating to [Y] also relied on inappropriate comparable sales. Specifically, RMS explains that the comparable sales used in the evaluation involved a maximum of 73 lots, while [Development 1] contained 299 unsold lots. The evaluation also failed to provide supporting information for adjustments other than those based on lot size. RMS asserts that these flaws raise concerns regarding the evaluation's market value conclusion.

RMS contends that the Bank's 2014 evaluation relating to [Z] also relied on inappropriate comparable sales, as it referred to two outdated sales.

RMS argues that the Bank's 2015 evaluation relating to [Z] also failed to include appropriate adjustments to the comparable sales upon which it relied. In addition, the evaluation failed to consider the existing competitive inventory of undeveloped lots or forecast new competitive inventory in determining an appropriate absorption rate. The evaluation also failed to justify the use of a 14% discount rate or to reconcile that rate to the discount rates applied in previous evaluations.

The Committee's Findings

Evaluations should contain sufficient information detailing the analysis, assumptions, and conclusions to support the credit decision.[38] The *Interagency Guidelines* provide that an evaluation should "[d]escribe the analysis performed and the supporting information used in valuing the property," and "[i]ndicate all source(s) of information used in the analysis . . . to value the property."[39]

Under the *Interagency Guidelines*, evaluations of tract developments, unlike appraisals, do not always require a discounted cash flow analysis. While such an analysis may be an effective tool for determining a tract development's value, the *Interagency Guidelines* do not specify any particular method that an evaluation must employ in valuing collateral. Other methods of valuation may be equally consistent with safe and sound banking practices. Safety and soundness warrant a careful valuation analysis where a loan is secured by a tract development, but the Committee concludes that the facts and circumstances here did not mandate the application of appraisal standards to the disputed evaluations. In this case, the Committee

[38] *Interagency Guidelines*, Section XIII.

[39] *Interagency Guidelines*, Section XIII.

concludes that the disputed evaluations used an alternative valuation method that satisfied the standard set forth in the *Interagency Guidelines*.

The Committee also has considered the specific criticisms of each disputed evaluation, many of which concern whether particular properties were comparable. The determination of whether particular properties are comparable inherently relies on judgment, experience, and knowledge of local market conditions. The Committee has reviewed the evidence and analysis presented with respect to the disputed evaluations relating to [Y] and [Z], and concludes that the Bank has established that these evaluations were sufficiently detailed and the assumptions and conclusions sufficiently reasonable to satisfy the standards set forth in the *Interagency Guidelines*.

4. Apparent Violation of Part 323 ([A] Appraisal)

The Bank's Position

The Bank argues that the [A] appraisal satisfied USPAP standards and did not violate Part 323. Specifically, the Bank asserts that the appraisal report discussed competing lots and their effect on the development's absorption rate. The Bank further asserts that the appraisal report adequately discussed and supported the appreciation rate, discount rate, and estimated return on investment used in the analysis. The Bank emphasizes that it obtained two peer reviews of the [A] appraisal, and neither review concluded that the appraisal violated USPAP requirements.

RMS's Position

RMS argues that the [A] appraisal failed to comply with USPAP requirements, in violation of Part 323. Specifically, USPAP Rule 1-1(a) provides that in developing a real property appraisal, an appraiser must "be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal." In addition, USPAP Rule 1-1(b) provides that an appraiser must not "commit a substantial error of omission or commission that significantly affects an appraisal."[40]

RMS argues that the [A] appraisal failed to adequately determine an absorption rate for [Development 1] based on the supply of competing lots and failed to sufficiently discount the lots for the assumed bulk sale. RMS further asserts that the appraisal report failed to adequately support the appreciation rate, discount rate, and estimated return on investment used in the analysis.

The Committee's Findings

The appraisal report addressed the inventory of lots in the relevant submarket as of December 31, 2014, as well as sales from 2012 and 2014. It also considered [Development 1]'s unsold lots and 97 lots in a nearby subdivision that were not listed for sale, but could be expected to be listed during the absorption period.[41] The absorption rate analysis did not include any other potential

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[40] *Uniform Standards of Professional Appraisal Practice*, 2014-15 ed., at U-16.

[41] Exhibit AI to the Bank's appeal, pp. 62-63.

competing lots, though it is unclear whether this was an error.[42] The review of the appraisal performed by [B] raised no issues with the absorption period analysis.[43]

The appraisal report addressed the discounting of lots for a bulk sale, noting that the primary challenge in valuing the property was the lack of recent transactions with a similar scale.[44] However, the report suggests that this concern is offset by the larger size of [Development 1]'s lots. The review of the appraisal performed by [B] also specifically discussed the bulk discount analysis and raised no issues with it.

The appraisal report based the assumed 3% appreciation rate on the annual 2.5% appreciation that was observed in the relevant submarket between 2012 and 2014, as well as the three-year running average inflation rate of 1.33%.[45] While the report also indicates that "property values have generally stabilized," this is not inconsistent with a slight rate of appreciation, particularly in light of the volatility experienced during the previous few years.

With respect to the estimated return on investment, the appraisal report notes that "an anticipated profit of [8%] of the gross retail sell-out is reasonable and supportable for the subject's proposed scope of development and limited exposure during the sell-out,"[46] implying that a lower return was reasonable because construction of the development was already completed. The [B] review of the appraisal also took no issue with the estimated rate of return. While the appraisal report's calculations may have employed a 7% rate of return instead of the 8% discussed in the narrative, it is not clear that such an error was substantial enough to warrant the resulting adjustment to the collateral's value.[47]

The Committee concludes that the Bank has presented evidence sufficient to establish that the [A] appraisal satisfied USPAP requirements and was not in violation of Part 323.

5. Required Specific Allocations to the ALLL

The Bank's Position

The Bank argues that examiners had no valid basis for questioning the valuation of collateral for the [Y] and [Z] loan relationships, and acted arbitrarily by substituting their judgment in place of the evaluators' analyses. The Bank asserts that examiners failed to show a reasonable amount of

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[42] The Bank presents a written response from [A] explaining that * * * represented the only relevant proposed inventory, while RMS points to the review of the appraisal performed by appraiser [C] stating that the absorption period analysis required more detail. *See* Exhibits AP and AQ to the Bank's appeal. However, these documents must be excluded from the Committee's review under Section M of the *Guidelines for Appeals of Material Supervisory Determinations*, as they were produced after the * * *, 2015 determination.

[43] Exhibit AO to the Bank's appeal.

[44] Exhibit AI to the Bank's appeal, p. 90.

[45] Exhibit AI to the Bank's appeal, pp. 62, 87.

[46] Exhibit AI to the Bank's appeal, p. 88.

[47] *See* Exhibit AI to the Bank's appeal, p. 89 (cash flow model assuming 7% return on investment).

deference, as required by the FDIC's *Policy Statement on Prudent Commercial Real Estate Loan Workouts* ("*Policy Statement*").[48]

RMS's Position

RMS argues that the *Policy Statement* recognizes that examiners may need to adjust the estimated value of collateral for credit analysis purposes where they can establish that the underlying facts or assumptions are inappropriate or can support alternative assumptions. Examiners only adjusted valuations after noting numerous concerns with the disputed evaluations.

The Committee's Findings

The *Policy Statement* provides that where an evaluation's assumptions are reasonable and well-supported, examiners should show "a reasonable amount of deference" when reviewing the evaluation. As explained above, the Committee concludes that the Bank has established that the disputed evaluations were sufficiently detailed and the assumptions and conclusions sufficiently reasonable to satisfy the standards set forth in the *Interagency Guidelines*. Because the cited deficiencies in the disputed evaluations did not warrant the adjustments that occurred, the required specific allocations to the ALLL based on those adjustments should be revisited.

IV. Conclusion

For the reasons set forth above, the Committee reverses the determination of the Director of the Division of Risk Management Supervision that the purchase of the Building in connection with the [X] loan was speculative. Absent the determination by the State that the purchase was a violation of state law, it appears that it would have been a permissible exercise of the Bank's DPC authority. The Committee also reverses the Division Director's determinations with respect to the apparent contraventions of the *Interagency Guidelines*, the apparent violation of Part 323, and the required specific allocations to the ALLL in connection with the [Y] and [Z] loan relationships.

The Committee notes that the Report includes determinations concerning the Bank's appraisal and evaluation program and numerous loan relationships that are not discussed in this decision. Those determinations are not being disputed by the Bank. The Committee makes no findings with respect to those determinations, and emphasizes that this decision is limited to the specific determinations contested by the Bank concerning the [X], [Y], and [Z] loan relationships. The Committee further emphasizes the continued importance of underwriting discipline and prudent risk management practices that identify, measure, monitor, and manage the risks involved in commercial real estate lending.[49]

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[48] FIL-61-2009 (Oct. 30, 2009).

[49] *See* FIL-62-2015, Statement on Prudent Risk Management for Commercial Real Estate Lending (Dec. 18, 2015); *see also* Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74,580 (Dec. 12, 2006).

For the foregoing reasons, the Bank's appeal is granted as set forth in this opinion.

This decision is considered a final supervisory decision by the FDIC.

By direction of the Supervision Appeals Review Committee of the FDIC, dated June 9th 2016.