Client Alert

April 2020

Appraisals during COVID-19

In light of COVID-19, financial institutions have had difficulties obtaining appraisals for additional extensions of credit or changes to existing note terms. In order to prevent the spread of COVID-19, federal, state and municipal governments have established significant restrictions on the conduct of non-essential businesses, in which case borrowers may not be allowed to operate pursuant to these governmental orders, including allowing interior appraisals. Despite the practical difficulties of obtaining appraisals, prior interagency guidance of the federal bank regulators encouraged institutions to work with borrowers suffering as a result of COVID-19.

Interim Final Rule on Real Estate Appraisals

On April 14, 2020, federal banking regulators issued an immediately-effective interim final rule ("interim appraisal rule") allowing financial institutions to defer requirements to obtain an appraisal or evaluation for up to 120 days following the closing of certain real estate transactions, excluding transactions for acquisition, development and construction of real estate ("ADC"). The deferral applies to both residential and commercial real estate related financial transactions that are not otherwise ADC. The temporary deferral sunsets on December 31, 2020 (unless extended by the agencies), but will apply to any non-ADC loans otherwise requiring appraisals or evaluations that close on or before December 31, 2020. The rule provides only for a deferral of appraisal and evaluation requirements because a waiver would require legislative action.

2010 Interagency Guidelines

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") required the federal banking agencies to adopt rules requiring that appraisals used in connection with real estate related transactions are performed in writing, in accordance with uniform standards, and by competent individuals whose professional conduct is subject to supervision.

Under the regulations established by each federal banking agency, the 2010 interagency appraisal guidelines ("Guidelines"), and the policies adopted by financial institutions in compliance with the regulations and guidance, appraisals are generally required when loans are secured by real estate collateral. The Guidelines set forth a framework for all transactions involving real estate as collateral, subject to certain exceptions that are not the subject of this alert. For more on the Guidelines and the exceptions, see our prior client alert here.

USPAP and the Current Environment

The federal banking agencies regulations require that appraisals be conducted in compliance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). While interior and exterior inspections are common, USPAP allows an appraiser to determine the characteristics of the property through other means, such as photographs, asset records and recorded media. Appraisers - and lenders relying on

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appraisal services - should remember that USPAP does not require an inspection unless necessary to produce credible assignment results.[1]

When an interior inspection would customarily be part of the scope of work, a health or other emergency condition may require an appraiser to make an extraordinary assumption about the interior of a property. This is permitted by USPAP as long as the appraiser has a reasonable basis for the extraordinary assumption and as long as its use still results in a credible analysis. Neither the Appraisal Standards Board (ASB) nor The Appraisal Foundation has the authority to suspend interior inspections. Appraisers have been encouraged to communicate with their clients and follow public health recommendations such as those issued by the CDC. However, The ASB and The Appraisal Foundation encouraged lenders, regulators, government agencies and Government Sponsored Enterprises (GSEs) to consider suspending or relaxing requirements for interior inspections during this national health emergency, consistent with the interim final rule.

As a result, appraisers are working with clients to identify the assignments that can be completed without interior inspections, in order to protect the safety of all parties. However, there are many cases where interior inspections are deemed necessary by the appraiser, client or both. In those cases, appraisers are continuing to perform internal inspections in situations where safety precautions minimize health concerns. Additionally, appraisers are able to leverage technology that allows the appraiser to complete interior inspections and allow a property contacts to virtually accompany the appraiser, without leaving the safety of their home.

While no economist can claim to perfectly predict the outcome of the COVID-19 business disruption or the future impact on commercial real estate values, appraisers are tasked with knowing the minds of buyers/sellers and presenting opinions that reflect what sale price the real estate would demand on the date of value. Any uncertainty that would be factored into a negotiation between buyer and seller should be reflected in the appraiser’s research, analysis and conclusions. In order to produce a credible and reliable opinion of value in times of economic uncertainty, appraisers must rely on the best - and typically the most recent - market observations available, as well as research on the current sentiment of market participants.

Given the short amount of time that has passed since this start of the COVID-19 business disruption and the subsequent decrease in transaction volume, most market observations that provide evidence of the impact on market value are based on value fundamentals (i.e. rent relief, tenant credit, etc.). Even the observation of properties that have sold in the last month require detailed analysis to determine what can be used as evidence of market value and what adjustments should be considered. Furthermore, not all markets are reacting in a similar fashion. While it is intuitive to assume that the COVID-19 disruption would result in a neutral or negative value impact, there are some markets that have actually experienced value appreciation for certain property types. In sum, in order to provide a reliable opinion of value, it is critical that the appraiser has access to sufficient quantity and quality of market data and is highly knowledgeable about local market specifics.

Effect of 2020 Interim Rule on Appraisals

Institutions extending or modifying credit to borrowers with repayment issues on real estate collateral-dependent loans are generally required to obtain an appraisal reflecting the current value of the collateral in connection with the extension or modification of credit. It is difficult to imagine that credit decisions are safe and sound without a meaningful estimate of the current value of the collateral, particularly in a stressed economic environment – both generally and with respect to the specific borrower. In fact, the interim appraisal rule stated that institutions that defer appraisals are still expected to conduct their lending activity consistent with safety and soundness standards and real estate lending standards focused on the borrower’s ability to repay.

[1] Please refer to USPAP Standards Rule1-2, Standards Rule2-2, and Advisory Opinion2 for further guidance.

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In light of the interim appraisal rule and related interagency statement issued with the rule, financial institutions have three possible avenues for extending or modifying loans secured by real estate collateral:

1. **<u>Determine that the modifications to the loan do not require appraisals.</u>** The appraisal regulations of federal banking agencies provide at least 14 exceptions to appraisal requirements, certain of which were set forth in the interagency statement issued with the interim appraisal rule.[2] Subject to the terms of relevant bank policies (which likely need to be modified in light of the interim appraisal rule), institutions may find exceptions eliminating the need for appraisals on loan modifications, including that there has been no material change in the market conditions of the property that threaten the institution's collateral protection. Institutions may be comfortable with this exception for decreases in interest rates or limited or short-term extensions.

2. **<u>Rely on existing appraisals</u>**. The interagency statement issued with the interim appraisal rule recognizes that institutions may use an existing appraisal or evaluation for subsequent transactions on an existing loan, provided that the underlying appraisal or evaluation remains valid. As with a determination that an appraisal is not required, the institution will have to be comfortable with existing market conditions, which is particularly challenging in markets that heavily impacted by COVID-19. However, the interagency guidance provides that:

    > *The passage of time is a criterion that institutions can consider when determining whether an appraisal remains valid. If the institution determines that the appraisal still reflects market value, the institution may rely on the appraisal based on an acceptable level of risk as evidenced by a loan's LTV ratio and other underwriting criteria.*
    >
    > *The agencies understand that it may be appropriate for institutions to have different criteria for assessing the validity of an appraisal or evaluation for purposes of subsequent transactions during major disasters or other emergencies. The institution's determination of the validity of existing appraisals and evaluations used for subsequent transactions conducted during the COVID-19 emergency will not be subject to examiner criticism if it is consistent with safe and sound practices.*

    Appraisers are questioning previous market evidence to form current opinions of value. Indeed, the current response to COVID-19 means that appraisers are faced with an unprecedented set of circumstances on which to base a judgement. Consequently, a higher degree of caution should be attached to valuations than would normally be the case. Values may change more rapidly and significantly than during standard market conditions. Given the unknown future impact that COVID-19 might have on the real estate market, appraisers are recommending that lenders keep property valuations under frequent review.

3. **<u>Obtain an appraisal within 120 days of the loan date</u>**. As noted in the interim appraisal rule, appraisals or evaluations consistent with safe and sound banking principles must be obtained before the end of the deferral period. Moreover, the interim appraisal rule provides that agencies expect institutions "to use best efforts and available information to develop a well-informed estimate of the collateral value of the subject property." Just as the 2010 Guidelines prescribed that institutions must show their work with respect to appraisals, the interim appraisal rule imposes the same show-your-work requirement even in the absence of an appraisal.

[2] Note that the interagency statement issued with the interim final rule also included information on appraisals for residential property underwritten to Fannie Mae and Freddie Mac standards).

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In addition, and possibly the hardest aspect of the interim appraisal rule, is developing a risk mitigation strategy if the appraisal or evaluation ultimately reveals a market value significantly lower than the expected market value. Many institutions already require borrower guarantees, so identifying additional collateral support that will become effective should there be a lower-than-expected market value may be challenging, particularly when many borrowers are stretched thin. As noted in the interim appraisal rule, an "institution's risk mitigation strategy should consider safety and soundness risk to the institution, balanced with mitigation of financial harm to COVID-19-affected borrowers." Despite the agencies' efforts to alleviate the appraisal burden, institutions are effectively in the same place as they were before the interim appraisal rule.

Regardless of the path chosen, the institution should document each borrower-specific determination as robustly as possible. In addition to documentation in the relevant loan files and loan covenants requiring credit support if subsequent appraisals are lower than expected, institutions should develop interim policies and procedures to estimate collateral value for purposes of extending or refinancing credit (which should apply to any of the three approaches taken by institutions). This may include tiers of action depending on how different the subsequent appraisal is from the assessment of the collateral's market value at the loan or modification is made. Appraisers offer solutions in the current environment to minimize that differential, including desktop and exterior-only appraisals and subscription and market data packages to further develop an understanding of real estate collateral.

Despite the deferral provided in the interim appraisal rule, the preamble to the rule provides that "[r]egulated institutions should make best efforts to obtain a credible valuation of real property collateral before the loan closing, and otherwise underwrite loans consistent with the principles in the agencies' Standards for Safety and Soundness and Real Estate Lending Standards." That directive, along with concerns that regulators will quickly forget their concessions as soon as the immediate crisis passes and the difficulty mitigating risk if the deferred appraisal comes back lower than expected, may temper the practical use of deferrals by financial institutions. In situations where a temporary deferral is relied upon, institutions should carefully document the assessment of collateral value at the time of the loan or refinancing, together with management and board monitoring of any interim credit policies and related exceptions.

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