

Are Appraisers Killing the Banking Industry?

As if the economy and the tight credit markets were not enough, real estate developers are faced with a new challenge. Banks are informing real estate developers at loan maturity that their cash flowing, debt servicing property is now considered substandard in the bank's view because of the value of the bank's collateral produced by the bank's latest appraisal. The opportunity to renew the developer's loan is predicated upon new pricing and a substantial equity contribution to pay down the existing loan balance to a "conforming" loan to value. For many developers this is a double lobotomy. Spoiled by historical pricing, the developer's shock is often followed by anger. The developer may have a stabilized project that meets debt service coverage ratios under the "old" deal. Now in order to keep the asset, not only is their cash flow negatively impacted by increased pricing but they must fund additional capital to meet the required paydown to a conforming loan to value.

In many cases, the developer's capital is already stressed and insufficient to make loan paydowns over their whole portfolio. In my opinion, the banks are too quickly trying to increase their spreads to restore profitability and increase their tier one capital base. The problems in the financial markets didn't happen overnight and neither can the speed of the solutions. The developers most hurt are those who bank at regional banks with poor capital bases, that need to show increased yields (pricing) to justify more capital. These poorly capitalized banks have seen their cost of funds rise and they are caught with the higher costs they have to pay for liquidity to make loans. Some of the banks that cannot attract adequate capital use the "new" appraisal to force paydowns on outstanding loans, thereby recovering capital.

However in terms of liquidity, the most onerous of terms is the required paydown to make a loan "performing" and not the increased pricing. This is where the appraiser is integral to whether the borrower and lending officer are at war or peace with each other.

The premise of every appraisal is "market value". Valuation experts use "fair market value" as the standard of value but there really isn't any difference. The Federal Reserve as promulgated by Financial Institution Reform Recovery and Enforcement Act ("FIRREA") defines the following presumptions for market value.

1. Most probable price
2. Competitive and open market under all conditions
3. Buyer and seller acting prudently and knowledgably
4. Assumes price not affected by undue stimulus

I would suggest almost every appraisal violates at least items two and four. There is almost no market for real estate today. There are far more trades on the debt underlying the real estate than the real estate itself. Most appraisals only consider the conditions today, which by any standard reflect the most depressing times in our nation's history

considering unemployment and foreclosures. Does anybody believe that the prices derived by appraisers from the market are not impacted by undue stimulus? Bank failures, government bailouts of corporations and a stimulus package for housing and autos are not business as usual.

Market transactions are difficult to find. Most are depressed under some undue influence of a stressed sale. Many of the ones found are not reflective of both ingredients of a fair market sale, a willing buyer and willing seller. Typically the seller is faced with the undue stimulus of, eminent foreclosure, personal bankruptcy or guarantor lawsuit. If anyone doesn't believe these are undue stimuli, they must also accept the premise that the poor blindfolded prisoner at sword point who is told to walk the plank and jump into shark infested waters does so because he seeks a leisurely swim or exercise.

The conclusion of value provided by the appraiser prohibits banks from entering into reasonable renewals or restructures and causes undue pressure on the real estate industry and the viability of financial institutions by negatively impacting their capital.

As a firm we currently manage home building activity in twenty residential subdivisions. There have been a number of instances where we have sold a house to a customer who has plunked down a 20% deposit. The house gets appraised at 65-80% of the sale price and the buyer is told he does not qualify for a mortgage because, according to the appraisal, he overpaid. Consequently, no sale is consummated and the house sits with property taxes, utilities and management fees accruing to the bank. This process results in the house continuing to be a liability to the bank for expenses and not an income producing mortgage and cash event for the bank. While this already sounds ludicrous, it gets better. We have a willing buyer. A buyer who can choose from the sea of foreclosed homes, builder closeouts, for sale by owners, all of whom are desperate for a transaction. The willing buyer shops around and makes the best deal he can. He is willing to plunk his hard earned money for 20% of the negotiated price of his "dream" house. The willing seller agrees to the sale price. Thirty days later during the mortgage process, the buyer learns he does not qualify for a mortgage because his down payment is insufficient as a result of the house appraising for substantially less than he was willing to pay for it. The appraiser, not a party to the transaction, has determined the fate of both the buyer and seller. For the bank this is catastrophic for at least two reasons. The obvious one is, there is no sale. The bank can not convert its negative cash flow asset to an income producing one. Secondly, and maybe not so obvious, the bank misses a great opportunity to establish the market price in the subdivision. Usually the bank has other properties in the subdivision to sell and this is a great chance to evidence a "true" market transaction instead of being compared to foreclosures and other forced sale transactions. To me the choice for the bank should be obvious. Make the sale, establish the market and inventory the mortgage. If the banks allow the appraisers to dictate arbitrary "market" value then they deserve the resulting impairments to their capital.

The last example I wish to elaborate on involves a large medical office building. Twelve months ago while the property was under construction and being tenanted, the property appraised for \$53 million. The project is now complete, fully tenanted and achieving

above proforma rents. The property was recently appraised at \$40 million requiring the developer to pay down the loan to a conforming LTV and increased pricing. Does anyone really believe the property lost \$13 million under these circumstances? While cap rates may have changed so has the apparent risk in project completion and vacancy. These factors have not adequately been assessed in the cap rate. In my opinion with 10 year leases in place and a long-term horizon for holding, the cash flow is predictable and over a long stabilized period. The value in this asset can't possibly be depressed under these circumstances, yet, this is the new environment the developer and bank must play in. With the tsunami of maturing CMBS loans in the horizon, these dynamics do not bode well for either developers or commercial banks.

So what is the solution? The government could suspend mark to market rules putting less pressure on developers in a down economy and quit forcing financial institutions to take paper losses that erode their capital base. When money is flowing and times are good nobody worries about the short term nature of debt maturities on a long term asset. The current state of regulation is forcing transactions on the market with no liquidity. This is a perfect storm for depressed pricing and capital erosion. There is a precedent for a solution to this dilemma. The Federal Government did suspend write downs of loans originated by banks to underdeveloped countries who couldn't pay back the loans. Rather than eroding the originating banks' capital immediately, they allowed the banks to amortize these potential loan losses over a period of time. This patience allowed banks to earn profits to restore their capital bases and absorb the losses. A similar type of accounting is also used in valuing pension plans to determine whether they are properly funded. Nobody forces a major corporation to fund an exorbitant amount when the stock market crashes or doesn't hit the actuarial rate of return for their employee pension plan. The accounting term is "smoothing" which recognizes the long term nature of both required funding and ultimate payout of the fund assets to retirees and allows the ups and downs to be averaged over a short period (3years). Such action allows companies to provide pensions without the roller coaster ride of returns in equity markets. The appraisals today are closer to forced liquidation values since nobody who could afford to hold an asset would sell in the current state of the market. Forced liquidation sales are not market sales. Trying to force banks and developers to change their historic relationships with short-term fixes on long-term assets will continue to depress real estate values, decimate developers and erode bank capital; a poor result in any time.