



Building Success. Together.

Commercial Real Estate Valuation Management

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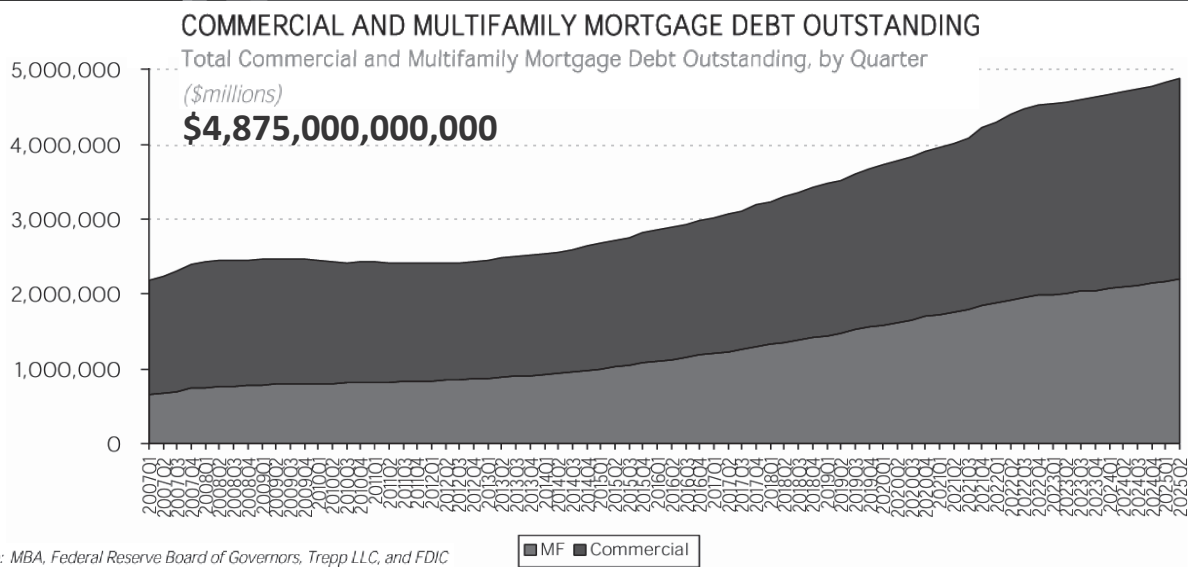
Agenda

- CRE Exposure
- Valuation-Related Issues
- Case Study
 - 294 Lots
 - Actual vs Projection
 - CRE Construction and Development (C&D) Loan
- Resources
- Q&As

CRE Exposure

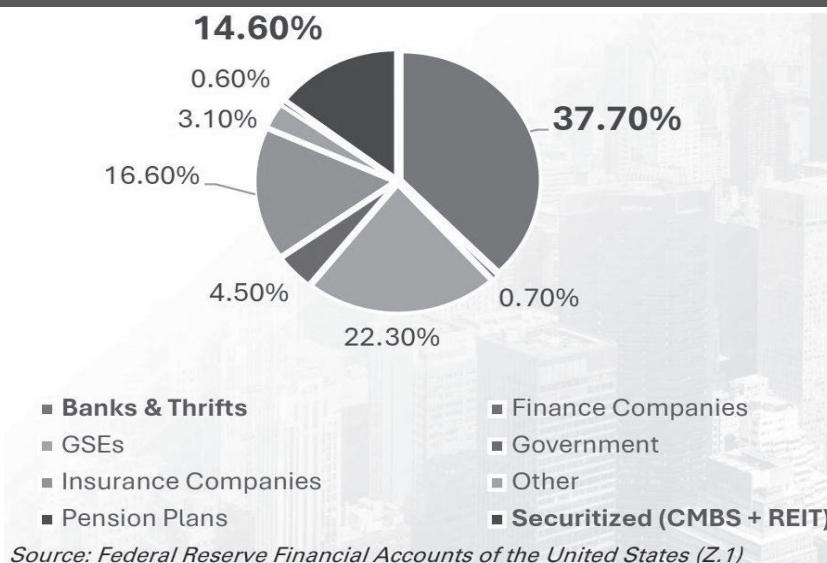
CRE Exposure

CRE Exposure



CRE Exposure

**\$4.875 Trillion
Income-Producing
CRE Debt Universe
2Q 2025**



CRE Exposure

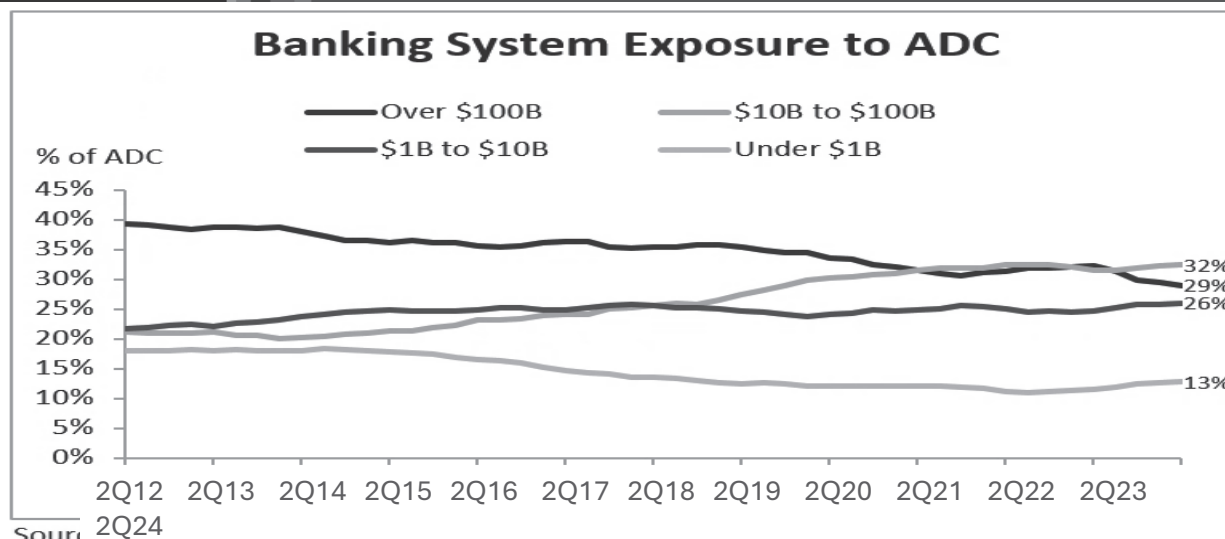
**Commercial
Real Estate &
Multifamily
Mortgage
Debt
Outstanding
by Sector**

	2025 Q2	
	(\$millions)	% of total
Bank and Thrift	1,830,030	37.5%
Agency and GSE portfolios and MBS	1,080,481	22.2%
Life insurance companies	769,485	15.8%
CMBS, CDO and other ABS issues	642,846	13.2%
Nonfinancial corporate business	115,787	2.4%
State and local government	112,163	2.3%
Federal government	101,747	2.1%
REITs	87,896	1.8%
Nonfarm noncorporate business	35,176	0.7%
Finance companies	33,601	0.7%
Other insurance companies	33,030	0.7%
Private pension funds	28,246	0.6%
State and local government retirement funds	3,162	0.1%
Household sector	1,551	0.0%
TOTAL	4,875,201	

**Of all CRE and Multifamily
Mortgage Debt, Banks/Thrifts
hold about 50.7%**

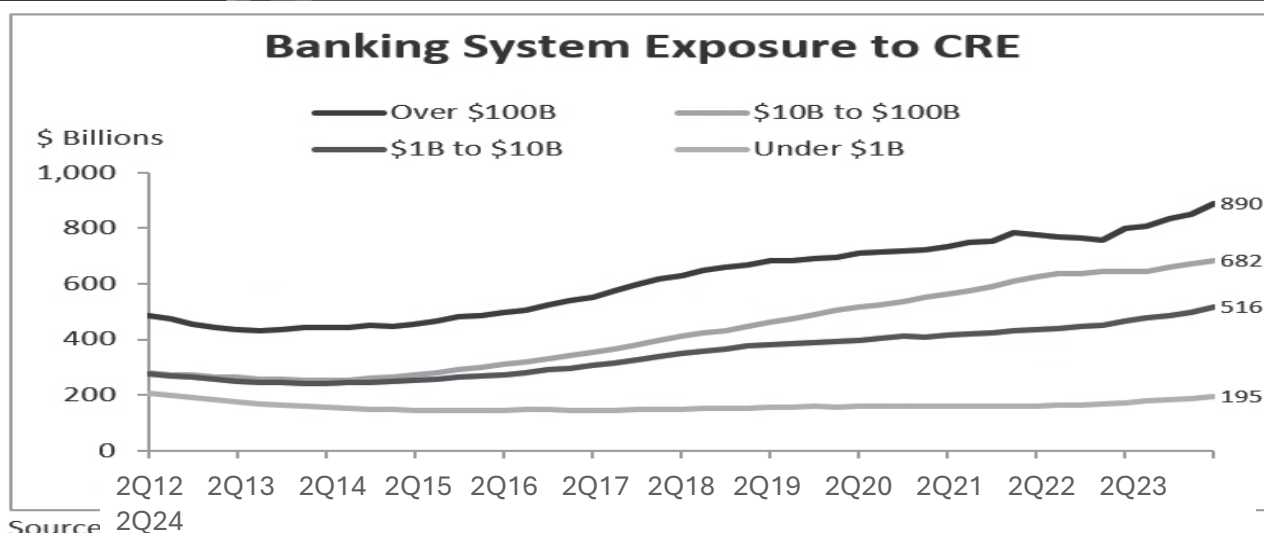
Source: Mortgage Bankers Association, Federal Reserve Board of Governors, Trepp, LLC, and FDIC.

CRE Exposure



Note: IDIs grouped by last reported asset size.

CRE Exposure



Note: IDIs grouped by last reported asset size. CRE excludes owner-occupied.

CRE Exposure

- Overall Bank Exposure to CRE

Smaller Banks Have Higher CRE Exposure

Share of Commercial Loans in Total Loans Held in Portfolio, 2024E

■ Commercial Loans ■ Gross Loans

Banks with \$0-10B in Total Assets

Commercial
Loans: 48.6%

Banks with \$10-\$100B in Total Assets

42.4%

Bank with Total Assets Above \$100B

13.2%

[U.S. Banks and Commercial
Real Estate Loans | S&P Global](#)

Source: Visible Alpha consensus (August 01, 2024)



CRE Exposure

- Small Bank Exposure to CRE

Small Regional U.S. Banks (<\$10 billion asset group) in CRE Spotlight

Bank	Total Assets, 2024E	CRE/CET1 Ratio, 2024E	YoY Growth (pps)
HomeStreet, Inc.	\$8,995 M	910	1%
Orrstown Financial Services, Inc.	\$5,505 M	550	12%
Civista Bancshares, Inc.	\$4,057 M	522	-2.0%
Hanmi Financial Corp	\$7,745 M	521	1%
Peoples Bancorp Inc.	\$9,366 M	520	-20%
TriCo Bancshares	\$9,771 M	458	-4%
MidWestOne Financial Group Inc	\$6,596 M	458	5%
QCR Holdings Inc	\$8,964 M	453	-11%
Premier Financial Corp	\$8,858 M	444	0%
Equity Bancshares, Inc.	\$5,358 M	435	-1%

Source: Visible Alpha consensus (August 01, 2024)

[U.S. Banks and Commercial
Real Estate Loans | S&P Global](#)



CRE Exposure

- Mid-Sized Bank Exposure to CRE

Mid-sized U.S. Banks (\$10 to \$100 billion asset group) in CRE Spotlight

Bank	Total Assets, 2024E	CRE/CET1 Ratio, 2024E	YoY Growth (pps)
Dime Community Bancshares, Inc.	\$13,850 M	925	14%
Independent Bank Group Inc	\$18,565 M	700	-2%
RENASANT CORP	\$17,803 M	656	-6%
VALLEY NATIONAL BANCORP	\$62,696 M	625	-10%
Provident Financial Services, Inc.	\$24,520 M	603	20%
Sandy Spring Bancorp, Inc.	\$14,212 M	591	-2%
OceanFirst Financial Corp.	\$13,420 M	553	-4%
First Foundation Inc.	\$13,771 M	547	-30%
Columbia Banking System, Inc.	\$52,430 M	488	-3%
Banner Corporation	\$15,996 M	461	-4%

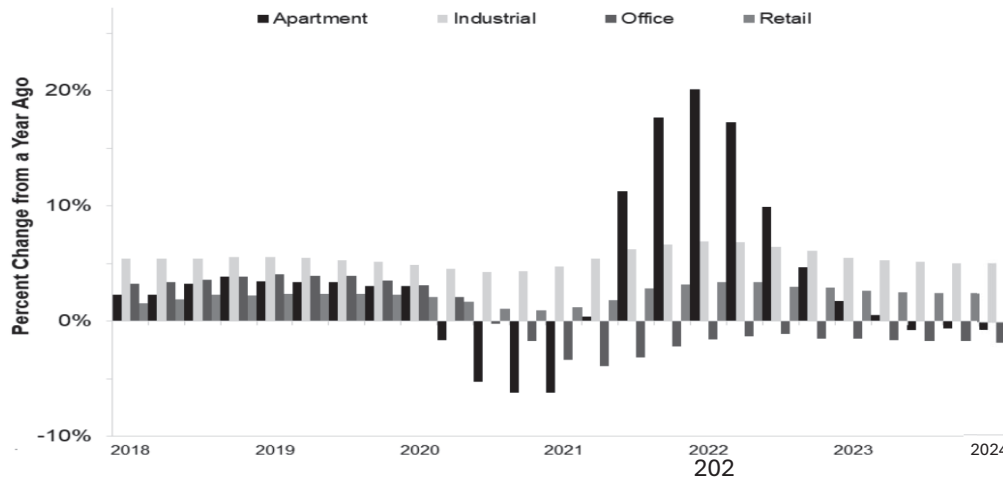
Source: Visible Alpha consensus (August 01, 2024)

[U.S. Banks and Commercial Real Estate Loans](#) | [S&P Global](#)

CRE Exposure

- CRE NOI Growth Is Erratic

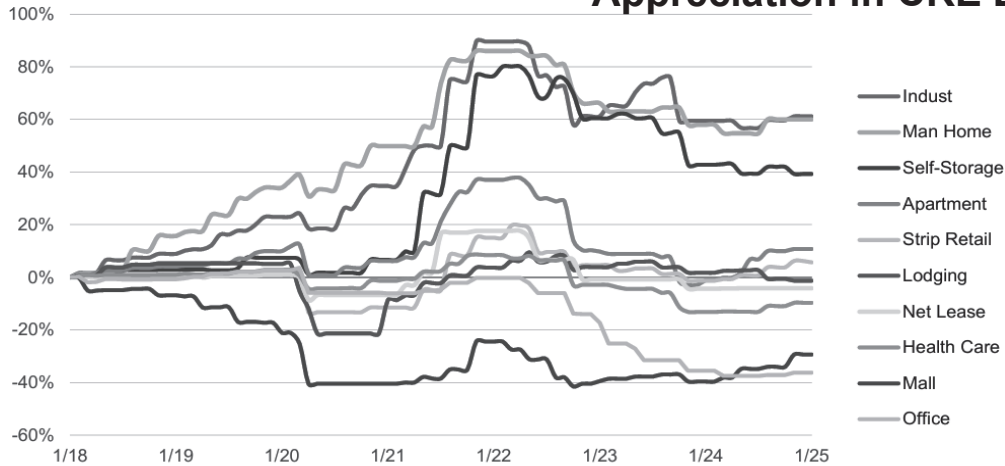
Growth in Net Operating Income for CRE Properties



Source: CBRE Group. NOTE: Data are from the first quarter of 2018 to the fourth quarter of 2024.

CRE Exposure

Cumulative Change in CPPI®: Past Seven Years



From March 2022 Peak

All Property: retail (20%), apartment (15%), health care (15%), industrial (12.5%), office (12.5%), lodging (7.5%), data center (5%), net lease (5%), self-storage (5%), manufactured home park (2.5%). Retail is mall (50%) & strip retail (50%).

Core Sector: apartment (25%), industrial (25%), office (25%), and retail (25%)

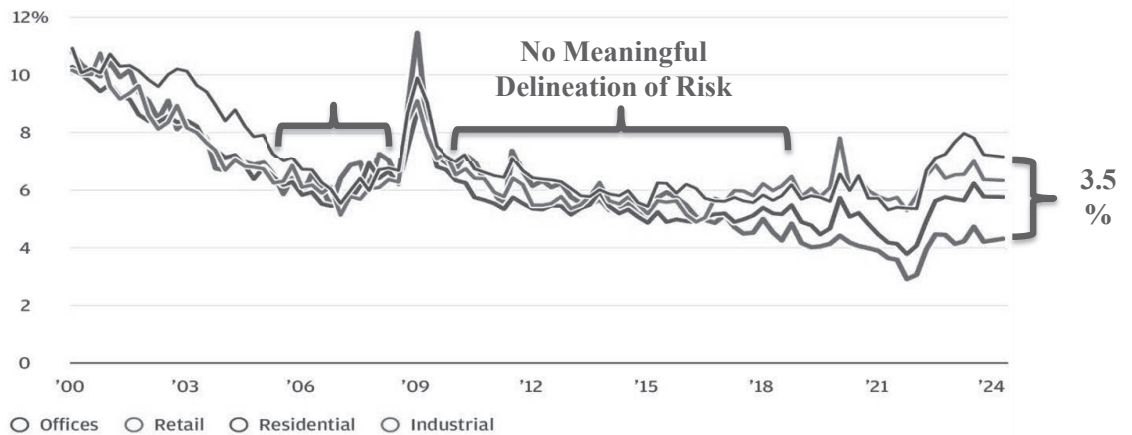
Health Care: medical office (30%), senior housing operating properties (25%), senior housing net leased (20%), skilled nursing (15%), and life science (10%)

Source: My GreenStreet.com. CPPI® is Commercial Property Price Index.

Microsoft Word - CPPI press release 20250206

CRE Exposure

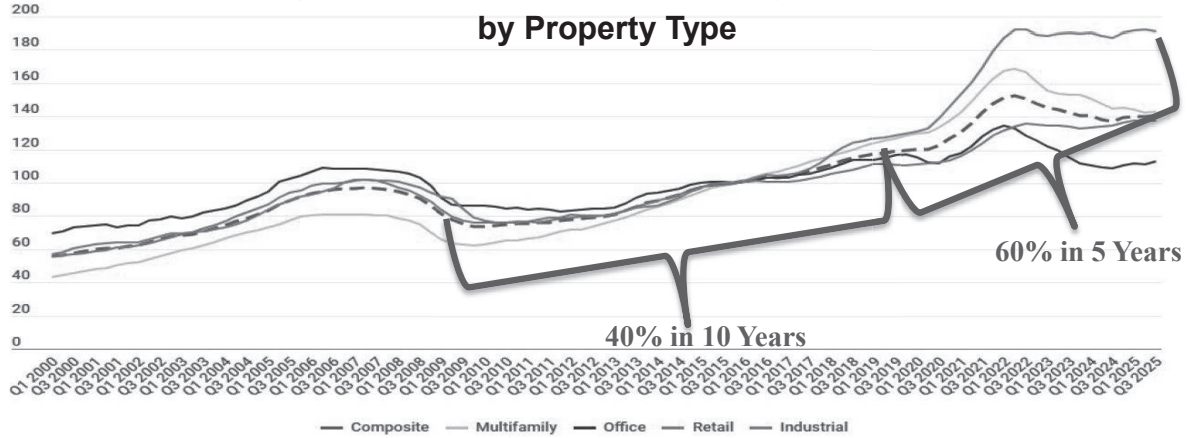
• CRE Cap Rates – No Meaningful Delineation of Risk



Sources: Bloomberg Finance L.P., Finance L.P., NAREIT. Data as of June 30, 2024.

CRE Exposure

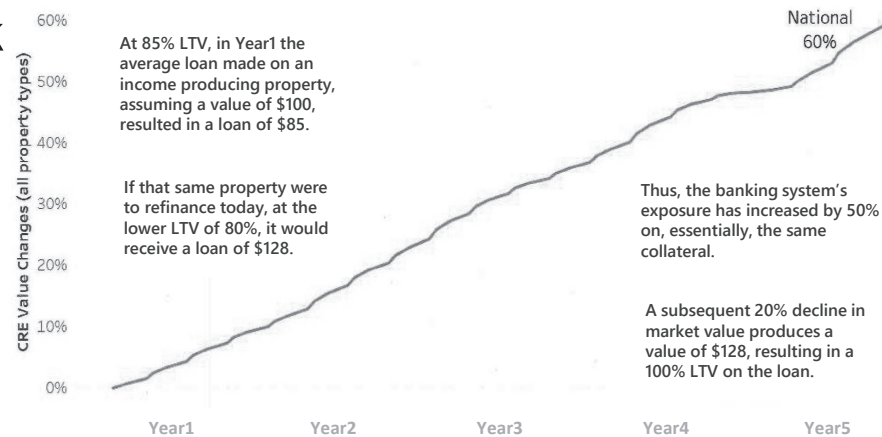
- **Low Cap Rates Plus Excess Cash Led to Appreciation**
Value Weighted Composite Trepp Property Price Index (TPPI)



Source: Trepp Talk <https://www.trepp.com/trepp-talk/office-leads-the-pack-in-commercial-real-estates-emerging-price-recovery-tpi-q3-2025>

CRE Exposure

- **Does a Lower Loan-to-Value (LTV) Mean Lower Risk**



Source: Moodys / Real Capital Analytics Commercial Property Price Index

CRE Exposure

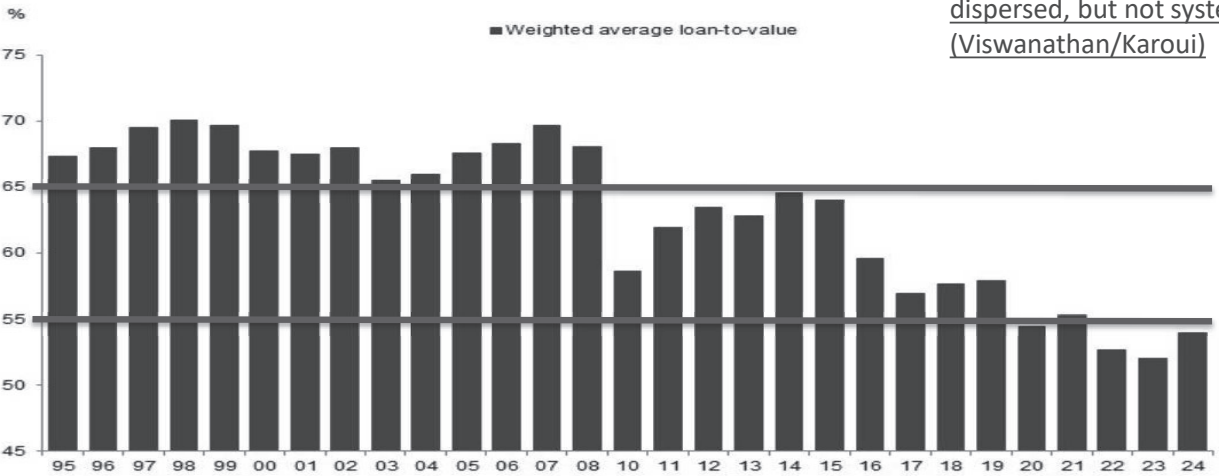
Loan-to-Value (LTV) Thresholds: Loan Terms and Risk Considerations

LTV Threshold	Loan Term Impact	Risk Considerations
65%	Favorable interest rates and terms	Lowest risk; strong equity position
70%	Competitive loan terms	Moderate risk; balanced financing
75%	Potential for negotiation on rates	Higher risk; may require additional collateral or guarantees
80%	Less favorable terms; higher interest premiums	Highest risk; may trigger added costs such as mortgage insurance

Note: These thresholds are examples and actual terms may vary by lender and market conditions.


[LoopNet® Loan to Value in Commercial Real Estate: Calculation, Analysis, and Strategic Financing Insights](#)

CRE Exposure



US CRE, one year later: Volatile, dispersed, but not systemic
(Viswanathan/Karoui)

Source: Trepp, Goldman Sachs Goldman Investment Research

Valuation-Related Issues

Valuation-Related Issues

Valuation-Related Issues

- Engagement Letters
 - Review for potential inappropriate instructions or limitations:
 - Exclude sales involving a foreclosure, a short sale, or real property covered by a Commercial Service Level Agreement (SLA).
 - Reduce the marketing period to 12 months.
 - Exclude holding costs, marketing costs and entrepreneurial profit or developer's profit.
 - Apply a nominal capitalization or discount rate.
 - Use artificial intelligence (AI) without understanding output.

Valuation-Related Issues

- Adjustments to Comparable Sales
 - USPAP requires appraisers to:
 - Collect, verify, and analyze all information necessary for credible assignment results.
 - Analyze available comparable sale data if using a sales comparison approach.
 - 2011 USPAP Q&A states it is misleading not to use distressed sales as part of the basis for a value conclusion when there is a glut of such sales and the properties are truly comparable to the subject.

Valuation-Related Issues

- Adjustments to Comparable Sales
 - Inconsistencies in quantitative adjustments:
 - Development over the near term is unlikely – Develop project with two-year absorption period.
 - Comparable sales used not truly comparable – Check percentage of “Adjusted Sale Price of Comparables.”
 - Use comparable sales from different market, but no adjustments for distance or market conditions.
- Supporting Information
 - Incorrect square footage or room count

Valuation-Related Issues

- **Unsupported Discounts**
 - Develop investors' premium (discount) based on bank's actual loss experience for different types of real property.
 - Use historical lower discount rates rather than higher more recent discount rates
- **Deductions and Discounts**
 - Used 12-month absorption period – exposure period of 2-3 years.
 - Omitted entrepreneurial profit or maintenance expense and capital expenditures.

Valuation-Related Issues

- **Adjustments Not Supported**
- **Common Regulatory/USPAP Deficiencies:**
 - No “as is” value.
 - Comparable sales not truly comparable.
 - Errors in square footage or in formulas.
 - Static increase in income or expenses not appropriate, *i.e.*, 2.5% increase in insurance premium.
 - Discount rate not reflective of investor risk.
 - Highest and best use inconsistent with economic conditions.
 - Discount “haircut” not supported.

Valuation-Related Issues

- Validation of Existing Appraisals
 - Stable or appreciating markets.
 - Depreciating markets, depending on the degree of unfavorable changes in market condition or property condition.
 - Inventory of competing properties (MLS Data/Building Permits).
- Evaluations for Subsequent and Low Risk Transactions
- Periodic Collateral Monitoring (Annual Review/Delinquent)
 - Specify when to get new/updated valuations.
 - Decide what type of valuation method to use.
 - Broker Price Opinions (BPOs)
 - Market and Property Condition Reports

Valuation-Related Issues

- Part 365 – Real Estate Lending Standards
 - Permits inclusion of other acceptable collateral, but must have:
 - Perfected Security Interest,
 - Quantifiable Value, and
 - Discounted according to lender's usual practices for making loans secured by such collateral.

Valuation-Related Issues

- Supervisory LTV limit is 85% for improved real property.
- Example of Other Acceptable Collateral:
 - \$10 million AV for a “going concern” business as follows:
 - \$9.0 million for real estate,
 - \$0.6 million for PPE or FF&E, and
 - \$0.4 million for goodwill, BEV, or franchise value.
 - \$8.5 million loan amount.
 - **Does this transaction result in a LTV exception?**

Valuation-Related Issues

- Loan-to-Value (LTV)
 - Part 365 – Other Acceptable Collateral
 - \$10 million AV for a “going concern”
 - \$7.65 million for real estate (\$9 million at 85%)
 - \$0.36 million for PPE or FF&E (\$600M at 60%)
 - \$0.04 million for intangible assets (\$400M at 10%)
 - \$8.05 million loan amount
 - \$8.5 million loan results in an LTV exception

Case Study

Case Study – Lots

Case Study – 294 Lots

Market Sales History

For the years 1 through 3, the sub-market sold 362 single family residential lots in the \$25,000 to \$60,000 range averaging 120.7 lot sales/year. The average lot sale during this 3-year period was \$42,230. While the average lot size was not readily available, it is known that most of these home sales were on 0.25 acre to 0.50 acre lots. The average sales price rose 4.95% over 2 years or 2.5±% annual appreciation. The average Days on the Market increased from 242 days in 2012 to 249 days in year 3. The average lot price decreased 1.34% from years 1 through 3.

MARKET DEPRECIATION/APPRECIATION

Inflation has a 1.33% three running average. The subject's competitive has supported a 2.5% annual appreciation from years 1 through 3. As such a 3% annual appreciation is supported across the 60-month projected sell-out. Total gross retail sell-out over the 5-Year sell out projection without appreciation is estimated at \$13,189,500.

Case Study – 294 Lots

MARKETING PHASE EXPENSES

Marketing Phase [Post-Development] expenses associated with the inventory sell-out are divided into four categories: Selling Costs, Administrative Expenses, Operating Expenses and Return on Investment. Respective marketing expenses are itemized as follows:

Selling Costs for the existing 294-lot inventory are estimated at \$769,246 or 5.8% of the gross retail sell-out. The cost to operate a sales office and sales commissions are estimated at 4.0% or \$527,580. State documentary stamps are estimated at \$92,327; title insurance is estimated at promulgated rates or \$75,840; and closing and recording fees are estimated at \$250/lot or \$73,500.

Administrative and Overhead Costs for existing 294-lot inventory are estimated at \$144,484 or 1.10% of the gross retail sell-out. The developer's overhead is estimated at \$60,000 or \$1,000/month to maintain an office during the 60-month sell-out. The developer's pro-rata ad valorem taxes are estimated at \$84,484 or 0.6% of gross retail sell-out based its actual 2014 assessments.

Operating Expenses for the existing 294-lot inventory are estimated at \$72,900 or 0.60% of the gross retail sell-out. This includes the developer's contribution of the average \$100/Lot Annual homeowner's association fees.

Case Study – 294 Lots

Return on Investment for the 294-lot development is projected at estimated at \$288,000 or 8.00% of the gross retail sell-out. It includes expenses associated with the entrepreneur [developer]. Entrepreneurial Profit is the anticipated profit to be achieved through a successful completion or sell-out of the development. This is the profit incentive that rewards the developer for its time, management and risks. On the basis of recent subdivision development in competitive markets where returns have been 8.0% to 25% an anticipated profit of 08.00% 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. There is controversy as to whether entrepreneurial profit is earned [deducted] against each dollar or only as a below the line cost after the project sells out. For the purpose of this analysis, I have applied it as a line item expense.

An 8% Return on Investment and an 8.0% Discount Rate is a 16.00% yield on the development and judged as sufficient to attract an equity investor.

Case Study – 294 Lots

A Certificate of Deposit yield is often accepted as the most risk free investment. Prime is currently at 3.25%. Current yields on 5-Year Treasuries are 1.24%, Corporate AAA Bonds are 3.40%, and 5-Year Jumbo Certificates of deposit are 2.40%. This rate is generally considered to be a "safe-rate". Risk rates for real estate even those requiring minimal management are discussed at 50% of the safe rate or 1.20%. Inflation has range from 1.50% in year 0 to a high of 3.0% in year 1 to a current low of 0.80% in year 3. The three year running average is 1.33±%. Taxes, insurance, and custodial services are typically less than 1.0%. A 5.93% unadjusted [inflation] composite rate is indicated. However, the subject is situated in a region (Florida Panhandle) that has experienced a considerable negative adjustment fueled by speculative development, low cost financing, and speculative investors. The area's real estate market suffered as much if not more than most regional markets. The subject as a property type, a subdivision, experienced failures second only to multi-family development as early as year 0. While MLS statistical data support additional residential lots in the subject's market to supply the increasing employment concentrated primarily in the area's industrial sectors, an additional 150% risk rate is factored in to ease the market's perceived caution.

I've selected a 7.50% IRR for the purpose of following analysis. The following pre-tax cash flow model is based upon the aforementioned assumptions and projections:

Case Study – 294 Lots

294-LOT PRE-TAX CASH FLOW MODEL								
PERIOD	1	2	3	4	5	TOTAL		
STARTING INVENTORY	294	231	174	117	60			
LOT SALES PER PERIOD	63	57	57	57	60			
ENDING BALANCE	231	174	117	60	0			
BUILDERS LOT @ \$36,000	\$216,000	\$0	\$0	\$0	\$0		6	
STANDARD LOT @ \$43,500	\$2,262,000	\$2,329,860	\$2,399,756	\$2,471,748	\$2,545,901		261	
PREMIUM LOT @ \$60,000	\$300,000	\$309,000	\$318,270	\$327,818	\$337,653		27	
REVENUE						\$ -		
LOT SALES	\$2,778,000	\$2,638,860	\$2,718,026	\$2,799,567	\$2,883,554	\$13,818,006	100	
AVERAGE LOT SALE	\$44,095	\$46,296	\$47,685	\$49,115	\$48,059	\$47,000		
EXPENSES								0.000
SELLING	\$134,510	\$127,061	\$130,446	\$133,931	\$138,272	\$664,220	0.048	
ADMINISTRATIVE & OVERHEAD	\$42,421	\$35,468	\$28,862	\$22,256	\$15,477	\$144,484	0.010	
OPERATING	\$26,250	\$20,250	\$14,550	\$8,850	\$3,000	\$72,900	0.005	
R.O.I. @ 07%	\$194,460	\$184,720	\$190,262	\$195,970	\$201,849	\$967,260	0.070	
CAPITAL EXPENDITURES	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	0.000	
TOTAL EXPENSES	\$397,641	\$367,499	\$364,120	\$361,007	\$358,598	\$1,848,864	0.134	
TOTAL PERIOD INCOME	\$2,380,359	\$2,271,361	\$2,353,906	\$2,438,560	\$2,524,956	\$11,969,142		
DISCOUNT @ 7.50%	0.93023	0.86533	0.80496	0.74880	0.69656	0.8070212		
PRESENT VALUE OF CASH FLOWS	\$2,214,288	\$1,965,483	\$1,894,803	\$1,825,996	\$1,758,781	\$9,659,351	0.699	
"AS-IS" NET PRESENT VALUE DISCOUNTED TO A SINGLE PURCHASER ~ BULK VALUE						\$9,659,351	\$32,855	
						Discounted Lot Value	\$32,855	

Case Study – 294 Lots

Appraiser DCF for 294 Residential Lots

Period	1	2	3	4	5	Total	%	Comments
Starting Inventory	294	231	174	117	60			
Builders Lots	6					6		
≥0.50 AL Lot Sales Per Period	52	52	52	52	53	261		
≥0.75 AL Lot Sales Per Period	5	5	5	5	5	25		7 lot sales in year 5, not 5 sales
Ending Balance	231	174	117	60	2	292		
Builders Lots at \$36,000	216,000	0	0	0	0	216,000	36,000	
≥0.50 AL Lots at \$43,500	2,262,000	2,329,860	2,399,756	2,471,748	2,545,901	12,009,266	43,500	Added 3% appreciation
≥0.75 AL Lots at \$60,000	300,000	309,000	318,270	327,818	337,653	1,592,741	60,000	Added 3% appreciation
Gross Revenue	2,778,000	2,638,860	2,718,026	2,799,567	2,883,554	13,818,007		
Selling Expenses	133,344	126,665	130,465	134,379	138,411	663,264	4.80%	No appreciation added
Admin and Overhead	27,780	26,389	27,180	27,996	28,836	138,180	1.00%	No appreciation added
Operating	13,890	13,194	13,590	13,998	14,418	69,090	0.50%	No appreciation added
ROI @ 7%	194,460	184,720	190,262	195,970	201,849	967,260	7.00%	No appreciation added
Total Expenses	369,474	350,968	361,497	372,342	383,513	1,837,795		
Net Income	2,408,526	2,287,892	2,356,528	2,427,224	2,500,042	11,980,212		
Discount at 7.5%	93.023%	86.533%	80.496%	74.880%	69.656%	80.70212%		
Present Value of Cash Flows	2,240,483	1,979,781	1,896,911	1,817,506	1,741,429	9,668,285		
					NPV per appraiser	9,659,351	8,934	Diff from rounding of expenses

Case Study – 294 Lots

Corrected DCF for 294 Residential Lots

Period	1	2	3	4	5	Total	%	Comments
Builders Lots at \$36,000	216,000	0	0	0	0	216,000	36,000	No appreciation added
>0.50 AL Lots at \$43,500	2,262,000	2,262,000	2,262,000	2,262,000	2,305,500	11,353,500	43,500	no correlation in inflation
>0.75 AL Lots at \$60,000	300,000	300,000	300,000	300,000	420,000	1,620,000	60,000	and comp sales
Corrected Gross Revenue	2,778,000	2,562,000	2,562,000	2,562,000	2,725,500	13,189,500	-628,507	Difference due to no appreciation and corrected number lot sales
Selling Expenses	161,124	148,596	148,596	148,596	158,079	764,991	5.80%	
Admin and Overhead	30,558	28,182	28,182	28,182	29,981	145,085	1.10%	
Operating	16,668	15,372	15,372	15,372	16,353	79,137	0.60%	
ROI @ 8%	222,240	204,960	204,960	204,960	218,040	1,055,160	8.00%	
Corrected Total Expenses	430,590	397,110	397,110	397,110	422,453	2,044,373		
Corrected Net Income	2,347,410	2,164,890	2,164,890	2,164,890	2,303,048	11,145,128		
Discount at 7.5%	93.023%	86.533%	80.496%	74.880%	69.656%	80.70212%		
PV of Corrected Cash Flows	2,183,631	1,873,344	1,742,650	1,621,070	1,604,211	8,994,354	(664,997)	Difference due to no appreciation and corrected math errors

Case Study – 294 Lots

Per Part 365, supervisory limit on land development is 75%.

Question:

If bank lends 75% on \$9.66 million appraised value (AV), then loan amount equals \$7,245,000. Correcting for mathematical errors (before considering other concerns) equals \$9 million AV, then what does the loan-to-value (LTV) equal?

Case Study – 294 Lots

Question:

If corrected AV is revised from 8% to a 10% discount rate, the adjusted AV is \$8,458,000. Now what does the LTV on the \$7,245,000 loan equal?

Case Study – 264 Lots

- **Exam Treatment:** You are all temporary bank examiners.
 - o Classification _____
 - o Non-Accrual _____
 - o CECL Impairment _____

Case Study

Case Study – Apartment Units

Case Study – Apartments – Actual vs Projected

Income Appr	<u>Projected</u>	<u>Actual</u>
GI	2,047,000	1,109,000
OE	1,079,000	<u>1,669,000</u>
NOI	968,000	-560,000
Cap Rate	8.75%	10% - 14%
Vacancy	12%	17%
Unit Repair	60,000	200,000
Bank Interest	48.1%	
Comp Appre		
Comps	#3 & #4 - REO	#5 - Class A Apt
Adjustments	-15% to +10%	No Basis

Other Loan Facts:

- 1) Delinquent
- 2) On Accrual
- 3) Rated Low Pass
- 4) Allocation is 1%
- 5) Checking Acct has \$11,765
- 6) No Guarantee



Case Study – Apartments – Actual vs Projected

	<u>Projected</u>	<u>Actual</u>
GI	2,047,000	1,109,000
OE	<u>1,079,000</u>	<u>1,637,000</u>
NOI	968,000	-528,000
Cap Rate	<u>8.75%</u>	<u>12.00%</u>
Value	11,062,857	-4,400,000
Interest	<u>48.1%</u>	<u>48.1%</u>
Collateral	5,321,234	0
Loan Amount	<u>3,029,000</u>	<u>3,029,000</u>
Classification	3,029,000	3,029,000
	Substandard	Loss??



Case Study – Apartments – Actual vs Projected

- **Exam Treatment:**

- o Classification _____

- o Non-Accrual _____

- o CECL Impairment _____

Case Study – Apartments – Actual vs Projected

	<u>Projected</u>	<u>Actual</u>	<u>Adjusted</u>	
GI	2,047,000	1,109,000	1,340,954	
OE	1,079,000	1,637,000	1,079,000	
NOI	968,000	-528,000	261,954	
Cap Rate	8.75%	12.00%	8.75%	
Value	11,062,857	-4,400,000	2,993,764	
Interest	48.1%	48.1%	48.1%	
Collateral	5,321,234	0	1,440,000	
Loan Amount	3,029,000	3,029,000	3,029,000	
Classification	3,029,000	3,029,000	1,440,000	Sub
	Substandard	Loss??	1,589,000	Loss

Case Study – Apartments – Actual vs Projected

Market Value = Fair Value	1,440,000
Less: Investors Premium	-216,000
Less: Costs to Sell	<u>-72,000</u>
Adjusted Fair Value - Substandard	1,152,000
Loss	1,877,000

ASC paragraph 820-10-35-54E states Topic 820 “does not prescribe a methodology for making significant adjustments to transactions or quoted prices. . . . Regardless of the valuation technique used, a reporting entity shall include **appropriate risk adjustments, including a *risk premium*** reflecting the amount that market participants would demand as compensation for the uncertainty inherent in the cash flows of an asset or a liability.”

Case Study

Case Study – Partially Complete Construction

Case Study- Partially Complete Construction

- Partially complete CRE project, delayed construction due to permit issues, bad weather, and bad economy.
- \$3 million remaining on \$12.5 million line of credit (LOC) is enough to finish construction, and if completed, then it will have a \$10 million “as complete” AV.
- Loan is current due to interest reserve, now depleted.
- Property will be completed in 4 to 6 months.
- Limited prospects for sales or leases today, but expect market to improve by the time the project is completed.
- Guarantor is strong based on current financial statements, but guarantee limited to 25% of LOC.

Case Study- Partially Complete Construction

- **Workout Terms**
 - Bank to advance \$3 million on LOC to finish construction
 - Guarantor will pay down \$2.5 million, resulting in loan balance of \$10 million with a 100% LTV
 - Restructured loan extended for 2 years on IO basis at 1-month SOFR (3.64%) + 400 basis points (7.64%) with interest due monthly
 - Guarantor will fund interest reserve for 12 months and has capacity to fund it for another 12 months
 - Bank did not report restructured loan as impaired credit for Current Expected Credit Losses (CECL) purposes, kept it on accrual, and graded it as pass.

Case Study- Partially Complete Construction

- **Exam Treatment:**

- o Classification _____

- o Non-Accrual _____

- o CECL Impairment _____

Questions?

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Disclaimer

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Resources

Resources

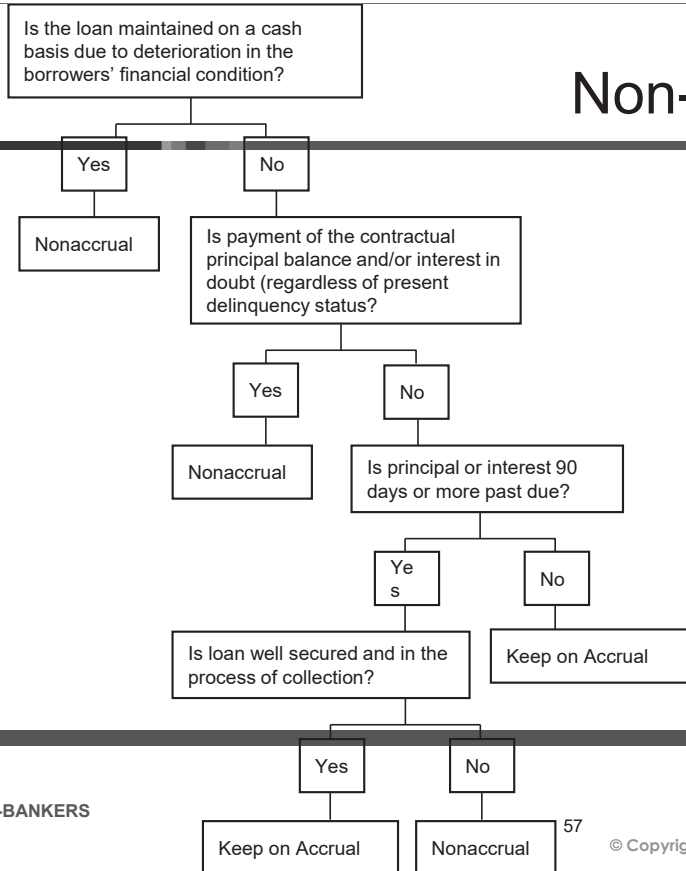
Resources

- Non-Accrual Determination
- High Volatility Commercial Real Estate (HVCRE)

Non-accrual Determination

- When should you put an impaired loan on non-accrual?
 - GAAP does not provide specific guidance
 - Lenders generally should not recognize income unless it is realizable and earned
 - The Instructions for Reports of Condition and Income permit the recording interest on impaired loans only if:
 - there has been a sustained period of consecutive repayment performance and
 - collection under the revised terms is assessed as reasonably assured.

Non-accrual Determination



If there is a concern about collecting principal in full, put the loan on nonaccrual.

Is an impaired loan always required to be on Nonaccrual?

HVCRE

HVCRE is a loan that primarily finances the Acquisition, Development, and Construction (ADC) and secured by real property, excluding a loan for:

- (i) **one-to-four family residential properties** or
- (ii) **commercial real estate projects** where:

- A. LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio in the real estate lending standards of the agencies;
- B. Borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and
- C. Borrower contributed the amount of capital required before the bank advances funds under the credit facility, and the capital contributed by the borrower or internally generated by the project is contractually required to remain in the project throughout the life of the project.

Revised definition of HVCRE* **appropriately identifies exposures that are particularly susceptible to systematic risk.**

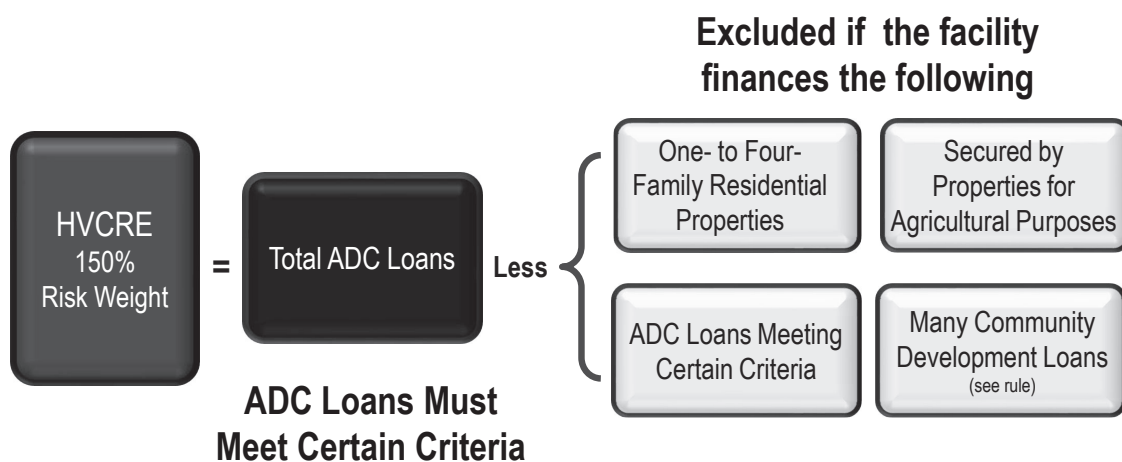
*Interagency regulatory final rule effective April 1, 2020. See at [High Volatility Commercial Real Estate: Final Rule | OCC](#).

HVCRE

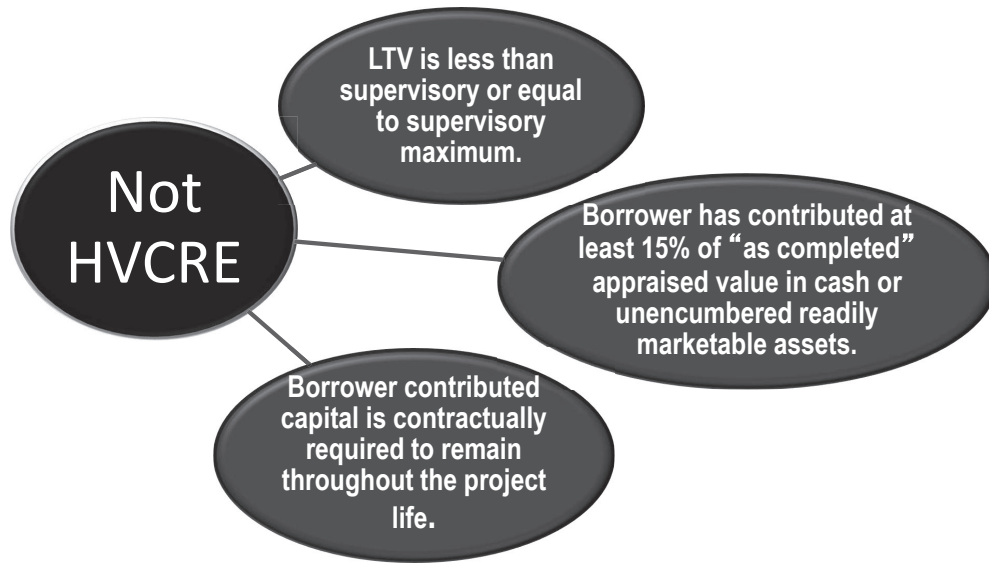
- **HVCRE** - subset of acquisition, development, or construction (ADC) loans and provide short-term financing to developers to purchase and develop commercial properties
 - Risk and performance of an ADC loan is dependent on the initial estimate of the property's valuation upon completion and on the amount of capital contributed by the borrower.
 - HVCRE exposures are assigned a 150% risk weight rather than a 100% risk weight.

HVCRE

What is included in HVCRE?



HVCRE



HVCRE

• 15% Contribution Requirements

- To be exempt from HVCRE designation, a borrower must contribute **15% of the "as completed" market value** (not the "as is" or the "as stabilized" market value) in:
 - Cash or unencumbered marketable assets.
 - Soft costs (development expenses) that contribute to project's completion/value:
 - Reasonable developer fees, leasing expenses, brokerage commissions, and management fees paid to third parties
 - Site preparation, such as engineering and permitting.
- Contributions must be done before any funds advanced and need language in the agreement that the funds will remain in the project (NOT withdrawn) over the life of the project.

HVCRE

- **15% Contribution Requirements Exclude:**

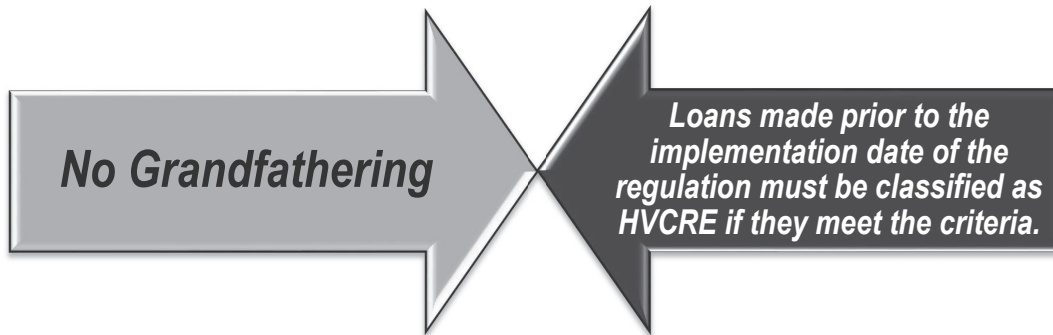
- An upward change in the market value of land being developed,
- Unrelated real estate owned “free and clear” by the borrower,
- Purchasers’ deposits on units in a condominium project,
- Cash received as a grant from a nonprofit, municipality, state, or federal agency,
- Deferred developer’s profit, incurred overhead expenses, or interest or other holding fees paid or accrued on contributed land, and
- Proceeds from another loan provided by same bank that is financing the ADC project, or a second mortgage provided by another bank.

HVCRE

<u>Not</u> HVCRE	HVCRE
One- to four-family residential properties	ADC loan on shopping center with LTV above supervisory maximum
Loan to finance farmland and valued as such	ADC loan to construct office building where borrower has not contributed qualifying capital
Community development ADC project	ADC loan to construct hotel where borrower-contributed capital is not held for life of project

HVCRE

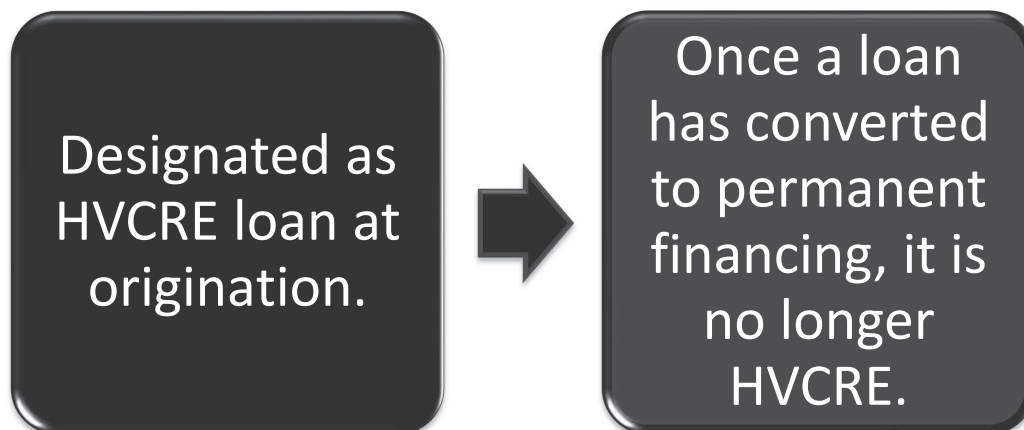
Can a loan be grandfathered from HVCRE requirements?



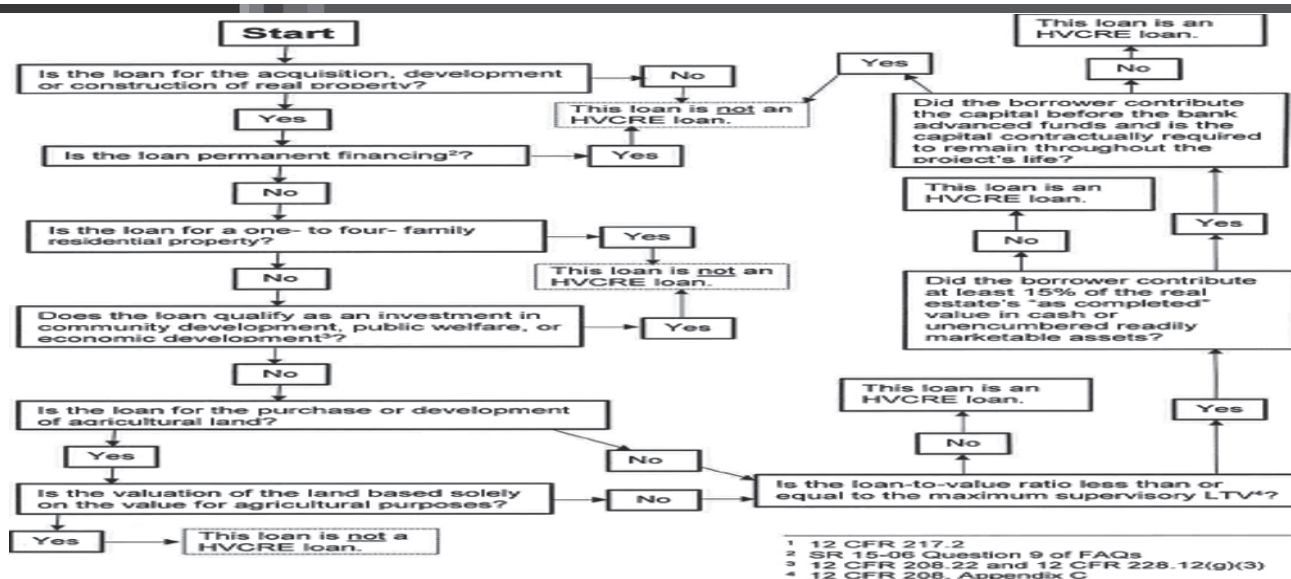
Final rule includes a grandfathering provision, which will provide banking organizations with the option to maintain their current capital treatment for ADC loans originated on or after January 1, 2015, and before April 1, 2020. Banking organizations also will have the option to reevaluate any or all of their ADC loans originated on or after January 1, 2015, using the revised HVCRE exposure definition.

HVCRE

When is HVCRE no longer HVCRE?



HVCRE Decision Tree



Questions?

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