

March 15, 2018

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley /
Director, Division of Risk Management Supervision

SUBJECT: Final Rule to Increase Appraisal Threshold for Commercial Real Estate Transactions

Summary of Recommendation

Staff recommends that the FDIC's Board of Directors approve the attached Final Rule (FR), entitled *Real Estate Appraisals*, for publication in the *Federal Register*. The FR would amend regulations requiring appraisals of real estate for certain transactions to create a new definition of, and separate category for, commercial real estate (CRE) transactions and increase the threshold for when these transactions do not require an appraisal. CRE transactions with a value greater than \$500,000 would require an appraisal, as opposed to the current \$250,000 threshold. Evaluations would be required for CRE transactions with a value at or below \$500,000.

The FR would be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System (Board) and the Office of the Comptroller of the Currency (OCC) (collectively the agencies). In the Dodd Frank Wall Street Reform and Consumer Protection Act,¹² Congress amended the threshold provision to require concurrence "from the Bureau of Consumer Financial Protection [CFPB] that such threshold level provides reasonable protection for consumers who purchase 1—4 unit single-family residences."¹³

SUPPLEMENTARY INFORMATION:

Rule Summary

The FR would increase the threshold level at or below which appraisals would not be required for CRE transactions from \$250,000 to \$500,000. A new definition would also be created for the term "commercial real estate transaction." For a CRE transaction with a value at or below the proposed threshold, the FR would require an evaluation of the real property collateral that is consistent with safe and sound banking practices. This requirement may be satisfied by an appraisal report completed by a state licensed or state certified appraisers, if the institution so chooses.

Background

Title XI of FIRREA sets forth Federal requirements with respect to appraisals.¹ In 1992, Congress amended section 1112 of Title XI by adding subsection (b), which expressly authorizes the agencies to establish a threshold level at or below which an appraisal by a state certified or

¹ 12 U.S.C. §§ 3331-3351.

licensed appraiser is not required in connection with federally related transactions if the agencies determine in writing that the threshold does not represent a threat to the safety and soundness of financial institutions. In 2010, through the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),² Congress amended section 1112(b) to require “concurrence from the Bureau of Consumer Financial Protection that such threshold level provides reasonable protection for consumers who purchase 1-4 unit single-family residences.” Transactions at or below the threshold level are exempt from the Title XI appraisal requirements and thus are not federally related transactions.

Under the current appraisal thresholds, which were established by rulemaking in 1994,³ all real estate-related financial transactions with a transaction value of \$250,000 or less, as well as certain real estate-secured business loans with a transaction value of \$1 million or less (“qualifying business loans” or QBLs), do not require appraisals. QBLs are business loans that are not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.

During the last decennial regulatory review process required by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), which was completed in early 2017, the agencies received comments related to the Title XI appraisal regulations, including recommendations to increase the appraisal thresholds. In their joint report to Congress on the EGRPRA review, issued in March 2017, the agencies noted that they were developing a proposed rule to increase the appraisal threshold for CRE transactions.

On July 31, 2017, the agencies published a notice of proposed rulemaking (NPRM)⁴ that would have amended the agencies’ Title XI appraisal regulations by increasing the appraisal threshold for CRE transactions from \$250,000 to \$400,000. The NPRM would have defined a CRE transaction to include any “real estate-related financial transaction,” as defined in the Title XI appraisal regulations, excluding any loans secured by a 1-to-4 family residential property, but including loans that:

- (1) finance the construction of buildings with 1-to-4 dwelling units; and
- (2) do not include permanent financing. Regulated institutions would have been required to obtain evaluations consistent with safe and sound banking practices in connection with CRE transactions at or below the new threshold.

The agencies did not propose increasing the appraisal thresholds for other transaction types, but they solicited comment and supporting data on the appropriateness of raising the threshold for QBLs and asked whether there were other factors that should be considered in evaluating the threshold for residential real estate transactions. The comment period closed on September 29, 2017. The agencies collectively received about 200 comments from appraisers, appraiser trade organizations, financial institutions, financial institutions trade organizations, and individuals.

² Pub. L. No. 111-203, 124 Stat. 1376.

³ See 59 Federal Register at 29482 (June 7, 1994).

⁴ 82 Fed. Reg. 35478

CRE Appraisal Threshold

The FR would increase the CRE appraisal threshold but with certain modifications from the proposal. After carefully considering the comments and conducting further analysis, staff of the agencies recommend increasing the threshold to \$500,000 instead of \$400,000 as originally proposed. The FR would also make a corresponding change to the provision requiring state certified appraisers to be used for federally related transactions that are CRE transactions above the threshold.⁵ Further, the FR would revise the proposed definition of a CRE transaction to mean a real estate-related financial transaction that is not secured by a single 1-to-4 family residential property.

The definition excludes residential construction loans secured by only one 1-to-4 family residential property, regardless of whether the loan is for initial construction only or includes permanent financing. Thus, under the FR, loans secured by only one 1-to-4 family residential property, including loans for construction, will remain subject to the \$250,000 threshold. Residential construction loans secured by more than one 1-to-4 family residential property will be considered CRE transactions subject to the higher threshold.

Effective Date

As in the NPRM, staff of the agencies recommend making the FR effective immediately upon publication in the Federal Register. The Administrative Procedure Act (APA) generally requires that a substantive rule not take effect less than 30 days after publication in the Federal Register but exempts from this requirement "a substantive rule which grants or recognizes an exemption or relieves a restriction."⁶ The FR, by expanding the types of real estate-related financial transactions that are exempt from the appraisal requirements under the Title XI appraisal regulations, qualifies for this exemption from the APA's 30-day effective date requirement upon publication in the *Federal Register*.

In response to comments, the preamble to the FR recognizes that some financial institutions will need time to update policies and procedures to obtain evaluations prepared by internal or external parties for affected transactions, but notes that financial institutions can continue to obtain appraisals for CRE transactions with transaction values between \$250,000 and \$500,000. Making the FR effective immediately will enable many institutions to benefit from lower costs and regulatory relief sooner. Moreover, having an immediate effective date is consistent with the 1994 amendments to the Title XI appraisal regulations, which also brought lower costs and regulatory relief by raising the appraisal threshold and became effective immediately.

CRE Appraisal Threshold

The agencies received many general comments regarding whether the agencies should increase the CRE appraisal threshold. Comments from regulated institutions and banking industry trade associations almost universally supported an increase in the threshold, while comments from appraisers and appraiser-related trade associations opposed any such increase.

⁵ See 12 C.F.R. § 323.3(d)(2).

⁶ 5 U.S.C. § 553(d)(1).

Several commenters stated a threshold increase would be appropriate given the increases in real estate values since the current threshold was established in 1994 and that an increase would provide cost and time savings to lenders and borrowers. Other commenters discussed rural areas or other areas facing shortages of licensed and certified appraisers, which can cause transaction delays and increase lending costs, and maintained that the proposed increase would provide particular relief to financial institutions lending in those areas. Supporting commenters also stated that the proposed increase would provide burden relief for financial institutions without sacrificing sound risk management principles or safe and sound banking practices, and that an increase would help justify the higher cost and lower return of smaller and less complex CRE loans.

The agencies proposed increasing the CRE appraisal threshold from \$250,000 to \$400,000. In determining the level of increase, the agencies considered the change in prices for CRE measured by the Federal Reserve Commercial Real Estate Price Index (CRE Index). The CRE Index is a direct measure of the changes in CRE prices in the United States. According to the CRE Index, a commercial property that sold for \$250,000 as of June 30, 1994, would be expected to sell for approximately \$760,000 as of December 2016. However, because CRE prices can be particularly volatile, the agencies proposed to base the increased threshold on the value of the CRE Index when CRE prices were at their lowest point in the most recent downturn (\$423,000 in March 2010).

The agencies invited comment on the proposed CRE appraisal threshold and how three threshold levels (\$250,000 for all transactions, \$400,000 for CRE transactions, and \$1 million for QBLs) instead of two would affect burden on regulated institutions. Of the commenters who addressed the proposed level, many supported increasing the threshold to \$400,000. Most of these also advocated for automatically increasing the level as real estate prices rise. A majority supported increasing the threshold to an amount higher than \$400,000.

Staff of the agencies recommend increasing the CRE transaction threshold to \$500,000, rather than the proposed \$400,000 level, after considering the comments and determining that increasing the CRE transaction threshold to \$500,000 remains within the range of CRE prices during the previous downturn and would be consistent with the safety and soundness of financial institutions. The higher increase is expected to reduce the burden on regulated institutions more than the proposed threshold would have. A \$500,000 threshold will exempt 15.7 percent more transactions from the appraisal requirements than the existing \$250,000 threshold. Furthermore, notwithstanding comments arguing that having three thresholds will increase complexity, particularly for small community banks, staff of the agencies have concluded that the burden reduction resulting from a higher CRE threshold outweighs the burden of having three thresholds.

Safety and Soundness Considerations for Increasing the CRE Transaction Threshold

Analysis of supervisory experience and available data presented in the proposal indicated that the proposed threshold level of \$400,000 for CRE transactions would not have posed a threat to the safety and soundness of financial institutions. The agencies invited comment on their preliminary finding and the data used.

The agencies received comments from financial institution trade associations, home builders, and realtors, as well as from financial institutions and individuals that supported the agencies' analysis. The agencies also received comments from associations for appraisers, valuation professionals, and other individuals stating that an increase in the threshold would pose a threat to safety and soundness.

Staff of the agencies have determined that increasing the threshold by an additional \$100,000 from what was proposed would not pose a threat to safety and soundness. This assessment is based, in part, on the fact that the dollar volume of affected transactions is low, despite the moderate number of transactions affected by the threshold increase. Furthermore, the Interagency Appraisal and Evaluation Guidelines, published in 2010,⁷ will continue to remain in effect. They provide that regulated institutions should establish parameters for ordering Title XI appraisals for transactions that present significant safety and soundness risk, even if those transactions are eligible for evaluations under the Title XI appraisal regulations.

Implementation Burden

Several commenters discussed the ease of implementing the higher threshold and whether the threshold increase would result in burden relief. The FR responds to these comments by raising the CRE threshold higher than the proposed level and, as discussed in more detail below, by simplifying the definition of CRE through elimination of the distinction between 1-to-4 family residential construction loans with or without permanent financing.

Definition of CRE Transaction

Under both the proposal and the final rule, the threshold increase would apply only to transactions defined as "commercial real estate transactions." Under the proposed definition, a CRE transaction would have included any "real estate-related financial transaction," as defined in the Title XI appraisal regulations, excluding any loans secured by a 1-to-4 family residential property, but including loans that finance the construction of buildings with 1-to-4 dwelling units that do not include permanent financing. The agencies received several comments related to the proposed definition of CRE transaction, most of which did not support the proposed treatment of transactions to finance the construction of 1-to-4 family residential properties. Other commenters supported including transactions to finance the construction of 1-to-4 family residential properties that included permanent financing in the definition.

Staff of the agencies recommend adopting a definition of "commercial real estate transaction" that is clearer and simpler than the one proposed. Accordingly, the FR defines CRE transaction as a real estate-related financial transaction that is not secured by a single 1-to-4 family residential property, thus eliminating the distinction between construction loans secured by a single 1-to-4 family residential property that only finance construction and those that provide both construction and permanent financing. Such loans would not meet the definition of a CRE transaction and thus would remain subject to the \$250,000 threshold.

⁷ 75 Fed. Reg. 77450 (Dec. 10, 2010).

The FR includes the term “single” in the definition to clarify that a transaction secured by one 1-to-4 family residential property, whether to finance construction or for other purposes, is excluded from the definition of “commercial real estate transaction.” However, under the amended definition, a loan that is secured by multiple 1-to-4 family residential properties (for example, a loan to construct a residential neighborhood development) would meet the definition of CRE transaction and thus be subject to the higher threshold. This approach reduces costs to some consumers and simplifies implementation.

Staff of the agencies have determined that the benefits of the FR’s definition of CRE transaction exceed the potential benefits of definitional consistency with other rules and guidance regarding CRE lending. Those rules and guidance are for different purposes than the Title XI appraisal regulations, and a different set of considerations is relevant for determining what types of transactions are appropriately exempt from the Title XI appraisal requirement on the basis of transaction size. The definition of CRE transaction in the FR ensures that loans made to individual consumers are largely treated consistently and remain subject to the \$250,000 threshold. In addition, by categorizing residential construction loans more clearly, the definition of CRE transaction may facilitate compliance and enhance the final rule’s burden reduction benefits.

The agencies decided not to change the thresholds for residential transactions or QBLs in the FR. The agencies stated in the proposal that they were not proposing to revise the threshold for these transactions, but solicited comment, supporting data, and whether there are other factors that should be considered relative to these thresholds. While some of the comments raised issues relating to the thresholds for residential transactions and QBLs, few commenters introduced new factors for the agencies’ consideration. Nevertheless, the comments reflect a variety of issues that the agencies would consider if they decide to propose changes to the residential or QBL thresholds in the future.

Use of Evaluations

Title XI appraisal regulations require regulated institutions to obtain evaluations for three categories of real estate-related financial transactions that the agencies have determined do not require a Title XI appraisal, including commercial and residential real estate-related financial transactions of \$250,000 or less and QBLs with a transaction value of \$1 million or less. Accordingly, the agencies proposed to require that regulated institutions entering into CRE transactions at or below the proposed commercial real estate appraisal threshold obtain evaluations that are consistent with safe and sound banking practices if appraisals are not obtained for such transactions.

After consideration of the comments, staff of the agencies recommend adopting this portion of the proposal without change. For a CRE transaction with a value at or below \$500,000, the amended rule will require an institution to obtain an evaluation of the real property collateral that is consistent with safe and sound banking practices unless the institution chooses to obtain an appraisal by a state certified or licensed appraiser.

CFPB Concurrence

The agencies have received concurrence from the CFPB that the CRE appraisal threshold being adopted provides reasonable protection for consumers who purchase 1-to-4 unit single family residences.

Recommendation

Staff recommends that the Board approve the attached Resolution to authorize publication of the FR entitled *Real Estate Appraisals* in the *Federal Register* of the attached FR.

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Attachments