ATTACHMENT.[1].
DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 34
[DOCKET NO. 94-10]
RIN 1557-AB34

FEDERAL RESERVE SYSTEM
12 CFR Part 225
[REGULATION Y; DOCKET NO. R-0803]
RIN 7100-AB20

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 323
RIN 3064-ABO5

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision
12 CFR Parts 545, 563, 564
[DOCKET NO. 94-47]
RIN 1550-AA64

Real Estate Appraisals

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively the agencies) are amending their regulations regarding appraisals of real estate. This final rule is adopted pursuant to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

The final rule increases to $250,000 the threshold at or below which appraisals are not required pursuant to Title XI, expands and clarifies existing exemptions to the Title XI appraisal requirement, identifies additional circumstances when appraisals are not required under Title XI, and specifies when exempt transactions nevertheless require appropriate evaluations. In addition, the final rule amends existing requirements governing appraisal content and the use of appraisals prepared by other financial services institutions.

.[1]. Source: 59 *Federal Register* 29482, June 7, 1994. Note: Federal Reserve Abridged Version: Duplicative material pertaining to the other agencies' rules has been omitted. It is noted, however, that these rules are uniform.

The agencies are adopting this final rule to further federal financial and public policy interests by reducing regulatory burden, while requiring Title XI appraisals when necessary to protect the safety and soundness of financial institutions or otherwise advance public policy.

EFFECTIVE DATE: This final rule is effective on June 7, 1994.

FOR FURTHER INFORMATION CONTACT:
Board of Governors of the Federal Reserve System (Board): Roger T. Cole, Deputy Associate Director, (202) 452-2618, Rhoger H Pugh, Assistant Director, (202) 728-5883, Stanley B. Rediger, Supervisory Financial Analyst (202) 452-2629, or Virginia M. Gibbs, Supervisory Financial Analyst, (202) 452-2521, Division of Banking Supervision and Regulation; or Gregory A. Baer, Senior Attorney (202) 452-3236, Legal Division; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

I. Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 3331 et seq., directs each Federal banking agency to publish appraisal regulations for federally related transactions within its jurisdiction. The purpose of the legislation is to protect federal financial and public policy interests in real estate related transactions by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, and by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision. See 12 U.S.C. 3331.

Section 1121(4) of FIRREA, 12 U.S.C. 3350(4), defines a federally related transaction as a real estate-related financial transaction that is regulated or engaged in by a federal financial institutions regulatory agency and requires the services of an appraiser. A real estate-related financial transaction is defined as any transaction that involves: (i) the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; (ii) the refinancing of real property or interests in real property; and (iii) the use of real property or interests in real property as security for a loan or investment, including mortgage-backed securities. See 12 U.S.C. 3350(5) (FIRREA section 1121(5)).

In their appraisal regulations, the agencies identify categories of real estate-related financial transactions that do not require the services of an appraiser in order to protect federal financial and public policy interests or to satisfy principles of safe and sound banking. These real estate-related financial transactions are not federally related transactions under the statutory and regulatory definitions. Accordingly, they are subject to neither Title XI of FIRREA nor those provisions of the agencies' regulations governing appraisals.

In December 1992, Congress confirmed that the agencies may set a threshold level below which the services of state certified or licensed appraisers are 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. See Housing and Community Development Act of 1992, Pub. L. 102-550, § 954 (amending 12 U.S.C. 3341).

The agencies jointly published a proposed rule to amend their appraisal regulations on June 4, 1993. See 58 FR 31878. The agencies published a notice of the availability of supplemental information concerning the proposed rule and invited further comments on November 10, 1993. See 58 FR 59688.

The agencies are issuing this joint final rule under their authority to issue rules to implement Title XI of FIRREA and each agency's authority to prescribe rules and regulations to carry out its responsibility to ensure that the institutions under its supervision conduct their activities in accordance with safe and sound banking principles. This final rule is intended to protect federal financial and public policy interests and the safety and soundness of financial institutions, while reducing duplication, costs and regulatory burden.

II. Comments on the Proposed Rule

A. Overview of Comments

Collectively, the agencies received over 19,000 comment letters on the proposed rule. In response to the June 4th Notice of Proposed Rulemaking, the agencies received comment letters from appraisers, bankers, and others as shown in Table A. Comment letters received in response to the November 10th Notice of Supplemental Information were distributed as shown in Table B.

Table A - Distribution of Comments Received in Response to June 4, 1993 Proposed Rule

AGENCY	Letters From Appraisers	Letters From Bankers	Letters From Others	TOTAL
OCC	1660	161	168	1989
Board	1608	259	276	2143
FDIC	1574	376	149	2099
OTS	1298	40 (14 thrifts)	134	1472

Table B - Distribution of Comments Received in Response to November 10, 1993 Notice of Supplemental Information

AGENCY	Letters From Appraisers	Letters From Bankers	Letters From Others	TOTAL
OCC	1878	659	242	2779
Board	1994	519	528	3041
FDIC	1818	1142	467	3427
OTS	1644	57 (22 thrifts)	502	2203

The agencies have reviewed and considered all comments concerning the proposed rule. The agencies discuss general comments immediately below. Responses to the agencies' specific requests for comment and comments concerning specific amendments to the appraisal regulation are discussed in the section-by-section analysis.

B. General Comments on the Proposed Rule

Regulated institutions generally endorsed the proposed changes to the appraisal regulations, though a small number of savings associations, banks, and other commenters opposed changing the regulation. Appraisers almost unanimously opposed changing the threshold, and a large number of appraisers opposed the business loan exemption. However, appraisers commented favorably on other parts of the proposed rule.

A large number of appraisers commented that the proposed changes would lead to abuses that caused savings associations to fail in the mid-to-late 1980s and that the changes would violate the intent of Congress. In the experience of the agencies, and in the opinion of studies conducted on the failures of the 1980s, abuses were related to real estate acquisition or development projects and larger loans. The regulations issued today continue to require appraisals for these transactions. Moreover, the regulations fully comply with the intent of Congress by continuing to protect federal financial and public policy interests in real estate-related financial transactions as well as the safety and soundness of financial institutions.

Regulated institutions and appraisers have over three years experience with the appraisal regulations and have urged changes in the regulations to improve credit availability and reduce duplication, costs, and regulatory burden. Some commenters, focusing on the proposed threshold, opposed changing the regulations because they believed that additional time was needed to study the effect of the existing regulations. Delaying the issuance of the final rule would deny regulated institutions, appraisers, and borrowers the benefits of these changes. To the extent that subsequent events demonstrate that additional changes are needed, the agencies can further amend the regulations.

One appraisal organization suggested that several of the proposed exemptions should be replaced with guidelines regarding when to obtain Title XI appraisals. Because regulated institutions and appraisers can become liable for substantial penalties for violating the regulation, the agencies believe that it benefits regulated institutions, appraisers, and the public for the agencies to identify categories of exempt transactions in the regulation. However, the agencies intend to provide supplemental information about the appraisal and evaluation practices of regulated institutions in guidance.

Some commenters stated that they were denied an opportunity to comment on the supplemental information identified in the November 10th notice because the materials were available only in Washington, D.C., and the comment period was 30 days. The agencies believe that the public procedures on the proposed amendments to the appraisal regulations fully complied with the requirements of the Administrative Procedure Act and accorded the public a full opportunity to participate in the rulemaking.

The November 10th notice explained that the supplemental materials were available from each of the agencies. In accordance with established procedures, all agencies mailed copies of those materials to any person requesting them, as well as having the documents available for review at each agency.

The agencies also believe the 30-day comment period was appropriate for the second comment period on the proposed amendments. The notice of supplemental information requested comment on materials that dealt almost exclusively with the appraisal threshold. As shown in Table B above, more than 11,000 comment letters were received in response to the November 10th notice.

III. Section-by-Section Analysis

§ ___.2 Definitions.
(d) Business Loan

The agencies are adopting the proposed definition of "business loan" as a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship (including an individual engaged in farming), or other business entity. The definition is used in connection with the exemption for business loans of $1 million or less that are not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.

Commenters suggested that the agencies amend the definition of business loan to include loans to individuals for business purposes and to permit use of the exemption when individuals lease real estate to a related business. Loans to individuals are included in the definition of business loan as loans to sole proprietorships and other business entities. This exemption does not apply to loans to individuals that are consumer or personal loans. Therefore, the agencies do not believe that it is necessary to amend the definition.

(h) Real Estate or Real Property

The Board is adding a definition of "real estate" and "real property" to § 225.62 of its regulation. The Board proposed this amendment to incorporate the definition of real estate and real property employed by the other agencies. That definition specifically excludes mineral rights, timber rights, growing crops, water rights, and similar interests.

Title XI of FIRREA does not define "real estate" or "real property" nor does the context in which these terms are used suggest that the terms are intended to have different technical meanings. See 55 FR 27762 (July 5, 1990).

The Board used "real property" and "real estate" interchangeably throughout its appraisal rule to mean interests in an identified parcel or tract of land and improvements. However, the Board did not intend these terms to include mineral rights, timber rights, or growing crops when they are considered separately from the parcel or tract of land. Valuation of such interests generally requires the services of a professional other than a real estate appraiser.

To clarify this distinction, the Board has amended its regulation to define "real property" and "real estate" for purposes of the appraisal regulation as an identified parcel or tract of land, including improvements, easements, rights of way, undivided or future interests and similar rights in a tract of land, but excluding mineral rights, timber rights, or growing crops.

Few commenters expressed an opinion on this proposed change. Those few commenters who opposed the definition stated that timber and growing crops should not be excluded from the definition of real estate in that the value of such items is tied to the value of the land. Comments opposing this definition were generally from appraisers who perform farm and timber appraisals.

In many states, minerals, timber, and growing crops that have not been severed from the land are considered interests in real estate or real property. Consequently, if mineral rights are collateral for a loan in one of those states, a question arises whether the institution must obtain a real estate appraisal of the parcel or tract of land to which the mineral rights are attached but in which the institution has no interest.

The Board's final rule clarifies that regulated institutions are not required to obtain appraisals of the parcel of land to which mineral rights, or similar severable interests in real estate are attached, if the transaction only involves the severable interest rather than the parcel or tract of land. Where mineral rights, timber rights, or growing crops, and the associated parcel or tract of land, are the subject of a real estate-related financial transaction, the services of a licensed or certified appraiser would be required unless the transaction is otherwise exempt.

In addition, the contribution of relevant mineral rights, timber rights, or growing crops should be included when appraising a parcel of land which possesses any of these features. However, valuation of these interests would not be required if they are not part of the transaction or if they are not relevant to the analyses which the appraiser needs to perform to arrive at an estimate of value for the parcel or tract of land.

§ ___.3(a) Appraisals required.

(1) Threshold

The agencies proposed an increase from $100,000 to $250,000 in the threshold at or below which a Title XI appraisal is not required, and specifically asked commenters whether a $250,000 or some other threshold would be appropriate. In addition, the agencies requested information on loss experience of depository institutions for loans greater than $250,000 and loans of $250,000 or less. On November 10, 1993, the agencies made available supplemental information on the proposed rule and extended the comment period for 30 days in order to allow commenters to consider and comment on the information. The supplemental information related primarily to the proposed increase in the threshold.

A majority of the commenters addressed the threshold issue. Almost all of the commenters opposed to the increase were appraisers, while almost all of the commenters in favor of the increase were depository institutions.

Most of those opposed stated as the basis for their opposition that an increase in the threshold would cause substantial losses for depository institutions, and thereby for the deposit insurance funds. To support this view, commenters generally cited the thrift failures of the 1980s and asserted that an increase in the threshold would lead to the same result.

A total of 74 comment letters provided data on loss experience. The institutions providing the data varied in size, and included large regional multi-bank holding companies, as well as small banks. This data is discussed below.

For the reasons set forth below, the agencies have decided to raise the threshold from \$100,000 to \$250,000. Such an increase will benefit consumers and lenders and will not threaten the safety and soundness of financial institutions, particularly as an evaluation will be required for all loans exempt under the threshold.

Benefits for Consumers and Lenders of an Increase in the Threshold

Many commenters stated that an increase in the threshold would benefit consumers and lenders. Numerous bank and thrift commenters pointed to the cost and time needed in order to obtain an appraisal as an impediment to lending. The appraisal was cited by several commenters as the most important factor causing delay in small business lending, and the cost of the appraisal was described as high, especially for commercial borrowers. Commenters reported that appraisal fees for commercial transactions between \$100,000 and \$250,000 could cost 5 percent of the loan amount to the borrower. Banks and thrifts also commented that increasing the threshold would reduce regulatory burden associated with making loans below \$250,000. Many appraisers, however, commented that appraisal costs have remained relatively steady.

Many appraisers also stated that appraisals by certified or licensed appraisers are necessary to protect the consumer. The agencies believe that this assertion mischaracterizes the role of the institution's determination of collateral value in a typical consumer transaction. The regulated institution obtains the appraisal or evaluation as part of its loan underwriting process in order to make certain that it is adequately secured. Any appraisal ordered by a financial institution is not designed, and generally comes too late, to assist the consumer in negotiating a contract price. In a purchase of real estate, the purchase offer is generally made before financing is sought and the financial institution orders an appraisal. Therefore, the appraisal represents an after-the-fact cost. Further, even when a Title XI appraisal is not required, nothing prevents a consumer from independently obtaining an appraisal by a licensed or certified appraiser for the consumer's own use in the negotiating process. Moreover, the agencies' rules require an institution to obtain an appropriate evaluation of the real property collateral for transactions below the threshold, and that evaluation would be available to the consumer.

The agencies believe that many of the concerns about consumer protection are addressed under statutory and regulatory programs other than Title XI of FIRREA, which focuses on bank and thrift safety and soundness.

The Real Estate Settlement Procedures Act (RESPA) establishes procedures for lenders to disclose to consumers the charges for a variety of settlement services, including appraisals and evaluations. To comply with the letter and intent of the Board's Regulation B (implementing the Equal Credit Opportunity Act), regulated institutions must either disclose to the borrower the right to receive a copy of the documents the lender uses to value the collateral in an application for a loan secured by a dwelling, regardless of whether the documents constitute a Title XI appraisal or evaluation, or, as a matter of course provide the borrower with the appraisal or evaluation. Thus, to the extent that a borrower benefits from knowing the value the lender places on the property the borrower has contracted to purchase or pledged as collateral, the borrower should be able to benefit from that knowledge whether it is in the form of a Title XI appraisal or an evaluation.

Furthermore, although such a disclosure is not required by RESPA, Regulation B, or Title XI, the agencies believe that a regulated institution should advise consumers whether the institution intends to have a licensed or certified appraiser prepare the estimate of value. This should be done early enough in the loan application process to allow the consumer to make an informed decision that the intended method of estimating the real estate's value meets his or her needs.

Effects on Safety and Soundness of Financial Institutions

The agencies have concluded that a $250,000 threshold would not threaten the safety and soundness of financial institutions.

Benefits to Safety and Soundness

The agencies believe that the increase in the threshold will have affirmative benefits for safety and soundness. A decrease in appraisal requirements should relieve regulatory burden for banks and thrifts and thereby improve their competitiveness with non-regulated lenders. Appraisal costs represent a significant expense for certain small loans, making such lending less attractive to a potential borrower or less profitable for the lender. Numerous comments from lenders supported this conclusion. The problem is particularly troubling for lenders in small towns, who must pay a premium for a licensed or certified appraiser to visit the town. A GAO survey of bankers in connection with a study of small business lending revealed that the minimum cost to perform the necessary appraisal on commercial real estate property used as collateral for small business loans was approximately $3,000..[2]. See GAO Report GGD-93-121, Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (September 1993).

Experience with the $100,000 Threshold

The Board has had a $100,000 threshold in place since August 1990, and the other agencies have had a $100,000 threshold since March or April 1992. The experience of the agencies has demonstrated that the $100,000 threshold has posed no risk to safety and soundness.

.[2]. The GAO noted that a survey performed by the American Bankers Association reflected a lower average cost.

A survey by each of the agencies of its senior examination staff indicates that over a period of many years, with a few possible exceptions,[3] no bank or thrift has failed or suffered significant losses as a result of appraisal problems with loans under $100,000 or even up to $250,000. Each of the regional representatives of the Board, the FDIC, and the OCC supported adoption of the $250,000 threshold as consistent with safety and soundness. Representatives of the OTS suggested that the threshold should only apply to healthier thrifts. As described below, this concern has been addressed by the agencies in the final regulation.

The $250,000 threshold was also supported by the Conference of State Bank Supervisors (CSBS), the professional association for state officials who supervise and regulate state-chartered commercial and savings banks. The CSBS concluded that the increased threshold would reduce unnecessary costs and would not represent a threat to the safety and soundness of financial institutions.

Numerous bank and thrift commenters also reported that their experience with the $100,000 threshold had been good. Moreover, commenters opposed to the increased threshold did not identify institutions that had failed or suffered significant losses because of the existence of the $100,000 threshold.

The agencies believe that low loss experience with a $100,000 threshold provides justification for an increase in the threshold to $250,000.

Data Indicate Similarities Between the $100,000 Threshold and $250,000 Threshold

A substantial body of evidence provides strong reasons to believe that exempting loans between $100,000 and $250,000 from the Title XI appraisal requirement will not present materially greater risk than the prior exemption for loans under $100,000.

Data from the commercial bank Consolidated Reports of Condition and Income (Call Reports) for year-end 1992 show that approximately 53 percent of the dollar volume of all real estate-secured loans of all sizes in the commercial banking industry are loans secured by 1-to-4 family residential properties. Data from the Thrift Financial Reports (TFR) for year-end 1992 show that the number is 77 percent in the thrift industry.

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[3] The Central Region of the OTS was the only OTS respondent to identify failures attributable to inadequate appraisal practices. The Central Region identified fewer than six failures over the previous twelve years where appraisal issues for loans under $250,000 were a major contributing factor to a thrift's failure. The Central Region noted that in those failures where inadequate appraisal practices were a problem, other areas of loan underwriting were usually found to be equally deficient.

One OCC survey respondent reported that one institution had failed because of residential and commercial loans between $100,000 and $500,000. The respondent noted that the problems occurred before 1987, when the OCC issued guidelines that would have prevented the institution's real estate valuation problems.

Data on loan size are not reported for residential loans on the Call Report or TFR. However, information from the National Association of Realtors, the Census Bureau, and the Department of Housing and Urban Development (HUD) indicate that approximately 29 percent of the dollar volume of 1-to-4 family real estate loans to purchase new homes, and 33 percent of the dollar volume of loans to finance the purchase of existing homes, fell below the prior $100,000 threshold. Approximately 56 percent of the dollar volume for new 1-to-4 family homes and 49 percent of the dollar volume for existing homes fell between $100,000 and $250,000. In sum, 85 percent of the dollar volume of mortgages financing new homes and 82 percent of the volume of mortgages financing purchases of existing homes will fall below the $250,000 threshold.

Thus, increasing the threshold from $100,000 to $250,000 is likely to more than double the amount of lending for 1-to-4 family residential real estate loans exempt from the Title XI appraisal requirement. Inasmuch as a solid majority of total real estate lending is composed of 1-to-4 family loans, the agencies believe that 1-to-4 family loans will be the largest block of loans exempted by the increase in the threshold.

The increase in 1-to-4 family residential real estate loans exempted by the $250,000 threshold will not affect safety and soundness, as these loans are traditionally the safest in a lending institution's portfolio. In 1992, the net loan charge-off rate[4] for all commercial bank loans secured by 1-to-4 family real estate was 0.23 percent; for thrifts, the net charge-off rate for loans secured by 1-to-4 family residential real estate was 0.22 percent. Low loss rates for 1-to-4 family residential real estate loans predate enactment of Title XI; for example, in 1991, when the great majority of 1-to-4 family loans had been originated prior to implementation of Title XI in August 1990, the charge-off rate for 1-to-4 family loans was 0.20 percent for commercial banks and 0.11 percent for thrifts. See FDIC Quarterly Banking Profile (4th Quarter 1991)) and Thrift Financial Reports (1991).

Beginning June 30, 1993, commercial banks and thrifts are required to report annually the number and dollar amount of non-farm non-residential real estate loans, which basically constitute business loans secured by real estate. They are also required to report the number and dollar amount of all agricultural loans.

The data from the June 1993 Call Reports show that 12 percent of the dollar volume of real estate-secured business loans was below the $100,000 threshold. Also by dollar volume, only 11 percent of outstanding real estate-secured business loans fell between $100,000 and $250,000. For thrifts, the TFRs show that 10 percent of the dollar volume of all real-estate secured business loans was below $100,000, and 9 percent between $100,000 and $250,000.

These findings are consistent with data compiled in the 1989 National Survey of Small Business Finances, which surveyed firms with fewer than 500 employees. See National Survey of Small Business Finances (1989) (cosponsored by the Federal Reserve Board and Small

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[4] The net loan charge-off rate is determined by taking the dollar amount of gross losses, subtracting the amount recovered, and dividing the result by the average of outstanding loans.

Business Administration). According to that survey, of the commercial mortgages to small businesses by depository institutions, 6 percent of the dollar volume of these loans was in loans of less than $100,000, and 12 percent was in loans between $100,000 and $250,000.

As noted in the regional examiner surveys, the $100,000 threshold has not resulted in significant losses, even though that threshold captures 12 percent of the dollar volume of small business loans. The agencies do not believe that an increase in the threshold that exempts another 11 percent of business loans will significantly increase such losses.

Call Report data also show that 63 percent of the dollar volume of agricultural real estate loans fell below the $100,000 threshold, and that 15 percent fell between $100,000 and $250,000. For thrifts, TFR data show that 46 percent of farm loans fell below $100,000, and 36 percent between $100,000 and $250,000. Farm loans represented approximately one-half of one percent (.58%) of non-residential mortgages held by thrifts. Thus, in the area of farm loans, only a relatively small amount of additional loans will be exempted by the raised threshold.

Although the increase in the threshold will increase the dollar volume of exempt transactions, the agencies believe that the quality of loans and lending practices of banks and thrifts will not change for these transactions. Moreover, an institution must obtain evaluations for these exempt transactions when it does not obtain appraisals.

In addition, there is evidence that the loss rates on loans below the $250,000 threshold will be low. For 1992, the commercial bank loss rate for farm loans was .23 percent (approximately the same loss rate as for 1-to-4 family loans). These loss rates on residential and farm loans are significantly lower than the loss rates for the types of real estate loans that are much less likely to fall below the $250,000 threshold -- construction loans (3.54% loss rate for commercial banks) and multifamily loans (1.68% loss rate for commercial banks). Loss rates for non-farm non-residential real estate loans at commercial banks were 1.55 percent, higher than residential or farm loans, but still below the loss rates experienced for loans for construction or multifamily housing.

Finally, in addition to the relatively lower risk of the portfolio of real estate related loans between $100,000 and $250,000, the fact remains that the dollar amount of each credit is relatively small. In the experience of the agencies, banks and thrifts generally do not fail because of real estate-related financial transactions under $250,000. It is generally large construction and development loans that have created safety and soundness problems. For example, much of the thrift losses of the 1980s were caused by losses in large, speculative real estate development projects, such as construction of offices, condominiums, and apartments. See, e.g., GAO Report AFMD 89-62, Thrift Failures: Costly Failures Resulted from Regulatory Violations and Unsafe Practices. Such projects generally involve loans in much greater amounts than $250,000. The experience of the agencies continues to be that larger development and construction loans are most likely to cause significant losses.

Although many commenters suggested that raising the threshold would result in losses similar to those of the thrift failures of the 1980s, they did not offer analysis to support those statements. The agencies do not believe that inadequate appraisals on loans under $250,000 were a significant cause of those failures.

Additional Protections

Significant protections exist so that loans under $250,000 will not create a safety and soundness problem once the $250,000 threshold is in place.

First, each agency will, during each required full-scope, on-site examination, analyze the prudence of each institution's credit underwriting practices, including appraisal and evaluation practices, as appropriate to the institution's size and nature of its real estate-related activities. If an institution is doing a poor job of evaluating real estate for transactions under $250,000, then the appropriate agency may order the institution to obtain appraisals for certain loans or for all loans above a certain amount that are not subject to another exemption.[5].

Second, even though a bank or thrift will not generally be required to obtain a Title XI appraisal for real estate-secured loans under $250,000, the institution must determine the value of the real estate before making the loan. Under the appraisal regulations, banks and thrifts must support any transaction below the threshold with an evaluation that is consistent with the agencies' guidelines. Evaluations will be performed by persons who are capable of rendering an appropriate estimate of value of real estate as a result of their real estate-related experience or training.

As several commenters noted, a $250,000 threshold will have its greatest effect in smaller communities where property values are lower. However, as many community bank commenters pointed out, local lenders in small communities tend to be extremely knowledgeable of property values. Also, collateral for loans of this size do not typically represent complex problems of analysis or valuation.

Third, a $250,000 threshold does not prevent the use of appraisals when needed. Banks and thrifts may obtain appraisals prepared by licensed or certified appraisers whenever the institutions believe it is prudent, and customer may independently obtain such appraisals. If, as some commenters contend, history demonstrates that such appraisals are important to the decision to lend and the failure to obtain such an appraisal will lead to higher loss rates, then banks and thrifts would presumably have a strong incentive to use appraisals. As several commenters noted, institutions will obtain appraisals when their underwriting criteria warrant one, regardless of whether regulations require it.

Fourth, in many cases involving residential real estate, banks and thrifts will be required to obtain the equivalent of a Title XI appraisal in order to make the loan eligible for sale in the secondary market. According to HUD data, in 1992, secondary mortgage market purchasers,

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[5]. As noted below, the agencies may require an appraisal for loans between $100,000 and $250,000 (not otherwise subject to an exemption) when an institution is in troubled condition, and that troubled condition is attributable to underwriting problems in the institution's real estate loan portfolio.

such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), purchased approximately 63 percent of all 1-to-4 family mortgages originated in the United States. In addition to the 63 percent that were purchased by major secondary mortgage market entities, other loans were originated so as to be eligible for sale to such entities. The agencies have concluded that the appraisal requirements of these government sponsored agencies should protect federal financial and public policy interests in the loans that are eligible to be purchased by them. The agencies also believe that compliance with these appraisal requirements will protect the safety and soundness of regulated financial institutions.

Data Submitted by Commenters

The notice of proposed rulemaking asked commenters to submit loan loss data for different categories of real estate-secured loans above and below $250,000. Many depository institution commenters noted that they do not maintain loss data by loan size and that this information is not reasonably accessible. Only a small number of depository institutions submitted such data. The agencies do not believe that this response is sufficiently large to base any conclusions about industry-wide conditions. Nonetheless, the agencies note that the information provided by commenters is consistent with the low loss rates for real estate lending indicated by other sources. The responses that the agencies received are summarized in the following table.

Real Estate-Secured Loans	Size of Loans	Number of Loans	Outstanding Principal Amount of Loans 1 (12/31/92)	Loss on Loans 1 (Annual Net Charge-offs) 2 (12/31/92)	Loss Rate 3 (Calculated)
Loans Secured by 1-to-4 Family Residential Real Estate	Loans Greater Than $250,000	7,151	3,169,918	4,129	0.13%
	Loans of $250,000 or Less	524,137	22,240,821	23,773	0.11%
Loans Secured by Commercial Real Estate	Loans Greater Than $250,000	25,344	28,315,961	372,706	1.32%
	Loans of $250,000 or Less	67,469	5,131,866	36,751	0.72%

1 Dollars rounded to thousands.
2 Annual net charge-offs are determined by taking the dollar amount of gross losses and subtracting the amount recovered.
3 The agencies have calculated the loss rate for each of the categories of real estate-secured loans about which the agencies requested data by dividing total annual net charge-offs by the total outstanding principal balance.

Additional Comments on the $250,000 Threshold

OMB Study

Several commenters opposing an increase in the threshold pointed to an August 1992 study by the Office of Management and Budget (OMB) entitled Report to Congress: De Minimis Levels for Commercial Real Estate Appraisals. The OMB study did not oppose an increase in the threshold level but instead stated, "OMB does not recommend -- at this time -- a *de minimis* level higher than $100,000 . . . ." OMB study at i.

The agencies believe that the major concerns identified by the OMB in urging delay have been addressed with the passage of time. Most importantly, each of the agencies now has an additional year's experience with the $100,000 threshold. Furthermore, OMB noted that FIRREA's appraisal requirements had not been implemented in all states, but such implementation has now occurred.

Rulemaking Process

Several commenters stated that the agencies had failed to justify increasing the threshold from $100,000 to $250,000 because the agencies had not produced a definitive study showing that doing so would not increase loss rates.

Congress granted the agencies explicit authority to establish a threshold consistent with safety and soundness. The delegation of authority was broad, and no requirement for quantitative analysis was included. Nor is it reasonably feasible for the agencies to conduct a definitive quantitative analysis that isolates the effect of obtaining Title XI appraisals on institutions' losses on real estate-secured loans given the many variables, including changing market conditions and varying loan underwriting practices, that may affect institutions' ultimate loss experience. For the same reason, the agencies did not conduct a random sampling of the experience of financial institutions, as suggested by one commenter. This does not mean, however, that the final rule fails to rely on objective data. Moreover, that data was analyzed in light of the agencies' experience and expertise.

As part of this rulemaking, the agencies reviewed the data the agencies currently collect from financial institutions and sought out data that would enable the agencies to analyze the effect of the threshold on regulated institutions. Consistent with statutory requirements, the agencies have carefully considered the effect of raising the threshold and determined that a $250,000 threshold level does not represent a threat to the safety and soundness of financial institutions based on the agencies' judgment, expertise, and experience. In making this determination, the agencies have, as described above, analyzed the available data, the comments received during the rulemaking, and relevant work of other governmental agencies.

Appraiser Employment

Many commenters from the appraisal industry objected to the proposed increase in the threshold on the grounds that it would decrease their business and employment in the appraisal industry.

In the event that an appraisal is not required because the transaction falls below $250,000, the appraisal regulation nonetheless requires that an evaluation of the property be conducted. The agencies' appraisal rules do not impede licensed and certified appraisers from performing these evaluations.

GAO Study

Several commenters suggested that the agencies delay action on any rulemaking pending completion of General Accounting Office (GAO) studies of the threshold scheduled for completion in April 1994 and October 1995. Congress delegated authority to the agencies to establish a threshold in the same legislation that directed the GAO to conduct two studies of the appraisal threshold. Congress clearly did not require the agencies to withhold action on the threshold pending completion of the GAO studies; nor did it make agency action contingent on the outcome of the GAO studies or any other studies. Also, in the Interagency Policy Statement on Credit Availability issued March 10, 1993, the agencies identified a need to reexamine their existing appraisal rules to make certain that thresholds below which formal appraisals are not needed are reasonable. Therefore, the agencies believe that it is appropriate to proceed with the rulemaking. The agencies are cooperating with the GAO by providing information that it may use in preparing its studies.

Private Mortgage Insurance Industry Experience

A trade association representing the private mortgage insurance industry opposed increasing the threshold level to $250,000, citing substantial losses on loans under $100,000. However, it also noted that for loans originated in 1984, loans above $250,000 had a relative claim rate more than 50 percent higher than the claim rate for loans originated under $100,000. Information provided by this commenter also showed that the relative claim rates on loans below $100,000 and loans between $100,000 and $250,000 were close for most years, while the relative claim rate for loans above $250,000 exceeded the claim rates for loans below $250,000 in all years except one. The commenter did not provide actual claim rates nor dollar amounts of claims. Nor did the commenter disclose the average loan-to-value ratios for those mortgages, a factor that could affect the loss experience.

Although the trade association stated its belief that a significant amount of the claims experienced by its members were related to inadequate appraisals, bank and thrift commenters stated that losses on foreclosed properties were more directly related to deterioration in the local real estate market, damage to the property, or actions or inaction by the borrower.

Application of $100,000 Threshold to Certain Troubled Institutions

As described in more detail below, the agencies are adopting substantially as proposed a separate amendment stating that each agency continues to reserve the right to require a regulated institution to obtain a Title XI appraisal whenever the agency believes that an appraisal is necessary to address safety and soundness concerns. This authority may involve the agency requiring an institution to obtain an appraisal for a particular extension of credit or an entire group of credits.

Whether an institution will be required, pursuant to this provision or existing safety and soundness authority, to obtain an individual appraisal or group of appraisals may depend on the condition of that institution. If an institution's troubled condition is attributable to real estate loan underwriting problems, then the appropriate agency may require appraisals for all new real estate-related transactions of more than $100,000 that are not subject to an exemption.

Since thrift industry assets are concentrated in real estate loans, OTS believes that problem thrifts or thrifts in troubled condition[6] generally will have real estate-related asset quality problems. As a matter of policy, OTS intends to require thrifts in troubled condition to adhere to a $100,000 threshold.

Reassessment of Threshold

Finally, just as the agencies have reviewed their experience with the $100,000 threshold in determining whether a higher (or lower) threshold was appropriate, so too will the agencies review their experience with the $250,000 threshold. If the agencies should determine that the increased threshold is causing safety and soundness problems, then the agencies will reassess that threshold.

(2) The "Abundance of Caution" Exemption

The agencies are amending their regulations to clarify and expand the scope of the exemption for real estate liens taken in an "abundance of caution." Under the amended rule, regulated institutions will be able to apply the abundance of caution exemption to a broader range of transactions in which real estate is taken as additional collateral for an extension of credit that is well supported by income or other collateral of the borrower.

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[6] A "problem" association is defined as an association that: (1) has a composite MACRO rating of 4 or 5; (2) is undercapitalized under prompt corrective action standards; (3) is subject to a capital directive or a cease and desist order, a consent order, or a formal written agreement, relating to the safety and soundness or financial viability of the savings association, unless otherwise informed in writing by the OTS; or (4) has been notified in writing by the OTS that is has been designated a problem association or an association in troubled condition. (See Regulatory Bulletin 27a, Executive Compensation.)

Prior to adoption of this amendment, the abundance of caution exemption was available only for transactions in which a lien on real estate had been taken as collateral solely through an abundance of caution and where the terms of the transaction as a consequence had not been made more favorable than they would have been in the absence of a lien. In the agencies' experience, however, this standard was being interpreted too narrowly. As a result, regulated institutions obtained appraisals even though they were unnecessary to protect federal financial and public policy interests in the transaction or bank and thrift safety and soundness. Further, a transaction would not qualify for the exemption if the regulated institution made the terms more favorable to the borrower because of the real estate collateral. Therefore, bankers believed they were unable to use this exemption when common business practices would call for a lower interest rate on a secured loan than an unsecured loan.

To qualify for the amended exemption, the regulated institution's decision to enter into the transaction must be well supported by the borrower's income or collateral other than real estate. The following examples from the proposed rule help to explain how this standard is applied.

Example 1: A business with an established cash flow seeks a loan from a regulated institution to purchase an adjacent property for expansion. As a common business practice, the institution takes a lien against real estate whenever available for greater comfort. However, the institution's analysis determines that the current income from the business and personal property available as collateral support the decision to extend credit without knowing the real estate's market value. During loan negotiations, the institution offers to make the loan on slightly better terms for the borrower if it receives a lien on real estate. The borrower accepts the offer and provides the real estate as additional collateral.

The regulated institution may reasonably conclude that the lien on the real estate was taken in an abundance of caution because the current income from the business and personal property taken as collateral support the decision to extend credit. Therefore, no appraisal would be required.

Example 2: The owner of a shop seeks a term loan from a regulated institution for modernization of its facilities. The institution determines that other sources of repayment and collateral do not sufficiently support the decision to extend credit without taking a lien on the real estate and knowing the real estate's market value. Therefore, in order to extend credit to the borrower prudently, the institution needs an appraisal.

The regulated institution should conclude that the real estate lien has not been taken in an abundance of caution because the other sources of repayment and collateral do not support the decision to extend credit without knowing the real estate's market value. This transaction would not qualify for the abundance of caution exemption.

Regulated institutions generally supported the proposed amendment. Some commenters representing appraisers agreed that the abundance of caution exemption had been too narrowly interpreted and supported the proposal to extend the scope of the exemption. Other appraisers commented that the agencies should require an appraisal, limited scope appraisal, or evaluation any time a regulated institution takes real estate as collateral. Some regulated institutions noted that the prior rule caused them to forgo liens on real estate collateral in order to avoid the expense of an appraisal, thus potentially increasing their exposure unnecessarily.

The agencies are not requiring appraisals for these transactions because an estimate of the real estate collateral's value generally would not assist the regulated institution to make its lending decision. Therefore, an appraisal generally would not further the purposes of Title XI of FIRREA nor significantly improve the safety and soundness of financial institutions.

(3) Loans Not Secured by Real Estate

The agencies are adopting a uniform exemption for transactions that are not secured by real estate. The exemption makes clear that a regulated institution is not required to obtain a Title XI real estate appraisal in connection with a loan used to acquire or invest in real estate if the institution does not take a security interest in real estate.

The prior appraisal regulations of the OCC, FDIC and OTS exempted these transactions, and the amendment does not result in any substantive change in regulatory requirements for these agencies. The amendment eliminates minor differences between the text of the rules adopted by the OCC and OTS and the text of the FDIC's rule. Prior to adoption of the amendment, the Board's appraisal regulation did not specifically exempt these transactions.

Although a few appraisers stated that Title XI appraisals should be obtained for these transactions, other commenters, including appraisers, supported this exemption. Several commenters stated that Title XI was never intended to reach transactions that were not secured by real estate.

In transactions covered by this exemption, the value of the real estate has no direct effect on the regulated institution's decision to extend credit because the institution has no security interest in the real estate. The agencies conclude that federal financial and public policy interests would not be served by requiring lenders and borrowers to incur the cost of obtaining Title XI appraisals in connection with these transactions.

(4) Liens for Purposes Other Than the Real Estate's Value

The agencies are adopting a new exemption for transactions in which a regulated institution takes a lien on real estate for a purpose other than the value of the real estate. This amendment will permit regulated institutions to take liens against real estate to protect rights to, or control over, collateral other than the real estate without obtaining an appraisal.

Regulated institutions frequently take real estate liens to protect legal rights to other collateral and not because of the value of the real estate as an individual asset. For example, in lending associated with logging operations, a regulated institution typically takes a lien against the real estate upon which the timber stands to ensure its access to the timber in the event of default. Similarly, where the collateral for a loan is a business or manufacturing facility, a regulated institution may take a lien against the land and improvements in order to be able to sell the entire business or facility as a going concern if the borrower defaults.

A Title XI appraisal contains an opinion of the market value of real estate. When the market value of the real estate as an individual asset is not needed to support the regulated institution's decision to lend, no purpose is served by requiring the institution to obtain a Title XI appraisal.

Commenters generally favored adopting an exemption addressing these circumstances, agreeing that Title XI appraisals did not enhance the safety and soundness of these transactions because the lenders were basing their decision to extend credit on the value of collateral other than real estate.

Some commenters suggested that this exemption could be combined with the abundance of caution exemption. Although there are situations in which the two exemptions overlap, the agencies believe that both exemptions are necessary because there will be transactions that qualify for one exemption, but not the other.

(5) Real Estate-Secured Business Loans of $1 Million or Less

The agencies are adopting a new exemption for business loans with a value of $1 million or less where the sale of, or rental income derived from, real estate is not the primary source of repayment. The agencies also are adopting the proposed definition of "business loan" as a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship (including an individual engaged in farming), or other business entity. This provision allows a regulated institution to take real estate as security in connection with a loan to a small- or medium-sized business when the primary source of repayment for the loan does not depend on sale of, or rental income derived from, real estate.

The final rule differs in two respects from the proposed rule. First, the exemption is available for business loans of $1 million or less. The proposed rule would have exempted business loans less than $1 million. The change was adopted to reduce confusion by making this provision consistent with the way other limits are treated in the rule. The change affects the scope of the exemption very slightly.

Second, under the final rule, the exemption is available for business loans that do not depend on real estate sales and rental income as the primary source of repayment for the loan. The proposed rule would have exempted business loans that were not dependent on sale of, or rental income derived from, the real estate taken as collateral as the primary source of repayment. The change narrows the scope of the exemption by preventing a borrower from qualifying for the exemption by showing that the primary source of repayment for the loan is income from real estate sales and rentals involving real estate other than the real estate in which the lender has a security interest. This means, for example, that a real estate developer cannot qualify for the exemption by showing that a real estate-secured loan for one project, in which the lender has taken a security interest, will be repaid with income from real estate sales or rentals from other real estate projects, in which the lender does not have a security interest.

The following examples illustrate the application of this exemption.

Example 1: The owner of a shop seeks a term loan for $1 million or less from a regulated institution. The loan will be repaid with income derived from operations. The regulated institution would not extend credit to the borrower without a lien against the real estate.

However, because the loan is for $1 million or less and the sale of, or rental income derived from, real estate is not the primary source of repayment, a Title XI appraisal would not be required for this transaction under this exemption.

Example 2: A company acquires an adjacent parcel of land to construct an office building. The company seeks a loan of $1 million or less from a regulated institution to provide construction financing and a permanent mortgage for the office building. The company intends to lease part of the building and will use the rental income to help repay the loan. The lender estimates that operations of the business would contribute approximately 45 percent of the funds necessary to repay the loan and rental income approximately 55 percent.

The regulated institution should conclude that rental income derived from real estate serves as the primary source of repayment for the loan. Therefore, assuming no other exemption is applicable to the transaction, a Title XI appraisal would be required.

Increased Lending to Small- and Medium-Sized Businesses

In the experience of the agencies, the appraisal requirement may have adversely affected the ability of small- and medium-sized businesses to obtain credit. In particular, there are indications that the cost of an appraisal may impede small- and medium-sized businesses from receiving working capital, operating loans, and other business-related credits that otherwise would be consistent with prudent banking practice.

The majority of financial institutions and financial institution trade associations that responded to the agencies' request for comment on the effect of the business loan exemption on credit availability stated that the proposed exemption would increase credit availability by reducing the cost and time to make real estate-secured business loans. These commenters generally stated that the changes would have the most significant effect on credit availability for small- and medium-sized businesses. Some appraisers also stated that the proposed changes would increase credit availability.

A large number of commenters responding to the specific request for comment thought that the changes would have no effect on credit availability. These commenters included appraisers and appraiser trade associations, a small number of financial institutions, and other commenters. Some of these commenters stated that the ability of financial institutions to earn a reasonable return by making relatively risk-free investments in U.S. government securities was the cause of credit availability problems.

The agencies believe that the final rule may reduce the cost of real estate-secured loans to small- and medium-sized businesses and increase the availability of loans to these borrowers.

Effect on Safety and Soundness

Some commenters stated that this exemption would eliminate the requirement to obtain Title XI appraisals for a large portion of the real estate-secured business loans in their communities. Others stated that this exemption raised safety and soundness concerns because the only tangible collateral for many businesses is real estate. Though real estate may be an important asset of many small- and medium-sized businesses, the agencies have concluded that this exemption for certain business loans that do not rely on real estate as the primary source of repayment will not threaten the safety and soundness of regulated institutions nor pose a threat to federal financial and public policy interests.

Although the agencies are not requiring Title XI appraisals in connection with these business loans, the agencies are requiring regulated institutions to obtain appropriate evaluations of the real estate collateral. The evaluation should provide the institution with sufficient information on the value of the real estate to satisfy principles of safe and sound banking. In addition, during each required full-scope, on-site examination, each agency will analyze the prudence of each institution's credit underwriting practices, including appraisal and evaluation practices, as appropriate to the institution's size and nature of its real estate-related activities.

Shortly after the agencies issued the proposed rule, the GAO completed its report entitled Regulatory Impediments to Small Business Lending Should Be Removed (September 1993). In the report's summary, the GAO stated: "Specifically, we believe that real estate appraisal requirements can be safely modified when applied to collateral taken as supplementary support for traditional small business loans. Therefore, we agree with those aspects of the rule changes recently proposed by the banking regulators to expand the exemptions from mandatory appraisals as they pertain to such loans." The GAO noted that the report and its comment on the proposed appraisal regulations were limited "to situations in which real estate collateral is used to support loans to small businesses for such purposes as working capital and equipment purchases." This exemption is intended to reach these loans, as well as loans for other business purposes where sale of, or rental income derived from, real estate is not the primary source of repayment.

The conclusion that exempting these transactions will not threaten the safety and soundness of financial institutions is supported by responses to a 1993 OCC survey of its senior examining staff. The survey asked for information on the effect of the proposed business loan exemption on bank safety and soundness, as well as information on the significance, by loan size, of losses on loans secured by 1-to-4 family residential real estate and other categories of real estate.

Eighteen of the 20 respondents to the OCC survey stated that the proposed exemption for business loans would not threaten the safety and soundness of financial institutions, although some respondents noted that the exemption could present more serious risks for small financial institutions. Respondents to the survey identified loans above $1 million secured by non-residential real estate as the category of transactions that had the most significant losses attributable to inadequate appraisals, followed by loans secured by non-residential real estate in the ranges $750,000 to $1 million and $500,000 to $750,000. In general, respondents noted that where real estate serves as only a secondary source of repayment for a business loan, an evaluation of the collateral would be sufficient to address safety and soundness issues. Although the other bank regulatory agencies' surveys did not include the specific questions posed in the OCC survey, the results of the other bank regulatory agencies' surveys also generally support the business loan exemption.

In addition to the survey responses, the data from the 1992 commercial bank Call Reports and savings associations' TFR indicate that the exposure to the banking system from these transactions is limited. All commercial loans secured by non-farm non-residential real estate in the range between $250,000 and $1 million (this includes both non-exempt and exempt transactions) represent less than 4 percent of all loans for commercial banks and less than 3 percent of all loans for savings associations. Furthermore, these loans represent less than 27 percent of commercial loans secured by non-farm non-residential real estate at commercial banks and less than 36 percent of commercial loans secured by such real estate at savings associations. This generally agrees with the National Survey of Small Business Finances (1989), cosponsored by the Federal Reserve Board and Small Business Administration. The results of the survey (adjusted to 1992 dollars) show that 22 percent of all commercial mortgages were for amounts between $250,000 and $1 million.

The agencies requested specific comment on loss experience for real estate-secured business loans. Only a small number of banks and no thrifts submitted the requested data. Although the agencies do not believe the response is large enough to reach conclusions about industry-wide loss experience, the data submitted is consistent with the conclusion that regulated institutions are not suffering high levels of losses in connection with real estate-secured business loans of $1 million or less that do not depend on real estate sales or rental income as the primary source of repayment. The responses that the agencies received are summarized in the following table.

Real Estate-Secured Loans[1]	Number of Loans (12/31/92)	Outstanding Principal Amount of Loans[2] (12/31/92)	Loss on Loans[2] (Annual Net Charge-offs)[3] (12/31/92)	Loss Rate[4] (Calculated)
All Real Estate-Secured Business Loans	90,410	17,488,561	178,237	1.02%
Real Estate-Secured Business Loans Less Than $1 Million That are not Dependent on the Sale of, or Rental Income Derived From, the Real Estate Taken as Collateral as the Primary Source of Repayment for the Loan	59,595	8,008,422	32,680	0.41%

1. None of the comment letters received by OTS included data on these loans.
2. Dollars rounded to thousands.
3. Annual net-charges are determined by taking the dollar amount of gross losses and subtracting the amount recovered.
4. The agencies have calculated the loss rate for both categories of real estate-secured loans about which the agencies required data by dividing total annual net charge-offs by the total outstanding principal balance.

Limited to Business Loans of $1 Million or Less

The exemption applies only to transactions involving business loans with a value of $1 million or less. Capping the exemption at $1 million serves two purposes. It helps to ensure that the transactions involve small- and medium-sized businesses. It also limits the overall exposure of the banking system to transactions exempt under this provision.

Some commenters stated that a $1 million limit may be too high for small institutions and suggested that the limit be set at a percentage of the institution's capital. Others stated that the exemption should cover business loans of any size.

Regulated institutions typically are subject to capital-based lending limits that restrict the amount of credit they can extend to any one borrower. While a $1 million business loan may be much more significant to a smaller institution, the agencies believe that a second capital-based limit in the appraisal regulation is inappropriate because it can place smaller institutions at a competitive disadvantage to larger institutions. In addition, the agencies regularly examine the lending practices of all regulated institutions and can address problems with individual institutions if they arise. The agencies believe it is appropriate, however, to place a limit on the size of loan that can qualify for this exemption. Many commenters agreed that a $1 million dollar limit was appropriate.

Primary Source of Repayment

Some commenters suggested that the exemption should be available only if the borrower could repay the loan entirely from sources other than sale of, or rental income derived from, real estate. Commenters also suggested specific percentage limits on the contribution of real estate to repayment of the loan ranging from 10 to 50 percent. Other commenters stated that the exemption should allow a regulated institution to determine whether a business loan requires an appraisal, regardless of the contribution of real estate sales or rental income to the borrower's repayment of the loan.

The exemption is intended to improve the ability of small- and medium-sized businesses to obtain real estate-secured loans for business purposes. As the contribution of real estate sales and rentals to the borrower's sources for repaying the loan increases, repayment becomes more dependent on the performance of the real estate market. Therefore, in deciding whether a transaction qualifies for this exemption, regulated institutions should be guided by the importance of the real estate-related sources of income to the borrower's repayment of the loan, rather than applying a universal numerical cap. In no case, however, may a business loan qualify for this exemption if real estate-related sources of income contribute more toward repayment of the loan than non-real estate sources of income.

Exempting these business loans will reduce the adverse effects on small- and medium-sized business lending associated with the requirement to obtain a Title XI appraisal. Moreover, since repayment of these loans generally will not depend primarily on the performance of the real estate markets, allowing lenders to make these business loans on the basis of evaluations of the real estate collateral does not threaten the safety and soundness of financial institutions.

Agricultural Lending

The agencies received comment letters from appraisers in rural areas who stated that the exemption should not apply to agricultural production loans because use of the real estate generates the income for repayment of the loan. For any transaction exempt under this provision, the regulated institution is responsible for documenting that the borrower's sources of income are not primarily dependent upon the sale of, or rental income derived from, real estate. The agencies do not view the sale of growing crops as the sale of real estate, nor as providing rental income derived from real estate. The agencies have concluded that transactions involving agricultural operations present no greater risk than other types of business operations, provided the primary source of repayment for the loan is not sale of, or rental income derived from, real estate.

(6) Leases

The agencies did not propose changes to the existing exemption for leases. Under this exemption, regulated institutions are not required to obtain appraisals of leases that are not the economic equivalent of the purchase or sale of real estate.

Even though the agencies did not propose changes to this exemption, some commenters suggested that Title XI appraisals should be required if a regulated institution takes any security interest in a real estate lease. The distinction between operating leases and capital leases is well recognized in accounting practice. Consistent with the distinction in accounting for operating and capital leases, the agencies have concluded that, in general, operating leases, which are not equivalent to the purchase or sale of the leased property, should not require Title XI appraisals given the limited real estate interest such leases represent.

In transactions that involve capital leases (leases that are the economic equivalent of purchasing or selling real estate), the given real estate interest is of sufficient magnitude to be counted as an asset of the lessee under accounting practices. Generally, the agencies will continue to require regulated institutions to obtain appraisals in connection with transactions that involve capital leases.

(7) Renewals, Refinancings, and Other Subsequent Transactions

The agencies are adopting a modified version of the proposed exemption for renewals, refinancings, and other subsequent transactions at the lending institution to simplify the conditions under which the exemption applies. Under the final rule, regulated institutions will be permitted to renew or refinance existing extensions of credit without first obtaining a Title XI appraisal for two general classes of transactions.

First, a subsequent transaction is exempt provided there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new funds. This modification to the proposed rule is intended to emphasize that an institution must consider the effect of changes in market conditions and physical aspects of the property on its collateral protection when it advances funds in excess of reasonable closing costs as part of a renewal, refinancing, or other subsequent transaction.

Second, a subsequent transaction is exempt provided that no new monies are advanced other than funds necessary to cover reasonable closing costs. The proposed rule did not explicitly address this class of transactions.

The agencies note that this exemption would not be applicable if a borrower refinances a mortgage with a new lender.

Prior to the adoption of this amendment, the agencies did not require a Title XI appraisal for a subsequent transaction that resulted from a maturing extension of credit if: (i) the borrower had performed satisfactorily according to the original terms; (ii) no new monies were advanced other than as previously agreed; (iii) the credit standing of the borrower had not deteriorated; and (iv) there had been no obvious and material deterioration in market conditions or physical aspects of the property which would threaten the institution's collateral protection.

In the agencies' experience, the original exemption may not have provided sufficient flexibility to regulated institutions and borrowers when a transaction was refinanced before its maturity. This is particularly true for refinancings to reduce a loan's interest rate. Further, bankers questioned whether a Title XI appraisal would be required for a refinancing where the borrower's payment history is sound and future repayment prospects are good, but the borrower's collateral has declined in value as a result of a general market decline. The agencies believe that not requiring a Title XI appraisal in such refinancings is consistent with safe and sound banking practices because the amount of the loan (except for the addition of reasonable closing costs) and the lender's collateral remain the same, and the lower loan payments may improve the ability of the borrower to repay the loan without adversely affecting the likelihood that the lender will be repaid.

If a subsequent transaction that includes the advancement of additional funds does not result in the level of collateral protection being threatened, despite a change in the market conditions or physical aspects of the property, a Title XI appraisal need not be obtained. For example, a loan originally extended with a low loan-to-value ratio could be renewed and additional funds advanced above closing costs without a Title XI appraisal, even though market conditions have deteriorated, if the regulated institution, after verifying the value of the collateral, concludes that the new loan-to-value ratio will provide adequate protection.

Similarly, if a borrower is refinancing a loan where the real estate collateral is located in a market that has experienced significant appreciation, the institution should ensure that the advancement of any new monies is based on substantiated appreciation in value. An institution can advance funds against an appreciated property whose future use is consistent with the use described in the original appraisal. If an institution makes a substantial advance that could possibly threaten the institution's collateral protection, it should consider the need to obtain a new Title XI appraisal. This exemption would not be available if a material change in the use of the property produces the reported appreciation, such as when property is rezoned for a different use.

While a Title XI appraisal is not required for transactions that qualify for this exemption, regulated institutions are required to obtain an appropriate evaluation of the collateral in accordance with the agencies' guidelines. The level of analysis and information included in the evaluation should be more detailed as the institution's exposure in the transaction increases.

Several commenters raised questions about the applicability of this exemption to loan restructurings and workouts. In such situations, the commenters contended that requiring a Title XI appraisal may impede an institution's ability to obtain additional real estate collateral to shore-up its position or to advance new funds to protect its existing collateral position. The agencies acknowledge that the time and cost of obtaining a Title XI appraisal may present barriers to institutions in their negotiations with borrowers in a loan restructuring or workout. The agencies believe that this situation has been addressed in the regulation and the agencies' guidance, such as the November 7, 1991 Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans. It is the agencies' policy to encourage lenders to work constructively with their borrowers when restructuring existing loans that have credible support for repayment.

(8) Transactions Involving Real Estate Notes

The agencies are adopting a modified version of the proposed exemption for transactions involving real estate-secured loans, loan participations, pooled loans, interests in real property, and mortgage-backed securities. The amendment clarifies when regulated institutions may engage in secondary mortgage market transactions involving real estate loans and other interests in real estate without obtaining a new Title XI appraisal.

The exemption adopted by the agencies clarifies and allows regulated institutions to purchase, sell, invest in, exchange, or extend credit secured by, real estate-secured notes or interests in real estate without obtaining a new Title XI appraisal if each note or real estate interest is supported by an appraisal that met the regulatory appraisal requirements for the institution at the time the real estate-secured note was originated. The prior exemption referred to purchases of these interests only. In addition, the agencies have changed the text of the final rule to more clearly state the appraisal requirements that the underlying notes must meet.

The exemption serves federal public policy interests by helping to ensure that the appraisal regulation does not unnecessarily inhibit secondary mortgage market transactions that involve these real estate-secured loans and real estate interests. The exemption makes clear that a regulated institution need not obtain new Title XI appraisals for loans originated before the effective date of the agencies' regulations in order to buy or sell them in the secondary mortgage market.

The agencies have concluded that the transactions exempted by this provision do not require new Title XI appraisals to protect federal financial and public policy interests or the safety and soundness of financial institutions. Principles of safe and sound banking practice require regulated institutions to determine the suitability of purchasing or investing in existing real estate-secured loans and real estate interests. Typically, these transactions will have a history of performance or will have been originated according to secondary mortgage market standards. The additional information from these sources, when coupled with the original documentation, permits regulated institutions to make appropriate decisions regarding these transactions.

Some commenters stated that this exemption raised safety and soundness concerns because exempt transactions may have appraisals performed before Title XI appraisal requirements went into effect. Because regulated institutions will have other sources of information about the performance of these seasoned loans, the agencies believe that new Title XI appraisals are not necessary to ensure the safety and soundness of these exempt transactions.

Some commenters urged the agencies to expand the proposed exemption, or adopt new exemptions, to eliminate the Title XI appraisal requirement for all mortgage-backed securities. In addition, commenters suggested that the agencies exempt residential mortgage warehousing loans (loans to residential mortgage lenders who ultimately sell the mortgages to the secondary mortgage market), transactions with credit ratings by established rating agencies, or transactions that were not subject to the agencies' jurisdiction at origination.

The agencies believe that to protect federal financial and public policy interests, the underlying loans or real estate interests should have appraisals that meet the requirements that were applicable to regulated institutions when the underlying transactions were originated. For this reason, the agencies are not adopting the suggestions for exempting additional categories of transactions under this provision.

Commenters also suggested that the agencies should permit a regulated institution that purchases a pool of loans, invests in mortgage-backed securities, or secures a mortgage warehousing loan with real estate notes, to confirm that the loans have appropriate appraisals without reviewing the appraisal for each underlying loan. The agencies agree that it should not be necessary to review the appraisal for each underlying loan in all cases. The agencies believe that regulated institutions may use sampling and audit procedures to determine whether appraisals for the underlying loans in a loan pool satisfy the regulation's requirements and to verify the seller's representations and warranties.

The agencies also believe that a regulated institution may presume that the underlying loans in an investment-grade, marketable, mortgage-backed security satisfy the requirements of the appraisal regulation whenever an issuer makes a public statement, such as in a prospectus, that the appraisals comply with the agencies' regulations. To be considered investment grade, a security must be rated in one of the top four rating classifications of at least one nationally recognized statistical rating service. A marketable security is one that may be sold with reasonable promptness at a price that corresponds to its fair value.

For mortgage warehousing loans, sale to Fannie Mae or Freddie Mac of the mortgages that secure the mortgage warehouse loan may be used to demonstrate that the underlying loans complied with the appraisal requirements of the agencies' regulations. The institution, however, must continue to monitor its borrower's performance in selling loans to the secondary market and take appropriate steps, such as increased sampling and auditing of the loans and their documentation, if the borrower experiences more than a minimal rejection rate.

(9) Transactions Insured or Guaranteed by a U.S. Government Agency or U.S. Government Sponsored Agency

The agencies are adopting a uniform exemption for transactions that are wholly or partially insured or guaranteed by a United States government agency or government sponsored agency because these loans pose little risk to insured institutions. This exemption will eliminate the confusion among regulated institutions who may believe that two separate appraisals are required -- one meeting the banking agencies' regulations and another meeting the federal loan programs' standards.

The prior regulations of the OCC, FDIC, and OTS exempted many of these transactions. However, they previously required that these transactions be supported by an appraisal that conformed to the requirements of the insuring or guaranteeing agency. Prior to adoption of this amendment, the Board's appraisal regulation did not specifically exempt these transactions.

Federally insured or guaranteed transactions must meet all the underwriting requirements of the federal insurer or guarantor, including real estate appraisal requirements, in order to receive the insurance or guarantee. The agencies believe that the standards of these loan programs are sufficient to protect the safety and soundness of regulated financial institutions. Therefore, it is unnecessary to require that these transactions also meet the overlapping requirements of the banking and thrift agencies' appraisal regulations.

Some commenters suggested that the agencies should limit the application of this exemption to federal loan programs with appraisal requirements that conform to the Uniform Standards of Professional Appraisal Practice (USPAP) and require the use of licensed or certified appraisers. In addition, commenters raised concerns that some loan programs may not have appraisal standards and asked the agencies to list those loan programs to which this exemption applies.

OMB has directed federal agencies with government guaranteed or insured loan programs to conduct real estate appraisal programs in a manner to reduce default risks to the federal government. Specifically, these federal agencies are required to ensure that all real estate credit transactions over $100,000 have an appraisal performed by a state licensed or certified appraiser and that the appraisal be conducted under appraisal standards that are consistent with the USPAP.[7]

The agencies believe that the authority of OMB to ensure that federal agencies adopt appropriate real estate appraisal standards eliminates the need to list specific loan programs for which this exemption applies. Moreover, OMB is monitoring the implementation of those appraisal programs and has required any federal agency not having appraisal standards and practices in place to submit an implementation plan and schedule to OMB. If the agencies later determine that a particular federal loan program poses a threat to the safety and soundness of regulated institutions, the agencies have retained the authority to require appraisals in such situations.

This exemption also applies to certain other real estate-related financial transactions involving government agencies or government sponsored agencies. For example, the U.S. Postal Service typically contracts with a developer to erect and lease a special purpose building for the Postal Service's use. Applicable contract procedures normally require only cost estimates when determining who is awarded the contract. The Postal Service also enters into a lease with the developer. The lease payments, which are assigned to the lender, are sufficient to repay the loan. Because the developer is complying with applicable contract procedures, which require only cost estimates, it would be an unnecessary burden for the developer or the lender to also obtain a Title XI appraisal.

(10) Transactions that Meet the Qualifications for Sale to a United States Government Agency or Government Sponsored Agency

The agencies are adopting a modified version of the proposed exemption for transactions that meet the qualifications for sale to any U.S. government agency or government sponsored agency. By referring to any U.S. government agency or sponsored agency, the exemption includes not only loans sold to federal agencies, but also any transaction that meets the qualifications for sale to agencies established or chartered by the federal government to serve public purposes specified by the U.S. Congress. These government sponsored agencies are:

* Banks for Cooperatives
* Federal Agricultural Mortgage Corporation (Farmer Mac)
* Federal Farm Credit Banks
* Federal Home Loan Banks (FHLBs)
* Federal Home Loan Mortgage Corporation (Freddie Mac)

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[7] OMB Circular A-129, "Policy for Federal Programs and Non-Tax Receivables," revised January 1993.

* Federal National Mortgage Association (Fannie Mae)
* Student Loan Marketing Association (Sallie Mae)
* Tennessee Valley Authority (TVA)

This exemption permits regulated institutions to originate, hold, buy, or sell transactions that meet the qualifications for sale to any U.S. government agency and the above listed government sponsored agencies without obtaining a separate appraisal conforming to the agencies' regulations.

The exemption contains a modification to the original proposal that permits regulated institutions to accept appraisals performed in accordance with the appraisal standards of Fannie Mae and Freddie Mac for any residential real estate transaction, both single family and multifamily, regardless of whether the loan is eligible to be purchased by Fannie Mae or Freddie Mac. This modification clarifies that a regulated institution's "jumbo" or other residential real estate loans that do not conform to all the underwriting standards of Fannie Mae or Freddie Mac, but that are supported by an appraisal that meets the appraisal standards of these agencies, will qualify for this exemption.

This exemption expands the prior exception to the regulations of the OCC, FDIC, and OTS for transactions involving 1-to-4 family residential properties that had appraisals conforming to the appraisal standards of Fannie Mae and Freddie Mac. In addition, the OTS exception applied to existing multifamily properties. These transactions were not required to comply with the additional supervisory standards set forth in the prior regulations. The Board did not have a similar exception in its prior regulation.

Some commenters requested that the agencies continue the prior exception allowing the use of Fannie Mae or Freddie Mac standards for any loans involving 1-to-4 family residential real estate. Other commenters stated that the proposed exemption should not be adopted because the agencies would not be meeting their statutory obligation to set appraisal standards for transactions within their jurisdiction.

The agencies believe the appraisal standards of the U.S. government agencies or sponsored agencies established to maintain a secondary market in various types of loans are appropriate for these exempt transactions. Recently, Fannie Mae and Freddie Mac revised their 1-to-4 family residential appraisal standards and report forms to incorporate the USPAP as the minimum appraisal standards. Further, the appraisal standards and forms of Fannie Mae and Freddie Mac are recognized as the appraisal industry's standard for residential real estate appraisals. The agencies have concluded that those appraisal standards should protect federal financial and public policy interests in the loans that are eligible for purchase by U.S. government agencies or sponsored agencies. The agencies also believe that compliance with these standards will protect the safety and soundness of regulated financial institutions.

The agencies believe that permitting regulated institutions to follow these standardized appraisal requirements, without the necessity of obtaining a separate appraisal or an appraisal supplement for conformance with the banking agencies' regulations, will reduce regulatory burden and increase an institution's ability to buy and sell these types of loans, improving the institution's liquidity.

(11) Transactions by Regulated Institutions As Fiduciaries

The agencies are adopting a new exemption for transactions in which a regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law. The amendment clarifies that regulated institutions acting as fiduciaries are not required to obtain appraisals under the agencies' appraisal regulations if no appraisal is required under other law governing their fiduciary responsibilities in connection with those transactions.

Prior to adoption of this amendment, it was unclear whether the agencies' appraisal regulations required appraisals for all real estate-related financial transactions in which regulated institutions participated as fiduciaries. For example, other law may not require an appraisal in connection with the sale of a parcel of real estate to a beneficiary of a trust on terms specified in the trust instrument.

While financial institutions were in general agreement with the proposed exemption, some of these commenters stated that a fiduciary should be exempt from meeting Title XI appraisal requirements regardless of whether other laws require an appraisal. Commenters opposing this exemption believe that fiduciaries should be required to obtain a Title XI appraisal for all their real estate-related transactions.

The agencies have concluded that a Title XI appraisal should not be required when regulated institutions engage in real estate-related financial transactions as fiduciaries and no other law (including state common law establishing the responsibilities of fiduciaries) requires appraisals for those transactions. Losses as a result of these transactions would not, absent some negligence by the institution, be incurred by the institution. Therefore, exempting these transactions from the Title XI appraisal requirement should not adversely affect the safety and soundness of financial institutions. When a fiduciary transaction requires an appraisal under other law, that appraisal should conform to the requirements of the agencies' regulations.

(12) Appraisals Not Necessary to Protect Federal Financial and Public Policy Interests or the Safety and Soundness of Financial Institutions

This provision was added to the rule to make clear that the agencies retain the authority to determine in a given case when the services of an appraiser are not required.

Only a few commenters addressed this issue. One commenter expressed the concern that the agencies are granting themselves the authority to create new exemptions without the benefit of public comment.

The agencies have the authority to implement and interpret regulations under their jurisdiction. The specific exemptions of the regulation describe the major categories of transactions that would not require appraisals. As a result of their experience in implementing their regulations, however, the agencies recognized that it is impossible to identify all types of transactions for which the services of an appraiser should not be required under Title XI of FIRREA and proposed this exemption to confirm their authority to determine that individual transactions do not require the services of an appraiser. The agencies will adopt any new exemptions covering broad categories of transactions in accordance with notice and comment rulemaking procedures.

§ ___.3 Evaluations required.

The agencies are adopting a modified version of the proposed amendment concerning evaluations.

The final rule requires regulated institutions to obtain evaluations for real estate-related financial transactions that do not require Title XI appraisals because they: (i) are below the threshold level; (ii) qualify for the exemption for business loans of $1 million or less where income from real estate is not the primary source of repayment; or (iii) qualify for the exemption for subsequent transactions resulting from an existing extension of credit. The agencies changed the text of this amendment to make clear that institutions must still obtain evaluations for these exempt transactions. The regulation does not require the institution to have an evaluation if the transaction qualifies for an exemption other than these three exemptions.

An evaluation provides a general estimate of the value of real estate and need not meet the detailed requirements of a Title XI appraisal. An evaluation must provide appropriate information to enable the institution to make a prudent decision regarding the transaction. Because institutions must tailor evaluations to provide appropriate information for different types of transactions, the content and form of evaluations will vary for different transactions.

In their prior regulations, the OCC, Board and OTS required evaluations for all real estate-related financial transactions that do not require appraisals. The FDIC's prior regulation stated that supervisory guidelines, general banking practices or other prudent standards may require an appropriate valuation of real property collateral when a Title XI appraisal is not required. For some institutions, the effect of these provisions may have been to require evaluations in cases where they did not assist in protecting the institutions' safety and soundness. The agencies are amending their regulations to require regulated institutions to have evaluations only for those real estate-related financial transactions where an understanding of the real estate's value is generally needed to assist the institution in deciding whether to enter into the transaction.

Some commenters stated that evaluations should not be required for any exempt transactions and that the decision to obtain an evaluation should be left to the institution. Commenters suggested that the agencies should require appraisals for any transaction that requires an evaluation and raised questions about the qualifications and independence of persons performing evaluations. Some commenters stated that only licensed or certified appraisers were qualified to perform evaluations.

The agencies believe that safety and soundness principles require institutions to obtain an understanding of, and document, the value of the real estate involved in transactions that: (i) are below the threshold level; (ii) qualify for the exemption for business loans of $1 million or less where income from real estate is not the primary source of repayment; or (iii) involve an existing extension of credit. In these cases, while a Title XI appraisal is not required to determine the value of the real estate, the agencies have concluded that regulated institutions must have an estimate of the real estate's value as a matter of safe and sound banking practice. For this reason, the agencies have decided that institutions should not have the discretion to decide whether they will obtain evaluations for these transactions. However, institutions will have discretion, within the limits of safe and sound banking practice as indicated in agency guidance, to determine the content and form of the evaluation.

While licensed or certified appraisers may be qualified to perform evaluations, the agencies do not believe these appraisers are the only persons that can render a competent estimate of the value of real estate for exempt transactions. Requiring institutions to procure the services of a licensed or certified appraiser to prepare evaluations or Title XI appraisals for exempt transactions could impose significant additional costs on lenders and borrowers without significantly increasing the safety and soundness of the transactions. However, the agencies' regulations do not, as suggested by some commenters, prohibit regulated institutions from using licensed or certified appraisers to prepare evaluations. Nor do the regulations prevent regulated institutions from obtaining Title XI appraisals for exempt transactions.

The agencies also believe that regulated institutions can take steps to ensure that the individuals performing evaluations are capable of providing an unbiased estimate of value. Institutions would generally be expected to check that persons who prepare evaluations are subject to adequate safeguards and controls to assure the integrity of the evaluation they perform. The agencies intend that regulated institutions have some flexibility in the safeguards they erect to ensure the independence of the person performing the evaluation.

The agencies' experience with transactions exempt under their prior appraisal requirements indicates that employees of a regulated institution generally can provide an unbiased and competent evaluation of real estate collateral for exempt transactions.

If there are deficiencies in an individual institution's evaluation procedures, including its procedures for determining whether to order Title XI appraisals for exempt transactions, the agencies can take appropriate steps to have the institution correct the problem. This can include requiring the institution to obtain appraisals for exempt transactions to address safety and soundness problems.

Several commenters requested that the agencies provide additional information on what is required in evaluations and who may perform them. The agencies intend to revise their existing guidance on real estate appraisal and evaluation programs for regulated institutions to further address these issues.

§ ___.3(c) Appraisals to address safety and soundness concerns.

The agencies are adopting substantially as proposed an amendment stating that each agency continues to reserve the right to require a regulated institution to obtain a Title XI appraisal whenever the agency believes that an appraisal is necessary to address safety and soundness concerns. This authority may involve the agency requiring an institution to obtain an appraisal for a particular extension of credit or an entire group of credits.

Some commenters raised the concern that the agencies' authority to require a Title XI appraisal for safety and soundness purposes should be exercised only on a prospective basis. Further, several commenters noted that the agencies' authority to determine on a case-by-case basis whether an appraisal is required may lead to inconsistencies among the agencies.

Whether an institution will be required, pursuant to this provision or existing safety and soundness authority, to obtain an appraisal for a particular extension of credit, or an entire group of credits, may depend on the condition of that institution. If an institution is in troubled condition, and that troubled condition is attributable to underwriting problems in the institution's real estate loan portfolio, then the agencies may require such an institution to obtain an appraisal for all new real estate-related financial transactions below the threshold that are not subject to another exemption. Thus, for example, a troubled institution whose problems are attributable to trading losses, investment losses, or a defalcation might be allowed to continue to operate under the $250,000 threshold, whereas an institution whose problems are attributable to poor underwriting of real estate loans may be subjected to a lower threshold.

However, regardless of a institution's condition, an examiner may determine that a particular real estate-related financial transaction requires a Title XI appraisal. This provision confirms that the agencies have the authority to require appraisals for a particular transaction to address safety and soundness concerns.

A determination that a particular institution will have to obtain appraisals below the threshold will be made by the appropriate agency's supervisory office. Although this provision is intended to be applied on a case-by-case basis to address the problems of a particular institution, the agencies will work to maintain consistency.

As previously stated in the discussion of the appraisal threshold, as a matter of policy, OTS intends to require problem institutions or institutions in troubled condition to continue to obtain Title XI appraisals for loans over $100,000. Given the overall concentration of real estate-related transactions in the thrift industry, OTS believes that a problem thrift or a thrift in troubled condition will, in general, have real estate-related asset quality problems.

§ ___.4(a) Minimum appraisal standards.

The agencies are adopting five minimum appraisal standards in place of the 14 standards in the prior rule. The final rule includes four modifications to the proposed rule concerning minimum appraisal standards. The final rule requires all appraisals for federally related transactions to: (i) conform to generally accepted appraisal standards as evidenced by the

USPAP unless principles of safe and sound banking require compliance with stricter standards; (ii) be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction; (iii) analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units; (iv) be based upon the definition of market value as set forth in the regulation; and (v) be performed by State licensed or certified appraisers.

Adoption of these standards will simplify compliance with the appraisal regulation without affecting the usefulness of the Title XI appraisals prepared for federally related transactions. The amendment allows institutions to make use of the USPAP Departure Provision and eliminates several regulatory standards that parallel existing USPAP standards.

The agencies proposed three alternatives for meeting the statutory requirement to use the USPAP in setting minimum appraisal standards for federally related transactions. Under the first two alternatives, the agencies would have published the USPAP as part of their regulations (either as an appendix to their rules or through incorporation by reference). The agencies have chosen to adopt the third alternative that generally references USPAP, but does not make USPAP a part of the agencies' regulations. The agencies agree with many commenters who believed that Alternative III was the most workable approach because the agencies would not have to republish changes to the USPAP adopted by the Appraisal Standards Board, and references to USPAP in the regulation could be assumed to always refer to the most current USPAP edition. The agencies believe that Alternative III minimizes potential conflicts between an institution's duty to follow the agencies' appraisal requirements and an appraiser's professional obligation to follow the latest USPAP version.

Since the agencies are adopting Alternative III, USPAP provisions applicable to federally related transactions will no longer be published as Appendix A to the agencies' appraisal regulations. Therefore, each agency has deleted Appendix A from its appraisal regulation.

Because application of present or future USPAP standards to federally related transactions may be inconsistent with maintaining the safety and soundness of financial institutions, the agencies have modified the standard on compliance with the USPAP. This modification makes clear that principles of safe and sound banking may require institutions to comply with stricter standards than the USPAP. Although the institution has the primary responsibility for obtaining a Title XI appraisal that meets its needs, the agencies may by regulation or guidance identify USPAP standards that are inappropriate for federally related transactions. For example, the USPAP allows an appraiser to appraise property even though the appraiser may have a direct or indirect interest in the property, if the appraiser discloses this fact in the appraisal report. The agencies believe, however, that federal financial and public policy interests are better served by requiring that an appraiser for a federally related transaction not have any direct or indirect interest, financial or otherwise, in the transaction or the property. The agencies have included this requirement in the section of the regulation that deals with appraiser independence.

The minimum standards also permit regulated institutions to use appraisals prepared in accordance with the USPAP Departure Provision for federally related transactions. The

Departure Provision permits limited exceptions to specific guidelines in the USPAP. Appraisers preparing appraisals using the Departure Provision still must comply with all binding requirements of the USPAP and must be sure that the resulting appraisal will not be misleading. The agencies believe that regulated institutions should be allowed to determine, with the assistance of the appraiser, whether an appraisal to be prepared in accordance with the Departure Provision is appropriate for a particular transaction and consistent with principles of safe and sound banking practice.

The agencies are adopting a modified version of the proposed standard that requires appraisals for federally related transactions to be written. The modification makes clear that the written appraisal must contain sufficient information and analysis to support the institution's decision to engage in the transaction. The modification puts regulated institutions on notice of their responsibility to have appraisals that are appropriate for the particular federally related transaction. The agencies are aware that the Appraisal Standards Board of the Appraisal Foundation has proposed changing the USPAP to expand the types of appraisal reports that appraisers may prepare. The agencies believe that the standard on written appraisals permits regulated institutions to take advantage of additional flexibility that may be available if the USPAP is amended, as long as the appraisal report contains information and analysis to support the institution's decision.

The agencies are retaining from the prior rule the standard regarding deductions and discounts. The USPAP provision on this subject requires the appraiser to include a discussion of deductions and discounts only when it is necessary to prevent an appraisal from being misleading. Although commenters were divided over the need to retain this regulatory standard, the agencies have decided that it is appropriate to emphasize the need to include an appropriate discussion of deductions and discounts applicable to the estimate of value in Title XI appraisals for federally related transactions.

For example, in order to properly underwrite a loan, a regulated institution may need to know a prospective value of a property, in addition to the market value as of the date of the appraisal. A prospective value of a property is based upon events yet to occur, such as completion of construction or renovation, reaching a stabilized occupancy level, or some other event to be determined. Thus, more than one value may be reported in an appraisal, as long as all values are clearly described and reflect the projected dates when future events could occur.

The standard on deductions and discounts is intended to make clear that appraisers must analyze, apply, and report appropriate discounts and deductions when providing values based on future events. In financing the purchase of an existing home, there typically would be no need to apply any discounts or deductions to arrive at the market value of the property since the institution's financing of the project does not depend on events such as further development of the property or the sale of units in a tract development.

In place of the proposed standard on market value, the agencies are retaining the prior standard that required the appraisal to be based on the definition of market value contained in the agencies' rules. Use of the standard from the prior rule is intended to emphasize that the agencies are not changing the definition of market value or the manner in which that definition is applied.

The agencies are eliminating regulatory standards that parallel or duplicate requirements of the USPAP. The regulatory standards originally were put in place because of uncertainty about the content of the USPAP and its interpretation. Based on their experience with the USPAP, the agencies believe that the additional standards may be eliminated. Commenters generally agreed. The majority of commenters responded to three specific questions on the need for additional regulatory standards by indicating that it was unnecessary to adopt separate standards on: (i) analysis of revenues, expenses and vacancies; (ii) valuation of personal property; and (iii) reconciliation of the three approaches to value. The elimination of regulatory standards that parallel USPAP standards should simplify the preparation of appraisals for federally related transactions and reduce regulatory burden.

As proposed, the agencies are adding a new provision to make clear that all appraisals for federally related transactions must be prepared by licensed or certified appraisers. This requirement is mandated by Title XI of FIRREA and repeated in other parts of the appraisal regulation.

§ ___.4(b/c) Unavailability of information. [Removed]

The agencies are removing the provision that required appraisers to disclose and explain when information necessary to the completion of an appraisal is unavailable. The USPAP currently requires appraisers to disclose and explain the absence of information necessary to completion of an appraisal that is not misleading. See USPAP Standard Rule 2-2(k). Moreover, when information that may materially affect the estimate of value is unavailable, the agencies believe that generally accepted appraisal standards require appraisers to explain the absence of that information and its effect on the reliability of the appraisal. Therefore, eliminating this provision does not result in a substantive change in the requirements applicable to appraisals for federally related transactions.

§ ___.4(c/d) Additional standards. [Removed]

The agencies are removing a provision that merely confirmed the authority of regulated institutions to require appraisers they use to comply with additional standards. The regulation's minimum appraisal standards for federally related transactions do not prevent a regulated institution from requiring an appraiser to follow additional standards or provide additional information to satisfy the institution's business needs and it is unnecessary to restate this fact in the appraisal regulation.

§ ___.5(b) Appraiser independence.

The agencies are adopting the proposed amendment concerning the use of appraisals prepared for financial services institutions other than institutions subject to Title XI of FIRREA. The agencies' prior appraisal regulations provided that fee appraisers must be engaged by the regulated institution or its agent. An exception to this requirement was permitted if the appraiser was directly engaged by another institution that is subject to Title XI of FIRREA.

The agencies concluded that the prior provision on the use of appraisals prepared for other institutions was too restrictive. It required a regulated institution to obtain a new appraisal if the borrower originally sought a loan from an institution that was not subject to Title XI of FIRREA and was not an agent of that regulated institution. There also was uncertainty about the meaning of agent in these cases.

The amended provision permits a regulated institution to use an appraisal that was prepared for any financial services institution, including mortgage bankers, if certain conditions are met. The appraiser must be engaged directly by the financial services institution and must not have a direct interest, financial or otherwise, in the property or the transaction. In addition, the regulated institution must ensure that the appraisal conforms to the requirements of the regulation and is otherwise acceptable. The prohibition on the institution using an appraisal prepared for the borrower remains in effect.

The majority of comments concerning this provision favored the proposed change. One commenter requested that the agencies define financial services institutions and include mortgage brokers within that definition. Other commenters requested clarification of the circumstances under which a non-regulated institution can be an agent of a regulated institution and whether agents are prohibited from receiving a commission on each transaction.

The agencies have decided not to adopt a specific definition of financial services institution. This term is intended to describe entities that provide services in connection with real estate lending transactions on an ongoing basis.

The agencies do not intend to limit the arrangements that regulated institutions have with their agents, provided those arrangements do not place the agent in a conflict of interest that prevents the agent from representing the interests of the regulated institution. For example, the agencies do not require that there be a written agreement between the regulated institution and the agent, and the agent may represent the regulated institution solely with respect to ordering appraisals. In addition, the agencies' regulations do not prohibit agents from receiving a commission for transactions on which they order appraisals.

Some commenters opposed the amendment because of their concern that it would increase the pressure on appraisers to render an estimate of value that favors the interests of the borrower. However, regulated institutions are not required to accept appraisals that are prepared for other financial services institutions. Therefore, the institution always retains complete control over the process of ordering real estate appraisals. In addition, institutions must determine that the appraisal ordered by the financial services institution complies with the requirements of the agencies' regulations and is otherwise acceptable. This should include obtaining assurance that the financial services institution has an independent appraisal.

Other suggested changes to reduce the burden on secondary market transactions involving real estate notes, particularly for mortgage warehousing loans, are addressed in the exemption for transactions in real estate notes.

IV. WAIVER OF DELAYED EFFECTIVE DATE

This final rule is effective on June 7, 1994. The 30-day delayed effective date required under the Administrative Procedure Act (APA) is waived pursuant to 5 U.S.C. 553(d)(1), which provides for waiver when a substantive rule grants or recognizes an exemption or relieves a restriction. The amendments adopted in this final rule exempt additional transactions from the appraisal regulation, reduce appraisal standards, and provide other modifications that have the effect of relieving perceived restrictions. Consequently, all amendments in this final rule meet the requirements for waiver set forth in the APA.

V. PAPERWORK REDUCTION ACT

Board Paperwork Reduction Act

The Board is adopting revisions to Regulation Y in this rulemaking that relate to recordkeeping requirements under authority delegated to it by the Office of Management and Budget, in accordance with section 3507 of the Paperwork Reduction Act of 1980, 44 U.S.C. chapter 35, and Part 1320 of Title 5, Code of Federal Regulations, 5 CFR Part 1320. In developing these revisions, the Board has consulted with the OCC, the FDIC, and the OTS.

The collection of information in this regulation is in 12 CFR Part 225. This information is required by the Federal Reserve System to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. State member banks will use this information in determining whether and on what terms to enter into federally related transactions, such as making loans secured by real estate. The Federal Reserve System will use this information in its examination of State member banks and bank holding companies to ensure that they undertake real estate-related financial transactions in accordance with safe and sound banking principles.

The likely recordkeepers are for-profit institutions.

The estimated annual burden per recordkeeper varies from 0 hours to in excess of 100 hours, depending on individual circumstances, with an estimated average of 25.1 hours.

Estimated number of recordkeepers: 1573

List of Subjects
12 CFR Part 34

Mortgages, National banks, Real estate appraisals, Real estate lending standards, Reporting and recordkeeping requirements.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 323

Banks, banking, Mortgages, Real estate appraisals, Reporting and recordkeeping requirements, State nonmember insured banks.

12 CFR Part 545

Accounting, Consumer protection, Credit, Electronic funds transfers, Investments, Manufactured homes, Mortgages, Reporting and recordkeeping requirements, Savings associations.

12 CFR Part 563

Accounting, Advertising, Crime, Currency, Flood insurance, Investments, Reporting and recordkeeping requirements, Savings associations, Securities, Surety bonds.

12 CFR Part 564

Appraisals, Real estate appraisals, Reporting and recordkeeping requirements, Savings associations.

FEDERAL RESERVE SYSTEM
12 CFR Chapter II
12 CFR Part 225

For the reasons set forth in the common preamble, the Board amends 12 CFR Part 225 as set forth below:

Part 225 - BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for Part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. Section 225.62 is amended by redesignating paragraphs (d) through (f) and paragraphs (g) through (k) as paragraphs (e) through (g) and paragraphs (i) through (m), respectively, and adding new paragraphs (d) and (h) to read as follows:

§ 225.62 Definitions.

* * * * *

(d) Business loan means a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship, or other business entity.

* * * * *

(h) Real estate or real property means an identified parcel or tract of land, with improvements, and includes easements, rights of way, undivided or future interests, or similar rights in a tract of land, but does not include mineral rights, timber rights, growing crops, water rights, or similar interests severable from the land when the transaction does not involve the associated parcel or tract of land.

* * * * *

3. Section 225.63 is amended by revising the section heading, revising paragraph (a), redesignating paragraphs (b) and (c) as paragraphs (d) and (e) and adding new paragraphs (b) and (c) to read as follows:

§ 225.63 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) Appraisals required. An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:

(1) The transaction value is $250,000 or less;

(2) A lien on real estate has been taken as collateral in an abundance of caution;

(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;

(5) The transaction is a business loan that:

(i) Has a transaction value of $1 million or less; and

(ii) Is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;

(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(7) The transaction involves an existing extension of credit at the lending institution, provided that:

(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or

(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;

(8) The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met Board regulatory requirements for appraisals at the time of origination;

(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;

(10) The transaction either:

(i) Qualifies for sale to a United States government agency or United States government sponsored agency; or

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or

(12) The Board determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transactions or to protect the safety and soundness of the institution.

(b) Evaluations required. For a transaction that does not require the services of a State certified or licensed appraiser under paragraphs (a)(1), (a)(5) or (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.

(c) Appraisals to address safety and soundness concerns. The Board reserves the right to require an appraisal under this subpart whenever the agency believes it is necessary to address safety and soundness concerns.

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4. Section 225.64 is revised to read as follows:

§ 225.64 Minimum appraisal standards.

For federally related transactions, all appraisals shall, at a minimum:

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005, unless principles of safe and sound banking require compliance with stricter standards;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in this subpart; and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this subpart.

5. Section 225.65 is amended by revising paragraph (b) to read as follows:

§ 225.65 Appraiser independence.

* * * * *

(b) Fee appraisers. (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise, in the property or the transaction.

(2) A regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution, if:

(i) The appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction; and

(ii) The regulated institution determines that the appraisal conforms to the requirements of this subpart and is otherwise acceptable.

6. Appendix A to subpart G, part 225, is removed.

5-25-94 [signed]

Date William W. Wiles
Secretary of the Board