TESTIMONY OF

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ON

DETERMINING MARKET VALUE OF ASSETS

BEFORE THE

TASK FORCE ON THE
RESOLUTION TRUST CORPORATION

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND
URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Task Force. I am pleased to appear before you today to discuss the RTC's proposed policy for determining the fair market value of assets.

As I have stated on many occasions, the magnitude of the RTC's challenge to dispose of assets, whether in conservatorship or receivership, dictates that we seek new and cost-effective ways to sell assets. On February 28, 1990, the RTC's owned real estate asset inventory totaled $16.4 billion. From the RTC's inception through the end of March, sales of owned real estate exceeded $2.1 billion--a substantial amount, but not as much as we would have liked. Clearly, the vast majority of our asset sales lies before us, and I will discuss with you proposed policies that will enhance the RTC's ability to accomplish our asset marketing objectives.

I. CURRENT POLICY

Currently, the RTC relies on appraisals to determine the fair market value of real estate assets. All commercial properties are appraised in accordance with the RTC's Uniform Appraisal Instructions to Appraisers (See Attachment 1), which were adopted in November 1989. These instructions state that an appraiser will provide an estimate of current market value, which is defined as "the most probable price which a property should bring in a competitive and ~~open~~ market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus." Furthermore, these instructions provide that an

appraiser is to estimate a normal marketing period, based on market evidence for the property, and is instructed not to assume fire sale or liquidation values.

Due to the subjective nature of appraising, the RTC generally requires two appraisals for any property exceeding $500,000 in value. The RTC has instituted a policy of waiving the second appraisal requirement on a case-by-case basis if timely appraisals cannot be obtained and if there is sufficient evidence (such as brokers' opinions, analysis of existing appraisals, etc.) to support the single appraisal's valuation. The appraised value, adjusted for holding costs and other costs not reflected in the appraisal, becomes the established fair market value for the asset, assuming the appraisal is deemed adequate and conforms to RTC standards. If two appraisals are obtained pursuant to RTC policy--and rarely are the value conclusions identical--the average of the appraised values, adjusted for holding costs, becomes the basis for the RTC's established fair market value for the asset.

In most cases appraisals are redone annually and we seek updated appraisals from different appraisers where possible. As a result, the established fair market value of an asset is also usually revised annually, unless market evidence or changes to the asset indicate the need to obtain a new appraisal sooner.

We now sell real estate at 95 percent of market value (as determined by the RTC) in the "distressed" states of Arkansas, Colorado, Louisiana, New Mexico, Oklahoma, and Texas. The RTC has set 90 percent of fair market value as the lowest sales price available in other areas. These percentages will continue to apply to the new determination of fair market value under our proposed new policies.

II. PROPOSED POLICY

Our proposed policy on establishing the fair market value of real estate (See Attachment 2) has two parts. One pertains to conventional marketing, which allows maximum reductions from the appraised value of 15 percent at the end of six months and another 5 percent at the end of nine months. The second part pertains to establishment of reserve prices for auctions. We expect to take this proposed policy to the RTC Board next week for approval.

Under both policies, the RTC will continue to rely on independent, current appraisals for the initial establishment of fair market value. The new policies differ, however, from the current policy in that the new policies give the RTC the flexibility to determine a lower fair market value where there is sufficient information to support the determination made. The purpose of these policies is to save the RTC and hence the taxpayers money by allowing the sale of property--whether by conventional marketing methods or by auction--at the earliest possible date, rather than having the RTC absorb its carrying costs and other expenses due to an unrealistically high appraisal.

A. Conventional Marketing under the Proposed Policy

Similar to the current policy for estimating fair market value, the proposed policy, as applied to the conventional marketing of properties, requires one or more appraisals to be obtained and reviewed for each real estate asset, in accordance with the RTC's existing appraisal instructions. As noted above, if the appraisal conforms to the RTC's standards, then the appraised value, adjusted for holding and other costs not reflected in the appraisal, will become the RTC's established fair market value and the basis for establishing a sales price. Each real estate property will then be exposed to the widest appropriate market for a minimum of six months or, for single family residential properties, four months. If few or no offers are received, or if all offers received are significantly lower than the asset's adjusted appraised value, the asset manager may reconsider the market value of the property, established initially by the appraisal, in light of this evidence from the marketplace.

Other evidence, such as brokers' opinions or recent comparable sales, also may be used by the asset manager to substantiate a reduction of an asset's established fair market value as initially estimated by an appraisal. As measured against the appraised (or average appraised) values, the value as initially established may be reduced by a maximum 15 percent after the applicable four or six month time period. Subsequent reductions of up to 5 percent could be made after an additional three months of active marketing. The maximum reduction permitted will be a total of 20 percent in the absence of another appraisal. In any event, these are not automatic markdowns. Each new valuation will depend on the circumstances of the individual property, and the new valuation will be documented. Consequently, we believe that these proposed guidelines for revising the initial value will ensure that an appropriate value is being set for each asset.

B. Auctions

The second part of the new RTC policy pertains to our use of auctions. Most auctions require extensive marketing efforts with large-scale regional, national, and possibly international, exposure. Minimum marketing efforts will include extensive advertising in newspapers and appropriate trade journals and publications, and the distribution of brochures and press releases, as well as solicitations to prospects in the RTC's data base of potential buyers.

Auctions offer an excellent method for efficiently selling real estate properties. The theory behind auctions is that, if marketed correctly, properties will be exposed to many potential purchasers--far more than would be possible for each property when marketed individually--and that an early sale will enable the RTC to forgo actual holding and opportunity costs.

Consequently, it is expected that, in the aggregate, the RTC will have as high a net present value return from auction sales as from individual sales. This has been the general experience from auction sales by the FDIC. In the FDIC auction conducted by Cushman & Wakefield last year, for example, the FDIC recovered, of the properties sold, approximately 99 percent of the total appraised value of those properties.

Under the RTC's proposed policy, properties auctioned may be sold absolute--that is, with no minimum reserve price--if the property has an established market value set by appraisal below $100,000 and the property has been widely exposed to the market. The RTC will reserve the right to reject any and all offers which are made in the absence of a competitive bidding environment. Also, the RTC will not sell at auction the properties in conservatorship which satisfy the eligibility requirements for the RTC's Affordable Housing Program.

All other properties may be sold at auctions with reserve prices set at levels to take into account the benefits of an expedited sale, including savings of holding and marketing costs. Furthermore, to stimulate active bidding associated with the auction process, the RTC may set reserve prices at less than the appraised value. The lowest reserve price that can be set is 70 percent of current appraised value, as adjusted for any savings of sale's expenses or other costs resulting from an expedited sale. Again, there will not be automatic discounts. Each property will be individually analyzed to determine its reserve price and that price will have to be rigorously documented prior to its inclusion in the sale.

III. BENEFITS

These proposed changes in valuation policy will allow the RTC flexibility in determining true market price and will more closely match private sector methods of determining market value. An initial fair market value will be made through an appraisal by an independent party. However, this development of fair market value is only a point-in-time estimation, untested in the marketplace. After testing the initial estimate of market value through extensive marketing efforts, the proposed RTC policy will permit the RTC to adjust prices to reflect the realities of the market. These new estimations of market value will be used both in the conventional marketing of properties and in setting reserve prices for auctions.

By contrast, the RTC presently must incur, in order to realign market values, the cost of obtaining a new appraisal, and again, these appraisals are only judgements. We must also incur additional holding costs, such as property taxes, management expenses, asset deterioration costs, costs of risk exposure caused by a delayed sale, and the cost of borrowing working capital. These costs easily exceed 10 percent annually (working capital costs alone are running 8 percent) and are probably closer to 15 percent. Although these costs for any particular asset may not be substantial, these costs become significant for a $16.4 billion and growing real estate portfolio. At 10 percent per year in holding costs, selling assets just six months sooner will save the RTC $825 million; at 15 percent per year, the savings would be $1.24 billion. It should also be noted that these savings are on an asset base that is certain to grow rapidly as our resolution pace quickens. In addition, in some parts of the country, particularly Texas, the demand for qualified appraisers for commercial properties is so great that substantial delays can occur simply in scheduling an appraisal, further delaying the sale of properties and thus increasing costs.

The principal benefit of the proposed policy will be to increase the rate of RTC real estate sales. This will reduce the RTC's direct and indirect holding costs. Also, like most other merchandise, the longer S&L assets set on the shelf, the more they deteriorate. If a property does not sell, probably it is because we are asking too much in the marketplace.

Also, it is simply not prudent for the RTC to hold properties in the hope that market prices will rise to meet the appraisal. We are in business to sell assets, not to bet on market movement.

IV. <u>CONTROLS AND INCENTIVES</u>

To attract customers, you must provide them with a potential for profit. We have yet to find citizens who will buy assets out of a sense of patriotic duty. The amount of profit investors expect to receive from RTC asset sales will vary from property to property. We want to sell properties resulting in a reasonable profit for our customers, but not a windfall profit. Our policy requirements that market values, based on an independent appraisal, can only be lowered after market testing on the individual asset, as well as the limits that are placed on the size of the change in values, will help assure that an appropriate price will lead to a reasonable profit.

We believe this to be the case because, as the FDIC's own experience has shown, asset sales that are conducted in an open and competitive environment will result in investors receiving a fair return for their purchase and the RTC receiving fair value for the sale. To promote an open and competitive environment, RTC staff has published a guideline booklet, How To Buy Real Estate, and will be providing investors with computer-based access to the RTC real estate asset inventory later this month.

Further, in using the private sector to provide the vast majority of asset management services required, the RTC has designed asset management contracts so that the contractor has a number of incentives to sell RTC properties at maximum value in the minimum amount of time. These incentives thereby ensure the protections necessary to maintain appropriate pricing strategies.

For example, the RTC's asset management fee structure for contractors varies depending on the composition of the portfolio. Where the RTC holds marketable title, we expect to pay asset managers a minimal management fee to cover their overhead, along with a substantial disposition fee. This disposition fee, earned upon the close of sale of an asset, is a function of three variables: a) the sale price, adjusted for expenses; b) the length of time a contractor was associated with the asset; and c) the percentage the price exceeds a target sale price. These contracts, with their incentives to maximize sales proceeds, give the RTC additional protections against selling properties at lower than market prices.

To monitor the asset contractors, the RTC oversees the activities of contractors chiefly through its Standard Asset Management Agreement (SAMA) and its Asset and Management Disposition Manual. The SAMA outlines the nature and scope of the contractual relationship between asset managers and the RTC. The Asset and Management Disposition Manual guides the RTC staff and the contractors as to the RTC's expectations and procedures.

V. CONCLUSION

In conclusion, consumers in the marketplace know that we own these properties and that they must be sold. Holding these properties off the market because of unrealistically high asking prices only lengthens the marketing process and increases our costs. The only way we are going to get the government out of the S&L asset sales business is to sell these assets as quickly as possible at current market prices.

Uniform Appraisal Instructions to Appraisers For RTC Real Estate Properties

(Not Required for Residential Single Family Properties)

1. Appraisals are to be made assuming a sale on a cash basis; however, if the appraiser is uncomfortable with supplying a valuation on a cash basis because of lack of comparable sales on a cash basis, a valuation based on typical terms, as provided for in item 2 below, may be used instead. If the appraiser prefers, he/she may also value the property on both a cash basis and on a typical terms basis. RTC does not want fire sale or liquidation value appraisals.

2. Appraisals are expected to reflect values based on sales prospects considering existing economic conditions.

3. When an appraiser supplies a valuation on typical terms, these terms must be precisely defined and their contributions to or negative influence on market value must be described and estimated.

4. All appraisals are to be on an "as is" basis.

. Estimates to complete essential repairs and to cure code violations should be provided, and the appraiser should specify whether those expenses (with a breakdown) have already been considered in estimating the property's "as is" appraised value.

6. All appraisers must clearly state the estimated marketing period in their analysis, based on comparable sales, or other market evidence such as listings and discussions with local brokers or other informed market participants.

7. The RTC expects the appraiser to provide an estimate of current market value as opposed to future market value.

8. All appraisals, including updated appraisals, must be in writing.

9. Generally, appraisals should be based on existing zoning, however, the appraiser may value the property based on both current zoning and any other zoning the appraiser feels is likely obtainable within a short period. This likelihood of the alternative zoning should be explained in the report for all cases in which the appraiser feels it is appropriate to supply both valuations.

10. When an appraiser is valuing distressed property solely on a land value basis that implies demolition or removal of improvements, the cost of demolition and/or removal should be netted against the land value with the estimated cost of removal so reflected.

11. The account officer is requested to supply the appraiser with a copy of the property's legal description, the survey, leases for income producing properties, and a three (3) year sales history including offers, listings, and options if known.

12. The appraiser should provide the amount of annual property taxes and any past due taxes in the appraisal report and comment as to their reasonableness. If high, explain the impact on appraised value.

13. The appraisal may be used for multiple purposes, such as bids at foreclosure sales, large protective advances, operating budgets, and sale of the property.

14. The appraiser should note any potential environmental hazards. For example, underground storage tanks, storage containers of known or unknown contents, evidence of waste disposal such as sludge, paints, chemical residues, oil spillage, asbestos content in building material, etc.

15. Appraisers (RTC instructions only) should note in the cover page of their appraisal report any property which has significant Natural, Cultural, Recreational or Scientific value. The criteria are as follows:

    Natural Value - Properties of special significance are identified as properties within or adjacent to, National Landmarks, National Wilderness Areas, National or State Parks, National or State Wildlife Refugees, areas identified by the U.S. Fish and Wildlife service as "Critical Habitats" or other special natural features which include Wetlands, Ocean and Lake Shores, Caves, Dunes, Coastal Barrier Islands and estuaries.

    Cultural Value - Properties of cultural special significance are based on criteria established by the National Register of Historic Places. (See Attachment D)

    Recreational Value - Properties of recreational special significance are identified as any property that is within or adjacent to existing public recreation area or adjacent to rivers, oceans, or lake shores.

    Scientific Value - Properties of scientific special significance are properties valued for scientific value or archeological importance.

16. A copy of these instructions should be made a part of the appraisal report.

Market Value Definition:

The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is consummation of a sale as of a specified date and passing of title from seller to buyer under conditions whereby:

- o Buyer and seller are typically motivated;
- o Both parties are well informed or well advised and each acting in what he considers his own best interest;
- o A reasonable time is allowed for exposure in the open market;
- o Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- o The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."

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perties, built before 1941, which have special significance in American story, architecture, archeology, engineering and culture and which having ildings, structures, and objects that posses integrity of location, design, tting, materials, workmanship, feeling and association and:

a. that are associated with events that have made a significant contribution to the broad patterns of our history; or
b. that are associated with the lives of persons significant in our past; or
c. that embody the distinctive characteristics of a type, period, or method of construction, or that represent the work of a master, or that possess high artistic values, or that represent a significant and distinguishable entity whose components may lack individual distinction; or
d. that have yielded, or may be likely yield, information important in prehistory or history.

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ATTACHMENT 2

DETERMINING MARKET VALUE OF ASSETS

I. INTRODUCTION

Pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the RTC has been charged with establishing "an appraisal or other valuation method for determining the market value of real property." [Section 501(b)(12)(D)(ii)] FIRREA imposes certain limitations on the RTC with respect to disposing of real property assets in relationship to market value, especially with regard to disposition of these assets in "distressed areas".

Title V of FIRREA permits some latitude in the method(s) used to determine the market value of properties. Title XI, however, mandates specific appraisal requirements on the RTC. The RTC's proposed regulation 12 C.F.R. Part 1608 - Appraisals, developed pursuant to FIRREA, requires that any real estate-related transaction (with a value greater than $15,000) including the sale, lease, or purchase of property or the use of real property as security for a loan or investment, requires an appraisal performed in accordance with the RTC's standards.

The RTC will normally rely on independent appraisals for determining a real property's market value. However, the RTC may use alternative valuation methods, such as appraisal reviews, brokers' opinions, competitive market analysis, and market evaluations based on offers received and comparable sales, to supplement appraisals when determining an asset's market value. The alternative techniques should be used on a case-by-case basis in order to maximize the RTC's use of independent and objective sources.

II. SIGNIFICANCE OF APPRAISED VALUE

The purpose of an appraisal is to provide an objective and realistic opinion of market value. The RTC requires appraisals performed by independent third parties, with the goal of providing objective and independent estimates of market value from individuals not associated with the disposition of the real property asset. Although appraisals do not provide indisputable evidence of value, they do provide a reasonable basis for determining the value for a given property. In particular, the valuation is useful in making the determination whether to sell property for a specific price.

III. POLICY

The following general policy will be performed by RTC staff and contractors when determining market value:

1) One or more appraisals will be obtained for each real estate asset in accordance with RTC's existing Appraisal policy. The appraisals should be reviewed and if appropriate, substantiated by brokers' opinions and other market analysis.

2) If the appraisal conforms to the RTC's standards, then the appraised value adjusted for holding costs and other verifiable costs not reflected in the appraisal will be the RTC's established market value.

3) If two current appraisals were obtained for the asset pursuant to RTC policy, then the average of the appraised value adjusted for the aforementioned costs will be the RTC's established market value.

4) Results of the RTC's marketing of the property should be monitored by RTC asset staff or the RTC's asset management contractor. If the property has been aggressively marketed and either i) no offers were received; or ii) all bona fide offers received were significantly lower than the appraised value, the asset manager should explore revising the RTC's established market value. Other evidence such as recent brokers' opinions or an analysis of recent comparable sales, should be obtained to substantiate a revision of market value.

5) Upon analysis of the marketing efforts and other substantiation, the asset manager may recommend revising the established market value. However, a revision greater than 15% of appraised (or average appraised) value adjusted for any savings of holding or other verifiable costs, will not be allowed at any one time. Furthermore, two revisions totaling more than 20% will not be permitted without obtaining new appraisal(s). The first revision will not be allowed if marketing efforts are deemed inadequate and if the asset has not been actively marketed for at least six months (four months for single family homes). Any subsequent revision would require at least three months of additional marketing since the prior revision.

6) If the asset manager believes that either i) a revision at any one time greater than 15%; or ii) revisions totaling more than 20%, are substantiated and appropriate, then a new appraisal(s) should be obtained.

IV. PROCEDURES

Approval of the revised market value may be made by the level of authority which approved the original sales price.

V. CONCLUSION

The RTC's establishment of market value will rely on sound appraisals, since the appraisal process requires an in-depth market analysis by an independent and objective party. However, appraisals only provide an estimate of market value, and do not necessarily offer indisputable evidence of value. These guidelines allow the RTC some flexibility for determining market value of assets, based on sound appraisal practices and market analysis valuation techniques.

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ESTABLISHING PRICES IN AUCTION SALES

I. INTRODUCTION

Auctions offer an excellent method for efficiently disposing of real estate properties, especially useful for an organization with the scale of disposition activity of the RTC. The theory behind auctions is that if marketed correctly, the properties will be exposed to many potential purchasers (far more than would be possible for each property when marketed individually) and that an early sale will enable the RTC to forego actual holding costs and opportunity costs. There are three general methods for conducting auctions:

- Selling properties absolute, that is, to the highest bidder without regard to a minimum price;
- Selling properties absolute with minimum bid absolute prices, that is, to the highest bidder as long as the final bid price is greater than a pre-determined price established for the asset; and
- Selling properties with the right of reserve to accept or reject any offer.

While the last method results in the greatest protection to the seller, it is a general belief that selling properties absolute will generate the greatest interest among potential investors, since they know that the seller is obligated to sell the properties, and hence, result in attaining true market value. Similarly, setting minimum prices high, rather than low, discourages participation and thus reduces actual bidding.

The RTC will explore conducting auctions on specified properties as an alternative to marketing properties through local, regional, or national brokers. Well conducted auctions can approximate the sales prices obtained by other methods of sales, in aggregate, if not on each property. Key characteristics of successful auctions are:

- Large scale, national or international marketing of the properties so that the auction brings even greater market exposure than would normally be attained through a normal listing arrangement;
- Accurate, sufficient information on each of the properties available to potential purchasers; and
- Ample time and opportunity for prospective bidders to inspect the property and property records.

Well conducted auctions with extensive marketing, and which enable the RTC to reduce its actual and opportunity costs of money, are consistent with the RTC's mandated objectives of: 1) maximizing the net present value return from the sale of assets; and 2) minimizing the impact of such transactions on local real estate and financial markets.

The pricing policies for auctions stated below are believed to maximize net present value return for the RTC.

II. POLICY

The following policy shall be followed by RTC staff and private sector contractors for establishing prices in auctions:

1) Auctions will require extensive marketing efforts with large scale regional, national, and possibly international, exposure. Minimum marketing efforts will include extensive advertising in newspapers and appropriate trade journals, publication and distribution of brochures, press releases and solicitations to prospects in RTC's data base of potential buyers.

2) Properties may be sold absolute in auctions if (i) the property has an established market value below $100,000; and the property has been widely exposed to the market. Property in conservatorship which satisfies the eligibility requirements for RTC's Affordable Housing Program may not be sold at auction. Finally, RTC will reserve the right to reject any and all offers which are made in the absence of a competitive bidding environment.

3) All other properties may be sold at auctions with reserve prices set at levels to take into account the benefits of an expedited sale, including savings of holding costs, and marketings costs. Furthermore, to stimulate active bidding associated with the auction process, RTC may set reserve prices at less than the expected sale price excepting under no circumstances can reserve prices be set at less than 70% of the current appraised value, adjusted for any savings of sale's expenses or costs as a result of an expedited sale.

III. CONCLUSION

The auction pricing policy outlined above gives the RTC reasonable flexibility when conducting auctions on real estate properties. If an auction exposes property to the market sufficiently and is otherwise properly conducted, disposition prices will establish the true market value, and if any discount is received, the cost savings resulting from the expedited sale compensates for any discount from market value.

It is thus expected that, in aggregate, RTC will have as high a net present value return from auction sales as from individual sales under existing policy. The sale prices on individual properties may vary up or down from that standard. The 70% reserve price floor for the larger properties has been established to meet the needs of the expected few properties which may sell well below established appraised value. A higher reserve figure would discourage participation and probably reduce aggregate net present value yield.

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