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THE APPRAISAL REDUCTION IN A RISING DELINQUENCY ENVIRONMENT

There were more than a few common themes discussed at the Commercial Mortgage Securities Association (CMSA) 2009 Investor Conference held last week. One was the need for simpler structures to avoid the very thin classes of the 2006 and 2007 vintages and another was a guess on how high delinquencies would rise in 2009.

Delinquencies in CMBS are rising, specifically in the 2006 and 2007 vintage, where delinquencies are rising at rates not experienced in other vintages and are estimated (based on popular vote at the CMSA) to end the year between 3% and 5%. As a result, we are reminded of the impact of the appraisal reduction mechanism on the advancing of delinquent loans.

Appraisal reductions were designed to limit the interest portion of the principal and interest (P&I) advanced each month. The intention is to not advance the entire payment if the value of the asset has eroded to less than the loan amount, thereby supporting liquidity to the senior classes and limiting it to the first loss if value is no longer there. Appraisal reductions can also alter the voting rights of the certificateholders and sometimes the controlling class(s) in an environment where commercial mortgage values are declining and delinquencies are rising.

Once a loan has been transferred to the special servicer, an appraisal is ordered and must be received within 120 days. Following receipt of the updated appraisal, the servicer is required to calculate the appraisal reduction amount according to the pooling and servicing agreement (PSA). Barring any unique calculation features or a high level of reserves, if the loan amount is more than 90% of the updated appraised value, the appraisal reduction amount will affect advances.

Next, an appraisal subordinate entitlement reduction (ASER) is calculated. In its simplest explanation, the ASER is the amount of interest of the loan's P&I payment that will not be advanced. By advancing only the portion of the P&I payment that is supported by value, it ensures that advances to the most subordinate certificates are cut off when losses are expected. This results in interest shortfalls to the bondholders, which, if there are many loans with significant appraisal reductions, can be significant, as in the case of Bank of America Commercial Mortgage Inc., Series 2006-3 (BACM 2006-3), with its large Boscov's Inc. exposure.

Example: BACM, Series 2006-3

Property Name	Current Loan Balance	Most Recent Appraised Value	Appraisal Reduction Amount	Monthly ASER (Interest Shortfall)	Contractual P&I Payment	Actual P&I Advanced
Boscov's Monroeville Mall	19,206,203	6,000,000	14,183,840	(78,413)	124,346	45,933
Boscov's South Hills Village	18,831,732	6,300,000	13,657,801	(75,505)	121,921	46,416
Boscov's Marley Station	17,005,062	6,800,000	11,335,343	(62,666)	110,095	47,429
Boscov's White Marsh	16,891,576	5,800,000	12,285,041	(67,916)	109,360	41,444
Boscov's Owings Mills	16,783,725	7,200,000	10,906,501	(60,295)	108,662	48,367
Boscov's Oxford Valley Mall	14,030,364	4,200,000	10,629,026	(58,029)	90,124	32,095
Boscov's Montgomery Mall	13,936,499	4,200,000	10,532,416	(57,501)	89,521	32,020
Total	116,685,161	40,500,000	83,529,968	(460,324)	754,029	293,705

$460,324 of the total $487,260 interest shortfalls are due to Appraisal Reductions on the seven Boscov loans
This was sufficient to short interest to nine classes of certificates because the classes are so thin.

As delinquencies rise within CMBS transactions, the controlling class(s) representative or directing certificateholder can potentially change before losses are realized if the definition of the controlling class within the PSA takes into consideration any appraisal reductions. Many of the PSAs we reviewed specifically exclude the appraisal reduction from the definition of the controlling class and many didn't mention it at all. Voting rights of the certificates, however, are often reduced with an appraisal reduction.

Another question that rises is the value used in calculating the appraisal reduction, which is an appraised value rather than the value or sale price at which the asset would trade in the current environment, where there is a dearth of commercial mortgage lending options and cash buyers.

Kevin Donahue of Midland Loan Services, Inc. used the following analogy to explain the discrepancy of appraised value versus achievable value: “Basically, the appraisers are riding in the bed of the pickup truck, facing the rear, and the special servicers are the hood ornament.”

Appraisers typically use historical comparisons and discounted cash flows divided by historical capitalization rates to determine value. With limited properties trading in the last year, the competitive set consists of either non-comparable properties or stale property sales that were completed at the height of the market. With capitalization rates rising, but limited trades to validate where they actually are today, a discounted cash flow valuation may also be flawed.

While one may speculate that relying on these valuations could leave the servicer in an over-advanced position, that is not the case. First, the valuations are required to be updated annually and servicers rely on more than the appraised value when determining recoverability. The special servicers are on the front line and will rely on local market intelligence, including broker opinions of the value of the property in today’s environment. This information is often shared with the master servicers or the master servicers will gather their own market intelligence.

Therefore, one needs to be aware that the appraised value may not be entirely indicative of the loss and if enough delinquent loans are subject to an appraisal reduction, it could result in significant interest shortfalls, changes in voting rights of certificateholders and potentially changes in the directing certificateholder. However, comfort can be gained that neither the master servicer nor the special servicer is taking the appraised value as the absolute value at which the property will sell. Both are relying on more opinions of realistically achievable sales prices when calculating recoverability in advancing and resolution strategy.

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