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Understanding CMBS Appraisal Reductions

Appraisal reductions are a fundamental component of CMBS servicing, with direct implications for cash flow, bond performance, and investor control. While widely referenced, their mechanics and impacts are not always fully understood. The concept of Appraisal Reduction in CMBS was created to limit the amount of servicer advancing that might not ultimately be recovered after a loan disposition.

An Appraisal Reduction, which is triggered by a delinquent or loan in some form of distress, estimates future potential bond losses. It results in producing an Appraisal Reduction Amount (ARA) that protects the senior bondholders in a securitized transaction by effectively reducing the amount of interest paid to subordinate bondholders.

In this report, we will discuss Appraisal Reduction trigger events, walk through a typical ARA calculation, explain the effect of an ARA on future payments to bondholders, and how the reduced interest payments might impact the ratings of the bonds.

Appraisal Reduction Trigger Events

The terms of the Pooling and Servicing Agreement (PSA) for a CMBS transaction determine when the Special Servicer must order a new appraisal for a loan.

Typical triggers that require a new appraisal include:

- Transfer to Special Servicing
- Loan is 60-days delinquent (a servicing transfer event)
- Prior to foreclosure or REO acquisition
- Borrower bankruptcy
- Maturity default

The special servicer will order a new appraisal according to PSA requirements, usually within 60 or 90 days of the trigger event. When a loan continues to be specially serviced, PSAs typically require updated appraisals annually, or before a major decision, such as a modification, note sale, or REO disposition. Appraisal reductions may change over time as assets can be reappraised several times while they are with the Special Servicer.

The Appraisal Reduction Amount (ARA) Calculation

Generally, an ARA represents the loan's current outstanding balance and all amounts due over 90% of the property's cash value adjusted for cash reserves. The ARA equals the Outstanding Unpaid Principal Balance (UPB) and all amounts owed under the PSA ***minus*** 90% of the appraised value ***plus*** (1) all reserve amounts not dedicated to taxes, insurance, or ground rents and (2) additional loan collateral (if any), such as a letter of credit.

Sample Appraisal Reduction Amount Calculation

Loan UPB ($)		$100,000,000	
+ Unpaid Interest/Outstanding Advances		$5,000,000	
Total Outstanding Exposure			$105,000,000
Appraised Value	$100,000,000		
90% of Appraised Value		$90,000,000	
+ Outstanding Reserves		$2,000,000	
Total Net Collateral Value			$92,000,000
Appraisal Reduction Amount (Outstanding Exposure Less Total Net Collateral Value)			**$13,000,000**

The ARA serves as the basis for the Appraisal Subordinate Entitlement Reduction (ASER), which will decrease the amount of the monthly payment to be advanced on the loan. See the Appendix for an example of the CREFC IRP Appraisal Reduction Template.

Appraisal Subordinate Entitlement Reduction (ASER)

The concept of an ASER was developed to determine how much the servicer will advance for a mortgage loan after the property has suffered a value decline. The advancing of interest payments is determined by the ARA. The interest advance percentage is calculated by subtracting the ARA from the unpaid principal balance (UPB) of the loan and dividing the result by the UPB.

That percentage is then applied to the monthly interest expense to determine the amount of interest to be advanced. The ASER is the difference between the full P&I payment due and the actual amount advanced to certificate-holders based on the ARA. See below for an example of the calculation.

Sample ASER Calculation

Current UPB	$100,000,000	
less ARA	$13,000,000	
	$87,000,000	
divided by UPB		
Interest Advance %		87%

Interest Advance = (Monthly interest payment x Interest Advance %)

ASER = (Monthly interest payment less the Interest Advance)

The calculated ASER is then used to determine those bonds that will be shorted due to the appraisal reduction.

The Impact of ASERs on CMBS Bonds

The potential impacts of an ASER on CMBS bonds are threefold:

- First, it reduces the payments to subordinate bonds.
- Second, after its application, the ASER is used to determine which bondholders will serve as the Controlling Class.
- Notably, any resulting interest shortfalls may result in bond rating downgrades.

An ASER creates an interest shortfall to bondholders equal to the difference between the full P&I payment due and the actual amount advanced on the loan based on the ARA. The interest shortfalls are applied in the transaction waterfall in reverse sequential order. The most subordinate bond class is the first to absorb the interest shortfalls. If the full shortfall is not absorbed by the most subordinate class, the remaining shortfall is applied to the next subordinate bond class. This process continues until the interest shortfall has been accounted for completely.

Determination of the Controlling Class of a CMBS securitization is made after the application of the ARA and the resulting ASER. The appraisal reduction is an indicator of future potential losses. These losses are applied on a theoretical basis to establish the new Controlling Class according to the prescribed terms of the PSA.

The Role of the Credit Rating Agencies

Rating agencies rate CMBS bonds based on the timely payment of interest and the ultimate repayment of principal. Bonds that experience ASERs no longer receive timely interest payments and may be subject to credit rating downgrade(s). Each rating agency has its own set of parameters regarding its tolerance for missed interest payments at each credit rating level. For example, there is little to no tolerance at the 'AAA' level, whereas there may be several months' tolerance for interest shortfalls at the 'B' level.

Bonds in Single Asset/Single Borrower (SASB) transactions that experience an ASER are generally more susceptible to ratings downgrades because they lack loan diversity and are backed by the cash flow of a single loan. Additionally, the structure of these transactions often lacks the cushion of below investment-grade rated or unrated tranches present in multi-borrower transactions that can potentially mute the effects of the interest shortfalls.

Conclusion

Understanding appraisal reductions is essential to interpreting CMBS deal performance across the capital stack, particularly in periods of asset stress. As demonstrated, ARAs and ASERs directly affect cash-flow distribution, investor outcomes, and credit dynamics. Greater transparency into these mechanisms supports more informed analysis and better decision-making across the market.

For questions or additional information:

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CREFC Resources

For more information regarding the topics discussed in this paper, please refer to the CREFC website:

https://www.crefc.org/cre/cre/content/learn/Glossary/CREFC_Glossary.aspx?hkey=73766de8-5900-480d-a0f3-b4e75bd3ed84

https://www.crefc.org/cre/cre/content/learn/irp/irp-home.aspx?hkey=3e3e54df-d39a-450d-b961-ae094b11e3db

Appendix

Sample Appraisal Reduction Template

SAMPLE

CREFC Investor Reporting Package

APPRAISAL REDUCTION

ARA Date (L100, D28):	20260209

Pursuant to the servicing agreement definition for Appraisal Reduction Event (Delinquency - 120 Days Following), the Appraisal Reduction Event triggered for the loan below:

Transaction ID (S1, L1, D1):	XXXX123456789
Prospectus Loan ID (S4, L4, D4):	1
Loan ID (S3, L3, D3):	XXXXXXX
Borrower Name:	
Property Name (S55):	123 Main Street
Paid Through Date (L8):	20250806
Most Recent Value (L75, D26): ($)	50,300,000.00
Most Recent Valuation Date (L74, D24):	20250731

Appraisal Reduction Amount: The excess, if any, of (a) - (b)

(a) =	the sum of:		
	(i) Stated Principal Balance of such mortgage Loan	$66,785,671.49	
	(ii) All accrued and unpaid interest on such mortgage Loan	$241,138.94	
	(iii) All accrued but unpaid fees (all types) and interest theron	$712.73	
	(iv) Any additional trust fund expenses	$0.00	
	(v) All unreimbursed advances and interest thereon	$1,717,117.40	
	(vi) All currently due and unpaid real estate taxes, assessments, insurance premiums, and if applicable, ground rents	$0.00	
	(vii) The Negative Sum of escrow and reserve balances	($849,464.56)	
	(a) TOTAL		**$67,895,176.00**
(b) =	An amount equal to 90% of the Most Recent Value	$45,270,000.00	
	(b) TOTAL		**$45,270,000.00**

Total Appraisal Reduction Amount (L99, D27):	**$22,625,176.00**