Risk Management Insights

The New Interagency Guidelines on Appraisals and Evaluations: A Concise Summary for Lenders

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In December 2010, the five federal banking authority agencies issued a statement titled "Interagency Appraisal and Evaluation Guidelines." These Guidelines supplement existing guidance and rescind the following (FDIC references):

- *1994 Interagency Appraisal and Evaluation Guidelines*, FIL-74-94;
- *Statement on Appraisal Standards*, FIL-20-2001;
- Interagency Statement on *Independent Appraisal and Evaluation Functions*, FIL-84-2003; and
- *2006 Revisions to Uniform Standards of Professional Appraisal Practice*, FIL-53-2006.

The statement can be found on the Web sites of the FDIC[1], Federal Reserve Board[2] and OCC[3]. All regulated institutions should obtain a copy of the recent statement because an institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program for all its lending functions.

The Guidelines contain 18 sections and four appendices. Although this article addresses some of the pertinent items, it does not cover everything in the statement. The authors reviewed each of the 18 sections and four appendices noting both new items that have not appeared in prior statements and items that the Agencies are reemphasizing.

SECTIONS

Sections I thru III titled "Purpose," "Background" and "Supervisory Policy" are basically an introduction that provide the origination of appraisal and evaluation guidelines and the importance of program compliance.

Section IV "Appraisal and Evaluation Program" lists 10 bullet points of which the authors find the following six noteworthy:

- *Provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.*
- *Establish selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.*
- *Ensure that appraisals comply with the Agencies' appraisal regulations and are consistent with supervisory guidance.*
- *Develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.*
- *Implement internal controls that promote compliance with these program standards, including those related to monitoring third party arrangements.*
- *Establish criteria for monitoring collateral values.*

[1] http://www.fdic.gov/news/news/financial/2010/fil10082.html
[2] http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm
[3] http://www.occ.treas.gov/news-issuances/bulletins/2010/bulletin-2010-42.html

Regarding program independence, the new Guidelines not only pertain to those persons performing appraisals and evaluations, but also to persons who order and review appraisals and evaluations.

This section states that appraisals must comply with the Agencies' appraisal regulations (which may differ from or exceed the Uniform Standard of Professional Appraisal Practice requirements). Also, institutions should "evaluate and monitor" the performance of fee appraisers and persons who perform evaluations. A simple rating of each appraisal received can be designed to address items like timeliness, report quality, responsiveness of appraiser to review questions, etc.

The last three bullet points listed above are now explained in their own sections of the new Guidelines. As such, we will discuss these sections later in the article.

Section V "Independence of the Appraisal and Evaluation Program" has been expanded substantially to clarify some points and also to address the communication process between an institution and its fee appraisers. As noted above, independence applies to those persons who order, perform and review appraisals and evaluations. The standards of independence apply to both appraisals and evaluations.

The Guidelines continue to state that *"An institution should establish reporting lines independent of loan production for staff who administer the institution's collateral valuation program…"* Appendix D further defines Loan Production Staff as *"Generally, all personnel responsible for generating loan volume or approving loans, as well as their subordinates and supervisors."* As such, this would not only include loan officers but also credit officers who approve loans regardless of dollar amount.

This section also addresses the types of communications that would not be construed as coercion or undue influence on appraisers and persons performing evaluations, as well as examples of actions that would compromise independence. For the most part, the Agencies' wording is self-explanatory and thus what follows is quoted directly from the Guidelines:

> *Communication between the institution's collateral valuation staff and an appraiser or person performing an evaluation is essential for the exchange of appropriate information relative to the valuation assignment. An institution's policies and procedures should specify methods for communication that ensure independence in the collateral valuation function. These policies and procedures should foster timely and appropriate communications regarding the assignment and establish a process for responding to questions from the appraiser or person performing an evaluation.*
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> *An institution may exchange information with appraisers and persons who perform evaluations, which may include providing a copy of the sales contract for a purchase transaction. However, an institution should not directly or indirectly coerce, influence, or otherwise encourage an appraiser or a person who performs an evaluation to misstate or misrepresent the value of the property. Consistent with its policies and procedures, an institution also may request the appraiser or person who performs an evaluation to:*
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> - *Consider additional information about the subject property or about comparable properties.*
> - *Provide additional supporting information about the basis for a valuation.*
> - *Correct factual errors in an appraisal.*
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> *An institution's policies and procedures should ensure that it avoids inappropriate actions that would compromise the independence of the collateral valuation function, including:*
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> - *Communicating a predetermined, expected, or qualifying estimate of value, or a loan amount or target loan-to-value ratio to an appraiser or person performing an evaluation.*
> - *Specifying a minimum value requirement for the property that is needed to approve the loan or as a condition of ordering the valuation.*
> - *Conditioning a person's compensation on loan consummation.*
> - *Failing to compensate a person because a property is not valued at a certain amount.*
> - *Implying that current or future retention of a person's services depends on the amount at which the appraiser or person performing an evaluation values a property.*
> - *Excluding a person from consideration for future engagement because a property's reported market value does not meet a specified threshold.*

It should be noted that this provision does not preclude an institution from withholding compensation from an appraiser or person who provided an evaluation based on a breach of contract or substandard performance of services under a contractual provision.

Section VI "Selection of Appraisers or Persons Who Perform Evaluations" emphasizes the importance of appraiser competency for a particular assignment relative to both the property type and geographic market and stresses that an institution should not select a valuation method or tool solely because it provides the highest value, the lowest cost, or the fastest turnaround time.

New subsections have been added to address the development, administration and maintenance of an approved appraiser list and the Agencies' recommendation that institutions use engagement letters. Ongoing monitoring of the work performed by fee appraisers and persons performing evaluations is once again emphasized.

A new and very important quote in this section states *"…An institution's use of a borrower-ordered or borrower-provided appraisal violates the Agencies' appraisal regulations. However, a borrower can inform an institution that a current appraisal exists, and the institution may request it directly from the other financial services institution."* This statement brings to an end the fairly common practice of Bank B receiving a copy of Bank A's appraisal from the borrower. Going forward this is not permitted and Bank B will have to contact Bank A directly to get a copy of that appraisal. As an aside, the appraiser who performed the appraisal for Bank A cannot provide a copy of the report to anyone (e.g., Bank B) without Bank A's permission.

Section VII "Transactions That Require Appraisals" simply refers to Appendix A, which lists the 12 instances in which an appraisal exemption may be employed. These remain the same as published in the last FIRREA amendments of 1994.

Section VIII "Minimum Appraisal Standards" is probably one of the most important sections in the Guidelines as it lists the five items that are mandatory for an appraisal to comply with the Agencies' appraisal regulations. This section has been greatly enhanced to clarify each of the five standards.

The first standard states appraisals still must comply with USPAP and contain the Agencies' definition of market value. However, the following two items have been added:

- *An institution may refer to the appraiser's USPAP certification in its assessment of the appraiser's independence concerning the transaction and the property.*
- *Under the Agencies' appraisal regulations, the result of an Automated Valuation Model (AVM), by itself or signed by an appraiser, is not an appraisal, because a state certified or licensed appraiser must perform an appraisal in conformance with USPAP and the Agencies' minimum appraisal standards.*

The second standard addresses the "sufficient information" requirement for an appraisal report to support the institution's decision to engage in the transaction. Additional explanation has been provided for this standard with the following quotations best summarizing the requirements:

- *The appraiser's scope of work should be consistent with the extent of the research and analyses employed for similar property types, market conditions, and transactions. Therefore, an institution should be cautious in limiting the scope of the appraiser's inspection, research, or other information used to determine the property's condition and relevant market factors, which could affect the credibility of the appraisal.*
- *An institution should specify the use of an appraisal report option that is commensurate with the risk and complexity of the transaction. The appraisal report should contain sufficient disclosure of the nature and extent of inspection and research performed by the appraiser to verify the property's condition and support the appraiser's opinion of market value.*

The third standard deals with deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms and tract developments with unsold units. Appendix C has been added to the Guidelines and explains the expectations for appraisals of these complex property types.

The fourth standard requires the appraisal to be based upon the Agencies' definition of market value and includes the requirement that an "as is" value be provided in each appraisal. The definition of market value applies to "real property" only and as such the Guidelines state:

> *Value opinions such as "going concern value," "value in use," or a special value to a specific property user may not be used as market value for federally related transactions. An appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed.*

The "as is" value defined as *"…the real property's actual physical condition, use, and zoning as of the effective date of the appraiser's opinion of value."* In addition to "as is" value, an institution can also request a prospective market value upon completion and/or stabilization as long as there is *"…a point of reference to the market conditions and time frame on which the appraiser based the analysis."* **Thus, a value conclusion based on a hypothetical value as if complete and/or stabilized as of the effective date of appraisal is not allowed**.

The last standard requires appraisals to be performed by appropriately state certified or licensed appraisers. Additional discussion regarding competency has been added to clarify that licensure alone does not indicate an appraiser is competent.

Section IX "Appraisal Development" reiterates most of what is discussed in the second item of the five minimum appraisal standards outlined in Section VIII.

Section X "Appraisal Reports" emphasizes the need to obtain a report that contains "sufficient information and analysis." The Agencies indicate a Restricted Use Appraisal Report probably will not be appropriate for most federally related transactions, but may be useful for ongoing collateral monitoring.

Section XI "Transactions That Require Evaluations" outlines the three exemptions that require an evaluation in lieu of appraisals, which remains exactly the same as stated in the 1994 Amendments to FIRREA. However, the Agencies have added the following guidance as to when an institution should consider getting an appraisal although an evaluation is permitted:

> *An institution should consider obtaining an appraisal as an institution's portfolio risk increases or for higher risk real estate- related financial transactions, such as those involving:*
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> - *Loans with combined loan-to-value ratios in excess of the supervisory loan-to-value limits.*
> - *Atypical properties.*
> - *Properties outside the institution's traditional lending market.*
> - *Transactions involving existing extensions of credit with significant risk to the institution.*
> - *Borrowers with high-risk characteristics.*

Section XII "Evaluation Development" is a new section that works in conjunction with **Section XIII "Evaluation Content."** The Agencies added the new section to emphasize that evaluations must be consistent with safe and sound banking practices and contain an appropriate level of analysis and information necessary to support the estimate of market value.

The content requirements for evaluations have been increased with emphasis placed on a physical inspection of the collateral and listing of all sources of information used in the analysis to value the property. Regarding the collateral's actual physical condition, the Guidelines now state:

> *… an institution should establish criteria for determining the level and extent of research or inspection necessary to ascertain the property's actual physical condition, and the economic and market factors that should be considered in developing an evaluation. An institution should consider performing an inspection to ascertain the actual physical condition of the property and market factors that affect its market value. When an inspection is not performed, an institution should be able to demonstrate how these property and market factors were determined.*

Lastly, these sections specify that valuation methods that do not produce Market Value conclusions are not acceptable as evaluations. Automated Valuation Models (AVMs) and Competitive Market Analysis (CMAs) do not constitute an evaluation on their own, but may be used as support for an evaluation. Broker Price Opinions (BPOs) may **not** be used because they do not produce a market value, but a potential selling price.

Section XIV "Validity of Appraisals and Evaluations" is mostly unchanged from prior statements and reference is made to including support for using a prior appraisal or evaluation in the credit file.

Section XV "Reviewing Appraisals and Evaluations" is now its own section and contains an abundance of new information. Subsections also address reviewer qualifications and depth of review by property type and for appraisals received from other institutions, resolution of deficiencies and review documentation. The Guidelines still require that an appraisal or evaluation review be completed prior to a final credit decision.

This section states that, *"An institution's policies and procedures for reviewing appraisals and evaluations, at a minimum, should:*

- *Address the independence, educational and training qualifications, and role of the reviewer.*
- *Reflect a risk-focused approach for determining the depth of the review.*
- *Establish a process for resolving any deficiencies in appraisals or evaluations.*
- *Set forth documentation standards for the review and the resolution of noted deficiencies."*

Many institutions will likely need to develop policies and procedures to address appraisal and evaluation review in accordance with the above requirements. In order to comply with independence and competency requirements for reviewers, the Agencies state, *"An institution may find it appropriate to employ additional personnel or engage a third party to perform the reviews."*

Section XVI "Third Party Arrangements" is a new section added to the Guidelines. This section addresses the risk management practices that an institution should consider if it uses a third party to manage or conduct all or part of its collateral valuation function. The Agencies make it clear that an institution cannot outsource its responsibility to maintain an effective and independent collateral valuation function.

Section XVII "Program Compliance" is significantly expanded from prior statements. Subsections now address monitoring collateral values, addressing portfolio collateral risk, and modifications and workouts of existing credits.

Specific items added to program compliance address appraiser competency, testing the appraisal and evaluation review process, and reporting appraisal and evaluation deficiencies to appropriate internal and external parties.

The subsections are quite detailed and well worth reading several times to fully understand the various options allowed by the Guidelines. As most institutions are dealing with modifications and workouts, this section is very relevant at this time. One noteworthy item is the recommendation that an institution obtain market data for its footprint to ensure that timely information is available to management for assessing collateral and associated risk.

Section XVIII "Referrals" has been strengthened with the following new paragraph:

> *An institution should file a complaint with the appropriate state appraiser regulatory officials when it suspects that a state certified or licensed appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct. In addition, effective April 1, 2011, an institution must file a complaint with the appropriate state appraiser certifying and licensing agency under certain circumstances (See 12 CFR 226.42(g)).*

Additional information is provided as to when a suspicious activity report (SAR) must be filed.

APPENDICES

In addition to the 18 sections discussed above, the Guidelines have added four appendices.

Appendix A restates the 12 appraisal exemptions outlined in the 1994 FIRREA Amendment.

Appendix B is titled "Evaluations Based on Analytical Methods or Technological Tools." This appendix contains four pages of discussion on using AVMs and a page on using tax assessment valuations. An institution should read this appendix carefully if it currently uses or plans on using one of these tools.

Appendix C is titled "Deductions and Discounts." This appendix relates to the third requirement in the five minimum appraisal standards. A discussion of the various property types requiring deductions and discounts is presented.

Appendix D is a "Glossary of Terms." This appendix contains 49 definitions. Some of the more useful definitions are included for: "as is" market value, business loan, evaluation, loan production staff, market value, raw land, sum of retail sales, tract development, transaction value and value of collateral.

SUMMARY

The most recent Guidelines were issued to provide further clarification of the Agencies' appraisal regulations and supervisory guidance to institutions and examiners about appraisal and evaluation programs. Although numerous items were addressed above, your institution should read the statement in its entirety and ensure compliance. As there are many ways of performing the appraisal and evaluation functions and because institutions vary by size, possibly the best advice is to ask your examiner for assistance. Federal examiners can review your policies and procedures and help determine if the federal guidelines are being met or if adjustments need to be made within your institution.

As to bringing your institution into compliance with the new Guidelines, the Agencies state the following:

> *The Guidelines are effective upon publication in the Federal Register. However, on a case-by-case basis, an institution needing to improve its appraisal and evaluation program may be granted some flexibility from its primary federal regulator on the timeframe for revising its procedures to be consistent with the Guidelines. This timeframe should be commensurate with the level and nature of the institution's real estate lending activity.*