Internal Controls and Best Practices for Appraisal Departments

Since the credit crisis began in 2008, the regulators have made appraisal departments a major focus of bank examinations. How effective is your bank's program?

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Although many banks have internal appraisal departments, there is no "gold standard" with which to compare them. Is the department operating effectively and efficiently? Is it understaffed or overstaffed? How well does it serve its internal customers? How does it compare to industry best practices? And what *are* the industry best practices?

Addressing these issues can provide a multitude of benefits. Most important, having the appraisal department adopt industry best practices enhances its support of the lending and workout groups—a benefit that pays off in both up and down markets. Also, it's better for the bank to implement policies and procedures at its own discretion rather than be ordered to by internal audit or bank examiners. Here are some guidelines that banks can follow in reviewing their appraisal functions.

Bank Examiner Perspective

In November 1995, the OCC published *Commercial Real Estate and Construction Lending: Comptroller's Handbook*, a document contains 92 questions relating to internal controls. The instructions state: "The following questionnaire is provided as a tool to assist examiners in assessing the

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The document *Interagency Appraisal and Evaluation Guidelines,* issued in December 2010, offers banks a guide to establishing an effective appraisal program:

"An institution's board of directors or its designated committee is responsible for adopting and reviewing policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:

- 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.
- Ensure that appraisals and evaluations contain sufficient information to support the credit decision.
- Maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
- Provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision.
- 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.
- Establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the Agencies' appraisal regulations."

bank's internal controls, policies, practices, and procedures in regard to commercial real estate and construction lending." Seventeen of these questions apply to appraisals and evaluations.

Although your bank may not be examined by the OCC, it would be useful to obtain this document and note the items examiners will be looking for in your appraisal department before your next examination. The 10 bullet points in the December 2010 *Interagency Appraisal and Evaluation Guidelines* are certainly items that will be examined (see box).

Internal Stakeholders

Internal stakeholders include lending units, workout and special assets groups, loan review, credit administration, and risk management. A positive—and hopefully value-added—relationship between the appraisal department and all internal stakeholders will benefit the bank.

Achieving total satisfaction is difficult, however, because stakeholders have diverse and sometimes conflicting goals for the appraisal department. It is not unusual for loan officers to contend that other banks are getting their appraisals done more quickly and more cheaply. Lending units often argue that values are too low, while special assets may claim the values are too high. Loan officers think appraisal reviews take too long, while the appraisal department manager seeking to add staff must make a well-supported case for it to senior management.

Recently, the authors reviewed a bank appraisal department, and the stakeholders posed the following questions:

1. Why do our internal reviewers sometimes direct the outside appraisers to change their work product rather than accept their product and then, through the review process, make value adjustments? Is our practice in this respect appropriate, common, or unusual?
2. Why do we differ frequently on participation deals, rejecting or extensively modifying the agent bank's appraisal? How is it we know better what to do than some of the biggest appraisal firms in the country?
3. Some perceive our turnaround times and service level agreement (SLA) delivery times to be slow, excessive, and/or uncompetitive. Are they?
4. Are our appraisal fees higher than our competitors'? Are we being forced into steep discounting to stay competitive?

How do you know if the appraisal department or stakeholder is right? Or what is actually happening at other banks? What are the industry standards? A detailed review of the appraisal department should answer those questions and many more. Here are the steps to take when reviewing an appraisal department.

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Step 1: Scope of Work

As with any project, determining the scope of work is an important initial step. A sample scope might be as follows:

1. Determine compliance with applicable laws, rulings, and regulations, specifically Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).
2. Evaluate the adequacy of policies, practices, procedures, and internal controls for analyzing the value of real estate collateral.
3. Learn if bank employees are operating in accordance with the established guidelines.
4. Review a sampling of appraisals and evaluations for quality and reasonableness.
5. Recommend options and solutions when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws, rulings, or regulations have been noted.

Step 2: Information Gathering

Essential Information

Memorandums of understanding addressing the real estate appraisal program, as well as findings of previous examinations and audits, provide insights into department operations and any issues. Appraisal and evaluation policies and procedures, including those for internal appraisal departments, are key to understanding how the program compares with best practices and if it is adhering to internal policy.

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A review of the operational technology platforms helps reveal the effectiveness of systems used to deliver services to internal customers, including request submissions, request for proposal (RFP) processes, data and report delivery systems, communications, and archival systems.

Finally, appraisal reports should be scrutinized for:

- Large-dollar credits.
- Loans secured by complex or specialized properties.
- Nonresidential real estate construction loans.
- Loans in geographic areas with unfavorable market conditions.
- Out-of-area real estate.
- Loan participations and Shared National Credits.
- Workouts; OREO/SAD.
- Other loans as determined by senior management.

Other Pertinent Information

- Employee resumes and state licenses (if available), as well as organizational chart(s) applicable to the real estate appraisal department.
- The list of approved fee appraisers and their application files, including a list of fee appraisers removed from the approved list.
- The list of agents that order and/or review real estate appraisals for the bank and copies of any agreements or contracts for such services.
- Appraisal related correspondence, including the department's RFP, engagement letter, and appraisal review forms.
- A sampling of internal evaluation reports, if the appraisal was performed internally.
- A sampling of internal review reports performed by each reviewer (internal and external), including reviews where a reconsideration of value was required.
- The list of approved internal evaluators and their qualifications.
- Internal management reports on loans with appraisal policy exceptions.
- Internal management reports used to monitor the progress and effectiveness of the appraisal process and copies of appraisal tracking logs.

Additionally, data and reporting for appraisal assignments pertaining to the following factors:

- Average turn times (internal and external).

Table 1

	Chief Appraiser Interview
1.	How do you qualify new fee appraisers who want to be added to the bank's approved list?
2.	When was the last time a fee appraiser was taken off the approved list? Why?
3.	How do you track appraisal quality?
4.	Who sends out the RFPs and engages appraisers?
5.	How do you handle employee education and training?
6.	Does the bank pay for any professional designations?
7.	Does your department charge the lending units for reviews? If so, how?

Table 2

	Staff Review Appraiser Interview
1.	What information is required from loan officers for appraisal requests?
2.	What type of interaction is allowed between the loan officer and fee appraiser?
3.	Do you release appraisal reports to loan officers *before* your review is complete?
4.	How long do you have to complete a review?
5.	How are complaints from loan officers and/or borrowers handled?
6.	For what reasons have you rejected an appraisal report?
7.	How often are reports rejected?
8.	How old does an appraisal have to be before you won't review it?
9.	How do you handle going concern or apartment appraisals with regard to FF&E?

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Table 3

Peer Survey Information

Bank Size	$20–$30B	< $5B	< $5B	< $5B	< $5B	$10–$15B	$10–$15B	$50–$75B
No. of Technical Reviews	140; Resid. –530	240	20	200–250	125	215; Resid –500	100	200
No. of Compliance Checklists	60; Resid. –660	N/A	130	200	150	240	N/A	240
Technical Review Turn Time	1 Week: Resid. –2 Bus. Days	5-7 Business Days	1 Week	1 Week	1 Week	6 Bus. Days	1 Week	1 Week
Compliance Checklist Turn Time	No set time; Resid. –2 Bus. Days	N/A	1 Week	3–5 Bus. Days	1 Week	3 Bus. Days	N/A	1 Bus. Day
Appraisal Turn Time	40 Cal. Days	21–28 Cal. Days	21 Cal. Days	25 Cal. Days	28 Cal. Days	30 Cal. Days	4–6 Weeks	35 Cal. Days
Average Appraisal Fee	$2700; Resid. –$840	$3200–$3500	$3000	$4000	$3600	$3400	$3500 - $5500	$2850
Perform Internal Evaluations	No	No	Yes	No	Yes	Occasionally	No	No
Charge LOBs for Evaluations	N/A	N/A	Soon	N/A	Yes	No	N/A	N/A
Fee for Evaluations	N/A	N/A	TBD	N/A	$500	N/A	N/A	N/A
Residential Appraisal Turn Time	7 Cal. Days	5–7 Cal. Days	7 Cal. Days	5–7 Cal. Days	N/A	5–6 Cal. Days	N/A	N/A

- Average fees by lending group.
- Percentage of appraisal report types ordered (restricted use, summary, self-contained).
- Number of rejected reports or any reports where a reconsideration of value was necessary.
- Appraiser concentrations.
- Appraiser scoring.

Any specific documentation, reports, reviews, or analyses senior management believes are necessary for the project.

Step 3: Interviews and Peer Survey

Interviews are an excellent way to determine if policies and procedures are actually being followed. Policies may appear appropriate, but if staff is not complying with them the bank may be taking on unknown risks. Interview results can also reveal ways to improve policies and procedures.

Parties that should be interviewed include appraisal department employees and stakeholders.

Tables 1 and 2 provide a sampling of questions for staff review appraisers and the appraisal department manager.

Another source of valuable information is peer banks. Table 3 shows the type of information that can be obtained from appraisal departments at peer banks. This information is helpful in showing stakeholders and senior management how the bank's SLAs compare with other banks.

Step 4: Results of Review

Write a memorandum stating your findings regarding:

- The quality of department management and employees.
- The adequacy of written policies relating to real estate appraisal and evaluation.
- The efficiency and effectiveness of the appraisal order and review process.
- The manner in which bank offices are operating in conformance with established policy.
- The overall quality and reasonableness of the appraisals ordered by the bank.
- The quality of internal appraisal reviews.
- The quality and reasonableness of internal evaluations.
- Market areas or property types of concern.
- Areas of noncompliance with FIRREA and bank policy.
- Suggested options or solutions to areas of noncompliance or items that could use improvement.
- Other items to be addressed specified by senior management.
- Other items of significance.

Conclusion

A well-functioning and efficient appraisal program is the cornerstone of a bank's collateral evaluation function. The bank's appraisal department must be in step with best practices, provide good internal customer service, and perform due diligence with a high level of competence.

This is important not only to credit quality and risk management, but also to the bank's ability to service its loan customers in a timely and professional manner. The elements discussed in this article provide a framework for evaluating your appraisal program's effectiveness—a determination that could help your bank avoid losses. ❖

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