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Risk Management Insights

Managing the Commercial Appraisal Function

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Bank examiners and regulatory agencies are scrutinizing commercial real estate appraisal management procedures now more than ever before. Further, market conditions are exposing financial institutions to new risks that strong risk management practices can mitigate.

This first article (in a series of four articles) will address how to establish or review an appraiser roster, manage the appraiser roster, and find appraisers for out-of-footprint assignments. Other articles in the appraisal series will cover the following topics:

- Appraisal Review Part I: Sales Comparison and Cost Approaches
- Appraisal Review Part II: Income Capitalization Approach
- Land, Condos and Subdivisions – Solutions to Hard to Value Assets

2010 Managing Commercial Real Estate Appraisal Functions Telephone Briefing Series

On December 16, 2009, ABA and the Appraisal Institute will start a series of four webinars that review key concepts involved in CRE valuation management, including engagement of appraisers and reviewing appraisal reports. The webinar will cover the topics covered in this article as well as:

- Understanding appraisal standards (Uniform Standard of Professional Appraisal Practice)
- Utilizing USPAP Scope of Work rules to order the right appraisal product
- Interpreting appraisal requirements – "appraisals" versus "evaluations"
- Differentiating between appraisal report options and when they can be ordered
- Determining what to ask from an appraiser under different scenarios

The Appraisal Roster

The foundation of an appraisal management program is a solid roster of approved appraisers. We begin the process by asking the following questions:

- Who set up the roster?
- When was the last time the roster was updated?

If any of the following are true, then red flags should go up and these items addressed in the near future:

- Loan officers set part or all of the approved roster
- No one has reviewed the roster for many years

An important part of the entire appraisal program is independence. Throughout the appraisal regulations, the Agencies make it clear that loan officers and borrowers can have no say in which appraisers are considered or used for any assignment.

As such, an existing roster that had loan officer involvement in which appraisers were approved to work for the bank needs to be revisited by an independent part of the bank, e.g., credit, loan review. An outside consultant can also assist with this process.

The end result may be that many of the same appraisers will remain on the roster. After all, just because an appraiser was recommended by a loan officer does not mean that appraiser is not a qualified, competent appraiser. The goal is simply to have a roster that was determined independent of the lending personnel.

Many rosters need to be reviewed because no one has looked at them for years. Rosters are often assembled from a group of bank affiliates/regions and bank mergers. The result is a melting pot of names that no one has really looked into in regard to appraisal quality, timeliness, etc.

In my personal review of appraiser rosters for bank clients, I have found appraisers that are in a different profession, or retired, or even deceased! On average, the contact information for over 20 percent of the appraisers is incorrect. Which leads us to yet another question – when was the last time the bank used these appraisers?

When you assign someone to review the existing appraiser roster, an area of focus should be the number of approved appraisers. Are there too many appraisers? Are there not enough appraisers in some markets?

I have seen some approved rosters that contain more appraiser names than a phone book. Consideration should be given to narrowing your roster down. A better business relationship can be built if you use an appraiser 10 or 20 times per year than once or twice. Like any business, appraisers will provide their best service to the clients who hire them the most. Building this relationship can be beneficial when the bank needs someone to call to ask about local market conditions, recent sales and rents, and general consulting issues.

The Application Process

The questions to ask here are:

- Do we have an application file for each approved appraiser?
- If so, who in the bank has the files?

If your bank does not have appraiser application files, or the files do not contain the same items for every appraiser, now is a good time to make existing and new appraisers complete a standard application package. At a minimum, I recommend requesting the following items:

- Resume/CV
- Copies of all state licenses
- 2 or 3 sample reports

Your bank may also want an application completed that addresses geographic areas covered by the appraiser, standard and unusual properties appraised, references, and other items of interest to you.

Remember, individuals are approved, not firms. Although a firm may want every employee approved, it is the bank's prerogative as to which individuals make the roster.

One item of note is errors & omissions (E&O) insurance. In the residential appraisal industry, it is the norm for appraisers to have E&O insurance and for banks to require such. However, this is not the case for commercial appraisers. I have not seen any statistics, but I would not be surprised if more commercial appraisers did not have E&O insurance than have it. In fact, requiring E&O insurance for all of your approved appraisers may eliminate some of the better appraisers from doing work for you. Consider this requirement carefully before invoking it.

I am often asked how the bank knows if an appraiser should be added to the roster. How does the bank know the sample appraisal reports that are submitted are good or bad? If you have these questions and do not believe anyone inside the bank can adequately make these determinations, then consider the option of using a fee appraiser to assist the bank in setting up an appropriate appraiser roster. When I was setting up a residential appraiser roster in an unfamiliar market area, I paid an appraiser to review all the applications (including sample reports) and rate them from 'Deny' to 'Accept.'

Out-of-Footprint Appraisals

The appraiser roster discussed above applies to the commercial appraisals ordered within the bank's footprint. However, what about those appraisals in markets a thousand miles away? I would recommend the following sources (in no particular order):

- National Appraiser Registry (www.asc.gov)
- Appraisal Institute (www.appraisalinstitute.org)
- American Society of Appraisers (www.appraisers.org)
- National Association of Independent Fee Appraisers (www.naifa.com)
- American Society of Farm Managers and Rural Appraisers (www.agri-associations.org)
- Peer Bankers where the property is located

If you are ordering one or two appraisals in an out-of-footprint market every few years, I would not worry about adding those appraisers to your roster or putting them through your application process. Just make sure they provide a valid copy of their appraiser license for the state where the property being appraised is located.

Uniform Standards of Professional Appraisal Practice

The minimum appraisal standards per federal regulations require appraisals to be in compliance with the current Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by The Appraisal Foundation. Therefore, all parties involved in ordering, preparing, and reviewing appraisals should have a copy of the most recent USPAP.

The USPAP is updated every two years and the new 2010-2011 edition has just been published. Copies are available for purchase at www.appraisalfoundation.org. Prices range from $60 for an electronic download to $75 for a printed, spiral bound copy. I would suggest every bank have at least one copy in house for their reference.

Scope of Work

Although the fee appraiser is ultimately responsible for determining that the scope of work is adequate to provide a credible appraisal, the client can communicate to the appraiser the intended use and what level of work is preferred. Every appraisal does not need to be 200 pages and include all three approaches to value.

Typically, the number of approaches to value developed by the appraiser has the most effect on the cost and time to complete the assignment. If you are uncertain about which, or how many, approaches to value are needed for a particular appraisal, simply ask some appraisers. Appraisers will generally agree on which approaches to value should be developed and most do not want to waste time performing unnecessary work.

There are many other items to consider in scope of work, but approaches to value are most significant in affecting the amount of work to be done. I suggest reviewing the Scope of Work Rule in USPAP and determining what level of work your bank prefers for various assignments. Do you want an interior and exterior inspection of the subject property? Do you want exterior inspections and photographs of each comparable sale or rental property? All of these items have different levels of work involved and thus can affect the appraisal cost.

Appraisal Report Options

Three report options have been in existence since 1994: Self-Contained, Summary, and Restricted Use. For new loans requiring an appraisal, regulations require a Summary or Self-Contained Report to be ordered– these report types meet the ‘sufficient supporting information’ requirement in FIRREA.

Restricted Use reports are intended for your bank only and cannot be given to the borrower or any other bank. Thus, this report type cannot be used for new 1-4 family loans (Regulation B requires a copy of the appraisal be given to the borrower) or participation loans. However, a Restricted Use report might be appropriate for loan renewals or other situations that require an evaluation.

What to Ask Appraisers under Different Scenarios

Banks should not hesitate to ask appraisers to provide specific market information or a variety of values under different assumptions. In today’s market, a number of scenarios may need to be analyzed so the bank can make an informed decision.

Regulations require an ‘as is’ value. Once that requirement has been met, the bank is not prohibited from asking for other values. For example, is a loan going to workout and maybe foreclosure? If so, then Liquidation Value may be of use.

For a property that is only 50 percent leased, it might be helpful to know the market value ‘at stabilization.’ The ‘as is’ value of an 85 percent complete high-rise condominium building isn’t of much use – so also ask for market value ‘at completion.’

For a just completed condominium building with no units sold, two value scenarios should be requested: 1) The entire building rented as apartment units, and 2) Sellout of the units as condominiums. Even in today's weak market we have seen situations where the higher projected value is from selling the units rather than renting them for a few years and then trying to sell them.

Communication is of utmost importance today. Fee appraisers and banks need to discuss in detail the property to be appraised and any possible scenarios that might be helpful to value. It is cheaper and more efficient to order one appraisal that answers a variety of questions than to order several appraisals over a period of time. Do not rush through the all important engagement process.

Next article in the series: Appraisal Review Part I – Sales Comparison and Cost Approaches

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