WHAT'S NEW IN APPRAISAL REVIEW?

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The growing regulatory focus on financial institutions includes the way banks review property appraisals. Recent guidelines spell out the qualifications expected of reviewers and call for institutions to perform quality-control audits.

BY GEORGE R. MANN

Since 2009, bank examiners and regulatory agencies have increased their focus on the quality of appraisal reviews.

Inadequate appraisal-review processes, for example, were among the OCC's findings in a 2013 horizontal review of banks' appraisal processes.[1] The December 2010 update of the *Interagency Appraisal and Evaluation Guidelines* added an entire section that focuses solely on the review of appraisals and evaluations.

The guidelines state the following: "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; and set forth documentation standards for the review and the resolution of noted deficiencies."

Bank Examiner Perspective

Another 2013 effort by the OCC that noted concerns about appraisal reviews was a manual called *Commercial Real Estate Lending: Comptroller's Handbook*. It included a 127-question "internal control questionnaire" with the following instructions:

"An internal control questionnaire (ICQ) helps the examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment."

Six of the questions applied to appraisal-review policies and procedures (see sidebar on p. 37), and 14 addressed what should be reviewed in each appraisal report.

Although your bank may not be examined by the OCC, before your next examination it might be useful to obtain the document and have your appraisal-review function note the items that examiners will be looking for. The agencies attempt to follow the same requirements, so implementing policies and procedures that are the most inclusive is always advisable.

Non-appraisers Performing Reviews

Part A of Section XV in the *Interagency Appraisal and Evaluation Guidelines* addresses the qualifications of reviewers.

"An institution," it says, "should establish qualification criteria for persons who are eligible to review appraisals and evaluations. Persons who review appraisals and evaluations should be independent of the transaction and have no direct or indirect interest, financial or otherwise, in the property or transaction, and be independent of and insulated from any influence by loan production staff. Reviewers also should possess the requisite education, expertise, and competence to perform the review commensurate with the complexity of the transaction, type of real property, and market. Further, reviewers should be capable of assessing whether the appraisal or evaluation contains sufficient information and analysis to support the institution's decision to engage in the transaction."

The guidance further notes that, when it is not possible to maintain "absolute lines of independence" because of limited staff, safeguards for reviewing appraisals are needed. For example, it says, the originating loan officer could be allowed to perform a review as part of the overall credit analysis "as long as the originating loan officer abstains from directly or indirectly approving or voting to approve the loan.

"It may be appropriate to employ additional personnel or engage a third party to perform the reviews," the guidance says. "When using a third party, an institution remains responsible for the quality and adequacy of the review process, including the qualification standards for reviewers."

Regulators want appraisal-review personnel to have the requisite knowledge of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA); the Uniform Standards of Professional Appraisal Practice (USPAP)[2]; and real property valuation development and reporting.

Here are some questions to ask internal reviewers:

- Have you attended a seminar on the USPAP?
- Do you have a copy of the current USPAP (2014-15 edition)?
- Have you attended seminars or webinars on FIRREA appraisal requirements?
- How much experience do you have in valuing commercial and/or residential real estate?
- How much education do you have regarding real estate appraisal?
- Are you current on bank policy and regulatory guidelines?

The most qualified people to review appraisals are appraisers themselves. After all, these individuals have significant education and experience regarding appraisal theory and USPAP, and many are familiar with FIRREA appraisal requirements.

However, employees who are not licensed real estate appraisers can still meet the requirements of the review guidelines as long as they understand FIRREA, USPAP, and appraisal theory. Some may have garnered adequate experience from serving as real estate credit or loan officers in the past. The guidelines say financial institutions should identify those individuals who meet the requisite qualifications.

A SIGNIFICANT NUMBER OF ERRORS GO UNDETECTED WHEN BANKS DO NOT PERFORM ROUTINE QCAs ON THEIR APPRAISAL REVIEWS.

Just as most appraisal clients have encountered a significant number of poor appraisals, many appraisal review clients have also been let down. This is one reason the regulators want banks to perform quality-control audits (QCAs) on their appraisal reviews.

The following are actual results from QCAs this author has performed over the past year. As you read the results, consider that all of the reviews were performed by highly experienced and licensed appraisers, some with professional appraisal designations (ASA, MAI, SRA) and/or professional appraisal-review designations (AI-GRS, AI-RRS, ARM).

Each review report is graded on a scale from 1 to 5, with 5 being excellent and 1 being unacceptable. (Each overall grade was an average of 20 to 30 grades for different parts of review development and reporting.) A grade of 3 and above was considered "passing" and below 3 was "failing."

The table below shows that only 40% of the review reports received a passing grade. For all of the QCAs completed in the past year, the average score is 2.88, slightly below the 3.0 passing threshold. Overall grades for individual reviewers have been in a narrow range between 2.8 and 3.2.

The results for Reviewers A and B show how differently the individuals fared. In comparison to Reviewer A, Reviewer B has a higher average grade, but a lower percentage of passing reviews. Reviewer B is providing a more consistent—but marginally inadequate—product. Reviewer A produces uneven reports—either solid or very inadequate.

Unfortunately, the audits of appraisal reviews are arriving at the same results as the reviews of appraisal reports: The overall quality is poor. My personal experience with reviewing appraisal reports for 22+ years—plus surveys of chief appraisers at banks of all sizes—indicates that 20% to 40% of appraisal reports have issues that require revisions. The data above suggests that an even larger percentage of appraisal-review reports have errors that require revisions.

A significant number of errors go undetected when banks do not perform routine QCAs on their appraisal reviews.

Until your institution has set up a QCA program, in the interim it might

	Total Population	Reviewer A	Reviewer B
Lowest grade	1.7	1.7	2.6
Highest grade	3.7	3.3	3.7
Average grade	2.88	2.8	2.9
Standard deviation	0.38	0.41	0.31
% passing	40%	40%	10%

APPRAISAL-REVIEW POLICIES AND PROCEDURES CHECKLIST

The OCC's 2013 manual, *Commercial Real Estate Lending: Comptroller's Handbook,* included an "internal control questionnaire" that referenced appraisal-review policies and procedures as well as appraisal reviews. The questions regarding appraisal-review policies and procedures follow:

- Does the bank's policy require that every CRE appraisal be reviewed, and is the policy followed?
- Does the bank have procedures to evaluate and address the competence of reviewers?
- Are appraisals reviewed and approved before funds are advanced?
- Are any appraisal reviews outsourced? If so,
  - Does bank policy state when such outsourcing is to occur?
  - Are procedures in place to test the quality of outsourced reviews?
  - Does the reviewer use bank-developed review documentation and specifications?
  - Does the bank have a quality-control procedure in place for these reviews?
- For internally performed reviews, is the employee independent of the loan production and collection functions?
- Are all appraisals reviewed, and is each review documented?

help your reviewers to ensure that issues are being adequately addressed in each and every review. Here is a list of the most common errors:

- Not following appraisal department policies and procedures—for example, performing a compliance checklist when what's required is a technical review.
- Not making sure all requirements in an engagement letter were met (the required copy of the appraiser's license in the report, all requested values, etc.).
- Accepting reports that do not state compliance with FIRREA.
- Accepting reports that have a definition of market value that does not reference FIRREA.
- Accepting a market-value conclusion that is based on a hypothetical condition.
- Accepting market-value conclusions that are not "real estate only"—in other words, the value conclusion includes furniture, fixtures, and equipment.
- Accepting an appraisal report with an incorrect property interest appraised. For example, the fee simple estate is for 100% owner-occupied and/or vacant properties, while leased fee interest is for properties with one or more arm's-length tenants (apartments, self-storage facilities, industrial, office, retail, etc.). The length of the lease(s) is not relevant to which property interest should be appraised.
- Review reports that do not include a summary of the revisions made by the appraiser and/or do not state whether the value did or did not change. If the value changed, the review report should show those figures.
- Appraisal reports where the appraiser does not indicate whether he or she verified each previous sale with a party to the transaction (attorney, broker, buyer, or seller). Such reports should be looked at with extra caution. Sources such as assessors, CoStar, Multiple Listings Services, and public records provide only some information and may be inaccurate. Recorded sales prices are often not the actual sales prices.
- Review reports should include the extraordinary assumptions used in the appraisal reports, as the value conclusions are predicated on those items.

Conclusion

Licensures and designations held by appraisers do not guarantee that you will receive an acceptable appraisal report. They also do not guarantee that you will obtain an acceptable appraisal review. Statements such as "I have appraised in the area for 20 years" or "I just received an appraisal review designation" do not mean much.

Quality is based on an individual's education, ethics, and experience. This being the case, all banks should implement a QCA program before their next examination. Since QCAs are very time-consuming (10-12 hours per review that is audited), banks may want to consider the services of a third-party vendor. Whoever performs the QCA must have substantial review experience and knowledge of FIRREA and USPAP. ®

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Notes

1. Other findings included general noncompliance with interagency guidance, noncompliance with third-party vendor management guidance, and inadequate evaluation-development processes. See *Interagency Appraisal and Evaluation Guidelines,* December 2, 2010.
2. Uniform Standards of Professional Practice (USPAP), the Appraisal Standards Board of the Appraisal Foundation, 2014-2015 edition.