Interagency Appraisal and Evaluation Guidelines

Kentucky Real Estate Appraisal Training
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Introduction

Federal Reserve Website: www.federalreserve.gov

Interagency Appraisal and Evaluation Guidelines

- Select Banking Information & Regulation tab
- Expand Supervision on left
- Select Supervision and Regulation Letters
- Change year to 2010
- Select SR 10-16

Appraisal Regulation

- Select Banking Information & Regulation tab
- Select Regulations
- Select Regulation H for State Member Banks (12 CFR 208 subpart E)
- Select Regulation Y for Bank Holding Companies (12 CFR 225 subpart G)

Independence

Collateral valuation function

- The selection and engagement of the appraiser needs to be isolated from influence by the loan production staff
- Individuals who prepare evaluations need to be independent of the transaction
- Appraisers should not begin work until officially engaged by the institution extending the credit facility

Small and rural institutions

- If absolute lines of independence cannot be achieved, the loan officer who orders the appraisal or performs the evaluation should abstain from approving the loan

Independence (continued)

Selection

- Selection process must be independent of the loan production staff
- For residential transactions, an approved appraiser list may be used so long as the list is not under the control of the loan production staff
- Appraiser must be competent for the assignment for both the property type and market
- Institution may not use a borrower-ordered or borrower-provided appraisal

Communications

- There should be a process for responding to appraisers' questions
- An institution should avoid actions that may compromise independence
- An institution may provide a copy of the sales contract to the appraiser
- Engagement letters document expectations for the appraisal assignment

Minimum Appraisal Standards

Conform to Uniform Standards Professional Appraisal Practice (USPAP)

- Results from an automated valuation model (AVM) by itself or signed by an appraiser is not an appraisal
- A Broker Price Opinion (BPO) is not an appraisal

Contain sufficient information

- Consider risk and complexity of the transaction
- Reflect a scope of work that is appropriate for the appraisal assignment
- Contain disclosure of the nature and extent of inspection
- Note: USPAP requires the appraiser to disclose whether or not the subject property was inspected

Analyze deductions and discounts

- Provide an estimate of market value based on future demand for the real estate
- Use realistic assumptions and appropriate valuation methods
- Need to consider the holding, marketing, and sales period
- Refer to Appendix C in the Guidelines for a discussion by property type on compliance with this standard; expectations for the "as is" market value; and treatment of entrepreneurial profit which may be a line item in the discounted cash flow analysis or reflected in the discount rate

Minimum Appraisal Standards (continued)

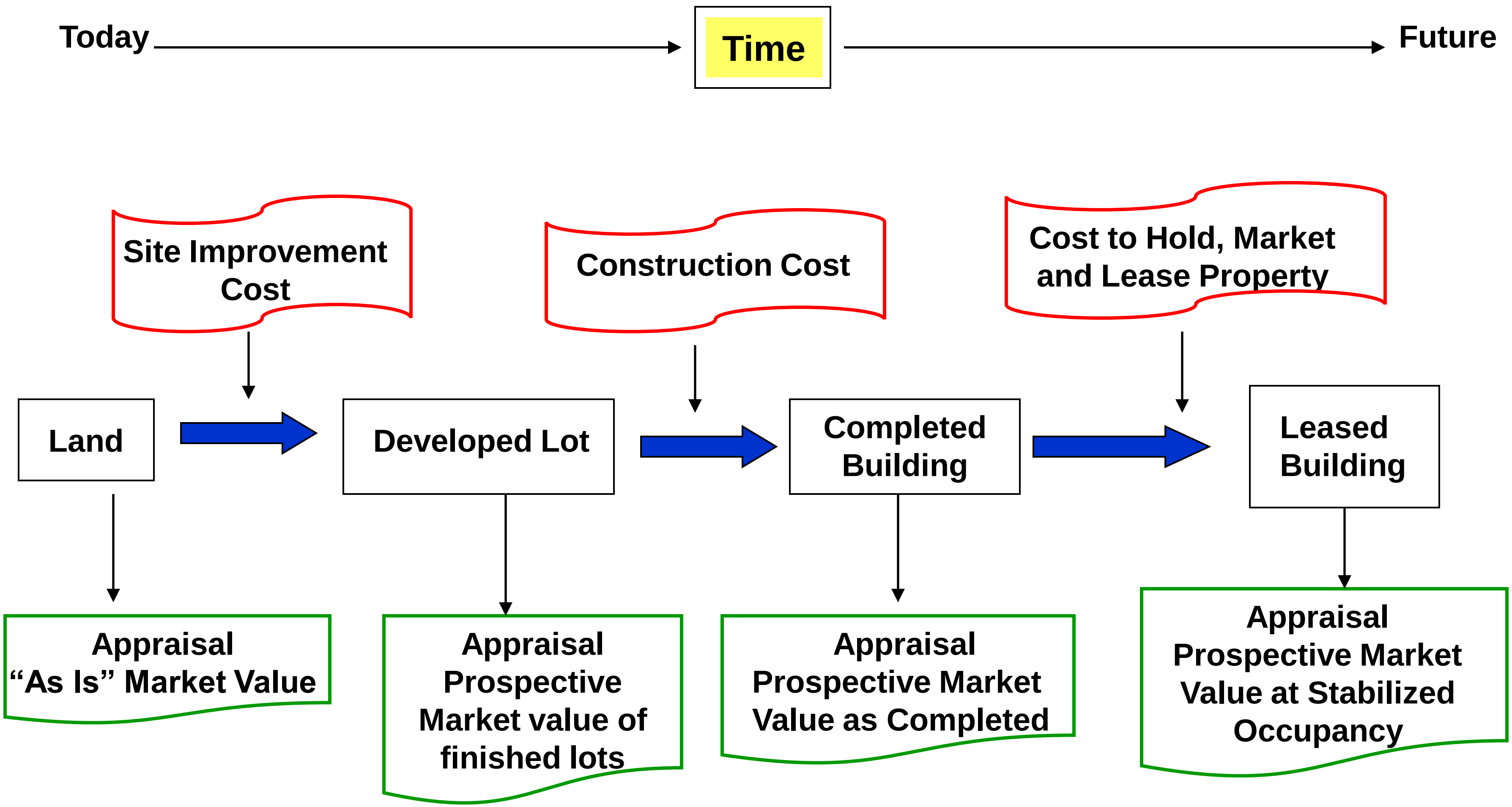
Be based on the definition of market value as set forth in the appraisal regulation

- Value opinions such as “going concern value,” “value in use,” “disposition value” can be given in the appraisal report, but are not considered the market value of the property.

Be performed by a state certified or licensed appraiser

- The selection of an appraiser should not be based solely on whether the appraiser is licensed or certified, but also on the appraiser’s competency, experience, and expertise.

Market Value – Matches the Purpose of the Loan



Refer to Appendix C in the Interagency Appraisal and Evaluation Guidelines

Appraisal Development and Appraisal Reports

- The appraisal must reflect an appropriate scope of work that provides for "credible" assignment results.
- The scope of work should reflect the extent to which the property is identified and inspected, the type and extent of data researched, and the analyses applied to arrive at the opinion of value.
- USPAP requires the appraiser to disclose whether he or she previously appraised the property.
- An institution should discuss its needs and expectations with the appraiser.
- An institution should not allow lower cost or the speed of delivery time to inappropriately influence its appraisal process or the appraiser's determination of the scope of work.

Appraisal Development and Appraisal Reports (continued)

- The appraisal must include any approach to value (that is, the cost, income, and sales comparison approaches) that is applicable and necessary to the assignment. The appraiser should disclose the rationale for the omission of a valuation approach.

- The appraiser must analyze and reconcile the information from the approaches to arrive at the estimated market value. Relevant information includes: property value trends, demand and supply factors, exposure time, the prevalence and effect of sales and financing concessions, the list-to-sale price ratio, and availability of financing.

- The institution should consider the risk, size and complexity of the transaction and the real estate collateral when determining the appraisal report format. (Refer to the Interagency Appraisal and Evaluation Guidelines Appendix D: appraisal report definitions.)

Evaluations

Transactions that Require at a Minimum an Evaluation

- A transaction equal to or less than the appraisal threshold of $250,000
- A business loan equal to or less than $1 million
- Transaction involves an existing extension of credit

Evaluation Development

- An evaluation must be consistent with safe and sound banking practices and support the institution's decision to engage in the transaction
- A valuation method should address the property's actual physical condition and characteristics as well as the economic and market conditions that affect the estimate of the collateral's market value
- 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 economic and market factors

Evaluation Content

- Contain sufficient information detailing the analysis, assumptions, and conclusions to support the credit decision
- Be documented in the credit file or reproducible
- Interagency Appraisal and Evaluation Guidelines Appendix B provides guidance on the use of analytical methods and tools in developing an evaluation

Appraisal and Evaluation Review

Expectations

- Ensure compliance with appraisal regulation and consistency with the guidelines
- Assess reasonableness and validity of the appraisal or evaluation
- Perform before the final credit decision
- May reflect a risk-focused approach to the depth of the review
- Performed by a qualified and independent individual

Depth of Review

- The methods, assumptions, data sources, and conclusions should be reasonable, well-supported, and appropriate for the transaction, property, and market
- The review process should consider whether the appraisal or evaluation was obtained by the institution or from another financial services institution

Resolution of Deficiencies

- Communicate the noted deficiencies to, and request correction of such deficiencies by the appraiser or person who prepared the evaluation
- Implement adequate internal controls to ensure that communications with an appraiser do not result in any coercion or undue influence
- Address significant deficiencies in the appraisal that could not be resolved with the original appraiser by obtaining a second appraisal or relying on a review that complies with Standards Rule 3 of USPAP
- Replace evaluations prior to the credit decision that do not provide credible results or lack sufficient information to support the final credit decision

Third-Party Arrangements

Third party collateral valuation services include: ordering or reviewing appraisals and evaluations, selecting an appraiser or person to perform evaluations or providing access to analytical methods or technological tools

An institution is accountable for ensuring that any services performed by a third party, both affiliated and unaffiliated entities, comply with applicable laws and regulations and are consistent with supervisory guidance

An institution is responsible for ensuring that a third party selects an appraiser or a person to perform an evaluation who is competent and independent, has the requisite experience and training for the assignment and thorough knowledge of the subject property's market

An institution should ensure that when a third party engages an appraiser or a person who performs an evaluation, the third party conveys to that person that the regulated institution is the client

Program Compliance

Monitoring collateral values

- An institution should:
  - monitor collateral risk on a portfolio and on an individual credit basis
  - be able to demonstrate that sufficient information is available to support the current market value of the collateral and the classification of a problem real estate credit.
- If an institution has insufficient information to demonstrate an understanding of a property’s current market value, an examiner may direct an institution to obtain a new appraisal or evaluation
- As loan repayment becomes more dependent on the sale of collateral, an institution’s policies should address the need to obtain an appraisal or evaluation for safety and soundness reasons even though one is not otherwise required by appraisal regulations.

Program Compliance (continued)

Changing market conditions

- Prudent portfolio monitoring practices should include criteria for determining when to obtain a new appraisal or evaluation
- The criteria should address deterioration in the credit since origination or changes in market conditions
- Changes in market conditions could include material changes in current and projected vacancy, absorption rates, lease terms, rental rates, and sale prices, concessions, and overruns and delays in construction costs
- Fluctuations in discount or direct capitalization rates also are indicators of changing market conditions

Program Compliance
(continued)

Loan modifications and workouts

- Current collateral valuation information is needed to assess collateral risk and facilitate an informed decision on whether to engage in a modification or workout.

- A loan modification to an existing credit that involves a limited change in loan terms and that does not adversely affect the institution’s real estate collateral protection after the modification does not rise to the level of a new real estate-related financial transaction.

- A loan workout can take many forms, including a modification that adversely affects the institution’s real estate collateral protection after the modification, a renewal or extension of loan terms, the advancement of new monies, or a restructuring with or without concessions. In such cases, the workout transaction is considered a new real estate-related financial transactions. In which case, the institution needs to comply with the Board’s appraisal regulation and may consider the exemption for existing extension credit.

Appraisal Exemption for Loan Renewals and Refinancings

Regulation (12 CFR 225 subpart G)

- A subsequent transaction related to an existing extension of credit are exempted from the appraisal requirement if (*still requires an evaluation)
  - ➢ There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the bank's real estate collateral protection after the transaction, even with the advancement of new monies; or
  - ➢ There is no advancement of new monies, other than funds necessary to cover reasonable closing costs.

Qualifying for the exemption

- A subsequent transaction <u>without</u> the advancement of new monies is exempted from the appraisal requirement, but a bank must have a valid evaluation.

- If there <u>has been</u> obvious and material changes in market conditions or physical aspects of the property that threaten the adequacy of the bank's collateral protection, the bank <u>must</u> obtain an appraisal when it <u>advances</u> new monies other than reasonable closing costs.

Appraisal Requirements for Loan Renewals and Refinancings (continued)

- **Renewing a term loan with the advancement of new monies**

  Example: A bank originated a 15-year term loan for $3 million and, in year 14, the outstanding principal is $2.5 million. In year 14, the borrower seeks to refinance the loan at a lower interest rate and requests a loan of $2.8 million. The $300,000 would be considered new monies.

- **Renewing the line of credit at its original amount would not be considered an advancement of new monies.**

  Example: A bank extends a $5 million revolving line of credit to a borrower for two years and, at the end of year two, renews the $5 million line for another two years. At the time of renewal, the borrower has drawn down $1 million.

Appraisal Exemptions

Appraisal Threshold

- Transactions with values less than or equal to $250,000 are exempt from requiring an appraisal but an evaluation is required.
- Transactions secured with multiple properties should apply the threshold to the estimated value of each property and appraise any property with an estimated value over $250,000.

Abundance of Caution

- The soundness of the credit extension should be well supported by verifiable borrower cash flow or other verifiable collateral
- The credit file should document primary and secondary verifiable sources of repayment for the credit extension.
- If reliance on the collateral becomes necessary to support the credit, an appraisal must be obtained.

Appraisal Exemptions (continued)

Loans Not Secured by Real Estate

- The institution has no legal security interest in the real estate even though the loan proceeds are used to acquire real estate

Liens for Purposes Other Than the Real Estate's Value

- The institutions takes a real estate lien as a means to secure rights to other collateral (such as timber, crops, and mineral rights)

Real Estate Secured Business Loans

- Transaction value must be less than $1 million
- The primary source of repayment cannot be from the sale or rental of the real estate.
- An Evaluation is still required

Leases

- The exemption applies to operating leases
- An appraisal is required for capital leases (e.g., a ground lease)

Appraisal Exemptions (continued)

Transactions Involving Real Estate Notes

- Purchase, sale, investment in, exchange of, or an extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property
- If the original appraisal(s) met the regulatory standards at the time of origination

Transactions Insured or Guaranteed by a U.S. Government Agency or U.S. Government Sponsored Agency.

- Applies to transactions wholly or partially insured or guaranteed by a U.S. government or government-sponsored agency
- The transaction must meet the underwriting requirements and appraisal requirements of the U.S. government agency or GSE

Appraisal Exemptions (continued)

Transactions that Qualify for Sale to or Meet the Appraisal Standards of a U.S. Government Agency or U.S. Government sponsored Agency.

- The transaction must qualify for sale to a U.S. Government Agency or a government sponsored agency and have already met their appraisal and policy standards.
- The appraisal must conform to Fannie Mae or Freddie Mac standards
- The credit file should document conformance with the U.S. Agency standards or Fannie Mae or Freddie Mac standards.

Transactions by Regulated Institutions Acting as Fiduciaries.

- If the Fiduciary transaction does not require an appraisal, no appraisal is required under the Interagency Guidelines.

Referrals of Unethical and Unprofessional Appraisers to States

1

- 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

2

- Under Regulation Z (Truth in Lending) effective April 1, 2011, an institution must file a complaint with the appropriate state appraiser certifying and licensing agency under certain circumstances (Refer to 12 CFR 226.42(g))

3

- An institution must file a suspicious activity report (SAR) with the Financial Crimes Enforcement Network of the Department of the Treasury (FinCEN) when suspecting fraud in the appraisal or identifying other transactions meeting the SAR filing criteria