

Federal Agencies Offer Guidance on Appraisals and Evaluations

by George R. Mann, MAI, SRA, and Larry R. Woodall

In December 2010, the five federal banking authority agencies—the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision, and the National Credit Union Administration (NCUA)—issued the *Interagency Appraisal and Evaluation Guidelines* (Guidelines). The new Guidelines update and replace the agencies’ existing guidelines on real estate appraisals and evaluations used to support real estate—related financial transactions. They provide federally regulated institutions and examiners with clarifications on the agencies’ expectations for “prudent appraisal and evaluation policies, procedures, and practices.”¹

Background

The *Interagency Appraisal and Evaluation Guidelines* apply to all real estate—related financial transactions “originated or purchased by a regulated institution or its operating subsidiary for its own portfolio or as assets held for sale, including activities of commercial and residential real estate mortgage operations, capital market groups, and asset securitization and sales units.”² Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA),³ the agencies must prescribe appropriate standards for the performance of appraisals in connection with federally related transactions that an agency “engages in, contracts for, or regulates and that require the services of an appraiser.”⁴ The Uniform Standards

of Professional Appraisal Practice (USPAP) is the minimum standard for agencies’ appraisals, but all the agencies have adopted additional appraisal standards. The new Guidelines supplement existing guidance and rescind a number of other guideline statements, including the following:

- *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-84-2005
- *2006 Revisions to Uniform Standards of Professional Appraisal Practice*, FIL-53-2006

(FDIC references shown.)

Commercial and residential appraisers should review the contents of the agencies’ new Guidelines. A copy can be downloaded from the website of the FDIC, Federal Reserve Board, or OCC.⁵ Two versions of the Guidelines are available; one is 45 pages and the other is 70 pages. The second, longer version includes 25 pages of comments by the agencies, explaining the process undertaken to arrive at the final document.

Sections and Appendices

The Guidelines contain eighteen sections and four appendices. Although this article addresses some of the pertinent items, it does not cover everything in the Guidelines. The following discussion reviews each of the sections and appendices, noting new items that

1. Section I, “Purpose,” *Interagency Appraisal and Evaluation Guidelines* (December 2, 2010).

2. *Ibid.*

3. 12 U.S.C. §3331, et seq.

4. *Ibid.* at 12 U.S.C. §3350(4).

5. FDIC available at <http://www.fdic.gov/news/news/financial/2010/fil10082.html>; Federal Reserve available at <http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm>; and OCC available at <http://www.occ.treas.gov/news-issuances/bulletins/2010/bulletin-2010-42.html>.

have not appeared in prior agency statements and items that the agencies are reemphasizing.

Section I—III: Purpose, Background, and Supervisory Policy

Sections I through III, titled “Purpose,” “Background,” and “Supervisory Policy,” are basically an introduction that provides the origination of the appraisal and evaluation guidelines and the importance of program compliance. It is in these sections that the Uniform Standards of Professional Appraisal Practice (USPAP) is first mentioned. Also, it is noted the agencies have appraisal standards in addition to USPAP.

Section IV: Appraisal and Evaluation Program

Section IV, titled “Appraisal and Evaluation Program,” lists ten bullet points on the required elements of an institution’s real estate appraisal and evaluation program. Four of these bullet points are especially noteworthy:

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.

These provisions make clear that appraisal independence not only pertains to persons who perform appraisals and evaluations, but also to persons who order and review the appraisals and evaluations.

This section states that appraisals must comply with the agencies’ appraisal regulations, which may differ from or exceed USPAP requirements. Also, institutions should evaluate and monitor the performance of fee appraisers and persons who perform evaluations. Many financial institutions have already implemented a simple rating of each appraisal received to address items like timeliness, report quality, and responsiveness of appraiser to review questions.

The issue of sufficient information mentioned in this section is discussed later in Section VIII of the Guidelines.

Section V: Independence of the Appraisal and Evaluation Program

Section V on “Independence of the Appraisal and Evaluation Program” has been expanded substantially to clarify some points and to address the communication process between an institution and its fee appraisers. As previously noted, independence extends to those persons who “order, perform, and review” and to both appraisals and evaluations. Section V specifically notes that the agencies’ requirements on appraiser independence exceed those in USPAP.

In Section V, the Guidelines provide that an institution should “establish reporting lines independent of loan production for staff who administer the institution’s collateral valuation program.” Appendix D 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. Therefore, appraisers should not be accepting appraisal requests from loan officers or other employees involved in the loan production or approval process.

Section V also addresses the types of communications that would not be construed as coercion or undue influence on appraisers and persons performing evaluations, and provides examples of actions that would compromise independence. For the most part, the agencies’ wording is self-explanatory:

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:

- 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.

Section V also requires institutions to have policies in place to prevent actions that affect the independence of collateral valuation, and it specifies the types of prohibited actions. It states as follows:

An institution's policies and procedures should ensure that it avoids inappropriate actions that would compromise the independence of the collateral valuation function, including:

- 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.

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

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 it 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 to address the agencies' recommendation that institutions use engagement letters. Because many financial institutions have limited or no engagement letters, appraisers may want to send their clients a sample engagement letter to use. This would help both sides of the transaction as all expectations would be outlined. Members of the Appraisal Institute can obtain sample engagement letters from the Appraisal Institute's website.⁶

A new and very important statement in this section provides, "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; 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. This affects banks more than appraisers, but appraisers should be aware of this requirement.

Section VII: Transactions That Require Appraisals

Section VII, "Transactions That Require Appraisals," states that most federally related transactions will require appraisals, but recognizes exemptions in certain circumstances. Appendix A lists the twelve instances in which an appraisal exemption may be employed. These exemptions remain the same as published in the last FIRREA amendments of 1994.

Section VIII: Minimum Appraisal Standards

Section VIII, "Minimum Appraisal Standards," is probably one of the most important sections in the Guidelines as it lists the five standards that are mandatory in order 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 appraisal standard states appraisals still must comply with USPAP and contain the agencies' definition of *market value*. However, the following two items have been added to the standard:

- 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.

6. The sample agreements are available at <http://www.appraisalinstitute.org/myappraisalinstitute/contract/default.aspx> (member log in required).

The second minimum appraisal standard in Section VIII 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 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.

The second appraisal standard also refers to the USPAP requirement that reports contain sufficient information for the intended user to understand the report; the standard states,

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.

This standard also states the appraisal must be written. Thus, it is not acceptable for a financial institution to rely on a verbal opinion of value.

The third minimum appraisal standard deals with deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units. This standard is designed to avoid appraisals with unrealistic assumptions. Appendix C, “Deductions and Discounts,” has been added to the Guidelines and explains the expectations for appraisals of these complex property types. Appraisers should read Appendix C and keep it handy when appraising these complex property types.

The fourth minimum appraisal standard requires the appraisal to be based upon the agencies’ definition of *market value* and includes the requirement that an “as is” market value be provided in each appraisal. Note, *market value* as defined in the 2010–2011 edition of USPAP is not acceptable for appraisals performed for financial

institutions. The Guidelines’ definition of *market value* applies to real property only, and it states,

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.

Since at least the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991,⁷ appraisals of going-concern properties like adult care facilities, convenience stores, fast food restaurants, hotels, and marinas must allocate values among real property; furniture, fixtures, and equipment (FF&E); and business value. USPAP does not require this, but FIRREA and FDICIA do since most banks calculate their loan-to-value ratios using the market value of real property only. How to allocate these values is a topic of an upcoming Appraisal Institute course, *The Fundamentals of Separating Real and Personal Property from Intangible Business Assets*, which will be released in late 2011.

Different methods obviously exist, and the agencies do not specify any particular methodology. However an appraiser arrives at the conclusions, it should be adequate to provide a summary of different values as shown in the following example.

Example

Market value “as is” of real property	\$14,000,000
Used to calculate LTV	→
Market value “as is” of FF&E	\$1,000,000
Business value	\$5,000,000
Market value “as is” of going concern	\$20,000,000

“As is” *market value* is defined in the agencies’ Guidelines as “the estimate of the market value of real property in its current physical condition, use, and zoning as of the effective date.” If an appraisal assignment calls for valuing a property that is to be renovated or converted to a different use, the appraiser must remember to include the market value “as is.” A common occurrence has been the omitting of “as is” value in the appraisals of to-be-renovated houses. Even if the client does not ask for “as is” value, the appraiser knows FIRREA requires “as is” market value in the appraisal report and thus needs to present it.

7. 12 U.S.C. §1828(o).

The fourth appraisal standard also states that in addition to “as is” value, an institution can request a prospective market value on 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. A prospective value reflects an effective date that is subsequent to the date of the appraisal report.

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

Sections IX—X: Appraisal Development and Appraisal Reports

Section IX, “Appraisal Development,” reiterates most of what is discussed in 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 in Appendix D that a restricted use appraisal report probably will not be appropriate for most federally related transactions, but may be useful for ongoing collateral monitoring. Appraisers should inform clients that a restricted use appraisal report is for internal bank use only and cannot be provided to the borrower.

Sections XI—XIII: Transactions That Require Evaluations, Evaluation Development, And Evaluation Content

Section XI, “Transactions That Require Evaluations,” outlines the three exemptions that qualify for an evaluation of real property collateral in lieu of appraisals; these exemptions remain exactly the same as in the 1994 Amendments to FIRREA.

Section XII, “Evaluation Development,” is a new section that works in conjunction with Section XIII, “Evaluation Content.” Here, the agencies added a new section to emphasize 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.

For the most part, the sections on evaluations do not apply to fee appraisers. Although many sources like to say that appraisers can perform evaluations for financial institutions, the fact is they cannot. State laws (except Tennessee) require licensed appraisers to comply with USPAP when providing opinions of value. However, an evaluation is an opinion of value that does not have to comply with USPAP. As such, in order to meet the requirements in an evaluation, a fee appraiser would have to meet USPAP requirements and provide at least a restricted use appraisal report. The lone exception to this is in Tennessee, which allows licensed and certified appraisers to perform true evaluations that do not meet USPAP requirements. If additional states followed the lead of Tennessee, appraisers would have the opportunity to participate in a huge volume of assignments that currently is provided by other professionals.

Lastly, these evaluation 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. Also, broker price opinions (BPOs) cannot be used because they produce a potential selling price, not a market value.

Section XIV: Validity of Appraisals and Evaluations

Section XIV, “Validity of Appraisals and Evaluations,” is mostly unchanged from prior agency statements and reference is made to including support for using a prior appraisal or evaluation in the credit file. Most financial institutions prepare validations internally. (We are aware of only one bank that has engaged fee appraisers to perform a validation.) Fee appraisers could be used to validate prior appraisals, but they would need to prepare at least a restricted use appraisal report.

Sections XV: Reviewing Appraisals and Evaluations

Section XV, “Reviewing Appraisals and Evaluations,” moves the discussion on reviews to its own section and contains an abundance of new information. Subsections address reviewer qualifications; 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.

Many institutions will likely need to develop policies and procedures to address appraisal and evaluation review in accordance with this section's requirements. The agencies' note "an institution may find it appropriate to employ additional personnel or engage a third party to perform the reviews" in order to comply with independence and competency requirements for reviewers.

Fee appraisers may be called upon by financial institutions to provide these appraisal review services. Obviously it is important to know all the nuances of FIRREA and USPAP because the appraisals under review must be in compliance with both documents. Those looking into review work may want to obtain the Appraisal Institute's book on the subject, *Appraising the Appraisal: The Art of Appraisal Review*.⁸ Also, the Appraisal Institute has several seminars on the topic of appraisal review.⁹

Section XVI: Third Party Arrangements

Section XVI, "Third Party Arrangements," is a new topic added by 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. Fee appraisers who provide appraisal reviews for financial institutions fall under this section and should be aware they are supposed to essentially perform their work as if they were an employee of the bank and following bank policies and procedures.

Section XVII: Program Compliance

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

Program compliance items have been added to 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 today.

Section XVIII: Referrals

Section XVIII, "Referrals," strengthens the agencies' statement on referrals 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.¹⁰

This section also provides information as to when a suspicious activity report (SAR) must be filed. Bank examiners are going to expect banks to report appraisers who provide appraisals that are not in compliance with USPAP and FIRREA. State regulatory officials may be inundated with complaints, and some appraisers will need to defend themselves against such complaints.

Appendices

In addition to the eighteen sections discussed, the Guidelines have added four appendices, Appendix A-D.

Appendix A, "Appraisal Exemptions," restates the twelve appraisal exemptions outlined in the 1994 FIRREA Amendment. Appendix B, "Evaluations Based on Analytical Methods or Technological Tools," contains four pages of discussion on using AVMs and a page on using tax assessment valuations (TAVs). Institution should read this appendix carefully if they currently use or plan to use one of these tools.

Appendix C, "Deductions and Discounts," relates to the minimum appraisal standard in

8. Richard C. Sorenson, *Appraising the Appraisal: The Art of Appraisal Review*, 2nd. ed. (Chicago: Appraisal Institute, 2010).

9. Seminars include *Spotlight on USPAP: Appraisal Review*; *Appraising the Appraisal: Appraisal Review*; and *Reviewing Residential Appraisal Reports*.

10. For details on mandatory reporting to state agencies, see the Federal Reserve's Regulation Z of the Truth in Lending Act, 12 C.F.R. 226.42(g).

Section VIII on deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units. A discussion of the various property types requiring deductions and discounts is presented.

Appendix D is the "Glossary of Terms," containing 49 definitions. Some of the more useful definitions are 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 by the federal banking agencies to provide further clarification of the agencies' appraisal regulations and to provide supervisory guidance to institutions and examiners about appraisal and evaluation programs. Although numerous items have been summarized here, appraisers and others involved in federally related real estate transactions should read the guidelines in their entirety to ensure compliance.

Many urban myths and false rumors have already sprung up related to the Guidelines. If something sounds unusual, simply ask the person to show it to you in writing. FIRREA, USPAP, and the new Guidelines contain everything you need to perform agency-compliant appraisals and evaluations.

George R. Mann, MAI, SRA, MRICS, is managing director of Collateral Evaluation Services, LLC. He has twenty-five years of valuation experience: four years as an independent fee appraiser, two years as a real estate assessor, and nineteen years with banking institutions. Mann graduated from the University of Florida and earned his MBA from Averett University. He has published articles in the *RMA Journal* and *The Appraisal Journal*. He has appraised and reviewed all types of commercial real estate in over thirty-five states and seven foreign countries. **Contact:** gmann@ces-wm.com

Larry R. Woodall is the founder, managing director, and chief appraiser of Collateral Evaluation Services (CES); CES is a virtual appraisal department servicing community and regional banks internationally. Woodall has twenty-six years experience as a commercial real estate appraiser and consultant, including five years as an independent fee appraiser and twenty-one years as a commercial review appraiser for various financial institutions. He has spent the past three years developing CES. Woodall has appraised and reviewed appraisals on all commercial property types within thirty-three states and three foreign countries. A graduate of the University of West Alabama in 1979, Woodall has also published in the *RMA Journal*. **Contact:** lwoodall@ces-wm.com