WHITE PAPER

Interagency Appraisal & Evaluation Guidelines

Insights into understanding and integrating the new guidance

by William E. King
Director, Valuation Initiatives
Veros Real Estate Solutions

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1. Executive Summary

The five federal banking regulatory agencies – Office of the Comptroller of the Currency (OCC), Federal Reserve Bank (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and National Credit Union Administration (NCUA) – jointly released updates in December 2010 to the Interagency Appraisal and Evaluation Guidelines (Guidelines), originally issued in 1994. Although the new Guidelines expand upon the 1994 Guidelines, the basic concepts remain unchanged and include:

- Independence of the appraiser;
- Complete and accurate reporting of property and market conditions; and
- Selection of competent individuals to perform valuation services.

The updated discussions concerning automated valuation model (AVM) usage and appraisal management companies (AMCs) result from the evolution of technology and the growth of third-party vendor managers. However, the discussions simply serve to reaffirm the original Guidelines' principle of establishing programs and practices to protect the safety and soundness of government institutions, and preserve public trust.

This paper will highlight areas of specific importance which have been clarified by or expanded upon in the updated Guidelines, and will also serve to frame additional reasoning and discussion behind statements within the Guidelines which have sparked much in the way of industry debate.

2. Transactions That Require Appraisals

Federally related transactions and real estate-related financial transactions, as defined in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), have not changed, nor has the threshold below which an appraisal is not required (currently $250,000) along with other listed exemptions.[1] In addition, the type of transaction that may be documented with an AVM or evaluation, as opposed to an appraisal, did not change. The updated Guidelines continue to recognize AVMs and evaluations as valid tools. In fact, there are several circumstances, such as portfolio analysis, abundance of caution liens, real estate secured business loans, and loan workouts, where an AVM is the preferred way of documenting collateral value.

[1] 12 USC § 3341(b) (Title XI of FIRREA § 1112 (b)); Dodd-Frank has added an additional uncertainty to the threshold in that it further required concurrence from the Bureau of Consumer Financial Protection which has yet to be formed.

2.1. Minimum Appraisal Standards

The five basic appraisal requirements from the 1994 guidelines are unaffected with the exception of expanded commentary.

The appraisal still must:

- *Conform to generally accepted appraisal standards as evidenced by the USPAP promulgated by the Appraisal Standards Board of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards.*

  The new commentary includes specific definitions for market value, appraiser independence, AVMs and Broker Price Opinions (BPOs). It emphasizes that AVMs and BPOs are not appraisals and therefore may not be used as the primary basis to determine value for loan origination.[2]

- *Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction.*

  The new commentary refers to the Uniform Standards of Professional Appraisal Practice (USPAP) Scope of Work Rule and includes the statement "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."

- *Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.*

  The 2010 commentary significantly expands the discussion of factors to be addressed in developing an "as is" value. Detailed discussion on analyzing deductions and discounts for residential tract developments was moved to Appendix C.

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

  The new commentary stresses that for federally related transactions, a property's value must be "market value." In addition, it reminds readers that market value must consider the property's ***actual physical condition***.

[2] Most real estate-related financial transactions, over $250,000 are considered federally related transactions and thus, require appraisals unless they meet other stated exemptions set forth in FIRREA. See, 12 USC § 3341(b) (Title XI of FIRREA § 1112 (b)).

- *Be performed by state certified or licensed appraisers in accordance with requirements set forth in the appraisal regulation.*

  The new commentary is intended to remind the reader that the simple possession of a certification or license is not evidence of competence, but merely a minimum requirement.

In addition to the above commentary, the expanded Guidelines include an Appendix A which elaborates on appraisal exemptions providing specific circumstances in which appraisals may not be required. For instance appraisals are often not required in real estate-secured business loans, or renewals, refinancing and other subsequent transactions. However, evaluations may be required for the above transactions.

2.2. Evaluations

The evaluations section of the Guidelines expanded considerably in the 2010 version. The concept of an evaluation as opposed to an appraisal was first emphasized in the 1994 Guidelines. Prior to that, almost all real estate-related transactions were supported with "complete" appraisals (a concept that no longer exists within USPAP). The initial threshold below which an appraisal was not required was set at $15,000. Very few transactions qualified for this threshold making an evaluation program unnecessary. By the time the Guidelines were issued in 1994, the threshold had risen to $250,000. Suddenly, creating an evaluation policy became essential.

An evaluation is an acceptable valuation method in lieu of an appraisal for transactions that qualify for certain exemptions, including transactions that:

1) Have a value equal to or less than the appraisal threshold of $250,000;
2) Are certain types of business loans equal to or less than $1 million;
3) Involve an existing line of credit where there is no advancement of new monies (other than closing costs);
4) Where there has been no obvious and material change in market conditions or physical aspects of the property that threaten the institution's collateral protection, even with the advancement of new monies; or
5) The transaction either qualifies for sale to a U.S. government agency or U.S. government sponsored agency or involved a transaction in which the appraisal conforms to Fannie Mae or Freddie Mac standards applicable to that category of real estate.[3]

[3] 12 USC § 3341(b) (Title XI of FIRREA § 1112 (b)).

While a great deal of attention is given to evaluation content in the updated Guidelines, the most notable points of emphasis surround the actual physical condition of the property and the extent to which an inspection of the property should be performed. Just as with an appraisal, an evaluation must address:

- Market value[4];
- Actual (current) physical condition of the real property;
- Current use of the real property; and
- Current zoning of the property.

2.2.1. Subject Property Condition

Under the new Guidelines, when using any valuation technique that does not include a ***concurrent*** physical inspection of the property with the valuation, an institution should establish criteria for determining the "level and extent of research or inspection necessary to ascertain the property's actual physical condition". They go on to state that "an institution should consider performing an inspection… [but] …when an inspection is not performed, the institution should be able to demonstrate how the property (and market) factors were determined". The key is that when used as an evaluation, an AVM cannot assume average property condition… the critical word being "assume".

Further complicating the interpretation of the updated Guidelines is the repeated use of the term "should". A quick review may lead some to understand that physical inspections are always required. It may lead others to believe that physical inspections are never required and are only suggested. *Neither is true.* The term "should" is used as opposed to "must" or "may" because the agencies are dictating a standard of practice. As with any standard, there will be reasonable exceptions.

There are many circumstances in which a regulated institution would be unable to ascertain property condition according to mainstream regulations. Crafting language within the Guidelines to account for all fringe cases would require extensive discussion to cover the myriad of possibilities within all real estate transactions. Thus, the agencies adopted the term "should".

Simply stated, the standard of practice is that when an AVM is used as an evaluation, documenting the condition of the property is a "must" in the absence of any otherwise compelling factor that would exempt the regulated institution from this requirement.

[4] As defined in 12 C.F.R. § 323.2(g)

2.2.2. Research Versus Inspection

According to the Guidelines[5], regulated institutions should establish policies and procedures addressing the extent to which an inspection or "research" is necessary to ascertain the property's actual physical condition. In addition, institution's policies should provide a sound process for using various methods or tools in their research.

In other words, there are cases where some form of research into the property's current condition is appropriate in lieu of an inspection. For example, in many junior lien decisions supported by an AVM value, a recent home inspection or appraisal may be available. Whenever a lender determines that an AVM is the appropriate valuation tool and has the benefit of a recent appraisal, home inspection report or current MLS data for the property, an additional condition inspection should only be performed if the lender has reason to believe that either the condition has changed (e.g. recent foreclosure or natural disaster) or that the existing report is unreliable (e.g. an appraisal that has failed review).

2.2.3. Inspection Options

It is important for regulated institutions to carefully consider the benefits of each solution with the specific need to accurately assess the property's condition in a given transaction. In many instances, the appropriate decision may be a full appraisal. However, it will often not be cost effective and therefore imprudent to order a full appraisal or BPO report where none is required. An AVM, even when combined with other condition reporting options, such as: VeroINSIGHT (property inspection report), ASHI Home Inspection, Fannie Mae 2075, BPO, or Exterior-Only Appraisal Reports, will almost always be less costly. In many circumstances appraisal reports or BPOs as property condition reporting tools is excessive and requires paying for additional information about the market, neighborhood and comparable sales that is simply not necessary for satisfying the requirements of the Guidelines.

2.2.4. AVMs as Stand-alone Tools

The Guidelines also recognize that AVMs are acceptable and useful tools to value collateral under circumstances where documenting current property condition is neither required nor practical. For example the use of an AVM is an acceptable valuation technique for most loan modifications and for monitoring portfolios where there has been no deterioration in credit or change in market conditions. Additionally, AVMs may be used to monitor valuation trends on portfolio risk and as a tool for appraisal or evaluation reviews (which the Guidelines also establish as a standard of practice).

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[5] Interagency Appraisal & Evaluation Guidelines, Appendix B – Evaluations Based on Analytical Methods or Technological Tools

It is important to note that in each of the above instances, when an institution's policies and procedures identify that an appraisal or evaluation is not required, there is no concurrent need to consider the property's current condition to use the AVM as a valuation tool.

For example, lenders using Freddie Mac's Loan Prospector are provided a single point AVM value through HVE for use in the appraisal review process. Lenders using other origination platforms also often use AVMs in the review process as an internal quality control measure. The continued use of these automated tools in reviewing appraisals and evaluations is also reaffirmed in the Guidelines and has also been recommended by secondary market participants such as Freddie Mac[6] as loans backed by additional AVM due diligence consistently outperform loans without the secondary valuation when all other factors are held equal.

3. Appraisal and Evaluation Independence

The appraisal profession was founded on the need for objective, independent and unbiased valuations which stemmed from the Great Depression when lenders first began to develop their own property valuation decisions. The absence of undue subjective influences of the parties involved in the appraisal transaction is the foundation of appraisal as a profession worldwide. Over the years, particularly in the United States, there has been a gradual erosion of this independence. Parties with a stake in the outcome of a transaction gained more access, and ultimately, more ability to influence the appraiser. Appraisals and BPOs often provide more detail than an AVM, but they are never as fully independent. It is not uncommon for any perceived benefit gained from the additional detail found in an appraisal to be offset with bias on the part of the provider or those who may have influence over the provider.

The new Guidelines offer detail on what regulated institutions should do to achieve and maintain independence for their collateral valuation programs. The Agencies' appraisal regulations[7] are more rigorous than the appraiser independence requirements from the Uniform Standards of Professional Appraisal Practice (USPAP).

Any interpretation of the Guidelines that suggests AVMs cannot be used is simply incorrect. If anything, the guidelines seem to validate the use of AVMs for a variety of transactions. AVMs have the unique advantage of being completely isolated from all parties involved in the transaction. An AVM will produce the exact same result regardless of who enters the required input data. The key to the new Guidelines is that AVMs *used as*

[6] Freddie Mac Bulletin Number 2009-18. July 10, 2009

[7] OCC: 12 CFR part 34, Subpart C; FRB 12 CFR part 208, subpart E and 12 CFR part 225; subpart G; FDIC: 12 CFR part 323; OTS: 12 CFR part 564; and NCUA: 12 CFR part 722

an evaluation cannot assume average property condition. As noted above, the crucial here word is "assume". Thus, if research or a concurrent inspection shows that the property is in average or better condition, the AVM value has no longer been made on an assumption of average condition. Further, if research or a concurrent inspection showed that the property was in less than average condition, many AVM providers, such as Veros, provide value ranges or distressed valuations that can account for the condition of the property when the condition has been independently verified.

Regardless of the valuation approach, the Guidelines make it very clear that the financial institution (i.e. the lender) is responsible for any third-party arrangements. "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. Therefore, an institution should have the resources and expertise necessary for performing ongoing oversight of third party arrangements."[8] Thus, whether an institution is selecting an AMC for appraisal services, an appraisal review firm, a BPO aggregator, an AVM company (or any other third-party or consultant that is related to the management, review or validation of the above), the lender is ultimately responsible to ensure proper independence and control are in place to meet the expectations set forth in the Guidelines.

4. Summary

In conclusion, it is important to remember that the Guidelines are focused on maintaining appropriate standards of safety, due diligence and proper consideration in real estate transactions.

The Guidelines reemphasize the critical importance of fully understanding the collateralized property and directs lenders to a variety of tools available for developing that understanding. Over-purchasing services may initially seem like a good way to protect against either loss or risk of being out of compliance, but using the right tools effectively benefits and protects institutions and the public alike.

For institutions and valuation service providers, these guidelines may raise questions and concerns, and lead to more rigid policies than needed. A thorough review shows that independence of the appraisal and evaluation function can be achieved while realizing greater efficiencies through responsible deployment of emerging tools and technologies.

[8] See pages 18-20 of the Guidelines.

As technology continues to change the mortgage industry's landscape, it is increasingly important that its participants fully understand the proper balance and application of valuation types and processes.

Just as the appraisal profession has its inherent strengths and weaknesses, the same is true for AVMs, BPOs and other qualifying methods of real estate evaluation. It is only through continued education and watchfulness that the mortgage industry can properly steer the course, using all available methodologies to their maximum potential for the benefit of lenders, servicers, investors and ultimately the homebuyer.

For additional information, please contact:
Emily Carpenter-Pulskamp
Veros Public Relations Manager
epulskamp@veros.com
714.415.6381