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FEDERAL DEPOSIT INSURANCE CORPORATION

# Appraisals and Evaluations

## I. Overview and Background Information

# Overview of Presentations

I. Overview and Background Information
II. When is an Appraisal or Evaluation Needed?
III. Regulatory Expectations for Evaluations and Validating Appraisals and Evaluations
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# Background

- Part 323 of the FDIC Rules and Regulations - Appraisals

- Interagency Appraisal and Evaluation Guidelines (Interagency Guidelines) in Financial Institution Letter 82-2010 (FIL-82-2010), issued December 2, 2010

# Real Estate-Related Financial Transaction

- Defined as any transaction involving:
  - **The sale, lease, purchase, investment in or exchange of real property, including interests in real property, or the financing thereof; or**
  - **The refinancing of real property or interests in real property (includes renewals); or**
  - **The use of real property or interests in real property as security for a loan or investment.**

# Appraisal and Evaluation Program

- Section IV of the Interagency Guidelines states:

  **“An institution’s Board of Directors or its designated committee is responsible for adopting and reviewing policies and procedures that establish an effective real estate appraisal and evaluation program.”**

# Effective Valuation Policy Components

- Provide independence in the valuation process;
- Evaluate and monitor the ongoing performance of appraisers and individuals who perform evaluations;
- Establish criteria for the content and appropriate use of evaluations;
- Establish a review program;

# Effective Valuation Policy Components

- Develop validation criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction;

- Establish criteria for monitoring collateral values; and

- Implement internal controls that promote compliance with the Interagency Guidance and bank policies.

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## II. When is an Appraisal or Evaluation Needed?

# Appraisal Requirement Exemptions

- Four common exemptions to the appraisal requirements:
  - **Transaction value $250,000 or less (Beginning January 18, 2014, certain higher-priced mortgage loans require an appraisal.  See Financial Institution Letter 11-2013, issued March 18, 2013.);**
  - **Lien on real estate taken as collateral in an abundance of caution;**
  - **Business loan with a transaction value of $1 million or less and not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or**
  - **Subsequent transaction of an existing credit at the institution if certain conditions are met.**

# Subsequent Transaction

**A subsequent transaction includes the following:**

- **Renewal of an existing loan at maturity;**
- **Refinancing of an existing loan prior to maturity;**
- **Modification that involves more than a limited change in terms; and**
- **Acquisition of other real estate.**

# Appraisal Requirement Exemptions

- The subsequent transaction exemption applies if:

  - **there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the real estate protection, even with the advancement of new monies; <u>or</u>**

  - **there is no advancement of new monies, other than funds to cover reasonable closing costs.**

# Policy Guidelines

§ Bank's policy guidelines for determining whether adequacy of the collateral protection is threatened should consider:

- **the strength of the borrower and guarantors,**
- **the loan's performance and internal classification,**
- **the loan-to-value ratio prior to and after the proposed transaction,**
- **the types of real estate collateral accepted by the bank,**
- **the marketability of the real estate collateral,**
- **a comparison of sales prices of similar real estate in the market, and**
- **any other factors determined by the bank to be relevant.**

# When is an Evaluation Required?

- These real estate-related financial transactions do not require an appraisal, but do require an evaluation:
  - **Transaction value is $250,000 or less (Beginning January 18, 2014, certain higher-priced mortgage loans require an appraisal regardless of transaction value. See Financial Institution Letter 11-2013 for details.),**
  - **Business loan of $1 million or less and not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment, or**
  - **Subsequent transaction (if at least one of these two conditions is met)**
    - No obvious or material change in market conditions or the property that threatens real estate collateral protection (even with new monies), or
    - No advancement of new monies, except reasonable closing costs.

# Example #1 – Appraisal or Evaluation?

- $2 million commercial real estate loan, five-year term;
- $3 million appraised value at origination;
- Obvious and material deterioration in local real estate market conditions at time of renewal; and
- $500,000 additional funds advanced at renewal.

**An appraisal is required due to market deterioration threatening collateral protection and because additional funds are advanced.**

# Example #2 – Appraisal or Evaluation?

- $2 million commercial real estate loan, five-year term;
- $3 million appraised value at origination;
- Obvious and material deterioration in local real estate market conditions at time of renewal; and
- No additional funds other than reasonable closing costs were advanced at renewal.

**An evaluation is required. An appraisal is not required as only reasonable closing costs were advanced.**

# Example #3 – Appraisal or Evaluation?

- $2 million commercial real estate loan, five-year term;
- $3 million appraised value at origination;
- No obvious or material change in local real estate market conditions since origination date; and
- $500,000 additional funds advanced at renewal above and beyond reasonable closing costs.

**An evaluation is required. An appraisal is not required as no obvious or material change in local real estate market.**

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# Appraisals and Evaluations

## III. Regulatory Expectations for Evaluations and Validating Appraisals and Evaluations

# What is an Evaluation?

- An evaluation is a credible estimate of the collateral's market value which supports the decision to engage in a transaction.

- An evaluation must be prepared by a competent individual; however, the preparer does not have to be a State-certified or State-licensed appraiser.

# Evaluation Expectations

- An evaluation must be consistent with safe and sound banking practices – this means that it must provide a credible estimate of market value.
- An evaluation should address the property's actual physical condition and characteristics, as well as the economic conditions that affect market value.
- Must meet documentation standards in the Interagency Appraisal and Evaluation Guidelines (FIL-82-2010).

# Minimum Evaluation Documentation

- Location of the property;
- Description of its current and projected use;
- Market value based on actual physical condition;
- Use and zoning as of evaluation date, and any potentially limiting conditions; and
- Listing of all sources of information used in the analysis.

# Who Can Perform an Evaluation?

- Anyone who is competent – must have real estate-related training or experience and knowledge of the market, including but not limited to:
  - **Bank employees,**
  - **Real estate lending professionals, and**
  - **Agricultural extension agents.**
- Must be independent of the transaction.

# Validating Existing Appraisals or Evaluations

- Key concept as an appraisal or evaluation may be used for subsequent transactions as long as it remains valid.
- Bank policy should include criteria to determine whether or not an appraisal or evaluation remains valid.
- Documentation in the credit file should provide facts and analysis to support the use an existing appraisal or evaluation in a subsequent transaction.

# Factors that Determine if a Valuation Conclusion Remains Valid

- Passage of time;
- Changes in, or volatility of, the local market;
- Improvements to, or deferred maintenance of, the subject property or competing properties;
- Changes in economic and market assumptions;
- Changes in zoning, building materials, or technology; and
- Potential environmental contamination.

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## IV. Applying Part 323 / Other Topics

# Residential Tract Developments

- Defined as five or more units constructed or to be constructed as a single development.

- The amount of time estimated to develop and sell a residential tract development project determines the type of market value to be used – either bulk sale market value or the sum of the retail sales market value

# Residential Tract Developments

- Projects that are not likely to be constructed and sold within one year must be valued using the bulk sale market value.
- The bulk sale market value incorporates appropriate deductions and discounts for holding and marketing costs for developers' profit.
- Projects that are likely to be constructed and sold within one year can be valued at the sum of retail sales values. Refer to Financial Institution Letter 90-2005 for more information.

# 80-Lot Tract Development Example

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Lot Sales ($80,000 per Lot) | $800,000 | $800,000 | $1,600,000 | $1,600,000 | $1,600,000 |
| Less: Selling Costs 10% per Lot | -80,000 | -80,000 | -160,000 | -160,000 | -160,000 |
| Less: Developer Profit 15% per Lot | -120,000 | -120,000 | -240,000 | -240,000 | -240,000 |
| Less: Development Cost | -2,500,000 | | | | |
| Net Proceeds | -$1,900,000 | $600,000 | $1,200,000 | $1,200,000 | $1,200,000 |
| Present Value @ 13% | -$1,681,416 | $469,888 | $831,660 | $735,983 | $651,312 |

Total Net Present Value $1,007,427

# Rental of Single-Family Residences

§ The appraisal must consider it as rental property. This can be satisfied by using:

- **Income approach;**
- **Sales comparison approach - use of comparable rental property sales, if available; or**
- **Cost approach.**

# Modifications

- As previously noted no appraisal/evaluation is required for a modification involving a limited change in note terms/loan agreement if there is no adverse effect on the bank's real estate collateral protection.
- Policies should provide guidance on when real estate collateral protection is adversely affected that considers:
  - **Changes in the interest rate, payment schedule, maturity date, collateral, obligors, and guarantors,**
  - **A modification is part of a workout program,**
  - **The loan is adversely classified internally, and**
  - **Market trends.**

# Added Collateral for Problem Loans

- If adding real estate to strengthen a problem loan, and the addition of the collateral is not part of a subsequent transaction, an appraisal or evaluation is not required.

- However, if the loan is impaired, a current market value of the added real estate collateral will be needed to calculate the amount of impairment.

# Business Enterprise Value

- Pertains to income-producing properties, such as hotels or motels, mini-warehouses, convenience stores, retail strip centers, office buildings, etc.

- Business Enterprise Value should be valued separately from the value of the real property and improvements thereto.

# Business Enterprise Value

Going-concern value of $1,370,000 is allocated as follows:

| | |
|---|---|
| $360,000 | Land |
| $750,000 | Building and Site Improvements |
| $140,000 | Furniture, Fixtures, and Equipment |
| $120,000 | Business Enterprise Value |
| $1,370,000 | Total Going-Concern Value |

Total room revenue:  $430,954 X 5% (mgmt fee) = $21,548

$21,548 capitalized at 18% = $119,711, rounded to $120,000

# Engagement Letters

§ Engagement letters should specify what values the appraisal should provide, for example:

- **Real property and improvements,**
- **Personal property, and**
- **Intangible assets, such as business enterprise value (going concern).**

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# Appraisals and Evaluations

## V. Appraisal and Evaluation Review

# Appraisal and Evaluation Review

- Section 1473(e) of the Dodd-Frank Act amended Section 1110 of FIRREA. It requires the federal financial institution regulatory agencies to establish a rule to require the appropriate review of all appraisals required in connection with federally related financial transactions for compliance with the Uniform Standards of Professional Appraisal Practice (USPAP).

- Until the agencies issue a final rule, institutions should refer to Section XV of Interagency Appraisal and Evaluation Guidelines (FIL-82-2010) for expectations regarding the review of appraisals and evaluations.

# Appraisal Review Definition

- Uniform Standards of Professional Appraisal Practice (USPAP) definition of appraisal review:

**“The act or process of developing and communicating an opinion about the quality of another appraiser’s work that was performed as part of an appraisal, appraisal review, or appraisal consulting assignment.”**

# Policy for Appraisal and Evaluation Review

- Reviewer qualifications -
  - **Factors include education, expertise, knowledge of market and independence.**
- Depth of review -
  - **Use a risk-focused approach.**
  - **Higher-risk loans require a more detailed review.**
- Resolution of deficiencies -
  - **Inaccuracies or weaknesses must be resolved.**
- Documentation of appraisal and evaluation reviews -
  - **Review must be documented in the credit file.**

# Appraisal and Evaluation Review Policy

**The review policy, 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 review;**
- **Establish a process for resolving any deficiencies in appraisals or evaluation; and**
- **Define documentation standards for the review and resolution of any noted deficiencies.**

# Resources on Appraisal and Evaluation Review

- Section XV of Interagency Guidance
- FDIC Supervisory Insights, Winter 2011 — “Navigating the Real Estate Valuation Process”

# Appraisals and Evaluations

## VI. Additional Resources

# References

- FDIC Rules and Regulations:  Part 323 — Appraisals
- FIL 82-2010, entitled “Interagency Guidance:  Appraisal and Evaluation Guidelines”
- FIL 90-2005, entitled “Residential Tract Development Lending:  Frequently Asked Questions”
- FDIC Supervisory Insights, Winter 2011 — “Navigating the Real Estate Valuation Process”

# Questions

If you have any questions regarding Appraisals, contact your Case Manager, Field Supervisor, Supervisory Examiner, or Examiner