

Comments on the Proposed Interagency Appraisal and Evaluation Guidelines

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December 5, 2008

Sirs,

As you well know, the 2008 USPAP scope of work rule implicitly places the burden of deciding appraisal requirements on the user of the appraisal (in this case via the governing agencies).¹ The current 2008 USPAP has deleted statement 10, (the appraisal guidelines for "Federally Insured Depository Institutions").² Because these guidelines have been deleted from USPAP, the guidelines proposed here will (de facto) become the primary "standard" that appraisers will look to for guidance on federally insured appraisals. It should be clear to the regulating agencies that they can no longer look to USPAP to set minimum appraisal standards for federally insured, federally related transactions.

Please consider pressing issues in the proposed guidelines (# 1, 2 and 3). Also, I applaud the guideline stance on going concern valuations (# 4). Other comments follow in the order found in the document (# 5).

To describe my background, I am a Senior commercial review appraiser for Bank of the West, a former Appraiser Investigator at the California Office of Real Estate Appraisers, a former reviewer for First Union Bank, and a former fee appraiser (20+ years in total). For clarification, these are my personal comments, and not that of my employer.

#1) (From the proposed guidelines)

P22: *"An institution's use of a borrower-ordered appraisal violates the Agencies' appraisal regulations."*

And:

P35: *"Appraisals that support federally related transactions must meet the standards of independence within the Agencies' appraisal regulations. Among other considerations, when accepting an appraisal from another institution, the acquiring institution should obtain documentation that the appraiser was engaged directly by the institution"*

transferring the appraisal and had no direct, indirect, or prospective interest, financial or otherwise, in the property or transaction. If an institution relies on a third party originator or its agent for the appraisal, the standard of independence still applies. For example, an engagement letter should confirm that the institution transferring the appraisal, not the borrower, was the original client that selected the appraiser and ordered the appraisal.”

“An institution must not accept an appraisal that has been readdressed or altered by the appraiser with the intent to conceal the original client. Altering an appraisal report in a manner that conceals the original client or intended users of the appraisal is misleading and violates the Agencies’ appraisal regulations and USPAP.”

I believe that the verbiage should be changed from “borrower-ordered” to “Borrower, Seller, or Purchase/Sale Agent”. If the appraiser is previously engaged to any of these parties, there is a potential for a later conflict of interest with the lender (see p18 of the proposed guidelines). I believe it is better for the guidelines to state that the appraisal must not have been prepared by an appraiser who appraised the property for the borrower, seller or purchase/sale agent in the previous 24 months.

The current USPAP readdressing rules were intended to address this problem, but are marginally effective. It is not uncommon to see (prepared for other lenders) a “new” appraisal with a new engagement letter, in a report with a changed report date and the original effective date. Otherwise it is often just a “legally” readdressed report. This complies with the wording of USPAP, but not the spirit.

I do not believe a “standards based” rule will resolve this problem. In this scenario, the short of the matter is the appraiser already has a prior relationship with an interested entity, and has prepared a prior report for an interested entity (perhaps for a different purpose). A subsequent report for the lender may be seen by this same interested entity, and any contradiction between the two reports would be pointed out to the appraiser. To avoid this dilemma, the appraiser may send to the lender, substantially a restatement of the original report (labeled a “new” report). Also, it is far too easy and lucrative for an unscrupulous appraiser to simply change the name and report date of the original appraisal. The lender may not be receiving a truly independent opinion of value if a “new” report is engaged from the same appraiser.

Cost or speed of the appraisal should not be factors in the scope of work (see p29 of the proposed guidelines) and it follows that they should also not be factors in the appraiser’s independence. There may other ways to ensure an independent value, but engaging a different appraiser seems to be a very straightforward solution.

#2) (From the proposed guidelines)

P24: Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units.

And:

P25: This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. An appraisal must include the market value of the property and should reflect the property's condition in its actual physical condition, use, and zoning designation, as of the effective date of the appraisal.

And:

P28: "The estimate of market value should consider the real property's current physical condition, use, and zoning as of the appraisal date. For a transaction financing construction or renovation of a building, an institution would generally request an appraiser to provide the property's market value in its "as is" condition as of the appraisal's effective date and the property's "prospective" market values at the time development is expected to be completed and at the time stabilized occupancy is projected to be achieved. Prospective market value opinions should be based upon current and reasonably expected market conditions. When an appraisal includes prospective value opinions, there should be a point of reference to the market conditions and time frame on which the appraiser based the analysis."

There is no discussion of hypothetical "As If Complete" and "As If Stabilized" market value scenarios (with a current date of value). There is also no definition of these terms in the appendix. The omission of these terms implies that a prospective valuation is the required methodology for the described situations.

There are many instances where a hypothetical "As If Complete" and "As If Stabilized" market value scenario (with a current date of value) is a better risk management tool than a prospective valuation. It is straightforward that a comparison of the "As Is" market value to a hypothetical "As If Complete" and "As If Stabilized" market value scenarios is facilitated by all being at the same date of value. Accuracy is often higher in a hypothetical "As If Complete" and "As If Stabilized" market value scenario, as no forecasting of a future market is involved. If hypothetical conditions are left out, I believe we will find ourselves facing a different problem of inadequate determination of market risk (trending). I also believe this will create less of a "fact based" appraisal and more of an "opinion based" appraisal.

I believe the hypothetical condition terms should be retained in the guidelines, and defined in the appendix. Or perhaps a comment could be made that these valuation scenarios are permissible in lieu of a prospective value.

Also, for clarification, I believe that parenthetical verbiage “(the “As Is” market value)” should be added to the end of the above statement on page 25.

#3) (Not mentioned in the proposed guidelines)

Exposure and marketing time are defined in the proposed guidelines, but are not required. The omission implies that they are not a requirement. This omission would leave an incomplete understanding of the stated market value. I believe (at the very least), that exposure time must be required.

#4) (From the proposed guidelines)

P28: *“Further, the market value should not include a going concern value or a special value to a specific property user. An appraisal may contain separate opinions of value for such items so long as they are clearly identified and disclosed.”*

I strongly concur with this statement. There are many asset classes that are commonly transacted on a going concern basis. The going concern price is not necessarily equivalent to the real estate component of that same property. In those cases, it is erroneous for an appraisal to state the real estate market value as equivalent to the going concern market value. This has been an ongoing problem with going concern properties.

#5) Other comments.

P20: *“While the information provided to the appraiser by the institution should not unduly influence the appraiser, the institution may provide a copy of the sales contract for purchase transactions”*

Per USPAP, the appraiser must analyze the purchase agreement and terms, if available in the normal course of business (SR 1-5(a)). I believe that the verbiage here should be changed from “may” to “must, whenever possible.”

P24: *“However, an institution should ensure that the scope of work is appropriate for the assignment. The appraiser’s scope of work should be consistent with the valuation methodology employed for similar property types, market conditions, and transactions.”*

I believe that the verbiage should be changed from “should” to “must”. The proposed guidelines previously “require” that the appraisal contain sufficient information to support the institution’s decision to engage in the transaction (p12).

There is an inherent problem with “should.” An appraiser may perform the minimum amount of work the appraiser feels is necessary to support a lending decision (see p29).

In contrast, the engager may be in a situation where he is “required” to have other analysis performed to make the lending decision. It does not seem logical that the lender “must” while the appraiser “should.”

P26: “Raw Land. The appraiser must provide an opinion of value for raw land based on its current condition and existing zoning that includes appropriate deductions and discounts. Appropriate deductions and discounts should include items such as holding costs, marketing costs, and entrepreneurial profit.”

I believe that the definition of “Raw Land” needs to be clarified, perhaps in the appendix.

I believe that parenthetical verbiage “(the “As Is” market value)” should be added to the end of this statement.

P30: An appraisal also should reflect an analysis of the property’s sales history and an opinion as to the highest and best use of the property.

I believe that the verbiage should be changed from “should” to “must”. Highest and best use fallen out of the USPAP requirements though the scope of work changes. (The sales history remains a USPAP requirement). The proposed guidelines “require” that the appraisal contain sufficient information to support the institution’s decision to engage in the transaction (p12). Highest and best use is certainly critical information.

P52: I believe that the statistical workings of “black box” AVM’s must be made available to the client bank. It is prudent to understand how the “black box” works in order to assess risk. Vendor refusals to disclose due to “proprietary information” concerns should not be acceptable. Confidentiality agreements can be entered to maintain the proprietary nature of the AVM vendor’s intellectual property.

If a statistically competent risk manager cannot understand the workings of the “black box,” perhaps it should not be used. A sharp analogy can be made to the current swap debacle. AVM “secrecy” has been ongoing for many years now, so perhaps it is more of a precedent for the current swap debacle.

I thank you for reviewing and posting these comments.

A handwritten signature in black ink, appearing to read 'Chris Kim', with a stylized, cursive script.

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- 1) USPAP 2008-2009, Scope of Work Rule
- 2) USPAP 2006-2007, Statement 10.