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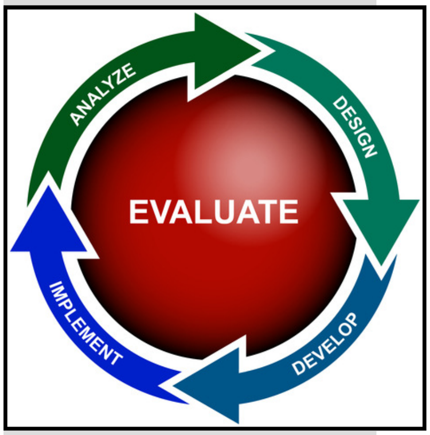
An Appraisal Policy Blueprint

Does Your Bank's Appraisal Policy Need a Tune Up?

November 28, 2012 by William L. Pittenger, MAI, SRA

Many bank appraisal policies in use today were crafted a decade or more ago. Some were created under regulatory pressure to do so following the thrift crisis and real estate meltdown of the late 1980s and early 1990s. Others were cobbled together quickly with little in depth understanding of what should be included and why. Others merely set forth procedure or intermingled policy and procedure and were not true policy at all. Still others were mere recitation of federal appraisal regulation or the Interagency Appraisal and Evaluation Guidelines set forth by the federal banking agencies.



A lot has happened over the last decade. We've seen real estate achieve both record highs and record lows in sales activity and price. We've seen a variety of new mortgage instruments created; most of which were previously untested in times of economic stress. We've seen remarkable innovation in technology. The down side to innovation was it advanced faster than risk management or regulation. We even saw legions of persons enter the residential appraisal business during the housing boom years and leave again after the crash. Many were *qualified* only by virtue of minimal state licensing or certification standards without the requisite training and experience to work in an environment of unprecedented volatility where experience truly matters.

Today, we've come full circle. It's been boom followed by bust, followed by new or amended law, regulation, policy and guidelines; much of it designed to cure the crisis just passed. We now have The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), which created new regulation and both eliminated and added regulatory agencies. It amended the old, such as FIRREA (Financial Institutions Reform Recovery and Enforcement Act of 1989 and Truth In Lending Act. We also have the SAFE Act (Secure and Fair Enforcement for Mortgage Licensing Act of 2008) and Interagency Appraisal and Evaluation Guidelines (amended December 2010).

If your bank's appraisal policy has not been revisited lately, it may be time for a tune up. The following is a high level look at some things to think about as you review your existing appraisal policy, make amendments or even craft a new policy.

Policies in general. By definition, a policy is a *guiding principle* intended to articulate a course of action which will influence decisions. It should be a guide to decision making that incorporates board and executive management tolerance for risk as well as management direction. It should describe the target user and clearly articulate what is expected. Alternatively, *procedures* are separate and ideally set forth a series of steps necessary to accomplish something. Ideally a policy does not get "in the weeds" by mingling procedure however we acknowledge that many, if not most, bank policies do and it is not just limited to appraisal policies.

Reviewing the old. Here are four fundamental questions to ask as you evaluate your current appraisal policy.

First. Does your bank's appraisal policy match its lending policy? While this question hardly seems worthy of serious consideration, most appraisal policies do not. They read like they were written in isolation without regard to the bank's vision, mission, risk tolerance and what types of lending it intends to engage in. Nevertheless, in most real estate lending transactions, an appraisal is the bank's primary source of information about prospective loan security and its competitive market place. It therefore follows that an appraisal policy should specifically address each real estate line of

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business the bank engages in as well as each type of real estate product it intends to accept as loan security. For example, if your bank does not engage in acquisition and development lending, it is not necessary to describe it in your appraisal policy.

Second. Does your bank's appraisal policy require that the type and amount of appraisal information be consistent with anticipated credit risk? Banks often treat appraisals as a "*one size fits all*" product. That usually results in too little information and analysis for complex property types or too much information for noncomplex property types or low risk credit. Be sure to tailor your bank's appraisal requirements to the anticipated credit risk. Doing so will also pay off in the fees you pay for appraisal services as you're more likely to pay for only the appraisal information you need.

Third. Does your bank's appraisal policy clearly assign responsibility (by position) for its implementation, maintenance, enforcement and oversight? Policies are dynamic. They must be monitored and, when necessary, be amended in response to shifts in market activity, consumer preferences, competitive influences and regulatory changes. Without clear accountability for policy implementation and maintenance, as well as executive management or board oversight, any policy is destined to become stale and potentially unworkable.

Finally. Is your appraisal policy user friendly? That is, is it organized logically and in a manner that allows it to be clearly understood by bank staff who must use it? Poorly organized policies; those that are unclear or that require users to sift through information not relevant to their line of business quickly lead to frustration among staff which in turn usually results in noncompliance.

How To Reshape Your Bank's Appraisal Policy

Now that you've evaluated your appraisal policy and determined what needs to be tuned up, here are some suggestions for reorganizing it and presenting it in a useful, understandable and user-friendly way. Your policy should include factors common to all appraisals. From there, your policy might branch to lines of business or property types your bank specifically deals with. For example, if you do acquisition, development and construction lending, your appraisal policy should specifically address that. Conversely, if you don't engage in this type of lending, there is no reason to address it in your policy. The following are several sections you might consider incorporating into your appraisal policy.

Preamble or Introductory Statement. Begin with a short statement of the policy's purpose, its intent, how it is consistent with your bank's mission, vision, tolerance for risk, safe and sound lending, regulatory compliance and commitment to fair lending. Describe how the policy will be implemented, maintained and enforced. This section might also include a statement of executive management and board concurrence with, and commitment to the policy.

Appraiser Qualification and Approval. Describe the standards, including applicable regulatory standards, your bank will use to evaluate the qualifications of appraisers who will be retained to perform appraisals for each of the bank's lines of business.

Appraisal Policy Elements Common to All Lines of Business. This section might include both regulatory and bank requirements that cross all lines of business such as when appraisals are necessary, the fact that they must be performed by appropriately licensed or certified appraisers and qualified appraisers and that all appraisals must comply with the Uniform Standards of Professional Appraisal Practice (USPAP). This section might also include a statement of your bank's commitment to fair lending, housing and non-discrimination in its appraisal policy and operation. It should also emphasize the need for appraiser independence in each step of the appraisal process from ordering the appraisal through final review and acceptance of the appraisal report.

Appraisal Policy Elements Unique to Each Line of Business or Product Type. Obviously the qualifications of appraisers and the type and amount of property and market information necessary to make an informed loan decision will differ among lines of business. For example, appraisal information necessary to underwrite real estate in connection with a small business loan is significantly different than information necessary to underwrite an acquisition, development and construction loan. This section would therefore begin with a statement describing each line of business or property type, the expected level of collateral dependence and anticipated credit risk. It would then follow with only those requirements unique to the line of business.

Appraisal Review. Describe who (what position) will review appraisals and the standards that will be used. Reviews may be prepared internally or externally by a qualified and independent reviewer or appraisal review firm. The operative words are qualified and independent. Link the appraisal review to USPAP requirements, bank standards and the factors that drive loan repayment. Try to avoid obscure technical matters. Indeed, the factors that drive real estate loan repayment are the same physical, functional and economic property or market factors that create, sustain or mitigate value.

Appraiser Performance Review. Periodically review the performance of all appraisers. Evaluate factors such as reliability, usefulness and consistency of the appraisal product as well as the adequacy and timeliness of service and fairness of fees.

Appraisal Oversight and Monitoring. Describe the standards your bank will use for monitoring your real estate loan portfolios, testing them and identifying property and market trends that could adversely affect loan repayment. This section should also address asset and portfolio stress testing.

Train & Implement. If properly crafted, your policy should be nearly self explanatory to those who use it. Nevertheless, it is helpful to offer a brief training session as part of policy implementation.

This is not the final word on appraisal policy nor does it cover everything. It is, however a general guide to what an appraisal policy should look like and what pieces should be included.

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