Enhancing Appraisal and Evaluation Reviews

Reviewing real estate appraisals and evaluations can seem a mundane but required task in the commercial lending process. The commercial appraisal and evaluation (valuation) review process[i] within community-based financial institutions includes internally prepared reviews, third-party prepared reviews, or some combination of the two. Often, the internally prepared review is completed by less experienced financial institution staff as a part of their training process, while some institutions have a dedicated appraisal and review department. Loan officers may also perceive the review as a necessary evil rather than a risk management function. The significance of the appraisal or evaluation review should be considered as a part of the pre-funding due diligence and risk management process, however pedestrian the process may seem.

Valuation reviews are a standard and vital part of a loan file review for commercial real estate lending transactions. Recently our loan review activities identified two situations where the compliance review completed by the financial institution did not identify material flaws with the information included in the appraisal. Both circumstances originated with a flawed appraisal engagement letter which did not appropriately identify the subject property. The reviews of these valuations did not detect the mismatch between the appraised property and the property identified in the credit approval pledged to secure the transaction. The result of the deficient appraisal review led to lending decisions using market values that did not represent the collateral pledged.

These transactions are only two examples of many which underline the significance of an effective valuation review process. The valuation review process cannot be taken for granted in the commercial lending process.

We believe financial institutions may face headwinds concerning the impact of repricing commercial real estate transactions. Financial institutions may experience a greater reliance on the underlying collateral, as cash flow and collateral may be adversely impacted in a higher-rate environment. We believe a few simple steps can provide a higher level of assurance that the appraisal review process will meet the financial institution's requirements. The 2010 Interagency Appraisal and Evaluation Guidance[ii] (Guidance) includes section XV – Reviewing Appraisals and Evaluations. In addition to this Guidance, we suggest the following:

- We recommend that the review process incorporate the valuation, the credit approval document, and the title commitment for the subject transaction. The review process should validate the property description in the valuation aligns with the property pledged to secure the transaction. This process should be in place regardless of whether a technical appraisal review or a compliance review is completed.

- We also recommend a technical review[iii] for a percentage of commercial appraisals or evaluations. A technical review can be based on various factors including the transaction size, the property's complexity, or other sampling methods. The technical review criteria can follow a risk-based approach to determine whether a compliance or more comprehensive technical review should be completed. The Guidance indicates under XV. B. Depth of Review, "this process should differentiate between high and low-risk transactions so that the review is commensurate with the risk."

- Finally, we recommend an ongoing training program for team members performing appraisal and evaluation reviews. "Reviewers also should possess the requisite education, expertise, and competence to perform the review commensurate with the complexity of the transaction, type of real property, and market," as noted in the Guidance.

The valuation review process serves as a front-end risk management function, with reviews completed before the funding stage. Valuation reviews are a part of the risk management first line of defense to ensure the financial institution's possibly primary and likely secondary source of repayment has been appropriately evaluated. The Banking cycle will likely enter a phase where reliance on accurate valuations will become more meaningful concerning increasing interest rates, cap rates, and the borrower's ability to service debt in a higher rate environment. Now is the time to ensure the review process provides the necessary review insights to shield the Bank from unintended incremental risk.

More about Integrity Loan Review

We are based out of Green Bay, WI and serve clients throughout WI, MN, MI, IL and IA. We provide both on-site and remote loan review and related services for community-based financial institutions. We provide a comprehensive approach to loan review and related services through our proprietary methodology.

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[i] The Uniform Standards of Professional Appraisal Practice (USPAP) 2010-2011 edition defines an appraisal review as 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. In addition, Section 1473(e) of the Dodd-Frank Act amended Section 1110 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 to require the federal financial regulatory agencies, Federal Housing Finance Agency (FHFA), and Consumer Financial Protection Bureau (CFPB) to issue appraisal review standards.

[ii] The Interagency Appraisal and Evaluation Guidelines can be found here: Interagency (fdic.gov)

[iii] Per the Winter 2011 Supervisory Insights, Navigating the Real Estate Valuation Process, "Depth of review. The scope of a review is usually a function of the property's complexity and the institution's perceived risk threshold. Therefore, the review's depth should be sufficient to ensure that methods, assumptions, data sources, and conclusions are reasonable and appropriate. A risk-focused review approach can assist in:

- Ensuring the review provides meaningful results. A review's depth and technical nature should be commensurate with the size, type, risk, and complexity of the underlying credit transaction. Factual or checklist-type reviews may be sufficient for low-risk transactions to verify report content, policy compliance, and conformance with the USPAP. However, reviews of complex or higher-risk properties may need to be supplemented with an explanatory narrative or other data to ensure critical assumptions and conclusions are supported. Generally, complex or higher-risk transactions should receive a more comprehensive review that assesses the technical quality of the appraiser's analysis.