

AuditOne Regulatory Advisory

From Bud Genovese, Chairman

In our ongoing efforts to keep you abreast of changes and news in the regulatory environment, we periodically issue AuditOne Regulatory Advisories. Here is the latest update on Appraisal and Evaluation Guidelines from AuditOne President Jeremy Taylor. Please feel free to forward it to the appropriate people in your bank, thank you, --Bud

Interagency Guidance: Appraisal and Evaluation Guidelines

An Interagency Guidance FIL 82-2010

(<http://www.fdic.gov/news/news/financial/2010/fil10082a.pdf>) on appraisals and evaluations was just released in December, 2010. While it is largely a reaffirmation of pre-existing guidelines, it does give more attention and clarity to the evaluation side. It builds on the USPAP (Uniform Standards of Professional Appraisal Practice) and 1989 FIRREA requirements, along with various more recent issuances (FILs 74-94, 20-2001, 84-2003 and 53-2006).

Banks are required to have an Appraisal Policy (also addressing evaluations) as part of a Board-approved Collateral Valuation Program (CVP).

Appraisals continue to be required for real estate-secured transactions in excess of \$250,000 (\$1,000,000 if it's a business loan where repayment isn't dependent on sale of or income from the property). Appendix A of the Guidance provides a list of exemptions from this requirement, which includes renewals where there are no new monies advanced and no material change in either the property or market conditions. Note also that in certain cases, a) an earlier appraisal or b) an appraisal prepared for another institution, may be used; those situations need to be carefully spelled out in the CVP, including the need for particularly close internal review.

Independence pops up in three different senses. First, the ordering, reviewing and accepting of an appraisal should be handled independently within the bank, though the practical difficulties of complete separation for smaller institutions are acknowledged and addressed. Second, the appraiser must be independent of any interests in the property. Third, while it's okay for the bank to share the sales contract, it's not okay to coerce the appraiser to have the valuation come in at a particular dollar amount.

A formal engagement letter to an appraiser on the bank's approved list is required. Being approved means they have the required credentials. Who gets used for a particular project will depend also on local-market and project-type familiarity. The CVP should set out the criteria for evaluating, selecting and monitoring approved appraisers. The monitoring comes in large part out of the internal review of all appraisals (as well as all evaluations) prior to the credit decision, another key element of the CVP; see Section XV of the Guidance.

The reporting must of course conform to USPAP guidelines. A key thing there is the definition of market value based on (as-is) current condition, usage and zoning – not on “going-concern value,” “value in use” or value related to a specific user. However, these other measures can be

included as well, if separately identified. And for construction financing, prospective value upon completion and/or stabilization is a standard element, predicated on an assumed timeframe and market conditions.

Another aspect worth emphasizing is the requirement for all three value approaches (cost, income, and sales comparison) to be considered, or an explanation as to why all three aren't considered. Other things to look for in reviewing an appraisal: the property's sales history, a discussion of market conditions, a disclosure as to whether or not the property was inspected, identification of discounts applied in coming up with market value. The latter are addressed in Appendix C of the Guidance and include things like lease commissions, non-market lease terms, and holding and marketing costs.

Many of the above comments apply also to evaluations, not just to appraisals. While an evaluation is a less formal/structured document, the Guidance (Section XII) is concerned to ensure that it includes all the main components: as-is market value estimate; location, description and all other information used; valuation method(s); whether inspected; and name of preparer. The Guidance discusses (Section XII and Appendix B) other ways to obtain pricing information – including Automated Valuation Models (AVM), Tax Assessment Valuations (TAV) and Broker Price Opinions (BPO) – but stresses that none of these are substitutes for an evaluation (or an appraisal). However, in performing an evaluation, these can be useful inputs, in combination with other information.

Given where we are in the credit cycle, these considerations will continue to receive close examiner scrutiny. The integrity of a bank's collateral valuation program and processes is particularly important for the handling of any problem loans, including the SFAS 114 impairment analysis. Please give AuditOne a call if you have questions on any of the above points. In accordance with the heightened regulatory attention, we at AuditOne are ensuring that our Credit Reviews, our ALLL validations and our audits of Special Assets and related functions provide appropriate coverage of the issues and requirements addressed above.

Developments observed from our audit associates working in the field inform us that regulators are closely scrutinizing two areas pertaining to the Flood Disaster Protection Act. They have extended their testing to ensure that banks maintain documented evidence (signed acknowledgement) that the borrower was notified that the loan collateral was in a flood zone and that the flood zone indicated on the Flood Hazard Determination form is the same as show on the flood insurance policy.

We at AuditOne are happy to talk with you about any of these regulatory updates and how to best implement recommended action steps.

Please contact Jeremy Taylor (jeremy.taylor@audit-one.com) at 650-299-9185 or Kevin Watson (kevin.watson@audit-one.com) at 562-802-3581 for additional information.

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