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Background

The purpose of this document is to provide an overview of how Federal Reserve examiners typically review and evaluate a community bank's appraisal and evaluation program.¹ Findings in individual cases will depend on the specific facts and circumstances in the context of the Board's appraisal regulations and related guidelines, as discussed below. If bankers have questions about specific cases, they are encouraged to consult the resources cited at the end of this document and to speak with local Reserve Bank staff.

- 1** While this document will refer to "banks" for the sake of simplicity, the Board's appraisal regulations and related guidelines also apply to bank holding companies.
- 2** The Board's appraisal regulations (12 CFR 225.62(a)) define an "appraisal" as a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information. An evaluation is permitted by the Board's appraisal regulations for transactions that qualify for the appraisal threshold exemption, business loan exemption, or subsequent transaction exemption, and must comply with the requirements of the *Interagency Appraisal and Evaluation Guidelines*.
- 3** Under the Federal Reserve Board's appraisal regulations (12 CFR 225.63(c)), examiners have the right to require an appraisal to address safety and soundness concerns.
- 4** See Supervision and Regulation (SR) letter 10-16, "Interagency Appraisal and Evaluation Guidelines," at www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm.

How Examiners Assess Appraisal and Evaluation Programs

A bank's real estate appraisal and evaluation policies and procedures (that is, its collateral valuation program) are reviewed as a part of the examination of the bank's overall real estate-related activities.² Examiners consider the size, complexity, and nature of a bank's real estate-related activities (both commercial and residential) when assessing the appropriateness of its program. When analyzing individual transactions, examiners review an appraisal or evaluation to determine whether the methods, assumptions, and value conclusions are reasonable and whether the appraisal or evaluation supports the bank's credit decision. Furthermore, examiners will assess whether the appraisal or evaluation complies with the appraisal regulations, supervisory guidance, and the bank's approved policies. Even though a bank's overall collateral valuation program may be considered adequate, an examiner still may find weaknesses in a particular appraisal or evaluation. In these situations, examiners may direct the bank to obtain a new collateral valuation.³

Examiners also review the bank's processes to ensure that the person(s) who perform the appraisals and evaluations are qualified, competent, and not subject to conflicts of interest. Examiners consider whether the collateral valuation function is independent of loan production and the collection process, while remaining cognizant of challenges this may pose for small community banks. As discussed in the *Interagency Appraisal and Evaluation Guidelines* (interagency guidelines):⁴

"For a small or rural institution or branch, it may not always be possible or practical to separate the collateral valuation program from the loan production process. If absolute lines of independence cannot be achieved, an institution should be able to demonstrate clearly that it has prudent safeguards to isolate its collateral valuation program from influence or interference from the loan production process. In such cases,

FedLinks is intended to highlight the purpose of supervisory policy and guidance for community banking organizations. FedLinks does not replace, modify, or establish new supervisory policy or guidance.

another loan officer, other officer, or director of the institution may be the only person qualified to analyze the real estate collateral. To ensure their independence, such lending officials, officers, or directors must abstain from any vote or approval involving loans on which they ordered, performed, or reviewed the appraisal or evaluation.”

Therefore, examiners will review the management structure in which the bank’s collateral valuation function resides to ensure sufficient independence is achieved. If a bank does not comply with the appraisal regulations, examiners will cite a violation of the applicable section of the regulation and require the bank to take specific corrective actions. The most severe cases of regulatory violations and/or program deficiencies may be criticized as an unsafe and unsound banking practice. Deficiencies of this type will require a bank to take immediate corrective actions.

Appraisal Regulations and Interagency Guidelines

The Board and the other banking agencies adopted their appraisal regulations pursuant to the statutory requirements of the Financial Institutions Reform Recovery and Enforcement Act of 1989 that mandated appraisal standards and requirements for federally regulated financial institutions. Therefore, the appraisal regulations establish specific minimum requirements and standards that a bank must meet in its real estate lending activity. The Federal Reserve’s appraisal regulations are codified in Regulation Y (bank holding companies), with Regulation H (state member banks) referencing Regulation Y. The agencies issued the interagency guidelines to promote safe and sound appraisal and evaluation programs at regulated banks and to provide further clarification on the appraisal regulations. Given that the interagency guidelines reflect the agencies’ expectations for a prudent appraisal and evaluation function, the agencies recognize that practices will vary based on a bank’s size and the nature of its real estate lending activity. Therefore, for an examiner to find a bank in non-compliance with the interagency guidelines, the examiner

would need to determine that the bank’s practices raise safety and soundness concerns.

Common Examination Findings noted in Community Banks

Common appraisal regulation violations cited during on-site examinations of community banks fall into five broad categories:

1. Failure to obtain an appraisal (12 CFR 225.63(a)) by:

- Not obtaining an appraisal when the transaction does not qualify for an exemption from the appraisal regulations.
- Using an outdated appraisal without documenting the reasons why the bank believes that the appraisal remains valid.
- Claiming an exemption from the appraisal regulations for a transaction when the transaction does not meet the requirements of the exemption. For example, the following exemptions all have certain limitations on their use that a lender should consider and document why the transaction qualifies for an exemption: a business loan, a subsequent transaction with the same borrower, and a loan for which a lien on the collateral was taken in an “abundance of caution.”

2. Failure to obtain an evaluation for certain exempt transactions (12 CFR 225.63(b)) by:

- Using an outdated appraisal as an evaluation without documenting that the appraisal remains valid and can be used as the evaluation for a subsequent transaction.
- Not obtaining an evaluation for a renewed loan.
- Not obtaining an evaluation for a loan under the appraisal threshold of \$250,000 (transaction value).
- Not obtaining an evaluation for a business loan under \$1 million.

3. Failure to use a state-licensed or state-certified appraiser (12 CFR 225.63(d)) by:

- Engaging an appraiser with an expired license or certification.
- Engaging a state-licensed appraiser when a state-certified appraiser is required.

4. Failure to meet the appraisal regulations' minimum appraisal standards (12 CFR 225.64) by:

- The appraisal not conforming to the Uniform Standards of Professional Appraisal Practice (USPAP).
- The appraisal not containing sufficient information on the market value of the collateral to support the bank's credit decision. For instance, the appraisal does not contain sufficient information on market conditions to support the assumptions on the length of time for the property to achieve stabilized occupancy.
- For a construction loan, the appraisal not including an analysis and report of appropriate deductions and discounts for the proposed construction and tract developments with unsold units. (Refer to Appendix C, Deductions and Discounts, of the interagency guidelines for further explanation.)

5. Failure to maintain appraiser independence in the bank's appraisal function (12 CFR 225.63(a)) by:

- Using a staff appraiser that is not independent of the lending function.
- Allowing the borrower to hire the appraiser.
- Using an appraisal prepared by an appraiser who has an interest in the real estate or the transaction. For instance, the appraiser previously appraised the property for the current owner of the property who is selling the property to the bank's borrower.
- Not confirming the independence of an appraisal acquired from another bank.

Of those listed above, the most prevalent violation of the appraisal regulations noted during examinations is the failure to obtain an appraisal and/or evaluation when one is required. This situation may occur when management decides an appraisal or evaluation is not necessary without adequately supporting its justification that the bank is in compliance with the appraisal regulations and that an appraisal or evaluation is not required. A bank should refer to Appendix A, Appraisal Exemptions, of the interagency guidelines for clarification on the exemptions in the appraisal regulations. Figure 1 provides an overview of the three types of transactions for which a lender may use an evaluation instead of an appraisal.

The most common example of noncompliance with the interagency guidelines is insufficient independence in the collateral valuation function. The guidelines state that a bank should be able to demonstrate clearly that it has prudent safeguards to isolate its collateral valuation program from influence or interference by the loan production process. Community bankers should be mindful of the following areas where examiners commonly identify concerns with regard to appraisal and evaluation programs:

- Insufficient independence of the persons ordering, performing, and reviewing appraisals or evaluations from the credit officer or the person who is making the credit decision.
- Inadequate selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.
- Failure of the bank to receive and review the appraisal or evaluation report before the final credit decision is made.
- Insufficient criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.
- Lack of program standards to ensure the bank monitors a vendor or third-party service provider that provides collateral valuation services to the bank.
- Failure to establish a bank's own criteria for obtaining appraisals or evaluations that are not otherwise required by the appraisal regulations.

Figure 1

An evaluation is sufficient when:

- **Transaction value is \$250M or less***
- **Transaction is a business loan of \$1 million or less and not dependent on sale of or rental income derived from real estate as the primary source of repayment**
- **Transaction involves an existing extension of credit at the bank (such as a loan renewal or refinancing), provided that there is 1) no obvious and material change in market conditions or physical aspects of the property that threaten the adequacy of the bank's collateral protection after the transaction, even with advancement of new monies or 2) no advancement of new monies, other than funds necessary to cover reasonable closing costs**

**Transaction value is the amount of the loan, not the value of collateral*

Review of a Commercial Real Estate Appraisal by Examiners

During the course of reviewing commercial real estate loans, examiners analyze collateral values based on the bank's initial appraisal or evaluation, any subsequent updates, relevant market conditions, and additional information. Examiners consider the appropriateness of the major facts, assumptions, and valuation approaches used in the collateral valuation and in the bank's internal credit review and any impairment analysis. Examiners generally are not expected to challenge the underlying valuation assumptions, including discount rates and capitalization rates, used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral under review. If examiners note weaknesses in the bank's supporting documentation or appraisal or evaluation review process, examiners typically will direct the bank to address the weaknesses, which may require the bank to obtain a new appraisal. However, if the bank is unable or unwilling to address these deficiencies in a timely manner, examiners still need to be able to assess the degree of protection that the collateral affords in analyzing and classifying a credit. This situation may result in examiners making adjustments, if applicable, to the collateral's value to reflect current market conditions and factors that the latest appraisal in the loan file did not consider. For further information on an examiner's review of commercial real estate loans and appraisals, refer to the interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*.⁵

Preparation for the Next Examination

Bankers often want to know how to prevent appraisal regulatory violations and how to have fully compliant appraisal and evaluation programs. The interagency guidelines pro-

vide bankers with an overview of supervisory expectations for prudent appraisal and evaluation policies, procedures, and practices, as well as provide a helpful reference guide to the appraisal regulations. Accordingly, the interagency guidelines should remain the banker's primary reference guide. In addition, examiners have some practical suggestions for bankers to promote compliance and to prepare for their next examination in the four areas highlighted in Figure 2.

Figure 2



- (1) **Determine whether the bank's appraisal and evaluation policies and procedures comply with supervisory guidance.** The interagency guidelines outline expectations for a bank's appraisal and evaluation program and provide additional guidance on compliance with the appraisal regulations. A bank should periodically review its policies and procedures to ensure compliance with these guidelines. A comprehensive internal review is particularly useful if the bank's policy originated prior to the issuance of the interagency guidelines in 2010. During an on-site examination, examiners will consider a bank's own internal review in their assessment of the bank's appraisal and evaluation program. Comprehensive policies and procedures will assist the bank in implementing an effective, efficient, and compliant program.
- (2) **Consider organizational changes that promote independence and accountability.** A bank should maintain standards of independence as part of an effective collateral valuation program for both appraisal and

⁵ See SR letter 09-7, "Prudent Commercial Real Estate Loan Workouts," at www.federalreserve.gov/boarddocs/srletters/2009/SR0907.htm.

evaluation functions. For a small community bank, a collateral-valuation function separate from the loan-production process may not be possible. As mentioned above, if absolute lines of independence cannot be achieved, prudent safeguards to isolate the collateral valuation program from the influence and/or interference of loan-production staff should be in place. To ensure independence, and in accordance with the appraisal regulations (12 CFR 225.65(a)), lending officials, officers, or directors must abstain from any vote or approval involving loans on which they have ordered, performed, or reviewed the appraisal or evaluation. While not required, many medium-sized community banks have centralized the ordering, reviewing, and accepting of appraisals under a designated bank officer, who is primarily responsible for program compliance. Some larger community banks have employed a full-time chief appraiser to manage the appraisal and evaluation programs. Organizational structure and reporting should promote the maximum level of independence possible given the size and sophistication of the bank. Examiners with knowledge about the bank and its management structure are well positioned to assess whether independence has been achieved.

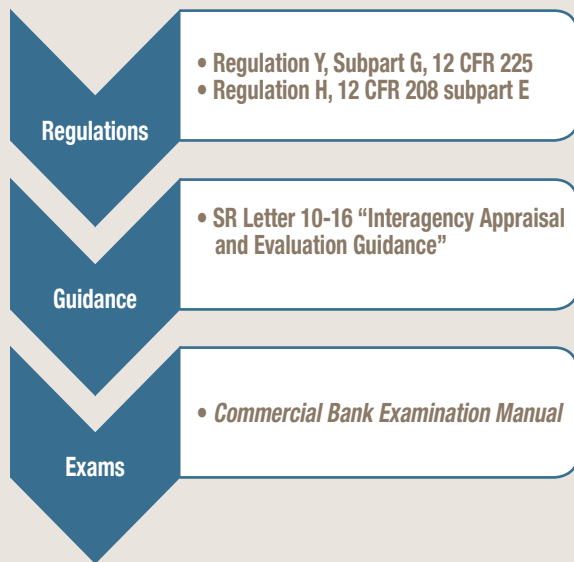
(3) Improve loan file documentation. The primary cause of appraisal regulation violations is the failure to obtain an appraisal when required by the regulations or improperly using an existing appraisal or evaluation for a subsequent transaction with the same borrower. In many cases, management decides an appraisal is not necessary, and fails to adequately support this decision in the loan file. Management should recognize that there are situations when the most recent appraisal or evaluation in the loan file should not be used for a subsequent transaction. For example, examiners often encounter situations where management states an appraisal was not necessary because the lien on the collateral was obtained as an “abundance of caution.” In many of these cases, examiners find conflicting information in the loan file indicating that the property is the primary source of repayment, which calls into

question the abundance of caution claim. To prevent violations, the credit approval document should explain: (i) the reasons why the transaction qualifies for an exemption in the appraisal regulations; (ii) the reasons why a new appraisal or evaluation is not required for a subsequent transaction; or (iii) the reasons, supported by current market and property information, that an existing appraisal or evaluation is valid and may be used for a subsequent transaction. Documentation of the rationale for not obtaining a new appraisal or evaluation should be apparent on approval memos; otherwise, the bank may be subject to a violation citation.

(4) Maintain a comprehensive and reliable appraisal review process. A robust appraisal review process promotes the integrity and quality of appraisals and evaluations and supports safe and sound credit underwriting. The appraisal review process should ensure that appraisals and evaluations comply with standards contained in the appraisal regulations, interagency guidelines, and the bank’s internal policies. A bank’s policies and procedures for reviewing appraisals and evaluations should:

- Address the independence, educational and training qualifications, and role of the reviewer;
- Reflect a risk-focused approach for determining the depth of a review;
- Establish a process for resolving any deficiencies in appraisals or evaluations; and
- Set documentation standards for the review and resolution of noted deficiencies.

Regulatory Reference Materials Appendix



- **Regulation Y (12 CFR 225, subpart G and Regulation H (12 CFR 208, subpart E)**

www.gpo.gov/fdsys/pkg/CFR-2013-title12-vol3/pdf/CFR-2013-title12-vol3-part225-subjectgroupid179-subpartG.pdf

www.gpo.gov/fdsys/pkg/CFR-2013-title12-vol2pdf/CFR-2013-title12-vol2-part208-subpartE.pdf

The Federal Reserve’s appraisal regulations are codified in Regulation Y (bank holding companies), with Regulation H (state member banks) referencing Regulation Y.

- **Interagency Appraisal and Evaluation Guidelines (SR letter 10-16)**

www.federalreserve.gov/boarddocs/srletters/2010sr1016.htm

The interagency guidelines provide further clarification on the appraisal regulations and supervisory expectations for a bank’s appraisal and evaluation programs.

- **Commercial Bank Examination Manual**

www.federalreserve.gov/boarddocs/supmanual/supervision_cbem.htm

Sections 4140.2, 4140.3, and 4140.4 in the manual explain examination objectives and procedures, and include an internal control questionnaire. Since examiners determine the scope of their review based on the risk profile of the bank, the scope of the examination will vary per bank and will be risk focused and reflect consideration of the above referenced materials.

SR Letters – Additional Guidance

- SR letter 12-10 / CA letter 12-9, “Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned” (Questions 10 to 13)

www.federalreserve.gov/bankinfo/srletters/sr1210.htm

- SR letter 09-7, “Prudent Commercial Real Estate Loan Workouts”

www.federalreserve.gov/boarddocs/srletters/2009/SR0907.htm

- SR Letter 05-14, “Interagency FAQs on Residential Tract Development Lending”

www.federalreserve.gov/boarddocs/srletters/2005/SR0514.htm

- SR Letter 05-5, “Interagency FAQs on the Agencies’ Appraisal Regulations and Interagency Statement on Independence of Appraisal and Evaluation Functions”

www.federalreserve.gov/boarddocs/srletters/2005/SR0505.htm