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On Behalf of the
Appraisal Institute and
American Society of Appraisers

Before the Senate Committee on Small Business and Entrepreneurship
On

SBA Reauthorization Roundtable: Credit Programs Part 1 & Part 2

Presented by
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Before the
Committee on Small Business and Entrepreneurship
United States Senate

Madam Chair and members of the Committee, I am Alan Eugene Hummel, President of Iowa Residential Appraisal Company in Des Moines, Iowa and 2003 President of the Appraisal Institute. I am pleased to provide official comments to the SBA Reauthorization Roundtable on behalf of the more than 25,000 members of the Appraisal Institute and American Society of Appraisers.

Real estate appraisals are used in virtually every program of the Small Business Administration to help establish market value of real estate and other property held as collateral for loans made to small businesses. Under the SBA 7(a) program, a prospective borrower might present property that is owned by the business to use as collateral to receive a loan for working capital expenses. In determining the size and adequacy of the application, financial institutions rely on the appraisal to estimate the value of the property (collateral) and subsequently the adequacy of the loan.

SBA's 504 loan program can be used to purchase fixed assets such as machinery, equipment and real estate. The appraiser typically does not know which SBA program is being used, as the appraiser is simply given appraisal assignment of a specific property by the financial institution or small business lending company.

Unfortunately, appraisers and lenders must rely on appraisal guidelines written by the SBA that lack clarity and reflect less than a full understanding of the appraisal process. What has resulted is confusion amongst both appraisers and lenders over the type of appraisals that should be ordered by financial institutions.

In addition, the appraisal guidelines do not adequately address business enterprise or "going concern" values. If this issue is not addressed, SBA will continue to take huge losses on loans that have been made on the value of the business rather than the value of the property.

We hope the Senate Committee on Small Business and Entrepreneurship considers these issues as it looks to reauthorize SBA's credit programs this year. I will detail more specific concerns below.

Issue 1: Going Concern Values

Many SBA-backed loans are used to acquire businesses which consist of real estate, furniture, fixtures and equipment and what is known as "ongoing business value." Properties with these features include: convenience stores, restaurants, motels, bowling alleys, golf courses, car washes, lube centers, and the like.

An appraisal of this type of property estimates a "going concern value." Because "going concern value" may include the business' value as well as personal property assets it should be differentiated from the

value solely of the real property. Unfortunately, SBA *Standard Operating Procedure (SOP) 50-10* fails to address this very important issue. Nowhere in the SOP is the “going concern value” discussed and there is no procedure or directive on how to treat this type of property during the appraisal process.

SBA is faced with a very serious problem -- appraisers are oftentimes hired to value this type of property, yet sometimes they incorrectly state that the appraised value is of the real property, when they have accounted for the business' value and personal property assets as well. Subsequently, the lender makes the loan believing that they have issued a loan on the real property only. If the business fails, another appraisal is ordered during liquidation proceedings, and the value may be reported as much as 50% less than the original appraisal prepared by another appraiser because there is now no business or “going concern value” associated with the real property. As a result, the SBA is left with a property that is worth half as much as it was originally loaned for, which results in a major loss to the agency. Recently, SBA experienced such losses, such as in a number of convenient stores throughout the country.

A key issue SBA should address is whether or not it wants appraisals to reflect the going concern or just the real property. The SOP should clarify for both lenders and appraisers what value it requires. Perhaps going concern values should only be used to value the purchase price of the going concern and real estate values should be used to value collateral value.

Once that is clarified, the SBA should ensure that qualified appraisers are used for these valuations. One way SBA might address this problem is to modify its appraiser qualifications to require appraisers who provide “going concern” appraisals to demonstrate experience and education relevant to such assignments.

The Appraisal Institute Course 800 currently deals with separating real and personal property assets. It provides the theoretical and analytical framework for separating the tangible and intangible assets of operating properties. Through discussion, lecture, readings, role-playing and case studies, participants actively solve problems related to “going concern value.” The American Society of Appraisers also has practitioners specializing in personal property and business valuation that can be relied on for such assignments.

Additionally, SBA could place greater emphasis on holding lenders and appraisers accountable when they do not adhere to these guidelines. Recently, the SBA incurred losses on loans where the appraisals were significantly inflated, improperly underwritten or misunderstood by the lender. When a business fails, the only collateral left is the real estate, and that value appears significantly lower because of the going concern issue stated above. Situations like these can contribute to significant losses to SBA programs, and this issue warrants the attention of SBA.

Issue 2: The Competence of the Appraiser

The issue SBA loans against going concerns values also involves the competence of real estate appraisers as much as with the SBA appraisal guidelines. Whether the SBA appraisal guidelines are clear or not, the appraiser should make the distinction between real property and personal property in the appraisal report. The appraiser should not appraise business value or personal property if they are not competent in such assignments, and doing so is a violation of the Uniform Standards of Professional Appraisal Practice.

Appraisers that violate these standards should be referred to the appropriate state appraisal board for possible disciplinary action. The SBA should also hold appraisers and lenders accountable if these standards are violated.

There is a need to train real estate appraisers on these issues, as this is an emerging issue in our profession. As stated above, the Appraisal Institute and the American Society of Appraisers have courses that address going concern valuation and they are being offered throughout the country.

Since SBA backs so many loans involving going concern values, it would be helpful for SBA to have more resources for training of SBA staff and SBA approved lenders and appraisers on these issues. We encourage Congress to consider providing SBA more resources to address these issues in the SBA reauthorization this year.

Issue 3: SOP 50-10 Appraisal Guideline Inconsistencies

We have a concern with language in SOP 50-10 which states that loans under \$1,000,000 require a "Limited Appraisal" while loans over \$1,000,000 must have a "Complete Appraisal."

To an appraiser, the terms "limited appraisal" and "complete appraisal" do not fully explain the assignment absent further instructions. According to our members, the lack of guidance in this area causes confusion amongst appraisers regarding the kind of complete appraisal SBA requires. This problem is made worse by non-regulated lenders and small banks that do not have compliance departments experienced with the *Uniform Standards of Professional Appraisal Practice (USPAP)* and the appraisal process.

According to USPAP, there are three types of appraisal reports: *Self Contained*, *Summary* and *Restricted Use*. There are two types of *appraisals*, Complete and Limited. "Limited Appraisals" are appraisals that usually involve the elimination of one or more of the three traditional approaches to value. The key difference is that the term "Complete Appraisal" means that there are no such Departures from USPAP.

The issue to be addressed by the SBA is whether a "Complete Appraisal" means a Self Contained Report of a Complete Appraisal or a Summary Report of a Complete Appraisal (the Restricted Use option would not apply to SBA loans). Clarification is also needed on whether the reference to a "Limited Appraisal" means a Summary Report of a Limited Appraisal.

SBA might address this issue in two specific ways:

- 1) SBA could review the different types of appraisals and appraisal reports to determine which will provide sufficient detail for the SBA and other intended users in making sound lending decisions. SBA should then amend the SOP 50-10 to give lenders and appraisers further guidance on the new SBA complete appraisal requirement. One such policy could require a "Summary Report of a Complete Appraisal" appraisal for loans under \$1,000,000 and a "Self-Contained Report of a Complete Appraisal" for loans greater than \$1,000,000.
- 2) Another option would be for SBA to require strict compliance with USPAP and allow the appraiser and the client to decide the level of appraisal and type of report appropriate, doing away with a loan-appraisal threshold entirely. Under these circumstances, the type of appraisal (complete or limited) would be based upon the purpose and intended use of the appraisal report. The

appraiser's "scope of work" would subsequently define what is to be done in the development of the appraisal.

The SBA could also adopt, wherever possible, the Interagency Appraisal and Evaluation Guidelines adopted by four of the five federal financial institutions regulators in 1994. Many of the definitional problems encountered by appraisers and lenders (limited vs. complete appraisals) that have been identified in SOP 50-10 could be solved if the SBA referenced the Interagency Appraisal and Evaluation Guidelines. Where it is not possible to adopt the Interagency Appraisal and Evaluation Guidelines, we suggest the language contained in the Guidelines be incorporated into the Standard Operating Procedures. We have attached a copy of the Interagency Appraisal and Evaluation Guidelines in this testimony.

Issue 4: Credit Union Appraisal Policies

Both Issue 1 and Issue 2 are relevant to a third concern resulting from recent changes to allow approximately 1,500 credit unions to participate in SBA credit programs. Generally speaking, credit unions are not used to making business loans. Unlike federally-regulated financial institutions, credit unions are not required to comply with the Interagency Appraisal and Evaluation Guidelines of 1994, discussed above. When the Interagency Appraisal and Evaluations Guidelines were adopted in 1994, the National Credit Union Administration was the only federal financial institution regulator that did not adopt them.

In addition, unlike most large banks, which typically have staff on hand to review the work of fee appraisers, credit unions typically do not have in-house appraisers to perform quality control. Credit unions are also not typically well-versed on appraisal procedures or methodologies.

The definitional problems outlined in Issue 1 and Issue 2 will likely be magnified through credit union involvement in SBA loans. In fact, it is further reason for the SBA, and Congress through the reauthorization of SBA's credit programs, to address the deficiencies within Standard Operating Procedures 50-10 before SBA backed financing is further in jeopardy.

For further information

We appreciate the opportunity to provide comment on SBA appraisal issues. We hope that you consider these suggestions during the course of improving SBA lending programs and reauthorizing the SBA credit programs. In the coming weeks, our Washington office will contact you to arrange a meeting with you and your staff. Should you have any questions, please contact Donald Kelly, Vice President of Public Affairs, Appraisal Institute at 202-298-5583, dkelly@appraisalinstitute.org or Ted Baker, Executive Vice President, American Society of Appraisers at 703-733-2199, tbaker@appraisers.org.

FDIC Law, Regulations, Related Acts

5000 - FDIC STATEMENTS OF POLICY

Interagency Appraisal and Evaluation Guidelines

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are jointly issuing these guidelines, which supersede each of the agencies' appraisal and evaluation guidelines issued in 1992.^{1}

{¹FRB: "Guidelines for Real Estate Appraisal and Evaluation Programs," September 28, 1992; OCC: BC--225, "Real Estate Appraisal and Evaluation Guidelines," September 28, 1992; FDIC: FIL--69--92, "Guidelines for Real Estate Appraisal and Evaluation Programs," September 30, 1992; OTS: Thrift Bulletin 55, "Real Estate Appraisal and Evaluation Guidelines," October 13, 1992.}

These guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions.^{2}

{²OCC: 12 CFR Part 34, subpart C; FRB: 12 CFR 208.18 and [12 CFR 225](#), subpart G; FDIC: [12 CFR 323](#); and OTS: 12 CFR Part 564.}

Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective State supervision.

Common agency regulations^{3}

{³OCC: 12 CFR 34, subpart D; FRB: 12 CFR Part 208, subpart C; FDIC: [12 CFR Part 365](#); and OTS: 12 CFR Parts 545 and 563.}

issued pursuant to Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) also require each regulated institution to adopt and maintain written real estate lending policies that are consistent with safe and sound banking practices and that reflect consideration of the

real estate lending guidelines attached to the regulation. The real estate lending guidelines state that a real estate lending program should include an appropriate real estate appraisal and evaluation program.

Supervisory Policy

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies,^{4}

{⁴The appraisal guidance contained in the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," November 7, 1991, generally applies to all transactions.}

supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

[{{8-31-98 p.5464}}](#)

Appraisal and Evaluation Program

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:

- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations;

- Provide for the independence of the person performing appraisals or evaluations;

- Identify the appropriate appraisal for various lending transactions;

- Establish criteria for contents of an evaluation;

- Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision;

- Assess the validity of existing appraisals or evaluations to support subsequent transactions;

- Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations; and
- Establish internal controls that promote compliance with these program standards.

Selection of Individuals Who May Perform Appraisals and Evaluations

An institution's program should establish criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. The criteria should ensure that:

- The institution's selection process is non-preferential and unbiased;
- The individual selected possesses the requisite education, expertise and competence to complete the assignment;
- The individual selected is capable of rendering an unbiased opinion; and
- The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal And Evaluation Function

Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

[{{8-31-98 p.5465}}](#)

Transactions That Require Appraisals

Although the agencies' appraisal regulations exempt certain categories of real estate-related financial transactions from the appraisal requirements, most real estate transactions over \$250,000 are considered federally related transactions and thus require appraisals.⁽⁵⁾

{⁵In order to facilitate recovery in designated major disaster areas, subject to safety and soundness considerations, Section 2 of the Depository Institutions Disaster Relief Act of 1992 authorized the agencies to waive certain appraisal requirements for up to three years after a Presidential declaration of a natural disaster.}

A "federally related transaction" means any real estate-related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.⁽⁶⁾

{⁶As a matter of policy, OTS requires problem associations and associations in troubled condition to obtain appraisals for all real estate-related transactions over \$100,000 (unless the transaction is otherwise exempt).}

Minimum Appraisal Standards

The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must:

- Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards;

Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise.

- Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.

- 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;

This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For

proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.

- Be based upon the definition of market value set forth in the regulation; and

Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.

- Be performed by State-licensed or certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options

An appraiser typically uses three market value approaches to analyze the value of a property--cost, income, and comparable sales--and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal.^{7}

{⁷USPAP Statement on Appraisal Standards No. 7 (SMT--7)--*Permitted Departure from Specific Guidelines for Real Property Appraisal*, issued March 30, 1994, effective July 1, 1994. }

When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value. Departure from standards designated as binding requirements is not permitted.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations

A formal opinion of market value prepared by a State licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate rather than an appraisal when the transaction:

- Has a value of \$250,000 or less;

- Is a business loan of \$1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or

- Involves an existing extension of credit at the lending institution, provided that: (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

Institutions should also establish criteria for obtaining appraisals or evaluations for safety and soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content

An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should:

- Be written;

- Include the preparer's name, address, and signature, and the effective date of the evaluation;

- Describe the real estate collateral, its condition, its current and projected use;

- Describe the source(s) of information used in the analysis;
- Describe the analysis and supporting information, and;
- Provide an estimate of the real estate's market value, with any limiting conditions.

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations

Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use State licensed or certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate-related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations

The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or

environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions

While the agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, an institution would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance

An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods.

assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified State licensed or certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring

The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques--even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals

Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a State licensed or certified appraiser violates USPAP, applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

[Source: FDIC Financial Institution Letter (FIL--74--94), dated November 11, 1994]
