The Evaluation Crossroads—

A New Frontier in a World of Evolving Finance & Regulation

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Welcome!
Bienvenido!
欢迎！
환영！

Bienvenue!
Willkomen!

Speaker Introductions

• Doug Potts
• Justin Slack
Abstract

• In the 29 years since FIRREA, the appraisal industry is being buffeted by strong demographic & business headwinds. Lending appraisals have always been a major source of business, but financial institutions are also buffeted by change they find hard to control.

• Banks look for ever greater ways to finance with maximum efficiency, and increasingly turn to evaluations in lieu of appraisals.

• Some appraisers believe that evaluations degrade the valuation pedigree, but this presentation takes a more positive view with an eye to future "best practices" aiding the sustainability and vibrancy of valuation practice for the coming era.

• We summarize the evolution in banking as it relates to valuation, illustrate many forms evaluations can take, and show how they can be applied to both loan origination and also loan monitoring.

• Lastly, we discuss the Regulatory Trifecta – state definitions, licensing restrictions, and standards – that must be reformed to permit appraisers into this promising and crucial frontier of the valuation business.
Disclaimer

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THE EVOLUTION OF RISK

Banking & Valuations
"If you don’t like change, you’ll HATE IRRELEVANCE"

Jeff Sherman MAI, AI-GRS
A New Sense of Crisis?

• 1994 -- FIRREA established Evaluations
• 2005 – FAQ on Appraisal Regulations
  • Interagency Statement – Independent Appraisal & Evaluation Functions
• 2010 -- Interagency Appraisal & Evaluation Guidelines
  • Expanded & Defined Evaluation
  • Independence & Content
• Has the Appraisal Community had the time
to focus on complicated & non-linear problems?

Does the 2018 threshold awaken new fears?
Risk Management in Banking

• Loan concentration risk managed by
  • Borrowing sector (e.g. industry sector, C & I, CRE, HVCRE)
  • Geographic diversification (where in bank footprint)
  • Loans retained (portfolio) v loans sold (2ndry market)
• Credit (customer) underwriting policy / process
• Collateral (real estate) underwriting policy / process
  • LTV reporting by FDICIA (supervisory) limits
• Alignment -- Policy to Regulation to Operating Practices
• Follow-through
  • Capture of all relevant lending activity within the framework
  • Consistent / appropriate handling of new / existing loan events
Risk Management in Appraising

RE Appraisal industry applies risk management tools

• Standards of Practice
• Scope of Work
• Data collection & verification methods
• Value measurement techniques
• Reconciliation of value indications
• Quantity quality & reliability of value indicators
• Community life cycle & remaining economic life
• SWOT analysis
Evolving Banking Regulation

• Before FIRREA – “a long time ago in a galaxy far far away .... ”
  • No independence – who is the client?
  • Few people in the review profession

• The early USPAP years
  • FIRREA
  • The Appraisal Foundation -- TAF
  • Licensing
  • FRTs & RETs

• Current Era
  • IAG - ECOA/Reg B
  • HVCRE
  • UCDP / UAD / EGRPRA

• Orwell was wrong! It’s not 1984! It’s 1994, or maybe 2018!
Evolution Appraisal Profession

• Before FIRREA
  • Cottage industry – many self-employed appraisers.
  • No licensing – few belonged to professional societies
  • Reputation referrals for business.

• FIRREA & early USPAP years
  • Licensing reshapes the landscape
  • Creation of The Appraisal Foundation
  • Larger professional societies merge
  • Lender pushback on *deminimis* & value doc requirements
  • Appraisal industry counters with “6 options”

• *We got – higher thresholds, 6 options, and EVALUATIONS*
Appraisal Industry – Current Headwinds

• Complex new rules emerge from Dodd Frank / CFPB / ECOA
• Significant increase in “warranty work”
• Major decline in new licenses since 2006
• Big Data – commoditizing residential space (e.g. UAD / AMCs)
• Emergence of numerous “Alternative Value Providers”
• New echelon of reviewers emerges since 1995, rapid growth since early 2000s
  • Loan origination & audit & accounting
  • Government (GSA, IRS, Interior, etc.)
• Major Organizations Get in on the Review Game
  • Appraisal Institute – AI-GRS & AI-RRS
  • American Society of Appraisers – ARM
  • American Society of Farm Managers & Rural Appraisers -- RPRA
  • National Association of Certified Valuators & Analysts -- ABAR
Current Banking Headwinds

• (In)Efficiency Pressure
• Margin Pressure
• New Lending Competition
  • Fintech, Securitization
• Regulatory Compliance Burdens
• Systems Security
• Changing Generation Expectations –
  • Customer Facing
• Long Term Structural Threat –
  • Cryptocurrency
FINANCIAL SYSTEM DYNAMICS
The QBP – a Measures of Financial System Risk

- FDIC – exactly who *ARE* they?
  - Created 1933 – in the depth of the Great Depression
  - Preserves confidence in the US financial system
  - Insures deposits in banks & thrifts
  - Regulates safety & soundness in over 4,500 institutions

- Quarterly Banking Profile – the QBP
  - Also known as the “call reports”
  - FDIC Publication quarterly
  - Covers all FDIC-insured institutions
  - Comprehensive summary of financial results
Who Makes Most of the Loans?

**Number of Institutions By Asset Size**
March 31, 2018

- $1 Billion to $10 Billion: 823 Institutions (11.2%)
- $10 Billion to $250 Billion: 123 Institutions (1.7%)
- Greater than $250 Billion: 4 Institutions (0.1%)
- Less than $100 Million: 1,302 Institutions (24.6%)
- $100 Million to $1 Billion: 3,453 Institutions (61.6%)
Consistently Lean Margins

Net Interest Margin (YTD)
March 31, 2018

Net Interest Margin -- Select Asset Groups

- Ag Banks
- Credit Card Lender
- Comml Lender
- Mortgage Lender

Pie Chart: Percent, Annualized

Bar Chart: 2012-2018

Net Interest Margin
0.00 2.00 4.00 6.00 8.00 10.00 12.00 14.00 16.00

International Banks
Agricultural Banks
Credit Card Lenders
Commercial Lenders
Mortgage Lenders
Consumer Lenders
Other Specialized < $1 Billion
All Other < $1 Billion
All Other > $1 Billion
What Does Utilization Data Tell Us?

![Utilization Rate Graph]

*Utilization rates represent outstanding loan amounts as a percentage of unused loan commitments plus outstanding loan amounts.*
RMA – LTV Data – the “WAETV”

Exposure to value (ETV) is a new measure now available in the RAS CPE database. ETV is defined as total borrower exposure (including outstanding loans and unfunded commitments) divided by the current market value of all associated collateral. In general, ETV has been trending down, reflecting continued increases in commercial real estate values.
Can I get this updated? Check with RMA

Author, 7/22/2018
LOAN VOLUME GROWTH

YOY Lending Volume

Loan Volume 3.5x Higher
WORKLOAD GROWTH

YoY # of Notes

- C & I Loan
- Non Farm Non Res
- Agri
- Farmland

Loan Volume 3.4x Higher
Is Risk Proportional with Workload?

LOAN WORKLOAD v PROFITABILITY

QBP - 2017 FYE

# of Notes (M)

-$ - $100M

Old thresholds

6% of risk

82% of workload

79% of risk

±10% of workload*

Loan Size Bracket

NIM Risk Earnings (M)

*$ DP estimate; not reported
Shrinking Institutions – Result of Pressure

• Combine all these challenges – efficiency demands, margin pressure, new competitors, regulatory demands, workload growth, etc.

• Banks are consolidating to economize where they can
  • Even in the face of great asset growth – which also demands greater efficiency
EXISTENTIAL THREATS

A Sense of Urgency
Is Risk Proportional with Workload?

QBP - 2017 FYE
LOAN WORKLOAD v PROFITABILITY

82% of workload

6% of risk

New thresholds

79% of risk

±10% of workload*

* DP estimate; not reported
Appraisers in the Financial Environment

Work We See

Work We Don’t See
(and mostly don’t get)

Can this hurt us?
Who Will Do the Work?

Workload v Workforce (all appraisers)

- 263 loans/appr
- 375 loans/appr + 43% workload
- Are appraisers 3x busier than 1995?
- -25% decline 2007 - 2016
Frigid Headwinds Blowing

• Significant demographic decline
  • Aging appraiser population → attrition of qualified providers
• Threshold increase -- $250M to $500M → reduced appraisal need
• FNMA & FHFA & VA redesign - “Bifurcated” Appraisal Process
• Appraisal waivers attempted in TN; considered in OK
• SB 2155 – rural appraisal waiver, now LAW
• MISMO & C-MISMO
• Proliferation of non-appraisal evaluation products

Can appraisers meet the demands of more loans?
The Lesson of History – DON’T DITHER

Be Careful of Meteoric Change
Complacency is Dangerous
ADAPTATION to CHANGE

Breaking the Trifecta

Douglas Potts, VP, MAI, AI-GRS
The Regulatory Trifecta & the Marketplace

All Valuations = Appraisal

Standard = Only USPAP

Only Appraisers Can Do Appraisals

Appraiser
Breaking the Trifecta – Recover the Marketplace

- Valuations = Appraisal or Alternates
- Allow Other Applicable Standards
- Only Appraisers Can Do Appraisals
Cracks in the Trifecta

• TX - Proposed Law for TREAT
• HB 1453 – evaluations allowed for small takings
• DOT waivers – TAF’s sudden “jurisdictional exception”
  • why not FIRREA?
• TN FAQ
• IL FAQ
• Georgia Law
• FL Law – Working through administrative process
Relief Initiatives – Laws / Proposals
It’s Coming -- the Perfect Storm

- We are late in economic cycle
- Real estate asset bubble is already present
- Problem loans will fester & increase
- Decline in bank earnings / stocks
- Regulatory pressure to manage loan quality
- Portfolio loan management – extreme sensitivity
- Banks will face tremendous pressure to maintain loan incumbency
- Loan Renewals -- only maintains income. Doesn’t grow the loan base.
- Appraiser shortages – getting the work done timely & economically

ENHANCE EXISTING PORTFOLIO MANAGEMENT
An Opportunity for Appraisers?

- Bank Challenges – the (in)Efficiency Ratio
  - Internal staff is costly
- Shifting Risk – from Bank to Appraiser
  - Internal bank eval staff cost shifts to Professional Appraiser
  - For a Fee! Can be charged back customer
  - More easily scalable to fit peaks & valleys in loan cycles
  - Less blowback risk in cases of adverse action due to LTV

FIND THE “MINIMALLY VAILABLE PRODUCT”
A HOUSE DIVIDED?

The Need for Professional Consensus
Purists v Pragmatists

**Purist Argument**
- Weak Standards = NO Standards
- We could go back to the Wild West
- Loss of Public Trust
- Existing system is flexible enough
  - Use the Restricted Option!

**Pragmatist Response**
- Multiple Standards Always Existed
- Evals by Non-Appraisers IS Wild West
- Public Knows the Difference
  - Eval Reliability ≠ Appraisal Reliability
- Minimal to no enforcement
- Marketplace Wants Evaluations
Restricted Appraisals -- “Restrict” Us?

- Restricted were part of the “6 options” revisions to USPAP
  - Intended to blunt the proposal that raised the 1994 threshold increase ($100M to $250M)
  - Also tried to blunt the threat of “evaluation” language introduced into FIRREA in 1994 – keep the business from migrating from appraisers

- 15 years later – evaluation intent and content clarified & expanded
- Why hasn’t the RAR option caught fire:
  - The RAR only requires methods & conclusions to be “stated”
  - Interagency Evaluation Guidelines – “describe the analysis that was performed and the supporting information that was used”

RAR has failed to address evaluation evolution
Fears of a Future of Evaluations

So, how do we deal with quality control in a totally new product?
Evaluations – Different Types for Different Needs

• **Value Setting** – mimics traditional appraising techniques
• **Stress Testing** – “Validation” Process
• **Managing Methods & Data Risk**
  • Applying the right evaluation method for the identified job problem
  • How good is the client-provided information?
• Could risk scoring an evaluation assignment be helpful?
  • Risk scoring = reconciliation process on STEROIDS
• **Accept Limitations of a Different Process**
  • Limited analysis may create a limited answer
  • How can appraisers get comfortable with this?
New Paradigm Needed

• Break free from traditional training into new thinking
• Develop “Versatile” Analytical Skills
  • We can’t be too generalized or hyper-specialized
  • Apply the toolbox of appraiser knowledge in new ways to meet new needs
• Build suitable & consistent new methods
  • What should a reasonable MVP look like?
  • Something that can catch fire – a new “Green Hornet”
• Something that can be sufficiently flexible
  • Maybe not ONE technique, but MULTIPLE techniques
LOAN PORTFOLIO MANAGEMENT

A Risk Perspective
Portfolio Management – Loan Risk

• Fundamental Loan Classes
  1. New Loans
  2. Existing Extensions
  3. Problem Loan Management

• Only #1 = New Risk to a Bank = Investment Risk

• #2 & #3 already in Portfolio
  • Money is already invested = Recovery Risk

• What generates most bank’s profits?
  • Loan Class #1? or
  • Loan Classes #2 & #3?
Perspective on Value Relationships

- **Point value** – hyper focus on precision
  - current appraisal techniques are designed around this concept.
- **Range value** – allows flexibility around a point
  - difficult to use for lending work without looking imprudent?
- **Relationship value** – higher or lower than a benchmark.
  - an opportunity in the evaluation space?

**Can a Relationship to an Historic Benchmark be helpful?**
- “Today’s value **is at least as much** as the Point Value issued 2 years ago.”
- “Today’s value **is likely less than** the Point Value issued 5 years ago.”

**Focusing on “stress-testing relationship value” permits us to introduce value range uncertainty in a reasonable way into our appraisal practice**
Perceived Risk & Algorithm Choices

• Risk Drives the Goal → Goal Drives the Scope

• Relating Goals to the 3 Perspectives on “Value”
  • Point - Range – Relationship

• Origination = Higher Perceived Risk =
  • Need for greater precision / accuracy
  • Mark to market; updated precision
  • Scope = traditional point valuation

• Subsequent Transaction = Lower Risk =
  • New point valuation? Range valuation?
  • Relationship valuation?
  • Emphasis on efficiency in Time / Cost
Validations – Recasting the Relationship

• Financial investor premise --
  • “Past asset performance is no guarantee of future results.”
  • If subsequent performance falls short, don’t we wish we could pay less for the investment?

• The Validation premise –
  • Prior appraised value results from that appraisal’s historic forecasts
    • Choice of sales & value indicators set market levels for comparison
    • Forecast of economic performance – EGI, expenses, NOI, and market Ro.
  • So, let’s rephrase the financial premise as a real estate question:
    • “Were an appraiser’s past forecasts proven out by subsequent actual performance?”
    • If actual performance beats an old forecast – is that old value still likely ok?
What is required after the origination? (excerpts below)

- **12CFR34.43 (a)** –
  “An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:” (emphases added)

- **(7)** The transaction involves an existing extension of credit at the lending institution, provided that:
  
  (i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens 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;

- **12CFR34.43 (b)** –

  “For a transaction that does not require the services of a State certified or licensed appraiser under paragraph ... (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.”
Evaluations & Relationship Value-Stress Tool

• The Nexus of Accuracy v Adequacy
  • Existing collateral & the subsequent transaction
  • Transaction cost v flat profitability shift

• Floor values on file as adequacy filter
  • Against current balance? Increasing balance?
  • Declining value? Physical deterioration?

• “no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution’s real state collateral protection after the transaction, even with the advancement of new monies” [12CFR34.43(a)(7)(i)]

Could we stress-test the values – “let them ride?”
“The vast majority (over 75%) of residential mortgage transactions fall outside the current definition of what constitutes a federally related transaction.”

The Appraisal Foundation --
“State Legislative / Regulatory Initiatives to Recognize Alternative Appraisal Standards” --
Update for The Association of Appraiser Regulatory Officials – April 2016

“Only 11% of all financial transactions currently tracked by the FDIC are federally related transactions. If the deminimis increases, that may diminish to 4%...... We simply didn’t know...”

John Brennan, the Appraisal Foundation --
Commercial Real Estate Risk Council Meeting – (notetaking - Doug Potts, presenter)
Baltimore MD – October 2016
Stress-Test Evaluation – Portfolio Tool

• Same asset – with its value from prior point of intake
• Value reliability established at loan origination
  • Now we measure only “change” rather than “value”
  • Minimizes numbers of inputs → increases reliability

• Tests a past appraisal’s crystal ball
  • Was the NOI forecast proved up by later performance?

• Tests a past appraisal’s editorial choices
  • What comps were available for consideration but not used
Relationship Value – Metrics Are Key

- Change (since loan inception) is a dynamic thing
  - Physical Condition
  - Market Forces
  - Asset’s Economic Performance
- Minimizing Risk - Maximizing Reliability
  - Risk scoring the stress test
  - Risk scoring the Asset
  - Risk scoring the Predictive Data
  - Risk Scoring the Predictive Model Algorithm
- Identify the “black swans”

Which way is it going?
How Can Appraisers Recapture the Market?

• Banks desperately need effective & efficient value consultation.
• Banks will find others who will do it – *and are looking*
• Should we eliminate mandatory rules linked to USPAP-only Standards?
  • Permit alternatives to USPAP -- provide flexible evaluations
• Become consultants again – reduce appraisal commoditization
• Bring appraisers out of the cold – take back our turf
• Support a more sustainable appraisal business model
• Stress-Test task segmentation will offer options in the war for talent
At the Evaluation Crossroad - Don’t Be Like This Guy

Thanks for Attending!
Merci pour votre présence!
Gracias por venir!
Danke fürs Kommen
謝謝你的到來！
와줘서 고마워！