NUMBERS, APPRAISAL REGS & LOWER STRESS

by Steve Brown

Did you know there are 293 ways to make change for a dollar? We bring this up not only because we enjoy numbers, but also since in Nov. of last year, the regulators came out with a 71 page proposal on changes to the appraisal process. This lengthy document was released primarily to clarify risk management principles around loan appraisals driven by heightened regulatory concern over loan credit quality. If you missed the proposed revision or simply couldn't bring yourself to read 71 pages during the holidays, have no fear because today we add it all up for you.

The guidelines are important for multiple reasons and the first of these is that they will supersede the 1994 Interagency Appraisal and Evaluation Guidelines (so we are talking about a comprehensive revamp of the existing rules). Next, the standards are from all regulators and apply to the entire financial industry. The third key point the regulators make is (they even say right up front in the proposal) that they are issuing the guidelines "to provide further clarification of supervisory expectations" for regulated institutions' appraisal and evaluation programs. When we read quotes like that it is pretty apparent to us a crackdown is coming, so reading 71 pages didn't seem that daunting when taken in perspective.

The proposed guidelines stress that banks should have an independent appraisal and evaluation program. Regulators want to be sure appraisals are not influenced by either the borrower or the loan production process.

Minimum appraisal standards apply and further clarification has been provided beyond the Uniform Standards of Professional Appraisal Practice ("USPAP"). USPAP is now the minimum and the proposal goes even further by indicating appraisals must be written in such a way to contain sufficient information to support the credit decision. That is pretty broad, but the point is that simply adhering to USPAP on a sophisticated loan structure is no longer enough. Appraisals must also provide additional discounts to the appraised value for construction or renovation property, partially leased buildings, non-market lease terms and tract developments with unsold units. In an effort to move further toward consistency, all appraisals must also be based upon the regulatory definition of "market value" and enhanced to incorporate real estate lending standards guidelines. Finally, appraiser licenses alone must no longer be the sole determinant of competency. Banks must take into account the appraiser's education, experience and incorporate other factors given the situation and based on loan type and complexity, etc.

When it comes to appraisal reports, it is still the appraiser's responsibility to comply with USPAP, but now the institution is responsible for complying with regulatory appraisal rules, which may be more onerous than USPAP minimums.

The proposal also requires banks to obtain more detailed evaluations to handle "higher risk" real estate transactions and "as its portfolio risk increases." Banks must also establish procedures for determining the appropriate use of evaluation alternatives for different transactions by considering the associated risk. In short, regulators want banks to have increasingly comprehensive appraisal reviews, wherever a transaction poses a higher credit risk to the institution.

On the good news front, the proposal allows banks (with prior regulatory approval) to use other techniques (such as automated tools or sampling methods) when performing pre-funding reviews of appraisals on lower risk lending activities. This allows banks to reduce costs, while capturing more up-to-date information.

The new guidelines also include a section emphasizing the importance of overall loan portfolio risk monitoring, inclusive of when to replace or update collateral valuations on existing loans. In that area, regulators want banks to consider the age of original appraisal, property type, current market conditions, use of the property, tool being used and other factors.

Finally, the guidelines focus on the board of directors, as well as policies and procedures. Specifically, regulators want boards to ensure independence of the person ordering, performing and reviewing appraisals, establish selection criteria, monitor ongoing performance of appraisal companies, ensure appraisals contain enough information to support each credit decision, make certain appraisals are reviewed in a timely fashion and set criteria to assess the validity of existing appraisals.

As we close, we leave you with another numerical thought as you absorb what you have just read. Studies show laughing lowers the level of stress. It is interesting then, that while children laugh an average of 300x per day, adults only laugh about 25x per day. The next time someone drops a 71 page regulatory document on your desk for review, give laughing a try.

BANK NEWS

Wells Fargo

The bank posted a $2.55B loss for the 4Q as it took on $11.2B in net loss from Wachovia. This included a $37.2B credit writedown, net chargeoffs of $1.2B and $4.2B used to boost credit reserves.

TARP

The NCUA is lobbying to use TARP to manage non-performing assets and for additional guarantees on deposits. Regulators have already guaranteed $1B of new capital for wholesale credit unions and $80B of uninsured deposits.