Real Estate Appraisals

by Steve Brown

We live in a world of instant updates; it happens in our personal and business lives, with a 24/7 news cycle and pundits in financial circles projecting the larger meaning of every miniscule hiccup in price of every financial instrument. There is one exception, though, and that is the basis of almost every bank's risk management and valuation assumptions. We are referring to real estate, of course. Nearly every community bank has a large portion of its asset base tied to real estate values. Note that we didn't just specify the loan portfolio because most holdings in securities portfolios are also based on real estate values (including mortgage backed securities, agencies and corporate bonds issued by financial companies).

As you ponder this, consider that it is clear the valuation of real estate is incredibly important to banks, and most specifically, community banks. But we can't just turn on the TV and get a true picture of what is happening in real estate. This is because real estate transactions occur relatively infrequently, and each property in each city or town is different, making a regular valuation, such as shares of stock, impossible.

Instead, banks are reliant on appraisals to determine how much money to lend a prospective borrower, and to determine whether that borrower's cash flows are sufficient. Property appraisals are based on the price of comparable properties that have been sold and this is where the remarkable real estate cycle of the last several years has created some difficulties. Bankers know the big issue with this process is timing and availability. This is because real estate transactions occur relatively infrequently, so in a rapidly changing market, whatever happened before is probably wrong or at least outdated. As the housing bubble began to show signs of strain in 2008, part of the problem was the fact that appraisals were based on comparables (which sold at higher prices) while prices were crashing quickly in the real world.

These days, as many markets begin to recover, appraisals are still a problem on the other side. Since they look to the past, they are still coming in quite low in many cases. This is especially true in markets where there have been lots of foreclosures and short sales that have bounced, and in markets that are seeing rapid investment flows. Just as inflated prices tend to perpetuate a bubble when prices are softening, low values make it difficult for new activity to find a footing with bankers because it doesn't pencil out when prices are rising rapidly.

The job of the appraiser is to identify the market value of a property. They must follow rules to do so and one key step is to look to recent sale history. That is true even if the only activity in an area has been distressed properties, with distressed values. Similarly, areas that have had very little activity at all can be difficult because finding so-called comparable properties is tricky. To be sure, appraisers don't set the market, but rather reflect what is happening in the market.

The Federal Financial Institutions Examination Council (FFIEC) that prescribes uniform regulations for banks and credit unions reported recently that the top 25 lenders reported 30k mortgage preapprovals last year vs. 102k in 2007. Part of the drop was attributed to lower than expected appraisals. Until there is enough activity in depressed markets to support higher prices, appraised values will lag, and activity will be restricted.

Regulators are interested in seeing up to date appraisals on commercial properties when real estate values fall quickly, because they are trying to figure out how big the hole may be and whether bank reserves and capital are adequate. Banks in improving markets should regularly update appraisals as well, in order to keep a good handle on recovery. Reliance on appraised values of real estate certainly presents a challenge to banks, but is an important part of risk management.

BANK NEWS

Shadow Banking

Bloomberg reports the shadow banking industry is about $60T.

Bluebird

Data released by American Express shows the credit card company has captured $1B on its Bluebird prepaid card offered at Walmart stores. Other metrics include 1mm new accounts captured this way, average card load of $1,000 per account and 87% of accounts are new to Amex.

Branch Activity

A Synergistics Research survey finds 19% of internet households have used RDC and among that group 40% say it has reduced their branch visits.

Facebook

SocialMedia reports while Facebook is the primary social network marketers use to get to customers, only 29% of businesses said their approach was effective.

Women

Research finds the average woman will outlive her spouse by up to 7Ys and 70% choose a new financial advisor within the 1st year after their spouse dies. Perhaps that is because a survey by National Financial finds 73% of women are unhappy with the way they are treated by the industry.

Small Business

The NFIB has found 64% of small businesses surveyed (2 to 200 employees) say they paid more in insurance premiums this year vs. 2012.

Customers

Community bankers should note a Schwab study finds 84% of women say an in person meeting with a financial advisor is an important part of establishing a financial relationship. Are you doing this?

Competition

Simple has launched a payments service called MoneyDrop that allows customers to send the first Bluetooth-enabled payment between one another.