

# Client Alert.

---

December 16, 2010

## Final Interagency Appraisal and Evaluation Guidelines

By Joseph Gabai

### BRIEF SUMMARY

On December 2, 2010, five federal banking agencies – the Office of the Comptroller of the Currency (OCC), Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS) and National Credit Union Administration (NCUA) (collectively, the “Banking Agencies”) – issued their long awaited revision to the Interagency Appraisal and Evaluation Guidelines (“Guidelines”) that were first issued in 1994. The Guidelines, which are applicable to regulated banking institutions, identify the components of a safe and sound program for performing appraisals and evaluations for real estate-related financial transactions. This Client Alert summarizes the Guidelines and discusses their ramifications.<sup>1</sup>

### HISTORY AND SCOPE

- The original Guidelines were jointly issued in October 1994 by the OCC, FRB, FDIC and OTS. Those Guidelines provided guidance on implementing the appraisal regulations promulgated in accordance with Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). See, e.g., 12 C.F.R. Part 34, subpart C (OCC regulations).
- The original Guidelines spawned various other pieces of supervisory guidance from one or more of the Banking Agencies. These include the 2003 Interagency Statement on Independent Appraisal and Evaluation Functions (see, e.g., OCC Advisory Letter 2003-9), the 2005 Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions (see, e.g., OCC Bulletin 2005-6), the 2005 Interagency FAQs on Residential Tract Development Lending (see, e.g., OCC Bulletin 2005-32), and the 2006 Interagency Statement on the 2006 Revisions to the Uniform Standards of Professional Appraisal Practice (see, e.g., OCC Bulletin 2006-27).
- As a result of continuing developments, technological changes, and challenges affecting the valuation of real estate interests, the Banking Agencies proposed a revision to the Guidelines on November 19, 2008 (see 73 Fed. Reg. 69647).
- On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) was enacted. Sections 1471-1476 of Dodd-Frank make significant changes to the federal regulatory framework for appraisals and valuations of real property. A detailed discussion of these provisions is found in our Dodd-Frank Residential Mortgage User Guide. See <http://www.mofo.com/files/Uploads/Images/ResidentialMortgage.pdf>. An interim final rule (“Interim Appraisal Rule”) to implement the appraisal and valuation independence provisions of Dodd-Frank, together with some related provisions, was issued by the FRB on October 18, 2010. See 75 Fed. Reg. 66554 (Oct. 28, 2010). The

---

<sup>1</sup> This Client Alert does not include a discussion of issues that pertain to credit unions.

## Client Alert.

---

Interim Appraisal Rule is effective on December 27, 2010 but compliance does not become mandatory until April 1, 2011. The Interim Appraisal Rule generally applies to all consumer credit transactions secured by a consumer's principal dwelling. A detailed summary of the Interim Appraisal Rule is found at <http://www.mofo.com/files/Uploads/Images/101101-Interim-Final-Rule-on-Real-Estate-Appraisals.pdf>.

- The revised Guidelines apply to all real estate-related financial transactions originated or purchased by a regulated institution for its own portfolio or as assets held for sale, including activities of commercial and residential real estate mortgage operations, capital markets groups, and asset securitization and sales units.
  - The regulated institutions that are governed by the Guidelines include: national or state-chartered banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, federal savings associations and their subsidiaries, federal savings and loan holding companies and their subsidiaries, and credit unions.
  - Unlike the Interim Appraisal Rule, which is limited to consumer credit transactions secured by consumers' principal dwellings, the revised Guidelines apply to all real estate-related financial transactions – consumer, commercial and industrial alike.
- The Guidelines are in a narrative format with four appendices. Appendix A provides guidance on the various exemptions to the general requirement for an appraisal by a state certified or licensed appraiser. Appendix B provides guidance on the use of evaluations that are based on analytical methods or technological tools, such as automated valuation models ("AVMs"). Appendix C provides guidance on the use of deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units. Appendix D contains a glossary of terms.
- The revised Guidelines became effective when they were published in the Federal Register on December 10, 2010. See 75 Fed. Reg. 77450. On a case-by-case basis, the applicable Banking Agency can provide some flexibility regarding the compliance date.
- With the issuance of the revised Guidelines, the following guidance documents have been rescinded: the original Guidelines issued in 1994, the 2003 Interagency Statement on Independent Appraisal and Evaluation Functions, and the 2006 Interagency Statement on the 2006 Revisions to the Uniform Standards of Professional Appraisal Practice. The following guidance documents remain in effect: the Interim Appraisal Rule, the 2005 Interagency FAQs on Residential Tract Development Lending, and the 2005 Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions. In addition, the Banking Agencies' appraisal regulations implementing FIRREA (see, e.g., the OCC regulations at 12 C.F.R. Part 34, subpart C) and the real estate lending regulations and guidelines issued under Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (see, e.g., the OCC regulations at 12 C.F.R. Part 34, subpart D and the guidelines at Appendix A to subpart D) remain in effect. Those real estate lending guidelines state that each institution's real estate lending program should include an appropriate real estate appraisal and evaluation program.
- While the Banking Agencies have taken Dodd-Frank into consideration in revising the Guidelines, there undoubtedly will be extensive rulemaking in the future to implement the appraisal and valuation provisions of Dodd-Frank. The federal banking agencies have acknowledged that further revisions to the Guidelines may be necessary to address these future regulations. In fact, it is highly likely that the Guidelines will require further revision. This "piecemeal"

# Client Alert.

---

approach to the development of implementing regulations and guidance – which we also have seen in other areas of Dodd-Frank – presents considerable challenges for regulated institutions.

## HIGHLIGHTS OF THE GUIDELINES AND ANALYSIS

### Supervisory Policy

- The Guidelines contain both regulatory requirements and prudent banking practices, and there is an effort to distinguish between the two. The extent to which examiners in the field will make these distinctions remains to be seen.
- The appropriateness of an institution's real estate appraisal and evaluation program will depend on the size, nature and risk profile of its real estate-related activities. For example, institutions that have significant real estate loan portfolios, that offer riskier loan products, that make complex commercial loans, that have experienced real estate loan losses, or that are thinly capitalized are expected to have more detailed and robust programs. The programs of these institutions likely will draw considerably more scrutiny from examiners.
- When an institution is examined, the examiner will focus on compliance with applicable regulations, supervisory guidance, and the institution's own policies and procedures. An institution that is found deficient will likely become subject to a formal or informal supervisory enforcement action.
- The Guidelines do not provide the final word on how institutions must develop and implement their real estate appraisal and evaluation programs. Federal law allows the Banking Agencies to impose additional appraisal standards if they determine that this is necessary for a particular institution. For example, the OTS requires all of its "troubled institutions" to obtain appraisals for all real estate-related transactions over \$100,000 (unless otherwise exempt), rather than applying the \$250,000 threshold that normally applies.
- If there is any overall lesson to be learned from the Guidelines, it is that strong appraisal and evaluation policies and procedures are critical. Faithful implementation of the policies and procedures, documentation of the rationale for decisions made, strong training, and effective monitoring all are essential. When the next real estate downturn occurs, it is safe to assume that examiners will give particular scrutiny to these items.

### Appraisal and Evaluation Program

- Every institution is responsible for establishing an effective real estate appraisal and evaluation program. The institution's board of directors, or a committee designated by the board, must adopt the program and review it periodically. Typically, this is done on an annual basis.
- At a minimum, the real estate appraisal and evaluation program must:
  - Provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.
  - Establish selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.
  - Ensure that appraisals comply with the Banking Agencies' appraisal regulations and are consistent with the Guidelines and other applicable supervisory guidance.

## Client Alert.

---

- Ensure that appraisals and evaluations contain sufficient information to support the credit decision.
- Maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
- Provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision.
- Develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.
- Implement internal controls that promote compliance with these program standards, including those related to monitoring third party arrangements.
- Establish criteria for monitoring collateral values.
- Establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the Banking Agencies' appraisal regulations.

Most of these items are discussed in more detail below.

### **Independence of the Appraisal and Evaluation Program**

- Independence in the appraisal and evaluation process is a central element of the Guidelines as well as Section 1472 of Dodd-Frank.
- Institutions are expected to develop independence in the following areas:
  - There must be independence between the appraisal and evaluation program and the institution's loan production staff.
    - The loan production staff includes all personnel responsible for generating loan volume or approving loans, their subordinates, and their supervisors. Included are any employees whose compensation is based on loan volume (such as processing or approving of loans). An employee is not considered part of the loan production staff just because part of his/her compensation includes a general bonus or profit sharing plan that benefits all employees. Employees responsible solely for credit administration or credit risk management are not considered loan production staff. This definition is similar to the definition of "loan production function" in the Interim Appraisal Rule. See Paragraph 226.42(d)(5)(i)-1 of the Federal Reserve Official Staff Commentary to Regulation Z.
  - The institution's reporting lines for its appraisal and evaluation program – including the ordering, reviewing, and acceptance of appraisals and evaluations – must be independent of the loan production staff.
  - Appraisers must be independent of the loan production and collection processes.
  - Appraisers must have no direct, indirect or prospective interest in the property being appraised or the transaction in question.

## Client Alert.

---

- The Guidelines provide some flexibility for small or rural institutions or branches, acknowledging that it is not always practical to separate the collateral valuation program from the loan production process in these institutions. In these instances, the institution bears the burden of demonstrating that it has safeguards in place to prevent the former from being influenced by the latter. Where another loan officer, other officer, or director of the institution is the only person qualified to analyze the real estate collateral, that person must not participate in the loan approval decision.
  - The Guidelines do not define the terms “small” or “rural” institutions or branches. If an institution believes it qualifies, it should discuss this with its regulatory agency.
  - Where an institution wishes to use the flexibility that this provision allows, it should have clear policies and procedures that are designed to show independence, provide appropriate training to its personnel, and monitor for compliance.
- Independence in the appraisal/evaluation process is addressed in considerable detail in the Interim Appraisal Rule. Some, but not all, of the principles underlying the Interim Appraisal Rule are contained in the Guidelines. While the Interim Appraisal Rule is generally limited to consumer credit transactions secured by a consumer’s principal dwelling, it is possible that examiners will consider its standards when determining whether an institution’s other real estate-related transactions have achieved sufficient independence.
- An institution’s policies and procedures should specify methods for communication between the collateral evaluation staff and the person performing the appraisal or evaluation, to ensure independence in the collateral valuation function.
- An institution may provide the appraiser or person performing an evaluation with a copy of the sales contract and exchange other information. However, this communication cannot cross the line and jeopardize the independence of the appraisal or evaluation process. An institution should develop policies and procedures that identify the types of communications that are permissible and the types of communications that are impermissible.
- Examples of permissible communications with an appraiser or person performing an evaluation include a request that the person:
  - Consider additional information about the property or comparable properties.
  - Provide additional supporting information about the basis for a valuation.
  - Correct factual errors.
- Examples of impermissible communications with an appraiser or person performing an evaluation include:
  - Communicating a predetermined, expected, or qualifying estimate of value, or a loan amount or target loan-to-value ratio to the person.
  - Specifying a minimum value requirement for the property that is needed to approve the loan or as a condition of ordering the valuation.
  - Conditioning the person’s compensation on loan consummation.

## Client Alert.

---

- Failing to compensate the person because a property is not valued at a certain amount.
  - Implying that current or future retention of the person's services depends on the amount at which the appraiser or person performing an evaluation values a property.
  - Excluding the person from consideration for future engagements because a property's reported market value does not meet a specified threshold.
- If the institution orders a second appraisal or evaluation, it should use the more credible of the two.
  - It is permissible for an institution to report an appraiser to a state regulator if the appraiser fails to comply with the Uniform Standards of Professional Appraisal Practice (USPAP), fails to comply with applicable laws or regulations, or engages in other unethical or unprofessional conduct. However, the institution may not threaten to make a report in an effort to coerce or exercise undue influence.

### **Selection of Appraisers or Persons Who Perform Evaluations – In General**

- An institution must have standards for the criteria, evaluation and monitoring of persons who perform appraisals and evaluations. The minimum criteria are as follows:
  - The person must possess the requisite education, expertise, and experience to handle the specific assignment for the type of property in question in the relevant geographic area.
  - The work performed by the person is periodically reviewed by the institution.
  - The person is capable of rendering an unbiased opinion.
  - The person is independent and has no direct, indirect, or prospective interest, financial or otherwise, in the property or the transaction.
  - An appraiser selected to perform an appraisal holds the appropriate state certification or license. Persons who perform evaluations should possess the appropriate appraisal or collateral valuation education, expertise, and experience relevant to the type of property being valued. Such persons may include – as appropriate – appraisers, real estate lending professionals, agricultural extension agents, or foresters.
- The institution or its agent – which can include an appraisal management company (“AMC”) – must directly select and engage an appraiser. The institution or its agent should directly select and engage a person who performs an evaluation.
  - An appraiser may never be selected or engaged by the borrower.
  - A borrower may not recommend the appraiser or person performing an evaluation.
  - The institution's loan production staff may not select or oversee the selection of an appraiser or person who performs an evaluation.
  - The Banking Agencies' regulations allow an institution to use an appraisal that was originally prepared for another “financial services institution” – that is, an entity that provides services in connection with real estate

## Client Alert.

---

lending transactions on an ongoing basis, including loan brokers – as more fully discussed below. If a borrower is aware of the existence of such an appraisal, the borrower may bring this to the attention of the institution, which will allow the institution to request the appraisal directly from the other financial services institution.

- An institution may not use an evaluation that was originally prepared for another financial services institution.
- The institution needs to document its compliance with the foregoing.

### **Selection of Appraisers or Persons Who Perform Evaluations – Approved Appraiser Lists**

- Institutions that establish approved appraiser lists need to have appropriate procedures for the development and administration of the lists.
- This includes a process for placing individuals on the list (including a review of their credentials and experience), monitoring their performance, and periodic review of the listing process to ensure independence.
- For residential transactions, it is permissible for the loan production staff to use a revolving pre-approved appraiser list, so long as the development and maintenance of the list is beyond their control.

### **Selection of Appraisers or Persons Who Perform Evaluations – Engagement Letters**

- The Guidelines state that engagement letters should be used, particularly for large, complex, or out-of-area commercial properties.
- Engagement letters define the scope and terms of the engagement and identify the intended user. In the case of an appraisal, the Guidelines state that an engagement letter typically may specify the following:
  - The property's location and legal description.
  - Intended use and users of the appraisal.
  - The requirement to provide an opinion of the property's market value.
  - The expectation that the appraiser will comply with applicable laws and regulations, and be consistent with supervisory guidance.
  - Appraisal report format.
  - Expected delivery date.
  - Appraisal fee.
- The institution's agent – including an AMC – can transmit the engagement letter on behalf of the institution.
- A copy of the engagement letter should be kept in the credit file.

# Client Alert.

---

## Transactions that Require Appraisals

- The general rule is that an appraisal performed by a state licensed or certified appraiser is required for any “federally related transaction,” a term that includes most real estate-related financial transactions. The Banking Agencies’ regulations provide 12 exemptions, and Appendix A of the Guidelines provide some gloss on those exemptions, as discussed below.
  - For purposes of the Banking Agencies’ appraisal regulations, the transaction value of a loan is the amount of the loan (including the full amount of any potential negative amortization – which will make it difficult for most negative amortization loans to appraise out at a sufficient level). The transaction value of a sale, lease, purchase, or investment in or exchange of real property is the market value of the real property interest in question. The transaction value for the pooling of loans or interests in real property for resale or purchase is the amount of the loan or market value of the real property calculated with respect to each loan or interest in real property.
- Appraisal Threshold
  - The current appraisal threshold is \$250,000, although a Banking Agency can establish a lower threshold for a specific institution.
  - For a transaction of \$250,000 or less, an evaluation is required.
  - In a single transaction secured by two or more properties that are not part of a tract development, the value of each property is estimated. For each property in excess of \$250,000, an appraisal is required. For each property of \$250,000 or less, an evaluation is required. The fact that the aggregate loan commitment exceeds \$250,000 is irrelevant.
  - Section 1473 of Dodd-Frank requires the new Bureau of Consumer Financial Protection (“Bureau”) to concur that the current \$250,000 threshold provides reasonable protection for consumers who purchase 1-4 family residences. This could lead to a reduction in the \$250,000 threshold for consumer, but not commercial, properties.
- Abundance of Caution
  - This limited exemption applies when the real estate lien is taken in an abundance of caution. The exemption cannot be used if the real estate is used in any manner to support the loan.
  - In the case of a business loan, the loan must be well supported by cash flow or non-real property collateral. The primary and secondary sources of repayment must be verified and documented.
  - If the loan is made on the basis of this exemption, but the borrower’s operating performance or financial condition subsequently deteriorates and the institution looks to the real property as a repayment source, an appraisal should be obtained (unless another exemption applies).

# Client Alert.

---

- Loan Not Secured by Real Estate
  - This exemption is limited to loan transactions. It does not apply to an institution's investment in real estate for its own use.
  - This exemption applies even if the proceeds of the loan are used to purchase or improve real estate.
- Liens for Purposes Other than the Real Estate's Value
  - As in the case of the abundance of caution exemption, this is a limited exemption. It allows the institution to take a lien on real estate to protect legal rights to or control over other collateral.
  - The exemption may not be used unless the value of the real estate is not necessary to support the loan.
  - The Guidelines provide the following example of the proper use of this exemption: An institution making a loan to a logging operation may take a lien against the real estate upon which the timber stands to ensure its access to the timber in the event of default.
- Real Estate-Secured Business Loan
  - This exemption applies to a business loan with a transaction value of \$1 million or less when the sale of, or rental income derived from, real estate is not the primary source of repayment. When this exemption applies, an evaluation is required.

A business loan is one made to a corporation, general or limited partnership, business trust, joint venture, syndicate, sole proprietorship, or other business entity.

- To use this exemption, the institution should document that the primary source of repayment is from the operating cash flow of the business, not the real estate.
  - This exemption cannot be used if an institution takes a security interest in property "A" but the primary source of repayment is the cash flow or sale of property "B," even if there is no security interest in property "B."
- Leases
    - This exemption applies when the lease is not the economic equivalent of a purchase or sale of the leased property. Many operating leases will fall into this category.
    - The exemption does not apply to a capital lease.
  - Renewals, Refinancings, and Other Subsequent Transactions
    - A qualifying renewal, refinancing, loan workout, or other subsequent transaction will require an evaluation rather than a new appraisal<sup>2</sup>. This exemption can apply in either of two ways.

---

<sup>2</sup> See further discussion below under Program Compliance, "Modifications and Workouts of Existing Credits."

## Client Alert.

---

- First, if 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.
  - To use this exemption, the current or planned future use of the property should be consistent with the use identified in the existing appraisal or evaluation. For example, the Guidelines state that if a property has reportedly increased in value because of a planned change in use due to rezoning, a new appraisal should be performed unless another exemption applies.
- Second, if there is no advancement of new monies, other than funds necessary to cover reasonable closing costs.
  - With this second form of this exemption, it does not matter if there has been an 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.
  - In general, an institution is considered to have advanced new money where there is an increase in the principal amount of the loan over the principal outstanding before the renewal or refinancing. For this purpose, the original principal balance is not relevant.
  - However, the renewal of a line of credit at its original amount is not treated as the advance of new money, regardless of the amount outstanding at the time of the renewal.
  - If an institution advances money to protect its interest in the property, such as to repair damage, a new appraisal or evaluation should not be required because the funds will be used to restore the damaged property to its original condition. However, other safety and soundness considerations may bear on whether it is appropriate to advance the money for this purpose.
- Where this exemption applies, the institution may fulfill the evaluation requirement through the use of an existing appraisal or evaluation so long as the institution verifies and documents that it is still valid.
- While the foregoing rules apply to loan workouts or restructurings, the Guidelines admonish that the quality of the collateral and validity of the underlying appraisal or evaluation should be considered.
  - If a workout involves acceptance of new real estate collateral, an appraisal or evaluation of the existing and new collateral may be prudent, even if it is obtained after the workout occurs and the institution has perfected its security interest.
- Transactions Involving Real Estate Notes
  - This exemption applies to transactions involving the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities. If each note or real estate interest meets the Banking Agencies' regulatory requirements for appraisals at the time the real estate note was originated, the institution need not obtain a new appraisal to support its interest in the transaction.

## Client Alert.

---

- The Guidelines state that the institution should audit a representative sample to make sure that the exemption is, in fact, available.
- Even where this exemption does apply, the institution is still required to determine and document the suitability of the investment.
- In the case of the purchase of a marketable mortgage-backed security, the institution may presume that the underlying loans met the appraisal requirement when the issuer so represents in a prospectus or other public statement. The Guidelines do not state whether this presumption is rebuttable.
- If the institution is providing a warehouse line, and the underlying mortgages are sold to Fannie Mae or Freddie Mac, that sale may be used to demonstrate that the mortgages complied with the appraisal requirement. However, monitoring is required. Also, if the warehouse borrower experiences more than a minimal number of put-backs, more sampling would be expected.
  - On its face, this special treatment is limited to loans sold to Fannie Mae or Freddie Mac. It does not apply to loans sold to private investors, which means that the warehouse lender will need to find a different way to demonstrate compliance. This might include appropriate auditing of the underlying loans.
- Transactions Wholly or Partially Insured or Guaranteed by a U.S. Government Agency or U.S. Government-Sponsored Agency
  - To qualify for this exemption, the transaction must meet all of the underwriting and appraisal requirements of the federal insurer or guarantor.
- Transactions that Qualify for Sale to, or Meet the Appraisal Standards of, a U.S. Government Agency or U.S. Government-Sponsored Agency
  - This exemption can apply in either of two ways.
  - First, where the transaction qualifies for sale to a U.S. government agency or U.S. government-sponsored agency.
    - The government-sponsored agencies include the Banks for Cooperatives; Federal Agriculture Mortgage Corporation; Federal Farm Credit Banks; Federal Home Loan Banks; Freddie Mac; Fannie Mae; and the Tennessee Valley Authority.
    - The institution should maintain adequate documentation that confirms that the transaction qualifies for sale. In the absence of this documentation, the exemption is not available.
  - Second, a residential real estate transaction in which the appraisal conforms to Fannie Mae or Freddie Mac appraisal standards applicable to that category of real estate.
    - This exemption also applies to jumbo loans that exceed the conforming loan limit, so long as the Fannie or Freddie appraisal requirement is met and documented.

# Client Alert.

---

- Transactions by Regulated Institutions as Fiduciaries
  - This exemption applies where the institution is acting in a fiduciary capacity.
  - However, if an appraisal is required by some other law governing the fiduciary relationship, then an appraisal will be necessary. In that instance, the appraisal must meet the requirements of both the applicable Banking Agency's appraisal regulations as well as the requirements of the other law.
- Appraisals not Necessary To Protect Federal Financial and Public Policy Interests or the Safety and Soundness of Financial Institutions
  - This exemption, rarely applicable, is provided on a case-by-case basis by the applicable Banking Agency. The institution must obtain a waiver before entering into the transaction.

## Minimum Appraisal Standards

- The Guidelines impose the following minimum standards for an appraisal.
- Conform to USPAP, unless safe and sound banking principles impose a higher standard.
  - For example, the appraisal must contain an opinion of market value and meet the more stringent Banking Agency independence requirements.
  - An AVM, by itself or as signed by an appraiser, does not qualify as an appraisal.
  - Under Section 1473 of Dodd-Frank, a broker price opinion may not be used as the primary basis to determine the value of a consumer's principal dwelling in connection with a loan to purchase that property.
- Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction.
  - The scope and detail of the appraisal should be appropriate for the risk and complexity of the transaction.
  - The appraisal report must contain sufficient information to enable the intended user to understand the report properly.
  - The appraisal report should disclose the inspection and research performed by the appraiser to verify the property's condition and support the appraised value.
    - Section 1471 of Dodd-Frank imposes a "super appraisal" requirement for certain "higher-risk" mortgage loans secured by the borrower's principal dwelling. Where Section 1471 is applicable, the appraiser must conduct a physical inspection visit of the interior of the property.
- 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. Deductions and discounts are covered in Appendix C of the Guidelines and are summarized below.

## Client Alert.

- The appraisal must reflect the “as is” value of the property as of the effective date of the appraisal. If the highest and best use of the property is for development to a different use, the cost of demolition and site preparation should be considered in the analysis.
- Proposed Construction or Renovation. The institution may request prospective market values upon completion and stabilization. The sum of retail sales for a proposed development may also be requested, but this is not the market value.
- Proposed and Partially Leased Buildings. The appraiser must make appropriate deductions and discounts (e.g., leasing commission, rent losses, tenant improvements, and entrepreneurial profit), to reflect that the property has not achieved stabilized occupancy. The appraisal should also include consideration of the absorption of the unleased space.
- Non-Market Lease Terms. If the leases do not reflect current market conditions, the appraisal must state the ownership interest being appraised and discuss the lease terms. In an appraisal of a leased fee interest where the contract rent is less than market, the market value of the leased fee interest should be used.
- Tract Developments with Unsold Units. This applies to projects of five or more units that are or will be constructed as a single development. The appraisal must reflect appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. The projected sales prices and absorption rate of the units should be supported and discussed in the appraisal report.
  - Raw Land. Raw land must be valued based on its current condition and zoning. If the appraisal uses a development approach that is based on projected sales, appropriate deductions and discounts must be taken for costs (e.g., feasibility studies, permitting, engineering, holding costs, marketing costs, and entrepreneurial profit) incurred during all stages of development (e.g., permitting, construction, and selling). If sufficient market data exists to perform both the sales comparison and developmental approaches to value, the appraisal report should reconcile the two approaches in arriving at a market value.
  - Developed Lots. The appraiser must analyze and report appropriate deductions and discounts (e.g., holding costs, marketing costs, and entrepreneurial profit) during the sales absorption period. The estimated sales absorption period should be realistic, start on the effective date of the valuation and end on the expected date of the last lot sale.
  - Attached or Detached Single-family Homes. The appraiser must analyze and report appropriate deductions and discounts (e.g., holding costs, marketing costs, and entrepreneurial profit) during the sales absorption period. However, if the institution finances construction on an individual unit basis, appraisals of the individual units may be used if an independent feasibility market analysis shows that all of the units can be constructed and sold within 12 months. If any of the units are not constructed and sold within 12 months, an appraisal of the development (including appropriate deductions and discounts) will be required.
  - Condominiums. The appraiser must analyze and report appropriate deductions and discounts (e.g., holding costs, marketing costs, and entrepreneurial profit) during the sales absorption period. If the

# Client Alert.

loan is to construct a single condominium building with less than five units, or a condominium project with multiple buildings with less than five units per building, appraisals of the individual units may be used if an independent feasibility market analysis shows that all of the units can be constructed and sold within 12 months. If any of the units are not constructed and sold within 12 months, an appraisal of the development (including appropriate deductions and discounts) will be required.

- Values must be based on the definition of market value set forth in the applicable Banking Agency appraisal regulation.
  - Value opinions such as “going concern value,” “value in use,” or a special value to a specific property user may not be used as the market value for regulatory purposes.
  - The property’s actual physical condition, use, and zoning should be considered as of the effective date of the appraiser’s opinion of value.
  - For the financing of the construction or renovation of a building, the appraiser should determine current market value of the property in an “as is” condition and, as applicable, its prospective market value upon completion and/or prospective market value upon stabilization.
- The appraisal must be performed by a state certified or licensed appraiser in accordance with requirements set forth in the applicable Banking Agency appraisal regulations.
  - A state certification or license is the minimum credential required. Beyond this, the institution must determine the competency of the appraiser based on his/her experience and knowledge of the type of property in question and the relevant market.
  - The minimum standards for the appraisal should be communicated to the appraiser. This can be done in an appraisal engagement letter.

## Appraisal Development

- The Banking Agencies’ appraisal regulations require appraisals that comply with USPAP, except where the regulations impose a higher standard. USPAP, in turn, imposes a number of requirements on the appraisal and the appraiser. For example, the appraisal must reflect an appropriate scope of work that provides for a credible result. The requirements of USPAP are generally not discussed in this Client Alert.
- While the appraiser is responsible for adhering to USPAP when performing an appraisal for an institution, the institution bears responsibility for obtaining appraisals that are, in fact, compliant with USPAP and the appraisal regulations. For example, the institution is responsible for obtaining an appraisal that contains sufficient information and analysis to support its decision to engage in the transaction. The Guidelines also state that the institution should discuss its needs and expectations for the appraisal with the appraiser.

## Appraisal Reports

- While USPAP recognizes various appraisal report options that reflect different levels of detail, the institution is responsible for identifying the appropriate appraisal report option to support its credit decisions.

## Client Alert.

---

- The Guidelines state that an institution should consider the risk, size, and complexity of the transaction and the real estate collateral when determining the appropriate appraisal report format, and that the institution should identify the selected format for the appraiser.
  - For example, and to state the obvious, a more detailed and in-depth appraisal report will be expected for a \$300 million mixed use office building than a \$200,000 single family home.
- The Guidelines also state that a report option that is restricted to a single client and intended user generally will not be appropriate to support most federally related transactions because it will lack sufficient supporting information and analysis. However, this type of report may be suitable for monitoring purposes.

### Transactions that Require Evaluations

- The Banking Agencies' appraisal regulations identify transactions in which an evaluation, rather than a formal appraisal, will suffice. These are discussed in more detail above.
- Nevertheless, the Guidelines state that an institution should have policies and procedures that dictate when an appraisal should be used for a transaction even where the regulations would, on their face, otherwise allow the use of an evaluation. Generally, these policies should mandate an appraisal when the applicable risks compel this result. Examples include:
  - Loans with combined loan-to-value ratios in excess of the supervisory loan-to-value limits. See, e.g., 12 C.F.R. Part 34, subpart D, Appendix A (OCC).
    - In the case of a loan to purchase an existing property, "value" means the lesser of (i) the actual acquisition cost, or (ii) the valuation of the property by an appraisal or evaluation, as appropriate.
  - Atypical properties.
  - Properties outside the institution's traditional lending market.
  - Transactions involving existing extensions of credit with significant risk to the institution.
  - Borrowers with high risk characteristics. This does not necessarily include all nontraditional mortgages and subprime loans.

In addition, see Section 1471 of Dodd-Frank, which imposes a "super appraisal" requirement for certain higher-risk mortgage loans secured by a principal dwelling. This requirement is imposed even if the loan is for \$250,000 or less, which ordinarily only requires an evaluation. In some instances, a second appraisal must be prepared, and the cost of the second appraisal may not be imposed on the borrower.

### Evaluation Development

- An evaluation must be consistent with safe and sound banking practices and should support the institution's decision to engage in the transaction.

# Client Alert.

- The Guidelines state that an institution should be able to demonstrate that an evaluation provides a reliable estimate of market value as of a stated effective date prior to the decision to enter into a transaction.
- A valuation method that provides a sales or list price cannot be used as an evaluation because it does not provide a property's market value.
  - The Guidelines define a BPO as an “estimate of the probable sales or listing price of the subject property provided by a real estate broker, sales agent, or sales person.” The Guidelines specifically state that a BPO may not be used as an evaluation. This seems inconsistent with the original Guidelines issued in 1994, which, although they did not mention BPOs by name, stated explicitly that evaluations may be performed by “real estate . . . sales persons.” It also seems inconsistent with Section 1474 of Dodd-Frank, which specifically references the use of BPOs in Section 701(e) of the federal Equal Credit Opportunity Act, suggesting that BPOs can be used for some first lien dwelling loans.
  - As noted above, Section 1473 of Dodd-Frank prohibits the use of BPOs as the primary basis for determining the value of property for a loan to purchase a consumer's principal dwelling. But even this provision suggests, by negative implication, that BPOs may be used for other valuation purposes.
  - The Guidelines state that a BPO could be used for monitoring the collateral value of an existing loan.
- Information on local housing conditions and trends (e.g., a competitive market analysis) is not an acceptable evaluation because it contains insufficient information on the specific property.
- An institution should establish policies and procedures for determining what type of evaluation will be appropriate for a particular transaction. This should be a risk-focused determination.
- The evaluation should address the property's actual physical condition and characteristics as well as relevant economic and market conditions.
  - It unacceptable to use unsupported assumptions, such as that a property is in “average” condition.
  - The Guidelines state that an institution should consider performing an inspection to ascertain the actual physical condition of the property. When an inspection is not performed, the institution should be able to demonstrate how the property and market factors were determined. This suggests that, as a practical matter, AVMs may need to be combined with some kind of inspection in order to be “bankable” as evaluations.

## Evaluation Content

- An evaluation should contain sufficient information to support the credit decision. An evaluation's content should be documented in the credit file or reproducible.
- Minimum requirements for an evaluation include the following:
  - Location of the property.
  - Description of the property and its current and projected use.

## Client Alert.

---

- Estimate of the property's market value in its actual physical condition, use and zoning designation as of the effective date of the evaluation. This means the date that the analysis was completed. Any limiting conditions must be stated.
- The methods used to confirm the property's actual physical condition and the extent to which an inspection was performed.
- The analysis that was performed and the supporting information that was used in valuing the property.
- The supplemental information that was considered when using an analytical method or technological tool.
- All sources of information used in the analysis, as applicable, to value the property, including:
  - External data sources, such as market sales databases and public tax and land records.
  - Property-specific data, such as previous sales data for the subject property, tax assessment data, and comparable sales information.
  - Evidence of a property inspection.
  - Photos of the property.
  - Description of the neighborhood.
  - Local market conditions.
- When an evaluation is performed by a person:
  - The name and contact information of the preparer.
  - Other relevant information on the preparer.
  - Signature of the preparer, which may be an electronic or other legally permissible signature.
- See discussion below for additional guidance on AVMs and other analytical methods and technological tools.

### Validity of Appraisals and Evaluations

- When an appraisal or evaluation is still valid, it may be used for a subsequent transaction. An institution needs to establish criteria that it can use to determine whether an appraisal or evaluation is still valid. This is not simply a question of the age of the appraisal or evaluation, but rather requires a consideration of the condition of the property, changes in the market, and the nature of the transaction.
- The decision to re-use an existing appraisal or evaluation is necessarily subjective in nature because it requires consideration of a variety of factors, which may be weighed differently from one transaction to the next. The key to success here is having policies and procedures that provide guidance regarding the decision to re-use. If a decision is made to re-use an appraisal or evaluation, the credit file must document support for that decision.

# Client Alert.

---

- The Guidelines state that a new appraisal or evaluation is required if market value has changed due to various factors, including the following:
  - Passage of time.
  - Volatility of the local market.
  - Changes in terms and availability of financing.
  - Natural disasters.
  - Limited or oversupply of competing properties.
  - Improvements to the subject property or competing properties.
  - Lack of maintenance of the subject or competing properties.
  - Changes in underlying economic and market assumptions, such as capitalization rates and lease terms.
  - Changes in zoning, building materials, or technology.
  - Environmental contamination.

## Reviewing Appraisals and Evaluations

- An appraisal or evaluation must be reviewed before the final credit decision to make sure that it is compliant with the Banking Agencies' regulations and guidance and the institution's own policies and procedures. This does not necessarily mean that a formal review appraisal/evaluation must be performed, but rather that the institution must take steps to satisfy itself that it is appropriate to rely on the appraisal/evaluation.
- If the review leads to a conclusion that the appraisal or evaluation contains deficiencies, the next step is to determine if the deficiencies can be fixed. If they can, the appraisal or evaluation can be used. If the deficiencies cannot be repaired, the appraisal or evaluation cannot be used, and it will be necessary for the institution to obtain a compliant appraisal or evaluation before making a credit decision. In any event, the file should document the determination made and the support for that determination.
- A person reviewing an appraisal or evaluation may not change the market value conclusion. However, if a formal appraisal review is performed by a state certified or licensed appraiser in accordance with USPAP, the review may result in a second opinion of market value, and the institution may rely on that second opinion to support a credit decision. The review appraiser must be qualified and competent to review an appraisal for the type of property in the geographic market in question.
- The Guidelines identify four factors that, at a minimum, an institution should consider when reviewing an appraisal or evaluation. These are discussed below.

# Client Alert.

---

- Reviewer Qualifications
  - An institution needs to establish qualifications for persons who review appraisals and evaluations. For the most part, these individuals must meet criteria that are similar to those that apply to the appraiser or person performing the evaluation – independent from the transaction; no interest in the property or transaction; insulated from the loan production staff; and possessing of the requisite education, expertise, and competence.
  - As in the case of performing an appraisal, the Guidelines provide some flexibility for small or rural institutions or branches with limited staff. If absolute independence cannot be achieved, reviews nonetheless may be performed if appropriate safeguards can be implemented. The Guidelines state that the review may be part of the originating loan officer’s overall credit analysis, as long as the originating loan officer abstains from directly or indirectly approving or voting to approve the loan.
  - An institution needs to assess the expertise of its personnel in order to determine if they have the competence to perform the review. This is particularly necessary for the review of complex projects, high-risk transactions, and out-of-market properties. An institution may retain a third party to perform the review, but remains responsible for all aspects of the review process.
- Depth of Review
  - The depth of the review that is necessary will depend on the risk that is associated with the transaction.
  - Commercial Real Estate. Transactions that are complex, involve large dollar amounts, are secured by specialized or unusual properties, or outside the institution’s traditional lending market have a higher risk and will require a deeper review process. The institution needs to have policies and procedures that specify the depth of the review that will be required.
  - 1-to-4 Family Residential Real Estate. Once again, a risk-focused approach is necessary to determine the depth of review that will be required.
    - Among others, these risk factors could include debt-to-income ratios, loan-to-value ratios, level of documentation, and loan amount.
    - A review may consist of an AVM, other automated tool, or a sampling method. The Guidelines state that these require the prior approval of the institution’s primary federal regulator and may only be used for “lower risk” loans. The institution needs criteria to identify when a deeper review is necessary. If any of these methods are used, the institution still needs to make sure that the quality of the appraisers and persons performing evaluations is periodically reviewed.
    - If an institution is buying I-4 family residential loans, it may use sampling and audit procedures to confirm the seller’s representations and warranties regarding the compliance of the underlying appraisals. If the audit does not confirm compliance, the institution must obtain appraisals before purchasing the loans.

## Client Alert.

- Appraisals From Other Financial Services Institutions. The Banking Agencies' regulations allow an institution to use an appraisal that was originally prepared for another "financial services institution" – that is, an entity that provides services in connection with real estate lending transactions on an ongoing basis, including loan brokers. The appraisal must comply with those regulations and otherwise be acceptable.
  - The institution should use the review to determine whether it will use the other institution's appraisal before making the credit decision.
  - The review of such an appraisal should be at least as deep as the reviews the institution gives to its own appraisals.
  - The institution should confirm that the appraiser was engaged directly by the other institution, the appraiser had no interest in the property or transaction, and that the other institution or its agent (not the borrower) ordered the appraisal.
  - An altered or readdressed appraisal from another financial services institution may not be used.
  - The documentation for the review should support the decision to rely on the other financial services institution's appraisal.
  - As noted above, an institution may not use an evaluation that was originally prepared for another financial services institution.
- Resolution of Deficiencies
  - An institution needs to have policies and procedures to govern its resolution of inaccuracies or weaknesses in an appraisal or evaluation.
  - The policies and procedures should cover the following:
    - Communication of the deficiency, which needs to be done in a manner that does not become coercive or jeopardize the independence of the valuation process.
    - If there is a significant deficiency in an appraisal that cannot be properly resolved with the original appraiser, the need to obtain a new appraisal or rely upon a compliant formal review appraisal. Review appraisals must comply with Standards Rule 3 of USPAP. See discussion above regarding the qualifications of review appraisers.
    - If an evaluation is not credible or sufficiently supported, the need to obtain a new evaluation.
- Documentation of the Review
  - As noted above, an institution needs to have policies and procedures for documenting all aspects of the review process.
  - These policies and procedures need to cover the level of required documentation based on the institution's risk-focused approach, the resolution of deficiencies, and any audit trail.

# Client Alert.

---

## Third Party Arrangements

- It is permissible to outsource one or more valuation functions, for both appraisals and evaluations, to a third party. However, the institution retains responsibility for the resulting appraisal or evaluation, as well as for compliance with applicable supervisory regulations and guidance.
- Before engaging a third party, the institution must have the infrastructure necessary to identify, monitor and manage the resulting risks. Effective due diligence is required before the relationship is initiated. The institution should have a written contract with the third party that sets forth the terms of the relationship. The contract and relationship should meet Banking Agency standards for outsourcing. See, e.g., FFIEC Statement on Risk Management of Outsourced Technology Service (Nov. 28, 2000); OCC Bulletin 2001-47, Third-Party Relationships (Nov. 1, 2001); OTS Thrift Bulletin 82a, Third Party Arrangements (Sept. 1, 2004); and FDIC Financial Institution Letter 44-2008, Guidance for Managing Third-Party Risk (June 2008).
- The institution is responsible for making sure that the appraisers and persons performing evaluations meet regulatory standards as well as the institution's own standards. While all of this can be covered in the contract that governs the outsourced relationship, the Guidelines make clear that the institution is obligated to monitor the third party's performance and periodically assess the overall relationship with the third party.
- If deficiencies are found in the third party's performance, the institution is responsible for fixing the problem. At a certain level of poor performance, the institution will be expected to terminate the relationship.

## Program Compliance

- As part of its compliance function, an institution is expected to have internal controls to support an effective appraisal and evaluation program. The program must test every aspect of the appraisal and evaluation process for compliance. The Guidelines state that the results of the institution's review process should be taken into consideration in making future appraisal and evaluation assignments.
- **Monitoring Collateral Values.** An institution is required to monitor collateral values on both an individual loan and portfolio basis. The key here is to have policies and procedures that govern the monitoring program, and then to faithfully implement those policies and procedures. Examiners retain the right to require an institution to obtain a new appraisal or evaluation where appropriate.
- **Portfolio Collateral Risk.** Policies and procedures for monitoring portfolio collateral risk should identify when it is appropriate to obtain new or updated appraisals and evaluations. The relevant factors include the condition of the loan and changes in market conditions. It is necessary to consider both the individual and aggregate effect of changes in market conditions on the portfolio. In addition, the policies and procedures should require the conveyance of information to management on a timely basis and identify what type of valuation will be obtained, given the risks and circumstances.
  - The Guidelines provide the following examples of techniques for monitoring the effect of collateral valuation trends on portfolio risk: external market data, internal data, and reviews of recently obtained appraisals and evaluations.

# Client Alert.

- **Modifications and Workouts of Existing Credits.** An institution is expected to consider the current value of a property when undertaking a loan modification or loan workout. However, the Guidelines treat these situations quite differently.
  - **Loan Modifications.** The Guidelines define a loan modification to mean limited change(s) to the terms of the loan that do not adversely affect the institution's collateral protection. Examples include an interest rate decrease (and the corresponding payment decrease) or a single payment extension of a limited or short term nature. Loan modifications are not treated as new transactions and a new appraisal or evaluation is not required. However, the institution should understand its collateral risk. In this regard, the Guidelines state that an AVM or other valuation method would be appropriate. Note that other safety and soundness principles will apply to the loan modification, such as the need to underwrite and document the transaction properly.
  - **Loan Workouts.** More significant changes to address the problems with a loan are treated by the Guidelines as a loan workout. Examples include a modification that adversely affects the institution's collateral protection, a renewal or extension of loan terms, the advance of new money, or a restructuring of the loan (including those without concessions). Loan workouts are characterized as new transactions. See discussion above regarding when an appraisal or evaluation will be required.
  - **Collateral Valuation Policies for Modifications and Workouts.** An institution's policies and procedures need to state when an appraisal or evaluation will be required for a loan modification or workout, and which type of valuation method will be employed in particular circumstances. The Guidelines state that when repayment of a loan becomes more dependent upon the sale of the collateral, it may be necessary to obtain an appraisal as a matter of safety and soundness, even if this is not specifically required by the applicable Banking Agency regulations. In any event, as noted above, examiners continue to have the right to require an institution to obtain a new appraisal or evaluation where appropriate.

## Referrals

- An institution is expected to file a complaint with the appropriate state appraiser regulatory officials when it suspects that a state certified or licensed appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct.
  - Section 1472 of Dodd-Frank contains a mandatory reporting requirement for transactions involving principal dwellings. This requirement has been implemented by the Interim Appraisal Rule. See 12 C.F.R. § 226.42(g).
  - Note that an institution that files a complaint is not protected by the Guidelines from defamation or other claims. This lack of protection emphasizes the need to develop detailed policies and procedures relating to filing.
- A suspicious activity report (SAR) must be filed with FinCEN when required by applicable regulations. These regulations discuss certain safe harbor protections that are provided for banks that make these filings. See, e.g., 12 C.F.R. § 21.11 (OCC regulation).
- The Guidelines direct examiners to take action if an institution has not filed appropriate complaints.

# Client Alert.

---

## Evaluations Based on Analytical Methods or Technological Tools

- The Guidelines confirm that a variety of analytical methods and technological tools may be used to develop an evaluation. The institution bears the responsibility for demonstrating that any evaluation method or tool used is consistent with safety and soundness and the Guidelines. The Guidelines warn that an evaluation method or tool should not be selected solely because it provides the highest value, lowest cost, or fastest turnaround time.
  - Issues regarding two specific types of evaluation tools – AVMs and tax assessment valuations – are separately discussed below.
- The Guidelines provide some guidance on what constitutes an acceptable evaluation. Valuation methods or tools that do not contain sufficient information and analysis, or provide a market value conclusion, will not be acceptable as evaluations. The Guidelines specifically state that the use of data from the Internet or other public sources, without more, will not qualify as an evaluation. As discussed above, the Guidelines also specifically state that a BPO may not be used as an evaluation.
- An institution needs to have policies and procedures that govern its use of the evaluation methods or tools that it employs. Institutions also need to have internal controls to verify that the policies and procedures are being followed. The Guidelines state that the policies and procedures should do the following:
  - Ensure that the institution’s staff has the competence to manage the selection, use, and validation of the evaluation method or tool. If necessary, the institution needs to hire additional staff or retain a third party to do this.
  - Address the selection, use, and validation of the evaluation method or tool.
  - Establish criteria for determining whether a particular evaluation method or tool is appropriate in particular circumstances, given the pertinent risks.
  - Establish criteria under which an evaluation method or tool should not be used.
  - Create standards for using multiple methods or tools to value the same property or to support a particular lending activity.
  - Make sure that the evaluation method or tool produces a reliable estimate of market value.
  - Address the extent to which:
    - An inspection or research is necessary to determine the property’s actual physical condition.
    - Supplemental information is needed.

## Automated Valuation Models

- Use of AVMs
  - Appendix B of the Guidelines confirms again that AVMs may be used for a variety of purposes, including loan underwriting and portfolio management.

## Client Alert.

- An institution bears the responsibility for demonstrating that use of an AVM is consistent with safety and soundness and the Guidelines.
- Consistent with the discussion above, the Guidelines state that an AVM will qualify as an evaluation only if it addresses the property's actual physical condition. An AVM that simply assumes that the property is in average condition will not qualify. Once again, this suggests that, as a practical matter, AVMs may need to be combined with some kind of inspection in order to be "bankable" as evaluations.
- An institution needs to have policies and procedures that govern its use of AVMs as evaluations. See discussion above regarding the content of the policies and procedures.
- Selecting an AVM
  - The Guidelines state that an institution should do the following when selecting an AVM or multiple AVMs:
    - Perform the necessary level of due diligence on the AVM vendors and their models. This includes a review of how the AVM developer conducted performance testing, the sample size used, and the geographic level tested (e.g., county level or zip code).
    - Establish acceptable minimum performance criteria for a model prior to and independent of the validation process.
    - Perform a detailed validation of the AVM model(s) considered during the selection process. This should be documented.
    - Evaluate data used in the AVM model(s), including the data sources and types, frequency of updates, quality control performed on the data, and the sources of the data in states where real estate sales data are not publicly disclosed.
    - Assess AVM modeling techniques and the inherent strengths and weaknesses of different model types (e.g., hedonic, index, and blended) as well as how models perform for different property types (e.g., condominiums, planned unit developments, and single family detached residences).
      - The Guidelines state that "hedonic" models generally use property characteristics (such as square footage and room count) and methodologies to process information, often based on statistical regression. "Index" models generally use geographic repeat sales data over time rather than property characteristic data. "Blended" or "hybrid" models use elements of both hedonic and index models.
    - Evaluate the vendor's scoring system and methodology for the AVM model(s). Determine whether the scoring system provides an appropriate indicator of model reliability by property types and geographic locations.
  - An institution's policies and procedures also need to address the monitoring of the AVM and the ongoing validation processes for the AVM.

# Client Alert.

- Determining AVM Use. An institution needs to develop policies and procedures to determine if an AVM may be used for a specific transaction. The Guidelines state that an institution should do the following in making this determination:
  - Maintain AVM performance criteria for accuracy and reliability in a given transaction, lending activity, and geographic location. The Guidelines state that an institution should establish a level of acceptable core accuracy and limit exposure to a model's systemic tendency to overvalue properties (known as "tail risk").
  - Establish internal confidence score minimums, or similar criteria, for when each AVM model can be used.
    - A "confidence score" generally refers to the AVM vendor's own method of quantifying how reliable a model value is by using a rank ordering process.
    - The scale and components of a confidence score are not standardized. An institution needs to understand how a confidence score was derived and the extent to which a confidence score correlates to model accuracy.
    - If multiple AVMs are used, an institution should understand how the combination of models affects overall accuracy.
  - Implement controls to prevent "value shopping" when more than one AVM is used for the same property.
    - Although the term "value shopping" is not defined, in this context it appears to refer to the practice of obtaining multiple AVMs in order to use the one that produces the highest property value.
  - Establish procedures for obtaining an appraisal or a different type of evaluation when the value determined by an AVM is not reliable.
    - The Guidelines provide the following example: In an area that has experienced a high incidence of fraud, an institution should consider whether an AVM produces reliable values.
  - Identify circumstances under which an AVM may not be used. The Guidelines provide the following examples:
    - When market conditions warrant, such as during the aftermath of a natural disaster or a major economic event.
    - When an AVM model's performance is outside of specified tolerances for a particular geographic market or property pricetier range
    - When a property is nonhomogeneous, such as atypical lot sizes or property types.
- Validating AVM Results
  - An institution needs to develop and implement standards and procedures for independent, ongoing monitoring and validation of an AVM. At bottom, the purpose of this testing is to make sure that the AVM continues to produce reliable results. In this regard:
    - The orientation of the testing effort must be risk-focused.

## Client Alert.

- An institution can do its own testing or outsource the testing to a third party. In either event, the persons performing the testing must be qualified and independent of (i) the AVM development and sales function, and (ii) the loan production and collection process.
- Even if an institution is relying on an AVM vendor's validation representations, the institution is obligated to take steps on its own to verify the accuracy of the testing. The institution can do this itself or outsource to a third party.
- If an institution is relying on insurance or a guarantee relating to the AVM model's performance, it is obligated to understand the extent or limitations of the insurance or guarantee and the claims process. Also, the institution is responsible for ascertaining the financial strength of the insurer or guarantor, and its ability to pay claims.
- The Guidelines state that, at a minimum, an institution's AVM validation procedures must specify the following:
  - Expectations for an appropriate sample size.
  - Level of geographic analysis.
  - Testing frequency and criteria for re-testing.
  - Standards of performance measures to be used.
  - Range of acceptable performance results.
- In testing an AVM model, the results of the model must be compared to actual sales data in a specific area prior to the sales data being available to the model.
- Each AVM model used by an institution must be validated through testing.
- The Guidelines state that the "performance expectations" of loans made on the basis of AVMs should be compared with those of loans made on the basis of other types of valuations. The Guidelines do not go so far as to say that valuations produced by AVMs must be compared to valuations produced by formal appraisals.
- An institution must document the results of its AVM validation testing and audits. The institution's findings should be used in the periodic updating of its AVM policies and procedures.

### Tax Assessment Valuations

- A tax assessment valuation ("TAV") is a value of a property as assessed by a local tax authority.
- The Guidelines indicate that a TAV, by itself, will not qualify as an evaluation. The Guidelines suggest that TAV data may be used to develop an evaluation if sufficient supplemental information is brought in. An institution needs to have policies and procedures that specify the type, level and extent of supplemental information that will be required.

## Client Alert.

---

- Because the practices of local tax authorities may vary considerably from one jurisdiction to another, an evaluation that uses TAV data should take into consideration the specific practices of the pertinent jurisdiction.
- As in the case of AVMs and other evaluation methods and tools, evaluations developed with TAV data must be consistent with safe and sound banking practices and the Guidelines. If the valuation produced by the evaluation is not credible, the institution's policies should require it to use an appraisal or a permissible alternative evaluation method or tool.
- The key to using TAV data is to be able to show that there is a valid correlation between that data and market value. In this regard, the Guidelines state that the institution should:
  - Determine and document how the tax jurisdiction calculates the TAV and how frequently property revaluations occur.
  - Perform an analysis to determine the relationship between the TAV and the property market values for properties within a tax jurisdiction.
  - Test and document how closely TAVs correlate to market value based on contemporaneous sales at the time of assessment and revalidate whether the correlation remains stable as of the effective date of the evaluation.

### Contact:

Joseph Gabai  
(213) 892-5284  
igabai@mofo.com

### About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com).

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*