Bankers and Appraisals: Where is the Disconnect?

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President, Appraisal Institute

Federal Reserve Bank of Atlanta – Banking Industry Outlook
February 28, 2013
About the Appraisal Institute

• Nation’s largest professional association of real estate appraisers
  – 23,000 professionals in 60 countries
  – Confers MAI, SRA designations
  – Largest publisher of appraisal texts; one of world’s largest education providers
  – 5-10% of AI professionals work for financial institutions
Former Bank of Clark County executive pleads guilty to concealing appraisals from regulators

By Jeff Manning, The Oregonian
February 19, 2010, 10:00PM
The wave of bank failures in the Pacific Northwest took an ugly twist Friday when a former high-ranking executive of the defunct Bank of Clark County pleaded guilty to concealing material facts from bank regulators.
SEC Charges Three Former Bank Executives in Virginia for Understating Loan Losses During Financial Crisis

FOR IMMEDIATE RELEASE
2013-4

Washington, D.C., Jan. 9, 2013 — The today charged three former executive: Commonwealth for understating million true health of the bank’s loan portfolio.

SEC Claims KPMG Auditors Failed to Scrutinize Nebraska Bank

By Dave Michaels - Jan 9, 2013 7:30 PM ET

Two KPMG LLP auditors are facing U.S. Securities and Exchange Commission claims that they failed to properly scrutinize a Nebraska bank that hid millions of dollars in loan losses from investors during the credit crisis.

John J. Aesoph, a partner, and Darren M. Bennett, a senior manager, didn’t get evidence to back up TierOne Bank’s allowance for loan and lease losses when issuing opinions on the bank’s 2008 financial statements, the SEC said in an administrative release today. Instead of independently testing TierOne’s value for collateral, the auditors accepted the bank’s “biased and inconsistent” estimates, the SEC said.
Recent Investigations

• Senate Government Affairs Committee Permanent Subcommittee on Investigations

• Wall Street & the Financial Crisis – Anatomy of a Financial Collapse, 4/13/11
  • “During the five-year period reviewed by the Subcommittee, from 2004 through 2008, OTS examiners identified over 500 serious deficiencies in Washington Mutual’s lending, risk management, and appraisal practices.”
Recent Investigations

• “Still another area in which OTS failed to take appropriate enforcement action involves WaMu’s appraisal practices.”

• “WaMu’s decision to outsource the appraisal function received minimal attention from OTS.”

• “Problems began almost immediately after WaMu outsourced the appraisal function.”
Recent Investigations

• “In its 2007 ROE, OTS identified serious issues with IndyMac’s appraisals.
• OTS found that the borrowers, rather than the mortgage originator, were paying the appraisers directly, which did not ensure appraiser independence.
• Despite these serious weaknesses, OTS did not require action be taken.”
Recent Investigations

• Material Loss Reports – What We’ve Learned
  • 2011 review of MLRs
    • 75% of now-failed banks had been previously cited for various appraisal violations
    • Citations include often failing to obtain appraisals where required, or having insufficient resources within the bank to manage and oversee the appraisal function.
Problems Identified After the Crisis

• Greed was pervasive; fraud was rampant
• You can’t lend on credit alone – Collateral matters
• Loan production staff (within institutions) were dominant
• Appraisal departments were often marginalized within banks
Problems Identified After the Crisis

• Examiners
  – Too little expertise on appraisal matters
  – May have been ill-equipped, unprepared to deal with technical appraisal issues

• Appraiser population
  – Marginally qualified

• Enforcement
  – Spotty at best in mortgage, real estate
Where the Disconnect Begins

• Perception of the appraisal function
  – Often seen as “onerous” or to be avoided
    • Expressed by bankers on both sides of market
    • Becomes a “compliance obligation” rather than integral part of risk management
Where the Disconnect Begins

• Examiner enforcement concerns
  – Big bank vs. small bank
    – Disparities, inconsistencies
  – Inconsistent Interagency Appraisal Guideline interpretations
Where the Disconnect Begins

• Failing to learn from past mistakes
  – Rating agencies have not altered methodologies for evaluating CMBS
  – Cursory audit and review of appraisals

• Understanding of appraisal theory, methods and practice
  – Appraisal is an applied science
  – It has a strong foundation in law and economics
Common Banker Criticisms

• Complaint 1
  – “It costs too much”

• Complaint 2
  – “Why can’t they get it right?”

• Complaint 3
  – “Why can’t I use a BPO instead?”
Where Can We Work Together?

• Evaluations
  – AI has fought for flexible appraisal standards
  – Starting in 2008, Scope of Work rules allow appraisers to tailor service to client needs
  – In 2012, AI published a Guide Note on preparation of Evaluations by Appraisers
Where Can We Work Together?

• Broker Price Opinions
  – Rush to use represents a failure to communicate on the part of appraisers and bankers
  – Creativity with the Scope of Work can
    • Provide a cost-competitive service
    • Maintain independence and competency in valuation process
Where Can We Work Together?

• Broker Price Opinions
  – Brokers do not have sufficient training in real estate valuation
  – Brokers are paid little or nothing ($0-$300)
  – Brokers are under no obligation for independence and impartiality
  – Experience shows that there is wide variation in BPOs
Variation in Broker Opinions of Value

<table>
<thead>
<tr>
<th>Sample</th>
<th>30 Properties, 60 BOVs</th>
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<tbody>
<tr>
<td>Median Variance</td>
<td>14.7%</td>
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<tr>
<td>Mean Variance</td>
<td>21.4%</td>
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<tr>
<td>Percentage with 15% or Less</td>
<td>53.0%</td>
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<tr>
<td>Percentage over 15%</td>
<td>47.0%</td>
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</tbody>
</table>
Where Can We Work Together?

Variation in BOVs: Actual case comparison

Sale Price, Appraised Value, BOVS

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<thead>
<tr>
<th>Broker</th>
<th>BOV</th>
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<tbody>
<tr>
<td>Broker #7</td>
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<td>Broker #6</td>
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<td>Broker #1</td>
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<tr>
<td><strong>Sale Price</strong></td>
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<tr>
<td>Appraisal</td>
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<tr>
<td>Broker #2</td>
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<tr>
<td>Broker #4</td>
<td>$2.072 m</td>
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<tr>
<td>Broker #3</td>
<td>$1.129 m</td>
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</tbody>
</table>
Where Can We Work Together?

• Enforcement
  – Strong self-police program
  – Peer Review Process recently streamlined and improved
    • Results show an increase in efficiency and effectiveness of the investigations
Where Can We Work Together?

• Guidance from AI
  – *Appraisal of Real Estate, 14th Edition* (to be published summer 2013)
  – Guide Notes from the AI Appraisal Standards and Guidance Committee
Where Can We Work Together?

• Legislation
  – Financial Institutions Examination Fairness and Reform Act
    • Likely to be reintroduced in 2013
  – Would tie hands of bank examiners
  – Bank examiners must have tools
Where Can We Work Together?

- Education
  - Examiner
  - Bank staff
  - Cutting edge issues
Thank you!

Questions?

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