The Regulatory Focus

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Division of Financial Institutions

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Real Estate Evaluations

Most Ohio banks and savings institutions have a large portion of their assets invested in loans secured by real estate. The importance of obtaining accurate valuations on such real estate for purposes of loan underwriting, credit administration, allowance calculations and problem resolution strategies is understandable.

On December 2, 2010 the banking agencies jointly issued the *Interagency Appraisal and Evaluation Guidelines* (Guidelines), which updated and clarified regulatory expectations regarding the use of real estate appraisals and evaluations. Pursuant to the Guidelines, evaluations may be used to establish the market value of real estate in certain transactions. Evaluations are not required to be performed by state licensed or certified appraisers and, consequently, may be more cost-effective than appraisals for determining and documenting real estate values. Evaluations are generally permitted in lieu of appraisals for the following real estate transactions:

- Transactions of $250,000 or less;
- Business loans of $1 million or less that are not dependent on the sale of, or rental income from, real estate collateral; and
- Transactions involving an existing extension of credit, provided that there has been no obvious and material change in market conditions or the collateral property or there is no advancement of new funds other than reasonable closing costs.

Examination Findings

Appraisal and evaluation program weaknesses are frequently cited in regulatory examination reports. Examination concerns generally apply to evaluations as well as appraisals. Common areas of criticism include:

- Policy and/or procedure deficiencies;
- Inadequate documentation/support for values;
- Inadequate review process;
- Failure to obtain evaluation prior to credit decision; and
- Improper use of broker price opinions (BPO) or automated valuation models (AVM).

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Appraisal policies that lack specific provisions governing the preparation and use of evaluations can result in evaluations that do not adequately analyze and support value conclusions. As with full appraisals, independent review processes for evaluations should be in place to ensure that reasonable and supportable values are used in making credit decisions. In some cases, credit managers have assumed that BPOs or AVMs qualified as evaluations, despite the fact that they did not comply with the Guidelines.

Evaluation Content

One of the more frequently cited examination criticisms of evaluations relates to documentation deficiencies. Although they typically are not as comprehensive as appraisals, evaluations should provide reliable estimates of market value and, according to the Guidelines, contain "sufficient information and analysis to support the value conclusion." In addition, an evaluation should "address the property's actual physical condition and characteristics as well as the economic and market conditions that affect the estimate of the collateral's market value." Expectations regarding evaluation documentation include the following:

- The location of the property.
- A description of the property and its current and projected use.
- An estimate of the property's market value in its actual physical condition, use and zoning designation as of the effective date of the evaluation, with any limiting conditions.
- The method 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.
- A description of the supplemental information that was considered when using an analytical method or technological tool.
- All sources of information used in the analysis 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; or
  - Local market conditions.
- The name, contact information and signature of the preparer.

Recommendations/Best Practices

In order to ensure that evaluations provide valid support for credit decisions, lending institutions should pay particular attention to the following areas:

Appraisal **policies and procedures** should have clear and comprehensive provisions governing the preparation and use of evaluations, including the types of transactions and risk characteristics for which evaluations may be used. Lenders should consider requiring appraisals for transactions involving higher-risk loan structures or borrower characteristics, or atypical collateral types. Policies and procedures should also specifically address:

- The independence of persons performing evaluations from the credit underwriting and decision-making functions;
- The qualifications of persons performing evaluations (must be competent, but do not need to be licensed or certified appraisers);
- A system to monitor the performance of individuals who perform evaluations;
- Standards for evaluation content and documentation to ensure that evaluations sufficiently support the credit decision;

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- A review program for evaluations;
- Internal controls to ensure compliance with regulatory requirements and institution policy; and
- Criteria for assessing whether existing evaluations remain valid.

An effective **evaluation review process** should be in place. Evaluations should be reviewed prior to making a decision on the proposed transaction. Evaluation reviews should be performed by qualified, independent personnel and be of sufficient depth to verify that the values are reasonable and supported by sound assumptions. The review process should also confirm that evaluations comply with institution policy and regulatory guidance.

Evaluations must **document the analysis** performed and the sources of supporting information in accordance with the Guidelines and the lending institution's policy.

BPOs do not qualify as evaluations. The Dodd-Frank Act prohibits the use of BPOs as the primary determination of value for mortgage loans secured by the borrower's principal residence. BPOs may be a source of information useful in preparing an evaluation, but the evaluation must contain the analysis and supporting information required by the Guidelines.

AVMs typically are not solely sufficient to meet the requirements of an evaluation; however, when combined with other procedures such as verification of property condition, **AVMs may be useful components of evaluations**. Institutions that make use of AVMs should develop prudent internal procedures and controls that conform to the Guidelines. Procedures should include a due diligence process, criteria for selecting an AVM and monitoring performance and standards for model validation. More detail regarding AVM use is contained in the Guidelines.

Conclusion

Evaluations can be effectively used to support real estate values when prepared and used in accordance with regulatory guidelines. The *Interagency Appraisal and Evaluation Guidelines* provide valuable guidance to help lending institutions structure valuation processes in a safe and sound manner. Detailed technical assistance is also available on regulatory agency websites.

References:

Federal Reserve Board:
12 CFR Part 225, Subpart G
SR Letter 10-16

Federal Deposit Insurance Corporation:
12 CFR Part 323
Financial Institutions Letter 82-2010
FDIC Technical Assistance Video Program:

From the Superintendent…

Superintendent
Charles Dolezal

An important goal of the Ohio Department of Commerce Division of Financial Institutions (Division) is to ensure that our examination teams maintain the highest level of training through continuing focus on examiner education and employee development. To help meet this goal, the Division has re-dedicated its efforts to ensure that examiners annually attend schools sponsored by the FFIEC, Federal Reserve and FDIC. These training opportunities range from core introductory and developmental schools for newly hired examiners, to topical training sessions that include emerging issues, structured finance, capital markets, financial crimes and fraud, and real estate appraisal review for more seasoned examiners.

Over the years, the Division has enjoyed a cooperative and collaborative relationship with both the Federal Reserve and the FDIC which helps to foster a more seamless regulatory environment. By holding joint training programs with our federal partners, this relationship further benefits Ohio-chartered banks and savings institutions. Through these sessions, examiners sit in the same room with federal counterparts with a focus on the same issues with the goal of providing more consistent examinations in the state system.

To help reduce the costs of training and to provide programs tailored to the needs of our examination staff, the Division is also utilizing web-based opportunities, conducting semi-annual in-house examiner training and developing specialized training modules.

In addition to focusing on employee development, the Division is planning future training for bank directors. Tentatively planned for Spring 2015, this event will help directors to identify board room best practices, understand the inter-relationship between financial condition and risk management in assigning CAMELS ratings, and learn about current regulatory hot topics.

As always, if you have any questions on these or any other topics, please feel free to contact me directly at **Charles.Dolezal@com.ohio.gov** or (614) 644-7501.

Division Announces Post Exam Survey

The Ohio Department of Commerce Division of Financial Institutions (Division) recently announced the implementation of a post examination survey. Completion of this brief survey will be requested after all current and future examinations of Ohio-chartered banks and savings institutions conducted by the Division. The survey will provide Ohio bankers the opportunity to provide direct feedback regarding a recently completed examination and will also provide the Division with suggestions for improving the examination process as a result of comments received from the industry.

Following the completion of an examination conducted by the Division, the survey will be emailed to the CEO, President or Managing Officer of the institution from the office of the Superintendent. Once completed, the survey can be returned to Division via email or direct mail. When requested, please take the time to complete the survey and contribute to improving our examination processes.

Outsourcing Internal Audit: Pros and Cons

Weakness in the internal audit function, a component of internal controls, can lead to an unsafe and unsound operating environment at an institution. The decision to outsource internal audit to an independent public accounting firm or other outside professional is often a challenging one.

A benefit to outsourcing the internal audit is that expertise and professional competency is easier to acquire and maintain. When outsourcing, you obtain broader audit experience and resources to use as your institution grows into new markets, offers new products or services and complies with a changing regulatory environment. Another benefit is typically cost. The cost of outsourcing is normally less, and it is variable and can be tailored to special needs versus fixed staffing and overhead expenses. In addition, independence is normally not an issue because outsourcing minimizes the loss of objectivity due to the fact that relationships with staff are not closely developed. Furthermore, management's focus is more on oversight versus the performance of the internal audit function.

On the other hand, when an internal audit is outsourced, goals between the auditor and management may not always align. One concern that arises when outsourcing the audit function is the extent of familiarity with the institution. Sometimes too frequent rotation of auditors occurs, reducing institutional knowledge and creating a continual learning curve. It is not uncommon to see misunderstandings between the auditor and management and/or the Board of Directors on expectation of performance. In accordance with the *1997 Interagency Policy Statement on the Internal Audit Function and Its Outsourcing*, outsourcing has to be prudently managed. Directors and management are still responsible for an effective system of internal control and to actively oversee the outsourced internal audit function.

The decision to outsource the internal audit function is situational and will depend on the size and complexity of activities at your institution given the choices available. The decision is one that will need to be frequently reevaluated as things within your institution change. Your arrangement should be the most effective and efficient way to accomplish the internal audit with consideration given to regulatory expectations and operational aspects.

Division Examiner Graduates from the Graduate School of Banking

The Ohio Department of Commerce Division of Financial Institutions (Division) is pleased to announce that Senior Examiner Shaun Starr graduated from the Graduate School of Banking (GSBC) in Boulder, Colorado in July. He completed the three-year program which consisted of on-campus course work, research projects and testing throughout his course of study at the GSBC.

Shaun speaks highly of his time spent in Boulder. "The Graduate School of Banking has provided a rewarding and beneficial experience over the past three years. I'm a big proponent of expanding the training program for our examination staff," Starr said. "We can only benefit from the challenging course-work and classroom sessions that the Graduate School of Banking offers, especially gaining the perspective and views from not only other regulators, but local and national bankers, industry specialists and academics."

Shaun began his career with the Division in August 2003 as a Financial Institution Examiner Trainee in the Northeast Region. Since then, he has progressed to a Senior Examiner. In 2011, Shaun completed the Ohio Bankers League Bank Management School. Throughout his career he has been instrumental in developing and providing training for not only state examiners, but also those from the Federal Reserve Bank of Cleveland and the FDIC. He is a subject matter expert for the Division in commercial lending. Congratulations Shaun for accomplishing this milestone in your career!

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2014 Ohio Bankers Day

Bankers Day attendees listening to one of several presentations held that day.

John Ryan, President & CEO, Conference of State Bank Supervisors addresses attendees at Ohio Bankers Day.