Validating Previous Appraisals and Evaluations

by George R. Mann and Larry R. Woodall

The validity of an appraisal of real estate property is in jeopardy if changes to the property or its surroundings have a negative effect. A bank may or may not be able to use the appraisal for a subsequent transaction. This article offers lenders a method to validate an appraisal. The two most important factors to consider in a validation are the physical condition of the property itself and the strength of the subject's current real estate marketplace compared to when the previous appraisal was performed.

In 1994, the Board of Governors of the Division of Banking Supervision and Regulation of the Federal Reserve System issued Bulletin SR 94-55 (FIS), "Interagency Appraisal and Evaluation Guidelines," to all officers in charge of supervision at the Federal Reserve Bank. Subsequently, the Fed, the FDIC, the OCC, and the OTS jointly issued these guidelines to all state member banks and bank holding companies and their nonbank subsidiaries engaged in real estate lending.[1]

The Guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate transactions, and they provide specific guidance to examiners and regulated institutions about several aspects of an institution's appraisal and evaluation programs, including:

1. Procedures for obtaining an appraisal or evaluation report in a timely manner to facilitate the institution's underwriting decision.
2. Selection criteria and procedures to evaluate and monitor the performance of individuals who perform appraisals and evaluations.
3. Criteria for using an existing appraisal or evaluation to support a subsequent transaction.
4. Internal controls for promoting compliance with the appraisal regulation.

This article examines the third item, typically referred to in the appraisal and lending industry as a "validation" analysis. This proce-

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dure is used to determine whether a value estimate presented in a previous appraisal report remains valid. The validation specifically aids in determining if negative changes have occurred to the physical condition of a property or to the marketplace in which it is located. If such changes are found to have occurred since the date of the previous appraisal, then a new appraisal of the property should be recommended.

Factors to Consider in Validation

If the institution provides a documented analysis indicating that the existing estimate of value remains valid, SR 94-55 (FIS) allows an institution to use an existing appraisal or evaluation to support a subsequent transaction. A qualified staff person (that is, licensed staff appraiser or loan officer) within the institution may perform the validation or the institution may enlist the original appraiser or another qualified appraiser to review the original appraisal or evaluation report, inspect the property, and research the marketplace. Regardless of who is chosen, the validation must include a reexamination of relevant market conditions, an analysis of comparable market data, an inspection of the collateral, and a conclusive written opinion regarding the validity of the original report. Institutions may ask the previous appraiser to perform an "update appraisal" to confirm the continued validity of the original value. In any case, the validation must be performed in an unbiased and professional manner acceptable to the agencies governing the institutions, and the regulated institution must properly document the basis for its findings and keep the documentation in the loan and/or credit file.

An issue that has been left to each institution to decide is the "time frame" in which a previous appraisal may be considered valid. Based on SR 94-55, each institution should determine a reasonable time frame in which a validation or new appraisal or evaluation should be conducted.

Criteria vary for determining whether an existing appraisal or evaluation remains valid, depending upon the condition of the property and the marketplace and the nature of any subsequent transaction. The institution must document the information sources and analyses used for validation. Factors that could cause changes to originally reported values include:

The passage of time. Have any changes occurred in the marketplace or to the subject property since the original transaction date? Federal regulation does not establish time frames during which appraisals or evaluations are presumed to be valid.

Volatility in the marketplace. Have any significant changes occurred since the original transaction? What is the effect of these changes on the subject property's market value?

The availability of financing. What are the current interest rates? How available is money to finance a real state transaction in the current market, compared to when the subject property transaction occurred?

The inventory of competing properties. Have there been any changes to supply-and-demand factors? What effect do they have on the occupancy potential of the subject property?

Improvements and physical changes. Have improvements been made to the subject property or to competing properties that could be viewed as negative influences on value? Has the subject property been properly maintained since the date of the previous appraisal? Is there deferred maintenance that could cause a loss in value?

Zoning changes. Have there been any zoning changes? Could they dramatically affect the property's potential of continued development?

Environmental changes to the subject property. Has the property, its improvements, and the adjoining and surrounding properties been subject to any environmentally hazardous changes since the previous appraisal? Examples of environmental changes may include the discovery of asbestos in the subject improvements and ground water contamination caused by leaks in underground storage tanks (USTs) on or near the subject site.

External obsolescence. Does the property suffer from external changes since the previous appraisal? Examples include the closing of a school in the neighborhood, the construction of a penitentiary near the site, and the redevelopment of a major roadway to alleviate traffic congestion.

Steps in Performing a Validation

A validation should include a thorough review of the original appraisal or evaluation, compilation and analysis of relevant market data on the subject neighborhood and comparable markets, and a formal site inspection of the subject property and the surrounding neighborhood.

- The review should always be the first step. The lender will then understand the quality and condition of the subject and its marketplace at the time of the original transaction. Interviewing the loan officer or asset manager, the property owner, tenants, and local brokers may also provide insight into the property itself and the marketplace.
- Upon gaining sufficient knowledge of the property and its marketplace, market data, such as rental rates, sale prices of similar use properties, and current building costs can be gathered and analyzed to identify obvious trends in market value.
- A thorough site inspection of the subject property and its surrounding neighborhood should then follow to reveal further indication of decline or improvement.

If any changes have occurred from the date of the original appraisal or evaluation, they should be documented and included with the collateral or credit files of the institution. Furthermore, in cases where negative changes are found, a new appraisal or evaluation should be recommended to adequately determine the amount of value lost. If there appear to be no changes (the market is stable) or if the changes are positive (property appreciation is evident), a new appraisal or evaluation would not be necessary, and the value in the previous appraisal or evaluation can be recommended as still valid.

Methods for Evaluating Market Trends

An analysis of real estate assessments is a simple, inexpensive way to evaluate market trends. In addition, known methods of valuation—the income approach, the sales comparison approach, and the cost approach—can be used to assess the direction of potential changes and the stability of the previous value. A review of the prior appraisal or evaluation should reveal which approach to value is most appropriate for the subject property.

Real estate assessments. The tax assessment represents an independent, unbiased estimate of value but may be considered less reliable than a current valuation. The date of an assessment is an obvious consideration in determining whether it is appropriate to use. Also, the frequency of assessments may vary by state. For example, the State of Maryland County Assessor reassesses property on a three-year rotation, while the Commonwealth of Virginia County Assessor does so on an annual basis. For a validation, the trend is more important than the actual, assessed value. Is the most recent assessed value at least as great as the assessment at the time of the prior appraisal or evaluation? If so, then the indication of value by the assessment supports the use of a validation. If the assessed value has declined since the previous appraisal, then it is likely that the collateral value may also have deteriorated; this situation would not support validating the previous appraisal or evaluation and a new one would likely be required.

Income approach. The income approach to value is most applicable to leased industrial, office, and retail properties and to apartment projects and hotels. Income data is needed for both the subject property and the marketplace. Actual subject income and expense information must be obtained from the owner of the property. This information should be compared with market rent and expense data to determine if the subject figures are above, at, or below market rates. In addition, two other items must be analyzed to arrive at a value using the income approach—market vacancy rates and capitalization rates. This data can be obtained from area market reports or in-house appraisals.

All information should be analyzed together, as some factors that influence value increase while others decrease. What matters is the overall indication. Figure 1 provides a sample income valuation that compares the prior appraisal valuation with current data. This example indicates an increase in subject rental income with no change in market vacancy (5%). Expenses increased from 47% of effective gross income to 50% of effective gross income, and market rates of return also increased since the previous appraisal. In this scenario, the various increases and decreases can be summarized by an overall decline in property value, suggesting the need for a new appraisal or evaluation.

Sales comparison approach. The sales comparison approach to value is most applicable to owner-occupied properties and some income-producing properties. Sales data can be obtained from such sources as COMPS, real estate appraisers, Realtors, assessors, and in-house appraisals. The idea is to compare current value indications with the prior value conclusion of the subject property. Typically, sales are analyzed by price per square foot of building area for improved properties and by price per square foot or acre for vacant land. A review of the prior appraisal or evaluation should reveal the unit of comparison that is appropriate for the subject property.

Current sales of comparable properties are adjusted for differences from the subject property and then compared with the subject's prior value indication. For example, the subject may have been valued at $50 per square foot of building area. If recent comparable sales range from $45 to $55 per square foot, then it is reasonable to conclude that the prior value remains valid.

Cost approach. An analysis of current building or construction costs of similarly designed buildings and of land sales can be used to determine value changes in special use properties, such as churches, golf courses, sport health clubs, horse or auto racetracks, auto dealerships, and data mining centers. This analysis focuses on the trend in which land values and building costs are moving but also considers the overall physical condition of the subject improvements in comparison to their condition in the previous appraisal.

Concluding Comments

A validation is a simple comparison of values at two points in time. It answers the question: Is the value in a previous appraisal or evaluation still valid in the current marketplace? In other words, is the subject's potential current value equal to or greater than the value estimated in the previous appraisal or evaluation? The two most important factors to consider in a validation are the physical condition of the property itself and the strength of the subject's current real estate marketplace compared to when the previous appraisal was performed. A blanket assumption about the validity of all past values based solely on a current position in the real estate cycle would be inappropriate, as the determination can depend on the particular date of a prior valuation.

A validation of a prior appraisal or evaluation can be a straightforward task when real estate values are increasing across the board, but trends are difficult to assess in the current environment of complex, dynamic real estate markets. For example, some widely respected real estate analysts conclude that the current commercial real estate cycle has peaked, while others assert that it has yet to reach its apex. Evaluating the appropriateness of a validation in such a climate necessitates a property-by-property and market-by-market approach. Changes in values may depend, for example, on the specific property type (such as industrial, office, or retail), fluctuating cycles of development between neighborhoods, supply and demand factors in a submarket, or the economic strength of a metropolitan area. Regardless of the position in the real estate cycle, however, a validation is a reasonable and cost-effective way for institutions to reevaluate the strength of their real estate portfolios.

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Notes

1 A copy of this bulletin is available to the public on the Internet at the Federal Reserve Board's Web site at: http://www.federalreserve.gov.

Figure 1

Comparison of Prior Appraisal Valuation with Current Data

Category	Prior Appraisal	Current Pro Forma
Potential Gross Income	$100,000	$105,000
LESS: Vacancy Allowance	($5,000)	($5,250)
Effective Gross Income	$95,000	$99,750
LESS: Expenses	($45,000)	($49,750)
Net Operating Income	$50,000	$50,000
Capitalization Rate	10.0%	10.5%
Value Indication	$500,000	$476,190