TB 37a was rescinded 1/13/95. Incorporated into Thrift Activities 210.

Handbook: Thrift Activities **Section: 320**
Subjects: Real Estate Mortgage Lending **TB 37a**

December 8, 1989

Use of Appraisal Information in Loan Risk Analysis

RESCINDED

Summary: This Bulletin describes information lenders can obtain from reliable appraisal reports and how such information can be used to evaluate property, market, and borrower risks inherent in real estate lending. (There is a correction to Item #10 in the attachment to this Bulletin. TB 37 issued November 17, 1989, is rescinded.)

For Further Information Contact:
OTS for the District in which you are located, or the Office of Supervision Policy of the OTS.

Thrift Bulletin 37a

Introduction

Prudent underwriting of a proposed real estate loan involves skillful evaluation of information about the borrower, the security property and the marketplace in which the property will compete. The objective of the underwriting process is to identify and quantify the most probable risks associated with a transaction and to structure it to ensure that the risks are manageable and timely repayment is likely.

Risks associated with a real estate loan fall into three general categories: property risk, market risk and borrower risk.

Lenders sometimes fail to fully consider borrower risk and instead focus exclusively on the value estimate contained in an appraisal, using it as their primary risk management tool. While the value estimate is relevant, it is only a portion of the information that can and should be obtained from a reliable appraisal.

A value estimate, exclusive of other data, does not show which risk factors were considered or how they will influence the value of a property. Moreover, the value estimate alone does not provide information about the assumptions related to the future financial performance of a property. A review of the appropriateness of these assumptions is critical in determining whether a commercial real estate credit transaction will be repaid.

Borrower creditworthiness must also be evaluated in deciding whether to grant a real estate loan. A borrower's financial strength and ability to repay the loan should be analyzed. This analysis requires a review not just of personal and business financial statements but also of the net income a property or business produces, and any proceeds that might be realized upon its eventual sale.

An appraisal does not automatically contain all information necessary to the lender's underwriting process. Many lenders accept appraisals that are not useful in identifying the risks associated with a property because they don't know what to ask for in an appraisal. Appraisals should be tailored to an institution's lending needs. (See attachment for an optional, sample checklist that lenders may use to evaluate information in the appraisal report and to identify special risks that should be considered in the loan underwriting process.)

Underwriting Management

Appraisals containing relevant information help lenders to properly underwrite real estate loans and to develop appropriately structured loan terms that minimize property and market risks.

Although professional appraisers follow a carefully defined series of steps to arrive at a final value conclusion, the content of their appraisal reports vary. Both Insurance Regulation 563.17-1a and Policy Statement 571.1b recognize that the content of an appraisal will not automatically match the information needs of a lender. Lenders should specifically identify the type and amount of information appraisers must include in their appraisals to ensure the resulting product is adequate for proper loan underwriting. This is most easily accomplished by the use of an engagement or assignment letter sent by the lender to the appraiser.

A lender's information needs will vary according to the complexity of a credit arrangement and the lender's experience with similar transactions. Appraisal policies should be individually tailored to fit the lender's requirements.

An effective appraisal policy should result in reports that:

- Match the actual loan collateral.
- Are based upon reasonable assumptions.
- Identify all property and market risk factors that will affect the marketability and value of the security property.
- Provide specific quantitative information pertaining to the expected financial performance of the property.

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- Identify all conditions that must be met in order to achieve the projected financial performance of the property.

- Identify the "as is" value of the property and, where appropriate, its prospective value upon completion and upon the achievement of stabilized occupancy, or its market value as if complete on appraisal date.

- Identify the economic feasibility of any proposed change in use, modernization, rehabilitation or remodeling program.

Property Risks

The physical, legal and economic characteristics of the security property must be carefully evaluated to identify conditions that may jeopardize the likelihood of the property generating sufficient income to service the loan. An adequate appraisal will contain all factors that materially influence the value of the property. Careful evaluation of the analytic sections of the appraisal report should disclose the quantitative effect of these factors.

Typical property risk factors that an appraisal should identify include:

- Inefficient or inadequate building components.

- Level of physical deterioration present.

- Defects in style, layout and site configuration.

- Presence of zoning, land use, environmental restrictions or other legal impediments to use of the property.

- Existence of potential environmental hazards, both on, adjacent to, or near enough to the subject property to pose a possible problem.

- Existence of soil conditions that might affect the structural integrity of an improvement or the cost to construct a proposed improvement.

- Presence of a flood hazard.

- Presence of topographic problems that might affect site drainage or development costs.

- Incompatibility with surrounding land uses.

- Presence of access problems.

Each of these factors may affect the ability of a property to compete successfully in the marketplace. They may also frustrate a borrower's ability to lease or sell newly created space or to keep existing space leased at anticipated rent levels. Such problems can be a source of unforeseen costs that may threaten a borrower's ability to meet scheduled debt service payments.

Market Risks

An adequate appraisal will identify and quantify the impact of all important market risks. An effective analysis of market risk should recognize that a security property must co-exist with similar properties and will compete in the marketplace. The lender should identify which characteristics of the marketplace will jeopardize the ability of the security property to attract tenants or buyers and to produce revenue.

Typical information about the competitive market that an appraisal should identify includes:

- Excessive current or future supply of similar properties.

- Inadequate current or future demand for similar properties.

- Favorable and unfavorable trends in the economic characteristics of a market area.

- Factors that might influence the timing of market entry.

In evaluating the presence of market risks, the lender should be aware that the scope of most appraisals will be limited to identification and evaluation of risks recognized in the marketplace. Most appraisals do not consider or evaluate the potential impact of unforeseen economic shock. Therefore, the lender should temper the market information found in the appraisal with an assessment of the likely direction of the economy and the resulting impact on the performance of a property.

In setting loan terms that recognize market risk, a lender will:

- Ensure that the term of a credit arrangement is consistent with the estimated time to develop, sell or lease up a property.

- Establish repayment terms that correspond with the expected pattern of net income.

- Establish cash flow projections to be used in monitoring the financial performance of the security property.

- Determine whether the acquisition cost of a property was influenced by excessive speculation in the marketplace.

Borrower Risk Analysis

In conjunction with the identification and quantification of property and market risks, the lender's decision process should focus on the level of borrower risk associated with the credit transaction. If the total level of risk is unacceptable, the loan should be rejected.

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Typical ways appraisal information can be used to assess borrower risk are to:

- Verify financial information submitted by the borrower pertaining to an income producing property.
- Establish the total loan amount and the maximum level of credit that will be extended at any point in time.
- Establish appropriate reserves for interest, construction and operating deficits.
- Identify conditions that must be satisfied before funds will be disbursed.
- Establish a loan disbursement schedule that corresponds with the expected pattern of value creation.

Conclusion

The usefulness of an appraisal in a real estate loan decision encompasses more than simply the value estimate. Reliable and relevant information about the security property and the marketplace help the lender to identify and quantify potential repayment risks.

Attachment

Jonathan L. Fiechter

— Jonathan L. Fiechter
Senior Deputy Director, Supervision Policy

Attachment to TB 37a

MEMORANDUM TO: Loan Committee   Date:__________

FROM: ______________________
(Loan Officer)

SUBJECT: LOAN RISK ANALYSIS BASED ON INFORMATION IN THE APPRAISAL REPORT

LOCATION OF SUBJECT PROPERTY:

____

DESCRIPTION OF SUBJECT PROPERTY:

____

DATE OF APPRAISAL: ______________________

NAME OF APPRAISER(S): ______________________

This memo represents the loan officer's assessment of information included in the appraisal report and may be used by the loan committee for purposes of loan risk analysis.

The loan officer rates the loan risk levels on the following issues as either "high," "moderate," "low," "none" or "not applicable." When comments are required, indicate the comment number in the addendum section attached to this memo. A "high" or "moderate" level of loan risk warrants a comment.

	Loan Risk Level					Comment Number When Applicable
Potential Risk	High	Moderate	Low	None	Not Applicable	
1. Physical condition of the subject property.	____	____	____	____	____	____
2. Functional deficiencies in the subject property.	____	____	____	____	____	____
3. Disclosures in the required sales history of the subject property.	____	____	____	____	____	____
4. Projected gross income for the subject property compared with the actual gross income on an existing property or the pro forma gross income on proposed.	____	____	____	____	____	____
5. Projected expenses for the subject property compared with the actual expenses on an existing property or with the pro forma expenses on proposed construction.	____	____	____	____	____	____

Potential Risk	Loan Risk Level: High	Moderate	Low	None	Not Applicable	Comment Number When Applicable
6. Comparison of the appraiser's vacancy allowance with either the actual vacancy on an existing property or the pro forma vacancy for proposed construction.	____	____	____	____	____	____
7. Comparison of the appraiser's estimated net operating income for the subject property with the actual net operating income on an existing property or the pro forma net operating income on proposed.	____	____	____	____	____	____
8. Absorption of the subject property. This relates to the forecast by the appraiser concerning what is reasonable or likely.	____	____	____	____	____	____
9. Aspects of the cash flow analysis on the subject property including negative cash flow, debt coverage ratios, etc.	____	____	____	____	____	____
10. Competition between the subject property and other existing projects.	____	____	____	____	____	____
11. Competition between the subject property and other projects under construction.	____	____	____	____	____	____
12. Competition between the subject property and other planned projects.	____	____	____	____	____	____
13. Competition for the subject property in either the rental market or sales market.	____	____	____	____	____	____
14. Probable success of the subject property as evidenced by the likelihood that the subject loan will be repaid in full according to the loan documents.	____	____	____	____	____	____
15. Indicated soil conditions on the subject property.	____	____	____	____	____	____
16. Indicated environmental risk factors that may impact the subject property.	____	____	____	____	____	____

Potential Risk	Loan Risk Level: High	Moderate	Low	None	Not Applicable	Comment Number When Applicable
17. Adverse conditions or factors that would impact the value and performance of the subject property.	____	____	____	____	____	____
18. Overall property rating for the subject property as prepared by the Loan Officer:						

SUBJECT PROPERTY:

OVERALL PROPERTY RATING	Good	Average	Fair	Poor	Na
Location	____	____	____	____	____
Architectural Appeal	____	____	____	____	____
Quality of Construction	____	____	____	____	____
Condition of Exterior	____	____	____	____	____
Condition of Interior	____	____	____	____	____
Layout & Utility	____	____	____	____	____
Protection From Adverse Influences	____	____	____	____	____
General Condition of Surrounding Properties	____	____	____	____	____
Overall Appeal to Market	____	____	____	____	____
Ingress & Egress	____	____	____	____	____
Adequate Support Facilities	____	____	____	____	____
Overall Rating	____	____	____	____	____

COMMENTS:

Specify any areas of concern regarding the subject property:

____

____

____

19. Any applicable summary comments:

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