STANDARDS OF SOUND BUSINESS PRACTICES

REAL ESTATE APPRAISALS

Bank of Jamaica
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REAL ESTATE APPRAISALS

A. PURPOSE

This document sets out the minimum policies that each financial institution needs to have in place and apply, and the minimum criteria it should use, to ensure that real estate appraisals conducted in support of real estate-related financial transactions are prudent and appropriate.

The soundness of real estate-related financial transactions made by each institution depends upon the adequacy of the analysis used to support these transactions. A real estate appraisal may be one component of such an analysis.

Although an appraisal may assist in the management of risks in the granting of credit, undue reliance should not be placed on the appraisal value in lieu of a sound assessment of a borrower's repayment ability. In this context, an appraisal cannot be a substitute for sound and prudent real estate investment and real estate lending. Accordingly, this paper should be read in conjunction with, and as an appendix to, the credit risk management standard.

B. DEFINITION

A real estate appraisal is a written report, independently and impartially prepared by a qualified appraiser, setting forth and justifying an opinion as to the market value (as of a specific date) of a property that is the subject of a real estate-related financial transaction. An appraisal is based on selective research into appropriate market areas, assemblage and documentation within the report of pertinent data, the application and justification of suitable analytical techniques, and the knowledge, experience, and judgement necessary to develop an appropriate opinion of market value.

C. REAL ESTATE APPRAISAL POLICIES

In order to achieve a sound portfolio of commercial and residential real estate lending, each institution needs to establish in writing sound and prudent real estate appraisal policies that set out specific criteria governing:

- the types of real estate-related financial transactions that require appraisals or the circumstances in which appraisals are required;

- the selection and engagement of appraisers that the institution is prepared to use;
- the required contents of an appraiser's report; and
- the valuation method(s) which the institution is prepared to accept in support of specific types of real estate-related financial transactions.

These policies need to be supported by effective implementation procedures.

Requirements for Appraisals

Real estate appraisal policies need to contain criteria governing the types of real estate-related financial transactions that require appraisals or the circumstances in which appraisals are required.

Although obtaining an appraisal assists an institution in determining the value of a property in support of lending, not all such transactions will require appraisals. Decisions as to whether or not real estate related transactions require an appraisal are a matter of credit or investment judgement and, as such, are the discretion of the institution. For example, an appraisal may not be needed where obtaining an appraisal is not a major consideration in the credit granting decision. Nevertheless, each institution should consider the need to support real estate lending decisions with an estimation of value.

Requirements for appraisals also need to contain criteria for conducting reappraisals, when required. Deciding when to obtain a reappraisal will depend on many factors, including the condition and quality of the loan, the soundness of the underlying collateral value, and general economic and real estate market conditions.

The need for reappraisals should receive particular attention when renewing loans, when examining applications for additional credit, and when credit problems arise. Although credits with amortising repayments (such as residential mortgages) and operating within the terms and conditions of the credit agreement normally will not require reappraisals, they may need to be included in appraisal review procedures in certain circumstances. For example, deteriorating economic conditions in a particular locality may prompt an institution to conduct a review of its real estate collateral.

Reappraisals may also be useful in situations where real estate-related credits become non-performing. In such situations, the value of the collateral may replace the borrower's capacity or willingness to repay as the primary source of repayment.

Engagement of Appraisers

Appraiser selection criteria should ensure that appraisers used to perform an appraisal for the institution are, at a minimum:

- member of a professional body (association) that conducts real estate valuations;

- experienced, competent and knowledgeable regarding the real estate market within the area to which the appraisal relates and the type of real estate being appraised; and

- independent of the estate being appraised or of the person whom the institution is dealing with respect to the real estate-related transaction.

The institution should only retain appraisers who have the training knowledge, ability, experience and integrity required to complete the assignment competently. Although not necessarily requiring the selection of an appraiser with a designated professional qualification, all institutions must use appraisers that have the above necessary attributes.

Appraisal policies need to be supported by procedures to monitor appraisers' performance and to review the adequacy of their appraisals. In ensuring that the appraisers selected and engaged to conduct real estate appraisals are acceptable to the institution, each institution needs to maintain a list of appraisers with which the institution is authorised, or alternatively, not permitted, to use.

An independent appraiser is one who:

- has no direct or indirect interest, financial or otherwise, in the property subject to appraisal or with the party to the real estate-related transaction with whom the institution is dealing; and

- is separate from the credit granting or investment decision-making authority in the institution.

The goal of an appraisal is to produce an objective opinion about the market value of a property and to allow the reader of such an appraisal to be able to draw the same or similar value conclusions as the appraiser, based on the supporting data and analysis. This objectivity may be compromised if the appraiser is involved in the transaction, has credit or investment granting authority over the property that he/she is appraising or is not at arm's length from the institution's client.

To ensure the appraiser's independence, all institutions need to have appraiser engagement policies requiring that appraisers are either employed by the institution or engaged directly by the institution or its agent, rather than the party with whom the institution is dealing. However, there may be situations in which appraisals commissioned by the institution's client are acceptable. In such situations, reliance on the appraisals may be acceptable only if:

- the appraisal is current;
- the appraisal is prepared by an appraiser acceptable to the institution and who meets the institution's appraiser engagement criteria;
- the appraisal meets all of the institution's criteria respecting the contents of the appraisal; and
- the institution obtains a letter of transmittal from the appraiser stating that the institution may rely on the appraisal. Such letter should include the terms of reference under which or the purpose for which the appraisal was made.

Contents of Appraisal Reports

Although the form, length and content of real estate appraisal reports vary depending on the type of property being appraised, the nature of the appraisal assignment and the generally accepted appraisal standards, a comprehensive appraisal report should, at a minimum, be clearly and accurately written and presented in a format that:

- describes the purpose of the appraisal being sought and the appraiser's terms of reference and provides a definition of both the property rights appraised and market value;
- identifies and provides a description appropriate for the type of the property being appraised including, but not limited to, the use of such means as a legal description, address, map reference, copy of a survey or map, property sketch and/or photographs;
- sets out the scope of the appraisal and all assumptions and limiting conditions (including, if appropriate, environmental hazards) that affect the analyses, opinions and conclusions, including the disclosure of any information that is pertinent to the appraisal but is unavailable;
- sets out the market value, the effective date of the appraisal, and the period for which the appraisal is valid;
- contains sufficient information and supporting documentation or data to enable the institution to readily and independently ascertain the reported market value, the appraisal procedures followed, and the information considered and reasoning

that supports the analyses, opinions and conclusions respecting the market value of the property being appraised, including;

- a description of the appraisal approaches and techniques used;
- a reconciliation of appraisal approaches and the final market value estimate;

- an explanation to support the exclusion of any usual real estate valuation approaches;

- the appropriate land use regulations, zoning and other restrictions that may affect the market value of the property;

- market conditions and trends; and

- considerations and analysis of any previous sale(s), current agreement of sale, or option of the property being appraised, if such information is available; and

- includes a dated and signed certification that:

  ~ the statements and facts contained in the appraisal report are true and correct;

  ~ the reported analyses, options and conclusions are limited only by the reported assumptions and limiting conditions;

  ~ a personal inspection of the subject property was or was not made by the appraiser signing the report, including the date of inspection, if applicable;

  ~ the appraiser has no interest – present or prospective , direct or indirect, financial or otherwise – in the property that is the subject of the appraisal;, and is not associated with the party with whom the institution is dealing;

  ~ the appraiser's compensation is not contingent upon an action or event resulting from the analyses, opinions or conclusions in, or the use of, the appraisal report;

  ~ the appraisal assignment was not based on a requested minimum valuation, a specific valuation, or the approval of a loan nor was the compensation contingent upon the amount of the value reported; and

  ~ states the final estimate of market value.

Undeveloped land or property, property development projects, unsold units, or unleased space may pose a significant risk to an institution in their capacity as lenders. For this reason, the impact of such risk must be reflected, and appropriately disclosed, in any appraisal; report supporting such transactions.

An appraisal should inform the reader of any market trends, regardless of whether the trend reflects rising or declining values. Such trends might include, for example, increasing vacancy rates, greater use of tenant inducements and rent concessions, increasing lease or sale listings, or declining sales or rental prices. Identification of negative trends is particularly important so that the institutions may avoid extending credit on the basis of insufficient collateral.

In this context, a sales history of the property is designed to enable a comparison to be made of an appraiser's opinion of a property's value with recent sales prices. In addition to providing a basis by which to evaluate the accuracy of the subject property appraisal, a sales history may assist in identifying recent trends in market prices. For example, a sales history may identify a single sale or a series of sales at artificially inflated prices. Alternatively, in a declining market where there is often a lack of sales that would assist in identifying market values, it is extremely important that the appraiser is able to communicate a supportable value based on sound reasoning and written justification.

Although one or more recognised appraisal valuation approaches may not be applicable in all appraisal assignments, or may have reduced significance because of the nature of the property and the related credit decision to be made, the appraisal approaches and techniques used need to be described and reconciled, and the reason for excluding a recognised valuation approach must be included in the real estate appraisal.

Assignment or engagement letters to appraisers converting the objectives and scope of the appraisal activities to be conducted, as well as the format and content of the actual appraisal report can help to ensure that the individual appraisals are conducted and communicated in a prudent, professional and appropriate manner.

Use of Recognised Appraisal Valuation Approaches

Real estate appraisals conducted for all institutions need to follow appropriate valuation approaches that result in a market value estimate that is both prudent and reasonable in relation to the physical and legal characteristics of the property appraised. The sales comparison, replacement cost, income capitalisation an discounted cash flow approaches are methods commonly used in the appraisal process to estimate the market value of real estate.

Although an appraiser's opinion of market value is a matter of professional judgement, such opinion, to be prudent and reasonable, should be based on:

- views of market conditions that are objective and not conjectural, speculative or hypothetical in nature;

- the use of appraisal valuation approaches that are supported by evidence of appraisal practice as to the acceptance, use and applicability of such approaches by persons experienced in dealing with properties similar to that being appraised;

- conditions or circumstances not so limited or so special that the resulting analyses, opinions or conclusions would tend to mislead or deceive users of the appraisal report or persons relying on the opinion of market value; and

- the effect, if any, on such market value of the merging or combining of the various estates or separate interests in the property, rather than the summation of the individual values of the various estates or separate interests.

All institutions need to ensure that:

- all appraisal valuation approaches used reflect accurately circumstances respecting the land or property use, zoning by-laws, regulations or other restrictions, and the market value of the property as a result of the commencement or completion of construction, renovation or other improvements to the property;

- appraisal valuations using the sale comparison approach are based on sound consideration of similarity and comparability between properties, such as their location, physical characteristics (e.g. lot size, type of construction, age), legal characteristics (e.g. zoning and property rights), market conditions and financing terms and conditions;

- appraisal valuations using the income capitalisation/discounted cash flow approaches are predicated on:

  ~ net operating income or cash flows produced by, and vacancies for, the subject property that are reasonable, or highly probable, given current market conditions and trends;

  ~ capitalisation and/or discount rates based on current market rates of interest and derived from appropriate evidence and sound appraisal theory; and

  ~ recognition of capita cost items such as tenant inducements, leasing fees and deferred maintenance, where appropriate; and

- appraisal valuations using the replacement cost approach are based on a reasonable and conservative method for:

- ~ valuing the land as if vacant and unimproved;
- ~ estimating the replacement cost of existing buildings and other enhancements to the property; and
- ~ reflecting a property's depreciation, deterioration and obsolescence.

D. ROLE OF THE BOARD OF DIRECTORS

The Board of Directors of each institution is ultimately responsible for ensuring that the institution has sound and prudent real estate appraisal policies and procedures. In discharging this responsibility, a Board of Directors usually charges management with developing real estate appraisal policies, reviewing their adequacy and ensuring their implementation in support of the institution's real estate-related financial transactions.

A Board of Directors needs to have a means of ensuring compliance with the real estate appraisal policies. A Board of Directors generally ensures compliance through periodic reporting by management and independent internal inspectors/auditors. The reports must provide sufficient information to satisfy the Board of Directors that the institution is complying with the policies.

At a minimum, a Board of Directors should:

- review periodically, but at least once a year, the management's real estate appraisal policies and procedures to ensure that they are sound and prudent and that they adequately and effectively support the institution's real estate-related credit activities; and
- ensure that an internal inspection/audit function reviews real estate-related transactions to verify that the institution's real estate appraisal policies and procedures are appropriate and are being adhered to; and
- ensure that real estate appraisal and valuation policies give appropriate recognition of the probable unsustainable of continuing inflation in real estate values in Jamaica.

E. ROLE OF MANAGEMENT

The management of each institution is responsible for developing and implementing real estate policies for the institution and ensuring that these policies are prudently and appropriately applied in support of real estate-related financial transactions.

Although specific responsibilities will vary from one institution to another, management at each institution is responsible for:

- developing real estate appraisal policies;
- presenting the real estate appraisal policies to the Board of Directors for their review;
- implementing the real estate appraisal policies;
- establishing, where appropriate, an internal real estate appraisal evaluation process to monitor real estate appraisals by randomly reviewing, on an on-going basis, appraisal reports to ensure that they:
  - ~ meet the requirements of the real estate appraisal policies;
  - ~ follow appropriate valuation methods; and
  - ~ result in a value that is prudent and appropriate in relation to the characteristics of the property appraised;
- developing lines of communication to ensure the timely dissemination of the real estate appraisal policies and procedures to all individuals involved in the real estate appraisal process; and
- reporting comprehensively on the institution’s real estate appraisal policies and procedures to the Board of Directors at least once a year.

GLOSSARY

Capitalisation Rate

For the purposes of real estate appraisals, the rate used in the income capitalisation approach to convert net operating incomes generated by an income-producing property into an estimate of value.

Credit Risk

The risk of financial loss resulting from the failure of a debtor, for any reason, to fully honour financial or contractual obligations to an institution.

Discount Rate

For the purposes of real estate appraisals, the rate of return used to convert cash flows generated by an income-producing property to present value.

Discounted Cash Flow Approach

A method of estimating value derived by applying a discount rate that converts the cash flow that can be reasonably expected from an income-producing property, to present value.

Income Capitalisation Approach

A method of estimating value derived by applying a capitalisation rate that converts the net operating income that can be reasonably expected from an income-producing property, to present value.

Market Value

The most probable price that a property should bring in a competitive and open market under current conditions requisite to a fair sale, the buyer and seller each acting prudently, willingly and knowledgeably, and assuming the price is not affected by undue stimuli. Conditions under which a fair sale exists are that a reasonable time is allowed for exposure in the open market, payment is made in cash or in terms of financial arrangements comparable thereto, and the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Net Operating Income

For the purposes of real estate appraisals, the gross income from an estate or interest in a property supporting a real estate-related transaction less tenant recoveries, the aggregate of all operating expenses and allowances for vacancies, bad debts non-recoverable expenses and normal management expenses.

Real Estate Appraisal

A written report, independently and impartially prepared by a qualified appraiser, setting forth and justifying an opinion as to the market value (as of a specific date) of a property that is the subject of a real estate-related financial transaction. An appraisal is based on selective research into appropriate market areas, assemblage and documentation within the report of pertinent data, the application and justification of suitable analytical techniques, and the knowledge, experience, and judgement necessary to develop an appropriate opinion of market value.

Real Estate-Related Financial Transaction

Any transaction involving:

- the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof;
- the refinancing of real property or interests in real property; or
- the use of real property or interests in real property as security for a loan or investment, including mortgage-backed securities.

Reconciliation of Appraisal Value and Approaches

The function in the real estate valuation process in which an appraiser analyses alternative conclusions and selects a final market value estimate from among two or more indications of value. A thorough review of the entire valuation process needs to precede reconciliation.

Replacement Cost Approach

A method of estimating the market value of a property by adding the estimated value of the land, as if it were vacant, to an estimate of the depreciated reproduction or replacement cost of a building and other improvements.

Sales Comparison Approach

A method of estimating the value of a property in which a subject property is compared with recent sales of similar and comparable properties in the market. The basic premise of the sale comparison approach is that the market will establish a value for the subject property in the same manner that the values of comparable, competitive properties are established.

Scope of the Appraisal

The process of collecting, confirming and reporting appraisal data. Imposed is a responsibility on the appraiser to determine the extent of the work, and of the report in relation to the nature of the property to be appraised.