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REAL ESTATE APPRAISAL INDUSTRY FACES MULTIPLE CHALLENGES

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QUALITY CONTROL

Issues

Third-party real estate appraisal firms are production-driven businesses designed to complete assignments as quickly as possible with fees that have been essentially static for decades. Together with increasingly compressed appraisal report delivery schedules and increasing transaction volumes, there has been a notable deterioration in the quality of appraisal reports.

A great deal of the deterioration is due to the implementation of accelerated report delivery schedules, two weeks being increasingly common. Accelerated delivery schedules are a function of the desire to confirm transaction metrics in advance of spending substantially more money on legal and other third-party fees. For this reason, and the fact that somewhat higher fees have motivated appraisal firms to accept this practice, accelerated delivery is expected to increasingly become a market standard. While accelerated delivery is generally limited to the origination side of the business, CMBS in particular, it disrupts quality across the commercial appraisal report production system as it attracts and consumes more resources from across the overall appraisal production platform. In addition, appraisal managers tend to have less time to review the reports, which has negative implications for staff training as well as report quality.

QUALITY CONTROL ISSUES ON THE PRODUCTION SIDE OF THE BUSINESS ARE LARGELY A FUNCTION OF COMPRESSED REPORT DELIVERY TIMES AND **HAVE PLACED EXTREME PRESSURE ON THE APPRAISAL REVIEW AND VALIDATION PROCESS AS A RESULT.**

Solution

The industry must acknowledge that compressed appraisal delivery schedules have become the market standard and provide the resources to meet that demand. Appraisal firms must increase resources, both staff and technology, dedicated to production and quality control. CRE mortgage originators must supplement appraisal review resources, both staff and technology, to provide adequate oversight. Incentives and disincentives can be administered to encourage third-party appraisal firms to perform at a higher level and meet reasonable standards for report quality at the report's first submission. The standardization of source documentation could also facilitate the appraisal production process.

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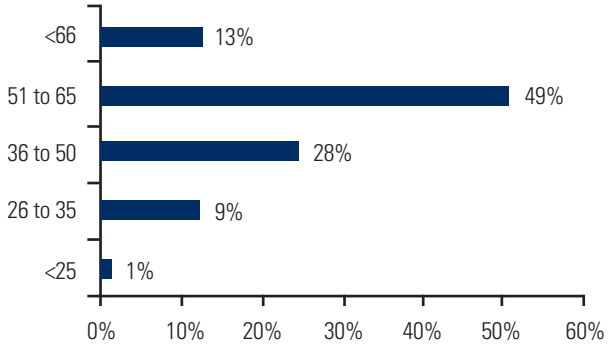
RESOURCE CONSTRAINTS

Issues

Many CRE mortgage origination businesses, particularly those that are regulated, have maintained strict cost controls since the financial crisis, while regulatory oversight and transaction volumes have expanded materially. Review appraiser compensation has been generally static, while talent recruitment is limited by a shrinking talent pool of appropriately qualified appraisers. There is a serious demographic labor supply gap in the appraisal industry as detailed in industry studies performed by the Appraisal Institute in 2014 and the National Association of Realtors earlier this year. While these studies include both commercial and residential appraisers, the industry's issues are consistently identified: A reduction in trainees and training programs, poor job satisfaction due to regulatory burdens and depressed fees and a dearth of appraisers in the critical 35 to 50-year-old age range.

Indeed, the unbalanced age profile of a Member of the Appraisal Institute (MAI) is illustrated in the following chart:



MAI Age Distribution Chart and Source: Appraisal Institute

COST CONTROL PRESSURES AND LIMITED STAFFING OPTIONS WILL **CONTINUE TO STRESS THE APPRAISAL PRODUCTION AND REVIEW SYSTEM.**

Solution

Recruitment and training programs, improved technology, and externally resourced staff are the most direct and logical solutions for what appears to be an acute supply issue in terms of the number of appropriately qualified appraisal professionals available for both production and review. Recruitment and training have primarily been accomplished on the production side of the appraisal industry. However, many trainee appraisers also move to other positions within the industry over time as suggested by the previously noted demographic studies. Technological advances in "big data" and automation signal more productivity is possible; however, adoption and reliability have historically been issues in practical application.

Externally resourced review support is a particularly attractive solution for financial institutions as these services can be augmentative and delivered in a strategic or tactical manner. This model can focus on supply-demand gaps, e.g., large portfolios, accelerated delivery transactions, designated high risk transactions, or specialized asset classes, specific markets, or complex assets. External appraisal review resources can also be applied in a more comprehensive way as business lines expand or are added to the organization. Further, external resources can be extremely cost effective as external third-party fees can frequently be recovered at loan origination and the cost is 100% variable.

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REGULATORY & AUDIT COMPLIANCE

Issues

For regulated financial institutions in particular, the scope and scale of internal and external bank audits have expanded substantially since the financial crisis. For the appraisal component of an audit, adherence to a comprehensive, well-specified real estate appraisal policy and relevant regulations are the focus.

Bank regulators and auditors are specifically focused on:

1. Adequate portfolio review coverage
2. Documentation of draft appraisal comments
3. Adequacy of high-risk transaction reporting
4. Approved appraiser list management and monitoring
5. Portfolio monitoring and stress testing

The primary directive for regulated financial institutions and credit functions at financial services institutions remains an independent appraisal process, including appraisal reviews by appropriately qualified professionals. Complete documentation is also a critical component of the current regulatory environment and audit process. Audit documentation requests have expanded to include more documentation of the draft appraisal commenting process.

A typical document request includes:

1. Engagement letter
2. Draft appraisal report(s)
3. Draft appraisal report(s) comments
4. Final appraisal report
5. USPAP Standard Rule-3 review memo and certification

INTERNAL AND EXTERNAL AUDITS OF APPRAISAL COMPLIANCE CONTINUE TO EXPAND IN SCOPE AND SCALE **ADDING TO THE PRESSURE ON INTERNAL APPRAISAL REVIEW AND QUALITY CONTROL RESOURCES.**

Solution

Appraisal regulation compliance is mandatory for all federally regulated financial institutions engaging in secured real estate related transactions and an institution's compliance is routinely audited. Complete documentation as noted above is not optional for successfully navigating comprehensive internal or external audits. Meeting the demands of appraisal regulatory requirements and sound appraisal credit standards requires a transparent policy, proactive third-party appraisal firm guidance, a clear set of procedures and the resources and technology to execute. All financial services institutions can benefit from the adoption of strong appraisal-related credit policies and procedures.

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ARGUS ENTERPRISE MIGRATION

Issues

The core industry cash-flow modeling software, Argus DCF, is actively being replaced by Argus Enterprise in the most transformative software disruption to the entire commercial real estate (CRE) industry in over 15 years. Most appraisers, production and review, have been training and migrating to Argus Enterprise as Argus DCF is no longer supported. It will be years before the migration by CRE intuitions is complete. This adds to the resource pressures being experienced by appraisal professionals across the industry, with material cost implications as well.

THE MIGRATION TO ARGUS ENTERPRISE SOFTWARE IS **TAXING BOTH ON THE REVIEW AND PRODUCTION SIDES OF THE APPRAISAL INDUSTRY.**

Solution

As the discounted cash-flow model is the core analytical component of the appraisal report, extensive training and practice is required to meet the challenge of this transition. The implementation of any new system requires careful quality control and more resources will be required to manage this transition effectively and efficiently.

RESTRUCTURING OF THIRD-PARTY APPRAISAL FIRM MARKET

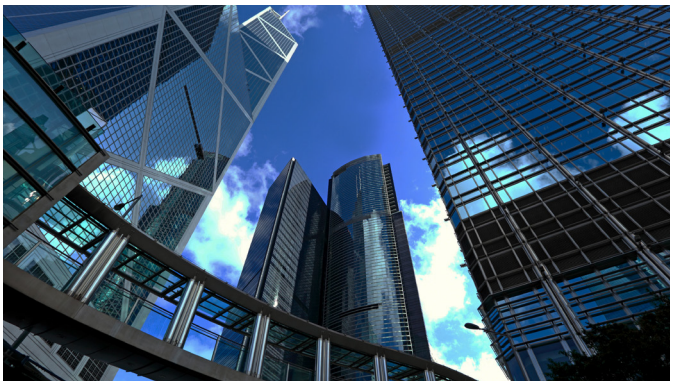
Issues

The production side of the CRE appraisal industry is actively undergoing a significant transition. Major new firms are emerging, while established firms are defending market share and adjusting to the new competitive landscape. The movement of staff has been significant. There has not been such change in the real estate appraisal industry since the emergence of broker-branded appraisal firms in the late 1970s. It is reasonable to anticipate material service disruptions before a more stable appraisal production system emerges.

THE APPRAISAL PRODUCTION INDUSTRY IS EXPERIENCING A MAJOR RESTRUCTURING, **WHICH IS CERTAIN TO PRODUCE SHIFTING CAPABILITIES AMONG APPRAISAL FIRMS, INDIVIDUAL OFFICES AND SPECIALTY PRACTICES.**

Solution

Users of appraisal services need to be extremely cognizant of a specific firm's capabilities and limitations at the time of engagement. This will be a very fluid process, and each assignment needs to be specifically examined in this context.



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CONCLUSION

The real estate appraisal industry is confronting multiple challenges:

- Quality Control
- Resource Constraints
- Regulatory & Audit Compliance
- Argus Enterprise Migration
- Restructuring of the Third-Party Appraisal Firm Market

Real estate appraisals are an integral part of the mortgage origination and monitoring process, providing third-party validation of critical metrics such as loan-to-value, debt service coverage ratios and important market perspective and context. For the reasons articulated in this paper, all originators of CRE mortgages should carefully examine and address their appraisal resources, including staffing, technology, policies and procedures. Collectively, all of these factors impose a serious challenge to the clear objective of documenting transactions with quality appraisal reports and producing credible results.

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