STATEMENT ON

REAL ESTATE APPRAISALS

PRESENTED TO

the COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

BY

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ROOM 2203, RAYBURN HOUSE OFFICE BUILDING

9:30

Mr. Chairman, members of the Subcommittee, I am Steven A. Seelig, Associate Director of the FDIC's Division of Liquidation. In your invitation you requested that I address certain matters relating to the liquidation activities of the FDIC, and specifically, those related to appraisal practices. I will first respond to the specific questions you have put forth and then summarize our observations on the appraisals performed on the real estate assets the FDIC acquired as a result of the Continental assistance transaction.

The FDIC's liquidation portfolio currently contains owned real estate with a book value of about $300 million and an appraised value of approximately $230 million. The FDIC acquires real estate as a result of bank failures or assistance transactions with troubled institutions. The real estate in our portfolio either came directly from banks' portfolios or resulted from foreclosure actions initiated by the FDIC. As a result, the book value represents the amounts bid at foreclosure sales and the values of the properties as carried on the books of the banks at the time of failure. These values are in no way reflective of the values associated with the original appraisals that supported the loans made on the properties.

In order to evaluate and administer real estate assets acquired as a result of failed or merged banks, the FDIC regularly employs professional real estate appraisers. The FDIC has established policies and procedures which address the use of appraisers, the frequency of appraisals, and uniform instructions to appraisers.

As a result of the failure activity in recent years, the FDIC is responsible for liquidating real estate mortgages with a book value in excess of $900 million in addition to its owned real estate of about $300 million. As part of our liquidation procedures, we require independent appraisals on all owned properties as well as for all of the underlying collateral associated with delinquent mortgage loans. These appraisals become the basis by which we determine the underlying value of the asset and make decisions relating to foreclosure bids, settlement offers from borrowers and the actual sale of owned properties or loans.

Before we sell any property a current appraisal must be obtained. By current appraisals, we mean those that are less than one year old. Appraisals must be performed by an impartial person of suitable qualifications and all appraisal reports must be in writing. By never compromising on the requirement for a written report we have found that we avoid the poorer quality work that is invited by allowing verbal appraisals. Should an emergency arise and the need for the appraised value figure be such that it is required prior to the time necessary to prepare a written report, we will accept a verbal appraisal but require a subsequent written confirmation and full appraisal report.

In order to assure that the appraisals we obtain are consistent with our purposes in valuing the property, and to assure that account officers do not deviate from our policies, the FDIC has developed specific written appraisal instructions that are provided to an appraiser. We require the appraiser to acknowledge receiving our instructions by including a copy of them in the final appraisal report. For all non single family residential properties, the FDIC has established such instructions. Included in our appraisal instructions are the following key points:

1. Appraisals are to be made assuming a sale on a cash basis. If the appraiser feels uncomfortable with supplying a valuation on a cash basis, due to the lack of comparables, a valuation on typical terms may be used instead; however, the terms must be spelled out.

2. Appraisals are expected to reflect values based on sales prospects considering existing economic conditions. With this requirement we try and avoid speculation on future rates of inflation and future changes in interest rates.

3. Whenever an appraiser supplies valuation based on typical terms, the appraiser should provide us with the percent down payment, maturity of the loan, whether or not it incorporates balloon payments and the interest rate assumption.

4. All appraisals are to be run on an "as is" basis.

5. The appraiser is to estimate the cost to complete essential repairs and to cure any violations and the appraiser is required to state whether these expenses have been considered in estimating the property's appraised value.

6. The FDIC believes in an intensive marketing program and the appraiser is to assume that the property will be sold within six months of acquisition.

7. All appraisals, including updates, must be in writing.

8. Appraisals should be based on existing zoning. However, the appraiser may value the property based on current zoning and any other zoning the appraiser feels is likely to be obtained within a short period of time.

9. In the case of a distressed property where the appraiser is valuing the property solely on a land value basis, the appraiser should provide the costs for demolition and/or removal and make appropriate adjustments to the land's value.

10. The appraiser should provide data within the appraisal report as to the annual property taxes and the amount of any past due taxes.

As you may be aware, even though appraising has become a quantitative field, it is by no mean scientific and in many ways, may be viewed more as an art than science. Hence, the same property may be valued differently by different appraisers. Consequently, whenever the independent appraised value of a mortgage property, or a property we own, exceeds $250,000, our employees are required to obtain a second independent appraisal. In addition, should the two independent appraisals vary by 30% or more, and the difference cannot be reasonably reconciled or justified by our own real estate staff, a third appraisal is obtained.

We attempt, as best possible, to monitor appraisers and to stop using those who consistently provide us with high or low appraised values. Unfortunately, with changing economic conditions and changing markets we occasionally have experienced situations where we have held properties for unnecessarily long periods of time because the appraised values exceeded what the market was willing to pay for the properties.

In using appraisers we require that appraisers have the MAI designation or another comparable designation. There are all too many individuals who are only too willing to sell their services as appraisers but who have not had the formal education that is required for these professional designations. Moreover, one must always be on guard for conflicts of interest. We attempt to never employ the same firm to both appraise a property and market or manage it. Such actions clearly present the appraiser with a conflict as well as sending the wrong signal regarding the client's desire for a truly objective independent appraisal.

Typically, the appraisals obtained are of good quality, due in part to our procedure of evaluating the appraisers' qualifications prior to ordering an appraisal. However, occasionally, inadequate appraisals are received and if the responsible appraiser is not receptive to improving the quality of the work, we will discontinue use of that appraiser. In the event gross errors are encountered or appraisals contain false statements, the FDIC may refer the matter to the appropriate certifying body.

As part of the FDIC assistance transaction with Continental Illinois National Bank, the FDIC acquired about $400 million in real estate mortgages and real estate owned. All of these loans and assets were nonperforming. Most of the assets that we acquired were originally land development, condominium construction, or condominium conversion loans made to an original borrower. Most of these loans were originated either prior to 1978 or during the period 1978 to 1980 when interest rates were low and inflation in real property values was high. With the subsequent sharp rise in interest rates, these sectors of the real estate market faced severe problems. As condominium sales collapsed, the bank was faced with potential problems and chose two alternative solutions. One was to put additional funds into the developments hoping to buy time and see a resurgence in property values or secondly, to find a new buyer for the mortgaged property at a price sufficient to cover the original loan balance plus additional operating expenses.

Loan presentations noted that appraisals were expected to support the loan balance or that preliminary appraisals estimates support the value and that such reports would be delivered later. In at least one instance the bank relied on an appraisal performed for the developer. In appraising condominium properties, the appraiser typically arrived at a market value for individual units and then multiplied the value by the number of units to arrive at an appraised value. No allowance was made for holding costs, sales costs, or a discount that might be necessary for a bulk sale. Similar practices were employed in valuing land holdings. In some cases the appraisals incorporated an assumption of high appreciation rates yielding high market values in 1988 and 1992 when the loans would become due. These appreciation rates, of course, were not supported by current market conditions. No recognition of vacancy rates, unabsorbed inventory or any other market information was included in some of the reports. It appears that some of the appraisals were developed to support the proposed loan rather than to give a true current market value of the underlying collateral.