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Guideline

Subject: Standards of Sound Business and Financial Practices -- Real Estate Appraisals

No: F-6 Date: February 1998

A. PURPOSE

This guideline sets out the minimum policies that each company needs to have in place and apply, and the minimum criteria it should use, to ensure that real estate market value appraisals conducted in support of real estate-related financial transactions or evaluations for financial reporting are prudent and appropriate.

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

Although an appraisal may assist in the management of risks in the granting of credit or the making of a real estate investment in some circumstances and is an essential element in the real estate mortgage or acquisition process, undue reliance should not be placed on the appraised market value in lieu of sound investment judgement or, where appropriate, a sound assessment of a borrower's repayment ability. In this context, an uncritical acceptance of an appraisal cannot be a substitute for sound and prudent real estate related lending or real estate investing. Accordingly, this guideline should be read in conjunction with, and as an appendix to, the credit risk management and securities portfolio management guidelines.

B. DEFINITION

A real estate appraisal is a written report prepared by a qualified appraiser who is independent of the mortgagor or seller of the subject property, setting forth 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 research into appropriate market 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 PROGRAM

Real Estate Appraisal Policies

In order to achieve a sound portfolio of real estate lending and real estate investments, each company 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; and

- the selection and engagement of appraisers that the company is prepared to use.

These policies need to be supported by effective implementation procedures.

Real Estate Appraisal Philosophy

Subject to the "Requirements for Appraisals" section set out below, the contents of appraisal reports and the valuation methodologies in appraisal reports should meet the minimum standards of the Appraisal Institute of Canada (AIC) contained in the Uniform Standards of Professional Appraisal Practice (USPAP) with the Canadian Supplement, and the Handbook for Appraisal Guidelines, as amended from time to time (AIC standards).

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. Where an appraisal is required, not all such appraisals will need to meet AIC standards.

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 a company. For example, an appraisal may not be needed where obtaining an appraisal is not a major consideration in the investment or credit granting decision. Nevertheless, companies should consider the need to support real estate lending or investment decisions with an estimation of value.

Not all such transactions will require an appraisal which meets AIC standards. The decision as to whether a real estate-related transaction requires an AIC standards type of appraisal will depend on the materiality of the transaction.

For the purposes of this guideline, transactions are deemed to be material where they represent an amount equal to or greater than the lesser of 0.1 per cent of the book value of the total assets of the company and $10 million. Such transactions should conform to the AIC appraisal standards, while transactions which represent less than that amount may have a less formal real estate appraisal.

Real estate appraisal policies 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 or investment, 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 amortizing 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 and/or real estate market conditions in a particular geographic area may prompt a company 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 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 company are:

- 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 real estate being appraised and of the person with whom the company is dealing in respect of the real estate-related transaction.

Companies should retain only appraisers who have the knowledge, ability, experience and integrity required to complete the assignment competently. Although not requiring the selection of an appraiser with a designated professional qualification, companies 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.

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 company is dealing; and

- may be involved in the credit granting or acquisition function but is not a person who authorizes the granting of credit on the security of, or the investment in, the particular property.

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 who is involved in the transaction has sole responsibility for the credit or investment granting authority over the property that he/she is appraising or is not at arm's length with the company's client.

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

- the appraisal is current;

- the appraisal is prepared by an appraiser acceptable to the company and who meets the company's appraiser engagement criteria;

- the appraisal meets all of the company's criteria respecting the contents of the appraisal; and

- the company obtains a letter of transmittal from the appraiser stating that the company may rely on the appraisal.

Contents of Appraisal Reports

Companies should ensure that the appraisal reports for those transactions which are deemed to be material for the purposes of this guideline conform to the AIC standards. These standards contain requirements as to the form and content of appraisals.

The form, length and content of appraisal reports vary depending on the type of property being appraised, the nature of the appraisal assignment and the generally accepted appraisal standards within the jurisdiction to which the appraisal relates. In accordance with the AIC appraisal standards, appraisal reports must be in one of three formats: the Self-contained Appraisal Report, which is the full narrative appraisal format, a less detailed Summary Appraisal Report, and the very concise Restricted Appraisal Report. The decision as to which of these different formats should be used will normally depend on the materiality of the particular property which is being considered, and whether it is an initial report or reappraisal. The Appendix contains information on these report formats.

Where transactions are not deemed to be material for the purposes of this guideline, the form and content of such appraisals are at the discretion of the company. However, the less formal appraisals should still be quantitative and objective rather than qualitative and subjective.

Undeveloped land or property, property development projects, unsold units, or unleased space may pose a significant risk to companies in their capacity as lenders or investors. For this reason, companies should instruct the appraiser to outline the inherent and market risks related to such properties so that the company can weigh such risks when evaluating such transactions. Such instructions should be set out in the engagement letter where an external appraiser is used and in the company's internal procedures where an internal appraiser is used.

Companies should instruct the appraiser to identify 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 companies may avoid extending credit on the basis of insufficient collateral or the making of inappropriate investments.

In this context, a sales history of the property is designed to enable a comparison to be made between an appraiser's opinion of a property's value and historical sale prices. 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 recognized 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 or investment decision to be made, the appraisal approaches and techniques used need to be described and reconciled, and the reason for excluding a recognized valuation approach must be included in the real estate appraisal.

Assignment or other instructions to appraisers covering the matters dealt with above, 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 individual appraisals are conducted and communicated in a prudent, professional and appropriate manner. Such instructions should be set out in the engagement letter where an external appraiser is used and in the company's internal procedures, or other written instructions, where an internal appraiser is used.

Use of Recognized Appraisal Valuation Approaches

Real estate appraisals conducted for companies need to follow appropriate valuation approaches that result in a market value estimate that reflects current perceptions of the real estate market, and the physical and legal characteristics of the property in question. The sales comparison, replacement cost, income capitalization and discounted cash flow approaches are methods commonly taken into consideration 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:

- assumptions regarding market conditions which reflect the current perceptions held in the marketplace;

- the choice of an appraisal approach or approaches which can be supported by current 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 fractional interests in the property, rather than the summation of the individual values of the various estates or fractional interests.

Accordingly, companies 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 sales comparison approach are based on sound consideration of similarity and comparability between properties, such as their geographic location, physical characteristics (e.g., lot size, type of construction, age), legal characteristics (e.g., zoning and property rights), revenue generating characteristics (e.g., occupancy, cash flow, security of the income stream), market conditions and financing terms and conditions;

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

  - net operating income or cash flows produced by market analyses, and vacancies for the subject property that reflect current beliefs and assumptions in the marketplace;

  - capitalization and/or discount rates based on current market rates derived from appropriate evidence and sound appraisal theory; and

  - recognition of current beliefs and assumptions in the marketplace regarding capital cost items such as tenant inducements, leasing fees and deferred maintenance; 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.

- END -

Appendix

The format of appraisal reports performed in accordance with AIC standards may change as the AIC standards are amended from time to time. At the present time, AIC standards allow for one of three formats:

(i) the Self-contained Appraisal Report,

(ii) the Summary Appraisal Report, or

(iii) the Restricted Appraisal Report.

See table on next page

The decision as to the format to be used in respect of a particular property should take into consideration the materiality of the transaction to the company.

STANDARDS RULE 2-2 REPORT COMPARISON CHART

The essential difference among the three options is in the use and application of the terms **describe, summarize** and **state. Describe** is used to connote a comprehensive level of detail in the presentation of information. **Summarize** is used to connote a more concise presentation of information. **State** is used to connote the minimal presentation of information.

a) **Self-Contained Appraisal Report**	b) **Summary Appraisal Report**	c) **Restricted Appraisal Report**
i. identify and **describe** the real estate being appraised.	i. identify and provide a summary description of the real estate being appraised.	i. identify the real estate being.
ii. **state** the real property interest being appraised.	ii. **state** the real property interest being appraised.	ii. state the real property interest being appraised.
iii. **state** the purpose and intended use of the appraisal.	iii. **state** the purpose and intended use of the appraisal.	iii. **state** the purpose and intended use of the appraisal.
iv. define the value to be estimated.	iv. define the value to be estimated.	iv. **state** and reference a definition of the value to be estimated.
v. **state** the effective date of the appraisal and the date of the report.	v. **state** the effective date of the appraisal and the date of the report.	v. **state** the effective date of the appraisal and the date of the report.
vi. **state** the extent of the process of collecting, confirming and reporting data. Comment:...the full extent of the process should be apparent to the reader in the contents of the report.	vi. **summarize** the extent of the process of collecting. confirming and reporting data. Comment:...the full extent of the process may not be apparent to the reader in contents of the report.	vi. **describe** the extent of the process of collecting, confirming and reporting data. Comment:...the full extent of the process will not be apparent to the reader in contents of the report.
vii. **state** all assumptions and limiting conditions that affect the analyses, opinions and conclusions.	vii. **state** all assumptions and limiting conditions that affect the analyses, opinions and conclusions.	vii. **state** all assumptions and limiting conditions that affect the analyses, opinions and conclusions.
viii. **describe** the information considered, the appraisal procedures followed, and the reasoning that supports the analyses, opinions and conclusions.	viii. **summarize** the information considered, the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.	viii. **state** the appraisal procedures followed, **state** the value conclusion and reference the existence of specific file information in support of the conclusion.
ix. **describe** the appraiser's opinion of the highest and best use of the real estate, when such an opinion is necessary and appropriate.	ix. **summarize** the appraiser's opinion of the highest and best use of the real estate, when such an opinion is necessary and appropriate.	ix. **state** the appraiser's opinion of the highest and best use of the real estate, when such an opinion is necessary and appropriate.
x. explain and support the exclusion of any of the usual valuation approaches.	x. explain and support the exclusion of any of the usual valuation approaches.	x. **state** the exclusion of any of the usual valuation approaches.
xi. **describe** any additional information that may be appropriate to show compliance with, or clearly identify and explain permitted departures from the specific guidelines of Standard l.	xi. **summarize** any additional information that may be appropriate to show compliance with, or clearly identify and explain permitted departures from the specific guidelines of Standard 1.	xi. contain a prominent use restriction that limits reliance on the report to the client and warns that the report cannot be understood properly without additional information in the workfile of the appraiser, and clearly identify and explain any permitted departures from the specific guidelines of Standard l.
xii. include a signed certification in accordance with Standards Rule 2-3.	xii. include a signed certification in accordance with Standards Rule 2-3.	xii. include a signed certification in accordance with Standards Rule 2-3.
Explanatory Comments have not been included in this chart, except for excerpt of Comment on vi.		

Identical Requirements
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