Underwriter risk requirements versus good appraisal practice

The conflict and how to address it

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Mortgage underwriting in Canada is the process a lender uses to determine if the risk of offering a mortgage loan to a borrower under certain parameters is acceptable. To help the underwriter assess the quality of the loan, banks and lenders create guidelines and even computer models that analyze the various aspects of the mortgage and provide recommendations regarding the risks involved.

Property appraisal is an important component in the loan assessment process. The most common tool used for risk management is the appraisal report, particularly key areas of the report such as the remaining economic life and condition of the property. For example, underwriters may match up a loan's amortization period with the remaining economic life estimates from the property appraisal to make sure the life of the property is longer than the life of the loan. The appraiser's description of the condition or quality of a certain aspect of a property may raise a red flag to the underwriter if the condition is rated 'poor' rather than 'good,' as it may represent a risk to the lender.

Automated underwriting has streamlined the mortgage process by providing analysis of credit and loan terms in minutes rather than days. For borrowers, it reduces the amount of documentation needed and may even require no documentation of employment, income, assets, or even the value of the property. Automated underwriting tailors the amount of necessary documentation in proportion to the risk of the loan. It is more common to see the use of such automated valuation models (AVMs) when the underwriting is looking to low loan-to-value ratios. However, it is still always up to the underwriter to make the final decision on whether to approve or decline a loan.

Appraisal is key to high-risk loans

When the underwriter or lender determines that the loan-to-value ratio is higher and thus has an increased risk, a full appraisal report is required. The appraisal report is completed by a qualified appraiser, sent out to view and assess the subject property, undertaking a full and complete appraisal report describing in writing everything from the city and neighbourhood demographics and local city bylaws to the more direct description of the land being considered for collateral and the residence or building that is affixed to the land.

Many lenders in Canada, including banks, credit unions, trust companies and brokerage houses, utilize the services of an appraisal management company (AMC). The AMC performs independent appraisal services, thereby removing any direct link between appraiser, applicant, and the lending party. The many services AMCs provide also include underwriting services and risk management on the loans handed out by financial institutions. The appraiser today must also be aware that many of the new AMCs now scan or mine information from uploaded appraisal reports to provide lenders with additional risk management tools that help underwriters make the most prudent decisions they can when deciding on a loan application.

Experienced appraisers find themselves having to be cognizant of each lending institution's Terms of Reference—the document describing the minimum content requirements of the appraisal report and the characteristics of comparable sales used to determine a final estimate of value. For example, a common Terms of Reference (TOR) includes:

- photographs of all interior rooms of the dwelling;
- maps depicting the subject property and comparable sales relied upon in the appraisal report;, both of which are long-establishesal
- photos of the fronting street looking both ways, the front and rear of the dwelling, and rear yard views;
- complete description of any internal influences regarding quality and condition and a full inventory of what is inside the dwelling;
- comments regarding floor plan, sizes, and any positive or negative impacts found by the appraiser; and
- comments on any external influences which may affect the property value, noted clearly and then accounted for in the final valuation.

Where the conflict lies

The above are just a few examples of TOR requirements provided by financial institutions to structure appraisal reports. The high standards are generally in concert with the standards practiced by BC appraisers who follow *Canadian Uniform Standards of Professional Appraisal Practice (CUSPAP)* and in reality meet the lender's TOR most of the time. However, appraisers sometimes find themselves in conflict with good appraisal practice when they are asked by a lender's TOR to meet certain underwriting requirements. Examples of this conflict occur where the following criteria are asked for, but the appraiser finds that the best sale comparables do not meet these criteria:

- sale comparables used by the appraiser should not exceed 20–25% of the net adjusted amount or the sale price after all adjustments;
- land value of the subject property should not exceed 25% of the total market value;
- appraised value should be bracketed by unadjusted comparable sales of which one is below the appraised value and at least one is higher than the appraised value;
- comparable sales used to support the appraised value should not have occurred longer than 90 days since the date of appraisal;
- seven-year sale and listing history of the subject property is to be included in the report (three years is standard and is a requirement of *CUSPAP* that is used by most appraisal firms); and

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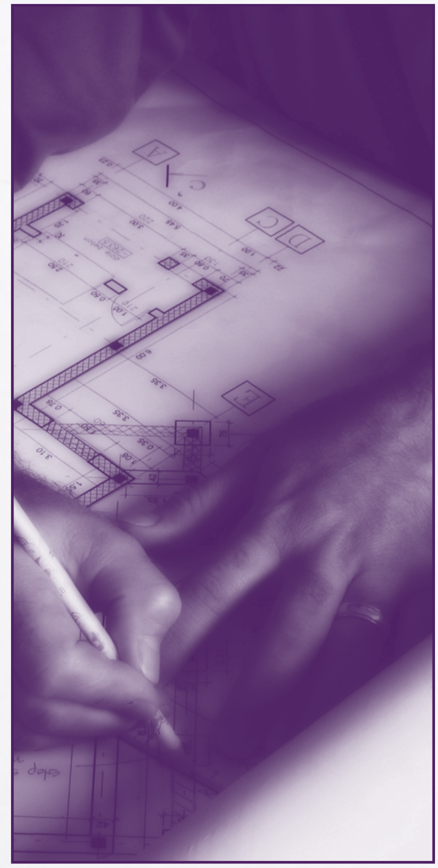

- sales of all homes on the same street as the subject property over the past year (not a *CUSPAP* requirement).

Many of the above TOR requirements find their way into the appraiser's report during strong economic cycles in urban areas where high volumes of real estate are being consumed with high demand and adequate supply. The more homogeneous the real estate is and the more volume of that type of property there is in the marketplace, the easier it is for the appraiser to meet the lender's underwriting criteria.

An example of an appraiser finding that he or she is in conflict with TOR requirements would be when dealing with a unique or out-of-the-box property, especially during a slower real estate market. The more unique a property, the more conflict there is with the appraiser attempting to meet the underwriter's requirements while at the same time producing a report that employs best practices by using the very best sale comparables from a real estate point of view and not a financial risk point of view.

How to solve the conflict

The usual approach our appraisal firm takes to mitigate such conflict uses three steps. First, we gain an intimate understanding of the TOR of each lender. This is necessary because lenders vary in their TOR requirements depending on what type of lending they perform. Second, we find the very best comparables (from a real estate appraisal point of view) for the first three sale comparables selected. Third, we select the next three comparables to meet the underwriting requirements. This way, the appraiser can satisfy the lender and *CUSPAP* requirements and ultimately provide the most professional appraisal report possible.

Appraisers today must not only be experts in the real estate they appraise, but also must be on top of the latest in risk rules and underwriting requirements that vary from lender to lender. Appraisers who strive to achieve this professional balance will find that they are achieving best practices that satisfy not only their professional association, but also the lender and the general public as well.

About the author

Daniel Jones, AACI is President of Campbell & Pound Residential Appraisals Ltd. and the majority shareholder/partner of Campbell & Pound Commercial, both of which are long-established appraisal and real estate consulting firms serving BC's Lower Mainland, Sea to Sky Corridor and Fraser Valley since 1939.