FOCUS ON THE INVESTMENT LAW

FIRREA and Its Effect on the Investment Community

BY BRADLEY R. CARTER, CRE, AND DORI D'ESPOSITO BOWER

IN 1989, THE U.S. PRESIDENT SIGNED into law Title XI of the Federal Institutions Reform, Recovery and Enforcement Act, more commonly known as FIRREA. With it came fundamental changes in the way that federally regulated institutions must order appraisals as well as how professionals perform them.

One of Title XI's key objectives is to ensure that appraisals conducted for federally related transactions comply with uniform standards and are completed by individuals with proven competence. Another critical point is to ensure appraisals that banks order and review in no way involve employees responsible for loan production.

At face value, these rules would certainly seem to have merit. Eighteen years and multiple revisions later, opinions vary about how well they protect lenders, and how they affect the investment community these lenders serve.

Supporters of the Act would point out that the integrity of the lending process has improved because conflicts relating to loan producers overseeing the ordering of appraisals should no longer arise. A substantial body of evidence supports this view. Proponents might also cite that the rules have resulted in less pressure for appraisers to produce opinions of value that meet needs of the loan producer and the borrower. Though this statement might be true, it is a topic of vigorous debate.

This paper's objective is to take a look at some of the act's shortcomings and its unintended consequences as they relate to investors.

DOES ANYONE EVEN UNDERSTAND THE RULES?

Ask real estate professionals whether they personally have a grasp of FIRREA, and many will probably answer with a sheepish "yes," then hope the conversation doesn't go any farther. If pressed, many would admit that they understand it only at the most superficial level.

About the Authors

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A high-level review appraiser at a large national bank described FIRREA as, "a broad act subject to much interpretation. The OCC (U.S. Office of the Comptroller of the Currency) … FDIC (U.S. Federal Deposit Insurance Corp.) and other agencies try to provide clarity from time-to-time. In some cases, interpretations are allowed to develop by default at the local bank level in the absence of OCC guidance." This review appraiser may be on to something. Research shows that many lenders report violations of FIRREA are common, but they cite things that do not, in fact, violate FIRREA—at least not according to some experts' interpretation.

If lenders don't understand FIRREA, is it reasonable to assume that investors do? Probably not. And because these regulations pertain to lenders, does it even matter if investors understand them? That depends. Consider, however, that when investors do learn about FIRREA, it is often though an unpleasant and costly experience.

FIRREA RESTRICTS INVESTORS

One of the basic tenants of FIRREA is that a borrower cannot have any involvement in ordering an appraisal that a federally regulated institution will use for lending purposes. This rule comes as a surprise to many investors who typically order their own appraisals; it also shocks a few employees at investors' favorite federally regulated lending institutions.

"Borrowers often don't realize that they can't order an appraisal any more. When they do, they expect that a federally regulated lender will accept it," says Harris "Bo" Simpson, CRE, MAI, a principal at Greystone Valuation Services. "Sometimes their contact at the bank itself doesn't even know this. There have even been instances where bankers have actually encouraged their clients to order an appraisal, only to find that their bank will not accept it simply on the basis of by whom it was ordered."

In an effort to exceed perceived minimum compliance standards, many banks have policies that prohibit the borrower from having even indirect influence over who may or may not appraise their property. An example would be excluding appraisers simply because the borrower suggested they be considered. Simpson calls this the "tofu effect"—bankers who have the responsibility of ordering appraisals sometimes have the notion that appraisers retain the flavor of whoever speaks with them first.

It now is common to eliminate appraisers from consideration for a specific assignment because of their previous experience with the property. In a complex deal, it may be a time-consuming setback to eliminate the one appraiser who has some knowledge of the project.

DOES ALL THIS AFFECT THE COST TO BORROW MONEY?

It is difficult to imagine that setting up appraisal ordering and review departments, and hiring compliance officers to develop and enforce a long list of policies and procedures would reduce the cost to borrow money. A more direct affect on borrowing costs, however, is that the information a lender needs to analyze a particular deal may not be consistent with the rigid requirements of FIRREA.

For example, FIRREA requires every appraisal to provide an opinion of value for the property in its "as is" condition. Usually a good idea, but rules with no flexibility are rarely practical in all situations. Consider the very common scenario of an investor purchasing a tract of land subject to rezoning.

The sale will not close until rezoning is approved, and involved parties will not disburse funds until that time. What would seem to be the best option is an appraisal that reflects the collateral in the condition in which it will exist at of the time of closing—in this case, as if rezoned. The information that parties involved with the deal really need, though, is an appraisal that reflects two scenarios: as if rezoned and as is, or under the zoning that will no longer apply at the time of closing.

In this situation, the borrower typically pays the higher cost of the additional work. Some lenders have found a way around this higher cost—to allow, and sometimes even encourage, FIRREA violations. "Based on changes in community banking and the lack of experienced loan officers, I believe that FIRREA exceptions are becoming more common," says Brad Day, senior credit officer with Quantum National Bank.

Of course, some would say that citing reasons why costs could increase without any substantive analysis is supposition. Though these regulations could have changed the pricing that FIRREA lenders charge to finance these investments, "ultimately these FIRREA lenders need to compete with Wall Street and the Life Companies and other capital sources," says Ken Barnes, CRE, MAI, a principal in the appraisal and consulting firm McKee &

Schalka. "So the presence of FIRREA restrictions could not have had much of an impact on the cost of lending capital. If a FIRREA source is overly restricted in its lending, then other sources spring up," Barnes adds. "I might guess that the early '90s FIRREA accelerated the arrival of the conduits, given the bank's tightness during that period."

DOES FIRREA ENFORCEMENT RESULT IN A DISSERVICE TO INVESTORS?

"I think the enforcement of FIRREA has done a great disservice to the investment community," says fee appraiser Mike Hunter, MAI, principal of McColgan & Co. "It has cut off a line of service (appraisers) previously provided to developers. We would often have a developer come in to our office to go over a development plan, walk through the project with them, address feasibility and market issues, etc. Now if they do this before an appraisal assignment is given, we are required to disclose it to the bank and it very well may disqualify us from doing the appraisal" because it may be perceived to taint or violate the client/appraiser relationship with the lender.

Another service Hunter says he now rarely provides is speaking with loan officers to assist them with underwriting. Because the rules now place speaking with production people on the same level of skepticism and cynicism as speaking with the borrower, this type of guidance is another casualty in the wake of FIRREA enforcement.

Just as counseling options for investors have been compromised, so has the ability of many banks to respond to a borrower's need to move quickly. "Some of the larger banks have their hands tied so tightly in regulations that they can't always get things done fast enough when timing is critical," Simpson says. "The smaller banks have a competitive advantage in that they don't get scrutinized as closely or have not yet had to implement layers of insulation between loan officers and appraisers, and are therefore able to be more flexible to meet clients' needs."

RECOMMENDATIONS

Regardless of whether investors understand the intricacies of FIRREA, they are affected. We offer those in the investment community the following suggestions.

- Never order an appraisal that might be submitted to a federally-regulated lender. Similarly, don't discuss the terms of an appraisal engagement with an appraiser who the investor wants the bank to hire. Terms of an appraisal engagement include fee, timing and any special assumptions or hypothetical conditions.
- Lenders are particularly sensitive about borrowers trying to "pre-qualify" appraisers. Conversations of any type with an appraiser before their formal engagement lead to a precarious situation. Any question the investor poses regarding value will result in the appraiser disclosing that conversation to the bank, which will likely preclude the appraiser's future involvement. Appraisers must report even indirect questions such as: "Where do you see cap rates headed?" Realistically, this disclosure may or may not happen, depending on the circumstances and the parties involved.
- Be cautious regarding advice from bankers. Most banks have recently installed firewalls between appraisal review and loan production functions. Therefore, the people the investor interacts with may not have relevant knowledge or the control they represent; the deal could be delayed by people the investor will never meet.
- Though FIRREA affects all federally regulated lenders, the impact on their customers seems to come in varying degrees. Do some research beforehand about who will be able to respond to investor needs if the deal requires the lender to move quickly.
- Some real estate counselors are also appraisers. If using the services of a counselor/appraiser, understand that providing counseling services will probably preclude that person from appraising the project for a federally regulated lender.
- Related to the point above, if using the services of a real estate counselor, his or her expertise can still be of value in the appraisal process. Few lenders would prohibit the retained counselor from communicating with the hired appraiser. Similarly, providing a well-prepared market study to an appraiser unfamiliar with the deal can go a long way in heading off misunderstandings about the project. ■