IBAT Insights

(Ask IBAT Anything)

An Exclusive Benefit for Members of:

The Independent Community Bankers Association of New Mexico

Question

Like many community bankers, we are seeing a rapid (and accelerating) increase in residential real estate appraisals. We have concerns about the credit risk associated with values that may be inflated based upon the current market conditions, which of course are subject to change. What can we do to address that credit risk?

Answer

Many community bankers who experienced the 80s and the 'Financial Crisis of 2008' share your concerns. You could certainly apply a 'stress test' to those appraisals to determine what the value of the property might be, for example, if markets fell by the same amount they did immediately after the 'Financial Crisis of 2008.' Some parts of rural America, particularly those that did not see rapid price increases, fortunately did not see a rapid price decrease either.

For those areas that have a higher risk of declining property values in the event of a downturn – let's call that 'appraisal inflation risk' - a lender could amend underwriting standards such as lower LTV's, increased debt service requirements or higher credit scores for loans with higher 'appraisal inflation risk.'

You should use a matrix that identifies the particular loan and property characteristics and the amount of risk the bank is willing to accept to avoid fair lending issues. For example, your bank may be willing to accept more or less risk based upon the amount of the loan and the value of the property securing the loan. For loans up to $500,000 your bank may be willing to accept 10% 'appraisal inflation risk' or $50,000. That same 10% 'appraisal inflation risk' on a $1,000,000 loan is $100,000 and may be more exposure than your bank is willing to accept.