

PROPERTY ANALYSIS

CHAPTER 10

KEY TERMS AND PHRASES

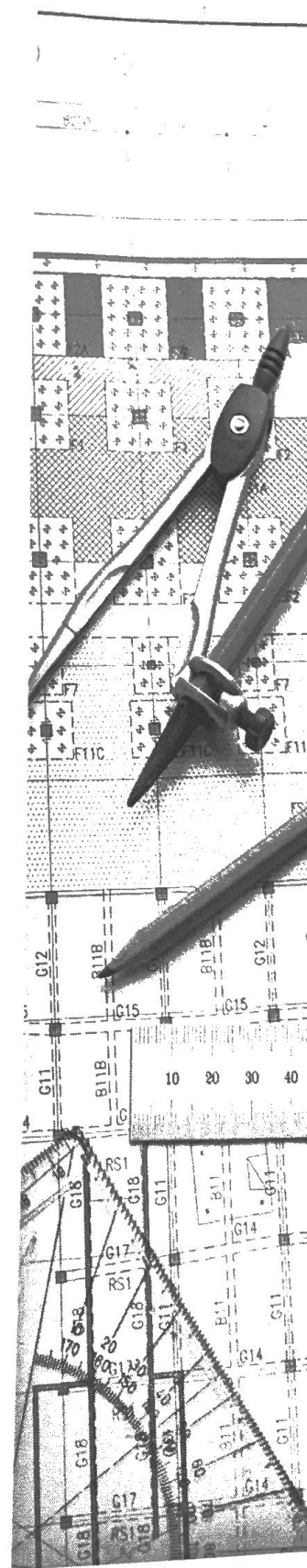
Apparent age
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Cost approach
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External obsolescence
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Remaining useful life
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Underwriting
Uniform Collateral Data Portal®

LEARNING OBJECTIVES

At the conclusion of this chapter, students will be able to:

- Understand the four unique processes involved in the underwriting decision
- Describe how the appraisal works as a key component of the analysis of any real estate financing credit decision
- Understand the development and importance of the professional qualifications of appraisers of residential and commercial real estate
- Describe how appraisers approach residential real estate appraisal and the three key methods they employ
- Explain the primary real estate property characteristics that appraisers must take into account when developing a final decision about a subject property's value



INTRODUCTION

The process of analyzing and approving a loan is called **underwriting**. The individual who assembles and analyzes the necessary data and is authorized to give a company's consent to a specific loan is referred to as the *underwriter*.

Properly underwriting any loan requires a complete analysis of all pertinent factors, including: (1) the borrower's ability and willingness to pay; (2) the property's condition, location, and usage; (3) all relevant economic influences; (4) laws controlling foreclosure procedures and assignments of rent; and (5) any unusual conditions that may exist.

An underwriter must examine the future, estimate the continued stability of the borrower, and try to judge the future value in a specific property. The underwriter must look beyond a normal appraisal, which provides an estimate of past or present value, and weigh the forces that affect the future based on his or her experience in this field. Many underwriting professionals were not in the business the last time residential real estate had a major decline in value—during the mid-1980s in the oil belt states and more generally in the 1991 recession—so this has proved a daunting task to many during the recent mortgage crisis.

A loan analysis covers a wide assortment of information, and from these diverse elements, an underwriter must determine the degree of risk involved. There is no such thing as a risk-free mortgage loan. It is the underwriter's prime responsibility to determine the magnitude of the risk and to compensate for it in the terms and conditions of the loan. The degree of risk determines the ratio of loan to value, the length of time for repayment, and the interest and discount points required by the lender.

As one of the essential elements in underwriting any mortgage loan, the property to be pledged must be examined for suitability. As discussed in the previous chapter, for a residential loan, it is the borrower's personal income that is expected to repay the loan. For commercial loans, it is the income from the property that becomes more important. So the analysis of property that will be pledged as collateral differs somewhat between residential and commercial loans. For a residential loan, the property serves as a backup, a pledge of something of value that better assures repayment of the loan. It is not something the lender expects to use for repayment of the loan. Therefore, the thrust of a property analysis for a residential loan is simply to determine the property's market value and whether that value serves as adequate collateral for the loan. Some of

the new requirements being placed on the appraisal community due to changes in the data collection process will be daunting. We will discuss these changes later in the chapter.

For a commercial loan, the property analysis must look further. Generally, the loan is expected to be repaid from income generated by the property. While the property does serve as collateral—a backup in case of loan default—it is more important for the underwriter to make sure the property income can sustain loan repayment. While the underlying purposes differ, both rely on professional appraisals as a starting point for property analysis.

PROPERTY APPRAISAL

An appraisal may be defined as an *estimate* of value of an adequately described property as of a specific date. It is the considered opinion of a knowledgeable and qualified professional supported by an analysis of relevant data. An appraisal can be an evaluation of a full ownership, a partial ownership interest, or leasehold rights.

A **property appraisal** provides information that has several uses in financing real estate. It is used as an important measure of the loan amount. Lenders limit loan amounts to a percentage of property value. However, for commercial loans, the loan amount may have an alternate limit as a percentage of the property's income. But a property's income is also a direct reflection of the property's value. In addition, an appraisal serves as a support document for institutional lenders when they undergo regulatory examinations.

Determination of appraised value is made by individuals specially qualified in the field. In the past, a lending institution's loan officer might have estimated the property value based on personal knowledge and experience in the area. However, as mortgage lending increased in volume and complexity, almost all appraisals were shifted to professionals who specialized in this work. Some work as employees of a lending institution and some as independent fee appraisers.

Federal/State Certification

In the past, both the qualification of professional appraisers and the determination of what comprises acceptable content in an appraisal have been the province of various independent appraiser associations.

These are primarily peer groups organized to develop quality standards among themselves and to award designations to eligible members meeting their requirements. Prior to 1989, there was no federal regulatory involvement in this field.

While many must share the blame for the collapse of savings and loan associations in the 1980s, Congress felt the quality of appraisals carried some of the responsibility. As a result, legislation was passed creating a system to set proper standards for both appraisers and the content of appraisals.

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), of which Title XI spelled out a system for setting federal appraiser and appraisal standards to be used as a guideline for each state to develop its own system of qualification. Title XI is applicable to both residential and commercial loans. FIRREA established a council called the Federal Financial Institutions Examination Council with a subcommittee known as the Appraisal Subcommittee. The law applies to a loan made by a federally related lender and is applicable to both residential and commercial loans.

The purpose of the Subcommittee was to develop suitable criteria for state licensure of appraisers and standards for appraisals that would assure credible information for federally related lenders. *Federally related* is a broad-brush definition of any lender with some relation to the federal government, including those carrying federal deposit insurance, and covers quasi-government entities such as Fannie Mae and Freddie Mac.

Since its creation, the Appraisal Subcommittee has set standards that are now reflected in every state's requirements for certification and licensing of individuals qualified to perform appraisals in federally related transactions. The Subcommittee continues to monitor requirements of federal regulatory agencies with respect to appraisal standards. It also maintains a national registry of state-certified and state-licensed appraisers eligible to appraise in federally related transactions. The Appraisal Foundation (TAF) is the Congressionally appointed writer of the Uniform Standards of Professional Appraisal Practice (USPAP) and sets qualification standards for appraisers.



THE APPRAISAL FOUNDATION

*Authorized by Congress as the Source of Appraisal
Standards and Appraiser Qualifications*

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Standards for Appraisers

FIRREA's Title XI calls for the qualification of appraisers through appropriate testing and experience requirements to be established by state law. As of January 1, 2008, the new examination criteria became effective. The new education criteria, including the college degree requirement, were effective January 1, 2010, as announced by the Appraisal Qualifications Board. It should be noted that state requirements may exceed AQB minimums. The four categories of appraisers and their qualifications are below.

1. A **Certified General Real Property Appraiser** is qualified to evaluate both residential and commercial property of any size. A general appraiser must demonstrate knowledge of the profession and understand the documents involved. To qualify, the applicant for the Certified General license must hold a Bachelor's degree or higher from an accredited college or university, and have 300 hours of AQB-approved education, including 15 hours of USPAP, plus 14 hours per year of continuing education and 3,000 hours of experience (1,500 hours must be obtained in non-residential appraisal work), during the past 30 months.
2. A **Certified Residential Real Property Appraiser** can appraise one- to four-unit residential properties without regard to value or complexity. To qualify, the appraiser must hold a Bachelor's degree or higher from an accredited college or university, and have 200 hours of education, including 15 hours of USPAP, in addition to 14 hours per year of continuing education. The appraiser must have passed the AQB-approved Certified Residential Real Property Appraiser examination and have 2,500 hours of experience during the past 24 months.
3. A **Licensed Residential Real Property Appraiser** is qualified to appraise non-complex one- to four-unit residential properties having a transaction value of less than \$1,000,000, and complex one- to four-unit residential properties having a transaction value less than \$250,000. LRRPA applicants for the Licensed Residential credential shall successfully complete 30 semester hours of college-level education from an accredited college, junior college, community college, or university. The college or university must be a degree-granting institution accredited by the Commission on Colleges, a regional or national accreditation association, or by an accrediting agency that is recognized by the U.S. Secretary of Education. In addition to the

30 semester hours, applicants must also complete 150 hours of education, including 15 hours of USPAP, in addition to 14 hours per year of continuing education and 2,000 hours of experience over the course of no fewer than 12 months.

4. An **Appraiser Trainee** must complete 75 hours of education and pass the Core Curriculum examinations and the 15-hour National USPAP course, in addition to completing 14 hours of continuing education in the third and successive years. Appraiser Trainees are not required to pass a state exam (as all other categories are) and must finish these requirements within 5 years of starting.

The Appraisal Foundation sets the criteria for who can reproduce the approved USPAP materials for training and education; this is limited to the firms referred to as Appraisal Sponsors.

Standards for Appraisers and FHA Mortgages

HUD/FHA requires that licensed qualified appraisers also be approved for FHA mortgage appraisal work. FHA Mortgagee Letter 1996-26 specifies that FHA Roster appraisers must avoid conflicts of interest and the appearance of conflicts of interest. In order to help appraisers avoid actual conflicts or the appearance of conflicts, no members of a lender's loan production staff or any person (i) who is compensated on a commission basis upon the successful completion of a loan, or (ii) who reports, ultimately, to any officer of the lender not independent of the loan production staff and process, is allowed to have substantive communications with an appraiser relating to or having an impact on valuation, including ordering or managing an appraisal assignment. FHA Mortgagee Letter 2009-28 is effective for all case numbers assigned on or after January 1, 2010. The existing requirements will remain in effect.

The new requirements are as follows:

- Mortgage brokers and commission-based lender staff are prohibited from participating in the appraisal process.
- Historically, the FHA prohibited mortgagees from accepting appraisal reports completed by an appraiser selected, retained, or compensated, in any manner by real estate agents. To ensure appraiser independence, FHA-approved lenders are now prohibited from accepting appraisals prepared by FHA Roster appraisers who are selected, retained, or compensated in any manner by a mortgage

- broker, or any member of a lender's staff who is compensated on a commission basis tied to the successful completion of a loan. FHA Mortgagee Letter 2009-28 lists those practices in which lenders, brokers, or other originators are prohibited from engaging. These practices might be construed as attempting to influence appraisers' independence.
- Compliance by December 31, 2011, with the Uniform Appraisal Dataset (UAD) was required for FHA appraisals reported on the 1004 (URAR) form and the 1073 (Condo) form. Appraisals reported on other forms, such as the 1025 and 1004C, may not be required to be UAD compliant. More specifics on the UAD will be covered later in this chapter.

Appraiser Selection in FHA Connection

Lenders are responsible for assuring that the appraiser who actually conducts the appraisal used for an FHA-insured mortgage is correctly identified in FHA Connection (discussed further in Chapter 14). The FHA has found that on numerous occasions, the name of an appraiser appearing in the appraiser log-in screen is not the appraiser who actually completes the appraisal. Lenders who fail to assure that FHA Connection reflects the correct name of the appraiser are subject to administrative sanctions.

Use of an Appraisal Management Company (AMC) and Appropriate Third-Party Fees

FHA does not require the use of AMCs or other third-party organizations for appraisal ordering, but recognizes that some lenders use AMCs and/or other third-party organizations to help ensure appraiser independence. To address several questions that have already been raised regarding compensation, this document corrects and expands existing fee requirements set forth in Mortgagee Letter 1997-46.

FHA-approved lenders must ensure that:

- FHA Appraisers are not prohibited by the lender, AMC, or other third party from recording the fee the appraiser was paid for the performance of the appraisal in the appraisal report.
- FHA Roster appraisers are compensated at a rate that is customary and reasonable for appraisal services performed in the market area of the property being appraised.

- The fee for the actual completion of an FHA appraisal may not include a fee for management of the appraisal process or any activity other than the performance of the appraisal.
- Any management fees charged by an AMC or other third party must be for actual services related to ordering, processing, or reviewing appraisals performed for FHA financing.
- AMC and other third-party fees must not exceed what is customary and reasonable for such services provided in the market area of the property being appraised.

Standards for Appraisals

As stated earlier in the chapter, FIRREA's Title XI requires that the content of appraisals meets the standards set by the Appraisal Standards Board, which is a part of the Appraisal Foundation. The Appraisal Foundation was created in 1987 by eight active private appraisal associations. Prior to passage of federal legislation in 1989, professional appraisers recognized a need for better qualification for both appraisers and appraisals, and established the Appraisal Foundation to develop practical standards and requirements. Federal recognition of their work is an indication of FIRREA's continued acceptance of their standards.

Federal standards require appraisals to conform to the USPAP as adopted by the AQB. A standardized appraisal form has been developed in a cooperative effort between the industry working group, Fannie Mae, Freddie Mac, HUD, and the VA. The form, called the Uniform Residential Appraisal Report (URAR), is a revision of Fannie Mae Form 1004/Freddie Mac Form 70. It became mandatory for use after January 1, 1994. The last major revision of the standards of appraisal review of residential properties and the revision of Form 1004 and Form 70 took place in March of 2005. (A copy of the current form in use as of February 2011 is reproduced in the Appendix.) Federal requirements also set a minimum level of certification based on the value and kind of property appraised.

New Quality Mortgage (QM) Appraisal Issues

The Truth in Lending Act (TILA) of 1968 and its implementing rules under Regulation Z seek to promote the informed use of consumer credit

by requiring disclosures about its costs and terms. In 2010, TILA was amended by the Dodd-Frank Act and now requires appraisals on principal residences securing higher-priced loans. The Consumer Financial Protection Bureau (CFPB) under the Dodd-Frank Act was to implement these TILA amendments in partnership with five other federal regulatory agencies that are adopting a new rule, the Higher-Priced Mortgage Loans (HPML) Appraisal Rule. The rule is part of Regulation Z.

A residential mortgage is defined as an HPML if it is secured by a consumer's principal dwelling and has interest rates above the following thresholds:

- It is a first-lien mortgage (other than a jumbo loan) with an annual percentage rate (APR) that exceeds the Average Prime Offer Rate (APOR), published by the Bureau at the time the APR is set, by 1.5 percentage points or more.
- It is a first-lien jumbo loan with an APR that exceeds the APOR at the time the APR is set by 2.5 percentage points or more. A loan is a jumbo loan when the principal balance exceeds the limit in effect as of the date the transaction's rate is set for the maximum principal obligation eligible for purchase by Freddie Mac. (Comment 35(a)(1)-3)
- It is a subordinate-lien with an APR that exceeds the APOR at the time the APR is set by 3.5 percentage points or more.

When you originate a higher-priced, first-lien, or subordinate-lien loan covered by the HPML Appraisal Rule, you must:

- Use a licensed or certified appraiser who certifies that the appraisal complies with the Uniform Standards of Professional Appraisal Practice (USPAP) and the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, as amended, 12 U.S.C. 3331 et seq., and any implementing regulations.
- Have the appraiser physically visit the property, view the interior, and produce a written appraisal report.
- Obtain an additional appraisal at your own expense if the property's seller acquired the dwelling within the past 180 days and is reselling it for a price that exceeds certain thresholds, which can be found in the January 2014 Small Entity Compliance Guide. (See link at end of chapter.)

- Provide a disclosure within three business days of application explaining the consumer's rights with regard to appraisals.
- Give consumers free copies of the appraisal reports performed in connection with the loan at least three days before consummation of the transaction.

Appraisal Associations

Federal certification standards for appraisers have not changed the existence of a number of private professional organizations offering appraisal designations to those who qualify under each organization's standards. These are peer groups made up of appraisers who are interested in maintaining and improving the quality of their profession. Each organization offers certain designations that indicate qualification in a particular area of appraisal work. The requirements differ somewhat, but all are based on a minimum prescribed level of education and experience, in addition to successful performance on some rather difficult tests. Following is a brief listing of some of the better-known organizations and the designations granted by each:

Appraisers Association of America, Inc. (1)

AAA—Certified Member

The Appraisal Institute (2)

MAI—Member of Appraisal Institute

SRA—Senior Residential Appraiser

SRPA—Senior Real Property Appraiser

American Society of Appraisers (1)

ASA—Senior Member of the Society

FASA—Fellow of the Society

American Society of Farm Managers and Rural Appraisers (the oldest group in the United States) (1)

AFM—Accredited Farm Manager

ARA—Accredited Rural Appraiser

International Association of Assessing Officers (1)

RES—Residential Evaluation Specialist

AAS—Assessment Administration Specialist

CAE—Certified Assessment Evaluator

National Association of Independent Fee Appraisers¹ (1)
 IFA—Independent Fee Appraiser (Residential Only), Member
 IFAS—Independent Fee Appraiser, Senior Member
 IFAA—Independent Fee Agricultural Appraiser, Specialist
 IFAC—Independent Fee Appraiser, Counselor

National Association of Real Estate Appraisers (2)
 CREA—Certified Real Estate Appraiser
 CCRA—Certified Commercial Real Estate Appraiser
 RTA—Registered Trainee Appraiser

1. On January 19, 2015, was an Approved Sponsor of the Appraisal Foundation and had the right to reproduce USPAP materials.
2. On January 19, 2015, was not an Approved Sponsor of the Appraisal Foundation without the rights to reproduce USPAP materials.

Peer designations are good indicators of expertise in a specialized area of appraisal work, and they give some assurance of an appraiser's interest in maintaining professional standards. But there is no requirement that a person belong to any peer group in order to qualify as a state certified or licensed appraiser.

Principles of Appraising

How do appraisers approach their problems? What are they looking for in determining values? What analytical details should lenders or borrowers expect to find in professional appraisals? Considerable study has been given to the theory that underlies all sound appraisals, resulting in specific **appraisal principles** that guide professional thinking in evaluating property. Following are descriptions of several of the more important principles:

1. **Supply and demand.** The theory underlying all economic practice is that scarcity influences supply, and that what people want and can purchase controls the demand.

¹The American Association of Certified Appraisers merged with the National Association of Independent Fee Appraisers for those members with the former professional designations of CA-R (Certified Appraiser, Residential), CA-S (Certified Appraiser, Senior), CA-C (Certified Appraiser, Consultant), and CA-F&L (Certified Appraiser, Farm and Land).

2. **Substitution.** The value of replaceable property will tend to coincide with the value of an equally desirable substitute property.
3. **Highest and best use.** It is the use of land at the time of the appraisal that will provide the greatest net return. This requires the proper balance of the four agents of production (labor, coordination, capital, and land) to provide the maximum return for the land used.
4. **Contribution.** This principle applies to the contributory market value added by an improvement, such as an elevator in a three-story building, or the value added to a building lot by increasing the depth of that lot.
5. **Conformity.** To achieve maximum value, land use must conform to the surrounding area. An over-improvement, such as a \$300,000 house built in a neighborhood of \$60,000 homes, will lower the value of the larger house. Conversely, a \$60,000 home in a neighborhood of \$300,000 homes might see its value increase.
6. **Anticipation.** Since value is considered to be the worth of all present and future benefits resulting from property ownership, the anticipation of future benefits must be evaluated.
7. **Arm's length transaction.** This is a transaction in which the parties involved are not related or previously involved. Transactions between family members and relatives are normally not considered arm's length. Transactions between friends, colleagues, or individuals with previous or existing relationships may or may not be arm's length. Appraisers must be careful to know individual state laws relating to licensed appraisers' responsibilities to disclose transactions that are not arm's length.

TYPES OF APPRAISALS

In 1994, the Uniform Standards of Professional Appraisal Practice (USPAP) was changed to include a Departure Provision that permits a limited appraisal, the rules of which are classified as specific guidelines rather than binding requirements. The burden of proof is placed on the appraiser to decide before accepting an assignment that the departure from the Uniform Standards will not confuse or mislead those relying on the appraisal.

The appraiser must advise the client that the assignment calls for something less than a full appraisal and that departures will be explained. The client must agree that a limited appraisal would be appropriate.

The USPAP Departure Provision now lists two types of appraisals:

1. A *complete appraisal*, defined as the act of estimating value without invoking the Departure Provision.
2. A *limited appraisal*, defined as the act of estimating value resulting from invoking the Departure Provision.

If an appraisal is being used for purposes of valuation in any circumstance involving the Internal Revenue Service (IRS), the appraiser should not invoke the Departure Provision under SR 9-4, the "Market Approach and Methods" section of the USPAP. The appraiser should generally follow the eight factors found in Revenue Ruling 59-60, which states that when the IRS is the intended user of the valuation, the person performing the valuation should follow all of the specific guidelines of SR 9-4 without invoking the Departure Provision for any part of SR 9-4.

USPAP now defines two different levels of reporting requirements. These are as follows:

1. The *appraisal report*, where the appraiser's responsibility to determine whether greater "detail or explanation" is required based on the Intended Use and the Intended User(s) of the report. The minimum standards for an Appraisal Report are:
 - a. When there are Intended Users in addition to the Client
 - b. When the Client may need to understand the appraiser's rationale for options and conclusions
 - c. When the Client may not have specialized knowledge about the subject property
2. The *restrictive report*, which is the least detailed of the reporting options. There is a minimal presentation of information and it is intended for the client only. The report must contain a use restriction that clearly limits reliance on the report on the part of the client, and warns that the report cannot be properly understood without additional information from the appraiser.

These two levels of appraisals may be found in practice in roughly the following formats:

1. The restrictive report: *Letter form*. In its simplest form, an appraiser can submit a letter to the client detailing only the most important points and reaching a conclusion of value. No background information or supporting data are given, although the appraiser must have developed these prior to issuing the estimate.

2. The *appraisal report: Standard form*. For residential appraisals, a standard printed form is now required. It is Freddie Mac Form 70/Fannie Mae Form 1004, called the Uniform Residential Appraisal Report. The most recently revised form was mandated for use in May 2005. Note: Due to new reporting rules issued by the USPAP in 2014 when a appraiser uses the standard Form 1004 they will have to deal with the label “built-in” to the form, there may be no way to delete the “Summary Appraisal Report” label from the form, but it should be viewed as an unnecessary [2nd] label and the USPAP “Appraisal Report” label should be prominently displayed somewhere near the beginning of the report. Since official form reports that cannot be changed, the USPAP seems to believe that relying on the fact that the phrase “Summary Appraisal Report” includes the words “Appraisal Report” is NOT adequate to properly identify the report option used and the term Appraisal Report should be prominently displayed by itself or within a longer identifying sentence. Most have just used: Appraisal Report; Prepared in Accordance with USPAP Standards Rule 2-2(a) or This report was prepared in accordance with the requirements of the Appraisal Report option of USPAP. As of July 14, 2015 the Fannie Mae Form 1004 called the Uniform Residential Appraisal Report had not been update to reflect the new language requirement of 2014-2015 USPAP Report Options (Standards 2 & 8).

Appraisal Report

To better explain major information found in an evaluation of property, appraisal report is detailed in the following section.

Description of Property

The property should be defined in accurate legal wording, and the precise rights of ownership must be described. The rights may be a leasehold interest, mineral rights, surface rights, or the full value of the fee simple rights in the land and buildings thereon.

The Date and Purpose of the Appraisal

Appraisals can be made for times other than the present, such as when needed to settle an earlier legal dispute. The date of the appraised value

must be clearly shown. Also, the purpose of the appraisal should be stated, as it will influence the dominant approach to value. In professional appraisals, there is no such thing as the buyer's or seller's value; this is not a "purpose" as identified here.

An example of purpose would be to estimate value for an insurance settlement, emphasizing a cost approach to value, as claims are adjusted on the basis of cost. If the purpose is a condemnation action, the most relevant approach is the market value approach.

The Background Data

While the standard form and simple letter report will not provide any economic background data, the narrative report discloses economic information as clues to value. An overall study of the market region is made, which may include an area as large as an entire state. The focus is then narrowed down to the local area—the town or that portion of a city where the property is located. From there, the analysis narrows even further, to the specific neighborhood and then to the actual site under appraisal.

The Approaches to Value

Appraisers use three common approaches to estimate value: (1) cost, (2) sales comparison, and (3) income. All approaches should be used wherever possible, and all should reach approximately similar values, although these values are seldom the same. In certain appraisals, only one approach may be practical, such as valuing a city hall building for insurance purposes. In such an analysis, only a cost approach would be practical, as there is not much buying or selling of city halls to provide sales comparison data, nor is there a true income from the building itself to provide figures for an income approach. A single-family residence may appear to lack any income for analysis, but certain neighborhoods have sufficient houses rented to provide enough data to reach an income-approach conclusion. We will discuss the three approaches to value in greater detail later in the chapter.

Qualifying Conditions

If, in the analysis of property, the appraiser discovers any material factors that will affect the property's value, these can and should be reported as further substantiation of the value conclusion.

Estimate of Value

This is the real conclusion of the study, the figure most people turn to first when handed a finished appraisal. Each of the approaches to value will result in a firm dollar valuation. It is the purpose of this estimate to explain why one of the approaches to value is favored over the others. For example, with an income property such as a motel, the value judgment would rest most heavily on the income analysis. The final conclusion is a single value for the property and represents the considered knowledge and experience of the appraiser making the report.

Certification of the Appraiser and His or Her Qualifications

The professional appraiser certifies his or her opinion by signature and disclaims any financial interest in the property being appraised that could influence a truly objective conclusion. A recitation of the appraiser's educational background, standing within the profession as indicated by professional ratings, and previous experience—such as appraisals previously made and for whom—is included. The certification serves to substantiate the quality of the appraisal for an underwriting officer.

Addendum

Depending on the need for clarification, the appraisal will include maps of the area under consideration with the site pointed out, plus the location of comparable properties referred to in the analysis. Charts may be used to indicate such things as the variables in a market analysis. Photos of the subject property are usually mandatory.

THREE APPROACHES TO PROPERTY VALUE

The three approaches to value, the essence of an appraisal, are discussed in the sections that follow.

Property Value as Estimated by Cost Approach

The **cost approach** is developed as the sum of the building reproduction costs, less depreciation, plus land value. The reproduction costs can be developed the same way a builder would prepare a bid proposal—by listing every item of material, labor, field burden, and administrative overhead. Reproduction cost estimates have been simplified in active urban

areas through compilation of many cost experiences converted to a cost-per-square-foot figure. The offices of active appraisers collect such data in depth for reference.

Depreciation, by definition, detracts from the value and must be deducted from the reproduction costs. However, **external obsolescence** can be either a deduction or an addition, depending on its nature. Three separate types of adjustments must be made in the cost approach.

1. **Physical deterioration.** Wear and tear on the building is the type most commonly associated with the word *depreciation*. Examples would be the flaking paint, a worn-out roof needing new shingles, and rotting window casements. These are curable items and, under the breakdown method, should be deducted from value as rehabilitation costs. Other items of physical deterioration are incurable—meaning not economically feasible to repair. For example, the aging of the foundations or of the walls is incurable, and this kind of deterioration should be charged off as a certain portion of the usable life of the building. Another method of handling physical deterioration, in contrast to the breakdown method, is the engineering or observed method wherein each major component of the building is listed and a percentage of its full life is charged off. This method recognizes that each major component of a building may have a different life and the percentage of depreciation would vary at any point in time.
2. **Functional obsolescence.** As important as physical deterioration is that category of loss in value resulting from poor basic design, inadequate facilities, or outdated equipment. These elements, too, can be curable or incurable. An example of incurable functional obsolescence would be an aging building that no longer meets the needs of modern business with its demands for greater flexibility in its office arrangements. There could be an excess of walls or partitions in an office building, which would cost money to remove and modernize, but might be curable. Lack of air conditioning in a hotel or office building is an older example of curable functional obsolescence.
3. **External obsolescence.** The third type of depreciation has a more elusive quality and is actually not part of the building at all. External obsolescence is the set of factors outside and surrounding the property that affect its value, requiring the determination of the plus or minus effect of these forces. Some are very obvious influences—for example, a new freeway bypassing an existing service station, or the construction of an

undesirable industry in an area adjacent to residential property—and would certainly lower value. However, the bridging of a stream to open new land for development would create a substantial increase in value. A more difficult problem is ascertaining the economic impact of a possible decline in a specific neighborhood. While landowners are able to exercise some voice in protest or encouragement of these outside forces, for the most part, what is done with neighboring properties is not controllable and is not curable. And it will always be a latent force that can affect the value of an individual property.

After determining building reproduction cost, then depreciation adjustments, the third factor to be considered under the cost approach is value of the land. Land value, which varies with local economic conditions, affects demand, and to a lesser extent, supply. More recently, environmental problems have affected the value and availability of land. Land value is best determined through an examination of recent sales of similarly located properties—i.e., the sales comparison method as discussed in the next section.

However, there are sometimes specific reasons for changes in the appraised value of land. Buildings can and do deteriorate, while land can continue to increase in value due to the same outside factors noted in the preceding discussion of external obsolescence. For example, as urban areas expand, certain intersections become more and more valuable, new thoroughways and freeways concentrate greater flows of traffic, and huge shopping centers add to the value of all surrounding land. As suburban sprawl moves outward, former farmland increases in value as it becomes potential residential subdivisions. Another example can be found in some older sections of a city when the land becomes more valuable than the building. The building may represent such poor usage of the land that it becomes a liability to the property value, and its removal costs should be deducted from the stated value of the land. By ascertaining these fluctuations in land value, the appraiser can bring a cost analysis into step with a changing market value.

Property Value as Estimated by Sales Comparison Analysis

Also known as a market analysis, the estimated value by a **sales comparison approach** is determined by prices paid for similar properties in the neighborhood. This approach is most commonly used with residential property because it offers sufficient sales information to make comparisons useful.

Since no two properties are ever precisely **comparable**, much of the analysis under this method concerns itself with detailing major characteristics and whether these add to or subtract from the value of the property. For example, if a similar property was sold two years earlier, the appraiser could assume that the subject property would show an increase, or decrease, in that time span, depending on the nature of the neighborhood. A fireplace in the subject property would give it a plus factor in comparison with a similar property lacking a fireplace. Comparisons are comprehensive, covering such points as location, size, physical condition, and amenities.

Some confusion does exist in the relationship between sales prices and asking prices. An appraiser is primarily concerned with completed sales and with sales uncomplicated by extraneous pressures such as forced sales, estate disposals, or transfers within a family. The willing-buyer and willing-seller standard of a free market sale is lacking in a forced sale. An asking or offering price is considered by most to represent a ceiling or maximum value for the property. Appraisers usually recognize the inherent inaccuracy of an asking price, especially one set by homeowners. This figure is often arrived at by adding together the original purchase price, the full cost of all improvements that have been made, the selling commission, and the owner's amateur notion of general market appreciation. But every so often, an owner actually receives such a sales price from a willing buyer, and this makes the professional feel a bit foolish!

Sales price as a sound basis for comparing market values of property came under question in the mid-1980s. By that time, it had become common for home sellers, particularly home builders, to offer attractive financing plans as a sales inducement. By paying a lender part of the interest cost up front, as in a buydown, a seller could offer lower-than-market "effective" interest rates to a buyer during the early years of a mortgage. The lower payment amount made loan qualification easier, which attracted more buyers. The cost of the buydown of interest was usually added into the price of the house. Since the sales price thereby included a built-in finance cost, it was no longer an accurate indication of true market value. Most lenders have since added a requirement that any market value used as a basis for sales comparisons be adjusted downward to reflect any excessive finance costs. Between 2007 and 2010, the use of a special code in the Multiple Listing Services (MLS) around the United States which allowed sales prices to be reported as listing prices caused distortions in the use of MLS data for the sales comparison approach. RE InfoLink (REIL)—the MLS serving the counties of Monterey, San Benito, San Mateo, Santa

Clara, and Santa Cruz in Northern California—approved adoption of a new policy enabling buyers or sellers to withhold the sale price of a property as a condition of a transaction. With completion of an “Authorization to Withhold Sale Price” form and payment of a \$500 fee, the listing price, rather than the actual sale price, can be entered into the “sale price” field at close of escrow.² The listing agent will be required to enter a code in the Confidential Remarks (agent only) field, indicating that the sales price was withheld. Some referred to this as the “Z” code. Both Fannie Mae and Freddie Mac have revised their definition of *market value* to “the most probable price [that] a property should bring.”

In June of 2010, in response to the issues discussed above and the continuing crisis in residential finance, Fannie Mae and Freddie Mac, at the direction of the Federal Housing Finance Agency (FHFA), developed the **Uniform Collateral Data Portal®** (UCDP®), which is a single portal for the electronic submission of appraisal data files. Lenders are required to use UCDP® to submit electronic appraisal data files that conform to all GSE requirements, including the Uniform Appraisal Dataset (UAD) when applicable, before the delivery date of the mortgage to either Fannie Mae or Freddie Mac. The goal of the UCDP is to allow lenders to take a more consistent approach to appraisal definitions and requirements through the use of a common portal for submitting appraisal data files.

UCDP became available in June 2011. To facilitate a smooth transition to the electronic submission of appraisal data files, lenders were encouraged to begin using UCDP for their live production immediately.

- Appraisal report forms for all conventional mortgages delivered to the GSEs on or after March 19, 2012, have been submitted to UCDP prior to the delivery date of the mortgage if:
 - The loan application is dated on or after December 1, 2011
 - An appraisal report is required

Appraisals must be submitted before the delivery date of the mortgage to Fannie Mae or Freddie Mac and must include the applicable required appraisal report forms listed below for all conventional appraisal reports issued on the dates listed above.

- Uniform Residential Appraisal Report (Fannie Mae 1004/Freddie Mac Form 70)*

²Berg, Kris. “How Timely—Northern California MLS Allows Sales Price to Be Withheld.” *San Diego Home Blog*, Aug. 8, 2007. Accessed May 11, 2011 at <http://sandiegocastles.com/sandiegohomeblog/how-timely-northern-california-mls-allows-sales-price-to-be-withheld/>

- Manufactured Home Appraisal Report (Fannie Mae 1004C/Freddie Mac Form 70B)
- Small Residential Income Property Appraisal Report (Fannie Mae 1025/Freddie Mac Form 72)
- Individual Condominium Unit Appraisal Report (Fannie Mae 1073/Freddie Mac Form 465)*
- Exterior-Only Inspection Individual Condominium Unit Appraisal Report (Fannie Mae 1075/Freddie Mac Form 466)*
- Exterior-Only Inspection Residential Appraisal Report (Fannie Mae 2055/Freddie Mac Form 2055)*
- Individual Cooperative Interest Appraisal Report (Fannie Mae Form 2090)
- Exterior-Only Inspection Individual Cooperative Interest Appraisal Report (Fannie Mae Form 2095)

The Direct Sales Comparison Approach uses the sales price of a comparable property and makes any positive or negative adjustments in that price to more accurately compare it to the value of the subject property. The URAR requires that at least three comparables be used. This is the only required approach by Fannie Mae unless otherwise directed by its automated underwriting system. This is a departure from the appraisal approach in effect prior to 2005, and the Appraisal Standards Board of the Appraisal Foundation has required that (1) appraisers do a cost approach when it is necessary for credible assignment results, and (2) the appraiser must always explain the omission of the comparison approach, cost approach, or income approach.³ It is unclear as to how the USPAP and the Appraisal Foundation will aid in the transition to the new UAD, which requires 50 additional data collection points and standardizes definitions and responses for a key subset of the fields now in use. The Appraisal Foundation met with the Federal Housing Finance Agency, Fannie Mae, and Freddie Mac on February 17, 2011, and March 10, 2011, to discuss the Uniform Mortgage Data Processing (UMDP) initiative and the Uniform Appraisal Dataset (UAD) and express its concerns with the implementation of the new regulations and their effects on the appraiser community, and submitted its concerns in writing on April 29, 2011. After introducing the UCDP[®] in 2011, Fannie Mae followed by launching proprietary appraisal messages in the UCDP[®] in January 2013.

³Wiley, Danny. "USPAP in the Real World." Presentation at Appraisal Standards Board, the Appraisal Foundation Annual Meeting, Aug. 1, 2006.

*These forms are uniform in appearance and required content and only the form numbers vary from Fannie Mae to Freddie Mac.

These messages have assisted lenders in detecting data inconsistencies and improving the overall reasonableness and quality of appraisal data.

On December 13, 2014, numerous other Fannie Mae proprietary appraisal messages were retired in order to focus lenders' attention on eligibility and compliance messages, and to better align with appraisal policy. In addition, Fannie Mae implemented additional changes to the proprietary messages in UCDP® to provide more information and help lenders identify potential defects during the appraisal review process. The changes included the introduction of an appraisal risk score, flags, and new messages in UCDP® from Collateral Underwriter™ (CU™), a new proprietary appraisal risk assessment application developed by Fannie Mae in January of 2015 to support proactive management of appraisal quality.

On January 26, 2015, the severity level for 21 Fannie Mae proprietary appraisal messages that relate to eligibility violations were modified. The severity level changed from a warning message that is automatically overridden to a hard stop requiring a lender action (a manual override or the submission of a corrected appraisal) to obtain a "Successful" submission status in the UCDP®.

Property Value as Estimated by Income Approach

Because the **income approach** examines the actual return per dollar invested, it is the most important method for any investment property. When people buy investment property, they normally expect to recover, or *recapture* in appraisal terminology, their money with a profit. The money comes from two sources: (1) the annual earnings (excess income over all costs) and (2) the proceeds from a resale at the end of the term of ownership, called the *residual value*.

There are several acceptable methods used to estimate value with an income approach. However, any method based on the value of future income suffers from the same problem: Real estate does not offer the certainty of future income that other kinds of investment may provide. Nevertheless, once an income stream has been developed for analysis purposes, two methods are more widely used to convert the income stream into a value of the income-producing asset: the capitalization method and the discount analysis method, described next.

Capitalization Method

Probably the oldest, and the simplest, method of converting an income stream into an asset value is **capitalization** of the income. This is done by using the following formula:

$$\text{Income Stream} \div \text{Rate of Return} = \text{Value}$$

In the formula, the income stream is the expected profit derived from the property for the year. The rate of return is the return, expressed as a percentage, that the investor expects to receive from the property. The return is determined by the investor, or the analyst, as one commensurate with current market conditions and the degree of risk involved.

Example

A property shows an income stream* of \$20,000. A fair rate of return for the present market, including comparable risks involved, is 9%. Using the formula:

$$\$20,000 \div .09 = \$222,222$$

If you are offered a property showing the foregoing returns, you can place a value of \$222,222 on the cash flow. Add to that amount the residual value of the property at the end of a holding period, and it will give the property value by one income approach.

Value of income stream	\$222,222
Value of residual (estimated)	85,000
Total value	<u>\$307,222</u>

*The term *income stream* is not precisely defined; it can mean different things to different analysts. However, when making comparisons between properties, whatever measure is used, the same measure must be applied to each property.

Discount Analysis Method

Another method of analysis—this one derived from financial markets—is **discount analysis**. This procedure takes each year's future cash flow and reduces it to its present worth. The investor receives a return on the investment delivered at intervals in the future. Yet payment for the income-producing asset is expected at time of purchase, either in cash or by borrowing money to deliver the cash at closing. So the question is: How much are the future cash flows worth in dollars today? By referring to the "Present Worth of a Dollar" (the third column in Table 10-1), we can easily calculate the discount. Using the same numbers as in the previous example leads to the result shown in Table 10-1.

The figures in Table 10-1 are hypothetical and intended only to illustrate the discount calculation. In practice, the holding period would most

TABLE 10-1 Present Worth of Cash Flow Plus Residual

TABLE 10-1		Present Worth of a Dollar Factor* at 9% Rate		Present Worth of Cash Flow
At End of Year	Annual Cash Flow			
		x	0.91743	=
1	\$20,000	x	0.84168	= \$ 18,349
2	20,000	x	0.77218	= 16,834
3	20,000			= 15,444
		Sum of annual cash flows		= \$ 50,627
At the end of year 3, the property is sold for \$250,000, discounted to its present worth equals \$250,000 x 0.77218				= 193,045
Total present worth of cash flows plus residual				= \$243,672

*Present worth factors are obtained from financial tables such as "An Introduction to Statistics for Appraisers," provided by the Appraisal Institute.

Source: ©2016 OnCourse Learning

likely be much longer. And the annual cash flows would be projected to take into account such variations as might be anticipated in occupancy and rental-rate adjustments. This kind of calculation can be made easily with a computer using any of several available software programs.

Where Are We Now?

Which Approach Has the Most Significant Weight?

While all three appraisal approaches are used in evaluating most properties, more weight is given to a specific approach depending on the property being appraised. The following table shows the approach being given the most weight as a function of the property:

TYPE OF PROPERTY	APPRAISAL APPROACH
Abandoned fire station	Cost
House in zoned residential subdivision	Sales Comparison
Stand-alone operating drug store	Income
Tract of raw land	Sales Comparison
Condominium unit	Sales Comparison
Office building	Income
House in unzoned industrial area	Cost
Mini storage complex	Income
School facility	Cost

PROPERTY CHARACTERISTICS

There are several considerations concerning the property's **physical characteristics** that may be used as "go/no-go" determinants in the approval of a mortgage loan. Commentary follows on several of the more common distinctions.

Dwelling Units

Statistical references class one- to four-family housing as residential. However, many lenders in the conventional loan market separate this group into single-family housing (which qualifies for prime loan rates) and multiunit commercial property (which is rated for higher risk loans). Both the FHA and the VA issue commitments for two-, three-, and four-family housing, but the requirements are not as favorable as those for single-family units.

Number of Bedrooms

Conventional lenders no longer view the number of bedrooms as an important consideration. Years ago, it was not unusual to restrict loans to housing that had more than one bedroom. But the market has changed so that a number of buyers prefer limited bedroom space. As long as the lender believes a reasonable market exists for the property should foreclosure become necessary, the collateral is acceptable. (The FHA does base some of its loan limits in certain programs on the number of available bedrooms.)

Square Footage

Minimum house size based on square footage is no longer used as a loan determinant. As builders have endeavored to reduce housing costs, the size of houses has been reduced. The old standard of "not less than 1,000 square feet of living area" is simply not applicable in today's markets. Actually, the importance of square footage is more relevant to the value of the house in an appraisal. There are a few exceptions for permanently installed mobile homes where the minimum square footage requirement for FHA and RHS is 400 square feet. An extremely small but growing housing trend known simply as the "Tiny House" movement has taken advantage of this FHA small-home financing outlet.

Paved Streets

While most cities have managed to pave their streets, there are some smaller communities and new subdivisions that have not. Lenders have used the lack of paving as a “no-go” situation for a loan if it can result in a lessening of the collateral value. For example, the cost of paving is often handled in the form of an additional assessment on the property fronting the new pavement. If the assessment’s amount is unknown, it is difficult to make adequate provision for the charge.

Utilities

A loan application may be rejected if the property offered as collateral does not have adequate sewer and water facilities. Top preference is given to a municipally operated or a regulated private operation furnishing both sewer and water services. The use of septic tanks or private water wells may be a cause for rejection. Some lenders will permit a septic tank if the percolation tests of the soil surrounding it meet certain minimum requirements. Also classed as *utilities* are the services of electricity, natural gas, and telephone. Lack of electricity would be a negative factor for urban and suburban properties, but could be accepted in rural areas. Lack of natural gas or telephone is not detrimental for a loan. Also, there are no requirements for electricity or phones to be furnished through underground systems at the present time.

Building Materials

As important as building materials would seem to be, only the use of asbestos is considered a negative factor in underwriting a loan. Whether the building is sheathed in aluminum, wood, brick, or stone is important to an appraiser in evaluating the building, but not to a lender in determining a “go/no-go” situation. The quality of building materials is expressed in terms of both the value of the building and in its estimated life or apparent age.

Amenities

The extra niceties that exist in some buildings are reflected in the value of the property, but are not considered critical for the underwriter. A swimming pool, fine landscaping, exterior lighting, a neighborhood club, or a recreational area are all added features that increase property value, but are never considered requirements for loan approval.

Hazardous Waste Areas

A more recent concern in the evaluation of real property as collateral for a loan is whether or not the land is on or near a hazardous waste area. While the problem is more likely to be found in a commercial area, residential developments may also be involved. The importance of all environmental requirements has become a major factor in loan determination and will be discussed more fully in a later chapter.

Location of Property

Lines are drawn by most conventional lenders among urban, suburban, and rural housing. The differences are not always clearly delineated, but they do provide a broad classification that is useful in describing packages of loans.

Due to the sprawl of metropolitan areas, the term *suburban* now means almost any location in a recorded subdivision of land in the general area surrounding cities—still the region of greatest growth in our country. *Urban* means the downtown and near-downtown areas of our cities. *Rural* identifies farm housing and, to many lenders, houses existing in the smaller towns. “Rural” may also be used to identify housing without access to a central water and sewer system.

Neighborhoods

Lenders no longer specify areas or neighborhoods within a city as acceptable or unacceptable for making loans. The practice is known more commonly as **red-lining**, from lines drawn on city maps to guide loan officers. Such identification has been interpreted as leading to possible discrimination in violation of the Fair Housing Act. Obviously, a neighborhood that is allowed to deteriorate does not make an attractive location for a 30-year loan. Nevertheless, lenders are asked to qualify houses on their individual merit rather than on the basis of the neighborhood in which they are located.

As assistance in monitoring compliance with these rules, federally regulated lenders are required to disclose the geographic areas in which they have made loans by census tract or by postal zip code number.

Interesting problems are arising in older neighborhoods that have declined but are now recovering due to a phenomenon called “gentrification.” This occurs in areas where older homes have been removed and

townhomes are built in their place. Just a few blocks away, however, other older homes remain that have market values sometimes as low as 25% the level of the new townhomes being built and sold.

Flood-Prone Areas

The federal government has designated certain areas of the country as flood plain zones. These are areas that either have been flooded in the past 100 years or that, if records do not exist, are calculated to have a one percent or greater chance of being flooded. Flood plain elevation lines have been determined by the U.S. Geological Survey, and land at lower elevation comprises a flood plain area. While houses may be built in a designated flood plain, they may not be financed by lenders subject to any federal regulatory body unless minimum elevation requirements are met. Essentially, this means that buildings in flood-prone areas must either be flood-proofed or have the ground floor raised at least one foot above the elevation of the 100-year flood plain line.

Since 1968, the federal government has offered assistance to property owners with subsidized flood insurance through the National Flood Insurance Program. For a homeowner to be eligible for such coverage, the community must agree to participate in flood management and regulate development in its flood-prone areas. The subsidized insurance is offered in cooperation with selected private insurance companies in approved areas.

In 1973, Congress passed the Flood Disaster Protection Act, which required communities to participate in the National Flood Insurance Program as a condition of receiving federal financial assistance. And it required property owners in flood hazard areas to purchase flood insurance as a condition of obtaining financing through a federally regulated, supervised, or insured financial institution. Even so, many borrowers, probably believing they would not be flooded, stopped paying premiums during the term of the loan.

To help make such nonpayment of premiums more difficult, the National Flood Insurance Act of 1994 imposed new obligations on lenders and servicers, including mandatory escrow requirements for flood insurance and mandatory provisions for "forced placement" of flood insurance if the borrower fails to pay premiums. The borrower must be notified if the required coverage is not purchased and kept in force. If no action is taken within 45 days of notification, the lender or servicer must purchase the insurance on behalf of the borrower, charging the cost to the

borrower. Lenders and servicers may now rely on a determination by the Director of the Federal Emergency Management Agency (FEMA) stating whether or not the building is in a special flood hazard area.

Other Disaster-Prone Areas

As new real estate developments increase in areas that are subject to certain kinds of natural disasters, many lenders are refusing to consider loans for such properties. The potential for disasters includes earthquakes, volcanic eruptions, swelling soils, subsidence of the land, landslides, firestorms, and geographic faulting. Where adequate hazard insurance is available, however, most lenders will make the loans.

Age of Property

The age of a house is a simple, frequently-used criterion for determining acceptable and unacceptable loans. The range varies from an insistence by a lender on exclusively new houses—which is unusual—to no fixed limit. Many lenders couple the age of property with the location of the house. Some neighborhoods maintain their desirability over the years, and 30- to 40-year-old homes may qualify for prime loans. Older houses that are not in prime neighborhoods may still qualify for mortgage loans, but at higher interest rates and for shorter terms. The originator of a loan must always keep in mind the specific requirements of various secondary-market sources of money in regard to property age.

Regarding the question of age, conventional loans are considered in two ways: One is the actual age of property; the other is its years of remaining useful life. If actual age is the criterion, a “no-go” limit is set at a specific maximum age—such as 15 years, for example. A lender may commit to take loans on new houses only, or perhaps on houses not over three years old, or not over 20 years old. Determining the actual age is the responsibility of an appraiser, and some flexibility is allowed in his or her professional opinion. It is not necessary, in most cases, to report the date of a building permit or the exact day of commencement of construction. Rather, the appraiser can make a judgment call on the **apparent age** of the house. Obviously, a well-kept house and yard would indicate a lower “apparent” age than would one that has been allowed to deteriorate.

The second method of using the age of a property as an underwriting guideline for a conventional loan is the appraiser’s judgment of its **remaining useful life**. For this purpose, both FNMA and FHLMC use the same standard

as the FHA and the VA to qualify loans that they will purchase—that is, the term of the loan cannot exceed 100% of the remaining useful life of the property pledged as collateral. Prior to 1986, the limitation was 75% of remaining useful life, which is why many older appraisals show an estimate of 40 years of remaining life rather than the 30-year estimate now in more common usage. There are still strict requirements concerning an appraiser's opinion for remaining useful life on any unit that is a condo conversion.

Where Are We Now?

Sample Items From Fannie Mae/Freddie Mac
Uniform Residential Appraisal Report

Item	Subject	Comparable No. 1	Comparable No. 2	Comparable No. 3
Proximity to Subject	1.42 Miles	0.32 Miles	0.60 Miles	
Sales Price	\$449,000	\$417,000	\$540,000	\$595,000
Price/Gross Area	\$161.98	\$210.61	\$205.32	\$230.00
Financing		CONV	CONV	CONV
Concessions		N/A	N/A	N/A
Date of Sale/Time		xx/yy DOM 35	xx/yy DOM 62	xx/yy DOM 328
Location	Good	Good	Good	Good
Site	7,603 Corner	8,669 Inside	14,586 C-Sac-40,000	6,895 Inside
View	Canal/Ocean View	Ocean View	Canal/Ocean View	Ocean View
Room Count	8-4-2.5	8-4-3 -1,500	7-3-3.5 -3,000	8-4-3 -1,500
Gross Living Area	2,772 sq ft	1,980 sq ft + 39,600	2,630 sq ft + 7,100	2,587 sq ft + 9,250
Rooms Below Grade	Boat Slip	None	+ 7,000 Boat Slip	None + 7,000
Garage/Carport	1 Bl GAR	2 Bl GAR	2 Bl GAR-2,500	3 Bl GAR-5,000
Fence, Pool, Etc.	Fence, Pool	None + 7,000	None + 7,001	Fence, Pool
Net Adj. (Total)		52,100	-31,400	9,750
Adj. Sales Price		469,100	508,600	604,750

Usage of Property

Residential properties fall into four categories of usage insofar as mortgage loans are concerned. These are as follows:

1. **Owner-occupied.** This usage of property is considered the best, and generally commands lower interest rates and discounts than apply to other usages.
2. **Tenant-occupied.** For loan purposes, rental property is classed in the commercial loan category. The rationale is that rental property would not have a first call on the owner's personal income should a troubled financial situation arise. This means a loan at a little higher interest rate and discount and for a shorter term than that for owner-occupied property. This is true even though residential rental properties classify as "residential loans" for savings association tax purposes and insofar as banking regulations are concerned.
3. **Resort housing.** Not too many years ago, resort houses could be described as cottages, sometimes poorly built of nonpermanent materials and generally not acceptable as security for loans. The locations often lacked proper fire and police protection, were subject to vandalism and excessive storm damage, and were often not connected to municipal utility systems. In recent years, the growth of new, higher-class subdivisions in lakefront or mountainous areas has greatly improved the quality and thus the acceptability of these homes as collateral. Lenders do, in fact, make many resort home loans, but they adjust the loan amount downward, ranging from, perhaps, 90% to as low as 65% loan-to-value ratio. In resort-type developments, it is not unusual for a developer to buy a loan commitment, paying the discount fee necessary to provide potential customers with a dependable, economical source of mortgage money.
4. **Second homes.** Second homes are a close corollary to resort homes, though they differ in several ways. The more affluent society has produced a growing number of families that are financially able to own and utilize two different houses. On occasion, the house in the city might be less lived in and less occupied, on the whole, than the so-called second home in the country. In financing these homes, a lender usually makes a careful determination as to which house might be considered the primary housing entitled to preferential treatment and which one should be downgraded as a second home,

receiving a 75% or 80% or smaller loan. A decision such as this would be required where the borrower was making a purchase based primarily on a substantial annual income and not much in other assets. The lender must then consider risk from the viewpoint of a sudden decrease in income due to job loss or working disablement. Which house, then, would most likely have to be forfeited under adverse circumstances?

CONDOMINIUMS

Changes in lifestyles have supported a growth in demand for **condominiums** in place of free-standing houses. The advantages include less maintenance responsibility, access to more amenities, and the same tax advantages that go with all home ownership. Those most interested in this type of dwelling are singles, young married couples, and senior citizens, together comprising over half the adult population.

Classifying a unit of space remote from attachment to the land as a piece of real estate has required new state property laws. All states passed such enabling legislation prior to 1960, making it possible to pledge this type of property as collateral for mortgage loans. Generally, these laws state how condominiums can be legally described so that they can be classified as real property. Nevertheless, from a lender's viewpoint, a condominium loan involves more questions than does a free-standing house loan because of **common areas** usually owned jointly by all unit owners.

Management of common areas is generally handled by a **homeowners' association**, or perhaps through a management agreement. Lenders need to know how maintenance costs are managed and how they are allocated to the unit owners because with an imprecise agreement or under inadequate management, costs could suddenly escalate, creating an early loan default. One example of possible problems is with new properties. A developer may hold maintenance costs to a minimum during the sell-out period, but this may leave an overload of maintenance costs for unit owners later on.

While a lender has little voice in the continuing operation of a condominium project, careful screening of the management agreement may point out other troublesome provisions. Besides maintenance costs, the rights associated with collecting these charges can present real problems. In some states, a maintenance assessment may carry lien rights similar to those of property taxes—that is, they can take priority over a mortgage lien.

Lenders generally require a copy of the management agreement or the homeowners' association operating contract for the condominium as part of the loan documentation. A review of this agreement takes time, so to spread the cost, lenders usually require more than one loan in a project before undertaking examination of a condominium loan application. To avoid this problem, some builders ask a lender for project approval prior to offering any units for sale. However, complicating this issue is the fact that the maximum time that an approved FHA appraisal is valid was reduced on construction loans from one year to 120 days in the HUD/FHA Mortgagee Letter 2009-30. This project approval is done to obtain a FHA Certification. The certification process is the method used by HUD to ensure that condominium complexes meet comprehensive criteria to ensure that they are fiscally stable and properly managed. The certification process is used by HUD as a risk management tool to reduce the possibility of foreclosures on FHA insured loans on condominiums and condo communities everywhere. Prior to 2010, condo communities were either previously FHA condo approved (by the developer) or could be purchased using a "FHA Spot Approval". The "Spot Approval" process has since been eliminated, and all Condos were given expiration dates for their FHA condo approval and certification and they must be re-certified every two years. Now all FHA-approved appraisers will first check to see if the subject property is on the FHA's approved list. (See link at end of chapter.)

Several pitfalls occurred in some of the earlier condominium projects, but with hindsight, these have been mostly overcome. These problems involved both apartment conversions and new developments in which developers held onto management control too long. Examples of this kind of problem include retention of exclusive rights to all future sales of the units, controlling distribution and resale of utilities to the individual units, and holding an unlimited right to expand the project that could overburden existing amenities.

While property qualification for a condominium differs as outlined, qualification for a borrower buying a condo is the same as for any other mortgage loan.

The following is a summary of all the basic "regulations/requirements" that must be in place before an FHA lender can endorse a condominium loan commencing in 2015:

- All units and facilities and phases inside the project must be 100% complete.

- At least 50% of total units must be sold prior to endorsement.
- At least 50% of the project must be owner occupied.
- There can be no greater than 50% of the units with FHA loans.
- Any investor/entity (single or multiple owner entities) may own up to 50% of the total units, only if at least 50% of the total units in the complex are owner occupied as principal residences. (The previous limit was 10%.)
- No more than 50% of property can be used as commercial space.
- No more than 15% of units can be arrears in dues payments more than 60 days.
- Right of first refusal can be present in the "Covenants, Conditions and Restrictions" (defined as limitations and rules placed on a group of homes by a builder, developer, neighborhood association and/or homeowner association). These CCRs cannot violate "Discriminatory Conduct," as defined under the Fair Housing Act Regulation 24 CFR part 100.

Commercial Condominiums

While the condominium concept has been most widely applied to residential units, a number of applications have been made for the use of condos as rental properties or as business locations. In some condo projects, a number of the dwelling units are owned by investors and are subject to rental. This fact has caused additional problems in that the motivation among occupants differs. Those owning their own condos consider the entire project, including common areas, as an asset to be maintained and protected to assure future value. Those renting units may consider occupancy a temporary situation and have little interest in maintaining the property's future value. Differing motivations present difficult problems for a homeowners' association. This conflict of interests is sometimes created unintentionally when a developer is unable to sell all finished units and resorts to rentals as preferable to vacancies.

The economic advantages of a multiple-occupancy building have encouraged groups of businesspeople to utilize the condominium concept for owner-occupied office space. The group can be one with similar interests, such as doctors, or it can be a diverse group of professionals or possibly a variety of sales offices. A developer or builder undertaking such a project may emphasize the presale of the units to assure acceptable

construction or rehabilitation financing. Individual condos used for business purposes may be purchased with long-term financing at commercial loan rates and conditions. They are eligible for the same basic tax treatment as any free-standing building used for business.

COOPERATIVE APARTMENTS

A **cooperative apartment** is one in which the ownership of the entire project is vested in an occupant-owned corporation or trust that leases the dwelling units. The concept originated in the eastern part of this country before condominium ownership was fully developed. It provides the advantages of multifamily dwellings along with certain ownership rights. In addition, co-op apartments offer owners some degree of control over who may occupy the units and a legal means to enforce compliance with their rules. This is accomplished through control over the ownership of stock.

To purchase an apartment unit, it is first necessary to buy shares of stock in the owning corporation or a beneficial interest in the trust, depending on how ownership is held. Then the apartment is leased from the corporate owner. The purchase price of the stock covers the basic cost of acquiring the unit, while the lease payment covers ongoing maintenance costs. Thus the occupant holds no title to the apartment unit. To sell a unit, an occupant must sell the stock held in the ownership entity. The occupant would be subject to certain restrictions on this right to sell. The difficulty of freely marketing a co-op unit has made this type of ownership less desirable than that of a condominium. In contrast, a condominium unit is classed as real property, and legal title can be conveyed to an owner upon acquisition. The right to sell is not subject to approval by other condo owners.

Nevertheless, cooperative apartments may offer an owner similar tax advantages as those available to the owner of a condominium. There are some minor differences in tax questions, though, as the common areas of a co-op are owned by the corporate owner rather than jointly by the unit owners, as would be true of a condominium unit.

Financing the construction of a cooperative apartment (or a condominium project) has the disadvantage of requiring a number of units to be built with the initial commitment of money. Unlike a single-family housing development, which allows houses to be constructed at about the same rate as they are sold, the cooperative apartment must be planned

and built as a complete project. One method that is sometimes used to assure a construction lender of loan repayment is to presell (or prelease) a certain number of the units. Release of construction funding can be made contingent on the presale of a specified number of units.

MANUFACTURED HOUSING/MOBILE HOMES

The only difference between a mobile home and a manufactured home is that the latter has been constructed on or after June 15, 1976. Otherwise, the same description applies. The date for the change of names derives from the Federal Manufactured Home Requirements imposed by the U.S. Department of Housing and Urban Development. The HUD description of such a unit is that it must be transportable in one or more sections not less than eight feet wide and 40 feet long. When assembled, such a home must contain no less than 400 square feet. It must be built on a permanent chassis and may or may not have a permanent foundation.

Unless the unit can be classed as real property, it does not qualify for a regular mortgage loan. Financing for these units, when considered other than real property, may be accomplished with a chattel mortgage as security for the loan. However, in most areas, the chattel mortgage has been replaced by a bill of sale with a security agreement that is regulated by the Uniform Commercial Code.

An FHA-approved appraiser must be aware of the maximum loan amounts that can be made on manufactured homes attached to real property. These are as follows:

Maximum Loan Amounts

Manufactured home only	\$69,678
Manufactured home lot	<u>\$23,226</u>
Manufactured home and lot	\$92,904

The maximum dollar limits for lot loans and combination loans may be increased up to 85% in designated high-cost areas. For further information on high-cost area limits, contact (800) CALL-FHA.

Conversion of Manufactured Homes to Real Property

State laws control the definition of real property, and there are some differences from state to state. Nevertheless, a manufactured home is initially

sold by a manufacturer as personal property with an instrument asserting title similar to that of a car. Liens may be included in the title instrument to accommodate purchase financing. Conversion of the unit to real property normally requires several steps. First, liens attached to the initial title normally must be released. The initial title must be canceled, an action that, in effect, releases the unit from its title as personal property. Then, to become real property, the unit must be permanently attached to the land. Depending on state law, in general, prior liens on the manufactured home do not attach to the land, but liens against the land will attach to the manufactured home upon permanent attachment.

Use of Broker Price Opinion (BPO)

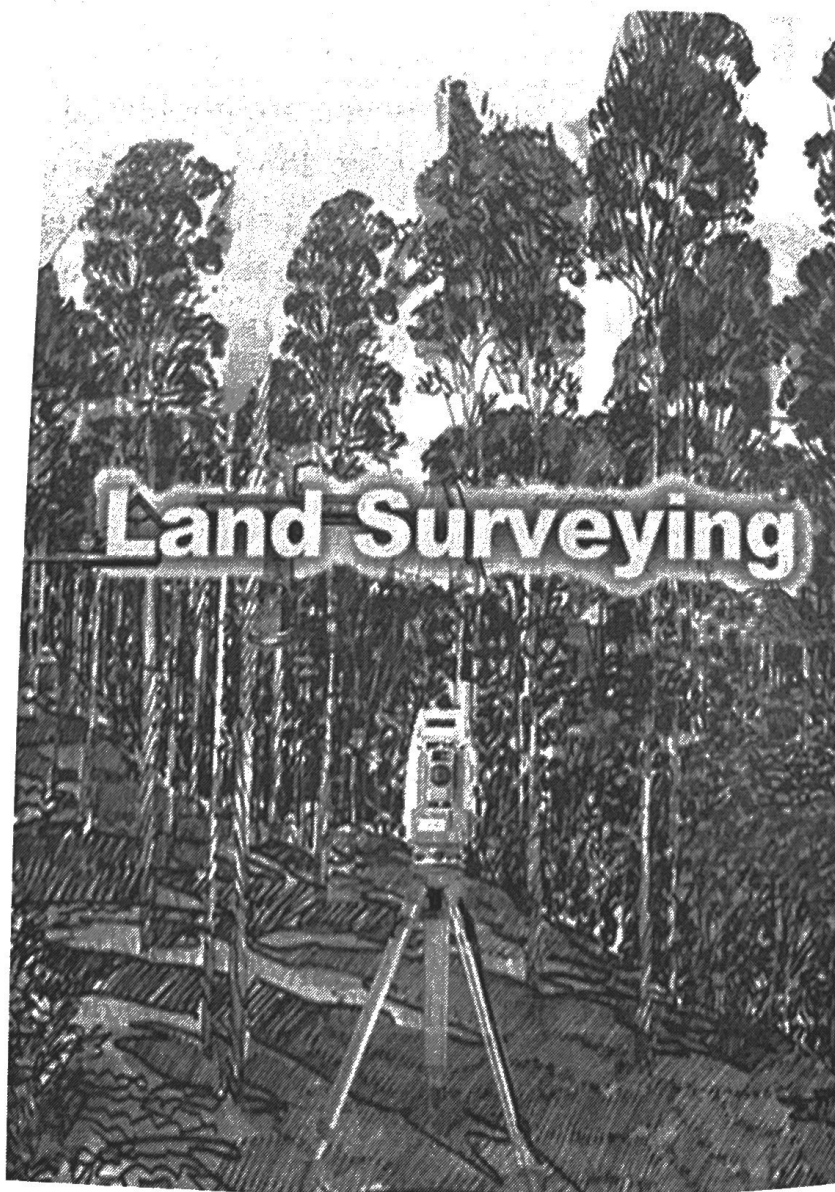
The **broker price opinion (BPO)** is a common way of estimating the value of a property. Typical reasons for ordering a BPO include estimating value prior to purchase or sale, understanding collateral value when securing a new loan or refinancing, estimating liquidation value, and buying out a partner's interest in a property, among many others. The major difference between a BPO and an appraisal is cost. Because a BPO is less comprehensive, it's normally a small percentage of the cost of a full appraisal. Appraisals are provided by a third party and are not biased in their estimate of market value. A BPO is normally done by a real estate broker who often is hoping to gain a listing of the property being valued and ultimately win the listing, and as such, the primary incentive behind a BPO may well differ from that of an appraisal. Regulated depository institutions or those approved as mortgage originators by Fannie Mae, Freddie Mac, or the Federal Housing Administration can use a BPO in lieu of a formal appraisal for a single-family residential mortgage they are in the process of underwriting. However, many financial institutions will use BPOs for the following types of valuation issues:

- Due diligence for investors or investment bankers
- Foreclosures
- Low-balance home equity lines of credit
- Mark to Market—a method banks/lenders use to assess the current value of assets (homes) on their books and for accounting purposes
- REO listings
- Requests to remove PMI (private mortgage insurance)
- Short sales

SURVEYS

One of the recurring problems in passing land titles and in ensuring that a lender is actually receiving a mortgage on the proper land is the identification of that land. Improper identification of the property to be mortgaged, through field error or typographical error, will invalidate the mortgage instrument (but not the obligation to repay the loan). A survey is made to physically identify a parcel of land. A **land survey** is an accurate measurement of the property, not a legal description of it.

An example of an error in property description occurred in a motel loan several years ago. In this case, the property described in the mortgage was identified by the perimeter of the building rather than by the boundaries of the land on which the building stood. The parking areas surrounding the building, which provided the only access to the premises, were not included in the mortgage indenture. When it became necessary to foreclose, the mortgagee learned the hard way that there was no access to the building.



For our purposes, a survey is the physical measurement of a specific piece of property certified by a professionally registered surveyor. In processing a mortgage loan, no lender will accept any measurements other than those taken by a professional. It is a precise business, and the loan package requires an accurate description of the land being mortgaged.

When a licensed surveyor physically defines a piece of property, it is customary to drive stakes or iron rods into the ground at the corners and to "flag" them with colored ribbons. It is not unusual for a lending officer to physically walk the land, checking corner markers, thus making sure of the shape of the parcel and whether or not there might be any encroachments that could infringe on the mortgage lien. Any purchaser of land is well advised to follow the same procedure. Walking the land prior to closing is a prudent exercise. However, the prime responsibility for locating encroachments belongs to the surveyor, which is one of the reasons why a survey is necessary.

LEGAL DESCRIPTIONS

A completed survey is a map showing each boundary line of the property with its precise length and direction. A survey should not be confused with a legal description. A legal description uses words, while a survey uses illustration. Legal descriptions are most commonly found in the following three formats.

Lot and Block

Probably the best-known type of legal description is that found in incorporated areas that have established procedures for land development. To obtain city approval to build streets and connect utilities, a developer will submit a master survey of the entire tract of land, showing how the area is to be divided into lots. The lots are each numbered and may be grouped into "blocks" for easier identification. Once the subdivision plat is approved, it can be recorded in the county offices and becomes a readily available legal reference to any lot in the plan.

For lending purposes, where the need is to identify a specific property over a period of 30 or even 40 years, the recorded subdivision plat is a much better method than a street address. Street names change and numbers can be altered, but the lot and block numbers remain secure because they are recorded. It may be argued that a street address gives a much better picture of where the property lies in discussing various houses or properties, but such identification is not sufficiently accurate to be acceptable

to a lender. The common method of clearly identifying property in real estate transactions is, first, to give the legal description, followed by a phrase such as “also known as,” and then to provide the street address. To illustrate, a property identification might be spelled out as, “Lot 6, Block 9, Nottingham Addition, Harris County, Texas, also known as 1234 Ashford Lane, Houston, Harris County, Texas.”

Metes and Bounds

When recorded plats are not available for identification of land (and sometimes when plats are available), it becomes necessary to use an exact survey of the boundary lines for complete identification. This might be true of a recorded lot that has a stream or river as one boundary, the precise boundary being subject to change through erosion or realignment.

The method used is to define a starting corner with proper references to other marking lines, then note the direction in degrees and the distance to the next marking corner, and so on around the perimeter of the property back to the starting point. These descriptions can be quite lengthy and involved. An example of the wording used to describe several boundary lines might be, for example, “. . . and thence along said Smith Street south 61 degrees 32 minutes 18 seconds west 948 and 25/100 feet; thence continuing along said Smith Street south 64 degrees 45 minutes 51 seconds west 162 and 80/100 feet to the point of beginning.”

It is obvious that considerable accuracy is required to figure the necessary directions down to a second of a degree and to measure the distances over highly variable and often rough terrain in order to close the boundaries properly. Such a description is acceptable only if certified by a registered surveyor.

In some rural areas, land is identified in the form of metes and bounds by the use of monuments. A *monument* may be something tangible—such as a river, a tree, rocks, fences, or streets—or an intangible—such as a survey line from an adjoining property. Physical monuments such as these are subject to destruction, removal, or shifting and do not provide lasting identifications for long-term loans.

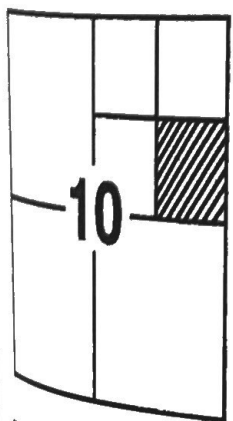
U.S. Geodetic or Government Survey

As long ago as 1785, the federal government adopted a measurement system for land based on survey lines running north and south, called *meridians*, and those running east and west, called *base lines*. The sys-

tem eventually applied to 30 western states, with the exception of Texas. A number of prime meridians and base lines were established. Then the surveyors divided the areas between the intersections into squares called *checks*, which are 24 miles on each side. These checks are further divided into 16 squares, each measuring 6 miles by 6 miles, called *townships*. The townships are then divided into one-square-mile units (36 to a township), called *sections*, which amount to 640 acres each. These sections are then divided into halves, quarters, or such portions as are needed to describe individual land holdings. An example is shown in Figure 10-1.

During the growth years of this country, much of the western land was laid out in this fashion by contract survey crews. Marking stakes were duly placed to identify corners, and these same markers are frequently used today. The fact that many of the surveys accumulated errors, including the failure to close lines, has created some confusion. It is a concern primarily for oil and mining companies, which must identify their land rights, and ranchers claiming property lines against a neighbor. However, these faulty descriptions have not constituted a serious problem for lending institutions. Land described, for example, as "Section 16, Township 31 north, Range 16 east, New Mexico Prime Meridian," could effectively collateralize a farm or ranch loan. A minor inaccuracy in describing such a tract would not undermine the basic security of the collateral.

In pledging property where there is the possibility or probability that some slight inaccuracy has occurred as to the exact amount of land involved, it is customary to use a qualifying term such as "comprising 640 acres, more or less." Any variation in property size should be considered in light of what might be termed "reasonable." A few acres out of line among 640 acres would not matter a great deal, but a few feet in a downtown city property could well be of critical importance.



Southeast quarter, northeast quarter,
Section 10
or
S/E 4, N/E 4, Sec. 10
Amounting to 40 acres

FIGURE 10-1 Section of Township Divided into Quarters
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