Useful information for Loan Officers regarding Residential Appraisals

- ## USPAP

  USPAP stands for Uniform Standards of Professional Appraisal Practice. USPAP establishes the standards and guidelines for real estate, personal property and business appraisals. It also defines the ethical conduct to which all members of the profession are held. All real estate appraisers must comply with USPAP regulations at the risk of having their licenses suspended or revoked. The ***intent*** of these Standards and Rules is to promote and maintain a high level of public trust in professional appraisal practices. The ***purpose*** of these Standards and Rules is to establish requirements for the development (how all aspects of the report are put together) and the communicating (how information is conveyed to the client) of credible appraisal reports. While there are countless rules and regulations for USPAP, the most essential concepts for the appraiser to learn and remember are never to misrepresent any information in the report nor to ever mislead their client.

- ## Market Value

  Stated in the most simple terms an appraiser's job is to estimate the market value of the subject (the property being appraised). The definition of market value according to USPAP is the most probable price for which a property should bring in a competitive and open market under all conditions requisite to a fair sale. The phrase 'conditions requisite to a fair sale' is commonly referred to as an "arm's-length transaction". There are five factors to an "arm's-length transaction", and they are:

  1.) Buyer and seller are typically motivated
  2.) Both parties are well informed and acting in what they consider their best interests
  3.) A reasonable time for exposure of the property is allowed on the open market
  4.) Payment is made in U.S. dollars or equivalent terms
  5.) The price represents the normal considerations for the property without any special or creative financing or any sales concessions by anyone involved in the transaction.

  Although the process to determine market value is very involved and detailed, it is important to remember that the final conclusion of market value arrived at by an appraiser is still only an estimate. The truest measure of the value of a property is what a buyer would be willing to pay for it.

- ## The Three Approaches to Value

  There are three distinct approaches or methods used in determining property value by appraisers. They are the **Sales Comparison Approach**, the **Cost Approach** and the **Income Capitalization Approach**.

The Sales Comparison Approach: The basic underlying principle of this approach is: the price someone is willing to pay for a property is influenced by the cost of acquiring a similar or comparable property (or "comp"). This is known as the principle of substitution. The basic formula for the sales comparison approach is: the sales price of a comp plus a positive adjustment for a feature present in the subject but not in the comp, and/or minus a negative adjustment for a feature present in the comp but not in the subject equals the indicated value of the subject. An example of a common adjustment is a two car garage as opposed to a one car garage. This formula will enable the appraiser to arrive at an adjusted sales price for the comp. When this process is applied to all of the comps being used in the report there will then be a range of adjusted sales prices for all the comps. From this range the appraiser will then determine the indicated value of the subject. Please note the appraiser never should average the adjusted sales prices of the comps to determine value. It will be helpful to remember that the amount of adjustment for any particular feature is not simply the cost to construct or add that feature, but what a buyer would be willing to pay for it, typically a lesser amount. For residential appraisals, by far the most common type of property appraised is the single family residence, whether it is a house, a condo or a PUD (Planned Unit Development). When determining the market value for these types of properties, most weight and consideration is given to the Sales Comparison Approach, as it best reflects the attitudes and actions of informed, knowledgeable buyers and sellers in the current real estate market.

The Cost Approach: In this approach the appraiser estimates the value of the improvements (house) in terms of its' reproduction cost (the cost to construct an exact duplicate as though new). Then any loss in value due to depreciation is subtracted from the reproduction cost. Depreciation is any loss of property value due to 1) the effects of wear and tear and/or the elements on a structure, and 2) obsolescence. Obsolescence can be functional (such as out of date features or design) or external (forces outside the property boundaries such as a nearby airport or being located on a busy street). Finally an estimate of the value of the site or lot itself is added. The basic formula for the Cost Approach is reproduction cost minus depreciation plus site value equals indicated property value. Typically this approach is most applicable with brand new property, unusual or non-conforming types of property and when no comps are available. For single family residences, the Cost Approach is supportive but is given less weight and consideration than the Sales Comparison Approach.

The Income Capitalization Approach: This approach is based on the net income, or investment return, that a buyer can expect from a property. The Income Approach is based on a property's 'net operating income'. Net operating income is based on what a property's income minus expenses should be. This approach is used for any income producing property (non-owner occupied, usually two units or larger) and always requires income analysis of the subject on the part of the appraiser. Most residential appraisers are not qualified to perform this type of analysis. For single family residences, the Income Approach to value is not considered to be a relevant approach to be utilized in the appraisal. It is not used because the majority of homes are owner occupied and most homes are purchased for occupancy and not for investment purposes. Generally speaking, the price an owner is willing to pay for a home in which to live is more than an investor for this type of property is willing to pay.

Reconciling Value: When reconciling, or correlating, the indicated values from each approach used in any given appraisal, the appraiser must produce a single value estimate. There is no formula for reconciling the various indicated values, rather the judgment of and analysis by the appraiser are required to reach a final value estimate.

- ## How Comps are selected

The single most critical factor in a residential appraisal is the selection of the comparable properties, or comps, that are to be used in the report. Comps are the driving force of the Sales Comparison Approach in determining property value and, as stated in the previous section, this technique is given the most weight and consideration when reconciling 'the approaches to value' used to estimate the market value of the subject. The most common sources for finding comps are the Multiple Listing Service (MLS) and Win2Data. When selecting which comps to use, the four main criteria looked at are:

1) Sales Date: Preferably within six months of the inspection date of the appraisal. The shorter the period of time from the comp's sales date to the date of inspection of the subject, the more support a comp will lend to the final estimate of value.
2) Year Built: As close to the age of the subject as possible in order to ensure that similar construction methods and materials were used. No more than ten years is desirable.
3) Distance: Within an approximately 0.75 mile radius of the subject.
4) GLA (Gross Living Area) or what is generally referred to as square footage. Adjustments for GLA are usually made for any difference over 100 square feet.
5) Lot Size: Please note that when comps are abundant, the size of the lot may also be used as a factor in selecting comps. Adjustments for lot size will vary depending on the appraiser, but any difference over 800 square feet should be adjusted.

Any or all of these parameters can be extended if recent activity in the subject's market area has been minimal, creating a lack of viable comps.

It is important to know that every parcel of real estate is considered unique from any other parcel of real estate even with properties of the same design and construction. This fact creates a significant amount of subjectivity that goes into the appraisal report. Real estate appraising will always be an inexact science because of this subjectivity.

- ## Appraisal Fees and how to prepare your client for them

The majority of residential appraisers today are self-employed or independent fee appraisers. They typically charge $350.00 to $400.00 for a full appraisal including interior inspection. The fee for properties with larger GLA's (gross living area) is often

times higher because more time is required to complete the assignment. Because appraisers are independent contractors, they will almost always expect payment from the borrower at the time of inspection.
A word to the wise: To avoid payment issues with your borrower, always confirm the appraisal fee, as well as the methods of payment acceptable to the appraiser, and pass this information on to your borrower prior to the appraiser scheduling the inspection.

It is the lender/broker who hires the appraiser for an assignment, not the borrower. Therefore the lender/broker, not the borrower, is the appraiser's client even though the borrower may pay for the appraisal. The appraiser's contractual obligation is to their client, the lender/broker. This is one aspect to the appraisal that many borrowers have difficulty with because, since they are paying, they consider themselves to be the client. The borrower may want to know what the value of the property is or may want the appraiser to give them a copy of the report directly. These are requests that the appraiser can not accommodate. This information must come from the lender/broker unless the client has given permission to the appraiser to do so. You will find that homeowners' curiosity regarding the property value derived at by the appraiser is something that will need to be satisfied as soon as possible.

- <u>Appraisal Reports</u>
  A typical residential report usually consists of 15 to 20 pages. The most pertinent section is the Uniform Residential Appraisal Report (URAR) also known as the '1004' which originated from Fannie Mae Form 1004 and has become the industry standard. It also contains a title page, transmittal page, statement of 'Limiting Conditions', sketch of the property, Plat Map, Location Map and pictures of the subject and comps. According to USPAP guidelines this is what is referred to as a 'complete appraisal and summary report'. Another common type of report is the Form 2055 which is a streamlined appraisal form. There may be an interior & exterior inspection of the property or just an exterior inspection, known as a 'drive-by'. Since only one Value Approach is used, USPAP classifies this as a 'limited appraisal and summary report'.

  A word to the wise: Because of all the useful property information in the appraisal the borrower should always save their copy of the report.

- <u>When estimating value of subject</u>
  When hiring an appraiser, the loan officer must provide some basic information regarding the property to be appraised (the subject). In order to expedite matters and enhance the turn around time of the appraisal this information should include the following:

1) Borrower data: Include as many telephone numbers for the borrower as possible.
   A word to the wise: This is an area where loan officers can really help themselves out in regards to their ratelock deadline by initially giving the appraiser correct information for home, work and cel numbers.
2) Subject data: Specify property type (Single Family Residence, Condo or PUD)

3) Type of Appraisal desired: Full or 1004, Interior/Exterior Drive-by or 2055, by far the three most common types of appraisals.
4) Type of Loan: Purchase or Refinance. Please note if the transaction is a Purchase, always provide the sales date (when the contract was either signed or recorded) and the sales price.
5) Estimated Value: The party hiring an appraiser typically states the estimated value of the subject property (this applies to refinancing only). This number should be based on a realistic reflection of the property value and not based or influenced by potential commission earnings. Unrealistically inflating the value of the property can often times lead to delaying the loan process or in some cases terminate the deal. Sources for obtaining estimated value are Multiple Listing Service (MLS), title company websites, local Real Estate agents and, occasionally, the well informed property owner. Please bear in mind that USPAP prohibits appraisers from accepting assignments which are contingent upon arriving at a predetermined value or a direction in value that favors the cause of the client.

   A word to the wise: Do not wait until the last minute when hiring an appraiser because the loan process will be delayed if the appraisal report is not submitted for whatever reason. Do not assume that an appraiser will be available whenever you need one. It would be prudent to take into consideration the appraiser's and the borrower's schedules.

- Condos and PUD's

The most common type of property appraisal is the single family residence. There are two other types of property that are very commonplace as well; they are Condos and PUD's or Planned Unit Developments.

Condominiums: In appraisal terms a condo refers more to the type of ownership interest than to the type of architectural design or structure. The owner of a condo has exclusive ownership interest in the airspace of a particular unit as well as an interest in any common areas that are associated with the development. In other words, the title holder of a Condo owns everything within the interior walls of the unit, but not the lot nor the exterior walls. Some examples of common areas are; pools, tennis courts, parks & playgrounds, open area, walkways and greenbelts. Condo owners have a specific fractional percentage of undivided interest in the common areas. This means that they have the right to use the entire property, regardless of the fractional interest owned. The common areas are maintained by means of a monthly Home Owners Association (HOA) fee. Condos come in all shapes and sizes; they can be as small as a two unit residence that has been subdivided or a highrise building with many units, or anywhere in between.

Planned Unit Developments: A PUD is a subdivision consisting of individually owned parcels or lots as well as an undivided interest in the developments' common areas. Unlike Condos the ownership interest is in the entire structure and the lot. However, as with Condos, a PUD's common areas are maintained by monthly HOA fees. A PUD may feature detached residences or town houses, which are houses on separately owned lots that share a common wall.

- <u>The Appraisal Process</u>

The following is a brief outline of the actual process that an appraiser will go through when appraising a property.

<u>Comp Check:</u> After receiving an order from a client, the first thing to be done is to see if the minimum value sought is attainable. In order to accomplish this, viable comps must be found in order to support the desired value. If the minimum value is not attainable due to a lack of available comps, then the appraiser must inform his client immediately and see if a lower value is acceptable.

<u>Inspection:</u> This is when the appraiser will visit the subject property to gather detailed information of the house and lot; take pictures of the interior and exterior as well as a 'street scene' photo; measure the subject to confirm GLA; if applicable, examine permitted/unpermitted additions. At this time the appraiser will also take pictures of the comps and observe the neighborhood and its' amenities.
A word to the wise: If the subject property has had a 'permitted' addition (a permit was acquired from the proper governing agency, usually the city in which the subject is located, to increase the GLA of the subject or add/replace to the existing improvements), inform the borrower that they need to present the appraiser with their copy of the permit for review. Even more helpful would be a photocopy of the permit for the appraiser to keep. If the house has had an 'unpermitted' addition (no permit was pulled) or the borrower does not have a copy of the permit, the subject **will not** receive any value for the addition under any circumstances.

<u>Report Completion:</u> When the report has been completed, the appraiser will send it to the client via e-mail rather than mailing a hard copy because loan officers usually need it 'yesterday'. The report will come in a PDF format and will be printable.
A word to the wise: When printing an appraisal report, have legal size paper available.

<u>Conditions:</u> Most loan officers are familiar with the term 'conditions'. In regards to appraisals, conditions come into play after a report has been completed and been reviewed by the lender's underwriting department. Conditions are any errors, incomplete information (including pictures), information that needs to be clarified and/or verified in the report and any problems with the report whatsoever in the opinion of the reviewer. A common example of a condition is the requirement of selecting a different or additional comp in order to justify value. While mistakes can happen to anyone, a conscientious appraiser will correct or satisfy a condition as soon as possible because they know that this can delay the loan process. Conditions are not always caused by errors, but oftentimes a report is conditioned because of a particular lender's underwriting guidelines.

By Rick Gordillo, January, 2005.