

Case Studies in Appraisal Review: *Focus on Risk*

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The goal of this presentation is to help underwriters/reviewers focus on risk management in the appraisal review process in pre-funding to prevent bad loans.

“Red Flags”: Focus of the Appraisal Review

- **Photos & maps**
- **Inconsistent information**
- **Age/Effective age variances not supported**
- **Sales/Financing concessions not reported; not adjusted properly**
- **Comparables located outside the subject’s market area.**
- **Adjustments not supported**
- **History omitted or improperly handled**
- **Inconsistent Information!**

CASE STUDY #1

(Handout)

Photographs:

- **Some of the comparable sales obviously are not comparable to the subject**

Photographs:

- Look at photographs first
- Ask yourself: “Do the comparables really look like the subject?”
- Similar design
- Surroundings
- Age/Condition

The Map:

- **Subject faces major highway**
- **Comparables appear to be located outside of the subject’s neighborhood**

Examine the Map for:

- Heavily populated area; yet, the comparables are located far away
- Notable divisions of land use
- Other location factors
 - Major thoroughfares, freeways, railroad tracks, etc. that may have a negative impact
 - Ocean, lakes, mountains, golf courses, etc.; that may have a positive impact

Neighborhood:

- **Area is in transition from residential to commercial**
- **Omissions in Neighborhood comments regarding location**
- **Property faces Hwy 6 which is a major 4-lane highway**

Neighborhood:

- **The information provided in this section will set the basis for the remainder of the report**
- **Review closely for inconsistencies with other sections of the report**

Site Information:

- **Report states subject's 18,000 sf lot is “typical” for the neighborhood**
- **States view is “average” (fronts highway and also is on a corner across from an auto repair shop)**
- **Subject is zoned “Highway-Commercial”**
- **Subject site has private utilities; most comps have public utilities**
- **None of the comments disclose subject’s frontage on Hwy**

Site:

- **Look for inconsistencies, i.e. subject’s site size rated “typical” or “average”, yet is much larger, or smaller, than the sites of the comparable sales**

Examples of Inconsistent Information—Neighborhood/Site

Sections:

- Neighborhood sections reports “good” or “increasing” yet comparables are older OR taken from outside immediate market area
- Site size reported “typical” for neighborhood, yet large site adjustments were made on comparables in the Sales Comparison Approach

Description of Improvements:

- **Age 47; Effective age 24 (not supported)**
- **Subject’s only bedrooms located on 2nd floor; no bathroom on 2nd floor**
- **Reviewer found that local tax records indicate property has 1852 sf; report did not explain deficiency**
- **Comments state that features are “typical” and no functional obsolescence acknowledged for the lack of baths on the 2nd floor**

Description of Improvements:

Age vs. Effective Age:

- Most abused section of the appraisal report
- Large *unsupported* differences between age and effective age will result in an inflated value

Effective Age:

- The age indicated by the condition and utility of the structure
- It is determined by an appraiser’s judgment and is not a market-derivable figure
- Similar standards of owners or occupants can influence the pace of building deterioration
- If a building is better maintained than others in the market area, its effective age will be less than its actual age
- If a building is poorly maintained, its effective age may be greater
- If a building has received typical maintenance, its effective age and actual age may be the same

Supporting Effective Age:

- The wider the variance, the more details needed for support.
- Specifics should be provided for updates, remodeling, etc., that would increase the subject’s value based on local market acceptance.

Other Issues in Description of Improvements:

- Subject noted as Manufactured home
- Inconsistencies with other sections of report

Cost Approach:

- **Land value questionable due to commercial influence; may actually be higher**
- **Depreciation not supported due to age/effective age**
- **Remaining Economic life inaccurate (should be shorter) due to area changing to commercial**
- **Variance too wide between value in Cost Approach and value in Sales Comparison Approach**

Depreciation: Cost Approach

- Depreciation is the loss in value to the property from all causes: physical functional and external
- Most appraisers will report the age-life method of depreciation

Depreciation: Age-life Method

Effective Age + Remaining Economic Life = Total Economic Life

Effective Age/Total Economic Life = Total Depreciation

Remaining Economic Life:

- Remaining economic life is the estimated period over which existing improvements are expected to continue to contribute to property value
- Affected by:
 - Economic conditions
 - Changes in land use
- Condition and functional utility of the property

Effective Age...Depreciation...Cost Approach...Market Value...

- The results of all Approaches to Value must be similar
- Therefore, the value in the Cost Approach must be similar to the Sales Comparison Approach
- There are two ways to make this happen:
 - Manipulate the Cost Approach/Depreciation
 - Manipulate the Sales Comparison Approach:
 - *wrong choice of comparable sales, and/or*
 - *unsupported adjustments to comparables*

| | | | |
|--|--|--|--|
| GENERAL DESCRIPTION No. of Units: 1 No. of Stories: 2.00 Type (Det./Apt.): Detached Design (Style): Traditional Existing/Proposed: Existing Age (Yrs.): 47 Effective Age (Yrs.): 24 | | COST APPROACH ESTIMATED SITE VALUE = \$ 15,000 ESTIMATED REPRODUCTION COST-NEW-OF IMPROVEMENTS: Dwelling 2,284 Sq. Ft @ \$ 60 = \$ 137,040 BSMT = Garage/Carport 288 Sq. Ft @ \$ 12.50 = 3,600 Total Estimated Cost New = \$ 142,440 Less: 40.0 Physical Depreciation = \$ 56,976 Depreciated Value of Improvements = \$ 85,464 *As-is* Value of Site Improvements = \$ 6,000 INDICATED VALUE BY COST APPROACH 106,464 = 3 | |
| Analysis of any current agreement of sale, option, or listing of the subject property and analysis of any prior sales of subject and comparables within one year of the date of appraisal: The sales history of the subject property and the comparable sales within the past twelve months included no atypical listings or sales. There has been no known sales activity regarding the subject within the past twelve months. | | | |
| INDICATED VALUE BY SALES COMPARISON APPROACH = \$ 91,000 | | INDICATED VALUE BY INCOME APPROACH (If Applicable) Estimated Market Rent \$ / Mo. x Gross Rent Multiplier = \$ N/A | |
| RECONCILIATION | This appraisal is made <input checked="" type="checkbox"/> "as is" subject to the repairs, alterations, inspections or conditions listed below subject to completion per plans and specifications. | | |
| | Conditions of Appraisal: This appraisal was electronically signed. The appraiser fully reviews the file before the code is utilized to allow the digital signature to be used. ***See Additional Comments*** | | |
| | Final Reconciliation: The sales data comparison approach is considered to be the best indicator of value as it reflects the actions of typical buyers and sellers in the market place. This approach is supported by the cost approach. Please note that the intended user of this appraisal is the mortgage broker, mortgage company and investor only. ***See Additional Comments*** | | |
| | The purpose of this appraisal is to estimate the market value of the real property that is the subject of this report, based on the above conditions and the certification, contingent and limiting conditions, and market value definition that are stated in the attached Freddie Mac Form 439/Fannie Mae Form 1004B (Revised 6/93). | | |
| | I (WE) ESTIMATE THE MARKET VALUE, AS DEFINED, OF THE REAL PROPERTY THAT IS THE SUBJECT OF THIS REPORT, AS OF June 18, 2002 (WHICH IS THE DATE OF INSPECTION AND THE EFFECTIVE DATE OF THIS REPORT) TO BE \$ 91,000 | | |
| APPRAISER: Signature _____ Name Appraiser Date Report Signed January 4, 1980 State Certification # TX-0000000 State TX Or State License # _____ State _____ | | SUPERVISORY APPRAISER (ONLY IF REQUIRED): Signature _____ Did _____ Name _____ Did Not _____ Date Report Signed _____ Inspect Property _____ State Certification # _____ State _____ Or State License # _____ State _____ | |

Sales Comparison Approach:

- **Selection of comparable sales questionable**
- **Note sales price of comparables prior to adjustments**
- **Reporting of seller paid points/concessions not accurate**
 - **Comp. #3 had \$1,800 in seller costs**
 - **Comp #4 had \$10,604 in seller costs**
- **Location is rated “average”**
 - **Differences in location of comparables not explained or adjusted**
- **Site/view – large variances in site sizes**
 - **Provided no explanation for adjustments**
 - **No comments regarding highway frontage**
- **Design and Appeal – no descriptions and no adjustments**
- **Quality of construction – no descriptions and no adjustments**
- **Age/Effective Age for comps – no explanations and no support**
- **Conditions – rated “Good” except for comp #5**
 - **Comps range from 4 yrs to 47 yrs**
 - **Only Comp #5 adjusted**
- **Room count – No adjustment for 3-BR comps (comp #5 has no bedrooms and no interior walls because it is a commercial property)**
- **Square footage – wide variance in size**
- **Functional utility – no mention of lack of bath on 2nd floor**

Choosing Comparable Sales

- The following will likely result in an over valued property:
 - Leaving the neighborhood for comps (when local comps are available)
 - Not confirming details of comps and therefore
 - Failing to report and adjust for the seller concessions
 - Failing to properly adjust for quality/condition issues

Using comps outside of the subject's market area:

Justified when:

- Site influence (Water, Golf Course, etc)
- Few sales, few listings (undersupply)
- Unique area (historical, etc.)
- Underwriting requirements*
- Rural or non-conforming area

Not Justified when:

- No sales in neighborhood high enough to support contract price or refinance amount
- Subject is unique for the neighborhood
- Subject is largest in neighborhood
- Subject is newest in neighborhood
- Client request

If appraiser has to “leave the neighborhood” to obtain a better comp, the 1st question should be “why are better comps not located within the subject's market area?”

- Consider older sales in the immediate area
- Consider listings as added support
- Request price ranges of houses in the “other” neighborhoods
- Call local appraisers or Realtors for opinion of area

Financing (seller concessions):

Be cautious of statements in the appraisal similar to the following:

“It is *typical* in the area for the sellers to pay 1 to 3 points and has no affect on property values”

This statement implies a lack of understand of the definition of Market Value and USPAP.

Sales Concessions:

Consider how sales concessions are addressed by the appraiser when completing the URAR (1004)

- Sales concessions influence the price paid for real estate.
- It may be in the form of
 - Loan discount points
 - Loan origination fees
 - Settlement assistance
 - Payment of condo/PUD fees
 - Builder incentives
 - Inclusion of non-realty items in the transaction

Appraisers are required to verify and analyze all sales on a cash equivalent basis (interest rate buy-downs, below market financing, owner financing, etc.)

- It should be noted that the need to make negative adjustments and the amount of the adjustments to the comparables for sales and financing concessions are not based on how typical the concession might be for a segment of the market (Large sales concessions can be relatively typical in a particular segment of the market and still result in sales prices that reflect more than the value of the real estate).

Sales Concessions:

- Adjust comparables for the following
 - Special/non-market financing terms
 - Points
 - Buy-downs
 - Gifts
 - Buyers closing costs paid by seller
 - Swaps/exchanges
 - Personal items included in sale

Confirmation of Sales Data (appraiser's responsibility):

- Price
 - Seller concessions
 - Points
 - Buyer costs paid by seller
 - Decorating allowances
 - Upgrades
 - Details of quality
 - Details of condition
 - Upgrades
 - Remodeling
 - Repairs made
 - Repairs needed
 - Age
 - Number of bedrooms/baths
 - Square footage
 - Site amenities
-
-
-

Explanation of Adjustments:

- All major adjustments should be explained by the appraiser
- Watch for “escape” adjustments and vague explanations
- Example often seen on appraisals: “Comparable #1 is inferior to the subject in condition and was adjusted upwards \$10,000”

Proper Explanation of Adjustments:

- The subject was recently updated with new carpet, ceramic tile and hardwood floors, designer wallpaper and complete remodeling of kitchen. Comparable #1 was recently painted, but has not been updated; therefore, it was adjusted upward \$10,000.
 - This type of statement explains and supports the conclusion

History:

- USPAP requires the appraiser to **analyze** all current agreements of sale, options, or listings of the subject property CURRENT as of the effective date of the appraisal".
- USPAP requires the appraiser to "analyze all sales of the subject property that occurred within three years prior to the effective date of the appraisal".
- Fannie Mae form requires sales history of comparables for the prior 1 year (this will likely be 3 years with release of new Fannie appraisal forms).

History: What does “analyze” mean?

- Did the subject sell same or higher than *list price*? Is this consistent and supported?
- Is the current estimate of value higher or lower than prior sale reported?
- Did the subject sell higher, lower, or the same as a prior sale reported? What does this mean?
- Did the appraiser analyze and explain....with details? If not, reject the appraisal.
 - Do not accept just the reporting, only, of prior sale price, list price, etc. without a complete explanation

CASE STUDY #2
(Handout)

Identifying Inconsistencies

Map: Indicates subject's location is rural

Neighborhood:

- "Suburban" box is checked

Site:

- Site size is 281,325 sf. (+/-5 acres)
- Zoning: classification is "R-1A Single Family Residential" (rural??)
- Utilities: Subject has well & septic system
- Off-site Improvements: Street is reported to be "gravel"

Comparable Sales:

- Comparables range in distance from 2.5 to 7 miles
- Comparables had lot sizes ranging from 1.88 to 5.01 acres

How Lenders Can Be Protected:

- Update Checklists and instructions to appraisers
- Monitor Appraisers Quality
 - Issue direct guidelines
 - Require compliance from appraisers
- Hold Appraisers Accountable
 - Keep tracking record of appraiser performance
 - Develop “A” list of appraisers
- Properly train reviewers/underwriters
- Maintain both internal & external databases
 - To verify history
 - To check for better comparables
 - To check for prior association with property address and/or applicant
- Take Advantage of Technology
 - Implement technology to assist in reviewing appraisals and tracking and monitoring of all individuals involved in the loan process

Shift focus from fixing errors...to preventing them

Technology as a Tool in Appraisal Review

- ✓ Automatically capture subject and comparable sales data without re-keying to build internal databases.
- ✓ Automate lender's customized review rules and review +/-80% of the appraisal in within seconds
- ✓ Automate pre-funding risk reviews
- Technology provides review feedback for ongoing improvement in quality control
- Automated appraisal review reduces underwriting time, while increasing quality and efficiency

| ELEMENTS | GENERAL DESCRIPTION | EXTERIOR DESCRIPTION | FOUNDATION | BASEMENT |
|----------|----------------------|----------------------|-------------|---------------|
| | No. of Units | Foundation | Slab | Area Sq. Ft. |
| | No. of Stories | Exterior Walls | Crawl Space | % Finished |
| | Type (Det./Att.) | Roof Surface | Basement | Ceiling |
| | Design (Style) | Gutters & Dwnspts. | Sump Pump | Walls |
| | Existing/Proposed | Window Type | Dampness | Floor |
| | Age (Yrs.) | Storm/Screens | Settlement | Outside Entry |
| | Effective Age (Yrs.) | Manufactured House | Infestation | |

In Conclusion:

“Red Flags”: Focus of the appraisal review

(Add to your Appraisal Review Check List):

- **Photos & maps**
- **Inconsistent information**
- **Age/Effective age variances not supported**
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QUESTIONS AND ANSWERS

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