FROM THE APPRAISER TO THE UNDERWRITER

LEE & GRANT COMPANY

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Welcome to our on-line course, "FROM THE APPRAISER TO THE UNDERWRITER."

If you have enrolled to take this course for real estate or real estate appraisal continuing education credit or for other course credit, please read over the instructions on the next page carefully. They explain in detail the requirements that have to be completed so that you can earn such credit. You will be issued a course completion certificate if you meet these requirements.

If you have come to our website just to browse through the text, please feel free to do so at your leisure. There are no security devices that prevent you from seeing the course material and we hope it helps you in your self-study.

Please share with us any comments or concerns you may have concerning this material. We are interested in your feedback. Our contact information is shown above.

Many thanks for your interest in our educational programs. And, best of luck from all of us at Lee & Grant.

Sincerely,

Patricia L. Mosure
President

Stephen G. Patten
Director of Education

REQUIREMENTS FOR COURSE CREDIT

1. Thank you for enrolling in Lee & Grant education on-line. This course is structured in four separate phases for your study: text material, review questions and problems, case study, and end-of-course exam. All four portions must be completed in order to earn credit for this course. Be sure to download a registration form from our website and send that in with your payment. We will not issue a course completion certificate without your registration form on file.

2. Study the textbook material in the sequence presented. Your course has three sets of review questions and problems that are positioned throughout the text. When you come to a set of review questions and problems after having read the preceding textbook pages, complete it and e-mail us your answer sheet. It is open book and you may refer to course materials in completing it. We will grade it and e-mail back your score along with an explanation of our answer for every question. Also e-mail your suggestion form for a proctor to administer your end-of-course exam. You'll find the form two pages after this one.

3. Follow this procedure for the remainder of the course: studying the course material in the sequence presented, completing the review questions and problems as you come to them, and e-mailing the answer sheet to us for grading. Then complete the case study at the end of the textbook and e-mail that into us. We will e-mail back to you our suggested completion of the case study appraisal report forms.

4. When you have taken each of the three sets of review questions and problems and completed the case study, we will fax your proctor the end-of-course exam, if you are not taking it at a Lee & Grant location. Contact your proctor to arrange for you to take the exam. This exam contains 50 questions and is multiple choice. It is open book and, like the quizzes, you may refer to course materials to complete it within the two-hour time limit. Your proctor will fax back your answer sheet to us for grading. We will e-mail your score to you and, if you have passed, fax you a course completion certificate. You must score at least 70% on the end-of-course exam to earn credit for the course. You may retake any exam you did not pass. We will send another exam to your proctor if you request that

we do so.

5. **Course fees are non-refundable. You have three months from your enrollment date to complete the course and pass the end-of-course exam. Any student wishing to re-enroll after the three months may do so for the full course fee effective at that time.**

6. **Please e-mail us at leeandgrant@leeandgrant.com any time we may be of help. Remember this is an on-line course. All assignments must be sent to us by e-mail.**

Again, thank you for coming to Lee & Grant Company. And now, in order to let your instructor introduce himself, please turn the page.

FROM THE INSTRUCTOR

On behalf of Pattie Mosure, who is the president of Lee & Grant Company, I'd like to welcome you to our course on "Uniform Standards of Professional Appraisal Practice."

My name is Steve Patten. I'll be your instructor for this course, which we hope you will find most beneficial to you and helpful in meeting those goals you have set for yourself. You have all the details on the previous page of how to complete the course. We at Lee & Grant are very interested in your success in understanding the material and passing the course.

I also want to introduce Ms. Lyn Graham, our coordinator for on-line education. Lyn will be the one who will be communicating with you on a regular basis, grading your quizzes that you send in, coordinating with your end-of-course exam proctor, and arranging, once you have passed our course, to get your course completion certificate to you as quickly as possible.

In addition to ensuring the course material is properly presented to you, my role as an instructor also includes answering any questions you may have along the way. So, I am as close as your e-mail. Anytime you have a question or maybe just want to make an observation or suggestion, ring me up at:

leeandgrant@leeandgrant.com

In the title section of your e-mail put "Question for Steve" or something like that and also please mention the course, if not in the title, at least somewhere near the start of your message. I will get back to you as quickly as possible. It is good to have you here. Please contact Lyn or me as often as you want.

Well, that is all I have to say, other than Good luck and enjoy!

(Your proctor form is on the next page and the table of course contents is on the following page.)

PROCTOR SUGGESTION

Your end-of-course exam may be taken at Lee & Grant Company's corporate headquarters in Atlanta, Georgia. Please contact us to arrange for when you would like to come in. If this would not be convenient for you, we can arrange for you to take the exam at the conclusion of one of our classes around the country, if a
classroom and instructor are available.

We may also approve an outside proctor whom you can suggest, such as a librarian at a local library or the education officer of a real estate board. Please complete the following information and send this form in with your first quiz.

Student name:_____

License number:_____

Mailing address:_____

_____

Course name:_____

Check one of the following:

(___) I would like to take the exam at Lee & Grant's offices in Atlanta. I will contact Lee & Grant to make arrangements.

(___) I would like to take the exam at the conclusion of a Lee & Grant course given outside of Atlanta. Please send me course locations.

(___) I want to suggest the following proctor to administer the exam. I understand Lee & Grant Company has the right to approve or disapprove any proctor suggestion I offer and I agree to abide by any such Lee & Grant decision.

Proctor name:_____

Title and organization:_____

Mailing address:_____

_____

Telephone number:_____

Fax number:_____

TABLE OF CONTENTS

I. The appraisal process, also called the "valuation process," is a structured approach to valuing real property that suggests a step-by-step procedure an appraiser would follow in order to appraise a subject property and is designed to assist the appraiser in valuing a subject by outlining the major steps through which an appraiser would likely proceed.

A. First step: definition of the problem

1. Identification of the real estate

a. This is generally done by giving the legal description of the subject.

(1) Monuments

(2) Metes and bounds

(3) Lot and block

(4) U.S. Government survey

b. In addition to the four systems of legally describing property listed above, the appraiser may describe the property by its commonly known address (for example, street address) and by its physical characteristics, including maps, drawings, photographs of the subject.

2. Identification of the property rights to be valued

a. Although it is typically stated that the property is to be appraised, it actually is a set of defined rights in the subject that the appraiser values.

b. Those rights valued may be fee simple, leased fee, leasehold, life estate, or interests, such as easements, air or subsurface rights.

3. Date of the value estimate or opinion

a. Called the "effective date," it is the date as of which the appraiser says the appraisal is valid

b. This "as-of" date can define one of three types of valuations.

(1) Current appraisal

(a) The valuation says what the property is worth at present.

(b) The appraiser generally uses that date that he/she physically inspected the property, so that if the property were damaged following the inspection, the appraisal would still be valid.

(2) Retrospective appraisal

(a) The as-of date is in the past.

(b) This could be an estate appraisal, as of date of death of the deceased, an appraisal for a property tax appeal, or one possibly involved in some type of litigation, as in divorce settlements.

(3) Prospective appraisal

(a) This valuation is an appraisal as of a date in the future.

(b) New construction or rehabilitation work of existing improvements are examples, with the as-of date likely to be when the work is completed.

4. Use of the appraisal

a. Why the appraiser's client requested an appraisal, what motivated the client to go to the appraiser for an opinion of value.

b. Called the "function" of an appraisal, it could be for many reasons, such as listing the property for sale, financing the property, tax appeal, insurance claim, negotiating a purchase, or simply wanting to know what the property is worth.

5. Definition of value

a. A client may believe there is only one kind of value and hence the appraiser should define the value being estimated, whether it is market or investment value, value-in-use, insurance value, assessed value, or some other kind of value.

b. Uniform Standards of Professional Appraisal Practice (USPAP) require that the appraiser include a definition of the value being appraised in the appraisal report.

B. Preliminary analysis and data selection and collection

1. After having defined what is involved in the appraisal assignment, the appraiser should begin to analyze what is needed to complete the assignment, including the data that will have to be gathered.

2. Types of data

a. General data are those data that describe the overall market in which the subject is located and may include regional and national information.

(1) Social data is about people, demographic statistics about the

numbers of people in an area, rate of births, deaths, family size, numbers of households, average number of people within a household.

(2) Economic data are about money, average wages and salaries, the economic base of the community, sources of revenues and services, rates of employment, unemployment.

(3) Governmental data talk about government at the local, State, federal levels, level of taxation, zoning ordinances and actions, methods for rezoning, obtaining building permits, efficiency of police and fire protection, maintenance of public roads/facilities.

(4) Environmental data includes information on the natural environment as well as description of what communities have done to meet the needs of the people living there.

b. Specific data talks about the specific subject property, comparables used in the valuation, and the neighborhood in which the subject is located.

C. Highest and best use analysis

1. That use of land which brings the greatest value to the land

2. There are two possibilities taken into account when conducting a highest and best use analysis, what would be the use if the land were vacant and available for development to its highest and best use, and, secondly, given the current improvements, what is the best way to use them to bring the most value to the land.

a. As if vacant

(1) The current improvements, if any, are ignored, and consideration is given to what should be built on the subject land.

(2) Any cost that would be required to remove current improvements should be considered in coming to the highest and best use conclusion.

b. As currently improved

(1) Determine whether the improvements on the land are being properly used or if a different use would increase the value of the property.

(2) The cost of conversion to a different use, if necessary, should be taken into account in coming to the highest and best use conclusion.

3. The criteria the appraiser uses in a highest and best use decision are considered in the sequence shown below.

a. Physically possible

(1) What use can be employed that the land can physically accommodate.

(2) Strength of the soil, shape of the lot, topography would be typical characteristics to look at in deciding what uses are possible for the land.

(3) A use that is not physically possible would be eliminated from any further consideration as a highest and best use candidate.

b. Legally permissible

(1) The appraiser studies those uses that are currently permissible under zoning ordinances and other applicable laws.

(2) If a use other than those allowed at the time of appraisal is the suggested highest and best use, the appraiser must comply with relevant requirements of Uniform Standards concerning a hypothetical condition.

(a) Such hypothetical must be disclosed in the appraisal report.

(b) Use of the hypothetical results in a credible analysis.

(c) The impact on value in using a hypothetical must be indicated.

(3) A use that is physically possible but then found not to be legally permissible would be eliminated from further consideration as a candidate for highest and best use.

c. Financially feasible

(1) A use that meets this criterion is one that will be at least bring some value to the land and make the property worth more than what the land would be worth unimproved.

(2) If a proposed use does not increase the value of the land, it is not a candidate for highest and best use, even though it is physically possible and legally permissible.

d. Maximally productive

(1) Once a candidate for highest and best use meets the three preceding criteria, then it should be determined whether it - or another use - is the use that will bring the greatest value to the land, that is, the one that is maximally productive.

(2) No use can be maximally productive - the choice for highest and best use - if it has not been determined first that it is physically possible, legally permissible, and financially feasible.

4. Whatever decision the appraiser makes concerning highest and best use of the subject land, the appraisal principle of consistent use must be adhered to, namely that the use determination for land and improvements be the same and that a property may not be projected where the use of land is different from the use of the improvements at any one time.

D. Land valuation

1. Any of six recognized techniques for valuing land may be utilized.

a. Sales comparison

(1) Analyzing recent sales of similar land in order to come to a value conclusion concerning the subject land

(2) This is usually the preferred method for estimating the market value of land, since it tracks what has been actually paid in the marketplace

for similar plots of land, that is, what investors are actually doing.

(3) The disadvantage of this technique is that often times it is not available or practical, in that few unimproved lots may be selling in the market, especially in built-up areas where land with no improvements on it may be a rarity.

b. Allocation

(1) Land is estimated as a percentage of overall property value of the same type as the subject and that percentage is taken of the subject property's value to yield an estimate of value for the land component of the subject.

(2) Land-to-property ratios might be accurately estimated from current tax assessments in the market (depending upon the reliability of the taxing authority) or possibly from what investors/ developers are paying for land they improve and subsequently sell.

c. Extraction (sometimes called "abstraction")

(1) The depreciated value of improvements is deducted from the property value to give an estimate of the value of the remaining component, the land.

(2) Accuracy of this method is very much dependent upon the ability of the appraiser to estimate improvements' cost new and accrued depreciation of the subject improvements, and the availability of data that will allow the appraiser to make such calculations.

d. Subdivision development analysis

(1) The total costs and entrepreneurial profit projected for a subdivision are deducted from the total sales revenues expected for the subdivision in order to estimate how much more the market paid for the properties than the sum of the costs and profit, this excess being the one component not taken into account yet, the land, and an indication of what the market feels the land is worth.

(2) It is very important to remember that if the highest and best use of

the land is not subdividing, then this method should not be used for valuing the land, since rolled into that subdivided land value may be many of the costs unique to subdividing and such land value given another land use would be misleading.

e. Land residual

(1) The income associated with the land component of an income producing property is capitalized using an appropriate land capitalization rate (return "on" only) to yield an estimate of the value of the land.

(2) In order to use this technique the appraiser must estimate the value of the improvements, the property net operating income, and the capitalization rates applicable for both the improvements and land components.

f. Ground rent capitalization

(1) The net operating income earned from a long term lease on land is capitalized into a value indication for the land.

(2) The land capitalization rate should reflect the probable stability of the long term lease and be lower than a comparable lease not on a long term basis.

E. Application of the three approaches to value

1. Sales comparison approach

2. Cost approach

3. Income capitalization approach

4. A business valuation may employ a fourth approach, called "liquidation value analysis," in which the real and personal property assets of the business are individually valued and then added up, deducting from that sum any liabilities to yield an overall value for the business.

F. Reconciliation of value indications to a final estimate/opinion of value

1. Reconciliation is that procedure by which final opinions are made on information, data, and value conclusions the appraiser utilizes in application of the appraisal process.

2. It is essentially a process of resolution, since the appraiser must often take conflicting data and, using the best judgment possible in the light of the information at hand, decide what the proper conclusions should be for the

final opinion of value, the cost data to be used, what the best capitalization rate may be, and any other decisions that must be made in the valuation process where not all the data entirely support one another.

3. Criteria of reconciliation

a. Accuracy

(1) The information should have been obtained from enough sources or a very reliable source that the accuracy of the data is not in reasonable question.

(2) It is sound policy to verify data with independent sources if at all possible, although a guideline of the Federal National Mortgage Association (Fannie Mae) does not require verification of information unless the source providing such information had a financial interest in the transaction about which the appraiser is inquiring.

b. Appropriateness

(1) Accurate information may not be useful or at least not weighted much in reconciliation if it is not relevant to the appraisal problem being solved.

(2) The appraiser decides what applicability information may have as part of the reconciliation process.

c. Quantity of evidence

(1) A preponderance of evidence pointing to a particular conclusion may be convincing enough to reconcile to a large extent on that evidence favoring such a conclusion.

(2) The weight of data should be sufficient to serve as a basis of defense and explanation of the appraiser's application of the appraisal process.

4. Before submitting an appraisal report to the client the appraiser should review the entire valuation process that led to the conclusions contained in the report.

a. Mistakes are corrected and conclusions examined again to ensure they are consistent with the data used in support of these conclusions.

b. Looking back at the appraisal process, it should be clear that all issues raised in the appraisal process step of defining the problem have been properly addressed.

5. A numerical reconciliation should illustrate the mechanics of how the conclusions were arithmetically derived and a full explanation given of the reasoning behind the weighting assigned to each of the indications.

a. Example of equal weighting

An appraiser valuing the fee simple interest of a single-family home for the purpose of estimating market value has used all three approaches to value and come up with the following values:

By the sales comparison approach:	**$151,000.**
By the cost approach:	**$162,000.**
By the income approach:	**$146,000.**

The appraiser believes that the quality and relevance of the comparables make the sales comparison approach a strong indicator of value. But, the

appraiser also notes, the subject improvements were completed only two years ago, depreciation was a minor consideration, and the availability of ample cost data make the cost approach another solid basis for valuation. And, since rentals account for a sizable portion of the market, the appraiser decides the income approach is very relevant to this appraisal and weights the three approaches equally as shown below:

Approach	Value estimate		Weighting		Weighted average
Sales	$151,000.	x	.333	=	$50,283.
Cost	$162,000.	x	.333	=	$53,946.
Income	$146,000.	x	.333	=	$48,618.
			Equally weighted:		$152,847.

Rounded opinion of value: $153,000.

It is highly frowned upon in real estate appraising to engage in strict averaging, as a sign of laziness or lack of knowledge on the part of the appraiser. That is not to say, however, that on occasion various numerical conclusions cannot equally apply to an appraisal situation. This is what we are suggesting above, without in any way proposing that exact averaging is always an acceptable appraisal technique.

b. Example of unequal weighting

In the above example if the appraiser felt the three approaches were not equally applicable, the weighting for each approach should not be equal. If, for example, the appraiser thinks the sales comparables are poor, the cost data and the depreciation figures marginal, but strong income data have been found for the subject from a predominantly rental market, the reconciliation might then look like this:

Approach	Value estimate		Weighting		Weighted average
Sales	$151,000.	x	.10	=	$15,100.
Cost	$162,000.	x	.10	=	$16,200.
Income	$146,000.	x	.80	=	$116,800.
			Unequally weighted:		$148,100.

Rounded opinion of value: $148,000.

Again, in addition to the derivation of the conclusion illustrated above, the appraiser would give full explanation in the appraisal report of why the value estimates were weighted as they were.

G. Report of defined value

1. The results of an appraisal assignment may be reported orally, as long as the appraiser maintains sufficient written data in the workfile to support the conclusions of the oral report.

a. While permitted by Uniform Standards, it is not allowed for a federally related transaction, for which a written appraisal report is required.

(1) A federally related transaction is one in which a federal regulatory agency has commissioned the appraisal or is regulating the transaction for which the appraisal is sought and the services of a licensed or certified real estate appraiser are required.

(2) Uniform Standards require that an oral real estate appraisal report include to the extent possible those data that would be in a corresponding written summary report on the same appraisal.

b. Expert witness testimony in court is probably the most common example

of appraisers rendering oral real estate appraisal reports.

c. Appraisers need to be careful to avoid an unintended oral appraisal report by responding to seemingly innocent questions about what a property might be worth in a manner that could be construed as an oral real estate appraisal report.

2. Written appraisal reports

a. Letter

(1) This report communicates the results of an appraisal assignment to the client in a letter format, from the appraiser to the client.

(2) Although previously in widespread use in the appraisal business, this reporting method is now used less frequently.

(a) There is concern that all the reporting requirements of Standard 2 of the Uniform Standards will not be met because of the constraint of adhering to a letter format.

(b) The dominance of the use of form reports in residential appraisal reporting has relegated letter reports to a very minor role in this part of the appraisal profession.

b. Form

(1) A set, pre-approved form is used in which the appraiser fills in the blanks for the requested information.

(2) The advantages of this format are the form makes clear what information is expected from the appraiser and the client is aware of what categories of information the report will contain and where in the report to find that information.

(3) The best known appraisal reports of residential appraising - the Uniform Residential Appraisal Report (URAR), the Small Residential Appraisal Report (2-4 family form), the Individual Condominium Unit Appraisal Report form, the newer forms from Fannie Mae, 2055 and 2065 - are in this format of filling in the blanks.

(4) Using form reports for the results of commercial appraising is seen much less than on the residential side, with many commercial

appraisers favoring the use of a narrative format to report the results of their appraisal assignments.

(5) The residential appraiser inexperienced in narrative report writing or any other appraiser unsure about structuring a narrative report may wish to ask appraisal software companies about two commercial forms that are available.

(a) The Uniform Commercial/Industrial Appraisal Report - Small Property (UCIAR - SP) - is for transactions in which the loan amount is $750,000. or less.

(b) The Uniform Commercial/Industrial Appraisal Report - Existing Property (UCIAR - EP) - is for transactions in which the loan amount is greater than $750,000.

c. Narrative, a suggested format

(1) Introductory section

(a) Title page

i. Address of subject property

ii. Appraiser name and business address

iii. Client name and address

(b) Transmittal letter

i. Cover letter accompanying the formal appraisal report sent to the client

ii. Information included

(i) Date of the letter

(ii) Effective date of the opinion of value

(iii) Opinion of value

(iv) Property interest appraised

(v) Property address

(vi) Signature of the appraiser

(c) Certification should contain statements similar to the following

i. Statements of fact are true, to the best knowledge of the appraiser

ii. Report contains the professional analyses, opinions, conclusions of the appraiser

iii. Whether or not the appraiser has an interest in the subject property and whether or not the appraiser has a personal relationship with the parties involved

iv. The appraiser has no bias with regard to the subject property.

v. The appraisal is not contingent upon the appraiser reaching a certain pre-determined value.

vi. The appraiser's fee is not contingent upon the value conclusion or subsequent event associated with the appraisal.

vii. The appraisal process has been conducted and the report written up in conformity with the Uniform Standards of Professional Appraisal Practice.

viii. Whether or not anyone who has signed the property has inspected the property and, if so, the nature of the inspection

ix. Identification of anyone who has provided significant real property appraisal assistance to the appraiser during this appraisal process

(d) Summary of important conclusions

i. Address of subject property

ii. Extraordinary assumptions and hypotheticals

iii. Highest and best use analysis

iv. Opinion of land value

v. Opinion of value of the specified interest in the subject property by each of the approaches to value used in the appraisal

vi. Reconciled opinion of value of the specified interest in the subject property

vii. Effective date of the valuation

viii. Definition of the value appraised

(2) Premises section

(a) Assumptions and limiting conditions should contain statements similar to the following

i. Although information supplied by others is deemed reliable, no warranty is given for the accuracy of such information.

ii. Title to the subject property is assumed to be marketable and free and clear of encumbrances unless otherwise noted

iii. It is assumed there are no defects in the land/improvements not apparent to the appraiser that would have an impact upon valuation.

iv. The appraiser is not an expert in the field of environmental hazards and is not qualified to render an opinion on the presence of such hazards and the effect they may have on the valuation of the subject property and its suitability for its present or contemplated use.

v. Referenced proposed improvements, if any, are assumed to be

completed in accordance with plans and specifications noted in the report and performed in a workmanlike manner consistent with the issuance of the required building permits and certificates of occupancy.

vi. The appraiser is not required to give further testimony or appear in court concerning this appraisal, unless specific arrangements have been made to do so.

(b) Purpose and scope of the appraisal

i. The purpose of the appraisal is to provide an opinion of a type of value.

ii. Uniform Standards require the appraiser to describe the scope of the appraisal, that is, what is covered in the appraisal and the extent of effort by the appraiser to complete that coverage.

(c) Definition of value and date of the value estimate

i. A generally recognizable definition of the value being estimated

ii. The "as-of" date or "effective" date may be as of a date in the past (retrospective appraisal), as of a recent date (current appraisal), or as of a date in the future (prospective appraisal).

(d) Property rights appraised

i. Fee simple

ii. A partial interest

(3) Presentation of data

(a) Identification of the property

i. Legal description and commonly-known-as address

ii. Photographs/maps/drawings/charts

iii. Classification of property

(i) Real property

(ii) Personal property

(b) Forces influencing subject

i. General data

(i) Social

(ii) Economic

(iii) Governmental

(iv) Environmental

ii. Specific

(i) Subject property

(ii) Subject's neighborhood

(c) Site information

i. Subject's size, dimensions, shape, soil conditions, topography

ii. Deed restrictions, easements, flood zone classification

(d) Description of improvements

i. Physical representation of the subject, including size, shape, number of units, common areas, actual age, effective age, remaining economic life

ii. Depreciation

(i) Physical deterioration

(ii) Functional obsolescence

(iii) External obsolescence

(e) History of the subject

i. Date of construction and subsequent capital additions

ii. Chain of title, that is, owners past and present

iii. Sales prices and financing

iv. Casualty losses

(4) Analysis of data and conclusions of the appraiser

(a) Highest and best use of the land as vacant

(b) Highest and best use as currently improved

(c) Land value

i. One or more of the six recognized methods for valuing land are presented, with a reconciliation to the opinion of value

ii. Special factors affecting land value should be described, if they exist,

such as being in a flood zone, difficulties in zoning/rezoning, configuration of the land, access to utilities/sewer, on septic.

(d) Presentation of each of the approaches to value that were used in the appraisal

(e) Reconciliation of value indications to final opinion of value, with a detailed discussion of the reasoning behind the reconciliation and how the final value opinion was reached

(5) Qualifications of the appraiser should be included and may be contained in

a full resume attached to the appraisal or at least information such as the following.

(a) Education and training, special courses, seminars completed

(b) Professional experience generally described

(c) Noteworthy clients, if they have granted permission to identify them

(d) Specific properties appraised, if the clients have granted permission to identify the appraisals

(e) Membership in professional associations

(6) Addenda - information not essential for understanding the appraisal but included to further explain and illustrate the data and conclusions contained in the body of the report

(a) Sketches, building plans, diagrams, photographs, maps of the subject, comparables, and the neighborhood

(b) Graphic data, tables, calculations utilized in support of the appraisal

(c) If the subject is an income-producing property, copies of leases or

summarized lease data, reconstructed operating statements, analysis of contract and market rents, vacancy and occupancy levels

(d) Construction costs

(e) Listing and sales prices in the market, marketing times, levels of supply and demand, predominant age and selling price of properties in the area

(f) Discounted cash flow analysis

i. Projection of periodic income streams

ii. Calculation of reversion

iii. Discounting to present value

(g) Statistical analysis

i. Mean, median, and mode

ii. Range

iii. Average and standard deviations

(h) Regression analysis

i. Simple linear

ii. Multiple regression

II. Financing/debt investing

A. If the purchase of real estate is financed, there are two investors - the equity investor and the debt investor - who come together in such purchase for their mutual benefit.

1. The equity investor actually buys the property, putting up the down payment, arranging for financing with a debt investor to complete the purchase, assuming or assigning management of the property, and servicing over the period of ownership the debt obligation that was created in order to buy the property.

a. Advantages of equity investment

(1) Option of possession or leasing the property

(2) Cash flows, if leased

(3) May pull out equity with refinancing or additional financing

(4) Possible appreciation of the property value

b. Disadvantages

(1) Management may be burdensome if owner-managed and expensive if a property manager is assigned.

(2) Risk of losing equity and ownership to foreclosure if the periodic debt obligation is not satisfied

c. Equity investors may be private individuals, corporations, partnerships, limited liability companies (LLC's), partnerships, real estate investment trusts (REIT's), pension funds.

2. The debt investor allows the equity investor to complete the purchase of real estate by providing the remainder of the funds needed over the equity investor's down payment.

a. Advantages

(1) The debt service (mortgage payments) is secured income, backed by a security device that will allow the debt investor to foreclosure upon the collateral property if the equity investor does not make the mortgage payments as called for in the loan note.

(2) Usually not involved in the management of the property

b. Disadvantages

(1) Servicing a debt - ensuring that the loan payments are collected - is expensive and requires the lender/debt service investor to maintain personnel to send out notices, make collection calls, initiate or authorize foreclosure, when necessary, and provide customer service throughout the life of the loan.

(2) The debt investor usually has no claim to any cash flows and/or appreciation of the collateral property, unless the equity and debt investors have agreed to share these economic benefits in something called a "participation mortgage." (See section on types of loan that follows.)

(3) Although adjustable rate mortgages are designed to keep up with a fluctuating market, fixed rate loans may become costly if the loan rate falls below market rates during the life of the loan.

(4) Inflation since loan origination erodes the value of the dollars paid back over time.

c. Any of the equity investors can also get into debt investing, but debt investors in real property are typically commercial banks loaning direct to the borrower, commercial banks working through mortgage brokers, life insurance companies, pension funds, credit unions, mutual savings banks.

3. The position of each investor - equity and debt - can be valued through the use of capitalization techniques.

a. The equity residual technique values the position of the equity investor by capitalizing income associated with equity into a value indication, using an equity capitalization rate.

b. The mortgage residual technique values the position of the debt investor by capitalizing income associated with debt into a value indication, using a debt capitalization rate.

B. Categories of loans

1. Insured

a. Government insures the lender against loss, with the borrower paying for the insurance, the most well known program being that of the Federal Housing Administration (FHA) of the U.S. Department of Housing and Urban Development (HUD).

b. Private companies may also insure lenders, often required by the lender when the loan-to-value ratio for the borrower exceeds 80%.

2. Guaranteed

a. The federal government and some State governments offer programs that will guarantee loans for the lender, without requiring issuance of insurance that can be costly to the borrower.

b. The best known guaranteed loans are from the VA home loan program of the U.S. Department of Veterans Affairs.

3. Conventional

a. The majority of home loans in this country are conventional loans, meaning government does not insure or guarantee the lender from loss.

b. In recent years conventional loans have become very competitive with FHA and VA loans, in some cases offering very high loan-to-value ratios and limited closing costs in order to capture the traditional FHA and VA markets.

C. Financing methods

1. Mortgage transaction

a. Documents

(1) Mortgage note

(a) Promise to repay the loan under specified terms and conditions

(b) It is the evidence of the debt.

(2) Mortgage contract

(a) Pledge of an interest in the real property used as collateral/ security for the loan, it is the security device, the act of "mortgaging" a property, meaning the borrower has used it for collateral to get a loan.

(b) Mortgaging the property places a lien on the interest that has been pledged, which is the right granted to the lender to take the property in a foreclosure action if the borrower does not satisfy the conditions of the mortgage loan note.

(3) Mortgage deed

(a) Used in some States in place of a mortgage contract, it transfers actual legal title to the property from the borrower to the lender, which eases the foreclosure process for the lender by allowing the lender to foreclose without having to go to court, since the legal title is already in the possession of the lender.

(b) Also known as a "deed to secure debt"

b. Parties to a mortgage transaction

(1) Mortgagor

(a) The one who is pledging the interest in the real property, the one who is giving the mortgage as a condition of getting the loan

(b) Borrower

(2) Mortgagee

(a) The one who receives the pledge of an interest in the real property from the borrower/mortgagor in return for the loan funds

(b) Lender

2. Trust deed transaction

a. Documents

(1) Trust note

(a) Promise to repay the loan under specified terms and conditions

(b) It is the evidence of the debt.

(2) Trust deed

(a) This security device for the loan actually deeds over legal title to a third party to be held as collateral for the loan.

(b) Although the trust deed itself probably is in the hands of the

lender, the legal title is recognized to vest in the third party, who may foreclose on the property if the conditions of the trust note are not satisfied.

b. Parties to a trust deed transaction

(1) Trustor

(a) The one who is conveying legal title to a third party as a method of putting up collateral in order to obtain the loan

(b) Borrower

(2) Trustee

(a) The recipient of the conveyance of legal title from the trustor

(b) The trustee, holding the collateral as the borrower is paying the loan back to the lender, should be a party other than the lender and is often a title company or attorney.

(3) Beneficiary

(a) The party benefiting from the trust arrangement in which the trustee is holding legal title until the trustor repays the loan

(b) Lender

3. Land contract

a. Agreement between a buyer and seller in which the buyer purchases the property through installment payments to the seller, with the buyer typically taking physical possession of the property but the seller remaining the legal owner of the property

b. Title

(1) The seller retains legal title to the property but is required to deed over that title to the buyer when the buyer has satisfied the terms of the contract.

(2) The buyer does have a interest in the property, holding what is called "equitable title."

c. Land contracts are known by a variety of names that all refer to the same arrangement.

(1) Contract for deed

(2) Agreement for deed

(3) Conditional sales contract

(4) Installment sales contract

D. Priority of loans as liens on real property

1. A lien is a money encumbrance on title to property, that is, a limitation on the ownership of property that is involved with the payment of money, in the case of a loan, with the repayment of the loan funds given to the borrower.

2. The priority of loans - the order of claims to a property serving as collateral - is established by the order the lenders have notified the public of their interest in the property, giving what is called "public" or "constructive" notice by recording such interest with the country recorder/court house in the county where the collateral property is located.

3. Loan order

a. The "first loan" or "senior loan" is that loan that has been recorded first and hence has the first right among lenders to the property and to funds that would be disbursed in a foreclosure action.

b. A "junior loan" is any loan (second, third, fourth) after the first loan and subordinate in claim to other loan(s) on the property.

4. The general rule of priority is that "first to record is first in right," but there are exceptions to this rule in which liens, even though recorded subsequently to a loan, may take precedence in claim to the property and funds deriving

from it.

a. Real property taxes usually are paid off in a foreclosure before other claims, except possibly for costs incurred for the foreclosure sales.

b. Mechanic's liens can take precedence from when work on the property first started, not from when a lien was later recorded because of non-payment.

E. Types of loans

1. Classified by method of payment

a. Amortized

(1) Repayment of the loan is made through a periodic series of payments typically applied to principal and interest.

(2) The loan is "fully amortized" if the loan will be fully paid off, principal and interest, by the end of the loan period.

(3) The loan is "partially amortized" if at least some principal remains due at the end of the loan period.

b. Balloon

(1) Any loan, whether amortized or not, that has principal, called the "balloon," due at the end of the loan period.

(2) An interest-only loan is one in which no payments of principal, only interest, are made during the life of the loan.

(3) There may be no payments of either principal or interest made during the life of a loan, at the end of which all principal and accrued interest will be due.

c. Graduated-payment

(1) The amount of the loan payment changes during the life of the loan, usually starting at an artificially low level and increasing later

according to a pre-determined schedule.

(2) If the loan payment is so low that it does not cover the interest due, this loan will involve "negative amortization."

(a) Negative amortization is where unpaid interest is added to the principal, thereby increasing the amount due to the lender.

(b) Example

A loan of $100,000. is made at 9%, 30 year-term, with monthly payments of $700. per month. The interest due per month would be:

$100,000.
x.09
$ 9,000. - interest on an annual basis

$9,000. ÷ 12 months = $750. interest due for the first month

$750. interest due for the first month
- 700. monthly payment
$ 50. remaining interest due after first month's payment

The $50. unpaid interest will be added to the principal, and so after the first month's payment the borrower will owe:

$100,000.	**beginning balance**
+ 50.	**remaining interest due after one month's payment**
$100,050.	**balance due after one month**

This is negative amortization, since the loan balance with payments is growing, not diminishing. The balance after the second month's payment would be:

$100,050.	**balance after first month's payment**
x .09	
$ 9,004.50	**interest on an annual basis**

$9,004.50 ÷ 12 months = $750.38 interest due second month

$750.38	**interest due for the second month**
- 700.00	**monthly payment**
$ 50.38	**remaining interest due after the second month's payment**

The remaining interest due after the second month's payment will be added to the balance due and the process will continue, each month the remaining interest due growing slightly larger because the loan balance is growing slightly larger. Many graduated-payment loans will have a provision that the loan payment will increase later, so that the negative amortization feature will be reversed and eventually the loan will be start to be paid down as the higher loan payment will be sufficient to pay all interest due each month and probably some principal.

2. Classified by agreement on interest rate

a. A "fixed-rate" loan is one in which the interest rate will remain the same over the life of the loan.

b. A variable-rate or adjustable-rate loan is one in which the interest rate may change over the life of the loan.

(1) The interest rate is tied to an independent economic index, such as the prime rate or composite yields on U.S. Treasury bills, that will increase the interest rate on the loan if the index goes up but must decrease the loan interest rate if the index goes down.

(2) The loan is often structured so that a change may occur no more than once or twice per year, no change each time may be more than a certain amount, and a ceiling will be set over which the rate

may not increase for the life of the loan.

3. Classified by the purpose of the loan

a. A "purchase-money" loan is for the purchase of real property, in which the loan is part of the purchase price and the property being purchased is the collateral.

b. An "equity" loan is to convert some of the equity of the property currently owned into cash by borrowing it and using the property as collateral.

4. Construction

a. A short-term loan that finances the building of the improvements, it is usually funded by the lender disbursing loan proceeds in installments or "draws" as the construction progresses.

b. "Take-out" financing used to replace the short term construction loan with long term financing from a different lender (the short term lender was "taken out" by the long term lender), but in recent years this has often been replaced with the "construction-perm" loan in which the same lender is providing the construction loan for a limited time and then replacing this short term loan with the long term permanent loan.

5. Blanket

a. More than one property is held as collateral for the loan, such as when a developer borrows money to build a subdivision and all the homes

being built and their lots secure (provide the collateral for) the loan.

b. The properties are released from the obligations of the blanket loan as they are individually purchased (see release clause below).

6. Package

a. Both real and personal property are used as collateral for the loan.

b. Business and hotel loans, for example, can be package loans.

7. Participation

a. The lender shares with the borrower in some of the benefits of equity investment, such as a realizing a portion of the periodic income flows and/or appreciation in the property after a given time.

b. This loan is likely to occur in high interest rate markets, where the lender, in return for a share of the economic benefits derived from the secured property, will give the borrower a below-market interest rate on the loan.

F. Loan clauses

1. Acceleration

a. Allows the lender to "call" the loan prior to maturity, that is, to ask the borrower to pay off the remaining balance due on the loan

b. The loan must state what events permit the lender to "accelerate" the loan payments.

(1) Default on the loan payments almost always allows the lender to call the loan.

(2) An acceleration clause that stipulates a sale of the property, also called a "due-on-sale" or "alienation" clause, is a commonly seen basis for calling the loan.

(3) Destruction of the improvements

(4) "Jeopardizing the security," such as non-payment of real property taxes or extreme neglect in maintaining the property

2. Subordination

a. Permits a loan to precede another loan in priority, even though the loan

taking the senior position was recorded subsequent to the loan being made junior

b. The subordination clause must be in the loan that is being made subordinate, such as a land loan already made that is then made subordinate by a subsequently negotiated and recorded construction loan for the purpose of building on the land (allowing the construction loan to be the first loan will save the borrower money in a lower cost for the construction loan, even though the lender of the land loan is likely to extract a price for agreeing to a subordination clause).

3. Release

a. Allows a property held as security under a blanket mortgage to be removed out from under that blanket loan on payment for that property

b. Some States require that any blanket mortgage must contain a release clause.

4. Escrow

a. Requires the borrower place in "escrow" with the lender funds for the payment of specified property expenses, such as monthly pro-rations for real property taxes and hazard insurance

b. This clause can be found in FHA and VA loans, as well as conventional loans made in loan-to-value ratios greater than 80%.

5. Pre-payment penalty

a. Describes what financial penalty the borrower must pay the lender if the borrower pays off the loan or a stated portion of the loan in advance of what is called for in the loan terms

b. The penalty may be a percent of the loan balance due or a certain number of months' interest, as a means of discouraging borrowers from paying off their loans unexpectedly after the lender has gone through the time and expense of making that investment in the borrower.

G. Mortgage markets

1. Primary

a. That financing market made up of borrowers and lenders originating loans

b. May be first or junior loans

2. Secondary

a. The market in which those loans originated in the primary market are subsequently bought, sold, traded, and borrowed against

b. Sometimes called the "lender's market" because it consists mainly of lenders dealing among themselves in loans already made.

c. The secondary market provides liquidity for primary market lenders, who sell their loans in order to raise cash so that they can originate more loans in the primary market.

(1) Benefits for the lender originating and then immediately selling the loan

(a) Loan discount points and other fees charged at origination

(b) Service contract for the loan in which the purchaser of the loan agrees to pay the selling lender a percentage of the loan - perhaps 0.50% - 0.75% of the loan balance each year - to continue to collect payments on the loan, send out notices, provide customer service to the borrower, foreclose, if necessary

(2) The selling lender may sell the loan at the face amount, or balance due if payments have been made on the loan, or sell it at a discount if the lender needs cash, but can still make a profit off the loan or at least recover any losses associated with the sale of the loan with the economic benefits described above.

d. Participants

(1) Financial institutions

(2) Private individuals and companies

(3) Fannie Mae

(a) Private, stockholder, financial company chartered originally by the U.S. Congress as a government agency and later sold to the private sector where it operates today providing liquidity for the primary market by buying residential loans in the secondary market

(b) Often called a "quasi-public" corporation, Fannie Mae is specially regulated by the federal government but it remains a private company whose stock can be purchased in the New York Stock Exchange.

(c) Fannie Mae does not originate loans but strongly influences the primary market through its immense purchases of residential loans in the secondary market, its mortgage-backed securities (MBS) described below in reference to Ginnie Mae, and its automated underwriting program called "Desktop Underwriter."

(d) Since Fannie Mae has certain guidelines for buying loans - including criteria for the appraisals conducted in association with the granting of the loans - its appraisal guidelines are widely observed and generally accepted as setting the standards for appraisals made in connection with the origination of conventional residential loans.

(e) Website: www.fanniemae.com

(4) Freddie Mac

(a) Similar to Fannie Mae, Freddie Mac is a private, stockholder financial company that was chartered by the U.S. Congress, but, unlike Fannie Mae, it was created as a private company to provide liquidity to the primary market with its purchases of loans in the secondary mortgage market.

(b) Also often referred to as a "quasi-public" corporation, it too is specially regulated by the federal government while its stock is available for investors to purchase in the New York Stock Exchange.

(c) Freddie Mac influences the primary mortgage market, as Fannie Mae does, with substantial purchases of residential loans in the

secondary mortgage market, its mortgage-backed securities, and its automated underwriting program called "Loan Prospector."

(d) Freddie Mac guidelines for residential appraisals tend to mirror Fannie Mae's and the two companies, although they compete in the purchase of loans and other important areas such as automated underwriting, cooperate in the sponsorship of the major residential appraisal report forms.

(e) Website: www.freddiemac.com

(5) Ginnie Mae

(a) A government agency created by the U.S. Congress and part of the U.S. Department of Housing and Urban Development

(b) Ginnie Mae operates in the secondary market through mortgage-backed securities (MBS) packaged by "issuers" approved by Ginnie Mae who put together pools of loans that provide the income flow for MBS purchased by investors.

(1) Most issuers are mortgage companies but commercial banks and savings and loans also participate.

(2) Through this mechanism of issuers and MBS Ginnie Mae provides liquidity for the primary market and the origination of more residential loans.

(3) MBS are called "pass-throughs," meaning the principal and interest payments of the mortgagors of the pooled mortgages are passed through to investors purchasing the securities.

(c) Website: www.ginniemae.gov

H. National economic policies

1. Fiscal

a. Tax and spending programs of the U.S. Government

b. Once money bills are passed by Congress and formulated into law, the resulting fiscal policy is then coordinated by the U.S. Department of Treasury under the direction of the President.

2. Monetary

a. Management of the supply of money by the Federal Reserve System

b. The Federal Reserve System consists of a seven-member Board of Governors headquartered in Washington, D.C. and 12 Reserve Banks located in cities throughout the U.S.

(1) The seven members are appointed by the President and confirmed by the Senate for 14-year terms.

(2) The Chairman and Vice Chairman are appointed by the President and confirmed by the Senate for four-year terms.

c. The Federal Reserve controls the money supply and hence availability of credit through three major devices.

(1) The sale and purchase of U.S. Treasury securities, which have the effect of contracting or expanding the available money supply in the country, by the Federal Open Market Committee (FOMC) of the Federal Reserve

(a) Selling securities in the market will contract the supply of money and generally increases interest rates.

(b) Buying securities back from the market expands the money supply and generally brings interest rates down.

(2) Setting of reserve requirements, the percentage of deposits a bank must retain as a safety measure, for member banks of the Federal Reserve by the Federal Reserve Board

(a) Increasing the reserve requirements contracts the money supply and tends to make interest rates higher.

(b) Lowering the reserve requirement expands the money supply and tends to bring interest rates down.

(c) Member banks who fall below their reserve requirements may borrow money from other banks of the Federal Reserve System, paying interest on these borrowed federal funds at a rate called the "federal funds rate," a key interest rate set by the Federal Reserve and closely watched throughout the economy.

(3) Setting of the discount rate, that interest rate the Federal Reserve charges its members banks to borrow from it, by the Federal Reserve Board and the Reserve Banks

(a) Raising the discount rate is likely to increase other interest rates.

(b) Lowering the discount rate is likely to bring other interest rates down.

I. Regulatory agencies

1. Federal Reserve System

a. Supervises and regulates banking institutions, in addition to the monetary policy of its Board of Governors described above

b. Website: www.federalreserve.gov

2. Federal Deposit Insurance Corporation (FDIC)

a. Insures deposits of the nation's financial institutions

b. Website: www.fdic.gov

3. National Credit Union Administration (NCUA)

a. Supervises and insures federal and State-chartered credit unions

b. Website: www.ncua.gov

4. Office of Thrift Supervision (OTS)

a. Regulates federal and State-chartered thrift institutions, including savings banks and savings and loan associations

b. Website: www.ots.treas.gov

5. Office of the Comptroller of the Currency (OCC)

a. Charters, regulates, and supervises all national banks

b. Website: www.occ.treas.gov

6. Federal Financial Institutions Examination Council (FFIEC)

a. A governmental interagency body that prescribes uniform principles, standards, and report forms for the examination of financial institutions by the five federal financial regulatory agencies described above

b. FFIEC membership consists of a representative from each of the five federal financial regulatory agencies.

c. Appraisal Subcommittee (ASC)

(1) Created by the U.S. Congress in the Federal Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 as a subcommittee of the FFIEC, the ASC regulates State real estate appraiser boards and The Appraisal Foundation to ensure compliance with FIRREA.

(a) The State appraiser boards supervise and regulate appraisers licensed to practice real estate appraising in their States.

(b) The Appraisal Foundation is a private, non-profit group and is the parent organization of the Appraisal Standards Board (ASC) responsible for the Uniform Standards of Professional Appraisal Practice (USPAP) and the Appraiser Qualifications Board (AQB) responsible for setting minimum criteria for certification of real estate appraisers, both boards having been granted such authority by the U.S. Congress in FIRREA.

(2) ASC membership consists of a representative from each of the five federal financial regulatory agencies and a representative from the U.S. Department of Housing and Urban Development (HUD).

(3) The ASC website at www.asc.gov contains a federal registry of all licensed and certified real estate appraisers in the country.

d. The FFIEC website at www.ffiec.gov contains links to all the federal financial regulatory agencies and to the ASC.

7. The individual States regulate their own State-chartered banks through agencies of the State governments.

Review questions and problems (1):

1. The lending institution loaning funds for the purchase of real property is referred to as the _____ investor.

a. Equity

b. Debt

c. Liquidity

d. Package

2. The Federal Housing Administration (FHA) is a(n) _____ program for real property loans.

a. Insurance

b. Guarantee

c. Conventional

d. All of the above

3. The concept that the highest and best use must be the same for a property's land and its improvements is most closely associated with what appraisal principle?

a. Anticipation

b. Conformity

c. Consistent use

d. Substitution

4. The effective date of an appraisal refers to when the appraiser:

a. Accepted the assignment.

b. Signed the appraisal report.

c. Says the appraisal is valid.

d. Applies the three approaches to value.

5. What is “pledged” in a mortgage contract?

a. Money

b. Interest in the collateral property

c. Promise to repay the loan

d. Right of foreclosure

6. The tax and spending programs of the U.S. Government form what policy?

a. Monetary

b. Reserve

c. Federal Funds

d. Fiscal

7. What U.S. Government interagency organization sets standards for the supervision of federally chartered financial institutions?

a. FDIC

b. FFIEC

c. OTS

d. OCC

8. Demographic statistics are called what kind of data?

a. Social

b. Economic

c. Governmental

d. Environmental

9. In what method of land valuation is the depreciated value of the improvements deducted from the property value in order to value the land?

a. Allocation

b. Extraction

c. Land residual

d. Ground rent capitalization

10. What is the "purpose" of an appraisal?

a. The reason the client requested the appraisal

b. To provide an opinion of value

c. To define the value appraised

d. The period over which the appraisal is valid

11. The mortgagee is the:

a. Regulator.

b. Borrower.

c. Lender.

d. Trustee.

12. "Equitable title" is most closely associated with what form of financing:

a. Mortgage

b. Trust deed

c. Mortgage deed

d. Land contract

13. Negative amortization is likeliest to be found with what kind of loan?

a. Partially amortized

b. Fully amortized

c. Fixed-rate

d. Graduated-payment

14. The valuation of what kind of property may involve four approaches to value?

a. Shopping center

b. Business

c. Retail store

d. Apartment complex

15. A highest and best use analysis should take into account which of the following?

a. If the land were vacant

b. The land as currently improved

c. Both of the above

d. None of the above

16. What would be the balance on a loan of $75,000. at an annual interest rate of 9% over a term of 20 years with monthly payments of $500. per month at the

time the third monthly payment was due (that is, two payments have been made)?

a. $74,832.49

b. $74,921.30

c. $75,074.21

d. $75,125.47

17. What is the name for a loan where a business used its company headquarters building and its fleet of company automobiles to serve as collateral for the loan?

a. Package

b. Participation

c. Blanket

d. Take-out

18. Which of the following is(are) a U.S. Government agency?

a. Fannie Mae

b. Freddie Mac

c. Ginnie Mae

d. All of the above

19. The FOMC is a committee of the:

a. FDIC.

b. NCUA.

c. Federal Reserve

d. U.S. Department of the Treasury

20. "Current," "retrospective," and "prospective" refer to three:

a. Effective dates of an appraisal.

b. Report dates for an appraisal.

c. Loan categories.

d. Data collection categories.

21. Which of the following is a criterion of reconciliation?

a. Accuracy

b. Appropriateness

c. Quantity of evidence

d. All of the above

22. The appraisal report for a federally related transaction:

a. May be oral.

b. May be oral or in writing.

c. Must be oral.

d. Must be in writing.

23. The statement that the appraiser is not biased with regard to the subject property is most likely to be found in what section of the appraisal report?

a. Assumptions and limiting conditions

b. Certification

c. Premises

d. Addendum

24. Who is called the "beneficiary" in a trust deed transaction?

a. Borrower

b. Lender

c. Third party holding the title security

d. Escrow company

25. A money encumbrance is a(n):

a. Deed restriction.

b. Easement.

c. Lien.

d. Mortgage note.

26. A lender may "call" a loan by invoking the loan's _____ clause.

a. Acceleration

b. Escrow

c. Pre-payment

d. Subordination

27. Loans are originated in the _____ market.

a. Primary

b. Secondary

c. Tertiary

d. Quarternary

28. What is the reconciled opinion of value for a property in which the value opinion from the sales comparison was $200,000., from the cost approach $215,000., and from the income approach $190,000. if the appraiser weighted the sales approach at 75%, the cost approach at 20%, and the income approach at 5%?

a. $201,500.

b. $202,000.

c. $202,500.

d. $203,000.

29. The setting of reserve requirements for banks is:

a. Fiscal policy.

b. Monetary policy.

c. Controlled by the Federal Reserve Board.

d. Both 'b' and 'c.'

30. The allocation technique is used to value:

a. Single-family homes.

b. Office buildings.

c. Land.

d. Businesses.

31. A legal description may be given by:

a. Monuments.

b. Metes and bounds.

c. Lot and block.

d. All of the above.

32. An appraisal assignment in which the appraiser is asked to render an opinion of value as of one year prior to the assignment is known as what kind of appraisal?

a. Retrogressive

b. Retroactive

c. Retrospective

d. Prospective

33. The sale of government securities by the Federal Reserve to the open market will most likely have what effect on interest rates?

a. It will probably increase them.

b. It will probably decrease them.

c. It will probably increase them if the return on the securities is at least equal to the prime rate.

d. It will probably decrease them if the return on the securities is at least equal to the prime rate.

34. Which of the following originates loans in the primary market?

a. Fannie Mae

b. Freddie Mac

c. Fannie Mae, Freddie Mac, and Ginnie Mae

d. None of the above

35. What mortgage market is sometimes called the "lender's market?"

a. Primary

b. Secondary

c. Tertiary

d. Quarternary

36. "Economic" and "governmental" are considered two categories of what kind of data.

a. General

b. Specific

c. Social

d. Environmental

37. "Physically possible" and "legally permissible" are two criteria for determining what?

a. Interest rates

b. Capitalization rates

c. Functional obsolescence

d. Highest and best use

38. The capitalization rate used in ground rent capitalization is most likely to be _____ _____ the capitalization rate for a comparable lease on a short-term basis.

a. Greater than

b. Equal to

c. Less than

d. Approximately half

39. According to the Uniform Standards of Professional Appraisal Practice, what section in the appraisal report should contain a statement indicating whether any signatories to the appraisal report inspected the property?

a. Limiting conditions

b. Conditions of the appraisal

c. Certification

d. Valuations

40. What is the reconciled opinion of value for a subject property in which the sales comparison approach indicated a value of $150,000., the cost approach a value of $155,000., and the income approach a value of $140,000., if the sales and cost approach are equally weighted and the income approach is weighted at 10%?

a. $149,750.

b. $150,500.

c. $151,250.

d. $152,000.

FROM THE APPRAISER TO THE UNDERWRITER

ANSWER SHEET

Put in the letter - 'a,' 'b,' 'c,' or 'd' - of your answer choice for each of the questions numbered below.

REVIEW QUESTIONS AND PROBLEMS (1)

1.	**16.**	**31.**
2.	**17.**	**32.**
3.	**18.**	**33.**

4.	**19.**	**34.**
5.	**20.**	**35.**
6.	**21.**	**36.**
7.	**22.**	**37.**
8.	**23.**	**38.**
9.	**24.**	**39.**
10.	**25.**	**40.**
11.	**26.**	
12.	**27.**	
13.	**28.**	
14.	**29.**	
15.	**30.**	

III. Underwriting

A. In financial transactions, the underwriting process involves risk assessment,
that is, the analysis and decision-making through which a lender considers the likelihood of profitable return and the wisdom of a particular investment
for its lendable funds.

B. What the lender studies

1. The security/collateral

a. That property the borrower is pledging and on which the lender may foreclose if the borrower defaults on the loan

b. The lender's underwriter depends upon the appraiser's valuation of the secured property in order to decide whether the property is adequate collateral for the loan.

(1) The underwriter is the individual representative of the lender charged with reviewing the appraiser's valuation as described in the appraisal report in order to ensure to the satisfaction of the lender that the potential collateral has been properly appraised.

(a) The appraiser's efforts to value and describe the subject, and also describe the neighborhood and market, all carefully documented in the appraisal process that is presented in the appraisal report, can minimize the requests underwriters make of appraisers to clarify/modify the valuation and appraisal report.

(b) It is the underwriter's duty to his/her lender to thoroughly analyze the appraisal and its report and, in the event of perceived deficiencies in the valuation process, to question the appraiser about them.

(2) As a result of the appraisal a lender may decide to proceed with the loan, modify its original terms, or forego the loan entirely.

c. The underwriter will be concerned not only about the current condition of the property and the area in which the property is located, but also about how trends described in the appraisal report may influence value in the future.

d. In looking at the subject property, the lender is especially interested in how it compares to other properties within its market and hence much of the work of the appraiser is to draw comparisons and contrasts of the subject and these surrounding properties.

(1) A lender must always consider the possibility that the borrower will default and therefore must judge the adequacy of the security to allow the lender in a foreclosure action to recover the invested loan dollars the borrower did not pay back.

(2) In the end the lender wants to know if the subject is valuable and marketable enough to provide reasonable assurance its depositor's

monies will not be lost in a failed investment the lender made with those funds.

e. Income-generating capacity

(1) For income-producing property, the lender's underwriter must study whether the subject property that will be the collateral will produce enough income to assure the investor, that is, the lender, that such income will enable the borrower to service the debt (make the mortgage payments).

(a) The reasoning behind this criterion is that a borrower forced to supplement an income property's cash flow with personal funds on a continual basis to meet the debt service obligation is more likely to default than a borrower owning a property that generates sufficient cash flow to make the mortgage payments.

(b) Single-family homes and many 2-4 family properties often do not generate the cash flow necessary to pay the debt and hence for these properties the financial strength of the borrower is especially important.

(2) The subject property's income-producing potential is assessed in the presentation of income and expenses on a reconstructed operating statement.

(a) This numerical description of the property's rental capability should make projections starting from the generation of monthly/annual gross income through to the production of net operating income.

(b) Example

A 15-unit apartment building is rented at the following schedule:

9 units @ $750./month/unit
6 units @ $875./month/unit

An appropriate vacancy and collection loss factor is 8% and the annual operating expenses are put at $53,500. The property expenses include fixed expenses, variable expenses, and reserves for replacements. Not included in the property expenses are owner expenses such as debt service, depreciation, and income taxes on the net income generated.

Reconstructed operating statement:

9 units x $750./month/unit =	**$6,750.**
6 units x $875./month/unit =	**$5,250.**
Monthly gross rent (MGR):	**$12,000.**
	x12 months
Potential gross income (PGI):	**$144,000.**
Vacancy factor:	**x .08**
Vacancy and collection loss:	**$ 11,520.**

Adjust the potential gross income downward for the vacancy and collection loss:

	$144,000.
	- 11,520.
Effective gross income (EGI):	**$132,480.**
Operating expenses (OE):	**- 53,500.**
Net operating income (NOI):	**$ 78,980.**

(3) The underwriter uses various arithmetic ratios to characterize the property's income-producing ability to meet its debt service and other financial obligations. These ratios, of course, are not the exclusive domain of underwriters, as investors and appraisers, for example, may also use such ratios for their own financial reasoning.

(a) Debt service coverage ratio (DSCR)

i. Measures the adequacy of the property's net operating income to service the debt

ii. DSCR = NOI ÷ DS DS = annual debt service

iii. Example

In reference to the property whose reconstructed operating statement is shown above, let's say the appraised value of the property is $750,000. and that the lender is considering making a loan on it at a 70% loan-to-value ratio.

Loan amount:	**$750,000.**
	x .70
	$525,000.

If the loan term were for 20 years, the interest rate at 10%, and the rate of amortization monthly, then the monthly payment required to fully pay off the loan by the end of the loan term would be:

Computed by monthly compound interest/discount tables, often called the "Ellwood Tables," in honor of the underwriter whose pioneer work made such tables generally available:

$525,000.	**loan amount**
x.009650	**Column 6, 20-year row, 10% monthly tables**
$5,066.25/month	

HP-12C financial calculator keystrokes for computing the monthly payment:

525000	
PV	
10	
g	
i	
20	
g	
n	
PMT	**Answer: $5,066.36**

Annualized monthly payments (total dollars paid each year):

$5,066.25
x12 months
$60,795.00

The underwriter would calculate the debt service coverage ratio as follows:

DSCR = NOI ÷ DS

= $78,980 ÷ 60,795.

= 1.30

The debt service coverage ratio indicates the net operating income is adequate to pay the projected debt service, with enough net left over to pay another 30% of the debt. Lenders' loan committees set the minimum debt service coverage ratios they require, which for many loan transactions would probably be slightly lower than that calculated in this example. Hence, the underwriter might conclude for this transaction the property's income-producing ability is sufficient to reasonably assure the lender the debt service will be paid. Conservative lenders might have a higher debt service coverage minimum than shown here and hence could feel the property income flow is inadequate and turn down the loan.

(b) Operating expense ratio (OER)

i. That percentage of effective gross income that must be expended for property operating expenses

ii. OER = OE ÷ EGI

iii. Example

For the property in the preceding example the

operating expense ratio would be calculated as follows:

OER = OE ÷ EGI

= $53,500. ÷ 132,480.

= .4038

= 40% (usually rounded to the nearest whole percentage)

(c) Net income ratio (NIR)

i. Percentage of effective gross income remaining as net operating income after payment of property operating expenses

ii. NIR = NOI ÷ EGI

iii. Complement of the operating expense ratio, that is, the operating expense ratio and the net income ratio add up to 100%

iv. Example

For the property shown above the net income ratio would be:

NIR = NOI ÷ EGI

= $78,980. ÷ 132,480.

= .5962

= 60% (usually rounded to the nearest whole percentage)

(d) Cash breakeven ratio (CBER)

i. Percentage of potential gross income required to pay property expenses aside from reserves (only expenses actually paid a creditor are counted, since this ratio is measuring the flow of cash) and the debt service

ii. CBER = (OE - R + DS) ÷ PGI

R = reserves for replacements

iii. Example

If we say for the property in the example for which we have been calculating the underwriter ratios that the reserves are $4,000. of the total operating expenses of $53,500., then the cash breakeven ratio can be calculated as follows:

CBER = (OE - R + DS) ÷ PGI

= ($53,500. - 4,000. + 60,795) ÷ 144,000.

= $110,295. ÷ 144,000.

= .7659

= 77% (usually rounded to the nearest whole percentage)

iv. The complement of the cash breakeven ratio (23% in the example above) represents the maximum vacancy and collection loss percent the property can suffer and still be able to meet the cash expenditures required for operation of the property and payment of the debt service.

2. The borrower

a. Financial resources for the single-family home purchase

(1) The income-earning capability measured by current salary/wages/ commissions is compared to the burden of paying for those costs in carrying the house and the borrower's other monthly debts.

(a) Housing expense ratio (HER)

i. Percent of the borrower's monthly income major housing expenses will consume each month

ii. HER = PITI ÷ Income P = loan principal

I = loan interest

T = real property taxes

I = hazard insurance

iii. Underwriters may consider either gross or net monthly income (before or after income taxes) of the borrower, depending upon their lending institution's policies.

(b) Installment debt ratio (IDR)

i. Percent of the borrower's monthly income that all debt obligations paid by the borrower on a monthly basis, including housing expenses, consume each month

ii. IDR = MID ÷ Income MID = monthly installment debts

(2) Net worth

(a) Total assets minus total liabilities

(b) While net worth considerations are usually more important in evaluating the borrower for larger investments than the single-family-home, it is a relevant concern of the underwriter looking

at the ability of the borrower to accumulate assets.

b. Credit history

(1) Included in the underwriting process is an evaluation of how well the borrower has handled his/her financial obligations in the past.

(2) Borrowers are rated or ranked, the underwriters relying heavily on the information obtained from the major credit reporting bureaus in the country and contained in a credit report on the borrower.

(a) Underwriters often utilize point systems to quantify the rating assigned to the borrower, which is used to estimate the likelihood a borrower will meet the debt service responsibility of repaying the loan as stipulated in the loan note.

(b) A particularly strong borrower may encourage the lender to

make the loan, even if the security, that is, the collateral property, may be only marginally adequate.

(c) Underwriters may identify a "default threshold," a percentage level at or below which (e.g., 3% chance or less) the lender is willing to risk default, since the possibility of such default appears minimal and within the financial ability of the lender to absorb the potential economic loss as a "cost of doing business."

i. Automated underwriting - Fannie Mae's "Desktop Originator" and "Desktop Underwriter" and Freddie Mac's "Loan Prospector" - has encouraged this trend towards acceptable default probability, especially in single-family home loan underwriting, and is called "credit-based lending," since the loan decision is largely determined by the credit status/strength of the borrower.

ii. The substantial sales of loans in the secondary market mean that the risk of default is spread among many lenders, as these loans are sold, resold, and packaged to provide returns for marketed securities ("securitization").

iii. The real estate appraiser needs to study in his/her market whether there is a de-emphasis by lenders on the value of the property collateral and, if so, what it means for the role of the appraiser, particularly the single-family home appraiser in a credit-based market.

c. Competence

(1) When underwriting loans on investment properties, the lender will look for evidence the borrower is capable of managing the investment successfully.

(a) Has the borrower owned this kind of property before?

(b) Is the borrower qualified to put together a management team for the investment?

(c) If the borrower owns or has owned other similar investment properties, how are they performing or did they perform?

(2) If the underwriting process results in approving the loan, that should

signify that the lender believes the borrower is capable of handling the investment and fulfilling the terms of the loan agreement.

(a) The debt and equity investors are cooperating for their mutual, financial benefit.

(b) Most such real estate loans are "non-recourse," meaning the lender may seek only the collateral property to satisfy any losses from default, not any other assets of the borrower.

3. The market

a. A financially well backed and competent investor may still be unsuccessful in an investment if the market is not suitable for such investment.

(1) The underwriting process should include an evaluation of current levels supply and demand for the subject property.

(a) Important data are current and projected vacancy factors, developments being built or planned for building, rates of absorption, interest rates, governmental restrictions.

(b) The real estate appraiser will normally be relied upon to provide within the appraisal report a study of supply and demand and their impact on value.

(2) The rental information the real estate appraiser will provide on investment property should survey present market and contract rents and what trends in these rents indicate for the future.

b. In underwriting single-family home loans the lender will also consider supply and demand, emphasizing what they mean for sales prices.

(1) The loan-to-value ratio for the lender's single-family home investment (the loan being made) is traditionally higher than for income property loans.

(2) Lenders wish to avoid making loans in a market that could depreciate so badly that loan amounts exceed values, leading almost inevitably to increased loan defaults.

C. Loan terms

1. The lender will set the conditions under which the loan must be repaid and which are set forth in the loan note.

a. The loan conditions must be attractive enough to be competitive with

other lenders, while protecting the lender by earning a profitable return and insuring as much as possible that the loan will be paid back.

b. The responsible lender will work out loan terms that its underwriting department has concluded will be manageable for the borrower.

2. Loan period

a. Length of time over which the borrower is allowed to retain part or all of the funds loaned, after which all monies should have been repaid to the lender.

b. Many loans are paid off prior to the end of the loan period.

(1) Borrowers may sell the property, causing an acceleration of the loan, may refinance, or may wish to remove any debt encumbering the property.

(2) Those loans that last the full length of the loan period are said to "run to maturity."

3. Interest rate

a. The rate at which the cost of the loan to the borrower is calculated by taking the interest rate percentage (usually expressed annually) of the principal amount, that is, the loan amount owed the lender

(1) Most loan payments will consist of monies applied to the principal, which reduces the loan balance, and the remainder paying for the cost of the loan, the interest dollars.

(2) Example of calculating principal and interest allocation of a loan payment

For a $200,000. loan at 8% annual interest over a term of 30 years, the monthly payment required to fully amortize the loan would be calculated as follows using 8% monthly compound interest/discount tables:

$200,000.
x.007338 Column 6 of the tables*
$1,467.60 monthly loan payment

***Column 6 contains what are called "loan constants" or "mortgage constants" that are factors by which a loan may be multiplied in order to calculate the payment required to fully amortize the loan. The above loan constant may itself be calculated using these HP-12C keystrokes:**

1
PV
8
g
i
30
g
n
PMT Answer: .007338

What this loan constant says is that to fully amortize the loan it is necessary to pay back every month .007338 dollars (about three fourths of a penny) for every dollar borrowed.

The payment may also be calculated using a financial calculator, such as with the following keystrokes using an HP-12C:

200000
PV
8
g
i
30
g
n
PMT Answer: $1,467.53*

***The answer calculated by a financial calculator is slightly more accurate because the 12C calculates nine places to the right of the decimal, while standard tables such as the Ellwood Tables calculate just six places to the right.**

The interest and principal for this loan may be calculated by:

$200,000.
x .08
$ 16,000. per year interest

The payment is made monthly and so the interest owed per month is calculated by dividing the annual interest by 12 months:

$16,000. ÷ 12 months =

$1,333.33 for the first month's interest

The principal portion of the payment is:

$1,467.60 total payment
- 1,333.33 interest portion
$ 134.27

Note that the interest and principal portions of the $1,467.60 loan payment will change slightly for the next month's payment, since the loan balance has been reduced by the amount of principal applied to it by the previous month's payment:

$200,000.00	**old loan balance**
- 134.27	**principal payment**
$199,865.73	**new loan balance**

Interest and principal allocation for the next month's payment will be calculated by taking 8% of the new loan balance and then 1/12 of that (for one month), resulting in slightly less interest and slightly more principal dividing up the $1,467.60 payment.

(3) Example of calculating loan balance, principal paid, and interest paid during the life of the loan

To calculate the loan balance at any time during the loan term, it

would be laborious to figure the principal amount being applied with each payment and then adding up all this principal in order to deduct it from the beginning loan amount to arrive at the loan balance after a given number of payments. Fortunately, the loan balance can be calculated directly and we will do it using the compound interest/ discount tables as well as a financial calculator.

Let's go back to our $200,000. loan for which we calculated the

interest and principal allocation above and look at what the balance of this loan would be (that is, the amount still owed the lender) after five years of making the monthly payment of $1,467.53. If we construct a time line for this loan we would see that at the end of five years there are 25 years remaining to be paid:

0_____5_____30
----------25 remaining years----------

The value of the lender's position at the end of five years is that there

are 25 more years to go of receiving the loan payment. We can calculate the value (present value) of this position by discounting the remaining 25 years at the interest rate of the loan. That will tell us the loan balance, that is, what this loan is worth after five years have been paid, but with 25 years more to go. Column 5 of the compound interest/discount tables is used to discount a future series of equal sums (the loan payment) equally spaced (every month) back to a present value:

$1,467.60	**loan payment**
x129.564523	**Column 5 factor**
$190,148.89	**value of the loan (loan balance) after five years**

Therefore, the amount applied to principal during these five years is:

$200,000.00	**beginning loan amount**
- 190,148.89	**loan balance after five years**
$ 9,851.11	

The amount applied to interest during this same time can be

calculated by figuring the total dollars paid to the lender in these loan payments, from which the portion applied to principal would be deducted. The remaining difference is the amount that went to interest, as shown below:

$1,467.60	**loan payment**
x60 payments	**five years of monthly payments**
$88,056.00	**total dollars paid in monthly payments**

loan

$88,056.00	
- 9,851.11	**amount applied to principal**
$78,204.89	**amount applied to interest**

These calculations may also be done with a financial calculator by first calculating the loan payment and then amortizing the loan over the five years. HP-12C keystrokes:

200000
PV
8
g
i
30
g
n
PMT **Answer: $1,467.53**

Now that we have calculated this loan payment again, let's amortize it over five years with the following keystrokes:

60 (total number of payments)
f
AMORT **Answer: $78,191.46**

This is the amount applied to interest. Yes, it is slightly different from that which we calculated using compound interest/discount tables. But, again, the answer using the 12C is more accurate

because it is calculating nine places to the right of the decimal while the standard tables use six places to the right.

The amount applied to principal is shown on the display of the 12C with a single keystroke:

x/y switch key Answer: $9,860.29

This is key 34 (third row down on the keyboard, fourth key to the right).

To see the loan balance use these keystrokes:

RCL
PV Answer: $190,139.71

b. The interest rate is actually a series of individual rates that are added up and are intended to compensate the lender for risk, loss of use of the money, and other factors, in addition to the so-called "real rate of return" that represents the lender's return on investment.

4. Amortization frequency

a. The time interval between required payments is typically monthly, but some loans may be amortized quarterly, annually, or on some other time basis.

b. Loans may be amortized over a longer period than the borrower is allowed to keep any portion of the loan funds.

(1) The purpose is to lower the loan payment by amortizing the loan over, for example, 30 years but requiring the loan to be paid off in 15 years by a final balloon payment.

(2) It would be said of the loan above that it is amortized over a 30-year schedule with a "call" in 15 years.

5. Loan amount

a. That sum of money the lender is willing to risk as a debt investor and, for secured loans (loans where the borrower has out up security as collateral), the underwriter believes is recoverable through foreclosure on the security in event of default

b. Often expressed as a percentage of the appraised value, that is, as the loan-to-value ratio.

D. Selection of the real estate appraiser

1. The underwriter is dependent upon the appraiser for a complete description of the subject property, a reasoned analysis of the market in which the property is located, and a supportable conclusion of value.

a. Those areas of an appraisal report that are unclear to the underwriter or with which the underwriter may disagree should be thoroughly discussed with the appraiser.

b. The underwriter should have confidence in the work of the appraiser

the lender has selected and should be aware of the limitations imposed on the appraiser by the Uniform Standards of Professional Appraisal Practice.

2. Fannie Mae guidelines for selecting an appraiser as presented in the Fannie Mae booklet, "Underwriting Property, Basics of Sound Underwriting," which can be obtained from the Fannie Mae publications department in Annapolis, Maryland at 1-800-471-5554 (telephone) and (301) 604-0158 (fax number)

a. The appraiser should be familiar with houses in the neighborhood in which the subject property is located.

b. The appraiser must certify that he/she uses Fannie Mae's definition of market value and understands what the market value definition means.

c. Appraiser credentials

(1) The appraiser should be qualified to appraise the type of property securing the loan the lender is underwriting.

(2) The appraiser should be familiar with Fannie Mae guidelines.

(a) Once Fannie Mae purchases a loan from a lender, Fannie Mae holds that lender - not the appraiser - responsible for the accuracy of the appraisal and the report of its results.

(b) The appraiser's fiduciary relationship is with the lender who made that appraisal assignment.

(3) What can assist the underwriter in evaluating the appraiser's qualifications

(a) The appraiser's education

(b) The appraiser's experience

(c) Sample appraisals performed by the appraiser

(d) Professional affiliations of the appraiser, although federal law prohibits lenders from selecting appraisers based solely on an appraiser's membership in a particular organization

(4) The appraiser should have access to necessary data sources.

(5) The appraiser is active in appraisal work and adheres in that work to Fannie Mae guidelines.

(a) Data in the appraisal must be accurate and factual.

(b) The appraiser must be diligent in factually describing negative factors of the property and neighborhood, including proximity to adverse influences.

(c) Appraiser must personally inspect exterior of comparables.

(d) Use only appropriate comparable sales.

(e) Data should come from sources with no financial interest in the sale or financing of a property and, if they do have such interest, their information should be independently verified.

(f) Adjustments should reflect market reactions.

(g) The appraiser should develop conclusions of value that are in no way based on any discriminatory considerations.

(h) The valuation conclusions developed should be clearly supported by data in the market.

d. What the underwriter should provide the appraiser

(1) Copy of the complete ratified sales contract on the property the appraiser has been assigned to value

(2) Relevant information that may not be included in sales contract

(a) Settlement charges

(b) Factors affecting sales prices or financing

(c) Condominium fees

(d) Non-realty items

(3) Any information on environmental hazards that could affect the subject property

Review questions and problems (2):

1. What does it mean that a loan is amortized over 20 years but has a "call" at the end of seven years?

a. The loan must be paid off at the end of 13 years.

b. The loan must be paid off at the end of 20 years.

c. The loan is amortized over 20 years and must be paid off at the end of 20 years.

d. The loan is amortized over 20 years and must be paid off at the end of seven years.

2. What is it called when loans sold in the secondary market are packaged together and investors then purchase an interest in their collective income stream?

a. Package lending

b. Gentrification

c. Securitization

d. Equity investing

3. What measures the adequacy of the property's net operating income to pay the mortgage payments?

a. Operating expense ratio

b. Debt service coverage ratio

c. Cash breakeven ratio

d. Net income ratio

<u>Use the following information to answer questions #4 through #9</u>:

$300,000. loan at 7% annual interest fully amortized over 30 years with equal monthly payments

The compound interest/discount tables have been used to calculate the correct answer. If you are using a financial calculator, your correct calculations will be very slightly different but still closest to the right answer.

4. What is the monthly loan payment? The loan constant (Column 6 from the compound interest/discount tables) is .006653.

a. $1,847.08

b. $1,930.64

c. $1,995.90

d. $2,143.50

5. What is the amount of interest paid on this loan in the first amortized payment?

a. $1,597.08

b. $1,695.64

c. $1,750.00

d. $1,797.20

6. What is the amount of the first payment applied to principal?

a. $250.00

b. $235.00

c. $245.90

d. $346.30

7. What is the balance of the loan after the first eight years of payments? Use

Column 5 discount factor 134.512723.

a. $259,022.

b. $268,474.

c. $272,401.

d. $275,720.

8. What is the amount that has been applied to principal over the first eight years of payments?

a. $24,280.

b. $27,599.

c. $31,526.

d. $40,978.

9. What is the amount that has been applied to interest over the first eight years of payments?

a. $160,080.

b. $171,297.

c. $180,743.

d. $191,606.

10. A loan may be amortized:

a. Weekly.

b. Monthly.

c. Annually.

d. Any of the above.

11. What is the complement of the operating expense ratio?

a. Cash breakeven ratio

b. Effective expense ratio

c. Debt service coverage ratio

d. Net income ratio

12. What income is calculated by adjusting the potential gross income for vacancy and collection loss?

a. Monthly gross income

b. Net operating income

c. Effective net income

d. Effective gross income

13. An underwriter will likely examine which of the following in deciding whether a loan should be made?

a. Borrower

b. Collateral property

c. Current market

d. All of the above

14. What is the housing expense ratio if a borrower with $6,000. monthly income has applied for a $150,000. loan at 8.50% annual interest fully amortized by equal monthly payments over 15 years, if the monthly pro-ration for real property taxes and hazard insurance is $275.? Use loan discount factor (Column 6) of .009847.

a. 27%

b. 29%

c. 31%

d. 33%

15. What is a "default threshold" in underwriting?

a. Minimum loan-to-value ratio

b. Maximum housing expense ratio

c. Minimum income for the borrower needed to make the loan

d. Probability level of default at or below which the lender is willing to make the loan

16. A loan that has "run to maturity" has:

a. Lasted the entire loan period.

b. Been paid off prior to the end of its loan period.

c. Been foreclosed upon prior to the end of its loan period.

d. Been refinanced.

Use the following information to answer questions #17 through #20:

Four-unit subject property rented out: Three units at $800./month/unit
One unit at $1,000./month
Vacancy and collection loss: 7%
Annual operating expenses: $15,500., of which $1,000. is reserves

Debt service is a fully amortized monthly payment calculated on loan of $160,000. at an annual interest rate of 9% over 25 years. Use a loan constant (Column 6) of .008392.

17. What is the debt service coverage ratio?

a. 1.31

b. 1.35

c. 1.39

d. 1.45

18. What is the operating expense ratio?

a. 41%

b. 43%

c. 46%

d. 49%

19. What is the net income ratio?

a. 51%

b. 54%

c. 57%

d. 59%

20. What is the cash breakeven ratio?

a. 73%

b. 75%

c. 77%

d. 80%

FROM THE APPRAISER TO THE UNDERWRITER

ANSWER SHEET

Put in the letter - ‘a,’ ‘b,’ ‘c,’ or ‘d’ - of your answer choice for each of the questions numbered below.

REVIEW QUESTIONS AND PROBLEMS (2)

1.	**11.**
2.	**12.**
3.	**13.**
4.	**14.**
5.	**15.**
6.	**16.**
7.	**17.**
8.	**18.**
9.	**19.**

IV. Fannie Mae guidelines for appraising 1-4 family properties

A. These are the traditional Fannie Mae guidelines for the appraiser who will be reporting the results of an appraisal on the Uniform Residential Appraisal Report (URAR), the Small Residential Income Property Appraisal Report (2-4 family form), or the Individual Condominium Unit Appraisal Report and are taken from the "Property and Appraisal Analysis" section, which is Part VII of the Fannie Mae Selling Guide for lenders.

1. The valuation and evaluation of the collateral property securing the loan is a vital part of risk analysis.

2. Fannie Mae expects lenders to place as much emphasis on underwriting the property and reviewing the appraisal as they do on underwriting the creditworthiness of the borrower.

B. Relationship of the underwriter and the appraiser

1. Roles of the appraiser

a. Provide the lender with an accurate and adequately supported estimate of value.

b. Properly describe the subject property.

2. Roles of the underwriter

a. Review the appraisal report to ensure it is professional and adheres to

Fannie Mae appraisal standards.

b. Analyze the property from what has been presented in the appraisal report.

c. Based on the value and marketability of the subject, judge the acceptability of the property as security for the mortgage.

3. It is essential for the lender to have an independent, disinterested examination and valuation of the subject property.

a. The lender, not any other party, must select the appraiser for the assignment.

b. It is fundamental to good underwriting that the appraiser must remain free of any outside influence in the valuation process.

4. Lenders must use only state-licensed and state-certified appraisers, as mandated by Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.

a. Appraiser requirements of Fannie Mae appraisal report forms.

(1) Personally inspect the property being appraised.

(2) Inspect the exterior of the comparables.

(3) Perform the analysis.

(4) Prepare and sign the appraisal report.

b. The appraiser may receive significant professional assistance from others, such as appraiser trainees and employees in the appraiser's office, who are not licensed or certified.

(1) The appraiser must describe such assistance in the appraisal report.

(2) The appraiser must also certify that anyone providing significant professional assistance is qualified to do so.

(3) The licensed or certified appraiser must sign the appraisal report

and conform to existing State law.

c. Requirements of a supervisory appraiser who also signs the report

(1) Certify he/she directly supervises the appraiser.

(2) Review and agree with the appraisal report.

(3) Agree to the same certifications to which the appraiser has agreed.

(4) Take full responsibility for the appraisal report.

5. Prohibited appraisal practices

a. Inaccurate factual data on the subject neighborhood, site, improvements, comparable sales

b. Failure to comment on negative factors concerning the subject property and neighborhood

c. Not at least driving by the exterior of the comparables

d. Using inappropriate comparable sales

e. Not verifying data used in the report, especially regarding comparable sales, that was provided by parties having a financial interest in the sale or financing of the subject

f. Making unsupported adjustments to comparables or not making adjustments when warranted

g. Partially or completely basing value on the sex, race, color, religion, handicap, national origin, or familial status of the prospective or current owners or occupants of properties in the vicinity of the subject

h. Developing a value not based on available market data

6. Fannie Mae does not approve appraisers, but reserves the right to refuse to accept appraisals from a particular appraiser and to notify a lender of such refusal.

C. Appraisal documentation and certifications

1. The property must have been appraised within 12 months of the mortgage and note date.

a. If the appraisal report will be more than four months old on the mortgage/note date, the appraiser must inspect the subject's exterior and consider current market data to see if the subject has declined in value since it was appraised.

b. The property must be reappraised if the appraiser concludes its value has declined.

2. Appraisal report forms

a. The appraisal process is guided by the Fannie Mae report forms, but the forms should not limit or control the process.

b. The appraiser should go beyond any limitations of the appraisal report forms when they are required for a proper appraisal.

c. Required exhibits

(1) Street map showing location of the subject and all comparables

(2) Exterior building sketch of the improvements, including dimensions

(a) For condominiums and cooperatives, provide instead the interior perimeter unit dimensions.

(b) Where the subject suffers from functional obsolescence to the extent its market appeal is harmed, the appraiser should provide a sketch of the floor plan only.

(3) Photographs showing front and back of the subject and street scene

(4) Photograph of the front of each of the comparable sales

(5) Operating Income Statement (Form 216) for 2-4 family properties where the loan applicant will occupy one unit

(6) Other attachments may be required depending upon the nature of the property being appraised

3. Appraiser certifications

a. The appraisal must be based on the Fannie Mae definition for market value.

b. Adjustments to the comparables must be made for financing or sales concessions that are not typical for the market.

(1) Adjustments are not necessary that are traditional or dictated by in the subject area.

(2) An adjustment may be calculated by comparisons to financing offered by a third party institutional lender not involved in the sale.

(3) The magnitude of the adjustment should be based on the appraiser's judgment of the market's reaction to the financing or sales concessions, and not on a mechanical dollar-for-dollar cost.

c. The Statement of Limiting Conditions and Appraiser's Certification (1004B) must be included with the appraisal report.

(1) The appraiser may not change this certification, but may add certifications on an additional page.

(2) Additional limiting conditions are prohibited.

D. Special appraisal considerations

1. Condominium appraisal reports

a. For most condominium appraisals the appraiser must report the results on the condominium form.

b. The appraiser may use the URAR for detached condominium units if the

condominium project does not have common area improvements (beyond greenbelts, private streets, and parking areas) and the appraiser adequately describes the project, owner association fees, and quality of project maintenance.

2. Planned unit development (PUD)

a. Characteristics

(1) The project contains commonly owned property for the benefit of individual units that are separately owned.

(2) The homeowner's association requires membership in the association for every unit and mandatory assessments.

b. Zoning should not be used as the basis for determining whether a project is a PUD.

3. Environmental hazards

a. If the lender is informed that an environmental hazard exists on or near the subject property, the lender must notify the borrower and the appraiser.

b. The appraiser is not expected to be an expert on environmental hazards, but should describe any adverse conditions that were observed during the normal research involved in performing the appraisal.

(1) The appraiser should comment on any effect a hazard has on the value and marketability of the subject property and make whatever adjustment is appropriate in the appraisal.

(2) If the appraiser notes whatever adverse impact a hazard has on the

property's value and marketability or notes there is no buyer resistance to the hazard, then the loan secured by the property is still eligible for Fannie Mae to purchase or securitize.

c. The lender makes the final decision on the need for inspection of the property and whether it is adequate security for the loan.

4. Manufactured housing

a. Single-width or multi-width units constructed off-site and then transported to a permanent site

b. Fannie Mae requirements for this housing

(1) Legally classified as real estate

(2) Permanently affixed to a foundation and wheels, axles, trailer hitches removed

(a) Perimeter and pier foundation must have footings located below the frost line.

(b) Piers must be placed where the manufacturer recommends.

(c) Anchors must be used if State law requires them.

(d) An engineer must have designed the foundation system to meet the soil conditions of the site.

(3) Similar in characteristics to site-built housing

(4) Adhere to the Federal Home Construction and Safety Standards of the U.S. Department of Housing and Urban Development (HUD), established in June 1976.

c. The appraiser must consider both marketability and comparability, addressing materials and construction of the improvements, adequacy of the living area, interior room size, storage, roof pitch, overhangs, and compatibility of exterior finish.

(1) Single-width units must be located in a Fannie Mae-approved project, while multi-width may be on individual lots.

(2) The appraiser must compare the marketability of manufactured housing in the local market to site-built housing.

(3) Site-built housing may be used as comparables to a manufactured housing subject if similar manufactured units are not available.

(a) The appraiser should explain the necessity of having to use site-built housing as comparables.

(b) If the market prefers site-built housing, the appraiser must make the appropriate adjustments.

5. Mixed-use properties

a. Fannie Mae will consider loans secured by residential properties that have an additional use as a business.

b. Special eligibility criteria

(1) The property must be a single-family home.

(2) This mixed-use property must comply with local zoning requirements.

(3) It would not require a significant expenditure to convert it back to sole use as a residential property.

E. Reviewing the appraisal report

1. The subject property

a. The subject must be identified by its complete property address and legal description.

b. The appraiser should provide a brief description of loan charges and/or concessions paid by the seller, including their total dollar amount.

2. Neighborhood analysis

a. Common characteristics and trends should be used to identify that area subject to the same influences as the property being appraised, so that

a neighborhood is defined from which comparables may be selected and value influences described.

b. The appraiser should consider social, economic, governmental, and environmental forces in their impact on the property values in the subject neighborhood.

c. Racial composition and age of the neighborhood are not appraisal factors.

d. Fannie Mae does not "redline," that is, designate certain areas as acceptable/unacceptable, and none of its property guidelines should be interpreted as fostering redlining.

e. The property securing the loan must be residential in nature but may be located in areas characterized as "urban," relating to a city, "suburban," relating to an area adjacent to a city, or "rural," referring to areas in the country beyond what is considered urban or suburban.

(1) The subject must be accessible by roads meeting local standards and adequate utilities must be available.

(2) If a loan is to be secured by a property that is not suitable for occupancy over the entire year, it would not be eligible for Fannie Mae's purchase or securitization.

(3) As a general rule, the property securing a loan would not be eligible if it is located in an area less than 25% developed and the land value of the site exceeds 30% of the property value, unless the appraiser can demonstrate the property is typical for the neighborhood.

f. If the average marketing time to sell a reasonably priced property in the neighborhood is greater than six months, the appraiser must comment on the reason for the longer time and the impact upon value of the subject.

g. Price range and predominant price

(1) The price range should show the prevailing range of prices in the neighborhood, excluding any isolated high and low extremes.

(a) The subject is considered an "over-improvement" if its sales price or value exceeds the upper price range, and an "under-improvement" if it falls below the lower price range.

(b) The appraiser should explain any over- or under-improved

properties and comment on the adjustments made in the sales comparison analysis for such over- or under-improvement.

(2) The predominant price is that price most commonly found in the neighborhood, which the appraiser may express as a single figure or as a range.

h. Age range and predominant age

(1) The properties selected should represent the newest and oldest in the neighborhood, excluding isolated extremes on either end of the range described.

(2) That age most commonly found in the neighborhood is the predominant age, which may be stated as a single figure or as a range.

(3) The properties that the appraiser uses to indicate the age range and predominant age should not necessarily be the same ones he/she used to represent the price range and predominant price.

i. Land use

(1) Percentage use should be shown for each type of property listed and undeveloped land shown as vacant, with the sum of each use adding up to 100%.

(2) If the appraiser checks off that the land use is likely to change or in the process of changing, he/she should indicate what appears to be the new use.

j. Competitive properties

(1) The Small Residential Income Property Appraisal Report (2-4 family form) requests three listing comparables, which should be selected from those properties most similar to the subject.

(a) The listing comparables can be the same as the rental or sales comparables, if they are currently listed for sale.

(b) Listings are requested in the form as a means of identifying conditions in the market, such as supply and demand, property values, growth rate, marketing time.

(2) If there are not three competitive properties currently listed for sale, the appraiser should note that in the comments section and explain why there are so few listings at present of properties competitive to the subject.

k. Neighborhood analysis rating

(1) The old rating grid that used to appear in the Uniform Residential Appraisal Report (URAR) was removed in the current form so that the appraiser will describe neighborhood factors rather than trying to rank or rate them.

(2) Important neighborhood characteristics

(a) <u>General appearance</u>: an evaluation should be made of the degree to which properties are being properly maintained in the neighborhood.

(b) <u>Appeal to the market</u>: an analysis of how attractive the neighborhood overall is to the typical purchaser in the market.

(3) Description of neighborhood components in comparison to other

neighborhoods

(a) Good: indicates the characteristics of a subject neighborhood are outstanding and superior to those found in competing neighborhoods.

(b) Average: indicates the characteristics of the subject neighborhood are equal to those that represent the "norm" for that market area and that are considered acceptable in the competing neighborhoods.

(c) Fair: indicates the characteristics of the subject neighborhood are inferior to those that are considered acceptable in the competing neighborhoods

(d) Poor: indicates the characteristics of the subject neighborhood are substantially inferior to - or in such small supply when compared to - those found in the competing neighborhoods to the point that property values are (or may be) affected adversely.

(4) Do not use a rating of "none" or "non-existent."

(a) A neighborhood should be compared to what is the "norm" in that location and in competing neighborhoods.

(b) If a component, such as public transportation, does not exist at all in a neighborhood, but there is no public transportation in competing neighborhoods as well, then public transportation should be described as "average."

3. Site analysis

a. Zoning

(1) The specific zoning classification for the subject should be reported, such as "R-1," and include a description of what that zoning permits, such as "single-family."

(2) It should be noted whether the improvements comply with zoning,

are legally non-conforming, or there is no zoning in the subject's area.

(3) Although Fannie Mae generally requires compliance with zoning, it may make an exception for a property that has an illegal, additional unit.

(a) The property must be appraised as how it is supposed to be used, that is, for example, as a single-family home with no consideration given to the illegal unit or any income it may be earning.

(b) The appraiser must describe the illegal use in the appraisal report and show that it is typical for the market by analyzing at least three competitive properties with the same illegal use.

(c) This exception does not apply to three- and four-family properties.

b. Highest and best use

(1) Although highest and best use analysis may assume the subject site is vacant and available for development, the appraiser should conduct his/her analysis of the property as currently improved.

(2) Requirements for the existing use to be the highest and best use

(a) The improvements represent typical market demand in the neighborhood.

(b) The improvements contribute enough value to the land so that the property value is greater than just the land value.

(3) The appraiser should indicate in the appraisal report if the improvements do not represent the highest and best use of the land, in which case Fannie Mae will not buy or securitize the loan.

b. Utilities

(1) The property must have utilities that meet community standards and are accepted in general by people living in the area.

(2) Non-public utilities

(a) If public utilities - supplied and regulated by local government - are not available, then the subject property must have community or private well and septic facilities.

(b) The subject must have a continuing right to these facilities, which should be located on the property or, if off-site, have a legally binding agreement granting access.

c. Off-site improvements

(1) The property should front on a publicly dedicated and maintained street or on a community/private street that has a legal agreement providing for maintenance of the street.

(2) The appraiser should describe the impact on the marketability and value of a subject fronting on a street that does not meet community standards.

d. Flood hazard area

(1) If the subject is located in a special flood hazard area as identified by a Federal Emergency Management Agency (FEMA) Flood Insurance Rate Map (FIRM), the appraiser should note that in the appraisal report.

(2) While property improvements in a special flood hazard area require

flood insurance, such insurance is not required if the land is in the hazard area but the improvements are not.

4. Improvements analysis

a. Conformity to neighborhood

(1) The improvements generally should conform to the neighborhood in age, type, design, construction materials.

(2) Non-traditional housing

(a) Unusual housing, such as earth houses, geodesic domes, log houses, are eligible for Fannie Mae, as long as the appraiser can reliably appraise their market value.

(b) The appraiser does not have to use comparables of the same design and appeal, as long as he/she can make proper adjustments to reflect the differences between the comparables used and the subject and can also demonstrate the marketability of the subject with data such as older comparable sales, comparables in competing neighborhoods, similar properties in the same market.

(c) If market acceptance cannot be demonstrated and the subject is so different that a reliable appraisal cannot be developed, the loan is not eligible for delivery to Fannie Mae.

b. There are no Fannie Mae minimum living area or size requirements, but there should be comparables of similar size to indicate general market acceptability.

c. Fannie Mae does not place any age restrictions on the subject improvements, as long as the quality and condition of the improvements is acceptable to the typical buyer in that market.

d. In the Small Residential Income Property Appraisal Report (2-4 family) the total square footage in the unit/room list section should show the net rentable area, which will not necessarily equal the gross building area.

e. Gross living area

(1) Interior perimeter dimensions should be used for condominiums and

cooperatives, but use the exterior dimensions for all other properties.

(2) Use only finished, above-grade areas

(a) Garages, basements, and any rooms partially below-grade should not be used as part of the gross living area, regardless of the quality of the finish or the presence of windows, but they should be described and considered in the adjustments for the sales comparison analysis.

(b) A walk-out basement with finished rooms, for example, should not be included in the above-grade room count.

f. Gross building area

(1) The total finished area, including interior common areas such as stairways and hallways, above- and below-grade.

(2) It should be based on exterior dimensions, but should not include exterior common areas, such as open stairways.

g. Property condition and appraiser comments

(1) The appraiser must express an opinion in factual, specific terms on the condition of the improvements, including any conditions that affect value or marketability.

(2) Any detrimental condition must be reported, even if such condition is typical for that market, such as deferred maintenance or lack of updating.

h. Improvements analysis rating

(1) Similar to the neighborhood section, ratings from earlier forms were eliminated in order to allow the appraiser to address the condition of the improvements in meaningful narrative format.

(2) Any relative ratings that are used - good, average, fair, and poor - should carry the same meaning as described for the neighborhood section on page 63.

(3) Any less-than-average rating should be explained and how it affects value and marketability.

i. Remaining economic life

(1) The appraiser does not have to report the remaining economic life.

(2) Fannie Mae does not require any correlation between the mortgage term of the loan and the remaining economic life of the improvements.

5. Valuation analysis

a. Cost approach

(1) The appraiser does not have to consider this approach when valuing units in condominium and cooperative projects.

(2) If the cost approach isn't used, the appraiser should explain why it is being omitted but still provide a value for the site.

(3) Fannie Mae will not accept appraisals that rely on the cost approach only.

(4) The lender should check that the appraiser's presentation of the cost approach is consistent with comments and analysis found elsewhere in the appraisal report.

(a) If the neighborhood or site sections say the subject is adjacent to a negative influence which affects the value of the subject, that should be reflected in the cost approach with a penalty for external depreciation.

(b) As another example, the subject improvements should likely show a penalty for functional obsolescence in the cost approach if the

improvements section described a poor floor plan for the subject.

b. Sales comparison approach

(1) Data and/or verification source(s) must be reported for each comparable sale in the Uniform Residential Appraisal Report (URAR).

(a) The appraiser may use a single source, if deemed reliable, or multiple sources.

(b) Data received from a party who has a financial interest in either the sale or financing of the subject must be verified with a party not having such an interest.

(2) Comparable sales

(a) The appraiser must report at least three comparable sales that actually settled or closed within the last 12 months.

(b) Sales that settled or closed over 12 months may be used if necessary, but any comparable sale more than six months must be explained.

(c) The subject may be used as a fourth comparable sale, if it previously sold, and also may use offers and listings as supporting data.

(d) For a subject in an established subdivision, comparables in that subdivision are preferable.

(e) For new subdivisions there should be one comparable selected from that subdivision, one comparable from outside the subdivision, and the third from either in or outside the new subdivision, with sales/resales from the same subdivision preferred as long as the developer/builder was not involved in the sale/resale.

(3) Adjustments to comparable sales

(a) Any adjustment made for "time," meaning a change in market conditions, must be made from the contract date of the

comparable to the effective date of the appraisal.

(b) The net adjustment should not exceed 15% and the gross adjustment should not exceed 25%.

(c) An explanation should be made for why any comparable was used for which the net and/or gross adjustment percentages exceed the guidelines for the maximums listed above.

(d) Individual adjustments that are excessively high should be explained.

(4) Sales or financing concessions by the seller

(a) If they are reasonably available, the dollar amounts of these concessions for the comparable sales should be included in the appraisal report.

(b) These concessions might be interest-rate buydowns, other below-

market rate financing, loan discount points, loan origination fees, closing costs customarily paid by the buyer, payment of condominium or PUD association fees, refunds of (or credit for) the borrower's expenses, absorption of monthly payments, assignment of rent payments, inclusion of non-realty items.

(c) The amount of the negative adjustment should equal the amount by which the appraiser determines the sales price was increased because of these concessions, not necessarily a dollar-for-dollar adjustment based upon the cost of the concessions.

(d) Fannie Mae will not accept a positive adjustment for these concessions.

(5) Gross living area should include only finished, above-grade space, but the appraiser also should report basements and partially below-grade areas and adjust for them if warranted.

(6) The appraiser should describe his/her reconciliation of the adjusted sales prices, including the comparable(s) receiving the most weight.

c. Income approach

(1) This may be an appropriate approach for single-family properties in a substantial rental market and for valuing two-to-four family properties.

(2) Fannie Mae will not accept an appraisal that relies only on the income approach.

(3) To illustrate when the income approach might not be used, for a subject two-family property in a neighborhood dominated by owner-occupied two-family properties the appraiser need not develop a gross rent multiplier but must report the estimated market rent for the subject property.

(4) If the subject is a single-family home used as an investment property, the appraiser must attach the Single-Family Comparable Rent Schedule (Form 1007) to the appraisal report, except for the Small Residential Income Property Appraisal Report (2-4 family) that already calls for the same information.

(5) If the appraiser uses the income approach, he/she should attach

comparable rental/sales data and the calculations for determining the gross rent multiplier as an addendum to the appraisal report.

d. Final reconciliation

(1) The appraiser reconciles the reasonableness and reliability of each approach and the reasonableness and validity of the data and indicated values to an opinion of market value.

(2) The appraiser must report the approach or approaches that were given the most weight.

V. Fannie Mae guidelines for use of the streamlined appraisal report forms

A. These guidelines apply to the Desktop Underwriter Quantitative Analysis Report (Form 2055) and the Desktop Underwriter Qualitative Analysis Report (Form 2065) as set forth in a letter to Fannie Mae sellers, dated 26 September 1996.

1. Form 2055 and Form 2065 are very similar, except that the 2055 uses the traditional numerical adjustments ("Quantitative Analysis") in the sales comparison grid.

2. Form 2065 uses a relative ranking of the comparables without resorting to numerical adjustments in the sales comparison grid ("Qualitative Analysis").

a. If an element of comparison for the comparable is superior to the subject, the appraiser records a minus ("-") for that element, meaning that a numerical adjustment of the comparable would have been downward.

b. If an element of comparison for the comparable is inferior to the subject, the appraiser records a plus ("+") for that element, meaning that a numerical adjustment of the comparable would have been upward.

c. If an element of comparison for the comparable to equal to the subject, the appraiser should record an equal ("="), meaning a numerical adjustment of the comparable is unnecessary since the comparable and the subject are similar in this element.

d. The appraiser then records for each comparable its overall relative

relationship to the subject, based upon the comparison of the various elements (pluses, minuses, and equals), reporting each comparable to be "superior," "inferior," or "equal" to the subject.

e. A conclusion of value is reconciled from the resulting ranking/rating of the comparables.

B. Desktop Underwriter is Fannie Mae's automated underwriting system that

evaluates the creditworthiness of the borrower and recommends one of three options for conducting the appraisal.

1. **Report the results of the appraisal on Form 2055 after performing an interior and exterior inspection of the subject property.**

2. **Report the results of the appraisal on Form 2055 after performing only an exterior inspection of the property.**

3. **Report the results of the appraisal on Form 2065 after performing only an exterior inspection of the property.**

C. Fannie Mae's suggestions to the lenders on what appraisal forms might be used in underwriting a loan represent the minimum documentation requirements for loans processed in the Desktop Underwriter system, with the lender retaining the right to request more information in the appraisal.

1. **Desktop Underwriter may recommend the use of the 2065, for example, but a lender might conclude that it needs the appraiser to use the 2055 and require that the appraiser inspect exterior and interior.**

2. **In another example, a lender might have specific underwriting concerns and request the appraiser to provide information the forms do not call for, such as site value, replacement cost value, additional comparable sales and listings.**

D. Fannie Mae bases its recommendations of the streamlined form to be used on the assessment of risk associated with the loan and, in the case of an exterior-only appraisal, the ability of the appraiser to obtain enough information about the physical characteristics of the subject from reliable sources.

1. **Reliable data sources on property characteristics for an appraiser conducting only an exterior inspection include multiple listing service (MLS) information, tax and assessment records, prior inspections, previous appraisal files, information provided by the property owner.**

2. If the appraiser concludes that the exterior inspection of the property is not sufficient to perform the appraisal, then he/she must also conduct an interior inspection of the subject.

a. The appraiser may not be able to view the improvements adequately from the street.

b. There are significant discrepancies from data sources regarding size, condition, other property factors that the appraiser is unable to reconcile.

c. During his/her exterior inspection the appraiser noted apparent physical deficiencies or adverse property factors.

d. The property is undergoing renovation.

E. Uniform Standards of Professional Appraisal Practice (USPAP)

1. The Appraisal Standards Board of The Appraisal Foundation has concluded that, if the appraisal is properly developed and reported, the the use of the 2055 or 2065 and the appraisal development processes will result in a summary appraisal report that does comply with USPAP.

2. Forms 2055 and 2065 call for only the sales comparison approach, excluding both the cost and income approaches.

a. An appraisal reported on these forms is considered to be "limited" and subject to the Departure Rule of Uniform Standards, if the cost and income approaches would otherwise be applicable in the appraisal.

b. An appraisal reported on these forms is considered to be "complete," if the cost and income approaches would not be applicable in the appraisal, because it does not constitute a departure under Uniform Standards to omit an approach to value that is not applicable in that appraisal.

3. The certification sections of Form 2055 and Form 2065 both identify the appraisal as "limited," unless the appraiser labels it as "complete."

F. While Forms 2055 and 2065 suggest the extent of the appraisal process to be conducted, they are not designed nor intended to control this process.

1. An appraiser should go beyond the limitations of a form if, based upon the appraiser's professional judgment, it is necessary in order to adequately document the valuation process or to support the appraiser's conclusions.

2. The complexity of the appraisal, not the form of the report, determine the extent of the appraiser's data collection, analysis, reporting, and the appraiser may, for example, include the cost and/or income approach, even though the 2055 and 2065 don't call for them, if the appraiser concludes they are necessary.

G. Required exhibits to Desktop Underwriter appraisal forms

1. When Desktop Underwriter recommends an exterior inspection only, using either the 2055 or 2065, the only exhibits required are a street map showing location of the subject and the comparables and a photograph of the front of the subject.

2. When Desktop Underwriter recommends both an exterior and interior inspection using the 2055, all of the exhibits applicable with the standard appraisal report forms are required.

H. This letter (described on page 71) amends Part VII of the Selling Guide with respect to loans processed through Desktop Underwriter.

VI. Fannie Mae guidelines for the use of the inspection report

A. These guidelines are for the use of the Desktop Underwriter Property Inspection Report (Form 2075) as set forth in a letter to Desktop Originator/Underwriter Lenders and Brokers, dated 3 July 1997.

B. Form 2075 requires the appraiser to conduct only an exterior inspection of the subject property, without any valuation of the subject.

1. Fannie Mae will rely on an appraisal performed by Desktop

Underwriter.

2. The lender will not be responsible for an appraisal assignment.

C. Required exhibits are a street map and front photo of the subject.

D. Freddie Mac has a form, "Loan Prospector Condition and Marketability Report (Form 2070) that appears to serve the same function as the 2075.

VII. Fannie Mae guidelines for underwriting rural properties

A. These guidelines are based on the Fannie Mae booklet, "Underwriting Rural Properties," and is available at the Fannie Mae publications department (see page 52 for contact information).

B. Reviewing the appraiser's description and analysis of the neighborhood and market area

1. The reason for the analysis is to identify that area subject to the same influences as the property that is to be appraised.

a. Defines the area from which comparables are selected

b. Enables the appraiser to understand market preferences and price patterns

c. Facilitates highest and best use conclusions

2. Appraisers should use their professional judgment in describing the market area and neighborhood boundaries.

a. The neighborhood and market area should not be set by a predetermined idea of distance, miles.

b. The buying and leasing patterns of buyers and tenants should indicate the market.

c. If the appraiser uses comparables outside the market area, a locational adjustment must be made.

3. The appraiser's reporting of market and neighborhood conditions must

be factual, impartial, and specific.

a. Racial composition and age of a market area are not appraisal factors.

b. Subjective phrases, such as "poor neighborhood," "pride of ownership," "crime-ridden area," should be avoided.

C. Location

1. In order for Fannie Mae to purchase a mortgage (loan), the property securing the mortgage must be residential in nature.

a. The properties may be in urban, suburban, and rural areas.

b. Fannie Mae will not purchase mortgages secured by agricultural properties, undeveloped land, or land-development-type properties.

c. A mortgage is eligible for purchase by Fannie Mae when the property securing the mortgage is in a rural location, as long as certain requirements are met.

(1) The nature and use of the property are primarily residential.

(2) The borrowers intend to use the property for residential purposes.

2. Locating comparable sales

a. It is acceptable to go a considerable distance to find comparables.

(1) The appraiser must document the analysis of the market in the appraisal report.

(2) An explanation of why it was necessary to go so far to locate comparables must be included in the appraisal report.

b. Competitive neighborhoods may also be used.

(1) This is allowable as long as comparables could not be found in the subject's neighborhood.

(2) The need for seeking comparables in a different neighborhood should be explained.

(3) The underwriter must be satisfied that it was necessary to go to a neighborhood other than the subject's and that appropriate locational adjustments were made.

c. If the property to be appraised is subject to unusual influences, it is preferable that the comparables are similarly influenced.

(1) Vacant, boarded-up, or abandoned properties

(2) Mixed-use properties

(3) If comparables similarly influenced cannot be found, a location adjustment will be required for comparables from other neighborhoods.

3. Outbuildings

a. These are improvements on the subject land, in addition to the residence, that serve other purposes, such as barns and stables.

b. Properties with minimal outbuildings may be acceptable to Fannie Mae under certain conditions.

(1) The outbuildings are insignificant in value when compared to the total appraised value of the subject.

(2) It is typical of other residential properties in the subject area.

c. If outbuildings are minimal, but atypical for the market, the property is acceptable to Fannie Mae as long as the appraiser assigns little or no contributory value to them.

d. Properties with significant outbuildings

(1) This still may not make the mortgage ineligible, if it can be demonstrated that the property is primarily residential in

nature.

(2) The appraiser should exercise care, since the presence of such outbuildings may mean the property is agricultural in nature.

(3) Examples

(a) Large barns

(b) Storage areas or facilities for farm animals

(c) Silos

4. Accessibility of the subject

a. The property must be readily accessible by roads meeting local standards and have adequate utilities available and in service.

b. If the roads are unpaved, they must be properly maintained and they must meet local standards.

c. The property must be accessible all year.

D. Degree of development and growth

1. Within a defined market area the degree of development is that percentage of available land that has been improved, what the appraisal report forms refer to as "built-up."

2. This may indicate whether or not a property is residential in nature.

3. Areas of the appraiser's report to which the underwriter should give special attention

a. Description of the neighborhood or market area

b. Zoning

c. Highest and best use

d. Degree of comparability between the subject and the comparables

selected

e. Description of a subject not relatively typical for the market, such as a significantly larger site

4. The underwriter should carefully study a subject that has a non-residential use in order to determine whether the property is primarily residential in nature.

E. Rural properties may not meet the general Fannie Mae guidelines contained in Part VII ("Property and Appraisal Analysis") of the Fannie Mae Selling Guide, but this does not necessarily make the mortgages they secure ineligible for purchase by Fannie Mae.

1. The appraiser should explain why certain guidelines are exceeded in a particular market.

2. Examples

a. Marketing time

b. Price range and predominant price

c. Age range and predominant age

F. Reviewing the appraiser's description and analysis of the site

1. The subject should generally conform to what is typical in the market where it is located.

a. Size, shape, and topography

b. Utilities, roads, site improvements

2. The appraiser must comment on any atypical aspects of the subject.

3. Zoning violations

a. Normally, Fannie Mae requires that improvements are a permissible use of the land.

b. Fannie Mae may still purchase a mortgage where there is an illegal use in the case of one-to-two unit properties with an additional unit that does not comply with zoning.

(1) The use must conform to the neighborhood.

(2) The property must be appraised based on its legal use.

(3) None of the income from the illegal unit may be used in qualifying the borrower.

4. Agricultural zoning can be acceptable to Fannie Mae under certain conditions.

a. The subject is primarily residential in nature.

b. Zoning and land use regulations permit the residential use.

c. The property improvements are the highest and best use of the site as improved.

d. The property is a relatively typical residence for the area.

G. Reviewing the appraiser's description and analysis of the improvements

1. What the underwriter should look for in the appraiser's description of the improvements

a. The property's compatibility with the neighborhood or market area

b. Actual and effective ages

c. Signs of infestation, dampness, or settlement that could affect the market value

d. Insulation and energy efficiency

e. Layout, floor plan, and gross living area

f. Heating and cooling systems

2. It should be recognized that in rural areas there can be favorable heterogeneity in architectural styles, land use, and age of housing and that Fannie Mae may still buy mortgages secured by such properties.

3. Special consideration must be given to unique housing.

a. Examples

(1) Earth houses

(2) Geodesic homes

(3) Log houses

b. The mortgages may be eligible for delivery to Fannie Mae as long as there is sufficient information to develop a reliable opinion of market value.

(1) It is not necessary that any of the comparables be of the same design and appeal as the subject.

(2) While it is preferable to have comparables as similar to the subject as possible, Fannie Mae might still buy the mortgage if the appraiser can determine sound adjustments for the differences between the available comparables and the subject.

(3) The appraiser should also be able to show that the unique property is marketable in the area.

4. Size and living area requirements

a. Fannie Mae does not specify minimum requirements for size or living area.

b. There should be comparables of similar size to the subject to demonstrate acceptability in the market.

H. Reviewing the appraiser's valuation of the property and opinion of market value

1. **The appraiser's opinion of market value should be based on the three approaches to value: sales, cost, and income.**

2. **Additional supporting data that may be required in unique situations should be included in an addendum to the appraisal report.**

3. **In the sales comparison approach the 15% net and 25% gross maximum adjustments generally apply.**

   a. **It is recognized that for rural properties the net and gross adjustment maximums may be exceeded, which is acceptable to Fannie Mae as long as they are justified by the appraiser.**

   b. **The appraiser should also explain excessively high individual adjustments, which Fannie Mae recognizes are not unusual for appraisals on rural properties.**

VIII. Estimating a financing adjustment

A. The preferable method for estimating an adjustment for financing is one that relies on extracting paired sales from the market.

1. Sales are compared of properties with similar characteristics except for differences associated with their financing, in which one property's sales price was affected by its financing while the financing of the other property did not have any influence on its sales price.

a. If the properties' characteristics, aside from financing, are so similar that they should have sold for approximately the same sales price, then any measurable difference in their sales prices is attributed to the impact of the financing on one but not the other.

b. Changes in sales prices of comparables caused by financing, as indicated by studying paired sales, are reconciled to a financing adjustment appropriate for the market from which the paired-sale comparables were extracted.

2. The disadvantage of this method is the difficulty of finding paired sales on any meaningful and recurrent basis which are so similar except for financing that they can be justified as a realistic technique for estimating a financing adjustment.

B. A technique involving discounting is a method that may be used to estimate a financing adjustment for those markets where paired sales are difficult to locate.

1. Discounting is the calculation of the present value of future benefits and, when applied to loans, it is figuring the present worth of the dollar benefits that will accrue to the holder of a loan.

a. If the loan is expected to run to maturity, the loan is valued (appraised) as the present value of the loan payments to be paid, the lender's future income stream as called for under the loan terms.

b. If the loan is expected to be paid off prior to maturity, then the loan is valued as the present worth of the future loan payments that are estimated will be made prior to payoff of the loan plus the present worth of the balloon payment (remaining balance of the loan) due at the termination of the loan.

c. Local lenders, mortgage brokers, investors in the secondary market

can be consulted to determine the likelihood of a loan going to maturity or, for a loan expected to be paid off prior to maturity, how long that loan is likely to run before being paid off.

2. The difference between the present value of a loan and its actual face amount is the base from which a financing adjustment may be estimated.

a. This technique may be applied when the grantor of a loan is the seller of the property securing the loan or a third party in a position to influence the sales price, such as a creditor of the seller.

b. If a seller of real property extending financing at a below-market rate, for example, realizes this means a loss in value of the loan, that seller may inflate the purchase price of the property to recover the loss associated with the loan.

(1) This is similar to what a seller might do, attempting to compensate for a loss, when paying loan points for the buyer or making sales concessions such as including personal property in the sale of the real property.

(a) An inflated sales price is a means by which the seller can recover dollars perceived to have been lost in other aspects the sale.

(b) The financing adjustment selected is not always the exact dollar loss, however, but a conclusion based on careful judgment, which is the point Fannie Mae makes in its guidelines and on the appraisal report forms when it warns against making a mechanical dollar-for-dollar adjustment when considering financing and sales concessions adjustments.

(2) A below-market rate loan is worth less than a loan made at market rate because the lender is receiving a smaller return than the market is enjoying.

(3) A lender purchasing a below-market rate loan in the secondary

mortgage market is likely to devalue that loan by discounting the loan benefits at the market rate, thereby calculating a present value of the loan at a dollar figure below the face amount.

C. Calculating the market value of below-market rate loans

1. Loan expected to be held to maturity

a. With the compound interest/discount tables

(1) Calculate the market value of the loan.

(a) Use Column 6 to calculate the loan payment at the interest rate of the loan.

(b) Use Column 5 to discount the loan payment at the market rate over the term of the loan.

(2) Deduct the market value of the loan from the face amount of the loan.

(3) Example

A seller has extended a $50,000. loan to the buyer at an 8% annual interest rate over a term of 10 years to be paid back with equal monthly payments that will fully amortize the loan. The current market interest rate is 9%. If the appraiser who wants to use this sale as a comparable believes the seller inflated the purchase price by the loss associated with this loan, what is the proper financing adjustment under the assumption this loan will run its full term to maturity?

Solution:

$50,000.	
x.012133	**Column 6 factor, 8% tables**
$ 606.65	**monthly payment to fully amortize the loan**

$606.65

x78.941693 **Column 5 factor, 9% tables**
$47,890. **market value of the loan**

Note to student: The tables used in this example offer a range of interest/discount rates and terms for loans. We have provided the proper factor to use. If you were to look them up, you would go, for example, to the 8% monthly tables and select

Column 6 to calculate the monthly payment. Since this is a ten-year loan term, you would go down Column 6 until you got to the 10-year row running left and right on the page. There you would find the factor (or constant), .012133, that we used.

The factor used to estimate the present value of the loan is found in Column 5, at the ten-year row, using a tables for the market interest rate of 9%.

$50,000. **face amount of loan**
-47,890. **market value of loan**
$ 2,110. **loss associated with the loan and the financing adjustment**

b. Working the above example using the HP-12C financial calculator

50000
PV
8
g
i
10
g
n
PMT **Answer: $606.64 loan payment**

After the keystrokes shown above you will discount this loan payment at the market rate of 9% by then keying in the following:

9
g
i
PV **Answer: $47,889.**

f
REG

These last two keystrokes clear the memory

banks of the calculator for your next operation, which is subtracting the market value of the loan from the face amount:

50000
ENTER
47889
- **Answer: $2,111.***

***As we noted previously, the slight difference in the answer between using the tables and the financial calculator is due to the calculator using nine places to the right of the decimal in its arithmetic operations, while the tables use six places to the right.**

2. Loan expected to be paid off prior to maturity

a. With the compound interest/discount tables

(1) Calculate the market value of the loan payments.

(a) Use Column 6 to calculate the loan payment at the interest rate of the loan.

(b) Use Column 5 to discount the loan payment at the market rate over the estimated period the loan

payments will be made before the loan is paid off.

(2) Calculate the market value of the balloon payment (loan balance at time of payoff).

(a) Use Column 5 to discount at the interest rate of the loan the remaining years of the loan at the time of its payoff (see pages 48-49 for a review of calculating loan balances).

(b) Use Column 4 to discount the balloon payment at the market rate over the time prior to the loan being paid off.

(3) Calculate the market value of the loan by adding the present

(market) value of the loan payments expected to be made and the present value of the balloon payment expected to be paid when the loan is paid off.

(4) Deduct the market value of the loan from the face amount of the loan.

(5) Example

Let's use the same loan described on page 84 but now we will project that this loan will be paid off at the end of three years.

Solution:	**$50,000.**	
	x.012133	**Column 6**
	$ 606.65	**monthly payment**
	$606.65	
	x31.446805	**Column 5 factor***
	$19,077.	**market value of three years of payments discounted at the market rate**

***This factor is taken from the 9% monthly tables, at the three-year row of Column 5.**

Now we need to calculate the balloon payment (balance

of the loan at time of payoff) so that we can discount that too at the market rate.

$606.65	
x64.159261	**Column 5***
$38,922.	**balloon payment**

***This factor is taken from the 8% monthly tables, at the seven-year row (seven years remaining on the loan at time of payoff) of Column 5.**

$38,922.	
x.722183	**Column 4***
$30,055.	**present value of the balloon payment discounted annually at the market rate of 9%**

***This factor is taken from the 9% annual tables,**

at the three-year row (the loan is expected to be paid off in three years from the time of its origination) of Column 4. The annual discounting is discretionary and it would not be necessarily incorrect to discount it monthly. But most investors think of annual returns and hence the annual discounting is more realistic. When we discount the monthly payment, we must use monthly discounting, since that is how the money is received.

Column 4 and Column 5 are both discounting columns. The difference is Column 4 has factors for discounting a single sum, while Column 5 is for discounting a series of equal

sums to be received over equally spaced periods of time in the future.

All we have left is to add the present values of the loan payments and the balloon payment:

$19,077	**market value of payments**
+30,055.	**market value of balloon**
$49,132.	**market value of the loan**

And, then deduct the market value from the face amount:

$50,000.	**face amount of loan**
-49,132.	**market value of loan**
$ 868.	**loss associated with the loan and the financing adjustment**

b. Working the above example using the HP-12C financial calculator

50000
PV
8
g
i
10
g

-88-
n
PMT **Answer: $606.64 loan payment**

Now we need to discount this loan payment over three years at 9% monthly:

f
REG

This clears the calculator for the next calculation:

606.64
PMT
9
g
i
3
g
n
PV Answer: $19,077.

This is the present value of the three years of loan payments expected to be received discounted monthly at the market rate of 9%. Next, we calculate the balloon payment:

f
REG

Again, we first clear the calculator, and then we'll calculate the loan payment once more:

50000
PV
8
g
i
10
g
n
PMT Answer: $606.64

Then we will ask the calculator for the future value (the

balance remaining, that is, the balloon) after three years:

3
g
n
FV Answer: $38,921.

And, let's now discount this balloon at an annual rate of 9%:

9
i
3
n

Note that we are not using the 'g' key, since this is annual discounting. Next, we must "zero" out the payment register, because we only want to discount the balloon in the future value register, but not the payment in the payment register. And then solve for the present value:

0
PMT
PV Answer $30,055.

Another note: If we had cleared the calculator and put $38,921. into the future value register, its present value discounted at 9% annual would have been $30,054. The $1. difference is due to our leaving $38,921. as an unrounded number (the cents were not shown) in the future value register.

Clear the calculator and add up the present values of the loan payments and the balloon:

f
REG
19077
ENTER
30055
+ Answer: $49,132.

Deduct the loan's market value of $49,132. from its $50,000. face amount to calculate the loan loss/financing adjustment:

50000
ENTER
49132
- **Answer: $868.**

IX. How some critique the work of the real estate appraiser

A. One well known underwriter circulated a document entitled, "The Most Common Errors and Deficiencies in Appraisal Reports," and listed the following:

Appraiser not familiar with local market.

Refinance appraiser: Appraiser not complying with current definition of market value - most probable price rather than highest possible price.

Lack of multiple data sources for comparable selection.

Multiple Listing Service data not considered for verification or support (i.e., sales, pending sales, listings).

Making unsupported, incorrect, or inconsistent adjustments for location, site, view, design and appeal, quality of construction, age, condition, and time.

Inadequate discussion of local market trends in marketing time, demand/supply, and property values (range/predominant).

Inadequate investigation of the sales and listing history of the subject.

Inconsistencies among cost and market approaches, remaining economic life, and depreciation estimates.

Failure to mention more recent, nearby sales and why they were omitted from the report.

Using comparables too far away in distance without comments.

Failure to properly consider zoning or potential zoning.

Loading the appraisal with "Chamber of Commerce" type data without relating factual data to the subject.

Poor exhibits (i.e. quality and relevance).

Typing, grammatical, and punctuation errors.

B. A State real estate appraisers board published the following in one of its newsletters (USPAP references are to the 2000 edition):

10 MOST COMMON APPRAISAL VIOLATIONS

To assist appraisers in avoiding potential violations of the Uniform Standards of Professional Appraisal Practice (USPAP) and federal and State statutes and regulations, (name of board) has identified the ten most common problems with appraisal reports that we have reviewed:

1. **Failure to disclose reporting option [USPAP Standards Rule (S.R.) 2-2].**

2. **Failure to address scope of work [USPAP S.R. 1-2(f)].**

3. **Failure to analyze any current agreement of sale [USPAP S.R. 1-1(a) and 1-5(a)] or previous sales history of subject property within prescribed USPAP time frames [USPAP S.R. 1-5(b)].**

4. **Failure to identify client, intended use, and intended users of the report [USPAP S.R. 1-2(a) and (b)], related to disclosure of original client (Advisory Opinion 10).**

5. **Failure to incorporate license number with signature on appraisal reports (State code).**

6. **Non-compliance with USPAP Competency Rule in accepting and developing appraisal report.**

7. **Inaccurate or insufficient property descriptions [USPAP S.R. 1-2(e) and (i)]:**

- Reliance on "boilerplate" language;

- Insufficient discussion of recent upgrades, repairs, etc.;

- Incorrect zoning [USPAP S.R. 1-3(a)]; and

- Incorrect neighborhood boundaries.

8. Problems with Cost Approach [USPAP S.R. 1-4(b)]:

- No support for cost/square foot even though Marshall & Swift is a reference;

- Land value by abstraction, but not credible; and

- Minimal support for depreciation estimates.

9. Problems with Direct Sales Comparison Approach [USPAP S.R. 1-4(a)]:

- Boilerplate discussion, minimal support for adjustments;

- Inconsistency of adjustments between comparable sales;

- Comparable sales out of neighborhood, when sales are available in immediate neighborhood; and

- Failure to exercise required due diligence, such as using MLS as a data source.

10. Problems with Income Approach (2-4 units) [USPAP S.R. 1-4(c)]:

- Boilerplate discussion for rental comparables, no discussion of relative comparability; and

- Lack of due diligence in GRM extraction. Based on actual rents, not the particular investor's perception of economic rents (actual versus projected).

Review questions and problems (3):

1. What is calculated in the process of discounting?

a. Future value of present worth

b. Present value of future worth

c. Future value of future worth

d. Present value of present worth

2. What is the preferable method for estimating a financing adjustment?

a. Paired sales

b. Discounting

c. Direct capitalization

d. Yield capitalization

3. How is the current balance of a loan calculated?

a. Compound the remaining periodic payments of a loan to a future value

b. Compound the remaining periodic payments and balloon payment to a future value

c. Discount the remaining periodic payments of the loan to a present value

d. Discount the periodic payments already made to a present value

4. Which of the following calculates a potential financing adjustment?

a. Face amount of the loan plus the market value of the loan

b. Face amount of the loan minus the market value of the loan

c. Market value of the loan minus the face amount of the loan

d. Market value of the loan multiplied by the discount rate

5. A loan made at a below-market interest rate is worth:

a. The same as a loan made at the market interest rate.

b. Less than a loan made at the market interest rate.

c. More than a loan made at the market interest rate.

d. More than a loan made at the market interest rate if the market rate equals the prime rate.

6. The market value of a loan may be the:

a. Present value of the remaining periodic payments.

b. Sum of the present value of the remaining periodic payments and the present value of any balloon payment.

c. Difference between the present value of the remaining periodic payments and the present value of any balloon payment.

d. Either 'a' or 'b.'

7. If it is projected that a loan made at a below-market interest rate is going to be paid off prior to the end of the loan term, then the market value of this loan is worth:

a. The same as if it were projected to run to the end of the term of the loan.

b. Less than if it were projected to run to the end of the term of the loan.

c. More than if it were projected to run to the end of the term of the loan.

d. The future value of the balloon payment.

<u>Use the following information to answer questions #8 through #14</u>:

A loan of $400,000. is originated at an annual interest rate of 6% over a term of 30 years and is to be fully amortized with monthly payments of $2,398.40. The market interest rate is 7.50%.

The correct answers below have been calculated using compound interest/ discount tables. If you use a financial calculator, your correct answers may vary slightly from the right answer, so select that answer closest to what you have calculated.

8. What is the loan constant (Column 6 factor) for this loan?

a. .005127

b. .005509

c. .005781

d. .005996

9. What is the balance of this loan after 9 years of monthly payments? The discount factor (Column 5) is 143.090806.

a. $343,189.

b. $351,237.

c. $359,064.

d. $361,220.

10. What is the total interest paid on this loan after the first 12 years of payments?

The discount factor (Column 5) is 131.897876.

a. $261,714.

b. $298,390.

c. $307,623.

d. $316,344.

11. What is the total principal paid on this loan after 20 years? The discount factor

(Column 5) is 90.073453.

a. $183,968.

b. $186,275.

c. $188,401.

d. $189,813.

12. What is the total interest paid on this loan if all 360 payments are made? You do

not need the compound interest/discount tables to solve this.

a. $390,001.

b. $438,710.

c. $463,424.

d. $493,227.

13. What is the market value of this loan if it is projected that the loan will run for the full term of 30 years? The discount factor (Column 5) is 143.017627.

a. $319,239.

b. $328,454.

c. $337,109.

d. $343,013.

14. What is the market value of this loan if it is projected that the loan will be paid off at the end of 12 years? The discount factor (Column 5) for the loan payments is 94.766401. The discount factor (Column 5) to calculate the balloon payment is 131.897876. The discount factor (Column 4) to calculate the present value of the balloon payment is 0.419854. (In this problem we are discounting the monthly payments monthly but discounting the balloon payment annually, since an investor would likely look at an annual return for the balloon.)

a. $350,257.

b. $360,106.

c. $367,509.

d. $375,482.

15. What is the value of a loan expected to run its full term?

a. Present value of the balloon payment

b. Present value of the loan payments

c. Future value of the balloon payment

d. Future value of the loan payments

16. What is the value of a 30-year loan at the end of nine years of payments.

a. The present value of the first nine years of payments.

b. The present value of the loan balance at the end of 30 years.

c. The present value of the remaining 21 years of payments

d. The future value of the first nine years of payments

17. What periodic basis of amortization would result in the most interest being paid over the life of the loan?

a. Monthly

b. Quarterly

c. Semi-annually

d. Annually

18. What would be the total interest paid on a five-year loan of $60,000. at an annual interest rate of 11% if the monthly payments are interest only with nothing applied to principal?

a. $30,000.

b. $31,000.

c. $32,000.

d. $33,000.

19. What would be the total amount applied to principal for an eight-year loan of $75,000. if the annual interest rate is 8.25% and it is fully amortized with monthly payments of $1,069.80?

a. $27,701.

b. $52,397.

c. $75,000.

d. $102,701.

20. What is the adjusted sales price of a comparable that sold for $325,000. after making the financing adjustment if the loan were for $280,000. at an annual interest rate of 6.75% over a term of 20 years if it is projected that the loan will run the full term? The market rate is 7.75%. The loan constant (Column 6) is .007604. The discount factor for the loan payment is (Column 5) is 121.810311.

a. $300,386.

b. $304,349.

c. $309,112.

d. $315,485.

FROM THE APPRAISER TO THE UNDERWRITER

ANSWER SHEET

Put in the letter - 'a,' 'b,' 'c,' or 'd' - of your answer choice for each of the questions numbered below.

REVIEW QUESTIONS AND PROBLEMS (3)

1.	**11.**
2.	**12.**
3.	**13.**
4.	**14.**
5.	**15.**
6.	**16.**
7.	**17.**
8.	**18.**
9.	**19.**
10.	**20.**

X. Case study: Quantitative analysis versus qualitative analysis

A. In 1996 Fannie Mae introduce the controversial appraisal report form, "Desktop Underwriter Qualitative Analysis Appraisal Report" (Form 2065).

1. The controversy stems around the method of adjusting in which the

comparables are ranked or rated, but not numerically adjusted for differences among the comparables and the subject property.

2. See page 71 in this textbook for an explanation of how the comparables are adjusted in "qualitative analysis."

B. We want to study in this section whether the differences between the new way of adjusting as introduced in the 2065 are really that profound when compared to the traditional adjustment process, as called for in the 2055, with its numerical adjustments.

1. In the case study that follows we will ask you to appraise a subject using the standard appraisal procedure of numerically adjusting the comparables to the subject, given the information provided, and then ask that you rank the comparables in a second valuation, adhering to the methodology suggested by the 2065 and the Fannie Mae underwriting guidelines for the form presented in this course.

2. When you have completed the two valuations, consider the differences and similarities between the two methods and, of course, compare the two values for a conclusion on the viability of the 2065 in realistic appraisal situations.

C. Case study

1. Subject

Financing is expected to be provided by an institutional lender for this 2,400.-square-foot home in a residential location with an average view. Its site measures 7,500. square feet, the improvements are in good condition, functional utility of the home is average, but it does have a two-car garage and its landscaping is extensive.

2. Comparables

a. Comparable 1 sold six months ago for $205,000, in part because of its desirable view and size of 2,750 square feet. The owner carried the

financing of $153,750. at an annual interest rate of 8.50% over a 15-year term, fully amortized with equal monthly payments. Functional utility of the home is poor and the landscaping is only adequate, but it does have a two-car garage and the improvements are in good condition. The 7,300.-square-foot site is in a residential area.

b. Comparable 2 has a one-car garage, but its improvements are in excellent condition and the property has extensive landscaping. It sold two months ago for $182,000., lower than might be expected for similar improvements and partially attributable to its location where light industry is slowly encroaching on what had been residential properties only. The home measures 2,200. square feet, while the site has 8,100. square feet. The purchaser used institutional financing. Average for both the view from the property and for functional utility of the improvements.

c. Comparable 3 sold for $190,000. five months ago, with a $140,000. loan carried by the owner at an annual interest rate of 8.25% over a term of 15 years, to be paid back by equal monthly payments fully amortizing the loan. The property is in a residential area, its site is 7,700. square feet, and the improvements are 2,100. square feet. Landscaping is extensive, condition of the improvements is good, but it has only a one-car garage. The view and functional utility are both average.

3. Adjustments

a. Financing

Calculate the financing adjustment as the difference between the face amount of the loan and its market value. The market interest rate for both comparables (#1 and #3) that require a financing adjustment is 9.25%. Assume for Comparable 1 that the loan will run full term, for Comparable 3 that it will be paid off at the end of five years of payments. Hence, the market value of Comparable 1 is the present value of its 15 years of loan payments discounted at the market interest rate of 9.25%. The market value of Comparable 3 will be the sum of the present values of its loan payments for five years and its balloon payment at the end of five years. If you are using the financial tables,

the following constants will apply:

Comparable 1: Loan constant (Column 6): .009847
Discount factor (Column 5): 97.163573

Comparable 3: Loan constant (Column 6): .009701

Discount factor for market value of the loan payments (Column 5): 47.892954

Discount factor to calculate balloon payment (Column 5): 81.531072

Discount factor to calculate market value of the balloon payment (Column 4): .642529

b. Market conditions: $500. per month appreciation, applied only if the comparable sold at least three months ago

c. Location: +$15,000. in favor of residential location not encroached by light industry

d. Site square footage: $3.00 per square foot (adjust only if difference is at least 500. square feet)

e. View: +$10,000. in favor of desirable over average

f. Improvements condition: +$12,000. in favor of excellent over good

g. Improvements square footage: $35. per square foot (adjust only if difference is at least 150 square feet)

h. Functional utility of improvements: +$7,500 in favor of average over poor

i. Garage: +$3,000. in favor of two-car over one-car

j. Landscaping: +$5,000. in favor of extensive over adequate

4. Assignments

a. Adjust each of the comparables to the subject property using the sales comparison approach as presented in the 2055 (quantitative analysis), that is, with numerical adjustments. Calculate the dollar and percent net and gross adjustments for each comparable. Reconcile the adjusted sales prices of the comparables to a final opinion of value for the subject.

b. Appraise the subject property using the sales comparison approach as presented in the 2065 (qualitative analysis) and reconcile the rated comparables to a final opinion of value.

c. Compare the results of your two appraisals and consider the applicability of each of the competing methodologies in appraisal assignments the professional real estate appraiser is likely to face.

d. Market data grids for the 2055 and 2065 analyses are on the next two pages.

	Subj	Comp #1	Comp #2	Comp #3
Sales price:				

QUANTITATIVE ADJUSTMENTS (Form 2055)

Financing
Adjustment

Mkt.conds.
Adjustment:

Location
Adjustment:

Site
Adjustment:

View
Adjustment:

Condition
Adjustment:

Size
Adjustment:

Func.Utility
Adjustment:

Garage
Adjustment:

Landscaping

Adjustment:

Net adj:

% Net adj.

Gross adj:

%Gross adj:

Adj. Sales Price:

Reconciliation and valuation:

	Subj	**Comp #1**	**Comp #2**	**Comp #3**
Sales price:				

QUALITATIVE ADJUSTMENTS (Form 2065)

Financing
Adjustment:

Mkt.conds.
Adjustment:

Location
Adjustment:

Site
Adjustment:

View
Adjustment:

Condition
Adjustment:

Size
Adjustment:

Func.Utility
Adjustment:

Garage
Adjustment:

Landscaping
Adjustment:

Overall comparison to subject (superior, equal, or inferior):

Reconciliation and valuation: