

## LESSON EIGHT

### WHAT ROLE DOES QUALIFYING THE PROPERTY PLAY IN LOAN UNDERWRITING?

#### PREVIEW:

The loan underwriting process consists of two parts, the property and the borrower. In this lesson we explore the first part. In Lesson Nine we examine the borrower. Before a lender decides to make a loan, the lender must consider the collateral for the loan, the property itself. In this lesson we discuss what is meant by qualifying a property for a loan, marketability of properties, various standards which lenders apply to properties, and how to work with appraisers.

#### PERFORMANCE OBJECTIVES:

After completing this lesson, you should be able to:

1. Describe what is meant by “qualifying the property” for a loan.
2. Describe how properties are appraised under three separate approaches to value.
3. Give an example of how Fannie Mae and Freddie Mac influence property standards.
4. Define “marketability” of a property.
5. Determine how the savings & loan bailout bill impacts upon the real estate financing process.
6. List the ways in which licensees can assist appraisers.

#### I. WHAT IS MEANT BY “QUALIFYING THE PROPERTY”?

The first question a lender must consider is: “Do we want to make a loan on this property?” If the answer is yes, the next step requires an appraisal of the property in order to determine its market value.

Following the appraisal, the lender must decide what loan-to-value ratio to apply. Will it be 75%? 80%? Or perhaps 90% and even more? These and other questions must be properly answered in the underwriting process referred to as “qualifying the property”.

## II. HOW ARE PROPERTIES QUALIFIED?

What is the process lenders follow in qualifying properties for a loan?

- A. Appraisal. A valuation of the property is made. This is accomplished by a fee or staff appraiser. Staff appraisers, full-time employees of FHA, are used to review appraisals in-house, rather than in the field. Staff appraisers are also employed by such sources as commercial banks and savings and loan associations, performing appraisal work or auditing the work of others. Fee appraisers are independent contractors who work with lenders and for the public. They charge predetermined fees for each job.
- B. Review. After the appraisal is made, the completed forms are subject to review and approval by a staff appraiser. FHA now allows approved lenders to select appraisers. Formerly, the selection was in the hands of FHA. FHA audit of the appraisal, as a part to the loan package, is subject to review when the MIP approval is issued. The FHA appraisal, or Conditional Commitment, may include conditions and repairs that must be accomplished before the final commitment is issued.
- C. Approval of appraisal. The DVA operates in much the same way, except that it still maintains an approved appraisal panel that the lender must select from. The DVA appraisal is referred to as a "Certificate of Reasonable Value" or CRV. The CRV may include conditions and repairs which the DVA may require on the structure as a condition for a loan guarantee.

## III. CONVENTIONAL LENDERS

### A. What are the Steps in the Qualifying Process?

- 1. Preliminary information. The qualifying process typically begins by the borrower or salesperson calling upon a prospective lender. Applicants are referred to a loan officer who obtains information on location, age of the structure, number of bedrooms and bathrooms, and other property data.
- 2. Acceptable valuation. Conventional lenders utilize both staff and fee appraisers. The lender must make certain that the appraisal is high enough to grant the loan being sought. The loan cannot exceed statutory limits. If the property is acceptable and the value sufficiently high to meet the requested loan amount, the lender will continue processing the loan by going through the next underwriting phase, qualifying the buyer/borrower.
- 3. Loan review and approval. Lenders use underwriters, staff and approved fee appraisers as well as committees who review and approve submitted appraisals.

4. In accordance with regulatory requirements, most institutional lenders are required to pre-approve fee appraisers which constitutes their appraisal panel. This process is normally approved by the Board of Directors upon recommendation from management.

IV. WHAT IS THE RELATIONSHIP BETWEEN MARKET VALUE, MARKETABILITY, AND SALES PRICE?

- A. Market value. This is generally defined according the Fannie Mae wording that is intended to reflect adjustments for any special or creative financing, as follows:

“the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus” The language goes on and on, but the bottom line is that market value represents the price at which sellers are willing to sell, and buyers willing to buy.

- B. Marketability of property. Marketability is closely correlated to value, but not in all cases. It may be defined as acceptance of a given property by potential buyers.

Example. A one-bedroom house may be highly valued, but have limited market appeal, therefore its marketability is said to be low. This would likely reduce its real value, unless a second bedroom can be added at a cost that is economically justified.

- C. Market value vs Sales Price. Sales price and market value are not necessarily synonymous. An example will help to illustrate the difference.

Example. A couple purchases a home for \$180,000 and apply for a first trust deed loan. The house is located in a new suburban subdivision. The appraiser is able to find a number of comparable sales and arrive at a fair market value of only \$144,000. Why such a large (20%) discrepancy between the sales price and valuation? The answer becomes apparent when it is discovered that the buyer has just moved into the area and is not aware of values. He is not a well-informed, knowledgeable buyer.

Incidentally, the definition of market value for many years included fully-informed buyer until Fannie Mae changed it to well-informed. After all, who is ever really fully informed about everything concerning a given property, including the most expert appraiser? Recall from R.E. Principles that an appraisal is only as good as the experience, skill and knowledge of the appraiser.

V. PROPERTY STANDARDS

- A. Policies. In setting up company policy, lenders look especially close at:
1. Age of the property
  2. Area (square footage)
  3. Number of bedrooms and bathrooms
  4. Location
  5. Degree of conformity to surrounding neighborhood
- B. Guidelines. Property standards are merely guidelines. Exceptions may occur according to such factors as down payment, financial strength of buyers, availability of funds, competition, previous borrower relationships with the lender, and changing market conditions.
- C. Influence of Fannie Mae and Freddie Mac. Both Fannie Mae and Freddie Mac strongly influence property standards on the part of conventional lenders. This is because lenders who sell loans to either of these agencies must conform their property standards to these two Secondary Market purchasers of originated conforming conventional loans as well as DVA and FHA loan originations.
- D. Influence of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). In 1989, Title XI of FIRREA was enacted by Congress, mandating all states to license real estate appraisers who appraise real property in federally related transactions. All federally-insured lenders must comply or be subject to stiff penalties. All 50 states must conform to the federal standards, developing training and licensing requirements that meet minimum requirements.
1. In response to the federal mandate, the Real Estate Appraiser's Licensing and Certification Law was passed by the California Legislature in 1990 (AB 527, chapter 491 of 1990). The law charged the office of Real Estate Appraisers (OREA) with licensing real estate appraisers in the State of California and enforcing national ethical and professional standards and qualifications that comply with the mandate.
  2. The mission of the OREA, a division of the Business, Transportation and Housing Agency in Sacramento, is to protect public safety by ensuring the competency and integrity of licensed real estate appraisers.
  3. OREA consists of two primary program components, which are Licensing and Enforcement. The latter investigates complaints and ensures that licensees adhere to all applicable laws and regulations.
  4. Four levels of OREA licensing are in effect in California
    - a. Trainee. The category of licensing allows the appraiser to appraise any property which the supervising appraiser is permitted to appraise.

- b. Residential. An appraiser so licensed is permitted to appraise any non-complex 1-4 family property with a transaction value up to \$1 million; and non-residential property with a transaction value up to \$250,000.
  - c. Certified Residential. An appraiser with this category of licensing is allowed to appraise any 1-4 family property without regard to transaction value or complexity; and non-residential property with a transaction value up to \$250,000
  - d. Certified Residential. This category of licensing allows the appraiser to appraise all real estate without regard to transaction value or complexity.
- E. Federal Housing Administration (FHA) and the Department of Veterans Affairs (DVA). If a property meets the minimum standards imposed by the FHA or DVA, it will qualify for the maximum loan amount permitted by law, in the case of FHA loans; or by prudent lending practices in the case of DVA loans.

## VI. Appraising a Property.

Accurate appraisal reports are vital because lenders rely on them to determine acceptability of a property for loans.

- A. Location. Where a property is located has a major influence on its value and marketability. What are some of the factors viewed by appraisers and lenders assessing location?
  - 1. City. Why is city location important? A developer built a subdivision partly located in a city that had an outstanding reputation, and partly in a city considered average. In walking around the subdivision, one could not tell that the houses were actually located in two different cities. Yet the sales results differed dramatically. Houses located in the city with the better reputation sold quickly, while those in the adjacent city did not. The only difference was the address – the city and the school district. The developer increased the prices of the homes with the prestige address. These continued to outsell the other because buyers were willing to pay more for a good address. The same houses on the same street sold for different prices for only one reason: status.
  - 2. Neighborhood. What does an appraiser look for when checking a neighborhood?
    - a. Approach to the Property. Is the drive to the property through a pleasant neighborhood, or is it through a rundown area?

- b. Appeal. Does the neighborhood have sales appeal? Is it attractive? Does it have tree-lined streets? Is it laid out in a drab grid pattern, or does it have winding streets with cul-de-sacs?
  - c. Homogeneity. Homogeneous neighborhoods are considered more desirable by most buyers and lenders than are heterogeneous neighborhoods. Most people want to live next to people with similar tastes, backgrounds, and interests. If you live in a \$250,000 house, you don't want to be surrounded by \$100,000 houses. Economists refer to this as the principle of conformity.
  - d. Maintenance. Houses in well-maintained neighborhoods have greater value and marketability.
  - e. Trends. Is the neighborhood improving, stable, or declining? Some neighborhoods are in a state of transition where single dwellings are being replaced by apartments, inevitably affecting the desirability of the neighborhood.
  - f. Adverse Influence. Airport flight patterns, slide and flood areas, inclement climate, obnoxious odors, and other adverse influences reduce property values.
  - g. Schools and shopping. Buyers with young children are interested in the quality of schools in the neighborhood, including distance from the property. Proximity to shopping facilities is also important.
  - h. Miscellaneous. Other factors considered by appraisers and lenders include the amount or percentage of neighborhood build-up, demand-supply balance, price range, present and prospective uses.
3. Subject Property. Appraisers examine properties for such things as conformity to the neighborhood, appeal, landscaping, extent of improvements, condition of roof, and so forth.
- a. After measuring or "taping" the exterior of the structure, the appraiser enters the house to complete the inspection, and summarizes the findings in the appropriate sections of the report. Many appraisers make a special effort to view the house as potential buyers might.

B. How Do We Determine Value?

(Show T 8-6)

After inspecting the property, the appraiser determines its value. Three methods are used to help determine reasonable value.

1. What is the Cost Approach?

a. The principle behind this approach is that buyers will not pay more for a property than what it would cost to replace or reproduce an equally desirable substitute property. Economists refer to this as the principle of substitution.

b. It should be noted that cost does not equal value.

c. This approach involves a five step process:

Step #1: Estimate value of the land (site value)

Step #2: Estimate cost of replacing the improvements, i.e., dwelling, garage, pool, patio, at current prices (estimated reproduction cost new of improvements)

Step #3: Determine the amount of depreciation (physical, functional, and external factors) that has accumulated over the years affecting the improvements estimated in Step #2, above.

Step #4: determine {as-is} value of any other site improvements, i.e., landscaping, fences, driveways, etc.

Step #5: Value indicated =  $a + b - c + d = e$

2. What is the Market Data Approach?

a. Also referred to as the sales comparison method, this approach to value assumes that buyers should not pay more for a property than the price of a comparable substitute property.

b. Adjusting for price. Real estate salespeople use an abbreviated form of the market data approach in determining the value of houses. They do this by mentally observing what other houses have been selling for in the neighborhood, noting differences in style, quality, size, condition, amenities, and so on. They are constantly comparing differences, adding and deducting for these differences, called “adjustments”. The lender’s appraiser does essentially the same thing, but more systematically, noting common but significant property variables that sanction price adjustments. Depreciation is not a factor to be calculated as in the cost approach as it is measured directly from the market.

- c. Sources. Appraisers and licensees obtain information for comparable sales from:
    - i. Files in appraiser's own office
    - ii. Multiple Listing Service (MLS) files
    - iii. Real estate brokers and salespersons in the area.
    - iv. Public records, especially the county Assessor and County Recorder
    - v. Society of Residential appraisers, a professional organization that publishes quarterly summaries of sales by county.
    - vi. Real estate lenders that maintain records.
    - vii. Commercial information vendors.
3. What is the Income Approach?

- a. Gross Rent Multiplier. The foundation for this method of appraising residences is that a relationship exists between what a property rents for and its value. A relationship is established by means of a gross rent multiplier (GRM). The GRM is arrived at by dividing the sales price of a house by its gross monthly rent. It is by no means an accurate index and is only used in 1-4 family situations. It should not be relied on for 5 or more units. A more sophisticated analysis of income is warranted in this instance.
- b. Estimating value. Once the GRM is found for a type of property in a particular area, it can then be used to find the probable sales price of the subject property. The formula for computing value is:

Estimated Value = Monthly Rent x Gross Rent Multiplier

- i. Example. Assume a monthly gross rental of \$5,000 and a gross rent multiplier of 100. The probable sales price or estimated value (EV) is:  
 Estimated Value = \$5,000 x 100, or \$500,000
- c. Two to Four Unit Properties. Duplexes, triplexes, and fourplexes – the “plexes” – are appraised similar to single family dwellings. However, when employing the market data approach, the following is also considered;
- i. Selling price per unit. If the property consists of a fourplex and has sold for \$200,000, the selling price is broken down into so much per unit:  $\$200,000 / 4 = \$50,000$  per unit

- ii. Selling price per room. If the fourplex consists of 16 rooms, the price per room is:

$$\$200,000 / 16 = \$12,500 \text{ per room}$$

- d) Use of the GRM, whether on a monthly or annual basis, can be very helpful if rental data on similar properties is sufficiently available.
- e) There should be less emphasis placed on the GRM as it is a broker-driven rule of thumb to determine value. Net operating income before debt service and depreciation with allowance for vacancies and maintenance is appropriate for apartments of five or more units, office buildings, multi-purpose commercial, industrial, and shopping center properties. Two to four unit residential structures follow the sales or market comparison approach.

### C. Correlation of Market Value

1. Cost. The cost approach has several major weaknesses. An accurate valuation of the land as if it were unimproved is difficult at best. It is also very difficult to estimate depreciation, particularly on older structures. But the cost approach provides a reliable estimate of value for newly-built houses, since little or no adjustment is needed for depreciation. The Cost Approach is the principal approach used to determine the value of improvements in new construction and unique structures, such as public holdings (libraries, museums, etc.).
2. Market. The market data approach is the one appraisers rely on most heavily for single-family dwellings. But here is at least one serious drawback: locating enough comparable homes that have sold in the recent past. Lenders ordinarily rely on sales that are not older than six months, are as comparable to the subject property as possible, and are as near to the subject property as possible. Deviations from these basic criterion may be accepted, subject to an explanation and justification by the appraiser.
3. Income. The use of the income approach to single-family residences is used sparingly, and is done chiefly as a check against the other two approaches to value.
  - a. An important drawback is that usually there are not enough rentals of similar homes in the neighborhood to arrive at a valid GRM. In such cases, most appraisers will ignore using it altogether.
4. Judgment. The final determination as to which approach is best depends upon the type of property, and the skilled judgment of the appraiser. Correlation or reconciliation is not the averaging of the three approaches. An experienced appraiser, for example, would not rely on the market data approach in appraising apartment buildings, since there would be few if any similar structures in the area that sold, say, within the past year. Rather, the appraiser would place most emphasis on the income

approach, unless the building was just constructed. In this instance, the cost approach might be the most valid.

5. In the final analysis, the reconciliation process employed by the appraiser will determine the most relevant approach that most accurately reflects the value that the appraiser is seeking.

## VII. CONDOMINIUMS, TOWNHOMES, AND PLANNED (UNIT) DEVELOPMENTS

- A. Condominiums and planned developments are not types of structures, but types of ownership. A townhouse, on the other hand, refers to its architectural, and structural form, rather than an ownership interest. Typical townhomes include attached or row housing.
- B. Definition: A CONDOMINIUM consists of an undivided interest in common in a portion of real property coupled with a separate interest in space called a unit, the boundaries of which are described on a recorded map, parcel map, or condominium plan in sufficient detail to locate all boundaries thereof. The interior of a unit is not only occupied by the owner, but owned in severalty to the exclusion of all others. The owner also receives an undivided interest in the common areas, including hallways, elevators, heating system, roof, grounds, and recreational facilities. In effect, the owner of a condominium unit owns the air space within the cubicle occupied. Beyond the inside walls, common ownership exists.
- C. Definition: A PD or PLANNED DEVELOPMENT consists of parcels owned separately and lots or areas in common and reserved for the use of some or all of the individual lot owners. Generally, an owner's association provides management, maintenance, and control of the common areas and has the power to levy assessments and enforce obligations which attach to the individual lots. Unlike condominiums, planned developments involved maximum individual ownership coupled with some common ownership. Typically, an owner in a planned development owns the land and the structure that it is on while an area or other areas outside of his or her property is owned in common with others.
- D. A PD could be a group of single-family homes if there is joint ownership of common areas. In a PD, no one resides in the "air space" above or below another. In short, PDs may be either separate units (Single Family Dwellings) or joined townhouse units.

E. Checklist. Lenders appraising condos and PDs are naturally interested in more than just the one unit for which there is a loan request. The total project is important because the value of a single unit is affected by the quality and operation of the entire project. Lenders are also interested in the sales activity surrounding the condo or PD project. When appraising a project, lenders check for the following additional items:

1. General appearance of the project.
2. Recreational facilities: adequate and well maintained?
3. Adequate parking for owners and guests?
4. Maintenance of common areas.
5. Amount of association dues assessed to each unit owner.
6. Provision for reserves for repairs and replacements.

### VIII. WHAT ROLES DO ENVIRONMENTAL FACTORS PLAY IN APPRAISING A PROPERTY?

A. Due to an increased awareness of environmental issues that may affect property, a special area of appraisal investigation has emerged, which affects and also protects owners, purchasers, renters, lenders, and builders.

#### B. Appraisers' Role

Appraisers are expected to give thought to the effects of environmental factors on the value of a property. These factors may be external to the property in the form of obsolescence such as polluted soil or groundwater from offsite impacting the subject property, or within the property itself, such as lead-based paint, formaldehyde, asbestos or radon gas contamination. If an appraiser suspects contamination of any kind they need to red flag the condition so that the lender may evaluate any risk it may be undertaking by making a loan on the subject property. This is an integral part of the process of qualifying the property.

#### C. Lenders Role

The lender may call for a Phase 1 environmental assessment, which consists primarily of a search of the prior land use records for evidence of potential contamination, if suspicious information is uncovered, the lender may call for a Phase II evaluation, which includes soil and groundwater sampling under controlled conditions.

D. Environmental Assessment

A lender may reject a loan for no other reason than the environmental condition of the site. It is likely that a property-owner would opt to walk away from a property that has become an environmental liability, leaving the cost of clean-up, which can often exceed the value of the property, to the lender. Such an undertaking should be performed by one who is specially trained in Environmental Assessments.

E. The Federal Residential Lead-Based Paint Hazard Reduction Act.

California has enacted a lead-based paint disclosure requirement that brings the state into compliance with the federal Residential Lead-Based Paint Hazard Reduction Act of 1992, referred to as "Title X". Under that law, all buyers or tenants of a pre-1978 home or housing unit must receive an informational pamphlet and a warning about lead-based paint hazards. Real estate agents, loan agents, buyers and sellers must all be aware of the potential for lead poisoning, especially to children, that may exist in pre-1978 homes, and ensure that the required disclosures are made to all parties. Appraisers will likely be paying more attention to this problem area in all affected homes, estimated to number over 50 million throughout the United States. A HUD study estimates that some 3.8 million are a priority-hazard" because the homes shelter children and the paint is deteriorating or peeling.

F. Earthquake and flood hazards.

1. Insurance is offered by private companies in concert with the federal government, providing coverage to property owners from negative effects caused by flood or tidal wave conditions.
2. Primary as well as secondary lending institutions regulated by the federal government require flood insurance on any financed property that fails within certain designated flood-prone areas as identified by the Federal Emergency Management Agency (FEMA)
3. The appraiser should indicate through site analysis as whether a particular site fails within earthquake or flood zones. If the property is in a flood hazard area as indicated by a FEMA map, the flood zone map number, zone code, and date of the map may be required for completion of the URAR.
4. Geologic and seismic-fault maps are produced by the national and state topographic and geologic agencies. Places where these maps can be viewed are at city and county engineering offices. Site drainage can play a significant role in the use of any particular site.

G. For more information on the subject of environmental concerns, consult the Internet at [www.epa.gov](http://www.epa.gov).

## IX. WORKING WITH APPRAISERS

Virtually every licensee will come into contact with appraisers. It is important then to know some “do’s” and “do-nots” in dealing with appraisers.

### A. Access

Be considerate of appraisers’ time and make it convenient for them to see the property.

### B. At the property.

Following the appraiser around or talking constantly about all of the good features of the property is distracting. Allow the appraiser to ask questions if he or she desires.

### C. Comparable sales.

If you have information on comparable houses that you have sold, the appraiser will appreciate data that will assist in the appraisal. Furnish complete information, however, including addresses, dates of sale, number of bedrooms and bathrooms, square footage, age of structure, etc.

### D. Influencing the appraiser.

Don’t try to influence the appraiser by a lot of sales talk. Most appraisers can differentiate between fact and fiction. Appraisers must be completely objective. If they are intimidated or harassed by an overly aggressive individual, it may cloud their outlook on the property.