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ABSTRACT

APPRAISAL PRACTICES AMONG MORTGAGE LENDERS IN THE LANSING AREA

by Terrell R. Oetzel

This study was undertaken to obtain information concerning the appraisal practices of lending institutions. It included a comparison of the current appraisal practices of these institutions with the appraisal process recommended by the American Institute of Real Estate Appraisers, a national society of professional appraisers.

From the information collected, the institutions were ranked with respect to how closely they followed the suggested ideal appraisal procedure. On this basis, the ranking was (1) insurance companies, (2) mortgage companies, (3) savings and loan associations, (4) commercial banks. Other institutions such as Federal Land Banks, Farmers Home Administration, Federal Housing Administration and the Veterans Administration were not included in the rankings because their organizations are quite different and rather specialized. However, the appraisal forms used by these other agencies were rather complete.

The study attempted to provide some insight into the question of how much an institution could pay from an economic standpoint for a complete appraisal and how complete an appraisal they could justify. To provide a definitive answer to these questions requires data concerning delinquencies,

foreclosures, numbers of loans made, present appraisal costs per loan, costs per loan for complete appraisals, and the expected losses with complete appraisals. Many of these data proved to be impossible to obtain. Only the numbers of loans and costs of present appraisals were obtained from the questionnaires and from the financial statements of various institutions.

If the needed information were available, the following relationship could be used to analyze the economics of improved appraisal procedures:

$$(C_a - C_p)N \text{ compared with } F_p R_p - F_a R_a$$

where

C is the cost of appraisal

N is the number of appraisals per year

F is the number of foreclosures

R is average rate of loss in dollars on foreclosures

p refers to present appraisal procedures

a refers to improved appraisal procedures

By comparing the costs of improved appraisals with the savings through reduced foreclosures or through lower average losses as above, a lending institution could determine whether it would pay to improve its appraisal procedures. It was not possible to make such a comparison by type of lending institution because data were unavailable.

The thesis contains a detailed description of the appraisal practices now being followed by the lending institutions in the area as well as some suggestions for improvement in appraisal procedure.

APPRAISAL PRACTICES AMONG MORTGAGE LENDERS
IN THE LANSING AREA

By

Terrell Ray Oetzel

A THESIS

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To my wife Beverly, thanks are extended for the typing of this thesis.

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CHAPTER I

INTRODUCTION

Financing real estate through mortgages is an expanding business in the United States. Almost sixty percent of the homes are financed by mortgage loans, and home mortgages under the National Housing Act, June 1934¹, must be appraised. The National Housing Act established the Federal Housing Administration.

At the end of September 1963 the real estate mortgage debt outstanding in the United States was \$273.3 billion for all holders, with commercial banks holding eighteen percent, mutual banks holding seventeen percent, insurance companies holding twenty-five percent, and savings and loans holding forty percent of the debt. The mortgage debt outstanding increased \$35.5 billion from 1945 to the end of September 1963.¹ Consistently about ninety-two percent of the mortgage debt has been secured by non-farm real estate and the other eight percent by farm real estate. Financial institutions hold close to seventy-seven percent of the total debt while other agencies² hold four percent and individuals

¹Federal Reserve Board Bulletin, February 1964, p. 215.

²Other Agencies: Federal National Mortgage Association, Federal Housing Administration, Veterans Administration, Public Housing Administration, Farmers Home Administration, and Federal Land Bank.

hold the remaining nineteen percent.³

The above statistics give some idea of the magnitude of real estate mortgage lending in the United States.

Demand for appraisals of market value in connection with financing have three functions: (1) to arrive at the value of the security offered for the proposed mortgage loan; (2) to provide an investor with a sound basis for deciding whether to purchase real estate mortgages or bonds, that is whether value is in line with asking or bidding price, and (3) to establish a basis for decision regarding the insuring or underwriting of a loan on real estate property.⁴ This study is concerned with functions one and three. All types of real estate property used for security will be considered. Common types of security include: residential homes, commercial, industrial, institutions, and farms.

Installment type mortgage loans have typical repayment schedules of from five to over thirty years and even more in some cases. For this reason a complete knowledge of the security is needed since it is desirable that the market value of the property always be greater than the outstanding mortgage debt. A complete appraisal of property should include both present market value and consideration of future market value of the security. Mortgage foreclosures are undesirable for both mortgagee and mortgagor. Complete, professional appraisals are one means of reducing foreclosures.

³Federal Reserve Board Bulletin, op. cit. p. 215.

⁴American Institute of Real Estate Appraisers, The Appraisal of Real Estate, 3rd ed., prepared by a special technical committee of the Education Committee (Chicago, Ill.: December 1962), p. 6.

Because of the expanding mortgage loans and the lack of information concerning appraisal practices of mortgage lenders, this study was conducted. For most families and businessmen the purchase of a home, business establishment, or farm is the most expensive item that is purchased in their lifetime. Each of these needs to be thoroughly examined, by means of appraisals, to protect the borrower and also the person or persons lending the money.

Objectives

This project is proposed to critically evaluate the appraisal procedures presently being used by mortgage lenders. The specific objectives are: (1) to describe appraisal procedures of mortgage lenders in the Lansing area; (2) to analyze the lending procedures in the light of practices set up by the American Institute of Real Estate Appraisers; and (3) to make suggestions for changes or improvements in appraisal practices by mortgage lenders in the Lansing area.

Procedures

To obtain information needed for this study a questionnaire was sent to all mortgage lenders in the Lansing area. Private lenders were not considered because little information is available concerning their lending activities and it would be virtually impossible to collect enough information to draw meaningful conclusions. The first part of the questionnaire (see Appendix A) was designed to obtain information concerning loan policies, including type of loans, percentage of loan to value ratio, and types of property mortgaged. The remainder of the

questionnaire considered appraisal procedures being carried on by the different lending institutions and firms. Information requested included appraiser's qualifications, checks on accuracy of appraisals, cost of the mortgage loan to the mortgagor and mortgagee, appraisal procedures for different types of property, items reflected in the appraisal, and some additional questions for those making farm loans.

While designing the questionnaire, a list of the mortgage lenders in the area was compiled. The major source proved to be the yellow pages of the telephone directory. Thirty-one different lending institutions and firms were included in the study. This total included three savings and loan associations, seven insurance companies, ten mortgage companies, seven banks, and four other institutions.⁵ On February 24, 1964, twenty-five questionnaires were sent out. No questionnaires were sent to other institutions at first, because it was felt that the questionnaire was not designed for them. One week later a reminder letter (see Appendix B) was sent to those who had not returned the questionnaire. On March 6, 1964, in order to get some response from "other institutions," the questionnaire was sent to these institutions. This fact was noted in a footnote to the agencies. They were asked for any additional information they had in this subject area. Thirty-one questionnaires were sent and twenty-eight were returned.

⁵Other institutions include: Federal Housing Administration, Veterans Administration, Federal Land Bank, and Farmers Home Administration.

Previous Work

A search for previous work on this subject was unsuccessful. A similar project is presently being conducted at the University of Wisconsin by a graduate student working with Professor R. U. Ratcliff. One article, written by a mortgage lending officer of a bank, appeared in the January 1960 issue of The Appraisal Journal.⁶ This article discusses the job of the loan officer, the appraiser, and various other aspects of mortgage lending.

Organization of the Study

Chapter II presents background information which will be helpful for a more complete understanding of this study. Also, terms used throughout the study are defined. The final section of Chapter II presents the appraisal process as recommended by the American Institute of Real Estate Appraisers. A diagram of this process appears in Appendix C.

Chapter III relates the data and information received from the institutions and firms in the Lansing area concerning their lending procedures. Chapter IV analyzes the appraisal procedures of the mortgage lenders in comparison to the appraisal process presented in Chapter II.

Information concerning foreclosure and delinquency data of lending institutions and firms is presented in Chapter V. In this chapter reasons

⁶American Institute of Real Estate Appraisers, The Appraisal Journal, Vol. 28, No. 1 (Chicago, Ill.: January 1960), (Published Quarterly), p. 69.

for some of the foreclosures and delinquencies are discussed.

The final chapter presents a summary and some recommendations for improvement of the appraisal procedures of lenders in the Lansing area.

CHAPTER II

BACKGROUND INFORMATION

The following items will be discussed in this chapter to give the reader a better understanding of mortgage lending: risk and uncertainty, review of the federal government's start in mortgage lending, discussion of a mortgage, discussion of the job performed by the loan officer and the appraiser, definition of terms, and the appraisal process recommended by the American Institute of Real Estate Appraisers.

Risk and Uncertainty

Every mortgage loan incurs a certain amount of risk and uncertainty. Risk refers to variability of outcomes which are measurable in an empirical or quantitative manner.¹ Risk is insurable in an actuarial sense. Uncertainty refers to future events in which the probability of the event cannot be determined empirically. Uncertainty cannot be insured. An example of a risk situation is the expected life of the borrower. This risk can be insured by mortgage insurance on the borrower. This is usually a decreasing term life insurance policy taken out on the life of the borrower effective during the term of the mortgage. If the borrower dies before the debt is paid, the insurance will cover the remaining debt.

¹Earl O. Heady, Economics of Agricultural Production and Resource Use (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., June 1957), p. 440.

Other items of risk that are insurable are fire, wind, and other natural hazards. All of these can be insured against, because their frequency can be measured empirically.

An example of uncertainty is the future value of real estate. Will the price increase, decrease, or remain the same? Another item is the ability of the borrower to withstand risk and uncertainty. Does he have job security? Is he insured against injury and loss of income so that he could continue to make mortgage debt repayment in spite of setbacks? Appraisals are made in order to estimate the value of this real estate. Appraisals can also help to reflect the stability of real estate throughout the term of the debt.

Real Estate Mortgage

A mortgage is a conveyance of real estate given as security for the payment of a debt. Real estate mortgages are distinctive. Real estate remains unchanged in character, except for erosion, and the mortgage extends for a given time. Also mortgages must be recorded and have priority as to date of record. Each piece of property has a certain location and is described by a legal description. An abstract, a brief summary of all conveyances on a given property, helps to determine the legal owner of the property the mortgage covers. Rights such as easements, right-of-ways, and other attachments and their owners will be revealed by an abstract.

The buyer should be aware of the legal responsibility when a property is bought with a mortgage. A property bought "subject to the

mortgage" means that the buyer does not agree to pay the mortgage. If the seller fails to pay off the mortgage, the lender may foreclose, and the property in due course will be sold at a foreclosure sale.² Buying property "assuming the mortgage" means that the buyer in effect is endorsing the original mortgage note and, hence, is liable up to the limit of his property. Thus, the buyer's property could be sold to settle any debt not covered by the real estate mortgaged.

The Job of the Loan Officer and the Appraiser

An appraiser is one who estimates value; specifically one who possesses the necessary qualifications, ability, and experience to execute or direct the appraisal of real or personal property.³ When an appraiser is doing an appraisal for mortgage lending purposes he must know the purpose of the appraisal, but he should not be informed as to the amount requested or the terms of the loan. The appraiser's duty is to estimate the market value of the property in relation to the economic conditions at the time of the appraisal. The maximum amount of money loaned is based on the appraiser's opinion of value under the given economic conditions at the time. Thus, the ability of the property to serve as security on the loan depends upon the soundness of the appraisal. This is another reason for each loan to be accompanied by a complete appraisal report of the subject property taking into

²William G. Murry, Agricultural Finance (The Iowa State Press 1960), p. 192.

³American Institute of Real Estate Appraisers, Appraisal Terminology and Handbook (4th ed., 1962), p. 12.

consideration all the facts concerning the property and following the appraisal procedures set up in a later section.

The role of the appraiser was described above with respect to the appraisal of property for the purpose of lending money. The role of the loan officer is another distinctly different job. The appraiser and the loan officer should be two different persons. The amount of loan and terms of the repayment plan are decisions made by the loan officer. The credit of the borrower, his resources, future earning capacity, integrity, life expectancy, and the relation of the debt to his financial ability to repay are of no concern to the appraiser.⁴ Yet, the loan officer must concern himself with these.

Definition of Terms

Some terms such as market value, appraisal and others will be used throughout this thesis. These terms are defined as follows:

Market Value is the highest price which a property will bring, if exposed for sale in the open market allowing reasonable time to find a purchaser, who buys with knowledge of all uses to which it is adapted, and for which it is capable of being used.⁵

Appraisal is an estimate of value in monetary terms.

Mortgage is a conveyance of land given as security for the

⁴Percy E. Wagner, "Appraising and Mortgage Lending," The Appraisal Journal (January 1960), p. 73.

⁵American Institute of Real Estate Appraisers, Op. Cit., p. 121.

payment of a debt.⁶

First Mortgage is the first conveyance given as security and the holder is entitled to first payment, if the property is sold because of default of the mortgagor.

Fee Simple Owner holds exclusive right in a piece of land limited only by the overall interest of society administered by the state.⁷

Staff Appraiser is an appraiser who works for one firm, is paid only by that firm, and is considered an employee of the firm.

Fee Appraiser is an appraiser who is employed by different firms for a certain appraisal, is not an employee of that firm, and considers himself a free agent.

Mortgagor is the person giving the mortgage, for example, an individual borrowing money from the bank.

Mortgagee is the person or firm receiving the mortgage, for example, an individual or firm who holds the mortgage and lends the money.

The Appraisal Process

The following is the procedure suggested for professional appraisers by the American Institute of Real Estate Appraisers. This procedure will be used to compare, contrast, and analyze the methods followed by the lending institutions or firms in the Lansing area. An

⁶Robert H. Pease and Homer V. Cherrington, Mortgage Banking (McGraw-Hill Book Co.,: New York 1953).

⁷Raleigh Barlowe, Land Resource Economies (Prentice Hall: Englewood Cliffs, New Jersey 1958).

illustrated appraisal process is listed in the appendix.

Definition of the Problem

The first step is to define the problem. There are five steps: (1) identify the property; (2) specify the right involved; (3) state the purpose of the appraisal and its function; (4) ascertain the date as of which the estimate is desired; (5) define the value to be estimated.⁸ These five steps, as explained below, help to set the form, set the limitations, and explain the necessary rights and purposes needed in every appraisal report. These five steps are defined by the person desiring the appraisal through a letter of authorization to make the appraisal. The legal description of the property is usually given to the appraiser but it is his job to check the description. If necessary, he will call in a surveyor to check. Another item that must be defined and checked is how the rights are distributed. A fee simple right means that the owner owns all rights to the property not owned by the public domain. Several rights may be owned by a number of individuals and those which are to be appraised must be known by the appraiser and described in his report. Purpose and function of the appraisal is important to the appraiser so that he knows the type of data needed, type of report needed, and method which he will use to arrive at the market value. In all cases though, he will arrive at the market value of the subject property. Because value fluctuates, the date of the appraisal is important. The

⁸ Appraisal of Real Estate, op. cit., p. 50.

value sought in an appraisal is market value but sometimes special circumstances are to be considered; thus, definition of value is needed.

Preliminary Survey and the Appraisal Plan

The preliminary survey is designed to look at the appraisal problem at hand and determine the material needed to complete the appraisal and how to present the report. Also the appraiser will determine the highest and best use of the property. Highest and best use is defined as that use which at the time of appraisal, is most likely to produce the greatest net return to the land/or buildings over a given period of time.⁹ Finally the appraiser will select the dominant approach to use: either income, cost of replacement or market data approach. These approaches will be discussed later in this section.

Data Program

Now that a plan has been outlined the appraiser will begin to obtain data necessary to carry out his planned procedure. An appraisal report requires two types of data, general and specific. General data include facts about the region, city and neighborhood in which the subject property is located. This section includes data which will help support the purpose of the appraisal. For example, when doing an appraisal for mortgage loans the stability or instability of the neighborhood is significant because the prospective lender is concerned not only with present worth but with the stability of the value during the period of the mortgage. In other words, this section will include all information

⁹Appraisal of Real Estate, op. cit., p. 35.

outside the property which affects the value of the property. Specific data describe the subject property. This includes owner, type of ownership (warranty deed or other), easements, zoning, assessed value, taxes, legal description, and description of all improvements on the property. Also, data are needed concerning all the utilities serving this property.

Data Classification and Analysis in the Three Approaches

The three approaches to value are the cost, income, and market data. The cost approach considers the cost of construction of the improvement less functional, economic, and deterioration depreciation, to arrive at the market value of the property. The three types of depreciation are defined as: (1) functional - lack of desirability in terms of layout, style, and design as compared with that of a new property serving the same function; (2) economic - loss of value from causes outside the property itself; (3) deterioration - the physical wearing out of the property. Briefly, the appraiser estimates: (1) the value of the land as if it were vacant, by using recent market sales, (2) the cost of reproducing the existing improvements, (3) the deduction for depreciation from all causes. These three figures are used to arrive at the market value of the improvement and land.

All of the approaches are not used in every appraisal. But the market data approach is used in all appraisals. This approach consists of obtaining recent sales of properties similar to the property that is being appraised. After the recent sales have been confirmed by talking with someone who is familiar with the sale, each of the sales is compared to the subject property to arrive at the market value of the subject property.

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The market data approach is not perfect because no two properties are exactly alike, but this approach does work by adjusting each recent sale to the subject property. The appraiser relies upon sound judgment and experience to make these adjustments. Because these adjustments are subjective, one or both of the other approaches is desirable as a check against the market approach to arrive at the best estimate of market value.

The income approach can only be used on those properties from which an income may be derived. Residential dwellings, except rentals, usually have no way of producing net income and for this reason only the market and cost approaches are used on residential homes. The income approach includes first estimating the gross income of the property from either rents, in the case of apartment or office buildings, or from gross sales. From the gross income all expenses such as taxes, maintenance, depreciation, and repairs are subtracted. The final figure is called the net income derived from the subject property. The net income figure is then capitalized. The capitalization rate may be found by several means. One way of obtaining this figure is to find the capitalization rate used in the market. This is done by figuring backwards. Take the recent sales, find their net income, and from these two figures it is possible to find the capitalization rate. Another method is to simply use the long term interest rate used by banks and insurance companies in the area. A third method is to use a rate that represents what investors would like to receive in the way of return on their investment. All three ways are somewhat subjective and, when using large figures, one-half percent can make a big difference in the final market value.

Correlation of Value Indications and Final Estimate

The purpose of the correlation is to develop the three value estimates into a final conclusion of value.¹⁰ The relative importance of the approach used in a given appraisal and the reason for the weight accorded to each estimate are discussed. Final value should be shown by sound logical reasoning that leads to the final conclusion. Final estimate should bear in mind the definition of value previously presented and the purpose and function of the report. In correlating the three value estimates (two in the case of residential property), averages of the value from each should not be used, but rather, sound judgment as to which estimate is nearer to the actual market value of the subject property.

Finally, every appraisal should have an appendix of exhibits consisting of photographs of the subject property, of the street or area showing the characteristics of the surroundings, and of the comparables used in the appraisal. Maps showing the location of the subject property, floor plans of the improvements, and any other material which would be helpful in assisting the reader to visualize the property or to better understand the appraisal presentation should also appear in the appendix.

The above description of the appraisal process applies to appraisals for lending purposes, sale of property or for any purpose an appraisal is needed. The objective of an appraisal is to arrive at present market value of property. Following this line of thinking, then all three

¹⁰ American Institute of Real Estate Appraisers, American Institute of Real Estate Appraisers, Candidate's Manual (Chicago, Ill.: As amended June 1, 1962).

approaches, where appropriate, should be used to arrive at market value whether the appraisal is for lending or any other purpose. The same procedures should be followed for each appraisal no matter what its purpose.

CHAPTER III

DESCRIPTION OF MORTGAGE LENDING OPERATIONS IN THE LANSING AREA

This chapter relates information received from lending institutions and firms concerning their mortgage lending practices. Information pertaining to their appraisal procedures is discussed primarily in the following chapter. Information of concern in this section includes: loan information, type and qualification of appraiser used by the institutions, loan to value ratios, and cost of loan information. Each institution or firm is discussed separately.

Mortgage Companies

A mortgage company, like most businesses, is in business to make a profit. A mortgage company generally uses other people's money, such as insurance companies, banks, or private individuals. It is the job of the mortgage company to find persons who desire to borrow money and bring them together with persons or institutions who wish to lend money. The mortgage companies make money through finders fees paid by the lender for the mortgage company's assistance in lending the money. Of course, a mortgage company may loan some of its own money, but generally it operates as above.

Ten questionnaires were sent to mortgage companies, seven were returned.

Loan Information

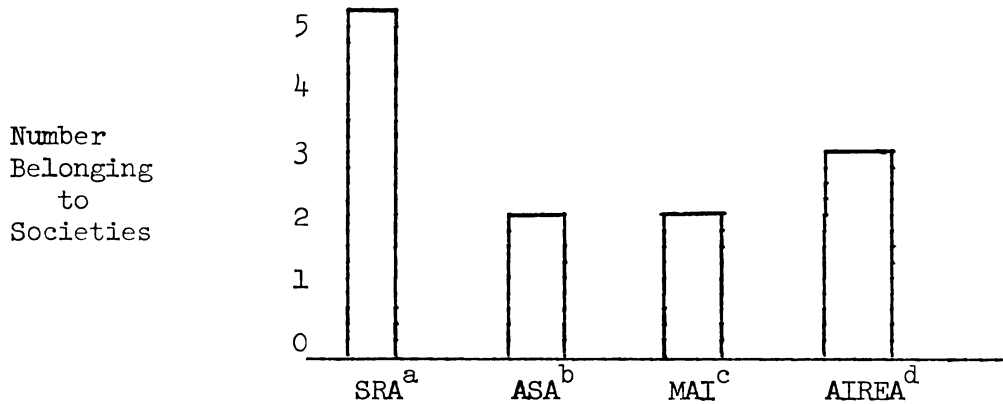
The mortgage companies loan money on many different types of property: commercial, institutional, industrial, farm (although very few), apartments and other types of income property, and residential. Five of the seven companies make conventional, FHA, and VA loans, and the remaining two companies make only conventional loans. Most emphasis is on residential and commercial loans. Two of the companies make farm loans, but in each case farm loans amounted to less than twelve percent of the total loan volume. Final approval of each loan is made by a loan committee consisting of the officers of the company.

Type and Qualification of the Appraisers

Each of the companies use their own staff appraisers on residential appraisals. Fee appraisers are hired to appraise commercial and other income properties. The appraisers, staff and fee, except in one case, belong to at least two well known professional societies. In three of the companies, the appraisers are required to belong to a professional society.

Professional appraisal societies are formed to keep their members up-to-date on the latest events in their profession, to discuss current problems in the appraisal field, and thus, attempt to help each member to become a better appraiser. The mortgage company appraisers belong to more societies than other lending agency appraisers. Mortgage companies are the only group that require membership in a professional society. This reflects a desire on the part of mortgage companies to obtain a very high degree of competence in their appraisers.

Figure 3.1 Professional societies and number of firms with appraisers belonging to the societies.



- (a) Society of Residential Appraisers
- (b) American Society of Appraisers
- (c) Member of the Appraisal Institute
- (d) American Institute of Real Estate Appraisers

Economic Information

Table 3.1 shows the loan to value ratio and cost of the mortgage to the borrower. The loan to value ratio is the amount of money an institution or firm will loan to the borrower in relation to the appraised value of the property. The mortgage companies are evidently loaning near the maximum amount on all types of loans.

Only three companies listed costs of the mortgage to the borrower. The others simply checked items that were charged to the borrower. The average cost of all the companies reporting was \$84 plus \$3.00 per \$1,000 of the loan for insurance. One company made an additional charge of \$2.50 per entry for the abstracting. The cost is paid by the borrower at the time of loan approval. The cost includes charges for the appraisal, insurance, recording fees, attorney fee, credit rating check, tax history, abstracting and additional fees for VA and FHA insured loans.

Table 3.1 Maximum and estimated loan to value ratio and borrower's mortgage costs on conventional, FHA, and VA loans by mortgage companies in the Lansing area.

Type of Loan	Maximum Loan to Value Ratio		Estimated Loan to Value Ratio		Cost of Mortgage to the borrower ^b		
	Mean	Mode	Mean	Mode	Low	Avg.	High
Conventional	77.2%	75.0%	72.2%	75.2%	\$68	\$84	\$112
FHA	97.0% ^a	97.0% ^a	96.7%	97.0%	\$68 ^d	\$84 ^d	\$112 ^d
VA	100.0% ^c	100.0% ^c	96.7%	100.0%	\$68 ^d	\$84 ^d	\$112 ^d

^aMaximum for first \$15,000 of appraised value.

^bDoes not include title insurance which costs \$3.00/\$1,000 of the loan.

^cMaximum of \$15,000 property.

^dIn addition, 1 percent of the mortgage note is usually charged as a processing fee.

Farm Loans

The two mortgage companies that made farm loans required some additional information on the farm appraisals. The additional material included soil maps, site data and more photographs. While they did not indicate the maximum loan to value ratio for farm property, they did indicate it was lower than for residential.

Insurance Companies

Insurance companies accumulate large sums of money from policyholders. Some of this money may be used by the mortgage loan department of the insurance companies to loan on real estate. Some insurance companies have their own staff appraiser and loan officer to make loans.

Other insurance companies work through mortgage companies to find people to whom they loan their money. The insurance companies surveyed in this study loan money through their own loan department.

Six questionnaires of seven sent were received from the insurance companies. Three of these questionnaires were from the same insurance company but from different divisions. The three divisions are: commercial, farm, and residential. The three were counted as three different questionnaire replies.

Loan Information

All of the insurance companies make either regular or insured conventional loans. Only one insurance company makes FHA or VA loans and the total is only ten percent of the total loans made. The insurance companies make all types of loans: farm, commercial, residential, industrial, and land development. All loans before approval require an appraisal by a field appraiser. Final approval of the loan is confirmed by a regional or home office. Periodical checks of the property are conducted by the field appraiser or by representatives from regional or home offices from time to time to inspect the property.

Type and Qualification of the Appraisers

All of the companies have staff appraisers making their appraisals. The appraisers of four of the six companies belong to one or more societies, and one company requires its appraisers to belong to a professional society. The companies all require an appraisal report by their appraisers for all mortgage loans.

Economic Information

Table 3.2 shows the loan to value ratio and cost of the mortgage to the borrower for insurance company loans.

Table 3.2 Maximum and estimated loan to value ratio and borrower's mortgage costs on conventional, FHA, and VA loans by insurance companies in the Lansing area.

Type of Loan	Maximum Loan to Value Ratio		Estimated Loan to Value Ratio		Cost of Mortgage to the Borrower	
	Mean	Mode	Mean	Mode	Low	Avg.
Conventional	66.0%	66.7% &75.0%	62.0%	70.0%	--	\$137(plus \$3 per \$1,000 for title insurance)
FHA	97.0% ^a	97.0% ^a	97.0%	97.0%	--	\$137
VA	100.0% ^b	100.0% ^b	100.0%	100.0%	--	\$137 ^c

^aMaximum for first \$15,000 of appraised value.

^bMaximum of \$15,000 property.

^cDoes not include the \$3.00 per \$1,000 for title insurance or the 1 percent of the mortgage note which is charged as a processing fee.

The figures for FHA and VA refer to only one company because only one company made any of these insured loans. For conventional loans the companies tend to loan near the maximum.

The cost to the borrower for a mortgage with the insurance companies varied from only recording and attorney fees to \$137.00 plus \$3.00 per \$1,000 property cost for title insurance. Two of the companies listing costs did not require the borrower to pay the appraisal fee, but assumed the cost themselves. It is hard to take an average for the group because

only two of the institutions gave cost figures. The others indicated that there were costs for items such as recording fees, attorney fees, credit reports, tax history, plus abstracting or abstracting plus attorney fees, but they did not specify the actual costs.

Farm Loans

Four of the insurance companies make farm loans. Two companies deal only in farm mortgages. For the other two, farm loans are less than ten percent of their total loan volume. Two of the companies require more complete appraisal reports than for residential appraisals in their farm and commercial loans. Two of the companies do not loan as high a proportion of value on residential loans as farm loans and one company does loan as high loan to value rates. The fourth company makes only farm loans.

Savings and Loan Associations

All three of the savings and loan associations returned completed questionnaires.

Loan Information

All of the savings and loan association loans are regular or insured conventional loans. Some conventional loans are insured by MGIC as explained later in this section. No FHA or VA loans are presently being made by the associations. This is because the associations have their own insurance plan and feel they do not need the insurance plans of the FHA and VA. One association has the policy of making open end mortgages as an optional feature of their conventional loans. An open end mortgage is a mortgage on which the amount of the debt can be increased after part

of the debt has been repaid. The vast majority of the loans made by the associations are for residential homes. One association makes a very small amount of commercial and farm loans. All loans undergo final approval by the board of directors or a committee appointed by the chairman of the board.

Type and Qualification of the Appraiser

All of the savings and loan associations have their own staff appraisers. In each case the appraiser belongs to one professional society. Membership in a professional society is not a requirement of this position.

Economic Information

Table 3.3 shows the loan to value ratio and cost of the mortgage to the borrower for savings and loan associations.

Mortgage Guarantee Insurance Corporation (MGIC), founded in 1956, is the largest private corporation in the United States insuring single family, owner occupied, non-farm homes. Ninety-five percent of MGIC's business is through 2,000 savings and loan associations in the United States. MGIC only insures the top twenty percent of the mortgage and only insures first mortgages. As could be expected there is a higher percentage loaned on the insured as opposed to the uninsured loans. Under both plans, the savings and loan associations appear to be loaning near the maximum amount.

All of the associations have closing costs charged to the borrower, but only two listed the actual cost. The range was from \$74.22 to \$79.50 plus two percent of mortgage debt for mortgage insurance. The mean cost of the two savings and loan associations reporting is \$76.86. Costs incurred by those having mortgage loans with savings and loan associations include

Table 3.3 Maximum and estimated loan to value ratio and borrower's mortgage costs on conventional, FHA, and VA loans by savings and loan associations.

Type of Loan	Maximum Loan to Value Ratio		Estimated Loan to Value Ratio		Cost of Mortgage to the Borrower		
	Mean	Mode	Mean	Mode	Low	Avg.	High
Conventional	75.0%	75.0%	70.0%	70.0%			
Regular							
MGIC	90.0%	90.0%	85.0%	85.0%	\$74.22	\$76.86	\$79.50 ^b
FHA ^a	-	-	-	-			
VA ^a	-	-	-	-			

^aNo FHA or VA loans are made by savings and loan associations in the Lansing area.

^bPlus two percent of the mortgage debt for insurance.

the following: appraisal report, insurance, recording fees, attorney fees, credit report, tax history and abstracting. In one case, costs are paid for by the association and in the other case it is not.

Banks

There are seven banks in the Lansing area to whom questionnaires were sent. Six of the banks returned completed questionnaires.

Loan Information

Only two banks deal with any loans other than conventional. One of these makes about one-half conventional and one-half FHA and VA loans. The other bank makes about ninety percent conventional and ten percent FHA. The other banks make first mortgage loans on real estate using regular

conventional loans. All of the banks loan money on residential and commercial properties. Five of the banks make a small percentage of farm loans. Residential loans receive most emphasis by five of the banks. The other banks loan on all types of property and do not emphasize one over the other. All loans are approved by a loan committee of the officers of the individual banks. The loan committee reviews the appraisals and decides whether to make the loan or not.

Type and Qualification of the Appraiser

Staff members and/or a committee of appraisers are used by five of the banks to do the appraisals. One bank uses a fee appraiser to complete the appraisals. The appraisers of four banks do not belong to any professional society or, at least, none were listed. The other two banks' appraisers each belong to one society. None of the banks require their appraisers to belong to any society.

Economic Information

Table 3.4 indicates the loan to value ratio and mortgage cost to the borrower for the banks.

In general, the banks were loaning about ten percent less than their maximum on conventional loans. The two banks that make FHA or VA loans did not list the maximum or estimated loan to value ratio they used on the insured loans. But according to federal regulations the maximum loan to value ratio for FHA is 97 percent on the first \$15,000 and for VA is 100 percent on homes of no higher value than \$15,000. (Other FHA restrictions are discussed in another section).

Table 3.4 Maximum and estimated loan to value ratio and borrower's mortgage costs on conventional, FHA, and VA loans for banks.

Type of Loan	Maximum Loan to Value Ratio		Estimated Loan to Value Ratio		Cost of Mortgage to the Borrower		
	Mean	Mode	Mean	Mode	Low	Avg.	High
Conventional	73.0%	75.0%	67.0%	66.7%	\$65	\$85.80	\$112
FHA	a	a	a	a			
VA	a	a	a	a			

^aNot sufficient data.

Four of the banks listed the cost incurred by the borrower when obtaining a mortgage. The others did not list the actual cost, but did indicate that a charge was incurred. Those not listing cost only checked the items that were charged to the borrower. For those who listed costs, the range was from \$65 to \$112. The mean cost to the borrower was \$85.50. Three of the banks did not itemize costs but gave a flat rate charged. The costs include: appraisal, recording fee, attorney fee, tax history, and abstracting. When indicated, the appraisal fee was less than the appraisal fee for the mortgage companies. This may indicate a less conclusive report is required by the banks.

Farm Loans

Five of the banks loan money on farms. The farm loans as a percentage of their loans varied from less than one percent to thirty percent. Two of the banks required a more extensive appraisal report for farm loans.

Two of the banks indicated they would loan a lower proportion of present value on farm loans than for residential loans. These banks do, however, loan as high a proportion of farm value as of commercial property value.

Federal Land Bank Associations

The Federal Land Bank is a farmer-owned organization which specializes in making farm real estate mortgage loans. The money used for lending is provided by the sale of Land Bank bonds and even though the Land Bank operates under federal charter no government funds are used at present.

Loan Information

The Federal Land Bank makes only conventional loans on farm real estate. Any person obtaining a mortgage loan from the Federal Land Bank has the option of taking out a decreasing term life insurance plan with the Minnesota Mutual Life Insurance Company. The loans generally run for ten to thirty years and in some cases are extended for a longer period. The Land Banks allow the borrower to make repayments to fit his particular income situation. Also the borrower may make extra payments without penalty or prepayment charges.

Type and Qualification of the Appraisers

The Federal Land Bank has its own staff appraisers who are not required to belong to any professional society. The appraisers submit their report to regional or home offices for final approval of the loan.

Economic Information

At present the maximum amount of the appraised market value the FLBA's are allowed to loan on a given property is about fifty percent. The typical amount loaned is about forty-five percent of the present market value.

The cost of the mortgage to the borrower is approximately \$10 for the recording and tax history plus the actual cost of the abstracting. The cost of abstracting is \$2.50 per entry. The other closing costs except for term life insurance are assumed by the Federal Land Bank Association.

The Federal Housing Administration

The Federal Housing Administration is not a lending institution. FHA only insures loans mortgaged by an approved FHA lender such as banks, insurance companies, mortgage companies, or savings and loan associations. There are two FHA home plans for mortgage insurance. Under section 203(b) FHA insures mortgages in amounts up to \$25,000 on individual homes. Under 203(i) FHA insures mortgages in amounts up to \$9,000 on homes in outlying areas and on farm homes.

The following are some of the FHA Loan requirements:¹

¹Housing and Home Finance Agency, Underwriting Manual, Underwriting Analysis under Title II (Sec. 203 of the National Housing Act), (Federal Housing Administration, Washington, D.C.: Revised April 1, 1958).

1. The mortgage must be a first mortgage on real estate which is primarily residential and involves a principal obligation not in excess of that prescribed by administration rules and regulations.
2. The mortgage must have a maturity satisfactory to the commissioners and it must contain complete amortization provisions requiring monthly payments by the mortgagor.
3. The mortgage must not bear interest rates in excess of those prescribed by the administrative rules and regulations.
4. The mortgage must be executed upon a form prescribed by FHA for use in the area in which the property is located.
5. The mortgage must have been made to and be held by a mortgagee approved by the commissioner.
6. Briefly other requirements:
 - a. Approved water and sewage systems.
 - b. Direct vehicular access to the property.
 - c. Each dwelling shall be provided with a means of access for removal of garbage and trash, and access for delivery of fuel.
 - d. Means of access to each living unit shall be provided without passing through any other living unit.
 - e. Other requirements are included to prevent slum type areas from receiving FHA loans.

Section 203(b) allows up to 97 percent of the appraised value on the first \$15,000 to be loaned. On the next \$5,000 ninety percent of the value may be loaned, and seventy-five percent of the value may be loaned on the

remaining \$5,000. The percentage to be loaned is figured from the market value of the property which an FHA appraiser estimates.

Section 203(i) mortgage is limited to not more than ninety-seven percent of appraised value or to not more than ninety percent, if the house was approved for mortgage insurance after construction started and within a year after it was completed.²

FHA requires certain minimum property standards which are higher for section 203(b) than 203(i). A buyer who finances a home under Section 203(b) must be prepared to pay the down payment, closing costs, and pre-paid items, in cash or the equivalent of cash. A buyer sixty-two years old or older may borrow the money for the down payment and initial charges from a person or corporation acceptable to FHA. Under Section 203(i), a buyer of any age can borrow the down payment, closing costs, and prepaid items from a person or corporation acceptable to FHA.³ Repayment is made by monthly installments over a term of from ten to thirty years.

Farmers Home Administration

The FHA is a government agency set up to help persons who are unable to obtain loans from other sources to get the loan through this federal agency.

²Office of Public Information, FHA Fact Sheet, FHA Home Mortgage Insurance, FHA No. 208 Revised January 1964, p. 5.

³Ibid., p. 5.

Loan Information

The FHA makes very few first mortgage loans on real estate. Most of the FHA loans are improvement loans, recreation loans on farms, and senior citizen housing loans in rural areas. Loans are recommended by a local committee of three farmers in each county and final approval is made by the state director of the FHA.

Type and Qualification of the Appraisers

Staff appraisers are used on all appraisals for loans made by the FHA. The FHA appraisers in the Lansing area belong to two professional societies but they are not required to belong to any professional society.

Economic Information

The maximum loan to value ratio for the conventional loans is seventy percent of present market value. Estimated loan to value ratio is fifty-five percent of the present market value. All loans require an appraisal report except rural housing improvement loans under \$1,500.

The actual costs incurred by the borrower for the mortgage loans were not given. It was indicated that the FHA assumes the cost of the appraisal, fire insurance, and the credit report. They expect the borrower to pay for the mortgage insurance, other insurance (wind, fire, etc.) if wanted, attorney fees, recording fees, tax history, and abstracting. It was noted that they do not loan as high a proportion of farm value as of rural residential property.

Veterans Administration

The Veterans Administration, like the Federal Housing Administration, makes no loans themselves. The VA guarantees loans through lending agencies who furnish the money and supporting papers for approval. About one percent of the loans are supplemental loans for improvements on direct loans where a VA holder has first mortgage on the property. The remaining are residential and farm single unit home loans.

Loan Information

The VA insures only residential and farm loans. Most of the loans are single residential units. Property which includes a business or more than one residential unit is not eligible for a direct loan. To be eligible for a VA loan the person must be a veteran with an honorable discharge from military service. Also the purchase price of the home or farm must not exceed a reasonable value, established by the appraisal section of the VA. Finally the veteran's income and credit rating must be favorable and in line with the loan requested.

Type and Qualifications of the Appraiser

The VA has no staff appraisers but hires fee appraisers to do the appraising. They use approximately 181 fee appraisers throughout the state of Michigan. A flat fee is paid by the VA for each appraisal. The VA does not require the appraiser to belong to any professional society.

Economic Information

The maximum amount of money obtainable through a VA loan is \$15,000. The average loan amounts to about \$10,000.

A VA loan costs the veteran about \$106 plus one percent of the loaned amount for origination charges. The above charges include appraisal report, attorney fees, mortgage discharge, deed to veteran, mortgage to the VA loaning agency, credit report, abstracting, and a survey.

CHAPTER IV

COMPARING INSTITUTIONAL APPRAISAL PRACTICES TO THE APPRAISAL PROCESS

This chapter compares the appraisal procedures now followed by the institutions to the appraisal process outlined by the American Institute of Real Estate Appraisers. Each institution is discussed separately. At the end of the section a summary table is presented.

Defining the problem as described in the appraisal process can be done by the use of a title page, description of the property, letter of transmittal, table of contents, assumptions and limiting conditions, and qualifications of the appraiser. This section, at the beginning of each report, describes the entire problem and makes the entire report easier to read and follow. Definition of value is included in each report so that the reader can better understand how value is defined and used in the report.

Mortgage Companies

Data Included in the Appraisal Report

Items such as identification of the property, purpose of the appraisal, property rights appraised, city data, and neighborhood data were generally

included in the appraisal reports required by the mortgage companies. One mortgage company indicated that the items required depended upon the lender for whom the loan is to be sold. This, of course, is not recommended appraisal procedure. Each appraisal report should have all of the items whether for residential homes, farms, or commercial.

The mortgage companies indicated that important items such as direction and distance to the central business district, the neighborhood and relation to the city's growth pattern, percentage of built-up, type of improvements, transportation, utilities provided, and general comments were all included as requirements for the appraisal.

The mortgage companies also require information on dimension and shape of the lot, area of the lot, topography, drainage, soil type, streets, and sketch of the property.

Zoning, assessment and taxes, and a detailed description of the improvements are all required by the mortgage companies. These are three important items necessary for every report. Zoning affects value, assessments and taxes affect future cost to the owner of the property, and of course, a detailed description of what is being appraised is absolutely necessary.

The mortgage companies appear to be using each of the three approaches to market value where appropriate. From the appraisal form and the questionnaires returned it appears that the cost approach is relied upon more heavily than the market sales approach. If this is true, the mortgage companies may need to consider putting more emphasis on the market approach. The market approach is important because the final determination of market value is the price a property sells for. The market is

also helpful in studying the future stability of the property throughout the term of the mortgage. The mortgage companies loaning on income property indicate that all three approaches are used.

Data Not Included in the Appraisal Report

The mortgage companies do not require a title page, a letter of transmittal, table of contents, assumptions and limiting conditions, and qualification of the appraiser. The author had an opportunity to review an appraisal report received by one of the mortgage companies by a fee appraiser. This report was complete in every respect. The information received from the mortgage companies indicates that for their staff appraisers, the above items were not required in the reports. The author surmizes that many of the reports are presented orally to the mortgage company representatives and that a formal report is not required by the staff appraisers. A complete appraisal should contain enough information so that the reader has to rely on no one or no material other than what is in the report for a complete understanding of the report.

A definition of the value as used in the reports was not included in the reports. Even though there is only one market value for a given piece of property at a given time, value for special functions is sometimes sought and whether it be one or more values each should be defined.

None of the appraisal forms or questionnaires indicated that a correlation of final value estimate was completed by the mortgage companies.

Insurance Companies

The nature of the mortgage lending procedures of the insurance companies should dictate complete appraisals. Field appraisers submit appraisals to regional or home offices. Each appraisal should be complete so that the reviewing appraiser can understand each appraisal completely. All of the questionnaires returned from the insurance companies showed fairly complete appraisals except one. This company has a four inch by six inch card for the appraisal form. A comment from the company that "experienced appraiser's opinion of value reflects all of the methods of valuation, but actual figures are not required" suggests questionable appraisal procedure.

Data Included in the Appraisal Report

All of the insurance companies, except the one mentioned above, required data pertaining to identifying the property, city data, neighborhood data and purpose of the appraisal. Also items that better describe the surroundings of the property such as distance to central business district, churches, schools and other data needed to describe the surroundings was included.

The insurance companies require information to describe the land and site data of the property. The one company described earlier did not require much of the information described above.

It appears that all three approaches are used where appropriate. This part of the appraisal report is of course, the basis of the estimated value and it is important that all the approaches are used. The companies

also indicated in each case that checks were made to see that the appraisal was done according to good appraisal procedures. A check by the home office was made on income property to make sure that its value and appearance is kept up during the term of the mortgage.

Data Not Included in the Appraisal Report

From the material received it appears that the appraisal reports do not have a title page, letter of transmittal, table of contents, or assumptions and limiting conditions. Also none of the reports require a definition of value as it is used in the appraisal report.

Items like the zoning of the subject property and complete description of the property are needed. None of the companies indicated that taxes, assessed valuation or highest and best use were wanted. These items are very important in the valuation and description of any property.

None of the companies indicated that the correlation of final estimate of value was followed at the end of the appraisal.

Savings and Loan Associations

Data Included in the Appraisal Report

Items such as identification of the property, purpose of the appraisal, neighborhood data, and city data are included in each of the association's appraisal reports. Land or site data are complete. Each association noted the facts about the site as to its distance from the central business district, schools and churches in the locality, and the utilities served by this site. Also a detailed description of the

site itself is done along with a complete description of the improvements. Items concerning the zoning, assessed valuation, and taxes are described in each appraisal report.

Each association relies mainly upon the cost approach to value on residential home appraisals.

Data Not Included in the Appraisal Report

The savings and loan associations returning the questionnaires indicated that the procedure followed by their appraisers is to present the appraisal facts orally to the loan committee who finally approves or disapproves the loans. This indicates that items such as the title page, letter of transmittal, table of contents, and assumptions and limiting conditions are not included in the appraisal reports.

For a complete understanding of the report, definition of value and property rights appraised need to be included. These two items were not included in the association's reports. Another item which affects value that is not in the report is highest and best use of the property. This item takes into account the possibility of the property being put to better use than its present use and should be considered by the appraiser in each appraisal report.

A very important item de-emphasized by the associations is the market sales value approach to market value. The American Institute of Real Estate Appraisers feels that neither the cost approach nor the market sales approach is complete in itself. For this reason the savings and loan associations could do a more thorough job of appraising each property,

if they would use the market approach as a check to the cost approach. The author realizes the problem of not having access to the Lansing Board of Realtors' files. But still, each savings and loan could develop their own comparable file with a little effort, especially with the numbers of homes they appraise. Market value approach is very important in that it shows the reaction of buyers and sellers in the real estate market. And, after all, if the property is sold because of foreclosure the buyers in the market are going to buy the house. If the market sales approach is also used, some idea of the future stability of the property throughout the term of the mortgage will be known. The market approach should probably be emphasized more by the savings and loan associations.

The correlation process of developing the two or three value estimates of course cannot be used by the savings and loan associations because of the emphasis placed on the cost approach. Thus, a final correlation of value estimate is not used. Being able to use checks in the final estimate of market value tends to make the appraisal more accurate.

Banks

Bank appraisal reports ranged from small reports of less than a full page to just over a page. Also the banks have fee appraisers, staff appraisers, and in one case the directors make the appraisals. The appraisals appear to be just brief statements with the person doing the appraisal giving an oral presentation to the loan committee who makes the final decision on the loan.

Data Included in the Appraisal Report

The banks require identification of the property and some city and neighborhood data. It appears, though, that not enough city and neighborhood data are required in the appraisal report. This information may be brought out in the oral presentation but should also be in writing so that it can be referred to at a later date, if someone wishes to review the appraisal.

Not much information is required showing how close the property is to the central business district, utilities serving the site, school and churches or other information that relates to the site. Also not much was mentioned about the shape of the site or other descriptive information about the land. Of the items mentioned above, most required information concerned improvement and site data.

The banks seem to use the market sale approach to estimate value. Some of the forms left no room for the cost approach or market sales approach but two of the forms indicated that the appraisal reflected current market value as nearly as possible. Three forms indicated they used the cost and market sales approach. The other two forms indicated that neither approach was followed and one of those said: "Our appraisals are made on the fair market cash value at the time of the appraisal." It is questionable whether the appraisal can reflect fair market value without using the cost or market sale approach???? From the information received in the study it appears that the estimated market value used by the banks is the appraiser's opinion only, and no supporting data are necessary.

Even though all appraisals, in the final analysis, are opinions, a well thoughtout appraisal, backed up with facts and figures in a complete form to show logical step by step formulation of final estimate of market value is needed. Apparently, the banks do not require this type of an appraisal.

Data Not Included in the Appraisal Report

The appraisal reports appear not to have such items as title page, letter of transmittal, table of contents, and assumptions and limiting conditions. Also nothing was mentioned about definition of value and property rights to be appraised. Little or nothing is said about highest and best use, assessed valuation and taxes, or zoning.

There appears to be no correlation of final estimate of value.

The banks appear to be doing the poorest job in the way of complete appraisal reports.

Summary of Banks, Savings and Loan Associations, Mortgage Companies, and Insurance Companies

Of the institutions discussed above it appears that the insurance companies followed the appraisal process most closely. They were followed closely by the mortgage companies. These two institutions are followed by the savings and loan associations and by far the poorest job of appraising, judging from the information available in this study, are the banks.

Table 4.1 shows a comparison of data required on real estate mortgage loans for the four institutions discussed above. The bank reports seem to be very incomplete as compared to the ideal. The major

fault with the savings and loan associations is their lack of the use of the market approach to the estimated market value. The insurance companies seem to be doing the best job. The major reason for this is that all reports have to be sent to a higher authority, so the report has to be very complete for the person to understand the appraisal. As was pointed out, one of the appraisal reports submitted to a mortgage company was complete in every respect. But some of the mortgage companies do not require a report this complete because the reports are submitted orally by staff members of the companies. The insurance companies appear to be doing just a little better job of appraising than the majority of the mortgage companies. But still the insurance companies are not following the ideal process completely.

Federal Land Bank Association

Data Included in the Appraisal Report

Identification of the property and neighborhood data are required in the appraisal report. Details of the farm, its soil, the buildings, drainage, and earning power of the farm under typical management are also included.

The FLBA uses all three approaches to estimate value. The market sales approach is not shown in the appraisal form but the questionnaire mentioned that the FLBA keeps a list of current market sales. One of the few questionnaires that included an income statement to arrive at a net income for use in the income approach was included in the FLBA appraisal form. There is no mention of the capitalization rate used by the FLBA.

Table 4.1 Comparison of data required on real estate mortgage loan applications of banks, savings and loans, mortgage companies, and insurance companies and the ideal form.

Type of Data or Approach	Ideal	Banks	Savings & Loans	Mortgage Companies	Insurance Companies
Title page, letter of transmittal and assumptions	Yes	No	No	Few	Yes
Identification of property	Yes	Yes	Yes	Yes	Yes
Definition of value	Yes	No	No	No	No
City data	Yes	Very Little	Yes	Yes	Yes
Neighborhood data	Yes	Very Little	Yes	Yes	Yes
Site data	Yes	Very Little	Yes	Yes	Yes
Improvement data	Yes	Very Little	Yes	Yes	Yes
Zoning	Yes	Very Little	Yes	Yes	Yes
Assessed value and taxes	Yes	Very Little	Yes	Yes	Yes
Highest and best use	Yes	No	No	No	No
Cost approach	Yes	Incomplete	Yes	Yes	Yes
Market approach	Yes	Incomplete	Seldom	Most of Them	Yes
Income approach	Yes	On Other Than Residential	No	On Other Than Residential	On Other Than Residential
Correlation	Yes	No	No	No	No

There is one item which appears on the FLBA appraisal that should not be included. That is the amount of money requested by the applicant. As discussed earlier the appraiser's opinion should not be based upon the amount requested or required by the applicant. The appraiser's opinion should be based on the factors he collects in arriving at the market value and not the amount an applicant wishes. Since the loan officer is the appraiser he probably does know the amount requested by the borrower. This situation can lead to poor loaning procedures as to amount actually loaned.

Data Not Included in the Appraisal Report

The title page, letter of transmittal, table of contents, and assumptions and limiting conditions do not appear to be part of the appraisal report. Also definition of value and property rights appraised, two necessary items, did not appear on the FLBA's appraisal form.

Other items that do not appear are zoning, assessment and taxes, and highest and best use. These items may not be as important in a rural farming area a good distance from any residential area, but times are changing, many of the townships do have zoning regulations even for farms. Of course, assessments and taxes are necessary for an overall look and complete understanding of the appraisal report.

Even though the FLBA uses the three approaches to value when appropriate, no correlation estimate of final value is shown. This might not be written down but the author suspects that the appraiser does this even if only mentally, because he completes all three methods when completing the appraisal form. Nevertheless, the correlation of final estimate of value should be written out.

Federal Housing Administration

The form used by the FHA for the appraisal of property to be mortgaged is used by three different persons: mortgage credit examiner, architectural examiner, and the appraiser. How much of the report each person completes is not clear. But everything from the borrower's credit report to the amount to be mortgaged and some information to be used by the appraiser is on the form. Like the form used by the FLBA, the appraiser should not be aware of all this information when completing the appraisal.

Data Included in the Appraisal Report

Information concerning identification of the property, neighborhood data, and site data are very complete. Information about the improvements seem to be complete, but it appears that an architectural examiner fills out this information. If the appraiser sees the improvement and goes through it with the architect or at some other time, this would be all right. But if he never sees the property, the appraiser cannot do a good job of appraising the property.

Assessment, taxes, and zoning are included in the appraisal report. Also the market approach and cost approach to estimate value are used in the report. The FHA does not appraise income property under the section discussed in this study. The market approach appears to be used more than the cost approach.

Data Not Included in the Appraisal Report

It appears that no title page, letter of transmittal or assumptions

and limiting conditions are used by the appraiser. Also no record is made for a correlation of the final value estimate.

Farmers Home Administration

The form followed by the FHA has been developed by the United States Department of Agriculture. The form is very complete.

Data Included in the Appraisal Report

Information pertaining to the location of the farm, roads, and community, farm utilities, condition and occupancy of the farm, condition of the land, natural resources, water, farming hazards, history, taxes, and suitability for production of family subsistence and supplies are all included in the appraisal report. These items cover all of the items that the appraisal process calls for in the beginning of each of the appraisal reports.

The report continues with an income statement of the crops and livestock that are used in the income approach. This is followed by an inventory of all the buildings on the farm as to their age, construction, depreciated replacement value, condition of the buildings, and the measurements of the buildings. This information, of course, is used in the cost approach. No specific place is set aside for the market sale approach but according to the questionnaires returned the market sales approach is used in estimating the market value of the farm.

Data Not Included in the Appraisal Report

The only item that may be left out of the form is the correlation of

final estimate of value. No specific place is set aside for this section but the author suspects that at the end of the form is a place for comments where this item could be completed.

Veterans Administration

Data Included in the Appraisal Report

The VA's appraisal form requires such items as identification of the property, property rights to be appraised, city and neighborhood data. Information as to the facts about the site and the improvements on the site required is fairly complete. The information concerning the improvements is then used for the cost approach to estimate value.

The cost approach appears to be complete with physical, economic, and functional depreciation used in the analysis. Also, comparables are required so they can be used in the market sales approach to market value.

Other items required on the VA form are detrimental influences, justification of capitalization rate, income and expense statements (if multiple unit property is involved), description of the real estate market in the community (explain if suitable for intended use), and explanation of depreciation. All of these facts are very important in every appraisal and it is good that this form requires each item to be explained thoroughly. Explanation throughout the report of necessary items and the completeness of the items required in the report makes the form very complete.

Data Not Included in the Appraisal Report

Nothing is mentioned as to the definition of value used in the report. Also the correlation of final estimate of value does not appear.

CHAPTER V

ECONOMICS OF IMPROVED APPRAISAL QUALITY

Introduction

Now that each institution's appraisal practices have been examined, the questions that logically follow are: should the institutions improve their existing appraisals? And if the institutions improved the appraisal, would the extra time and cost involved pay for it? An analysis has been developed to answer these questions.

Many items have to be considered in creating such a model. Some of these include: foreclosure and delinquency data, loss incurred from foreclosures, extra cost of the appraisals, amount of money saved by completing more accurate appraisals, and foreclosure rates of institutions. The following is a discussion of these items.

Foreclosure and Delinquency Data

At the start of this study it was thought that enough information could be gathered to present foreclosure and delinquency data which pertained to each of the institutions. It was hypothesized that if this could be found there might be a relationship between the losses from foreclosures and delinquencies, and the appraisal practices of the various institutions. But, foreclosure and delinquency data are not widely

published. A thorough search of the campus library and correspondence with each of the lender associations showed only information from banks and savings and loan associations is available.

Savings and Loan Associations

Financial statements of each savings and loan associations in the Lansing area, along with the other associations in Michigan, are published annually by the Michigan Department of State in accordance with statutory provisions. These statements indicate the amount of loans held for redemption. The data are compiled from foreclosures and delinquencies. Also shown are the loans made during the fiscal year which include: first mortgage loans, share loans, and real estate contracts. Mr. Eadon Doty, Director of the Savings and Loan Division of the Michigan Department of State, said approximately eighty percent (in dollars) of the amount held for redemption is from insured loans.

This indicates that appraisals for insured loans are more critical from the lender's standpoint. A smaller proportion of value is loaned on conventional loans; therefore, an appraisal does not have to be as accurate when a smaller percentage of the value of the property is loaned. Improved appraisal procedures could possibly justify higher loan to value ratios on conventional loans without bringing about higher foreclosure rates or greater losses.

Banks

Foreclosure information for banks in the Lansing area was obtained from the Mortgage Bankers Association of America. The information

pertaining to banks indicates the same pattern as the savings and loan associations; namely, foreclosures and delinquencies are higher among the insured loans than the conventional uninsured loans. Chapter IV suggested that bank appraisal procedures were not as near the ideal as were those of the savings and loan associations.

Method of Analysis

To answer the question whether better appraisals would be economical, a model has been constructed to test whether expected returns from better appraisals are greater than expected costs. The method for developing this model is shown below.

- a. Extra costs are C_a (cost of improved appraisal) minus C_p (cost of present appraisals). The cost of the improved appraisal, following approved appraisal procedures by a fee appraiser is \$50.00. The cost of present appraisals averages \$18.50. Hence, the difference is \$31.50.
- b. To find the total cost of the improved appraisals $C_a - C_p$ is multiplied times N (the number of appraisals in one year).
- c. The extra return results from the reduction in losses from better appraisals; i.e., fewer foreclosures, and lower loss ratios on foreclosures.
- d. Hence, $[(C_a - C_p) N]$ (the extra cost) is compared with $F_p R_p - F_a R_a$ (the present loss minus expected loss) to see if benefits exceed costs. F is defined as the number of foreclosures and R as the loss ratio on foreclosures. Subscripts p and a refer to present and improved appraisal practices, respectively.

Data for some of these important variables are nearly impossible to obtain. Hence, some assumptions are needed to illustrate the analysis. Assume that Fa (foreclosures with improved appraisal practices) or that Ra (the loss ratio with improved appraisal procedures) is zero. With this assumption Rp can be solved to see the reduction in loss ratio that is needed to justify improved appraisals.

To find the breakeven point set both sides of the equation equal and solve for Rp. Four examples are presented.

Case I

$$(50.00 - 18.50) 9383 = 162,242.72 \times R$$

$$\frac{295,564.50}{162,242.72} = R$$

$$\underline{\underline{182\%}} = R$$

Case II

$$(50.00 - 18.50) 123,654 = 38,095,200 \times R$$

$$\frac{3,895,101}{38,095,200} = R$$

$$\underline{\underline{10.2\%}} = R$$

Case III

$$(50.00 - 18.50) 44,762 = 6,567,600 \times R$$

$$\frac{1,410,003}{6,567,600} = R$$

$$\underline{\underline{21.5\%}} = R$$

Case IV

$$(50.00 - 18.50) 94,378 = 33,196,800 \times R$$

$$\frac{2,972,907}{33,196,800} = R$$

$$\underline{\underline{9\%}} = R$$

The four examples suggest that for conventional mortgages (Cases I and III) which generally have low foreclosure rates, the extra cost of the improved appraisals do not pay. But for the insured mortgages (FHA, VA) in which institutions loan a high proportion of value (Cases II and IV), a moderate ten percent reduction in the loss ratio would pay the extra cost involved.

Information other than the breakeven point (loss on foreclosure) can be obtained from this equation. For example, if an institution knows its average loss on foreclosures and its extra cost for improved appraisals, the institution could find how many fewer foreclosures, or how much lower loss ratio would be needed to justify the extra cost. Then too, if other data are known, the breakeven analysis could be used to find out how much more money it could afford to spend on improved appraisals. Thus, it can be seen that any institution could use this analysis to benefit itself and its borrowers by using figures for its own situation.

Thus far, this analysis has dealt with the idea of increasing the cost of present appraisals. There are some cost-free changes that institutions can use which might produce added returns to either the borrower or the lender. More complete forms should be used. These forms should be set up to follow the appraisal process discussed in Chapter II. Staff or hired fee appraisers could be required to belong to some professional societies to keep informed on the latest techniques in the appraisal profession.

Some of the institutions place little emphasis on the market approach and use only the cost approach; others do the opposite. Institutions should use both approaches, if they are not already doing so.

In Chapter III each institution was discussed in detail. Items which they left out of their appraisal could be added to make their reports more complete. Many of these suggestions could be used by institutions to increase the accuracy of their appraisals.

CHAPTER VI

CONCLUDING REMARKS

The purpose of this study is to describe mortgage appraisal practices used by lenders in the Lansing area and to compare their appraisal practices with the appraisal process recommended by the American Institute of Real Estate Appraisers. Data for the study were obtained by sending a questionnaire to the thirty-one mortgage lenders in the Lansing area. Information received from the twenty-eight returned questionnaires is the major source of the data used in this study. The information relating to the appraisal practices now being carried on was then compared to the recommended appraisal process.

Quality of Appraisal Practices of Mortgage Lenders

From the information collected in this study, the following is the author's ranking of the institutions with respect to present appraisal practices: insurance companies, first; mortgage companies, second; savings and loan associations, third; and banks, fourth.

The insurance companies generally seem to have the best and most complete appraisal reports. Information as to city, neighborhood, site, and improvement data is included in each report. The insurance companies do not require any definition of value. But the insurance companies do

a better job of using the market value to estimate property value than the mortgage companies.

The mortgage companies included most of the important data concerning the description of the improvements, site, city, and neighborhood data in their appraisals. They did not, however, require definition of value used in the report. Another item missing from the report was a complete market sales approach to value. For residential home loans they emphasized the cost approach.

The savings and loan associations appear to use oral presentation of the appraisal to a committee. Thus, they leave a lot of the information out concerning definition of value, assumptions and limiting conditions, and letter of transmittal in the written report. Whether or not the above is mentioned in the oral presentation is not known. But whether the above is mentioned in the oral presentation or not this information should be in the report so that anybody reading the report at a later date can understand every item leading to the final estimate of value. Identification of the property, city data, site data, and improvement data are all included in the report. The savings and loan associations, however, rely mainly on the cost approach to estimate market value. This, of course, does not make for a complete appraisal.

Generally the banks require less data than the other institutions. Little information is required about the neighborhood, site, or the improvements on the site. The banks vary on which and how many of the approaches are used in the appraisal. It appears that the banks rely on the appraiser's opinion without the supporting data for their appraisals.

The remaining four institutions, Federal Land Bank, Federal Housing Administration, Veterans Administration, and Farmers Home Administration each follow fairly complete appraisal forms. In each instance their reports have to be sent to someone else for formal approval. But even though the appraisal forms are fairly complete, the accuracy of the appraisals depend upon the ability of the person completing the report. Thus, the accuracy of the appraisal of the above institutions varies between the institutions in the different areas of the country. It is also significant that the appraisers of these institutions are not required to belong to any professional appraisal societies.

One of the problems in studying appraisal practices of mortgage lenders is getting foreclosure and delinquency data. The final analysis of a loan is its soundness. Foreclosures would seem to imply poor lending practices; hence it is not surprising that institutions would not wish their foreclosure figures to be made generally available. From the limited information published, an analysis indicates that conventional loans probably cannot justify the increased cost of professionally qualified appraisers. It appears that with the comparatively low proportion loaned with conventional loans, foreclosures are less frequent and less accurate appraisals will suffice. The insured loans for which institutions loan a high proportion of value, would seem to be a different story. The cost-returns analysis suggested that the potential benefit of improved appraisals on insured mortgage loans might very well cover the increased costs for a truly professional appraiser.

Recommendations

Some recommendations that would seem to be in order on the basis of this study are as follows:

1. Lending institutions might well require more complete appraisal reports from the title page to the correlation of final estimate of value.
2. Lending institutions could benefit by using all of the approaches that are necessary and appropriate to estimate the value of a given piece of property.
3. Lending institutions might consider obtaining a capitalization rate for use in the income approach by checking the market to determine the rate of interest currently being earned on that type of property.
4. Lending institutions should perhaps give more emphasis to market trends and other economic data as a means of trying to analyze the future stability of each property.
5. Lending institutions should consider a requirement that each appraisal report define value as used in the report.
6. Institutions should keep the loan officer and the appraiser's job separate and not allow one man to hold both jobs.

The above recommendations are made with the thought that real estate mortgage lending institutions might consider them as possibilities for improving their lending practices.

Possible Future Studies

One area of possible study concerns the amounts and types of information that would be desirable on the credit worthiness of the borrower. Who is a good credit risk, what factors indicate credit worthiness, and how to determine how much credit to extend, are all questions that might be considered in this area of study.

Another area of study is how to determine what is a safe load of foreclosures or delinquencies an institution can have and still remain solvent.

A third possible area of study is, how much should the institutions improve their appraisal practices? The question here involves the extra time and money incurred to improve the appraisals and whether the extra time and money, off-set money lost in foreclosures or delinquencies. This question can be analyzed by using the model set up in Chapter V but much more research is needed to obtain relevant and more accurate data concerning foreclosures and losses. Follow-ups on foreclosures is one means of collecting this data.

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APPENDICES

APPENDIX A

QUESTIONNAIRE USED IN THE STUDY

February 24, 1964

As part of research being carried on in the field of appraisal, we are undertaking a project entitled "Appraisal Practices Among Mortgage Lenders in the Lansing Area". The objective of this project is to describe and analyze appraisal procedures followed by mortgage lenders.

Information received from the enclosed questionnaire will be of interest to businessmen like yourself as well as students and educators in the field of appraisal. Results of this study will be available to you.

This project is being supervised by Dr. Arthur Warner of the Graduate School of Business Administration and Dr. John Brake of the Agricultural Economics Department.

Please complete the enclosed questionnaire and return in the envelope provided. Information provided by you will remain strictly confidential and will be used in such a manner as not to identify your institution or firm.

Your cooperation will be greatly appreciated.

Sincerely yours,

Terrell Ray Oetzel
Graduate Research Assistant

TRO/bko

Enclosure

Questionnaire Pertaining to a Study Entitled, "Appraisal Practices
Among Mortgage Lenders in the Lansing Area"

Name of institution or business firm _____
Person answering questionnaire _____ Position _____

Does your institution:

Make regular conventional loans (see footnote)? _____ yes _____ no _____ % of total loans

Make insured conventional loans? _____ yes _____ no _____ % of total loans

Make FHA loans? _____ yes _____ no _____ % of total loans

Make VA loans? _____ yes _____ no _____ % of total loans

What other type of loans and percent of total does your institution make? _____
(improvement loans, etc.)

On what type of property does your institution make loans? _____
(commercial, farm, residential, etc.)

Which type of property loans do you emphasize most? _____

How is the loan finally approved? _____

Questions concerning the appraisals made for each mortgage loan

Do you use your own staff appraisers? _____ yes _____ no

Do you use a committee of appraisers? _____ yes _____ no

Do you hire fee appraisers? _____ yes _____ no

If fee appraisers are used, how is the fee calculated? _____

Does the same appraiser do all your appraisals? _____ yes _____ no. If no, explain _____

Does your appraiser, staff or fee, belong to any professional societies? _____ yes _____ no.

If yes, which societies? _____

Do you require your appraiser, staff or fee, to belong to any professional societies? _____ yes
_____ no. If yes, which societies? _____

If your appraiser is a fee appraiser, on the average how many days a month do you hire him? _____

* "Loans" as used in this questionnaire are defined as first mortgage loans on real estate
in the Lansing area.

Is the same appraisal procedure followed for:

(a) Residential and commercial? ☐ yes ☐ no. If no, explain _____

(b) Residential and farms? ☐ yes ☐ no. If no, explain _____

(c) Farms and commercial? ☐ yes ☐ no. If no, explain _____

Items required in the appraisal report (if a regular form is used please send a copy) _____
neighborhood _____

data, area data, market sales, etc.) _____

Do you require a surveyor to check the legal description of the property? ☐ yes ☐ no.

Do you require an abstract as to the title? ☐ yes ☐ no.

Do you require title insurance? ☐ yes ☐ no.

Do you require that the appraisal report reflect the following:

(a) Recent market sales ☐ yes ☐ no.

(b) Cost of replacement ☐ yes ☐ no.

(c) Capitalization of income ☐ yes ☐ no.

(d) Other (explain) _____

For purposes of mortgage loans, do you keep a current list of the sales that have taken place in the Lansing area on this type of property? ☐ yes ☐ no.

Do you ever have need for appraisals on special purpose properties (properties you do not usually loan money on)? ☐ yes ☐ no. If yes, on what type of properties? _____

On the special purpose properties, who does the appraising? _____

What is your institution's typical maximum loan to value ratio on the following types of loans?

(a) Conventional _____

(b) FHA _____

(c) VA _____

(d) Others _____

What is your institution's typical loan to value ratio on the following types of loans?

(a) Conventional _____

(b) FHA _____

(c) VA _____

(d) Others _____

Under what circumstances are loans made without an appraisal report? _____

What are your policies and procedures for checking the accuracy of appraisals made for mortgage lending purposes? _____

Questions for institutions or firms making farm loans

What additional procedures do you require for farm loan appraisals? _____

What percent of your loans are farm loans? _____

Does the same appraiser do your farm loans as your other loans? ____ yes ____ no. If no, who? _____

Do you require more complete appraisal reports on farm loans? ____ yes ____ no. If yes, explain _____

Do you loan as high a percent of the loan to value ratio on:

- (a) farm as residential ____ yes ____ no
(b) farm as commercial ____ yes ____ no

Questions concerning the total cost incurred for each mortgage loan

List the usual costs incurred while preparing mortgage loans:

	<u>Yours</u>	<u>Borrower's</u>
(a) Cost of appraisal	_____	_____
(b) Cost of mortgage insurance	_____	_____
(c) Cost of fire insurance	_____	_____
(d) Cost of insurance (other)	_____	_____
(e) Attorney fees	_____	_____
(f) Recording fees:		
(1) Mortgage discharge	_____	_____
(2) Deed	_____	_____
(3) Mortgage	_____	_____
(g) Credit report	_____	_____
(h) Tax history	_____	_____
(i) Abstracting	_____	_____
Other costs (specify:		
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

APPENDIX B

REMINDER LETTER

March 2, 1964

About a week ago you should have received a questionnaire concerning appraisal practices among mortgage lenders.

Since the study involved is designed to be of use to the business community at large as well as those in the field of appraisal, I am sure you will agree that the project is important. Its successful completion depends upon prompt return of the questionnaire. May we have yours back as soon as possible?

Once again I would like to point out that all information will be held in strictest confidence.

Sincerely yours,

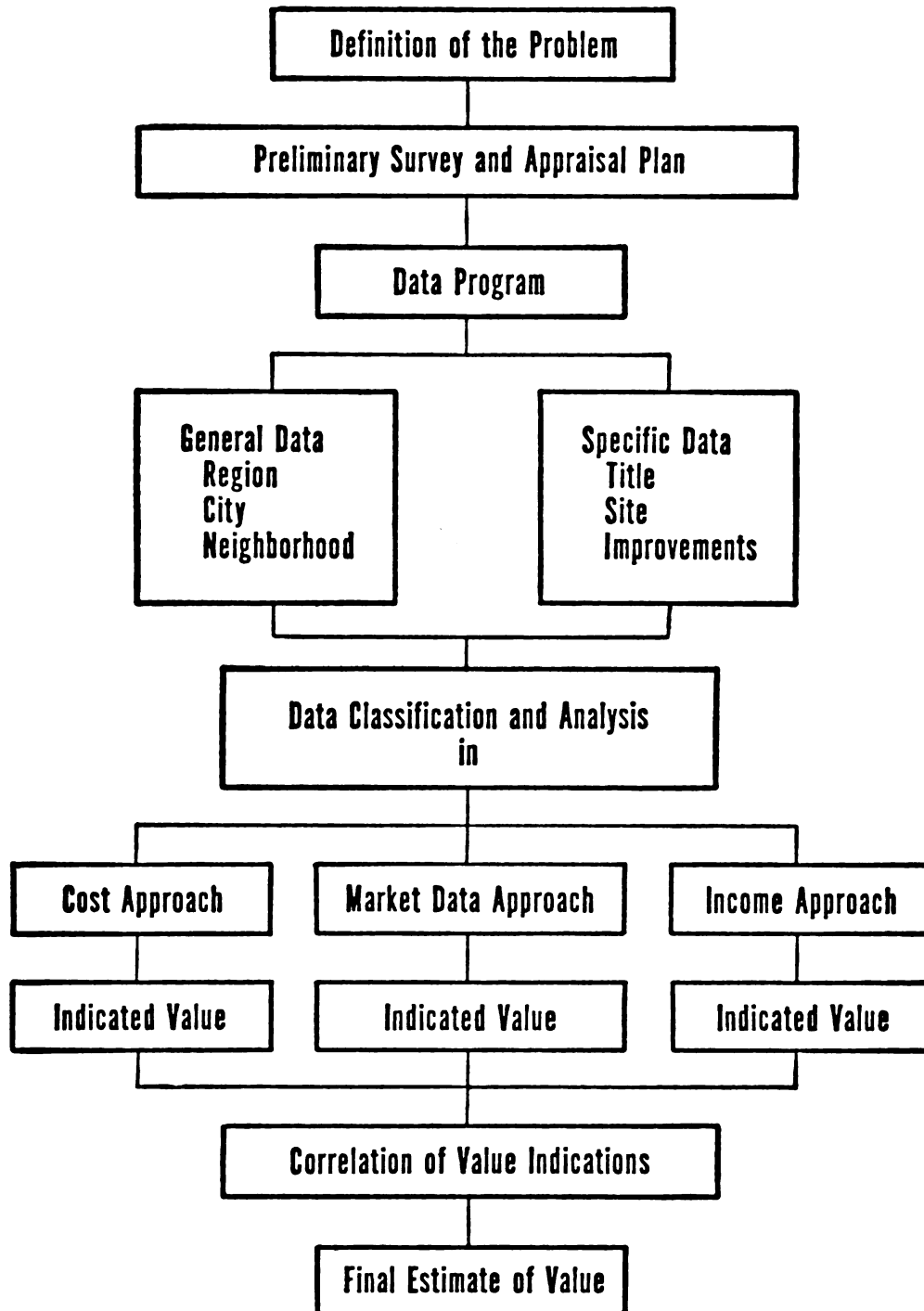
Terrell Ray Oetzel
Graduate Research Assistant

TRO/bko

APPENDIX C

APPRAISAL PROCESS

The Appraisal Process



From the AIREA text book, *The Appraisal of Real Estate*

THE

AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS

of the National Association of Real Estate Boards

. . . wishes to help you increase your real estate appraisal knowledge. We invite your serious consideration of the following literature . . . available for purchase by anyone interested.

1. **THE APPRAISAL OF REAL ESTATE.** 4th Edition, revised as of 1964. The textbook required in A.I.R.E.A. Case-Study Courses. \$9.00 per copy.
2. **APPRAISAL TERMINOLOGY AND HANDBOOK.** Fourth Edition revised November, 1962. \$7.50 per copy.
3. **A STUDENT'S DEMONSTRATION REPORT ON A SINGLE-FAMILY RESIDENCE.** Illustrating as many of the principles and techniques of a single-family residential appraisal as practicable in the allotted time. \$2.50 per copy.
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11. **URBAN RENEWAL AND REDEVELOPMENT.** 18 selected articles which appeared in The Appraisal Journal. 172 pages, \$4.00 per copy.
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14. **THE APPRAISAL JOURNAL.** The professional quarterly of A.I.R.E.A. 15,000 subscribers. Published since 1932. Annual subscription rate, \$7.00. Designed for everyone in real estate.
15. **THE APPRAISER.** A monthly round up of appraisal news and views. Formerly available only to Members and Candidates of the Appraisal Institute. Issued monthly except for July and August. Annual subscription rate is \$7.50.
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