Real Estate Appraisal

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Introduction

According to Wikipedia, the definition of Real Estate Appraisal is “the practice of developing an opinion of the value of real property, usually its Market Value.” The terminology real estate appraisal is primarily the American usage whereas in other countries, it is often called land valuation or property valuation. Since no two properties are identical and differ by their locations, the need for appraising arose as the determining method of property evaluation. Or as Wikipedia puts it, “the absence of a market-based pricing mechanism determines the need for an expert appraisal/valuation of real estate/property.”

A real estate appraisal must always be conducted by a certified or licensed appraiser in order to be considered in the process of buying and selling property. The appraisal is usually based on what is referred to as the Highest and Best Value of the real property since the appraiser bases their conclusion on Market Value.

The Uniform Residential Appraisal Report is the document that is used when determining residential property evaluation. Income producing property, raw land, and other more complex property are normally reported in a narrative type appraisal report. The term “value” is categorized and defined in a number of different ways, however for the purposes of this textbook, the following are considered the most common:

- **Insurable Value** - value of the property that is covered by an insurance company
- **Investment Value** – value of the property to the investor, and is usually higher than the market value
- **Liquidation Value** – a commonly sought standard in bankruptcy proceedings
- **Market Value** – the price at which an asset would trade in a competitive auction type setting and is often interchangeable with Open Market or Fair Market Value
- **Value-in-Use** - The net present value (NPV) of a cash flow that an asset generates for a specific owner under a specific use
Normally, the methodologies used in appraising are referred to as the *Three Approaches to Value*, and are the following:

- The Cost Approach
- The Income Approach (or Income Capitalization Approach)
- The Sales Comparison Approach

In recent years, it became apparent that appraisers did not fully understand the process for identifying the scope of their work in order to obtain credible results. Despite the fact that the Uniform Standards of Professional Appraisal Practice (USPAP) have always required this, there was an update to this performed in 2006 and was called the Scope of Work project. Because appraisers, appraisal reviewers, and clients alike were oftentimes confused due to the use of a limited versus a complete appraisal, as well as the use of the Departure Rule, the update became necessary.

(NOTE: “The departure rule provided under the USPAP, intends certain limitations and exceptions for an effective usage and easy understanding of the appraisals. However, it is important to report for any modification or justification related to the appraisal for the departure rule that limits the working of appraisal in specific areas.” [This comment/excerpt was taken from the website Free Term Papers, Research Papers, and College Essays online at http://www.termpapergenie.com/index.html]).

As a result of the Scope of Work project, the Departure Rule and the concept of a limited appraisal were eliminated by the USPAP. At the beginning of each assignment, appraisers had to identify six key parts of the appraisal problem at the beginning of each assignment:

1. Client and other intended users
2. Definition of value (e.g. -- market, foreclosure, investment)
3. Effective date of the appraisal analysis
4. Hypothetical conditions or extraordinary assumptions
5. Intended use of the appraisal and appraisal report
6. Salient features of the subject property

The appraiser is now obligated to identify the scope of work needed based on the above factors, as well as the applicable approaches to value, extent of investigation needed, and methodologies to be used in the process. The rule provided a strict stipulation that the minimum standards for the scope of work were the actions of the appraiser's peers (who carry out similar assignments), as well as expectations of the client and other users.

Since the scope of work has become the first step of the appraisal process, an appraiser's conclusions may lack necessary viability. The intended use of the appraisal is to actually develop a value for a given property for the intended user, so the appraiser needs to define the scope of work.

**Chapter 1**

**Residential Buyers & Pre-Qualification**

**Introduction**
As we mentioned in the beginning of the course, everyone has his or her own thoughts, ideas, and memories regarding home ownership. Some people feel that it may be too much of a commitment where maintenance, payments, and liquidity of the asset are concerned. Others enjoy the advantages that home ownership provides, such as security, pride, and the freedom to do what one wants with the property.

One of the most important benefits is the pride that owning a home can bring. Ownership allows the privacy and freedom that cannot be found in renting or leasing from a landlord. Homeowners can make changes to their property, choosing house colors, planting trees and planning landscaping, having pets, and remodeling without having to get permission.

**Advantages of Home Ownership**

Obviously, a person decides that they want to own their own home because of having so many advantages over renting and leasing. Listed below are the main advantages that most people find for owning their own home.

- Pride of ownership
- Freedom to change or alter the property
- A reflection of the owner’s self-image
- Control of premises – landlord cannot make you move out
- Can dramatically strengthen credit ratings
- Equity to borrow against or resulting in profit when selling
- A practical investment of increasing in value by appreciation
- Civic contribution through property taxes that support local concerns
- Tax advantages by deducting property taxes and interest for mortgage

Naturally, where there are advantages, there are also some perceived disadvantages such as the following:

- Down payment and closing costs can amount to a large amount of cash
- Down payment could drain cash that could be used to earn other income
- Time consuming to negotiate and close sale
- May leave owner low on cash to make other payments. Real estate investment is “frozen”, rather than liquid investment
- If forced to sell quickly a loss may result
- Monthly mortgage payments could be variable and payments could increase
- Ownership has the responsibility of ongoing costs and obligations
- Owner responsible for own repairs and maintenance
- No built in recreational activities (such as apartments with pools)
- Increases in property taxes and the additions of special assessments
- Expense of homeowner's insurance
As a licensed professional, you will find that there are all kinds of buyers in every market. However, for the most part, buyers are classified into four primary groups as follows:

- First-time home buyers
- Buyers moving to larger home
- Buyers moving to smaller home
- Recreation home buyer and retirees

In order to understand these different types of buyers, a description of each category would be in order, so let’s dig in and learn more about them.

**First Time Home Buyers**

It can be extremely satisfying to work the first-time homebuyer. They are often very excited about buying a home, but they can also be a serious challenge. First time buyers may have a limited amount of cash and have some difficulties coming up with a down payment. Since this is their first large purchase, they also may not have built up enough established credit to get a home loan.

The first time buyer can also be uninformed about important matters concerning a home purchase, and can tend to turn to the advice of friends and family, rather than letting you assist them and educate them in the process. This can cause some frustration if the first time buyer is relying on information given from a person who has little or no knowledge of real estate.

There are several ways to overcome these challenges. Agents who work with first time buyers should provide plenty of information, and use patience to build a rapport and trust. When handled properly, the process can be very rewarding.

**Buyers That Are “Moving Up”**

Homebuyers who are moving up to a larger or more expensive home usually have more knowledge of how a real estate transaction works. Because this is not their first real estate purchase, they most likely have a clear picture of the home they want to buy, and more funds (usually from their current home’s equity) for the purchase of the new home.

These buyers often appreciate the knowledge and expertise that their real estate agent has to offer them, and will oftentimes insist on working with the best. It is wise for the agent working with this type of buyer to be prepared with an organized method to find the right home and expertise in listing and marketing the buyer’s current home.

**Buyers Moving To Smaller/Lower Maintenance Homes**

These are buyers that no longer want or need the financial or maintenance demands of a large family home. Maybe their children have grown up and moved into their own homes, or maybe they just don’t want to have to take care of a big house or a large yard.

Or maybe the buyer has retired and is now living on a fixed income and wants (or needs) to make smaller monthly payments. Like the buyers who are moving up, these buyers have also have a clear picture of the home they want, and also have more funds resulting from their current homes built up equity.

This may also be an opportunity for the real estate agents to not only sell the buyer a new home, but to list and market the buyer’s current home. For this reason, this often equates to a win-win situation where this type of buyer is concerned.

**Recreation Home Buyers and Retirees**
Recreational or second homebuyers are usually looking for a home that offers not only a house, but recreation and entertainment as well. Often these buyers have retired and now want a different lifestyle. Or, as in the case of the buyer that is “moving up”, they are now in a financial position to buy a vacation home or a waterfront property as examples.

This buyer might also be interested in condominiums or planned unit developments that offer recreational facilities. These buyers are typically well informed and well qualified financially.

So now that we have gotten to know a little about the types of different buyers, how do you go about finding them? What are some of the best methods for “prospecting” as it’s called? Successful agents will prospect for buyers, just like listing agents who prospect for listings. Listed below are 20 of the best methods you can use for prospecting for home buyers.

1. Make ad calls from your listings
2. Call friends or relatives and specifically ask who might be buying soon
3. Ask people in your area, either face to face or by phone
4. Check the Internet for buyers
5. Advertise as a Buyer’s Agent.
6. Hold Open House at your own listing, or get permission to open another agent’s listing
7. Mail out, or hang on doors, 100 invitations in the surrounding neighborhood of the open House in order to attract viewers to the home
8. Ask past clients, open house guests, and everyone for possible buyers
9. Send information with clippings from birth announcements, various promotions, marriage announcements, etc
10. Design a Buyer’s Agent presentation for you to use with potential buyers
11. Attend Home Buyer’s Seminars
12. Contact your local Chamber of Commerce
13. Contact personnel managers about transfers and relocations of employees
14. Attach a buyer referral form to each of your listing agreements
15. Pass out your business cards no matter where you are
16. Ask for business
17. Cold call any “for sale by owners” that you happen to see when you are out on business. They also have to buy another house!
18. Wear your name badge everywhere. People will talk to you about real estate!
19. Practice good phone skills for maximum floor time advantage.
20. Make it a habit to even call expired listings. This is a good way to find listings, but remember that they also are moving somewhere!

The following form is an example of a “Buyer Information Worksheet”. These are very easy to design and create on Excel and will help you to not only keep track of your clients, but will make it easy for you to perform follow-up calls with your clients.
Personal Information
Name ___________________________ Address ___________________________
Phone: Home __________ Work ___________ Cell _______________
Desired Style ___________________________ No. Bedrooms _____ No. Baths _____
Family room _____ Dining room _____ Fireplace _____ Sq. ft ________ Age ________
Heat _____ Garage _____ Lot size _____ Location ________________________________
Preferred School district _____________________________ Price range: $___________

Financing Information
Mr. Income $ _________________ Employer ____________________________________
Position ___________________________________________ How long ___________
Ms. Income $ _________________ Employer ____________________________________
Position ___________________________________________ How long ___________
Other income $ ________________ Closing funds $ ______________ Available by ________
Maximum mortgage payment $__________ Conventional / FHA / VA

Monthly Obligations       Total Payment Balances       Total Payments Remaining
Housing
Auto(s)
Credit cards
Revolving accounts
Other

As you can see, this is a very basic form, however it is a very effective tool.

Tracking Your Prospects
Using this information, the agent can determine the buyer’s income-to-debt ratio to determine the buyer’s loan qualification. This is only a preliminary determination. The buyer should still qualify through a loan officer and even then, the loan may be subject to a good credit rating and other criteria.

The agent can also be helpful in suggesting some ways for the buyer to come up with a down payment. Many times a buyer will have good credit and a good income, but has not saved for a down payment. If the buyer inquires about ways to appropriate a down payment, here are some of the suggestions that you can offer them:

- Credit cards (not always advisable as it does create further debt)
- Home equity loan
- Personal loan (credit union -lending institution)
- Relatives (borrow from Mom, Dad, brother, sister, cousin, good ol’ Uncle Joe)
- Gift letter
- Borrow against a car, truck, or other vehicle
- Borrow against the tools of the trade
- Cash out or borrow against an insurance policy
- Draw from an investment portfolio (such as stocks, bonds, or CD's)
- Draw from a retirement plan
- See if you can arrange to receive cash instead of vacation time from your employer
- Draw from a 401-K plan
- Draw or borrow against a savings account
- Borrow against jewelry, art, or antiques
- Refinance other owned property
- Have a huge garage sale
- Sell contracts that are payable to you
- Take on a second job
- See if your landlord will refund all of your deposits early
- Borrow from employer as a future draw
- Trade in something in lieu of down payment (such as land, car, bike, etc.)

**Using the Prospect Sheets**

Before the agent begins the search for the buyer's home, they must first know the answer to two critical questions:

1. What does the buyer want and need?
2. What can the buyer afford to pay?

It does no good to begin a search for a home that the buyer wants and needs, if the buyer cannot qualify for a loan or other method of financing for that home. If the buyer were to find the “perfect house”, and then find out that they qualify for a much smaller loan amount, the buyer will be disappointed, and ALL other homes will seem inferior. Chances are, you may be fighting an uphill battle from that point on.

“Pre-qualifying” the buyer can prevent this. In order to determine what the buyer can afford and qualify for, the agent must determine the amount of the buyer’s income, the buyer's debts, and the buyer’s available cash or savings. It is also important to know how much the buyer is willing to pay for monthly payments. Sometimes, a buyer will qualify for a loan amount much higher than they are willing to pay.

Pre-qualifying can also help your buyers to prioritize their “needs” with their “wants”. There may be times when the buyer's expectations exceed their ability to purchase. This can usually be overcome by the buyer prioritizing and by the agent exercising some creativity.

Here’s an example:

The McKenzies tell their agent, Joe, that they have three young children and they take care of Mr. McKenzie's mother in the home. They tell Joe that they need a 5 bedroom, 2.5 baths with an eat-in kitchen, family room, large deck, a garage with a shop, fenced yard, and a pool. They
would also like to have a full basement and prefer a two-story. Joe has pre-qualified the McKenzies, and knows from recent previewing that a home with ALL of these features will not be in their price range.

Joe actively listens to the McKenzies and begins to write down the most important features that they truly need. Joe says that he feels he can find a home in their price range with the most important features, such as enough bedrooms for the family and “Mom”, at least 2 baths, a large kitchen and a fenced yard for the kids.

"If we find a home with a couple of the other desired features, that would be nice, too.

What do you think"? The McKenzies agree, and begin the search using the most important features.

**Review**

The factors that influence home ownership are extremely diversified. One of the most important benefits is the pride that owning a home can bring. Ownership allows the **privacy and freedom** that cannot be found in renting or leasing the landlord’s house or apartment.

Advantages of owning a home include:

- Pride of ownership
- Freedom to change or alter the property
- A reflection of the owner’s self-image
- Control of premises – landlord cannot make you move out
- Can dramatically strengthen credit ratings
- Equity to borrow against or resulting in profit when selling
- A practical investment of increasing in value by appreciation
- Civic contribution through property taxes that support local concerns
- Tax advantages by deducting property taxes and interest for mortgage

Disadvantages to owning a home include:

- Down payment and closing costs can amount to a large amount of cash
- Down payment could drain cash that could be used to earn other income
- Time consuming to negotiate and close sale
- May leave owner low on cash to make other payments. Real estate investment is “frozen”, rather than liquid investment
- If forced to sell quickly a loss may result
- Monthly mortgage payments could be variable and payments could increase
- Ownership has the responsibility of ongoing costs and obligations
- Owner responsible for own repairs and maintenance
- No built in recreational activities (such as apartments with pools)
- Increases in property taxes and the additions of special assessments
• Expense of homeowner's insurance

There are four main types of buyers:
• First-time homebuyers
• Buyers moving to larger home
• Buyers moving to smaller home
• Recreation homebuyer and retirees

It can be extremely satisfying to work with first-time homebuyers, but they can also be a challenge. First time buyers may have a limited amount of cash for a down payment and they may not have built up enough established credit to get a home loan.

Homebuyers who are moving to a larger or more expensive home usually have more knowledge of how a real estate transaction works. Because this is not their first real estate purchase, they most likely have a clear picture of the home they want to buy, and more funds (usually from their current home’s equity) for the purchase of the new home.

Buyers moving to a smaller home may no longer want or need the financial or maintenance demands of a large family home.

Recreational or second homebuyers are usually looking for a home that offers not only a house, but recreation and entertainment as well. Often these buyers have retired and now want a different lifestyle.

Pre-qualifying can also help your buyers to prioritize their “needs” with their “wants”. There may be times when the buyers’ expectations exceed his/her ability to purchase. This can usually be overcome by prioritizing the buyer and creativity on behalf of the agent.

By practicing “active listening”, the real estate agent can gain a better understanding of features that are most important to the buyer.

Chapter 2
The Appraisal Process

In order to fully understand the appraisal process and its concepts, it is necessary to be familiar with the following terms and their definitions. Whether it’s the buying and selling of property, divorce, relocation, or the settling of an estate, appraisal becomes a key aspect of the process.

Glossary

Arm’s Length Transaction

A sale with full disclosure of property condition including advantages and disadvantages, without duress, within a reasonable marketing time

Capitalization Rate

The rate of return on the investment of the property
Comparables (or Comps)

Situation wherein the appraiser compares the subject property to another local property

Cost Approach

Method used to estimate the replacement cost of the building minus depreciation plus the value of the site

Depreciation

Decrease in value of the property over time, or from any cause such as deterioration, lack of maintenance, repairs, and upkeep

Effective Gross Income

The potential gross income minus debt and/or vacancy factor

External or Economic Obsolescence

Depreciation caused by factors surrounding the property that could influence value such as decline in value, environmental issues, noise or nuisance situations, and so on

Fair Market Value

The median price between the highest price acceptable to the buyer and the lowest price acceptable to the seller

Income Approach

An appraisal method to determine value by dividing net income by a capitalization rate commonly used in appraising income property

Insurable Value

The value of the property that is covered by its insurance policy

Investment Value

The amount that the investor would pay to acquire the property. The Investment Value may be higher or lower than the fair Market value.

Market Value

The probably selling price of a property in a competitive market under normal conditions and not influenced by unusual circumstances

Net Income

The effective gross income minus operating expenses

Price
Often confused with market value. Although the Market Value gives the seller an idea of how much to sell the property for, the price may be higher or lower than the Market Value.

**Principle of Change**

Ongoing changes such as deterioration, disintegration, or rejuvenation caused by internal and external factors that affect the property

**Principle of Substitution**

Occurs when a buyer will not pay more for a property than they could pay for an equally acceptable substitute

**Sales Comparison Approach**

Comparison of the subject property to similar properties that have recently sold in the same or similar area

**Subject Property**

The property which the appraiser evaluates or analyzes. The Appraiser analyzes the location, amenities, and condition of the subject property to arrive at the fair market value.

**Value in Use**

Relates to the net present value (NPV) of the property use. The NPV is the difference between present value of cash inflow and outflow.

**Introduction**

The word “appraiser” comes from the Latin word *appretiare* meaning to value and today is defined as one who sets a value on property either personal or real. Appraisal means the practice of developing an opinion of the value of real property. Appraisers are licensed by the state and are often contractors or self-employed, however they can also be employed by corporations, the government, lenders, mortgage firms, and real estate brokers. It is not uncommon for them to spend most of their time researching and writing reports for individual clients. They are professionals who have the utmost expertise and knowledge when it comes to estimating the value of all forms or real estate.

When you consider all of the people involved in a real estate transaction --- real estate agent, lender, mortgage company, and title company --- they all want to be sure that the value of the property falls in line with the amount that it is sold for. Real estate sales are dependent on the value placed on the property. Enter the role of the appraisal, which is the unbiased estimate of what the buyer expects to pay and the seller expects to receive. When a buyer applies for a loan, the lender usually requires an appraisal.

An appraisal is an educated opinion and explanation of the property’s value based on many different factors and approaches. Real estate sales are dependent on the value placed on the property. The most reliable and systematic estimation of a property’s value is the real estate appraisal process.

The estimated value results are for a specific purpose and are valid as of a specific date. The appraisal could be for the present value of the property, or an estimate of what is, was, or will be
worth as of another date. Property has many different types of values. The appraiser’s job is to
determine the purpose and actual value of the property, without “emotional” influences such as
needs and desires or the seller’s memories.

Remember that the appraiser’s duty is to inspect the property and ascertain its true value. They
must see features such as the number or bedrooms, bathrooms, location, and so on
to ensure that they exist as stated and are in the condition that the buyer expects them to be in.
The final documentation should include items such as a sketch or the property, the square
footage, and the layout. They also search for obvious features or defects that will affect the
value of the property.

When a buyer applies for a loan, the lender usually requires an appraisal. The lender uses the
appraisal to determine if the property is worth enough to provide sufficient security for the loan amount. They want to know if the buyer can afford the loan, but
they also want to know if the property is worth enough to secure the loan if the buyer defaults.
The estimated opinion of the value can be different depending on the purpose or objective. The
purpose of the loan can be for an evaluation to determine tax assessments, rent, exchanges,
condemnation, insurance, probate, bankruptcies, etc.

An appraiser can also help to establish a reasonable list price. The person who hires the
appraiser is the client, and the appraiser is the agent of the client. This creates an agency
relationship between the appraiser and client, and all agency laws apply.

**Licensing of Appraisers**

The Uniform Standards of Professional Appraisal Practice allows only state licensed or certified
appraisers to prepare appraisals used in "federally related" loan transactions. FIRREA, or
Financial Institutions Reform, Recovery and Enforcement Act, is the Federal law that requires
that appraisals used in federally-related transactions meet standards set by the Appraisal
Foundation and must be performed by a person who is licensed or certified by the state.

The majority of real estate loans are federally related, including loans made by federally
regulated or insured banks, or savings and loan associations. Transactions for $250,000 or less
are exempt from this requirement. To qualify for licensing or certification, the appraiser must
satisfy the requirements set by state law under the guidelines adopted by the Appraisal
Foundation.

State-licensed real estate appraisers may appraise the following:

- Non- Complex 1-4 family residential units valued under $1,000,000
- Complex 1-4 family residential units valued less than $250,000
- Non-residential property valued less than $250,000

State-certified real estate appraisers may appraise the following:

- All residential property of 1-4 units regardless of value or complexity
- Non-residential property valued less than $250,000

State-certified general real estate appraisers may appraise the following:

- All types of real property regardless of value

**Professional Conduct**
The person who hires the professional appraiser is referred to as the “client”. This means that the laws of agency apply to the appraisers just as they do to agents and brokers. Like licensed agents, professional appraisers have and abide by a strict code of ethics and conduct. Professional appraisers:

- DO NOT charge appraisal fees based on appraised value.
- DO NOT accept referral or finder fees, percentages of real estate commissions, or ANY type of rebate as an inducement to give a predetermined value.
- DO NOT pay referral or finder fees for their business.

Professional appraisers:

- DO NOT appraise property they own or have a personal interest in
- DO NOT appraise types of property that they are NOT trained for, without first disclosing this fact to the client

Professional appraisers:

- If accepted, appraiser usually requests the assistance of a qualified appraiser
- A flat fee is usually charged for residential appraisals. More complex appraisals are sometimes based on time, effort, expense and degree of difficulty.
- WILL NOT falsely claim membership in an appraisal group affiliation or profess professional qualifications if non-existent; or affix professional appraisal designations, such as M.A.I. or S.R.A., to credentials if designations have NOT been granted.

**Competitive Market Analysis (CMA)**

An appraisal is usually ordered after the actual sale of the property, but a real estate agent's expert advice is valuable and important to sellers to determine a realistic listing price. Competitive Market Analysis is an estimate of value of a property to determine a fair listing price. It is the real estate agent’s opinion of value.

The analysis includes recent sales of similar properties as well as properties that are currently available for sale. It will also show listings of properties that were recently exposed to the market but failed to sell. The CMA should show how many days the property was marketed before it sold or was taken off the market. This gives sellers a good overall picture of what buyers are willing to pay, as well as letting the seller see the competition and the results of overpricing.

Overpricing a property usually results in it not selling at all, or only after lowering the price below the market. Under-pricing property can result in the loss of hundreds, or thousands of dollars. A real estate agent can also help sellers maximize their profit by offering advice on many.

C.M.A.’s are most commonly used in the evaluation of residential property for the purpose of marketing. The C.M.A. is not designed to be as comprehensive or technical as an appraisal, but they are similar to an appraiser's market data approach.

The real estate agent’s use of a well-prepared C.M.A can also provide valuable assistance in relocation. For instance, if a person is transferred to an unfamiliar city many miles away, the agent can provide a list of recently sold homes as well as available homes, to help the transferee become more familiar with the area’s values. The agent can also include valuable information on schools, employment, attractions, shopping centers, fire and police protection, transportation and economy.
Uses of Real Property

Real property has many different types of uses and values. Owner occupied, residential property can be valued subjectively, or “emotional valuation”, or objectively, by using the “market approach” appraisal. Rental homes, apartment buildings and commercial buildings and land that are used for income are usually appraised using an “income approach” or “gross multiplier” method of appraisal.

Real property is also used for speculation, investment and other special purposes. These properties are sometimes difficult to appraise using a market or income approach. When there is no recent market history or income, it is obvious that the market approach or income approach cannot be used.

The method used in these cases would be the “cost” or “replacement” approach. There are many different reasons to appraise property and each has its own purpose. The purpose of the appraisal can influence the appraiser to use a certain approach. Each approach measures value differently so each evaluation of the same property can be different. Appraisals are usually ordered to determine:

Market Value

What a typical buyer would pay in cash to purchase the property, used when a person is buying or selling a property.

Financing - Loan - Credit Value

For loan commitment purposes. Important if the lender is forced to repossess and sell the property in case of default. Cost to replace the property in case of a casualty loss, usually done prior to writing or renewing a casualty policy.

Inheritance and Estate Tax Value

For IRS, inheritance, and tax calculation purposes.

Condemnation Value / Eminent Domain Value

"Fair and just compensation" where the government is buying property from an unwilling seller.

Ad Valorem Tax Value

Real estate property tax calculation purposes.

Liquidation Value

The value of assets if sold under a forced sale or auction.

Investment Decisions

And other situations that require an informed decision of real estate value - market potential of a proposed project, rent or lease schedules, real estate investment analysis, etc.

Market Price / Cost / Market Value
Market price is the price a person paid for the property whatever the circumstances. It is a price based on the relationship between the property and the potential purchaser's value of it's "worth". A property may be "worth" much more to one person than another if that person has a specific "use" for that piece of property. This often applies where the property will be used for income.

Cost is the price to replace the property and all improvements without considering supply, demand, use or transferability. It is the cost the buyer paid even if it is over-improved! When there are no comparable sales the appraiser estimates the value by using the cost or reproducing the property just as it is today.

Market value is what a seller could expect to be paid if a property is sold under an "arm's length transaction", meaning that all required conditions to a fair sale have been met. The market value is the estimated selling price of a specific property, for a specific reason, at a specific time and is usually used in residential property appraisals.

Value is a term that has many meanings. We will use two general classifications:

1. Market Value – objective value of a property based on data
2. Value in Use - subjective or emotional value of the potential buyer or seller of the property

Market Value

Market value is also known as exchange value and is a more reliable type of value. The Uniform Standards of Professional Appraisal Practice's definition of market value is:

“The most likely price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimuli.”

Example:

Guy bought a home in a high demand market 3 years ago, for $160,000. His promotion will require a job transfer out of town. After comparing similar homes in the same area, Guy could see that the market had changed and homes like Guy's that sold in the last 6 months averaged $155,000.

Similar homes, in the same area were being offered for sale at list prices between $150,000 and $157,000. Even though Guy paid more for his home, the comparison of like features and condition showed the "market value" of approximately $155,000.

Value of Use

When a buyer has a specific use for a property, that use may influence how much the prospective purchaser would pay for the property. The "use" may not influence another buyer's value.

Example:

The Nelsons, who are computer consultants and antique car collectors, built a home with a large office and a 10-car shop. They designed it with a very small living room and ONLY two bedrooms. This home works perfectly for the Nelsons, so the "use value" is more to these owners than to a prospective buyer.
Potential buyers will likely expect more living area and bedrooms for the same price. When two properties are similar, the lower priced property will be in greater demand. A buyer will NOT pay more than the lowest price property that is equally desirable as a substitute, if the terms and conditions of the purchase are about the same.

**Example:**

Kevin finds a house that he likes in an area that he wants. It is listed at $125,000. The same day he sees two other homes within a few blocks of the first home, with the same number of bedrooms, baths, and square feet and with very similar amenities. They are listed at $117,500. Kevin will buy one of the second homes.

**The Principle of Anticipation**

The anticipation and/or expectation of a future benefit can create value which is also important to appraisers. This means that the informed expectations and anticipations of buyers and sellers can have an effect on the value of property in the future. Property values usually tend to increase, but a decline in value can also occur due to deterioration, environmental issues, zoning or other factors.

**Example:**

Kip learns that a shopping mall is going in across from his commercial property. His property will probably increase in value because of the added exposure.

**The Principle of Conformity**

The conformity of the size, age, and quality of the homes in a neighborhood are taken into consideration in the estimate. The value of a property will increase if there is a certain amount of conformity without being monotonous. Areas that have no conformity of style, appearance or use can decrease the value of the home.

**Example:**

The Jeffersons spend the day looking at homes. They drive by a lovely home that appeals to them. As they drive on, they can see that the homes in the area are all different types and ages. Some are very high quality and others are unkempt and small.

Regression is the lowering of value of a superior property because it is located in area of lower valued homes. The lower valued homes in the area have a regressive effect on the superior property. If there are several high quality homes in an area, and then later, several lower quality homes are built nearby, the lower quality homes will have a regressive effect on the value of the higher quality homes in the surrounding neighborhood.

**Example:**

Greg builds seven homes and sells five of them for $300,000- $500,000. A couple of months later someone else builds 12 homes in the same area in the $89,000-$95,000 range. The lower
priced homes will lower the value of the more expensive homes and Greg may have to sell the
last two at a reduced price.

The Principle of Progression

Progression is the increase in value of an inferior property, because it is in an area of superior
properties. The superior quality homes cause a progressive effect on the value of the lower
quality properties.

It is better to buy the “worst home” in the best neighborhood, rather than the best home in the
worst neighborhood. You can change the home to make it more valuable, but you cannot
change the location!

Larry has a poorly maintained 700 square foot home in a neighborhood of 2,400 square foot,
well maintained homes. His home lowers the value of the surrounding homes. However, his
small home is worth more in this neighborhood than if it were in a neighborhood of other small
homes.

The Principle of Contribution

Contribution is the value an improvement may add to the property. Some improvements
increase the property’s value more than the cost of the improvement. Some improvements cost
more than they will contribute to properties value. Redecorating the living room will not usually
increase value of the home enough to cover the cost. However, the addition of a second
bathroom or updating the kitchen could increase the home’s value by much more than the cost
of the improvement.

Martha has a lovely home on the park, BUT it had a dated, obsolete kitchen. The house was
valued at $225,000 with the outdated kitchen. Martha has the entire kitchen remodeled and
updated at a cost of $17,000. HOWEVER, once the kitchen was completed, the house
appraised at $265,000.

The Principle of Competition:

Competition is the financial impact that other businesses have on the value of income producing
properties. Businesses that are making a profit tend to encourage competition, but excessive
profits can also create excessive competition and eventually destroy profit.

Example:

A retail business in a community becomes extremely profitable. The success is obvious and this
attracts a similar competing business into the area. The competition will probably cause lower
profits for the first business because of the new business’ share of the same market. The first
property’s value decreases as profits decrease.

The Principle of Change:

Principle of change is the theory that values can increase or decrease depending on changes
that constantly affect value through a four-phase life cycle. Examples of these would be the
following:

- Integration
- Equilibrium
- Disintegration
• Rejuvenation
• Integration is a first phase of the property development.
• Equilibrium is a the stability (no or very few changes).
• Disintegration is a the decline of the property.
• Rejuvenation or revitalization is the renewal, or restoration to the property’s highest and best use.

The physical life of a property is measured in years and the economic life cycle is measured in profitability. The appraiser will estimate the remaining time period that the property can produce income greater than ground rent. The principle of supply and demand for real estate has the most dramatic affect on the value of a specific piece of property.

Appraisers and agents use these four principles of value as important factors in the valuation process:

1. Increasing supply or decreasing demand = buyer’s market and decreased value
2. Increasing demand or decreasing supply = seller’s market and increases value
3. Demand is the desire accompanied by ability = buying power
4. Desire created by advertising, marketing and education = awareness

Example of High Demand:

After selling nearly 50 homes he adds 75 new homes, but the public responds to demand for better schools by updating technology and benefits of an existing nearby school. Seventy homes are for sale near the newly updated school, BUT they are priced 18-20% lower than the new homes.

The existing homes are 7 - 8 years old, but they have mature landscaping and more square feet. The existing homes are advertised and the public is informed of the improved school. The demand decreases for the new homes and the prices begin to come down. However, the existing homes have now increased in demand and these prices will rise.

Supply Factors:

• Construction costs
• Available new construction
• Price and availability of land
• Available existing homes
• Owner / tenant ratio
• Vacancy rates
• Building- zoning -environmental issues
• Ecology issues
• Tax structure and assessments

Demand Factors:

• Social standards/customs
• Population density
• Geography
• Transportation
• Employment
• Retirement/ disposable income
Factors That Create Value:

- Use
- Supply
- Demand
- Transferability

Because many factors affect value, the value of property can change. A home may be worth more or less today than it sold for last year and can change many times over time.

Appraisals are estimates of value for a specific point in time. It could be the date of the appraisal in the past or future. This date is the effective date of the appraisal.

Highest and Best Use

The maximum value of property is achieved when it used for the highest profitable net return or income. Return also means amenities, such as a view, waterfront, educational or recreational features that increase desirability. Deed restrictions, zoning ordinances and other possible or feasible uses may also affect highest and best use.

“Use density” is the relationship between the supply and demand for property that has a particular use. The ideal density of use is reached when the supply of land is equal to the demand for that use. “Consistent use” must be used in evaluation if the property is changing to another use.

The appraiser cannot value the land on basis of one use PLUS the proposed improvements of another use. There can be only one use.

Example:

A coastline area quickly becomes a tourist attraction. New hotels are built as the demand increases. An investor buys an old grocery store in this area. When the store was originally built for the small town, the highest and best use to yield the highest net return was a retail food store. With change being constant, the most likely highest and best use for this property may now be for a hotel.

The appraiser must evaluate the land for the use of building the hotel. If the highest and best use was still the grocery store, the appraiser would evaluate the land and the improvements as a grocery store. Since the store would have to be destroyed to build the hotel, the improvement (the store building) would not be added to the value. It would be deducted from the land value (now evaluated as highest and best as a hotel site), as a cost to demolish and remove to build the hotel.

The Concepts of an Appraisal

The Federal Housing Administration’s explanation of market value is, “the price which typical buyers would be warranted in paying for the property for long-term use or investment, if they were well informed, acted intelligently, voluntarily, and without necessity.”

The steps in the Appraisal Process are generally thorough, orderly and systematic:
1. Define the purpose

2. Gather data

The appraiser will obtain data specific to the subject property as well as general area statistics. Specific data includes boundaries, type of construction, amenities, sizes, and other information of the subject property itself. The land and utilities make up the site. The improvements are usually appraised separately from the land.

If the land is worth a lot more than the house, or if it is worth quite a bit less, the property would not be at its highest and best use. Rectangular lots are more useful than irregularly shaped or sloped lots for ALL types of use.

Site Data Includes:

- Frontage
- Width
- Area
- Depth
- Shape

Building Data:

- Year built
- Quality
- Condition - good- average - poor
- Workmanship
- Square footage
- Improved living area

Finished living General Data:

- General Data comes from the area surrounding subject property that could affect its value such as zoning, economy, population density and schools, etc.

Economic Trends:

- The appraiser looks for local, regional, national, or international level indicators of the property's future value.

Neighborhood Analysis:

- For the purpose of appraisal, a neighborhood is defined as a group of similar property types. Properties can be grouped by physical boundaries, age, or by economic levels. Or they can be grouped by the type of use, such as residential, commercial, agricultural or industrial. The values of the surrounding properties will affect the value of the subject property.

3. Verify Data

All data must be verified and documented with photos, records and other support. Appraisers often call the agents involved in recent sales of comparable properties for their opinions and other information.

4. Apply the Three Approaches

The most commonly used methods are the sales comparison approach, the cost approach, and
the income approach. When possible, the appraiser will use all three approaches and reconcile the results to arrive at opinion of value. In some situations it may be better to use only the method that seems most practical.

The appraiser may determine how many methods to use. There are properties where a method cannot be used, such as vacant land that cannot be appraised by the cost approach. The sales comparison would be better, or if it were producing a crop, the income approach might be used. A property such as a fire station MUST be appraised by the cost method.

It cannot be appraised by the income method, because it generates no income, and there can be no sales comparison because no market exists for it.

5. Reconciliation and Final Report
The appraiser will consider the purpose, type and use of the property, as well as the reliability of the data gathered. The most appropriate and reliable approach to estimate the property for the specific purpose of the appraisal will be given the most weight.

**The Market Data Approach**

The market data approach or sales comparison approach is the most widely used approach in the evaluation of residential property. It is also used whenever possible in the appraisal of Recent sale prices of comparables are good indicators of what informed buyers will pay and what sellers have accepted.

The value is estimated by comparing the subject property with actual properties that have recently sold. These properties are called “comparable sales” or “comps”. The appraiser gathers information about comparable sales and compares them with the subject property. The “subject property” is the property being appraised.

Adjustments are made for the differences in the features and amenities found in the subject property compared to the features and amenities of the comparable properties. The adjustment in price is always made to the comparable properties and never to the subject property.

The appraiser makes adjustments to compensate for the differences and then translates this data into an estimate of the market. The appraiser must use a high degree of skill, knowledge, and judgment in adjusting the values of comparable properties. The appraiser will use the data from three or more comparable sales to evaluate a residential property.

When adequate data on closely comparable properties is available, the market approach gives great reliance in evaluating residential properties.

**Inspect the property**

The appraiser thoroughly inspects the interior and exterior of the subject property. Measurements, sizes, quality, quantity and condition of the improvements and the land are used as the basis for comparing the subject property to the comparable properties.

The appraiser will search for three or more comparable properties that have recently sold. Sometimes there will not have been comparable recent sales, so the appraiser may have to use older data.

If all available data is old, the appraiser will include an explanation in the appraisal that the age could affect the evaluation. Sometimes there will be no recent sales at all that are comparable sales. This usually happens when appraising a custom built home or an unusual property, such as an historical mansion, or a lighthouse. When no comparables are available the market
approach cannot be used. 

Appraisers get their information on recent sales from the MLS, recorders office, title companies, courthouse files, land from contacting local real estate brokers and agents. The appraiser usually makes a visual inspection of each comparable. These comparable properties must be from the same or similar area as the subject.

Detailed information describing physical characteristics, sold price, concessions made by the seller or buyer, terms, type of financing, and any conditions that could have influenced the sale must be considered.

**Adjust the Comparables**

The appraiser will then analyze the data and use typical adjustment factors for each difference in the comparable properties to the subject property. It is crucial that the appraiser uses very similar properties and properly adjusts by increasing or decreasing the comparable properties according to the property’s features and amenities.

Adjustments can never be made to the subject property. The next step is to determine the value and prepare the written report. This form is the “appraisal”. The adjusted comparable values are shown and compared to the subject. This report shows the appraised value of the property as of a certain date and for a certain purpose.

**The Cost Approach**

The replacement cost approach is the method of evaluating vacant land alone. Next, the cost of all materials and labor are estimated to reproduce the building and all improvements exactly as the property exists at the time of the appraisal. Subtract the depreciation of the building and improvements. Then total the depreciated building, improvements and the land. This method could be used in high demand areas where there is an inadequate supply of new homes, or where there are few or no available building lots.

The replacement approach is based on the assumption that a new building is worth more than an existing building, and that the price to replace the property would be in the upper ranges. However, there are many cases where the older buildings would have a higher value than a newly constructed building. This could occur in an area of historical buildings.

**Replacement and Reproduction**

Replacement cost and Reproduction cost are not the same. Replacement value is the estimate of the current cost to build another building, with the same amenities, size and with the same use. Reproduction value is the estimated cost of building a replica. This means building an exact duplicate of the subject building, just the way it was originally constructed, at the current price of the labor and using the same materials.

Sometimes reproduction and replacement can be the same. This is often true when the subject property is new construction. Reproduction cost is often used when the subject has “historical” or “cultural value” or is an older structure.

The ornate workmanship as well as materials used in earlier days, are often much more expensive than used today, but to “reproduce” the structure, these important factors must be considered. The cost to reproduce a structure can be prohibitive, and usually does not reflect the current market value.
Inspect the Subject Property

An on-site inspection must be made of the buildings and all improvements. The measurements, sizes, as well as quality and condition will be the basis for calculating an accurate replacement cost and the accrued depreciation. An appraisal of the land itself is completed. This can often be done by the comparison method.

Estimate Replacement Cost Building & Improvements

The three methods used to estimate the replacement costs of the buildings and improvements are:

- Square Foot
- Quantity Survey
- Unit-In-Place

This is the easiest way to estimate replacement.

The appraiser measures the square feet of each floor from the outside. The appraiser then determines the average cost per square foot of recently built new construction of similar type homes. Then the appraiser multiplies the averaged cost per square foot times the number of square feet in the subject property. When there are no recent sales the appraiser will use the cost of materials and labor.

Formula:

Square feet of the subject property times average cost per square foot of similar homes minus the land value = estimated cost of replacing improvements

Quantity Survey

This method involves very detailed estimations of the quantity and price of specific materials as well as the cost of labor for each type of job.

All costs to complete the job including surveys, building permit, environmental impact statements, and other related costs are added in. This is a highly accurate method but is costly and time consuming.

Unit-in-Place

This method uses the cost to replace specific components, such as electrical, plumbing, roof, siding, insulation and foundation. The appraiser totals all estimates to figure replacement cost of the building.

Formula:

Cost of roofing number per square feet + cost of concrete per cubic yard + cost of framing per square foot, etc. = replacement

Once the appraiser estimates the replacement cost of the building as though it was new, the appraiser must subtract for depreciation. Depreciation is the decrease of value.

The appraisal of property assumes that a new property is worth more than a used property, because of depreciation or decrease in value because of:
Deferred Maintenance
• Deferred Maintenance
• Functional Obsolescence
• External Obsolescence

Deferred maintenance, or physical deterioration, wear and tear can be:

• Curable if cost of correction can be recovered in sales price
• Incurable if impossible or too expensive to correct roof, cracks in foundation
• Need of paint
• Worn carpet

Functional Obsolescence or adequacy for use, age, poor floor plan, or outdated can be:

• Curable if cost of correction can be recovered in sales price
• Incurable if impossible or too expensive to correct
• Four-bedroom house with one bath, in area of two bath homes
• Outdated kitchen

External obsolescence refers to the decline of the area. These are conditions outside the control of the owner and are considered incurable because it is caused by external factors such as:

• Noise
• Traffic
• Decline
• Zoning changes OR
• Safety hazards

Estimating depreciation is a difficult part of the replacement cost appraisal that requires a great deal of skill and experience on the part of the appraiser. The value of the land is then added to the depreciated value of the structure and improvements. The land can be estimated by comparing recent sales of similar lots to the subject lot, which is the market approach. The appraiser totals the land value with the depreciated improvement value and prepares a final report of the subject property value as of a certain date.

Over-improvement

These are improvements made by the owner with the intent to add not only pleasure or desirability, but also value. An example could be a basketball court that the owner installed in the back yard, and enjoyed. The owner probably thought that it would also add value.

However, it could be that the new owner didn’t like sports of any type, and now has to remove the court to put in grass. This improvement may have actually reduced rather than increased the property value.

Straight-line depreciation

Straight-line depreciation is commonly used for income tax purposes and is a way of measuring loss in value in yearly increments that is caused by age. The thought is that as the building ages, it becomes worth less money.
Formula:

Replacement Cost ÷ Remaining years of Useful Life = Annual Increment

After the number of years of “useful life” is over, the cost has been completely depreciated.

**Accrued Depreciation**

This is the difference in value between the current price of an item and the depreciated value of the item as of a certain date. This means that if an apartment building is valued at $300,000 today, and it is compared to a four year old apartment building, the four year old apartment building would have used up a percentage of its useful life and that difference would be the amount of accrued depreciation.

**Physical Life** - the length of time the improvements will remain standing

**Depreciation Life** - the length of time the IRS allows the investor to depreciate the property.

**Economic Life** - the length of time the improvements will produce an income in excess of possible rent as vacant land.

**Loan Life** - the length of time an investor uses the property to security the loan.

**The Income Approach**

The Income Approach is much more complex than the others and should be used only by experienced real estate appraisers. The income approach bases the property value on the income that it produces.

When using the income method, the appraiser determines the rent or income the property is currently earning. However, when appraising or buying rental properties, a percentage of vacancies and non-payment of rent must be expected.

This is called the “vacancy factor”. It is a percentage that is deducted from the potential gross income to arrive at a more realistic income estimate. This estimated income is called the “effective gross income”. Once effective gross income is established, the appraiser will deduct the expenses to operate the building. These are the operating expenses, which fall into three categories:

1. **Fixed** - property taxes, insurance, etc.
2. **Maintenance** - repairs, utilities, services, supplies, cleaning, employee wages, etc.
3. **Reserve** - amounts set aside for replacement of systems, major repairs or replacements, etc.

Personal income tax, reserves for depreciation, and mortgage payments are not considered operating expenses for appraisal purposes. After these operating expenses are deducted from effective gross income, the remainder is called “net income”.

The net income will then be converted into a capitalization rate, or “cap rate”, to determine the property's value. The capitalization rate is the desired percentage of return on the purchaser's investment.

**Formula:**

Annual Net Income divided by the (desired) Capitalization Rate = Value
Residential property is not considered “income property”, so a residential appraiser might use the gross rent multiplier method if the residential property is being used as a rental. The appraiser calculates a multiplier for the subject property, by determining the relationship between the rents and the rent paid for similar properties in the same or similar area.

**Example:**

Let’s say that a property recently sold for $100,000. It rents for $850 per month. Divide $850 by $100,000 = .01.

Since this rental income was computed on a monthly rather than annual basis, the result is expressed as a monthly gross rent multiplier or MGRM. The MGRM is 0 .01 for this property. OR, if the same property sold for $100,000 and the rent is $850 per month, or $10,200 per year, the annual gross rent multiplier or AGRM, would be 0.10.

Properties that rent for the same amount would be considered to be worth the same amount. Because operating expenses and vacancy factors can be very different, the gross rent multiplier can be an unreliable method to use.

**Example:**

Marie rented a home four years ago for $500 a month. Market rents have increased over the past four years, and the property could now rent for $900 a month. If the appraiser uses the $500 rent to calculate the gross rent multiplier method, it would not be an accurate estimate of value.

The GRM is quick but not very reliable method to estimate market value and should be used only as a “rule of thumb” until a more reliable approach is used. GIM, Gross Income multiplier is much the same, using Income rather than rent. It is also unreliable.

**Reconciliation**

The final step in the appraisal process is called the reconciliation. Appraisers generally prefer to use all three appraisal approaches whenever possible as indications of value. The results of the three approaches are called “value indicators”.

They only give indications of what the property is worth and will be used to help determine the final estimates. However, because sometimes data is unavailable, or the approach is not applicable, the method may not be included in the evaluation.

The estimate of value is based on the most *appropriate* and reliable approach based on the specific purpose of the appraisal. The final estimate of value is weighed against the other approach values as indicators of value. Ideally, these values are in the same ranges.

**The Appraisal Report Form**

The completed form will include:

- The date of the appraisal
- A description of the subject property
- The purpose of the appraisal
- Supporting data
- Conditions
- The appraised value
- Appraiser’s signature, certification, license or other credentials
Review

The most reliable and systematic estimation a property's value is the real estate appraisal process. An appraisal is an educated opinion of value based on factors that affect the property with the appraiser explanations of the results.

When a buyer applies for a loan, the lender usually requires an appraisal. The lender uses the appraisal to determine if the property is worth enough to provide sufficient security for the loan amount.

The Uniform Standards of Professional Appraisal Practice allows only state licensed or certified appraisers to prepare appraisals used in "federally related" loan transactions.

FIRREA is the Federal law that requires that appraisals used in federally-related transactions meet standards set by a non-profit organization called the Appraisal Foundation and MUST be performed by a person who is licensed or certified by state.

Real property has many different types of uses and values. Owner occupied, residential property, is usually valued subjectively “emotional valuation”, or objectively, by using the “market approach” appraisal.

Rental homes, apartment buildings and commercial buildings and land that are used for income are usually appraised using an “income approach” or “gross multiplier method” appraisal.

There are many different reasons to appraise property and each has its own purpose. The purpose of the appraisal can influence the appraiser to use a certain approach.

Market price is the price a person paid for the property. It does not matter whether the parties were informed of the property condition or if there were unusual circumstances (such as a forced sale or the buyer needed that specific piece).

“Cost” is the price of putting together the building and the land with all improvements.

Market value is what a seller could expect to be paid if a property is sold under an “arm's length transaction”, which means that all required conditions to a fair sale have been met.

The principle of supply and demand for real estate has the most dramatic affect on the value of a particular type of real property, rather than property in general.

Because many factors affect value, the value of property can change. A home may be worth more or less today than it sold for last year and this value will change many times over the years.

The Highest and Best Use of a property is the most profitable use. It is the use that will produce the greatest net return over a certain period of time.

The most commonly used methods are the Sales Comparison approach, Cost approach, and Income approach. When possible, the appraiser will use all three approaches and reconcile the results of the approaches to arrive at opinion of value.

Residential property appraisals are usually completed on a preprinted form called the URAR Uniform Residential Appraisal Report.
Chapter 3
Investment Property Evaluation

Glossary

Appreciation
The increase of value of the asset due to inflation or supply and demand

Capital Gain
Profit realized from an investment that is subject to taxation

Capital Loss
Loss realized from an investment that may be tax deductible

Cash Flow
Spendable income left after all expenses have been paid, such as operating costs, debt payments, taxes, etc.

Equity
The amount of difference between the property’s current value and the amount of encumbrances against it

Gross Income
Unless specifically excluded by the IRS, all income including active, passive and portfolio income

Leverage
Using other people’s money (OPM) to purchase assets for investments

Liquidity
The asset’s ability to quickly and easily convert to cash

Portfolio
Collection of different investments held by a person or a company

Real Estate Investment Trust
REIT – these are trusts that invest only in real estate and real estate mortgages

Real Estate Syndicate
A group that is formed to develop and purchase real estate as an investment

Taxable Income
28
Income on which tax is paid

**Tax-deferred Exchange**

Also called the 1031 Tax-Free Exchange, a non-taxable exchange, subject to established rules

**Introduction**

The ultimate goal of the investor is to make a profit. Investments are assets that are acquired for the purpose of generating a profit. These properties are bought and sold as investments for the sole purpose of producing an income.

Homeowners often become investors of real estate after selling their own home. They see how much it appreciated and realize that the value usually increases over time. Real estate appreciates because of inflation and demand. When property in a high demand area becomes scarce, the remaining properties will normally increase in price.

**MOST IMPORTANT OF ALL ---**

Common sense mandates that real estate agents should never represent themselves as financial advisors or investment counselors. Nor should they offer advice in these areas. Although agents should have knowledge of these subjects, they should always refer their investment clients to an investment specialist or accountant for advice.

**Choices of Real Estate Investment**

Investors can hold many different types of investments. This collection of investments is called a “portfolio”. REIT or Real Estate Investment Trust is an investment group formed as a trust. REIT’s have some special tax benefits for investors, but complex IRS requirements must be met to qualify for these advantages.

Mortgage-backed securities are issued from the secondary market, such as Fannie Mae or Freddie Mac. Individuals or groups can purchase them.

Real Estate Syndicates are formed for the purpose of investing in a particular real estate project. These syndicates can be corporations, partnerships, or an LLC (Limited Liability Company).

**Investment Property Types**

There are many different types of real estate for investors to choose from such as:

- Single family houses
- Multi-family units
- Manufactured home parks
- Condominiums
- Raw land
- Retail and office buildings
• Shopping malls, etc.

Some types generate a return from rental income, and some are meant to produce a capital gain when sold. Rental homes are one of the most common real estate investments, and are generally the easiest to manage for the owner. Duplexes and small apartment houses can also be a benefit to the investor who lives in one of the units. Being on the premises to manage can cut costs and prevent potential problems and damage.

**Preferred Qualities**

An investment property has a better chance to increase in value if it is kept in good condition and is well located. The property should fit an average renter and be somewhat conforming and functional in design.

A good structural condition, sound foundations, safe heating, safe electrical wiring, and a good roof are features to look for. The investor will look for properties that have the "right things wrong." These are cosmetic defects that require little work and money, such as paint, carpet, and cleaning and small repairs.

**Capitalization Rates**

The "capitalization" rate is the desired percentage rate of return that an investor wants to make on his/her investment. Determining value, by dividing net income by the investor's desired capitalization rate, is the most commonly used method when investors make offers to purchase income-producing property.

After operating expenses are deducted from effective gross income, the remainder is called net income. Some examples of operating expenses would be items such as maintenance, management fees, utilities, repairs, etc.

Personal income taxes, reserves for the property's depreciation, and mortgage payments made on the investment property are not classified as operating expenses. The net income is converted into a capitalization rate, or cap rate, to determine the property's value.

The formula for determining the property's value is:

\[
\text{Annual Net Income divided by the (desired) Capitalization Rate} = \text{Value}
\]

**Advantages of Investing In Real Estate**

The home buyer decides to purchase based on the perceived advantages over leasing or renting. This is also the case with investing in real estate as there are advantages involved there, also. The following is a list of advantages that real estate investors perceive:
• Increasing value due to \textit{appreciation}
• Leverage - buying real estate with OPM (Other People’s Money)
• Real estate and mortgage tax benefits
• Ability to rent or lease as income
• Pride of ownership
• Freedom to do as one wishes with the property – no landlord

“Buy low - Sell high” is the real key to the advantages of investing in real estate.

Leverage is a term for using borrowed money at interest rates less than the rate of return earned by property that you already have or will acquire. Real estate investors are wise to use OPM (Other People’s Money) in order to take advantage of leverage. Leverage allows the investor to make big investments with little or no cash of their own. The investor keeps his/her cash to continue buying property, while the previously purchased properties continue to appreciate increasing the rate of return on the investment.

Appreciation increases the equity, which is the difference between the property’s value and the existing encumbrances. The declining loan balance also increases the equity by reducing the principal balance, although very slowly.

Real estate is generally referred to as a “frozen asset”, as opposed to a “liquid asset,” because liquid assets can be quickly converted to cash. Cash in a bank account is a liquid asset. The disadvantage of liquid investments is that they don’t pay high returns, because there is little or no risk involved.

However, liquid assets are the safest investments for the same reason. Even though real estate is not liquid, it can offer a very high rate of return and can increase the investor’s net worth.

\textbf{Disadvantages of Investing in Real Estate}

Just as there are advantages to investing in real estate, there are also disadvantages. The following are some of the ones to be aware if you are contemplating any type of real estate investment:

• Responsibility of maintaining the property
• Frozen asset – some risk
• Subject to value changes due to economy & other factors
• Real estate involves the maintenance of the property, such as painting, yard work, and general upkeep.
• Real estate investments are not liquid and do not typically result in quick returns.
• They are long-term investments, which may be a disadvantage for some investors.
• Finding the right property can take a lot of time and work.
• There is also risk that the property’s value could decrease because of other factors outside the control of the investor that could result in a loss of capital and income.

Here is an example of how investing in real estate can result negatively:
Lloyd has been watching the national economic trends and the economy looks healthy. He purchases a mobile home park in Wallace which happens to be a mining town. Most of the miners live in the park and it has been generating a high income for years.

Six months after Lloyd has made his purchase, the mines suddenly and unexpectedly close down, ceasing all operations. As a result, the miners are forced to move to another state to find employment. Wallace’s economy is ruined and local businesses begin closing down.

Although the economy has not changed on a national basis, Lloyd’s mobile home park has now become obsolete.

*Federal Income Tax Classification of Property*

There are several different *classifications* of property and the IRS treats each differently for tax purposes. The following is a list of how the IRS classifies the different properties.

**Dealer Property**

Dealer property is usually a short-term investment of real estate intended to resell quickly. Building lots are an example of dealer classified property. A dealer status allows deductions for ALL operating expenses and mortgage interest.

The dealer does not hold property as a capital asset, so gains and losses are not capital gains or capital losses, and because the properties are not capital assets there are no deductions for depreciation. Gains are taxed as ordinary income and losses can be deducted as business expenses.

**Income Property**

All income received from property held for the production of income is taxable as passive income for the year the income was received, even it is due and payable in a later year.

Operating expenses, mortgage interest and depreciation of the income property is all classified as deductible. The gains from the sale of the property are considered to be capital gains and capital losses.
**Unimproved Investment Property**

Vacant land held for investment purposes is classified as unimproved investment property. This unimproved land produces no income but may appreciate and produce a future profit.

**Property Business or Trade Use**

This use includes land and structures owned and used for a business. A real estate broker could own an office building or a manufacturer could own a factory. These buildings would be considered property used for a business or trade. Again, all operating expenses, mortgage interest and depreciation is deductible. Gains from the sale or transfer are classified as capital gains, and any losses are fully deductible as ordinary losses.

**Principal Residence**

Principal residence refers to the homeowner’s primary home. The homeowner is allowed to have only one primary residence.

Homeowners that fall into this classification can deduct property taxes and uninsured casualty losses. They can deduct debts secured with the principal or the second residence. In addition to this, the can deduct all interest on money borrowed to buy, build, or improve the home for $1,000,000 or less, as well as any and all interest on home equity loans up to $100,000 or for any purpose.

**IMPORTANT NOTE: TAX LAW CHANGES TO REAL ESTATE FOR 1997**

For sale of a principal residence after 5/7/97, the rules are as follows:

1. No more rollover to new home purchased in a 2 year period or once-in-a-lifetime tax exclusion for persons over 55.

2. If the residence at the time of sale was used as a principal residence (i.e., not a vacation OR second home) for 2 of the last 5 years prior to sale, a single return filer can exclude $250,000 of gain, and joint filers can exclude $500,000 of gain.

Exclusion can be taken an unlimited number of times but not more than once every two years.

3. Gain in excess of the $500,000 OR $250,000 limits is taxed at capital gains rates.

**Personal Use Property**

This refers to property owned by the taxpayer for a personal use, but is not used as the principal residence. Ski condos, lake cabins, or vacation homes are some examples of this type of property.

**Taxable Income**

The Internal Revenue Service collects income taxes for the United States from all individuals and businesses. Federal income tax rates are “progressive.” This means the higher the income level, the higher the tax rate. The progressive tax rates are grouped into “brackets,” or levels of incomes. Tax brackets for individuals are 15%, 28%, 31%, 36% and 39.6%.
They are not equal, and each dollar is taxed on the “bracket” it is counted in. The income above each bracket is taxed at the next bracket, but the higher bracket does not affect the part of the income that was already taxed at the lower bracket.

The IRS considers all income, from all sources, as taxable income unless it is specifically excluded. This includes all income resulting from salaries and wages, as well as rental income, investment income and all other income received in the year even if it was paid in advance.

**Tax Credits and Deductions**

When real estate is sold or transferred, the seller or investor almost always has a profit or a loss. A profit is referred to as a capital gain, and a loss is referred to as a capital loss. Tax deductions are taken from the income which reduces the taxable amount. A loss may be a deduction, which can lower the taxable income.

Tax credits were initially created to revitalize the economy and they are important to real estate investors because they are deducted directly from the amount of income tax due. A good example of a tax credit is the homeowner’s deduction of mortgage interest from income tax due.

One of the main benefits to real property ownership is the numerous deductions available for property owners. A deduction is subtracted from the gross income before it is counted into a tax bracket, thus reducing the amount of taxable income. Deductions include depreciation, property taxes, and interest on mortgages, as well as passive losses.

Deducting depreciation allows the taxpayer to recover the cost of an income-producing asset over its estimated useful life. Remember that land does not depreciate because it is always considered to be useful. However, buildings and equipment have an estimated useful life that will eventually run out. Depreciation must be taken over the number of years of the property's useful life. It can never be taken all at once.

Depreciation is subject to legislation and does not actually mean the property’s useful life has really ended when the time period runs out. Congress has modified the time periods of useful life many times, and the periods are subject to change.

Property taxes, such as real estate taxes and assessments are generally deductible as well. Interest payments made on personal residences are the only allowable interest deduction and are deductible in the year they were paid. The taxpayer may deduct interest paid on a mortgage up to $1,000,000 on a primary or second home.

Deductions affect property owners by reducing the taxpayer’s adjusted basis if the deduction is allowable. The reduction in the adjusted basis will reduce the eventual gain or loss.

Capital expenses are those that add value to the property, and repairs are not capital expenses. However, property owners may deduct the cost of repairs only in the year they were paid. It is up to the property owner to keep track of all expenses and keep receipts.

Passive income is the income generated from the property, such as a rental house. Passive losses result if the losses are higher then the income from the property. Passive losses can only be offset by passive income, but if the owner doesn’t have enough passive income that year, the passive losses can be carried forward to be used in a year when a passive income is generated.

Exceptions are always made for investors of rental properties that have a taxable income of no more than $100,000. In this case, the owner can use up to $25,000 of the passive loss to offset income from any other source. The maximum deduction is a reduction of 50 cents for every dollar of taxable income over $100,000.
Taxpayers involved in real property trades or businesses may deduct all losses from rental real estate to their non-passive income if they are in the real property business. A good example real property business example here would be a Realtor. They are required to perform more than 750 hours of work and over 50% of their personal services in the business. All passive losses that were not deducted in the first year can be carried forward to future years.

**Property Value after Profit or Loss Formula**

If the investor made no profit, but also had no loss, the property value would remain the same. The percentage of the profit or loss is the comparison of the property “value before” the profit or loss, to the property “value after” the profit or loss is taken.

The value of the property before the profit or loss was taken is 100% of its value. This 100% figure is called the “value before.” If the investor realizes a profit, the property is valued at 100% of its “value before”, plus the percentage of profit. Of course, if the investor shows a loss, the property is valued at 100% of its value before, minus the percentage of profit.

**Value Before and Value after Formula**

The percentage of the profit or loss is multiplied by the Value of the property before the profit or loss, plus 100% (of the Value BEFORE), equals the Value after the profit or loss. Or to write this as a true formula:

\[
\text{VB} + 100\% \text{ (of VB)} \times \% = VA
\]

(The Value after divided by the Value before plus 100% of the Value before equals the percentage of profit or loss)

Here are a couple of examples to illustrate the formula:

1) Joe bought a house seven years ago for $169,000. He sold it to Troy for 40% more than he paid. What is the “value after” of this property?

Remembering that the \( \% \times \text{VB} = \text{VA} \), \(.40 \times$169,000 = $67,600. Therefore, Joe’s profit is $67,600. He can now add the profit to 100% of “value before,” which was $169,000 for a total of $236,600 “value after”.

2) If Wanda sold her rental for $174,300, which was 27% more than she paid for it 1 year ago, how much did Wanda originally pay for it? She knows the “value after” is $174,300 and that the percentage of profit is 27%.

Once again, applying the formula above, \( \text{VA divided by } \% + 100\% \text{ of VB} = \text{VB} \)

Since 100% + 27% is 1.27%, $174,300 divided by 1.27 = equals $137,244, therefore Wanda originally paid $137,244 for her rental property.

**Capital Gains**

Profits are considered income and are subject to taxation. The rules for capital gains tax have been changed as follows:

- For sales or exchanges after 7/28/97, the holding period to qualify for long-term gains is increased from 12 months to 18 months.
- For sales after 5/7/97, the capital gains tax rate has been reduced from 28% to 20% for long-term gains.
- For those in the 15% tax bracket, the rate is reduced to 10%.
• For sales after 12/31/2000, the tax rate will be reduced to 18% (or to 8% for those in the 15% tax bracket) for assets held at least 5 years.
• For sales after 5/7/97, depreciation recapture will be at a tax rate of 25%.

If a taxpayer takes depreciation on a principal home (e.g., if it was used as rental property) after 5/7/97, that depreciation must be recognized and recaptured on sale.

Basis

To figure capital gains and/or losses, first the basis of the investment must be determined. The initial basis is usually what the taxpayer has invested in it, including the purchase price plus specific closing costs including attorney fees, title insurance, etc. When an asset is sold or transferred the taxpayer’s basis is the amount that can be received without realizing a capital gain.

This means that if Drew bought a home for $108,000 and paid closing costs of $4,500, for a total of $112,500, he could sell the house for $112,500, and without owing Federal tax, because he did not realize a gain.

The taxpayer’s initial basis can be adjusted by considering capital expenditure, depreciation, and cost recovery deductions. After these costs are figured into the initial basis, it becomes the adjusted basis.

Capital expenditures are capital improvements that add to the value of the property or extend the property’s useful life. This could be assessment for streets, or improvements such as adding bathrooms or remodeling the kitchen. Normal maintenance and repairs do not add value or extend the useful life and cannot be added to the basis.

Here’s an example showing how the basis is calculated:

Charles pays $165,900 for his house, plus $6,400 in closing costs. Three years later he adds a second bath for $3,200. He totals the original $165,900, plus the $6,400 in closing costs, plus the $3,200 for capital improvements for an adjusted basis of $175,500.00.

Realization

Capital gains are not taxable until the property has sold or transferred and the gain has been realized. If the property has appreciated in value, the gain would not be realized (taxed) until the property was sold or exchanged. When the property is sold or exchanged, the gain would then be figured and become taxable.

Here’s an example to illustrate how realization is figured:
For the past three years, Charles’ house has been appreciating in value. His house now has a market value of $250,000.

Charles paid $165,900 for the house, $6,400 in closing costs and added $3,200 in improvements for an adjusted basis of $175,500.00. His house is now worth $74,500 more than he has invested. Charles will not have to pay tax on the $74,500 gain until it is realized when he sells OR transfers it.

**Net Sale Price**

A gain or a loss is the net sale price (that is realized) minus the adjusted basis. The “net sale price” is the amount realized. This is a total of all money paid, plus the value of other property or exchange received, plus any debt relief (assumed or paid off), minus the selling costs.

Money paid (including cash, notes, and mortgages) plus the value of exchange or other property plus the debt relief (mortgages paid or assumed by buyer) minus the selling costs (commissions, legal & loan fees, points) equals the amount realized (or the net sale price).

**Investment Exchanges and Investment Sales**

A “tax free exchange”, also called non-taxable exchange or 1031 exchange, is actually a tax-deferred exchange. Section 1031 of the IRC establishes the rules for all tax-free or “tax deferred” exchanges.

These tax free (deferred) exchanges help to make it possible to purchase property with tax deferred proceeds from the first sale. The tax-free exchange is used in the exchange of investment properties. These exchanges must be of tangible “like-kind” properties.

Like-kind property is exchanged and the recognition of realized gain is deferred. Like-kind means that both properties are properties held for investment or is capable of producing income.

Personal use homes, principal residences, and dealer owned properties are not like-kind and are not eligible for the tax-free exchange.

A Laundromat in exchange for a manufactured home park would be like-kind. Any money or other property other than like-kind is called “boot”. Boot, such as personal property, cash, etc., cannot be deferred.

Here’s an example to help illustrate the above:

Stan exchanges his tavern for Skip’s café. Stan owes $100,000 on his loan balance and Skip owes $60,000 on his mortgage. By making this exchange, Skip is giving Stan $40,000 as boot as a result of debt relief. This is because Stan now has a balance of $40,000 less than he did before with his $100,000 loan on the tavern that Skip now owns. As a result, Stan will have to pay tax on the $40,000 in the year he received it, as though it were income.

**Installment Sales**

All sales automatically qualify for tax deferral if the seller does not receive the full purchase price of the property in the year of the sale. It should be noted that almost all seller-financed transactions are installment sales that allow the seller to defer recognition of part of the gain.

The seller is only required to pay taxes on the profit amount received in each year. The gain recognized in any year is based on the ratio of gross profit. The gross profit is the difference between the sales price and the adjusted.
### Gross Profit

Gross profit divided by the contract (sales) price equals the gross profit ratio. In other words,

\[
\frac{48,813.00}{289,500.00} = 0.17 \text{ OR } 17\%
\]

Now the Gross Profit Ratio is applied to the payments made to the seller in any given year to figure the amount of principal that is taxable gain.

Gross Profit Ratio is not applied to interest. Interest payments are taxable the year in which they are received.

Assuming that the seller above had received $28,950 as a down payment, and $1,460 in installment payments, then the total principal payments would be $30,410.

So to calculate the seller’s total taxable income, it would be as follows:

\[
30,410 \times 0.17 = 5,169.70 \text{ Total taxable Income}
\]

When a seller allows the buyer to assume a loan that is bigger than the seller’s basis, the amount over the basis is treated as a payment received and is subject to taxation.

### Review
The ultimate goal of the investor is to make a profit. Investments are assets that are acquired for the purpose of generating a profit. For this reason, homeowners often become investors of real estate after selling their own home. They see how much it appreciated and realize that the value usually increases over time.

Real estate appreciates because of inflation and demand. When property in a high demand area becomes scarce, the remaining properties will normally increase in price.

Mortgage-backed securities are issued from the secondary market, such as Fannie Mae or Freddie Mac. Individuals or groups can purchase them.

Real Estate Syndicates are formed to invest in a particular real estate project. The Syndicates can be corporations, partnerships, trusts or an LLC (Limited Liability Company).

Rental homes are one of the most common real estate investments and are generally the easiest to manage for the owner. An investment property has a better chance to increase in value if it is in good condition and is well located. The property should fit an average renter and be somewhat conforming and functional in design. The investor will look for properties that have the "right things wrong." These are cosmetic defects that require little work and money, such as paint, carpet, cleaning and small repairs.

Appreciation increases the equity, which is the difference between the property’s value and the existing encumbrances.

Real estate investments are not liquid and do not typically result in quick returns. They are long-term investments, which may be a disadvantage for some investors.

Dealer property is usually a short-term investment of real estate intended to resell quickly. Building lots are an example of dealer classified property.

Principal residence refers to the homeowner’s primary home. The homeowner can have only one primary residence.

The IRS considers all income, from all sources, as taxable income unless it is specifically excluded. This means that all income from salaries and wages, as well rental income, investment income and all other income received in the year, even if it was paid in advance.

When real estate is sold or transferred, the seller or investor almost always has a profit or a loss. A profit is called a capital gain, and a loss is called a capital loss.

Deductions affect property owners by reducing the taxpayer’s adjusted basis if the deduction is allowable. The reduction in the adjusted basis will reduce the eventual gain or loss.

Capital expenses are those that add value to the property, and repairs are not capital expenses. However, property owners may deduct the cost of repairs in the year they were paid. It is up to the property owner to keep track of ALL expenses and keep receipts.

The percentage of the profit or loss is the comparison of the property “value before” the profit or loss, to the property “value after” the profit or loss is taken.

There are several ways that tax on gains may be deferred. A “tax free exchange”, also called a non-taxable exchange or 1031 exchange, is actually a tax-deferred exchange. Section 1031 of the IRS establishes the rules for all tax-free or “tax deferred” exchanges.

All sales will automatically qualify for tax deferral if the seller does not receive the full purchase price of the property in the year of the sale. Almost all seller-financed transactions are installment sales that allow the seller to defer part of the gain.
Chapter 4
Rental Property Evaluation

Glossary

Abandonment

When a tenant has failed to pay rent and has also clearly indicated in words or actions that tenant no longer intends to occupy the property

Automatic Renewal Corrective Maintenance

Repairs done as needed to the building’s systems, structure, equipment, etc., to keep it operational

Deposit

An amount of money collected from the tenant and held by the landlord as protection in case there is any damage or default by the tenant (also called security or damage deposit)

Expenses (fixed)

Reoccurring expenses that do not change or depend on the amount of rental income, such as insurance or property taxes

Expenses (variable)

Expenses that change depending on present needs or amount of rental income

Lease

A conveyance of a leasehold estate and a contract for the term and payment of rent

Management Agreement

An agency relationship which is created between the owner and the property manager

Management Plan

A schedule of the manager’s duties, including expense projections and management strategies that focus on the owner’s goals

Preventive Maintenance

An organized plan to detect potential problems and prevent serious damage by making scheduled inspections and immediate repairs

Property Manager

A qualified person who is hired by the owner to supervise and manage the building and its operations
Rent Roll

The total rent earned, which is the amount of rent collected and the amount of rent that is due but uncollected.

Statement of Operations

The manager’s report to the owner showing the income, expenses and the condition of the property.

Introduction

Although property management is usually limited to those agents that are specifically educated and experienced in this area, all real estate agents should have some basic knowledge of the field.

There are companies that specialize only in property management, but many real estate companies offer property management as an additional service. The position of the property manager can be very demanding, requiring constant attention to many details.

Preparing for a career in property management should include background in real estate, education in business and management, knowledge of computerized accounting systems and experience as an apprentice with a qualified investment property manager.

The Management of Rental Property

The purpose of hiring a property manager to handle rental properties is to enhance profitability by maximizing income and minimizing expenses while providing service to the tenants and increasing the value of the property.

Owners purchase rental properties to produce income and take advantage of tax benefits, but are often unable to manage these large properties themselves.

Instead these owners hire a property manager to supervise income-producing property and perform the following duties:

- Collecting rent
- Showing properties
- Keeping records
- Handling maintenance
- Planning a strategy to achieve the owner’s goals.

The property manager is not only expected to maximize income, but also protect and maintain the owner’s investment in the property. A property’s value is based on its income from tenants.

The number of potential tenants depends on many important factors, such as location, employment, and rent rates and other factors. The “occupancy rate” is the number of available units compared to the number of potential tenants for those units, or “supply and demand”. If the population increases so much that there are not enough potential tenants to fill the vacancies, a technical oversupply occurs.
Rental rates can constantly change according to the supply and demand of occupancy. A residential property manager can get a basic idea of rental trends by averaging the monthly rent per unit or square foot of their managed buildings.

They can also compare rents of other advertised rentals in the area, or by using the Bureau of Labor statistics on rents paid for residential units. It is important to consider the increasing national trend towards smaller families and single person households.

Local employment trends can show if earnings are increasing or decreasing. It is important to know if a potential tenant is able, as well as willing to pay the rent. It is important to consider the increasing national trend towards smaller families and single person households.

If smaller families are also the local trend, smaller units may be in more demand and would increase in value. Effective property management that will bring the owner the highest yield involves the careful consideration of these factors.

**Example:**

Tom and Jim build identical 50 unit apartment buildings. They contain only 2 bedroom units and cost exactly the same amount of money. Tom builds his apartment building in a highly populated city with high occupancy rates, low. Jim builds his apartment building in a rural area, with a small population, low occupancy rates, a trend of large families and very little employment.

Even though both buildings cost the same to build, you can see why the value of Tom’s building will be much greater than Jim’s. Tom’s building has a much greater potential income because it will attract more potential tenants.

**Property Management Agreement**

The management agreement is a *written document*, signed by both parties that must be established before the owner and manager enter into a working relationship. The management agreement creates an agency relationship between the property manager and the property owner as a listing contract creates an agency relationship between the broker and a seller. Once the management agreement is established, the manager assumes the legal duties and responsibilities of an agent representing the owner.

This agreement cannot be verbal even if the owner does not demand a written agreement, and applies to all types of property. The duration of the agreement is usually not long term, but there should be a method for terminating the agreement. It is important to include a description of the owner's goals, such as maximizing income or increasing the property value, and to spell out the manager's specific duties and extent of the manager's authority.

**Example:**

The apartment building that Dave is managing needs to be painted. The management agreement states that Dave may have repairs and painting done without consulting the owner. Dave also wants to use television advertising to fill the 500-unit complex.

The management agreement states that the manager must have prior approval of the owner BEFORE committing to major advertising campaigns.

The management agreement should not authorize the manager to purchase, list, sell, lease option or exchange the property. If the manager is authorized to list the property for sale, a
separate listing agreement should be used.

The property manager’s compensation is typically a fee equal to the percentage of operating income collected. However, all commissions are negotiable, and there are no “standard” “average”, or “fixed” commission rates. If the property manager performs work on the property for the owner as a personal business interest, this interest must be disclosed in the agreement. The manager is allowed to provide other services to owners with written disclosure of fees, and written permission from the owner.

**The Management Proposal**

Property owners have different goals, which can change depending on their needs at the time. The manager must have an excellent understanding of the owner’s goals, and use the most effective methods to achieve them.

**Example:**

Paul is retired, and his goal is to rely on a steady stream of income from his apartment building. Pat is an attorney, and his goal is to use his apartment building as a tax shelter. Pam’s goal is to increase the value of her apartment building to sell at a profit in ten years.

Paul, Pat and Pam’s property managers will each develop a different management plan to achieve their owner’s specific goal. To set a rental schedule and prepare a budget proposal, the manager must complete neighborhood analysis, regional analysis, property analysis, and market analysis.

**Neighborhood Analysis**

The most important features to consider are the condition of the neighborhood homes, growth or decline, and local economy.

**Regional Analysis**

The manager will analyze the region’s general economy, physical attributes, and the growth and distribution of the population. This is a physical description of the building’s design, condition, and the general layout.

**Market Analysis**

This is a CMA or Comparative Market Analysis of the property that compares properties that will be competing with the subject property in the area. The proposal will include a description of the daily operations, including policies and procedures. The manager will outline these operations and estimate the costs of carrying them out.

**Budget**

The budget will estimate income as the total of rent that could be earned from every unit or space, at the proposed rental rates, minus a percentage for vacancy. The budget will also estimate the “fixed” and “variable expenses”. These expenses are “operating expenses” and are deducted from the estimated income to establish the cash flow.

**Rental Schedule**
A property that offers more desirable amenities than a similar nearby property can demand higher rent. But effective marketing can also increase the income and value of the property.

Extremely high or low vacancy rates are indications that the rent is higher or lower than the “going rate” of comparable properties, and should be adjusted. A rental schedule lists the rental rates and occupancy levels of units according to their type, based on neighborhood, regional, property, and market analysis.

Approval

To have highly effective management, the property manager and the owner must be in agreement of the management plan. This plan must be focused on the owner’s financial goals using the most efficient methods.

To be certain that the owner and the property manager have a “meeting of the minds”, the management proposal is presented to the property owner for approval as the “management plan”. This plan will serve as the roadmap to successful management of the property.

Licensing Requirements

Licensed real estate brokers may conduct property management activity and negotiate property management agreements for a fee, on behalf of property owners. Real estate agents and associate brokers may not conduct or negotiate management activity on their own, but they may on behalf of their broker.

However, there are several exceptions to the licensing rule. A “resident” manager is a property manager that actually resides in the property that he/she is managing. A license is not required for a “resident” manager. The owner of the property and members of owner’s family also need not be licensed to manage the property.

A corporation or partnership can qualify as an owner of its own property, but it must be licensed as a real estate broker if the corporation or partnership represents others as a property management business. The licensing requirement excludes secretaries, bookkeepers, accountants, and other office personnel that do not perform acts that require a license.

Attorneys that represent the property management’s account as a client are exempt from licensing and are required to place all funds into trust accounts. Authorized attorneys in fact may not use the exemption to evade licensure. Also excluded are persons managing self-service storage rentals or leases, or persons who manage property on an incidental basis that is not a main source of income.

Property Management Functions

The property manager is often placed between the demands of the tenant and the goals of the owner, and must be able to handle conflicts with diplomacy. There are no state exams, required courses, educational or degree requirements to become a property manager. However, the professional property manager should have the skills to gain the highest possible net return to the property owner and keep good tenant relations.

The manager is expected to show the property, collect rent, keep records, and manage tenant concerns. Preventive maintenance and repairs to protect the property value is also a part of the manager’s duties.

Showing and Renting the Property
The property manager will advertise the property to attract potential tenants. The manager gives the prospect a tour and points out desirable qualities of the property. If the prospect is interested, the manager must qualify the prospect for income and credit. Once the prospect is qualified, the property manager and tenant will execute a rental agreement.

Renewal

A property manager should notify tenants in plenty of time when they are getting close to the end of their lease, to ask the tenant if they want to renew. Finding new tenants is more expensive and time consuming than renewing an existing lease.

Rent Collection

Rental payments should be collected when due. The manager’s qualification process of new tenants is the most effective way to avoid late or delinquent rent payments. A careful property manager will investigate the prospect’s qualifications and references, and rent only to qualified tenants with a good payment history.

Renewal eliminates vacancy time between tenants, and builds stability of longer-term leases. If the tenant does not have an automatic renewal clause, the manager and tenant must negotiate the terms of the new lease.

Marketing and Advertising

Advertising and marketing brings potential customers to the property. The property manager wants to attract the highest number of prospects for the lowest possible cost. There are many types of advertising that vary in advantages and costs. Non-licensed employees or licensees working under the broker may prepare the ads.

However, this must be done under the broker’s direct supervision and include the broker’s name as licensed. All advertisements must be truthful, and not deceptive or misleading. Using signs is a relatively inexpensive form of advertising that can be used to rent space in office buildings, large apartment complexes, and shopping centers.

Signs with the name and phone number of the manager are often used to indicate a vacancy. Direct mailing has the benefit of reaching potential tenants as a good cost-effective means of advertising. Mailing lists can be purchased, and should be up to date to be effective. Materials that are sent should be carefully designed to appeal to prospective tenants.

Classified ads are the most common way to advertise residential rental space. The least expensive ads are the lines in the “classified” section of the newspaper. Display ads cost much more than line ads, and are usually used to rent very large properties such as industrial parks or shopping malls. Television advertising is the most expensive method and is seldom used.

However, advertising on cable channels can be much less expensive. Some types of properties need to be advertised only when there is a vacancy to fill. Properties in a high demand area may not need to be advertised at all. However, most properties will require some advertising to generate enough interest to fill vacancies as they occur.

Screening/Selecting Tenants

Screening of tenants means the checking of financial references, credit reports, and references from former landlords. The manager may consider the tenant’s credit and ability to pay, but
cannot consider racial or ethnic backgrounds, sex, familial status, or other factors, which would violate laws prohibiting discrimination.

Record Keeping

The owner and manager should set up a special bank account to pay property expenses and track deposit receipts as well as a separate trust account for security deposits. The funds from the general expense account and the trust account for security deposits may not be commingled.

The property manager often has control of these accounts, subject to audit by the owner. The manager must collect rent, keep good records and give immediate notification of late payments. If the tenant fails to pay, the manager can take legal action according to the owner's policies. An accountant or bookkeeper can do the record keeping, but the manager is still accountable.

Each state has procedures for the maintenance of records and trust accounts. Any fraud or misuse of funds by a broker or agent could result in fines or revocation of real estate licenses.

Maintenance

The property manager must protect the value of the property by keeping it well maintained without excessive spending. Preventive maintenance can prevent costly repairs that can result from neglect. The regular cleaning of the building's interior and exterior is housekeeping maintenance.

Corrective maintenance is the repair of an existing problem, such as a leaking roof or pipe. Alterations to new construction are also considered maintenance. The required changes could be minor, such as new carpet and paint or as extensive as moving walls.

Property managers must also be aware of federal laws requiring public accommodations to be accessible to the disabled. These laws are discussed in Fair Housing. Property managers are responsible for the scheduling, inspection and supervision of the maintenance. They are not required to be contractors or to actually make repairs but they are expected to be knowledgeable of maintenance needs and be capable to direct the maintenance staff or independent.

Manager/Owner Relationship

The manager provides reports to the owner on all aspects of the property. These reports should be detailed, clear and concise. It is important that the manager and owner remain in contact and that all lines of communication are kept open. A computer literate property manager can be a tremendous benefit to the property owner. Technology has given the property manager a variety of programs to quickly generate customized reports for any purpose.

Statement of operation reports can be generated showing the income and expenses, collections and disbursements, return on investment, budgets, cash flow, vacancy rates and performance comparisons. The report can also give a statement of the overall condition status of the property, maintenance records and the manager’s recommendations.

The rent roll report will show the total rental rates of the leased and the vacant space of the property. The total of collected and uncollected rental income earned (from occupied and vacant space), should equal the total rental value of the building.
In addition to using computerized programs to generate all types of detailed reports, the property manager should include a written narrative of opinions or explanations regarding the reports. Owners often appreciate an update on local trends that could bring changes in occupancy or rents.

**Types of Properties**

The basic types of income producing properties are:

- Residential - Houses, apartments, condos, and co-ops
- Retail - Stores and shopping centers
- Industrial - Industrial parks
- Office - Office buildings and office parks

Residential property managers will find that because there is a relatively high turnover rate, showing, negotiating and leasing out space will take up most of their time. The residential property manager is obligated to fulfill the landlord-tenant laws. Because the property manager must follow the letter of the law, a thorough understanding of Fair Housing laws is essential.

There have been many recent lawsuits against landlords for failing to make provisions for the disabled or rejecting prospective tenants because they have children. The commercial property manager must take into consideration many of the same factors as the residential property manager, but the commercial manager must also determine the type of prospective tenant that is suitable for the property.

Commercial rent is usually determined by using the “market survey grid”, which is a comparison based on rent per square foot of available area, taking into account many of same adjustment factors. In a retail shopping mall, the financial success of each tenant will depend on each tenant’s ability to generate customers from the attraction of the other tenants.

Because a percentage of the tenant’s income is typically part of the rent, the ideal of tenant mix will attract the widest variety of potential customers and eliminate direct competition within the mall.

**Review**

Preparing for a career in property management should include background in real estate, education in business and management, knowledge of computerized accounting systems and experience as an apprentice with a qualified investment property manager.

The “occupancy rate” is the number of available units compared to the number of potential tenants for those units, or “supply and demand”. The management agreement creates an agency relationship between the property manager and the property owner like a listing contract creates an agency relationship between the broker and a seller.

The property manager’s compensation is typically a fee equal to the percentage of operating income collected. However, all commissions are negotiable and there are no “standard” “average”, or “fixed” commission rates.

Licensed real estate brokers may conduct property management activity and negotiate property management agreements for a fee, on behalf of property owners. Real estate agents and associate brokers may not conduct or negotiate management activity on their own, but they may on behalf of their broker.
Not everyone has the business background and temperament to function effectively as a property manager. The property manager is often placed between the demands of the tenant and the goals of the owner and must be able to handle conflicts with diplomacy.

Screening of tenants means the checking of financial references, credit reports, and references from former landlords.

The manager may consider the tenant's credit and ability to pay, but cannot consider racial or ethnic backgrounds, sex, familial status, or other factors, which would violate laws prohibiting discrimination.

Property managers are responsible for the scheduling, inspection and supervision of the maintenance. They are not required to be contractors or to actually make repairs but they are expected to be knowledgeable of maintenance needs and be capable to direct the maintenance staff or independent.

Statement of Operation reports can be generated showing the income and expenses, collections and disbursements, return on investment, budgets, cash flow, vacancy rates and performance comparisons. In addition to using computerized programs to generate all types of detailed reports, the property manager should include a written narrative of opinions or explanations regarding the reports.

Chapter 5
Land Use Restrictions

Glossary

Building codes

Minimum standards regulation of construction methods and materials

Condemnation

A permit that authorizes a special use for a property where it would otherwise be prohibited by the zoning, such as allowing a hospital in a neighborhood

Eminent domain

The power of the government to take private property for public for fair compensation

General plan

A long-term comprehensive development plan implemented by local zoning and other laws

General real estate taxes

Annual taxes based on the value of the property OR “ad valorem” and levied against real property for the payment of general government services

Non-conforming use

Allowing a use to continue that was previously legal, BUT because of a new zoning ordinance
would be considered technically illegal

**Police power**

State government rights to regulate use of private property for the protection of the public safety, health, welfare, morals, and general welfare

**Rezone**

A zoning ordinance amendment that changes the use of property resulting from a successful application for rezone by an owner who believed the property was improperly zoned

**Special assessment**

A tax levied against property to pay for a local improvement project that benefits the property

**Variance**

An authorization from zoning officials to conduct a land use that is prohibited in a zoning ordinance to eliminate undue hardship for the property owner

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**Introduction**

Public and private restrictions affect real property. The developer or grantor of the property usually imposes private restrictions. The government imposes public restrictions. These restrictions affect title to property, and may affect the value of the property.

**Private Restrictions**

Private restrictions are those that are not created by government entity. They are binding restrictions created in deeds or other written agreements as the property owner’s right to restrict the future use of property:

- By grantor in deed
- By testator in will
- By agreement between 2 OR more owners

In this way the seller can control or limit all future owners use of property forever. The developer or sub-divider’s general plan will contain the recorded declaration of restrictions. The buyer’s individual deeds will not contain the actual restrictions, but will refer to a recorded declaration of the CCR’s.

Private restrictions are not limited to fee interests, but are also included in leases to restrict lessee’s use of property. Sub-dividers buy a large amount of raw land and divide the large piece into lots or smaller parcels for building sites. Developers may also be sub-dividers. They may purchase sub-divided land and develop it to sell it as lots or build on them and sell them as lots with homes. Before any building takes place, both private and public restrictions must be determined.

When a deed restriction and a zoning restriction are on same property, the most restrictive has priority over the other. The developer must investigate the public restrictions on the use of land, such as:
- Local building codes
- Housing and health codes
- Zoning restrictions
- Subdivision regulations

As well as private restrictions such as:

- Covenants and conditions
- Deeds
- And any other written agreements

These private restrictions, or Covenants, Conditions, and Restrictions are also called the CCR's.

**Conditions**

Conditions are promises in a deed that if not kept, could result in the loss of ownership.

**Covenants**

Covenants are promises in the deed, that if not kept can result in injunction or lawsuit for money damages, but not loss of ownership. Restrictions are public or private limitations on the use of the property. Private restrictions can be used for any purpose that is not illegal or against public policy. Any restriction that limits or restricts ownership or occupancy based on race, color, national origin, religion, or physical or mental handicap is void and unenforceable.

An unenforceable restriction has no effect on the conveyance of the title and is treated by law as though it does not exist. However, if the remainder of the deed were valid, any other deed restrictions would still be valid.

**Personal Restrictions**

Some restrictions are created by the owner out of a personal concern, such as the restriction of alcohol use, and are enforced by the grantor or heirs for the benefit of land that is retained by original owner (grantor).

The restriction could also be out of a concern to enhance the value of the property if it is sold, such as restricting the height of a structure to preserve the view from owner’s (grantor's) property. The restricted use of the property is retained by grantor and must be enforced by all future owners of the property.

**Developer's General Plan Restrictions**

Developers often invest quite a large amount of money in a project and take a calculated risk that the development will sell at a profit. The developer’s general plan restrictions are intended to enhance the salability of the project by prohibiting or restricting certain uses.

Many developers establish homeowners’ association or architectural committee to approve building plans of homes to be constructed in the subdivision. Common restrictions include:

- Limitation of exterior color choices
- Limitation of height and type of fences
- Prohibition of parking boats/RV’s on the street
- Prohibition of outside television antennae
• Limitation of number and type of animals
• Control of style, height, size, and location of homes on lots

**Deed Restrictions**

Deed restrictions apply to ALL owners and are appurtenant or “run with the land”. Many restrictions have a time limit and unless extended at the end of the period by approval of 100% of the landowners, the restrictions will expire.

Although each lot owner has the right to enforce restrictions, enforcement may be denied if it is NOT reasonable. If restriction violations had been previously and continuously ignored for other owners OR if no one bothered to enforce a restriction for an unreasonable period of time, OR if the person seeking enforcement is also in violation, the violation may be unenforceable.

The usual procedure to enforce a deed restriction is to apply for an injunction to prevent OR remedy the violation. An owner could also be sued for damages to compensate for any losses caused by the violation.

**Conditions**

It is common for conditions to be a part of an agreement. Conditions also run with the land. They are much stronger than covenants and actually qualify the type of estate that will be granted. By placing a condition on the agreement, the grantor creates a defeasible fee estate. This means that the grantee retains title to the property only as long as the grantee complies with the condition.

A condition can be written to bind only the original grantee, or it can extend to all future owners of the property. If the condition contains a reverter clause, it will revert back to the grantor or heirs if there is a violation of the condition. If the property reverts back to the grantor, the violator will not receive any compensation. The court can remove any encumbrances that were placed on the property by the violator.

**Public Restrictions on Land**

In the process of planning, local governments impose public land use controls. Owners have many rights, but those rights are limited by the powers of the federal, state and local governments. Property ownership is most affected and impacted by planning, zoning, other public restrictions on land, and the government’s power to tax property.

The Constitution gives the government the power to interfere with private property rights on the basis of land use control laws called police power. The police power allows state and local government to regulate a private individual’s use of their own property by making enforcing laws for the protection of the public safety, health, morals and general welfare.

However, a property owner must be compensated if land was taken through eminent domain. But, no compensation can be expected if the land use is restricted by zoning or other actions of police power. Enforcement of police power must meet constitutional limitations.

In general, a land use law or regulation is considered to be constitutional if it protects the public health, safety, morals, or general welfare. It does not amount to confiscation by drastically reducing a property’s value. It benefits the public by preventing harm.

**Zoning**
Zoning has the greatest affect on the value of real property. It is a restriction on the use of private land although it is not considered to be an encumbrance. Zoning actually outlines areas of land to be used for specific uses such as:

- Residential
- Commercial
- Agricultural use

Then these categories are classified further in to subcategories. A residential district could be divided into multi-family residential and single family residential.

The purpose of zoning is to assure conformity and compatibility in surrounding areas. Prohibitive zoning protects existing property owners from being affected by undesirable uses. Directive zoning is to ensure that all future uses must only be the highest and best use of the land and compatible with the surroundings.

Zoning regulations can affect housing, preservation of open spaces, as well as regulate the use, height, size and shape of buildings, including setback distance between a structure and the property lines.

**Non-conforming Use**

Land uses that do not conform to present zoning and conflict with present zoning are allowed to continue under a grandfather clause as legal non-conforming use. The buildings are allowed to continue to be used as they had been. Although there is no requirement to change, demolish or remove the buildings, the intent of rezoning is to eventually eliminate all non-conforming uses.

Grandfather clauses allow non-conforming use to continue BUT prohibit:

- Expansion or remodeling to extend the structure’s life
- Rebuilding if structure is destroyed or torn down
- Extensive repairs to structural damage (allows basic repairs for wear and tear)

And could require:

- Termination, if owner voluntarily abandons structure or discontinues use.
- Amortization provision, terminating use within reasonable period of time.

**Example:**

Elizabeth Young bought property three years ago that was legally zoned for her hair salon business, which she operates. The property is rezoned to residential, and Young is allowed to continue her business as a non-conforming use.

But non-conforming use properties are usually prohibited from rebuilding, adding on to the building or abandoning the property and then re-opening again. However, if Ms. Young's property is destroyed (fire, flood, wind) the zoning authority will not allow her to rebuild the salon because it is in a residential zone.

**Rezones**

If owners feel the property was improperly rezoned, they can file a petition the local appeals board. Notice is given to the surrounding landowners and a hearing is held.
Variances

Variances to a zoning ordinance allow special permission for a use normally that would normally be in violation of current zoning.

Variances are granted only if strict adherence would cause practical difficulties and cause unnecessary hardship on the owner, or if the use would not change character or integrity of the area and is consistent with the basic intent of the current zoning.

The property owner can apply to request a variance. However, they are not usually granted unless the property owner can prove severe difficulties or hardship as a direct result of the zoning.

Conditional Use or Special Use Permits

Conditional or Special Use Permits are exceptions that allow uses that do not conform to zoning requirements, provided that the use is within the limitations of the permit. Conditional use permits are commonly granted for non-classified categories that benefit the community, such as medical clinics, schools, daycare centers, hospitals, etc., allowing limited uses as long as they comply with specified conditions. As with a variance, the owner is generally required to prove that the zoning prevents any reasonable use of the land, not merely the most profitable use.

Building Codes

Building codes are another form of police power that require a person to submit building plans and obtain building permits before building, altering or repairing, as evidence of compliance with municipal building regulations.

Building codes were created to specify material and construction standards for new construction and building alterations and to protect the public from unsafe or shoddy workmanship. They are usually categorized in specialized areas or codes for plumbing, fire, and electrical, etc.

During the course of construction the building permit system allows inspectors to inspect to verify compliance with the code requirements as a means of enforcement. A certificate of occupancy will be issued only upon satisfactory inspection of the completed work.

Interstate Land Sales Full Disclosure Act (ILSFDA)

This Congressional act applies to the sale or lease of undeveloped land through interstate commerce or the mail. ILSFDA is administered through the Office of Interstate Land Sales Registration, a division of HUD. It is a federal law created to inform and protect prospective buyers of lots for sale or lease in interstate commerce.

In general the law applies to subdivisions containing more than 26 vacant lots. However, the statute contains numerous exemptions and stipulations of number and size of lots, subject to state or local registration and disclosure requirements, visual inspection by the purchaser, and many other factors.

If the statute does apply the subdivider must:

- File a Statement of Record with HUD and informational materials concerning the land and title
- Not offer any land for sale until HUD accepts the filing as complete (non-rejection within 30 days is acceptance)
- Provide each buyer or lessee with a written Property Report prior to buyer or lessee signing any contract

Property Report

This property report should be very detailed and outline all claims, disclaimers, and disclosures. Any representations made by the developer either expressed or implied to provide for roads, water, sewer, gas, utilities, or recreational amenities, are part of the contract with the purchaser and specifically bind the developers to perform.

If the report is not furnished prior to signing a contract, the purchaser has a right to rescind. If the report is not furnished at all, the purchaser has two years to rescind. Known as the anti-fraud provision, the purchaser also has the right to sue for civil damages caused by failure to provide the report or by any false statements or misleading information in the report.

Environmental Laws

Air and Water Pollution Control Laws

Federal legislation imposes standards for air and water quality, requires the states to enforce them and determines approval for permits to allow the discharge of pollutants into the air or water.

*Taxation - General Real Estate Taxes*

Real property taxation has always been the government’s preferred method to raise revenues.

Real property taxes affect title by creating liens. But because real property is virtually impossible to hide, if the property owner defaults, the government can sell the property to recover the tax.

General real estate taxes assessed ad valorem, or according to value, and are levied to pay for the general operation and services of government such as public schools, police, and fire protection.

A property can be situated in five or six taxing districts such as cities, counties, school districts, and water districts. The amount of tax owed is determined by the value of the property. This type of evaluation is called assessment. Market value is the estimation of the most probable price at which a property would sell.

Property Tax Exemptions

Individual property owners also have some exemptions such as a partial exemption for low-income elderly (61 or older) or disabled retired. In some cases these partial taxes are deferred until the owner sells the property.

Special Assessments & Local Improvement Taxes

Special assessments, like general real estate taxes, create liens against the property. A special assessment is usually a one-time tax, although the property owners may be allowed to finance the tax through ULID’s or LID’s. If an owner fails to pay the assessment, the government can foreclose on the property.
Special assessments are charged against real property to pay all or part of the cost of improvements that benefit these properties, such as paving, sidewalks, sewers, or public water. This tax is charged on the theory that the value of certain properties is increased by the improvement.

**ULID’s are:**
Utility Improvement District Bonds

**Local Improvement Districts**
assessments imposed on the benefited property.

The main distinctions between general real estate taxes and special assessments:

- General real estate taxes pay for government services, such as fire and police protection.
- ALL real property within a taxing district is assessed as general real estate for the benefit of the community.
- General real estate taxes are an annual levy.
- A special assessment is against specific properties that benefit from the improvement.
- A special assessment is for a specific improvement, such as paving, water, sewer, etc.
- Special assessments are levied when a property is benefited.

**Eminent Domain**

Eminent domain is the federal or state government’s power to take private property for a public purpose with a provision for fair compensation to the owner. The state government may authorize power of eminent domain to local governments, and also to private entities that serve the public, such as utility companies, provided that it is for a public use.

The police power regulates the use of private property, but cannot take it away from the owner. If property is taken by police power, rather than eminent domain, the government is not required to compensate the owner even if the act significantly reduces the value of the property, as in a zone change.

**Condemnation**

Condemnation is the process by which the government takes property by eminent domain. Once it is determined that the property is needed for a public purpose, the government offers to purchase it from the owner. The owner may refuse, but only on the grounds that the price offered is not just. If the owner cannot prove that the compensation is unfair, or that the use was not for the public, the court will order the property to be transferred to the government.

**Types of Housing**

- PUD’s - Planned unit developments
- Townhouses
- Cooperative

**PUD - Planned Unit Developments**

Planned Unit Developments are detached homes that usually provide reduced lot sizes, larger recreation areas and facilities and reduced individual maintenance requirements. Each lot is
sold and owned separately, and members of the homeowners’ association own the open space and common areas.

These units can be:

- Stick built
- Modular
- Manufactured homes

Many PUD’s necessitate cluster zoning, in which dwellings are clustered together to create larger amounts of land for common areas and various land uses.

**Townhouses**

Townhouses are dwellings with shared walls where the owner owns the unit and the lot on which it was built.

Common walls and the surrounding areas such as the:

- Parking lots
- Swimming pools
- Tennis courts etc

are owned in common with the adjoining owner.

Townhouses usually have restrictions that regulate the:

- Color of exterior
- Landscaping
- Roof type, etc.

**Cooperatives**

Unlike a condominium, living units in a cooperative are owned by a trust or corporation formed by the cooperative. If title is held by a trust, the owner purchases a certificate of beneficial interest in the trust.

If a corporation holds title, the owner purchases shares of stock in the corporation. These purchasers have a personal property interest, rather than a real property or fee interest, so the purchaser does not receive a deed.

This interest gives the purchaser ownership shares, which provides the cooperative apartment tenant the exclusive right to occupy one unit on a long-term proprietary lease. The Trustor for the cooperative will take out one loan when building or purchasing the building, and will receive one bill for property taxes on the entire building.

**The Trustor:**

- Makes ALL mortgage payments
- Pays property taxes
- Property insurance premiums and pays
- All costs of operating and maintenance for the property
Then each is assessed a prorated share of expenses. When one owner does not pay, the other owners must make up the deficiency or unpaid lien holders could foreclose on the entire property.

Cooperatives usually maintain a reserve account and have bylaws, which allow the nonpaying owner to be foreclosed against by the corporation or trust.

**Advantages**

Advantages of a cooperative could be lower costs, the right to sell and assign, treated as capital gain property taxes and mortgage interest is deductible and no personal liability of owner for debts of the trust or corporation.

**Condominiums**

Condominiums can be:

- Residential
- Industrial
- Commercial
- Resort properties
- Basically any type of building

Each unit is sold and owned separately and the land is owned by all of the unit owners in common.

**Advantage of Condominium Ownership**

Condominiums have much the same advantages as single family home ownership, with a lesser degree of privacy, but also less maintenance. Condominium ownership relieves owner of much work and reduces land and maintenance costs involved with home ownership. Condominiums are very popular in vacation home areas, and units may be easily managed when owners are not using them.

**Review**

The government’s power to regulate and enforce laws for the protection of the public safety, health and general welfare is called police power. Police power includes regulation of land use controls such as building codes, planning, subdivision and zoning.

In the process of planning, the government imposes public land use controls. Landowners have many rights that come with ownership. But those rights are limited by the powers of the federal, state and local governments. These powers affect property ownership most directly by planning, zoning, other public restrictions on land, plus the government’s power to tax property.

These police powers allow state and local government to regulate a private party’s use of their property by enforcing laws and regulations for the protection of the public health, safety, and general welfare. A landowner is entitled to fair compensation if the government takes real property through eminent domain. However, no compensation can be expected for any loss resulting from land use restrictions by zoning or through other police power.

A general long-term comprehensive plan for development in accordance with zoning ordinances
and other laws are required by most communities. Many cities and counties are required by law to develop and conform to a general plan.

Zoning ordinances keep conformity of the land uses, but allows for some exceptions for non-conforming uses, variances and conditional uses. The government can use the power of eminent domain to execute its general plan. When private property is taken by eminent domain, the government must pay fair compensation to the owner.

If property is taken by police power, compensation is not required. Real property taxation has always been a method of raising government revenues. Real property taxes affect title by creating liens and if the property owner defaults, the government can sell the property to recover the tax.

General real estate taxes assessed “ad valorem” which means according to value, and are levied to pay for the general operation and services of government such as public schools, police and fire protection.

The county can foreclose if taxes have been unpaid for three years. Special assessments, like general real estate taxes, create liens against the property. Utility Improvement District Bond, or ULID, is an assessment that is paid off by use fees. Local Improvement District, or LID, is an assessment imposed on the benefited property.

Chapter 6
Legal Description of Property

Glossary

Air lot
A lot without land, such as a fourth floor condo unit

Distance
Used in metes and bounds to measure between boundaries

Government lot
A system to describe a parcel that is NOT in a regular section in a government survey system

Metes and bounds
A system to describe property by reference to monuments, courses, and distances

Monument
Natural or artificial marker used in a survey or metes and bounds legal description

Platting
A system to describe subdivided or platted-subdivision lots using numbers for the lot and block on a plat map

**Point of beginning**

Used in metes and bounds description as the starting point- can be a monument or point measured from a monument

**Principal meridian**

Used in government survey system- is the main north-south line in a grid as the starting point to number ranges and township tiers

**Range**

Used in the government survey system- north and south tier of land six miles wide

**Rectangular survey**

A land description land is divided into townships-townships are divided into 36 sections-each section is one square mile

**Township**

Six miles square and contains 36 sections - used in the government survey system

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**Introduction**

The purpose of a property description is to adequately describe the property, so that it can be accurately conveyed from one owner to another.

The Statute of Frauds requires that all elements in a real estate contract be in writing. Oral testimony may be used to help identify property that has been described in a written contract, but it cannot be used as the actual description. Oral testimony is also called parol testimony.

If an unclear written description of the property cannot be clarified by oral testimony to describe the area well enough to enable a surveyor to locate the property and establish boundaries, the contract may be void.

**Adequate Description**

All purchaser and sales agreements as well as listing contracts should include a full and accurate description of the property, to adequately identity the property that is being transferred. Adequate means that the description is clear enough so that a court could order a seller to convey or a buyer to accept the property.

To avoid misunderstandings and possible litigation, the property should be described by correct legal description. If the legal description is not available at the time of listing or when an offer is made, it is wise to put in writing that the “legal description is to be provided prior to closing or acceptance”, or “will be provided in the title report” or whatever the parties agree to.

It may be a good idea to have seller make a counteroffer or addendum that clarifies the description of the property, or that gives a date when the legal description will be provided. A
legal description must be provided as soon as possible so that it can be written into an offer to purchase. The agent should ask to see the seller's deed, and copy the description from that document.

Legal descriptions can also be obtained from the Title Company, owner's title insurance policy, assessor's office, and present owner's deed, deed of trust, land contract or other documents. Many times, especially when rural property is involved, the legal description may be too long to fit into the space provided in the listing or sales contract.

Rather than attempting to copy the long legal description by hand, the real estate agent can make a photocopy and have all parties sign and date it. It should then be attached to contract with a reference to the addendum such as “See attached” or “See Exhibit A”.

Types of Legal Descriptions

There are three major methods of land description:

- Lot and Block or Plat map
- Metes and Bounds
- Government Rectangular Survey

**Lot and Block or Plat Map**

The easiest, shortest and most common used method for describing property is by the platting method. Platting is also referred to as the lot and block method or the recorded plat method. This system is usually used in urban and suburban areas where tracts of land are divided into lots as building sites.

A subdivision is a tract of land that has been divided into lots. The tract is surveyed and each lot and block is numbered to describe the parcels in the platted subdivision. The plat map is then recorded in the county or city where the subdivision is located, and made available for public inspection.

Once the plat map is recorded in the recorder's office, the lot and block numbers of the subdivision plat are considered to be a sufficient legal description that can be incorporated into any legal document.

The county recorder's office will have a map book of plats that show the exact location and the dimensions of parcels. When a tract of land is subdivided in several stages, the subdivision might be divided into sections. These sections will be identified in the map book by name or number.

The subdivisions and sections are divided into blocks that are groups of lots defined by streets, physical barriers or other parcels of land. Each block is assigned a number or letter. The block is then divided into lots, and lot number or letter identifies each lot.

**Example:**

Lot 6, Block 9, Hillside 2nd Addition, in the City of Spokane, County of Spokane, State of Washington, as per map recorded in Book of maps 501, page 16, in the office of the recorder of said county.
Plat maps feature useful information such as the front, rear, and side lot line measurements, square feet of each lot, deed and zoning restrictions, building or “setback” lines, easements for streets, utility lines for water and electricity, sewer lines, flight paths, etc.

The plat map will usually show the north and south compass points. If it does not, the top of the map is North.

**Air Lots**

The air space above the land can be divided into "air lots". Condominiums and structures built above railroad tracks often require legal descriptions that show the elevation of airspace within the land boundaries above the parcel of land. Owners of condominium units own the air space within the floor, ceiling and walls of the unit.

"Benchmarks" are permanent reference points, used to measure elevations based on measurements from a starting level. Elevations are also measured in relationship to an official reference point called a datum. The U.S. Geological Survey uses the mean sea level at the New York Harbor as its datum. Most large cities have an official local datum for survey purposes that establishes a plane of elevation to be used as a reference point.

**Metes and Bounds**

Metes are measurements, and bounds are boundaries. The metes and bounds method describes property by identifying its boundaries. This method is especially well suited to describe large, irregular-shaped parcels that are not platted.

Monuments, compass directions, and distances describe the boundaries. Monuments are fixed objects or markers that are used to form real estate boundaries. These markers and monuments can be natural or artificial. Natural markers and monuments are rock formations, rivers, lakes, etc.

Artificial markers and monuments are man-made, such as buildings, fences, walls, or stakes placed by the surveyor. Artificial markers may also be intangible; such as references to a lot line measurement or the centerline of a street that was established by another survey.

**Point of Beginning**

Metes and bounds descriptions start by identifying a defined point of beginning, and then providing measurements and directions (also called course or bearings) to each boundary line. The point of beginning is a monument or a marker, such as "the NE corner of the intersection of Sprague Avenue and Division Street," or "10 feet west of the Jones’ Lighthouse."

This gives the surveyor a way to follow the boundaries of the tract from the point of beginning where it started, back to the point of beginning where it also ends. The description must start and end at the same point or it would not fully enclose the entire parcel.

When there is no monument or marker to use for the point of beginning, a reference to the measurement from a monument can be the point of beginning, such as "10 feet west of the Jones' Lighthouse."

Boundaries may also include waterways. The owners of property that adjoins water such as rivers, or streams are called riparian owners. The owners of property that adjoin lakes and oceans are called littoral owners. Waterways that are capable of commercial traffic are called
navigable. Adjoining owners of navigable waters have title to the property’s mean high water
mark.

The land that is under water beyond the mean high watermark belongs to the state. These
owners have a secondary right to the reasonable use of the water, but not a right to the water
itself. The primary use of the waterway is for public use for navigational purposes. Adjoining
owners of non-navigable waterways have title to their land that extends to the center (or thread)
of the river or streambed.

The public has right to use waterway for transportation or recreation purposes, if they first obtain
legal access to the waterway. The public does not have the right to trespass over the owner’s
property to get to the water.

From the point of beginning are directions, courses and distances that will trace the boundaries
of the property to a corner or the point at where the direction of the boundary line will change.

Directions and courses are given compass bearings and are described by measurements from
either the north or south, using the direction that is closest. These measurements should
contain specific measurements and compass bearings.

When the word "thence" is used, this means that the boundary will now turn or shift into a new
direction. These directions, courses and distances will describe each part of the boundary line
from one point to another until the last boundary returns back to the original point of beginning.

Example:

"West, 10 feet" is direction, course and a distance.

The direction course and the distance can be shown in relationship to a monument or a marker,
such as "west 10 feet of the Jones’ Lighthouse, thence easterly along the south white board
fence".

When the description contains conflicting directions, or a discrepancy between the relationships
in a metes and bounds description, there is an order of priority that is used, showing which
monument will take precedence.

These monuments and markers are numbered beginning with natural monuments. Because
they are less likely to change quickly, they have the first priority. These priorities are in
descending order:

- Natural monuments
- Man-made monuments
- Courses
- Distances
- Names, such as "The Jones’ Lighthouse"
- Areas such as "10 acres"

The element with the higher priority level will prevail over all others when there is a discrepancy.

A disadvantage is that this type of description is long and complicated, and a survey is usually
necessary. The lengthy description could be misinterpreted so more mistakes and errors can
occur when copying them.
Also, the markers or monuments can be destroyed, deteriorate or move over the years. However, the metes and bounds description is considered to be adequate, unless the property could be better described by another method.

**Example**

**Meted and Bounds Description:**

A parcel of land, located in Spokane County, described as follows: beginning at the old hollow oak tree, thence directly north to the stone wall, thence northwesterly along the Thompsons' white board fence to intersection of Walnut and Lewis Road, thence south along Lewis Road 210', thence northerly along the wire fence to the point of beginning.

**Government Survey**

The government survey system is also called the rectangular survey, or the section, range and township method. The government survey system is used in **all** the states **except** the 13 original states, New England and Atlantic coast states, West Virginia, Kentucky, Tennessee, Texas and Hawaii. The entire west and most mid-west states have land surveyed by this system. It is not used to describe irregular-shaped parcels or tracts that are not aligned in north-south direction.

The government survey system describes land by references to a series of grids. The grid system is somewhat confusing, but studying the diagrams will be helpful. There are 36 fixed points in the country with lines going north to south, and lines going east to west.

The lines going north and south are called the meridians, or principal meridians. The lines going east and west are called base lines. The grids are made up of these two sets of lines. Each grid is numbered according to the principal meridian, which is the original north/south line in that grid. Every fourth range line is a guide meridian. The north-south boundaries are formed by east/west lines called baselines.

The township lines divide the land into rows or tiers called townships. Each township is 6 miles by 6 miles, which equals 6 miles square (36 square miles) and contains 36 sections. Each section is one square mile, or 640 acres.

The base line is the original east/west line. Grid lines run parallel to the principal meridian and the base line at a distance of six miles apart. The north/south lines called range lines form the east-west boundaries. The range lines divide the land into columns called ranges.

The area of land within the intersection of each range line and township tier is called a township. Townships are divided into 36 sections containing one-mile square each or one mile by one mile. Townships are numbered consecutively in a back and forth direction, from the principle meridian such as 1W, 2W, 3W, and 4W, etc.

The areas between these tiers that run east and west are numbered: 1S, 2S, 3S, 4S, etc. Or 1N, 2N, 3N, 4N, etc. The numbering begins with number 1 in the furthest northeast corner of township, ending with number 36 in the furthest southeast corner.

Each township is identified by its relationship to the principal meridian and base line. Property is described by identifying the township, range, and meridian. This means that if the township is in the third tier south of the base line, and the sixth range east of the principal meridian, it is called "Township 3 South Range 3 East." The description would be abbreviated to "T3S, R3E".
T1N, R2E, WM is the 1st tier north, 2nd range east of Willamette Meridian Spokane County, State of Washington. The name of the principal meridian, such as Willamette Meridian in Washington State, is necessary to include in the description.

Grid systems are the same all over our country, so the name must be included in the description as a reference. The principal meridian always has its own base line, so the base line does not have to be specified. To prevent confusion, the county and state of the described land should also be included.

**Government Lots**

Government Lots are irregular shaped lots within the government survey. The government survey uses sections that are exactly one mile square. However, because of the natural the curvature of the earth where the range lines come together along the north and west boundaries of each township, some parcels might be larger or smaller.

The north and west boundaries along these sections contain quarter sections which are used to make up larger or smaller parcels. The quarter sections are then divided into quarter-quarter sections and are given government lot numbers. Irregular parcels within the government survey might also occur if the parcel contains land that is bordered by a waterway.

Another situation in which government lots occur is when a body of water or some other barrier makes it impossible to survey a one-mile square section. Or another situation could be that the survey and staking out of section was impossible because of exclusion from prior surveys for town sites, Indian reservations, military bases and other land claims.

In order to maintain townships that are as square as they can possibly be formed, a corrective adjustment is made to every fourth, or every of 24 miles, using guide meridians that run parallel to principal meridian. The range lines run continuously for 24 miles, and then begin to be slightly offset.

Corrections lines are then used to keep the range lines as close to 6 miles apart as possible. The areas formed by correction lines and guide meridians are 24 miles by 24 miles, or 24 miles square or 16 townships.

**SE ¼, Section 12**

Begin with the Section which is 640 acres. Then divide the section according to the fraction in the description. The description shows ¼ of SE of a section, so take:

\[
640 \div 4 = 160 \text{ acres}
\]

Formula: 1/4 of a section = 640 ÷ 4=160 acres

**Example:** SE ¼, SW ¼ of Section 12

Begin with the Section (Section 12) which is 640 acres.

\[
640 \text{ acres ÷ 4 (SE ¼)} = 160 \text{ acres.}
\]

\[
160 \div 4 (SW ¼) = 40 \text{ acres}
\]

Formula

1/4 of 1/4 of a section = 640 ÷ 4=160 acres, and ÷ 4 again = 40 acres

64
**Example:** SE ¼, NW ½, SW ¼ of Section 10

Begin with the Section (Section 10) which is 640 acres.

\[
640 \text{ acres} ÷ 4 (\text{SW ¼}) = 160 \text{ acres} \\
160 ÷ 2 (\text{NW ½}) = 80 \text{ acres} \\
80 ÷ 4 (\text{SE ¼}) = 20 \text{ acres}
\]

**Formula:**
\[
\frac{1}{4} \text{ of } \frac{1}{4} \text{ of a section} = 640 ÷ 4 = 160 \text{ acres and } ÷ 2 = 80 \text{ acres and then } ÷ 4 = 20 \text{ acres}
\]

**Basic Length Measurements**

1 foot = 12 inches  
1 yard = 3 feet 1 mile = 5,280 feet  
1 mile = 320 rods or 80 chains  
1 rod = 16 ½ feet  

**Basic Area Measurements**

1 square foot = 144 square inches  
1 square yard = 9 square feet  
1 square mile = 27,878,400 square feet  

1 acre = 43,569 sq. ft. or 160 rods  
Commercial acre = 43,569 sq. ft. (minus the area for streets, sidewalks, alleys)  
1 square acre = 208.71 feet x 208.71 feet or 43,559.87 feet  

1 section = 1 mile x 1 mile or 1sq.mi = 640 acres  
1 township = 6 miles x six miles or 36 sq. mi. = 36 sections  
1 tract = 24 miles x 24 miles or 576 sq. mi. = 16 townships  

To calculate areas of partial sections, multiply the fraction of the section by 640 (acres):  

One half section = \(\frac{1}{2} \times 640 = 320 \text{ acres}\)  
One quarter section = \(\frac{1}{4} \times 640 = 160 \text{ acres}\)  
One half of one quarter section = \(\frac{1}{2} \times \frac{1}{4} \times 640 = 80 \text{ acres}\)  
One quarter of one quarter section = \(\frac{1}{4} \times \frac{1}{4} \times 640 = 40 \text{ acres}\)  
One half of one quarter of one quarter section = \(\frac{1}{2} \times \frac{1}{4} \times \frac{1}{4} \times 640 = 20 \text{ acres}\)  

**Review**

Before a property can be conveyed from one owner to another, it must be adequately described. The Statute of Frauds requires that all elements in a real estate contract be in writing.

The easiest, shortest and most common used method for describing property is by the platting method. Platting is also referred to as the lot and block method or the recorded plat. The subdivisions and sections are divided into blocks that are groups of lots defined by streets, physical barriers or other parcels of land. Each block is assigned a number or letter. The block is then divided into lots, and lot number or letter identifies each lot.

Plat maps feature useful information such as the front, rear, and side lot line measurements, square feet of each lot, deed and zoning restrictions, building or "setback" lines, easements for streets, utility lines for water and electricity, sewer lines, flight paths, etc.
The air space above the land can be divided into "air lots". Condominiums and structures built above railroad tracks often require legal descriptions that show the elevation of airspace within the land boundaries above the parcel of land.

"Benchmarks" are permanent reference points, used to measure elevations based on measurements from a starting level. Elevations are also measured in relationship to an official reference point called a datum. The U.S. Geological Survey uses the mean sea level at the New York Harbor as its datum.

Most large cities have an official local datum for survey purposes that establishes a plane of elevation to be used as a reference point. Metes are measurements and bounds are boundaries. The metes and bounds method describes property by identifying its boundaries. This method is especially well suited to describe large, irregular-shaped parcels that are not platted.

Monuments, compass directions, and distances describe the boundaries. Metes and bounds descriptions start by identifying a defined point of beginning and then providing measurements and directions (also called course or bearings) to each boundary line. From the point of beginning are directions, courses and distances. The government survey system is also called the rectangular survey, or the section, range and township) method.

The government survey system is used in all the states except the 13 original states, New England and Atlantic coast states, West Virginia, Kentucky, Tennessee, Texas and Hawaii. The entire west and most mid-west states have land surveyed by this system. It is used primarily to describe large parcels, such as timberland, farmland, and grazing land. It is not used to describe irregular-shaped parcels or tracts that are not aligned in north-south direction.

The government survey system describes land by references to a series of grids. The grid system is somewhat confusing, but studying the diagrams will be helpful.

There are 36 fixed points in the country with lines going north to south, and lines going east to west. The lines going north and south are called the meridians, or principal meridians. The lines going east and west are called base lines. Townships are numbered consecutively in a back and forth direction, from the principle meridian such as 1W, 2W, 3W, and 4W, etc.

The areas between these tiers that run east and west are numbered: 1S, 2S, 3S, 4S, etc. Or 1N, 2N, 3N, 4N, etc. The numbering begins with number 1 in the furthest northeast corner of township, ending with number 36 in the furthest southeast corner.

Government Lots are irregular shaped lots within the government survey. The government survey uses sections that are exactly one mile square. However, because of the natural curvature of the earth where the range lines come together along the north and west boundaries of each township, some parcels might be larger or smaller.

Irregular parcels within the government survey might also occur if the parcel contains land that is bordered by a waterway. Another situation in which government lots occur is when a body of water or some other barrier makes it impossible to survey a one-mile square section.

Always begin with the end of the description and work forward to the beginning to calculate the number of acres in a description.
Chapter 7
Evaluation Formulas

**Introduction**

Math is a fundamental tool used by real estate agents on a daily basis. Mastering math skills is important in providing service in all aspects to buyers and sellers.

**Four Basic Principles**

1. Understand the Question
2. Determine the formula
3. Replace Letters for Known Numbers
4. Calculate the Known Numbers using the Formula

1. **Understand the Question**

You must know what the question is asking for before you can successfully work any math problem. Once you have determined all known numbers, you can use the correct formula to find the unknown number, such as an:

- Area
- Profit
- Commission

Sometimes a math question will contain irrelevant numbers. You will need to understand the question BEFORE you can determine which numbers are relevant to this question.

2. **Determine the formula**

After carefully reading and understanding what the question is asking for, always begin by writing out the formula in letters. An example would be the formula to use to calculate the Area inside a rectangle:

\[ \text{AREA} = \text{Width} \times \text{Length} \text{ or } A = W \times L \]

(The first letter of each factor in the formula will be used to make it easy to remember.)

3. **Replace Letters for Known Numbers**

Replace all of the known (relevant) numbers with the letters used in the formula. Understand the problem so that the numbers are in the right position.

Practice with an easy problem such as:

The length of a rectangle is 3’ and the width is 2’. What is the area?

\[ W \times L = A \]
\[ 2’ \times 3’ = 6’ \]
Many times you can simply calculate this amount and be done. However, in some problems, you will need to first make some conversions such as changing percentages from a fraction to a decimal figure, or changing yards in to feet, feet into miles, etc.

**Basic Formulas**

**Fraction to Decimal Formula**

Divide the top number (numerator) by the bottom number (denominator) one ÷ two = ½

**Percentage to Decimal Formula**

Move the decimal point two places to the left and remove the percentage sign (%) 50% = .50

**Percentage Formula**

\[
\text{Percentage} \times \text{Total} = \text{Part} \\
\% \times T = P \\
25\% \times 100 = 25\%
\]

**Interest Formula**

\[
\text{Principal} \times \text{Rate} \times \text{Time} = \text{Interest} \\
P \times R \times T = I \\
$30,000 \times .08 \times 360 \text{ months} = $86,400
\]

**Value after Formula (resulting in Profit OR Loss)**

\[
\% \times \text{Value Before} + 100\% \text{ of Value Before} = \text{Value After} \\
\% \times \text{VB} + 100\% \text{ of VB} = VA \\
25\% \times $30,000 +$30,000 = $37,500
\]

**Capitalization Rate Formula**

\[
\% \text{ Rate} \times \text{Value} = \text{Income} \\
\% \times R \times V = I \\
10\% \times $30,000 = $3,000
\]

First you must know the amount paid. If it was an annual amount, divide by 365 to find the daily Rate. If monthly, divide by the number of days in the month. Then:

\[
\text{Rate} \times \text{number of Days} = \text{Share} \\
R \times D = S
\]

Then use this Share for the buyer and the seller to determine how much each party will be credited or debited.

**Linear (Line) Measurement Formulas**

Use these formulas to calculate measurements.
Measuring Perimeters

Add total measurements of all sides. Then convert to the unit you want.

**Example:**

A lot is 100' x 350'. What is the perimeter? The formula is:

\[
\text{Length of all sides} = \text{Perimeter in feet:}
\]

\[
100' \text{ (east side)} + 100' \text{ (west side)} + 350' \text{ (front)} + 350' \text{ (back)} = 900 \text{ feet in yards:}
\]

Then divide 900' by 3 (3 feet in a yard) = 300 yards.

**Example:**

Jennifer wants to fence her entire lot. Her lot is 75' x 150'. She finds the fencing materials she will use for $6 per foot. Her cost will be $6 per foot of the perimeter of her lot. Jennifer must:

Use the formula:

\[
\text{Measurement Total of all Sides} = \text{Perimeter}
\]

\[
\text{MT of all Sides} = P
\]

She must measure the front, back, and both sides of her lot

\[
75' + 75' + 150' + 150' = \text{total of 450 feet}
\]

\[
450 \text{ feet x $6.00 cost per lineal foot} = $2,700 \text{ cost for her fence materials}
\]

**Cost per Front Foot Measurement**

Formula:

\[
\text{Cost x Front Dimension of lot} = \text{cost of lot}
\]

\[
C \times F \ D = \text{cost of lot}
\]

**Example:**

William (a developer) is selling a lot on a busy highway. He is asking $250 per front foot. The front of his lot is 75'.

\[
\frac{250}{\times 75'}
\]

\[
$18,750 \text{ total price}
\]

**Square or Rectangular Areas**

To calculate the area of square OR rectangular boundaries, multiply the length by the width.

Formula:

\[
\text{Length x Width} = \text{Area}
\]

\[
L \times W = A
\]

If Length x Width = Area, then Area + Length = Width or A + L = W
Example:

Stan has a rectangular family room that is 18’ long x 14’ wide. He needs to know how many square yards of carpeting he must buy to cover his family room floor. Stan must:

1. Use the formula:

   \[ \text{Length} \times \text{Width} = \text{Area} \quad (L \times W = A) \]

2. Write down the formula and replace with known numbers:

   \[ 18’ \times 14’ = 252 \text{ sq. ft.} \]

3. To convert to yards:

   \[ 3’ \times 3’ = \text{Area in square yards} \quad (3 \text{ feet per yard}) \quad \text{or} \quad 3’ \times 3’ = 9 \text{ sq. ft.} \]

4. Stan knows that there are 9 square feet in a square yard. So:

   \[ 252 \text{ sq. ft.} \div 9 \text{ sq. ft. per sq. yard} = 28 \text{ sq. yards} \]

5. Since carpeting costs $20.00 per square yard:

   \[ \$20 \times 28 \text{ square yards} = \$560.00 \text{ total cost} \]

Area of a Triangle Formula

\[ \text{Base} \times \text{Height} \times \frac{1}{2} = \text{Area} \quad \text{or} \quad B \times H \times \frac{1}{2} = A \]

(HINT: A triangle is really just half of a rectangle. So ignore the diagonal side of the triangle and just multiply the Base x Height and then divide by 2 or \( B \times H \div 2 = A \))

Example:

Rod buys a triangular parcel that has a Base of 170’ and a Height of 85’, for $6 per square foot. He needs to know how much it will cost. Rod must:

1. Use the formula:

   \[ B \times H \times .5 = A \]

   \[ 3 \times 8 \times .5 = 12 \]

   And ---

   \[ H \times .5 \div A = B \]

   \[ 8 \times .5 \div 12 = 3 \]

2. Write down the formula and replace it with known numbers:

   Base = 170’, height = 85’

   \[ 170’ \times 85’ = 14,450 \text{ sq. ft.} \div 2 = 7,225 \text{ sq. ft.} \]

   If Rod paid $6 per square foot of land, then the total cost of the land will be:
7,225 sq. ft.  
\times \$6 \text{ per sq. ft.}  
\$43,350 \text{ total cost for the land}

Divide the odd shaped area into rectangles, squares, parallelograms and triangles. Then use the formula for each shape to calculate the area of each shape. Then total the areas of each.

1. Divide the area into rectangles, squares and/or triangles.

2. Write down and use the formula and replace with known numbers to calculate the area of rectangles.

\[ L \times W = A \]
\[ 2 \times 3 = 6 \]

3. Write down the formula and replace with known numbers to calculate the area of triangles

\[ B \times H \times .50 = A \]

4. Calculate the area of the rectangles.

5. Calculate the area of the triangles.

6. Total the areas of each shape.

**Area of Inside Dimensions**

1. Use the formula to subtract the thickness of all sides --- both widths and both lengths.

\[ \text{Length times Width minus thickness of each side} = \text{Inside Area} \]
\[ L \times W - T = IA \]

2. Subtract the thickness of each side then multiply both widths (minus thickness) by both lengths (minus thickness)

3. Calculate to equal the Inside Area

**Example:**

Chris has a foundation that is 25 x 56 on the outside. The foundation is 6” thick ALL the way around. He needs to know the inside area. He must:

1. Use the formula to subtract the thickness of each wall from each side

\[ L \times W = A \]

2. Write the formula and replace with known numbers

56’ Length minus .50’ from one side and minus .50’ from the other side  
25 ’Width minus .50’ from the front and minus .50’ from the back

3. Calculate

He must subtract \( \frac{1}{2} \) or .50’ from both outside Lengths
Cubic Measurement

Formula:

\[
\text{Length} \times \text{Width} \times \text{Depth} = \text{Cubic Area} \\
L \times W \times D = C \ A
\]

Cubic measurement is also measuring “volume”. This means the number of cubic units that a certain object could hold or contain.

Example:

Alicia has a container that is 36’ in Length, 18’ in Width, and 12’ in Depth. She needs to know the cubic square yards of her container. She must:

1. Use the formula

\[
L \times W \times D = C \ A
\]

If the Length = 2, the Width = 3 and the Depth = 4, then the formula would look like this:

\[
2 \times 3 \times 4 = 24
\]

It follows suit that if \(L \times W \times D = C \ A\) or \(2 \times 3 \times 4 = 24\). Then if \(C \ A \div (L \times D) = W\) it would be \(24 \div (2 \times 4) = 3\). or if \(C \ A \div (L \times W) = D\), then it would be \(24 \div (2 \times 3) = 4\)

2. Now, write the formula and replace with known numbers

\[
36' \ L \times 18' \ W \times 12' \ D
\]

3. When you calculate the total

\[
36' \times 18' \times 12' = 7,776 \text{ cubic square feet}
\]

There are 27 cubic feet in a cubic yard, so to find out how many cubic yards the container is, it would be:

\[
7,776 \text{ cubic sq ft} \div 27 = 288 \text{ cubic yards}
\]

(HINT: To convert cubic measurement, simply multiply the number of inches, feet, etc. three times over)

Cubic Foot formula

\[
12'' \times 12'' \times 12'' = 1,728 \text{ cubic inches}
\]

Cubic Yard formula
Percentages

When you see “Percentage of” or “% of”, it means you must multiply. You can always tell when to multiply when the question asks for a “% of” something. When you multiply the number by a percentage that is less than 100%, the answer will be a number that is smaller than the original number.

When you multiply by a percentage of more than 100%, the number will be a number larger than the original number.

To figure a percentage:

Multiply the percentage times the total to equal the part

Formula

\[ % \times \text{Total} = \text{Part} \]
\[ \% \times T = P \]

Example:

10% x 3,000 = 300 or 3,000 x 10% = 300

Dave has a lot that is 300 feet long. His neighbor's lot is 30% longer than Dave's lot. Dave wants to figure out how long his neighbor's lot is. He must:

1. Use the formula \( % \times \text{Total} = \text{Part} \)

2. Write the formula and replace with known numbers

\[ % \times T = P \]
\[ 30\% \times 300' = \text{Part} \]

3. Calculate

\[ 30\% \times 300' = 90' \]

Now Dave knows that his neighbor's lot is 90' longer than Dave's 300' lot. Dave can simply add the extra 90' that his neighbor has, to his own 300' to find the length of his neighbor's lot. So, 90 + 300 = 390' neighbor's lot

You can also divide by a percentage. If you use division, the opposite is true. If you divide a number by a percentage of less THAN 100%, your answer will be a number larger than the original number. You must read carefully to determine if you will multiply or divide.

Example of Dividing a Percentage:

\[ \text{Part} \div \text{Percentage} = \text{Total} \]
\[ 300 \div 10\% = 3,000 \]
\[ \text{and} \ 300 \div 3,000 = .10 \ OR \ 10\% \]

Many people feel that when calculating percentages, it is easier to calculate in a decimal form, rather than a fraction form. To convert fractions to decimals use this formula: Divide top number
by bottom number. The top number of the fraction is called the numerator. The bottom number of the fraction is called the denominator.

**Formula**

Top number ÷ Bottom number would be written t/b or \(1 ÷ 2 = .5\), or \(\frac{1}{2}\)

**Example:**

“\(\frac{1}{2}\)” is a fraction. To change it to a decimal divide the top number 1, by the bottom number 2. Now using your calculator, do this:

Press the number “1”. Now press the symbol for divide (÷). Now press the number “2” and then press the symbol for equal (=). Your answer will be “.5”, and your decimal point will be in the correct place.
Adding and Subtracting Decimals

When adding or subtracting several decimals of different lengths by hand, line the numbers in a column with the decimal points lined up. You can add zeros on the right end to even up your columns.

Add 2.65, 10.42, 2.245, .45, 567.22, and 2.2, put the numbers in a column with the decimal points lined up as shown below, then add them together.

```
2.650
10.420
2.245
.450
567.220
2.200
585.185
```

When using a calculator, make sure you place the decimal point in each number. If you place them as they are shown, your calculator will put the decimal point where it belongs.

Multiplying Decimals

When you are multiplying decimals, always make sure that you show each decimal point in the correct place. Then, simply multiply the numbers without regard to the decimal points. Once you have calculated your answer, count the number of decimal places in each of the numbers that were multiplied.

Decimal places are the amount of numbers that are to the right of the decimal point. Count the total number of decimal places of your numbers and add them together.

Example:

To multiply 4.567 by 3.45, do this:

```
4.567 (3 decimal spaces) 
X 3.45 (2 decimal spaces)
The answer is 15.75615 (5 decimal spaces)
```

The first number has 3 decimal places. The second number has 2 decimal places. This is a total of 5 decimal places. The decimal point of your answer should be placed in the 5th decimal place from the right of the number. A calculator will do this for you automatically.

When dividing decimal numbers, place the decimal point of the denominator all the way to the right as the denominator is the number you will be dividing by.

Example:

```
12.456 ÷ 2.6 
(2.6 is the denominator)
```

Now, 2.6 will look like 26.

Then, using the same example:

```
12.456 ÷ 2.6 
(12.456 is the numerator)
```

Move the decimal point of the numerator, in this case 12.456 the same number of decimal places to the right that you removed from the denominator. The decimal of the denominator
was moved one place, so move the decimal point of numerator one place. Now the 12.456 will look like 124.56

Now calculate using the numerator and denominator with moved decimals:

\[
124.56 \div 26 = 4.79
\]

It is good practice to use a calculator when performing these functions. Be careful to place your numbers correctly with the correct decimal places, and your answers will be accurate.

**Converting Percentages to Decimals**

Simply drop the percentage sign (%) and move the decimal point two places to the left. You may need to add zeros to accomplish this.

**Examples:**

\[
\begin{align*}
78 \% &= .78 \\
6 \% &= .06 \\
14.7 \% &= .147 \\
43.24\% &= .4324 \\
\end{align*}
\]

To show a decimal as a percentage, move the decimal point two places to the right, and add the percentage sign (%)

\[
\begin{align*}
.78 &= 78 \% \\
.06 &= 6 \% \\
.147 &= 14.7 \% \\
.4324 &= 43.24\% \\
\end{align*}
\]

**Interest Percentages**

Almost all real estate loans are calculated as annual simple interest. This means that if the lender charges a 9% rate of interest, which means 9% of the principal amount of the loan, per year. Simple interest means that interest is paid only on the principal amount of the loan. Compound interest is actually where the borrower is paying interest on the principal, and “interest” on the accumulated unpaid interest. Interest is calculated like a percentage, but must include a factor for time.

**Example:**

Compound interest means that during the first year 9 % interest on a $112,000 loan = $10,080 in interest.

But, the second year interest will be paid on $112,000 plus $10,080 since $122,080 \times 9\% = $10,987.20 and so on each year.

For our purposes we will use simple interest in all questions unless the question specifically asks for compound interest. Other loans may be calculated on a semi-annual, biannual, semi-monthly, or bimonthly interest rate.

Semi-annual is twice a year, Bi-annual is every two years, Semi-monthly is twice a month, and Bi-monthly is every two months.

**Formula:**

\[
\text{Part} \times \text{Rate} \times \text{Time} = \text{Interest}
\]

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Example

Paul gives Lenny a note for $5,000. The note bears interest of 11% per annum and will amortize over one year. Lenny wants to know how much interest he will be paid in that year. Lennie must:

1. Use the formula, but turn it around to fit the question \( P \times R \times T = I \)

2. Write down the formula and replace with known numbers

\[
P \times R \times T = I
\]

\[
$5,000 \times .11 \times \text{one year} = I
\]

3. Calculate

\[
\frac{$5,000}{x .11}
\]

\[
$550 \times \text{1 year} = \$550 \text{ Interest paid to Lennie.}
\]

Example:

Buck took out a loan and repaid it over 9 months. His rate of interest was 10.5% per annum and he paid a total of $750.00 in interest. He wants to know the principal amount of the loan. Buck must:

1. Use the formula

\[
P \times R \times T = I
\]

But, since he must turn it around to fit the question, it needs to be written like:

\[
I \div R \times T = P
\]

2. Write the formula and replace with known numbers

\[
I \div T \times R = P
\]

\[
$750 \div 9/12 \times 10.5\% = P
\]

First convert the fraction of the year to a decimal (top number ÷ bottom number). Time is 9/12 of a year, so \(9 \div 12 = .75\). Then convert 10 1/2% to a decimal by dropping the % and moving the decimal point 2 spaces to the left.

\[
$750 \div .105 \times .75 = P
\]

3. Calculate

\[
$750 \div 105 \times .75 = $5,357.14 \text{ (which is Buck's principal loan amount)}
\]

**Loan to Value Percentages**

Always begin with “known” numbers. Carefully read the question to determine how to calculate the known numbers, to arrive at the unknown number.
Loan-to-Value Ratio Formula

\[ \% \times \text{Value} = \text{Loan} \]

You can turn the formula around to fit your questions. For example:

\[ \% \times V = L, \text{ or } \]
\[ L \div \% = V, \text{ or } \]
\[ V \div L = \% \]

(Use LTV for Loan to Value)

When a lender makes a loan in relationship to the value of the property, the lender will use either the appraised value of the property, or the sales price, whichever is less. If the lender will make a loan of 75% LTV (loan to value) this means that the lender will loan 75% of the amount that a property appraised and/or sold for, whichever is less.

IF the property appraised for $119,950, but sold for $116,500, the loan amount will be:

\[ 75\% \times 116,500 = 87,375 \text{ loan amount because the sold value was less.} \]

IF the property appraised for $116,500, but sold for $119,950, the loan amount will still be:

\[ 75\% \times 116,500 = 87,375 \text{ loan amount, because the appraised value was less.} \]

Desiree bought a house for $82,500, but was appraised for $79,900. The lender will give Desiree a loan to value ratio of 80%. Desiree wants to know how much the loan will be. She must:

1. **Use the formula**

\[ \% \times \text{Value} = \text{Loan} \]

2. **Write the formula and replace with known numbers**

\[ \% \times V = L \]
\[ 80{\%} \times 79,900 = L \]

3. **Calculate**

\[ 80{\%} \times 79,900 = 63,920 \text{ (which is the amount of Desiree's loan)} \]

Now Desiree wants to know what her down payment will be. Subtract the Loan of $63,920 from the $ 82,500 sale price.

\[
\begin{align*}
\text{Sale Price} & \quad \text{Loan} \\
82,500 & \quad - 63,920 \\
\text{Down payment} & \quad 18,580
\end{align*}
\]

**Important:** If the sale price is higher than the appraised value, the lender will use the appraised value to base the loan amount. However, if the buyer agrees to pay a sales price higher than appraised value, the down payment will be the difference between the sale price and the loan amount. The buyer will have to pay the difference between the sale price and appraised value in cash. Lenders usually charge a loan origination fee, or discount “points”, when making the loan.

**Loan Fee Formula**

Formula:

\[ \% \times \text{Loan} = \text{Fee} \]
You can turn the formula around to fit your question such as:

\[ \% \times L = F \text{ or } F \div \% = L \]

**Example:**

Old US Mortgage charges Tina 2 points for her $166,800 loan. “Points” means percentage. Tina wants to know how much the fee is. She must:

1. **Use the Loan Fee Formula**
   
   \[ \% \times \text{Loan} = \text{Fee} \]

2. **Write the formula and replace with known numbers**
   
   \[ \% \times \text{Loan} = \text{Fee} \]
   
   \[ 2\% \times 166,800 = \text{Fee} \]

3. **Calculate the Fee**

   
   \[ \frac{166,800 \times .02}{1} = 3,336 \text{ Fee} \]

**Property Value after Profit or Loss**

This formula will help an investor determine the percentage of increase or decrease of the value of a property after the investor has realized a profit or taken a loss. If the investor made no profit, but also had no loss, the property value would remain the same. However, if the investor makes a profit, the value of the property will then be more than it was originally.

If the investor shows a loss, the value the property value will be less than the original value. The percentage of the profit or loss is the comparison of the property “value before” the profit or loss, to the property “value after” the profit or loss is taken.

The value of the property before the profit or loss was taken is 100% of its value. This 100% figure is called the “value before”. If the investor realizes a profit, the property is valued at 100% of its “value before” plus the percentage of profit. Of course, if the investor shows a loss, the property is valued at 100% of its value before minus the percentage of profit.

**Value Before and Value After Formula**

\[ \% \times \text{Value Before} + 100\% \text{ of VB} = \text{Value After} \]

\[ \% \times \text{VB} + 100\% \text{ of VB} = \text{VA} \]

First convert the percentage to a decimal.

**Example:**

Jack bought duplex seven years ago for $169,500. He sold it to Kip for 40% more than he paid. Jack wants to know the property's “value after” this profit. Jack must:

1. **Use the formula** to find value after:

   \[ \% \times \text{VB} + 100\% \text{ of VB} = \text{VA} \]

   First convert the percentage to a decimal
2. Write the formula and replace with known numbers

\[ \% \times VB + 100\% \times VB = VA \]

\[ 40\% \times $169,000 + $169,000 = VA \]

3. Calculate

\[ 40\% \times $169,000 + $169,000 = $236,600 \text{ (the property’s value after the profit)} \]

Example:

Rich sold his apartment house for $73,500. He bought it three years ago for $125,000. Rich knows the value before was $125,000 and that the “value after was $73,500. He took a loss, but he needs to know the percentage of his loss. He must:

1. Use the formula

\[ VA \div VB = \% \]

2. Write the formula and replace with known numbers

\[ VA \div VB = \% \]

\[ \frac{73,500}{125,000} = \% \]

3. Calculate

\[ VA \div VB = \% \]

\[ \frac{73,500}{125,000} = .59 \]

Convert the decimal to a percentage by moving the decimal point two places to the right and adding a %. Rich’s property value after the loss was 59% of the value before the loss. 100% of property value before (prior VB of property) - 59% value after the loss (new % of VA of the property - not % of the loss) 41% is the percentage amount of his loss.

Example:

Dr. Harvey sold his condo for 27% more than he bought it for 1 year ago. He received $174,300 at closing. Dr. Harvey needs to calculate what he originally paid for the condo. He knows the “value after” is $174,300 and that the percentage of profit is 27%. To find the “value before” he must:

1. Use the formula

\[ VA + \% + 100\% = VB \]

2. Write the formula and replace with known numbers

\[ VA + \% + 100\% = VB \]

3. Calculate

\[ VA + \% + 100\% = VB \]

\[ 174,300 + 27\% + 100\% = 1.27 = $137,244 \]

Dr. Harvey bought his condo for $137,244.

**Capitalization Formula**
Capitalization is a method used in the evaluation of property as approach to value. The “cap rate” of a property is the desired rate of return, multiplied by the property value, to calculate what the income of the property must be.

\[
\text{\%Rate \times Value} = \text{Income}
\]

\[
\% \times V = I
\]

The annual net income of the property is the Income. The capitalization rate, or “cap rate” is the desired percentage of return that the investor is looking for.

If a property produces $15,000 per year income, and the investor wants a cap rate of 12, the investor could pay $125,000 for the property. However, if the investor wants a higher cap rate, he/she would have to buy the same property for a lesser value with the same income.

Let’s say that the investor desires a cap rate of 10.

Now the investor could pay $150,000 for the same property with the same income. There are many types of investment properties where the Net Income should allow for vacancy factors and operating expenses that must first be deducted from the Gross Income.

Sarah’s apartment building has an annual net income of $53,000. Roger wants to buy an investment property that has an 11% capitalization rate of return. Roger decides to make an offer on Sarah’s Apartment building so he must figure out how much to pay for it. To do so Roger must:

1. **Use the formula**

   \[
   \text{NI} \div \% \times R = V
   \]

   \[
   $53,000 \div 11\% = V
   \]

3. **Calculate**

   \[
   $53,000 \div .11 = $481,818
   \]

   To get a cap rate of 11%, with net income of $53,000, he should pay $481,818.

Using his annual Net Income, Mickey valued his triplex at $150,000 using a cap rate of 9%. Bud wants a cap rate of 11% so he has to figure out how much to pay for Mickey’s triplex. Mickey must:

1. **Use the formula**

   \[
   \text{NI} \div \% \times R = V
   \]

2. **Write the formula and replace with known numbers**

   \[
   \% \times V = \text{Net Income}
   \]

   \[
   .09 \times $150,000 = \text{Net Income}
   \]

3. **Calculate**
% Rate x Value = Net Income
.09 x $150,000 = Net Income $13,500

Mickey’s net income is $13,500. BUT, Bud wants an 11% capitalization rate.

4. Now Bud must use the formula

\[
\frac{NI}{\% R} = V
\]

\[
\frac{13,500}{.11} = $122,727
\]

Bud could pay $122,727 for Mickey’s property to get the higher rate of 11%. You can see that if an investor demands a higher cap rate from an investment property that produces X amount of income, the investor will have to pay less for it than an investor who requires a lower cap rate from the same property with the same income.

Example:

Dan has a twenty-unit office building with 12 offices that rent for $750 per month, and eight offices rent for $1200 per month. He has a 6% vacancy and bad debt factor. Dan’s operating expenses include annual property tax of $8,600, monthly utilities of $1,150, and maintenance cost of approximately $2,100 per year.

Dan owes a mortgage balance of $18,000 at 7% interest, with monthly payments of $279. Pat wants to buy the office building to produce a 12% rate of return.

Pat can add up the income and he knows his cap rate, so he must use the formula to figure out how much to pay for the property. If Dan’s property will provide Pat with a 12% rate of return, at a price of less than $2,000,000 Pat will buy the property. Pat must do some calculations to find the Net Income before using the formula:

1. Calculate to find the annual income from rent.

\[
12 \times 750 \times 12 \text{ months} = 108,000
\]

\[
+8 \times 1,200 \times 12 \text{ months} = 115,200
\]

Total Gross Income = $223,200

2. Calculate the 6% vacancy and bad debt factor and deduct it

\[
6\% \times 223,200 = 13,392
\]

3. Deduct the $13,392 from the Gross Income.

\[
223,200 - 13,392 = 209,808 \text{ (the Effective Gross Income)}
\]

4. Calculate the operating expenses and deduct from the Effective Gross Income. Operating expenses are:

- property taxes $8,500 per year
- utilities $1,150 per month x 12 months = $13,800 per year
- maintenance $2,100 per year
- Total annual operating expenses $24,500

Mortgage payments are not an operating expense and may not be deducted.

\[
\begin{align*}
\text{Effective Gross Income} & \quad \text{($209,808)} \\
- \text{Operating Expenses} & \quad \text{($24,500)} \\
\text{Annual Net Income} & \quad \text{($185,308)}
\end{align*}
\]
Net Income is the number you use to calculate “cap” rates.

1. Now you can use the formula

\[ NI \div %R = V \]

2. Write the formula and replace with known numbers

3. Calculate

\[ NI \div %R = V \]
\[ $185,308 \div .12 = $1,544,233 \]

Pat would have a cap rate of 12 %, so he pays $1,544,233 for Dan’s office building. Wouldn’t you like to be Pat’s agent?

Example:

What if Pat paid $1,950,000 for Dan’s office building and the income and expenses were the same. Now what would Pat’s cap rate be?

1. Use the formula.

\[ NI \div V = %R \]

2. Write the formula replacing the letters with the known numbers

\[ NI \div V = %R \]
\[ $185.308 \div $1,950,000 = %R \]

3. Calculate.

\[ NI \div V = %R \]
\[ $185.308 \div $1,950,000 = .095 \]

When you convert .095 to a percentage, it becomes 9.5%, so the cap rate at this price would be 9.5%.

**Pro-Ration Formula**

Pro-ration means figuring out the share of each party’s expenses “per diem” which means “per day” according to the period of time that each will or have already benefited from the expense.

This is usually required to figure costs for the real estate closing. Cost of insurance and taxes are pro-rated according to the amount paid and the amount left by the closing date. The proration formula is:

\[ \text{Rate per day} \times \text{Number (of days)} = \text{Share} \]

The formula can be turned around to fit the question.

\[ R \times N = S \]
\[ N \div S = R \]
\[ S \div R = N \]

\[ 2 \times 3 = 6 \]
\[ 3 \div 6 = 2 \]
\[ 6 \div 2 = 3 \]
The “per diem” for monthly expenses must be calculated to at least 4 decimal places. The “per diem” for annual expenses must be calculated to 5 decimal places. At a real estate closing, it may be necessary to find pro-rations to divide certain costs.

What if the seller of a house paid for the entire year’s insurance on January first? The insurance is paid for the entire year, but then the seller sells the house on May 15th. The seller will want some money back.

If the buyer wants to assume this insurance, first we need find out how much the insurance cost for the year, and divide that number by 365 days to find the per diem or cost per day. Then we would count the number of days there are from January first to the date of the closing when the buyer takes over.

Next, take the number of days left, and multiply that by the cost of the insurance per day. Then, at closing the seller would be credited the amount that the buyer took over. To find the per diem or cost per day of a monthly expense, divide the expense by the number of days in those particular months.

Roberta makes an offer to purchase a home. As part of her terms she agrees to pay the prepaid interest, or “interim interest”, at closing. This is the amount of interest that will have accrued from the date of the closing, which will be August 11th, until the end of the month, August 31st. The principal amount of the loan is $163,000. Roberta wants to figure out her share of the cost. She must:

First calculate the annual interest cost.

Use the formula

\[ \text{Part} \times \text{Rate} \times \text{Time} = \text{Interest} \]
\[ P \times R \times T = I \]

\[ \text{Part} \times \text{Rate} = \text{Interest} \div \text{Time} \]
\[ P \times R = I \div T \]

\[ \$163,000 \times .08 = \$13,040 \div 365 = \$35.73 \text{ per diem} \]

Now Roberta must count the number of days in the month of August from the date of closing to the end of the month. August 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31 = 21 days

1. Use the Pro-ration Formula:

\[ \text{Rate per day} \times \text{Number (of days)} = \text{Share} \]

2. Write the formula, replacing the letters with the known numbers

\[ \text{Rate per day} \times \text{Number (of days)} = \text{Share} \times N = S \]
\[ \$35.73 \times 21 = S \]

3. Calculate

\[ \text{Rate per day} \times \text{Number (of days)} = \text{Share} \]
\[ \$35.73 \times 21 = \$750.33 \text{ (Roberta's share)} \]

Ginger buys Frank's house, which will close on March 16th. The annual property taxes of $1,652 were due on January 1st, BUT have not been paid. Ginger will have to pay taxes to bring them current at closing. Frank owes Ginger for taxes from January 1st to March 16th. Frank wants to know what his share will cost. Frank must:

First divide the annual rate of his taxes by 365 days to find the per diem
$1,652 ÷ 365 \text{ days} = $4.53 \text{ per day}

Then count how many days there are from January first to March 16th. There are 75 days.

1. Now use the Pro-ration Formula

\[ \text{Rate per day x Number (of days)} = \text{Share} \]
\[ R \times N = S \]

2. Write the formula replacing the letters with the known numbers

\[ \text{Rate per day x Number (of days)} = \text{Share} \]
\[ R \times N = S \]
\[ $4.53 \times 75 = S \]

3. Calculate

\[ $4.53 \times 75 = $339.75 \text{ (Frank's Share)} \]

**Depreciation/Appreciation Formula**

Appreciation is when a property rises in value. Depreciation is when a property has a loss in value. Buildings and land can appreciate or depreciate at different rates. An appraiser looks at depreciation as an actual loss that affects the appraised value. An accountant will look at depreciation as a hypothetical loss that affects the investor's financial statement and income taxes.

Although there are many different forms of depreciation and appreciation, the exam contains mostly questions concerning only one type, which is called “straight line” depreciation. Straight line depreciation means that the property will depreciate in equal annual amounts throughout its useful life.

**Straight Line Depreciation**

\[ 100\% ÷ \text{Number of Years} = \text{Annual Rate of Depreciation or } 100\% ÷ N = D \]

The formula can be turned around to fit your question

\[ 100\% ÷ N = D \quad N \times D = 100\% \quad 100\% ÷ D = N \]
\[ 6 ÷ 2 = 3 \quad 2 \times 3 = 6 \quad 6 ÷ 3 = 2 \]

For Total % for months, years, etc. use:

\[ \text{Number of Years} \times \text{Annual Rate of Appreciation} = \text{Total %} \]
\[ N \times A = T \% \]

**Example:**

Brenda has a building with a “useful life” of 20 years. She wants to know the Rate of her annual depreciation. She must:

1. Use the formula

\[ 100\% ÷ \text{Number of Years} = \text{Annual Rate of Depreciation} \]
\[ 100\% ÷ N = D \]

2. Write the formula and replace with known numbers
3. Calculate

\[
100\% \div N = D \\
100\% \div 20 = .05
\]

Her building will depreciate at a rate of 5% per year.

Henry has a rental house with an estimated useful life of 35 years. What annual rate will the house depreciate, using straight-line depreciation?

1. Use formula

\[
100\% \div \text{Number of Years} = \text{Annual Rate of Depreciation} \\
100\% \div N = D
\]

2. Write the formula and replace the letters with known numbers

\[
100\% \div N = D \\
100\% \div 35 = D
\]

3. Calculate

\[
100\% \div N = D \\
100\% \div 35 = D
\]

The formula which equals .02857 could be rounded up to 3% annual Rate of depreciation. Henry's house will depreciate at annual rate of .02857 or rounded up to 3%.

Example

Steve's office building has an estimated economic life of 20 years. To find out how much it have depreciated after 4 years, Steve must:

1. Use the formula

\[
100\% \div \text{Number of Years} = \text{Annual Rate of Depreciation} \\
100\% \div N = D
\]

2. Write the formula and replace with known numbers

\[
100\% \div N = D \\
100\% \div 20 = D
\]

3. Calculate

\[
100\% \div N = D \\
100\% \div 20 = .05
\]

Then to calculate the amount for 4 years:

\[
.05 \times 4 \text{ years} = .20 \\
or 20\% \text{ total loss from depreciation}
\]

**Straight Line Appreciation**
The formula for appreciation is the same except that the annual rate is added to, rather than subtracted from, 100% of the property value.

Formula:

\[
\frac{\text{Number of Years}}{\text{Annual Rate of Appreciation}} = \frac{100\%}{N} = A
\]

The formula can be turned around to fit your question.

\[
\begin{align*}
100\% & \div N = A \\
N \times A & = 100\% \\
N & \div A = 100\%
\end{align*}
\]

\[
\begin{align*}
6 & \div 2 = 3 \\
2 \times 3 & = 6 \\
6 & \div 3 = 2
\end{align*}
\]

Example:

Rob’s triplex has appreciated by 7.5% of its original value each year for the last 8 years. Rob wants to know how much appreciation has occurred. Rob must:

1. Use the formula

\[
\text{Number of Years} \times \text{Annual Rate of Appreciation} = \text{Total \%}
\]

\[
8 \times .075 = T \%
\]

2. Write the formula and replace with known numbers

\[
\text{Number of Years} \times \text{Annual Rate of Appreciation} = \text{Total \%}
\]

\[
8 \times .075 = T \%
\]

3. Calculate

\[
\text{Number of Years} \times \text{Annual Rate of Appreciation} = \text{Total \%}
\]

\[
8 \times .075 = 60 \text{ or } 60\% \text{ (Rob’s total appreciation)}
\]

Amortization Formula

Amortized loans are repaid with payments that include both principle and interest. In the beginning, the payments are nearly all interest and very little is applied to the principle. This is because interest is always deducted first, and then interest is only charged on the remaining principle balance. Every monthly payment will reduce the loan balance, so that less and less is applied to interest while more and more is applied to principle, until the entire loan is completely paid off.

Example:

Caitlin takes out a loan for $110,000 at 12 ½ %, which will be amortized over 30 years. Her first monthly payment is $1,173.98 with interest of $1,145.83 being applied to the interest:

\[
\begin{align*}
$1,173.98 & \text{total payment} \\
- $1,145.83 & \text{interest payment} \\
$ & \text{28.15 applied to principle}
\end{align*}
\]

You can see that $28.15 of her first payment was applied to the principle of Caitlin’s loan balance. Her loan was for $110,000.00. So now deduct $28.15 principle payment from the balance.
$110,000.00 original loan
- 28.15 paid to principal
$109,971.85 new balance

Interest for the 2nd payment will be calculated on the new balance of $109,971.85

The formula for calculating the principle and interest amounts of each payment is complex. However, there are two easy methods to find the amounts. The first and most practical way is to use a financial calculator. Virtually all real estate agents use a calculator to figure payments, interest, and principle amounts.

**DO TAKE A CALCULATOR TO THE EXAM.** The second best method is to use an amortization book. Agents can get these small booklets from lenders and title company representatives. These booklets are not allowed in the license exam. Do not take one to the exam. The amortization process, if done without a calculator or booklet, is tedious and complex. We will describe the formula for amortization for questions that ask for loan balances up to the third year.

It is unlikely the exam will ask for amortization beyond three or four years. It is best to know the formula for amortization on your financial calculator, which is allowed in the license exam.

Learning the amortization formula for your financial calculator is extremely important. The exam may contain questions regarding amortization.

**Amortization Formula**

Each part of the amortization formula will be explained in four steps.

**Example:**

Louis borrowed $92,500 at 9% interest amortized over 30 years with principle and interest payments of $744.28. After making just three payments, he was transferred and had to sell the home. What was his loan balance after three payments?

Formula to Calculate the First Month’s Principle Balance

1. Calculate the interest for the initial loan amount

   \[ PV \times I\% = AI \]

   
   $92,500 is the original loan OR principle value OR PV
   Multiply by the annual interest rate, OR I\% $92,500 \times .09 = $8,325.00 annual interest OR AI

2. Determine the monthly interest:

   \[ AI \div N \text{ of months} = MI \]

   
   $8,325.00 \div 12 = $693.75 MI

3. Then, deduct the monthly interest from the combined monthly principle and interest payment.

   \[ $744.28 \text{ principle and interest payment} - $693.75 \text{ interest part of the first monthly payment} = $50.53 \text{ applied to principle} \]

4. Next, subtract the first principle payment from the original loan.
The interest part of the second payment is based on the declined principle balance. Remember that the principle balance was reduced by $50.53, making the new principle balance $92,449.47. This means that interest for the second payment is calculated on the basis of the new principle balance. There will be a declining principle balance each month, so it is necessary to calculate the interest part of the payment on the new principle balance each month.

Formula to Calculate the Second Month’s Principle Balance

1. Calculate the interest for the balance after the first payment.
   
   $92,449.47 loan balance after first payment x .09 = $8,320.45 annual interest

2. Calculate the monthly interest by dividing the annual interest by 12 months.
   
   $8,320.45 ÷ 12 months = $693.37 monthly interest

3. Next, deduct the monthly interest from monthly principle and interest payment.
   
   $744.28 principle and interest payment
   - $693.37 interest part of second payment
   $ 50.91 of the second payment applied to principle

4. Then, subtract the amount of the second payment that was applied to the principle balance after the first payment. $92,449.47 was the principle balance after first payment. Then, $50.91 was applied to that balance.

   $92,449.47 balance after first payment
   - $50.91 amount applied to principle from the second payment
   $92,398.56 new principle balance

Formula to Calculate the Third Month’s Principle Balance:

1. Calculate the interest for the balance after the second payment.
   
   $92,398.56 loan balance after second payment x .09 = $8,315.87 annual interest

2. Calculate the monthly interest by dividing the annual interest by 12 months.
   
   $8,315.87 ÷ 12 months = $692.99 monthly interest

3. Next, deduct the monthly interest from monthly principle and interest payment.
   
   $744.28 principle and interest payment
   - $692.99 interest part of the third payment
   $ 51.29 of the third payment applied to principle

4. Subtract the third payment applied to the principle balance after the second payment.

   $92,398.56 principle balance after second payment
   - $51.29 of third payment applied to that balance
   $92,347.27 balance after second payment
This four-step process can be repeated as many times as necessary to answer an amortization question. The example above asked for the loan balance after the third payment, so to find the balance after six months, you would need to repeat the process three more times.

**Example:**

Louis wants to know how much interest he will pay on this loan if it runs the entire 30 years. Louis must:

Use the formula to determine Total Interest Paid.

\[
\text{Monthly Payment} \times \text{Number of Months of the loan} = \text{Total Principle and Interest} - \text{Principle Balance} = \text{Interest Paid.}
\]

\[
\text{MP} \times \text{N} = \text{PI} - \text{PB} = \text{I}
\]

\[
$744.28 \times 360 = $267,940.80 - $92,500.00 = $175,440.80
\]

$175,440.80 is the Total amount of Interest Louis will pay over 30 years!

**Review**

Mathematics is an important tool for the agent, and is used continually. The following formulas are the more important ones to be knowledgeable of.

The formula for calculating interest:

\[
\text{Principle loan (part) x percentage of interest (rate) x duration of the loan (time) = interest}
\]

Or more simply, \( \text{PART} \times \text{RATE} \times \text{TIME} = \text{INTEREST} \)

Loan-to-Value Ratio: \( \% \times \text{Value} = \text{Loan} \)

Loan Fee formula: \( \% \times \text{Loan} = \text{Fee} \)

The Value before and Value after formula: \( \% \times \text{Value before} + 100\% \times \text{VB} = \text{Value After} \), or more simply \( \% \times \text{VB} + 100\% \times \text{VB} = \text{VA} \)

The formula for determining the cap rate: \( \% \times \text{Rate} \times \text{Value} = \text{Income} \) or \( \% \times \text{R} \times \text{V} = \text{I} \)

The pro-ration formula is: \( \text{Rate per day} \times \text{Number (of days)} = \text{Share} \)

Straight Line Depreciation Formula: \( 100\% \div \text{Number of Years} = \text{Annual Rate of Depreciation} \), or put more simply \( 100\% \div \text{N} = \text{D} \)

Straight line Appreciation Formula: \( \text{Number of Years} \div \text{Annual Rate of Appreciation} \), or put more simply \( 100\% \div \text{N} = \text{A} \)

The remainder of the review focuses on the different calculations involved with the Amortization Formula.

To calculate the first month’s principle balance: \( \text{PV} \times \text{I}\% = \text{AI} \)

Determine the monthly interest using: \( \text{AI} \div \text{N of months} = \text{MI} \)

Deduct the monthly interest from the combined monthly principle and interest payment. Subtract the first principle payment from the original loan.
Formula to Calculate the Second Month’s Principle Balance:
1. Calculate the interest for the balance after the first payment.
2. Calculate the monthly interest by dividing the annual interest by 12 months.
3. Next, deduct the monthly interest from monthly principle and interest payment
4. Then, subtract the amount of the second payment that was applied to the principle balance after the first payment.

Formula to Calculate the Third Month’s Principle Balance:
1. Calculate the interest for the balance after the second payment.
2. Calculate the monthly interest by dividing the annual interest by 12 months.
3. Next, deduct the monthly interest from monthly principle and interest payment
4. Subtract the third payment applied to the principle balance after the second payment.

To calculate how much interest will be paid if the loan runs the full 30 years:
Monthly Payment x Number of Months of the loan = Total Principle and Interest, minus the Principle Balance = Total Interest paid, or putting it more simply, the formula would look like this:
MP x N = PI - PB = Interest paid

Chapter 8
Lender Appraisal

Introduction
Today, there are very few “cash” buyers for homes. Most homebuyers purchase their homes by borrowing the funds from a bank, mortgage company, savings and loan, or other lending institution. The financing of real estate is a concept that evolved from the alodial system of ownership. Long ago, when farms and homesteads were purchased, they were used as the security for the borrowed money.

Before there was a lien theory, lenders actually took possession of the property as security. Over the years as the lending business grew it became impossible to actually take possession of properties for security. It became increasingly more popular to permit the borrowers to keep possession of their properties, although the title was transferred to the lender for the term of the loan. The lender held legal title to the property, but the borrower had possession. When only the title to a property is pledged as collateral, without giving up possession, it is called hypothecation.

When title is transferred without any right to possession, and only as collateral, it is called legal title, or naked title. The right of possession to the property is called the equitable right or title. If there were no sources of financing, buyers would have to pay cash and very few people could afford to own homes.

Today, we tend to look at financing as a wise way to use money to make money. Buying on a cash basis or owning property “free and clear” seems senseless because it freezes the use of the money that could otherwise be invested to produce a return. Financing real estate is known as “leverage”. Leverage is a benefit that comes from using as little cash of one’s
own as possible, while using someone else's cash. This frees up more of the purchaser’s cash to invest in more purchases to make more money.

Finance is the lending and borrowing of money and is considered to be the core of the real estate business. To be able to provide high quality service, the agent needs a thorough understanding and knowledge of lending practices, charges and benefits, and the underwriting process.

**Underwriting Process**

Lenders care about three main things:

1. Can you afford to repay this loan? (income)
2. Have you repaid debts in full and on time before? (credit)
3. What happens if you can’t or don’t repay the loan? (value of the property used for security)

If the lender is very secure about #1, then #2 and #3 may be less important. If the lender is not very secure about #1 or #2, the lender may be much more concerned about #3.

The lender lends money for a fee. This fee is “interest”, which is the cost of borrowing the money. If a borrower has an excellent record of repaying debt, and has enough income to pay his/her ongoing bills including the new mortgage payment, the lender may be more willing to make a higher loan amount, or offer lower interest rates.

A borrower who may not have a spotless credit record, or who may have marginal income may have to pay a higher interest rate, or may qualify for a lower loan amount in relationship to the value of the property. This is because the lender is taking more risk, so #3 (value of the secured property) may become much more important.

A lender may take the added risk of making a loan if the secured property has a large equity, and/or if the lender is paid a higher interest rate for the loan. Although, lenders are careful to evaluate the buyer’s capability of repaying the loan, the lender must also make sure that in case the buyer does default, that the value of the secured property would bring adequate proceeds to pay the debt if sold in a foreclosure sale.

The decision whether or not to make the loan will depend on these three main concerns, but also on a number of factors used for the qualification process. Because the wide majority of all loans are sold on the secondary market, virtually all lenders use the underwriting standards of Fannie Mae, Freddie Mac, FHA and VA. FHA, VA and conventional loans each have their own specific rules, but all use the same underwriting process. Top production agents also tend to work with only the best loan officers who are knowledgeable, creative, and have a good understanding of what the underwriter requires and will accept.

**Automated Underwriting System (AUS)**

The Automated Underwriting System was created to save time and cut costs in the loan approval process. This computerized program, recently released by Freddie Mac, uses the “point system” which has been used for over 30 years as a basis for loan approval or denial decisions.

This software can access the three major credit reporting bureaus. These are Equifax Mortgage information Service, TRW Redi Property Data and Trans Union Corporation. These reports can be merged to give a more accurate credit history of the applicant. The computerized program can also access credit card information of the applicant which shows credit balances, payment history and credit limits.
A number of points are added or subtracted for factors such as years of employment, credit, savings accounts, assets and many other factors. Then these points would be totaled and if they added up to a certain threshold, the loan would be approved.

With the AUS, the loan approval may be given in just minutes. Let’s say that the number of points were high. The loan application would be “accepted” subject to some further processing, such as the appraisal of the proposed secured property. If the number of points were too low the loan would be denied. If the number were “borderline”, loan approval may be reviewed for other factors or circumstances.

This borderline application may fall into the category of “refer”. This means that the application is sent to the underwriter with reasons for the referral status, and then, depending on these reasons, it may be processed as normal. If the points are low, then the application is categorized as a “caution” status. Caution status applications are also sent to underwriting, but they have less of a chance of being approved.

**Collateral Assessment**

Collateral assessment is the appraisal underwriting evaluation. If the applicant has excellent credit, and the subject property fits generally accepted standards such as a tax assessed value, the lender may request an “expedited” evaluation.

If this is the case an approval may be given in just a few hours. This is usually the case in applications where the property has little or no encumbrance and has a high market value. This is an example of a high “loan to value ratio”, or LTV.

If the application is not in this category, the lender normally requests a “non-expedited” evaluation. This means that the underwriter will require a full appraisal. However, in most cases an answer can be given in two or three days.

**Letter of Explanation**

A lender may accept less than perfect credit if there were extenuating circumstances, or a sudden, unexpected or temporary situation that caused the problems, but has since been corrected. The lender will be looking for five things.

1. **A description of each credit problem. They cannot be grouped together.**
   Example: “My credit was bad between 4/20/92 and 6/15/94 because of a car wreck.” Each spot on the report must be explained separately. Example: “The late payment to Household Furniture dated 8/14/93 was due to, etc.” “The slow pay to Dr. White, dated 4/15/95 was due to my recovery from cancer surgery, etc.”

2. **A detail of what happened.**
   Example: “I was injured in a car wreck and had to spend 6 months in the hospital.”

3. **Why did this cause credit problems?**
   Example: “I was unable to work during this time and I did not have disability insurance to cover debts while I was recovering.”

4. **What was done to correct the problem?**
   Example: “Since then I have returned to work and made arrangements to pay off all debts. All are now paid or current and have been for 18 months.”

5. **What I have learned from this and why will this never happen again.**
   Example: “I realize now that things like this can happen so I took out a life and disability policy. “I have set aside a reserve in case anything sudden should ever happen again.”
Making timely payments are important to me, so I have a special account that I pay into each month just to make sure that I am never caught in this situation again.”

It is always a mistake to blame someone else when explaining bad credit. For instance the lender will most likely not look favorably on a letter that says something like:

“My spouse told me I had to file bankruptcy or he/she would leave me”, or “my spouse ran up bills and I didn't know about it”, or “Household Furniture sent us incorrect bills”, or “Household Furniture sold us shoddy goods and we refused to pay”.

The lender may feel that these are the excuses of a person who does not pay bills willingly or does not take their credit rating seriously. Although the real estate agent is not allowed to write the explanation letter for the client, it is good practice to know what the lender is looking for and to seek out and work with lenders who understand the importance of a well-written explanation.

**Usury**

These loans typically demand very high interest and contain prepayment penalties if paid off before maturity. Federal law exempts real estate transactions from usury laws, so the lender may charge what the “market will bear”.

**Supply and Demand**

The factors that affect supply and demand are constantly changing. To keep the economy functioning, supply and demand need to remain in reasonable balance.

The United States Treasury and the Federal Reserve System manage the national debt and influence and control real estate financing through the supply, demand and cost of money. Treasury funds, which come from the personal and business income taxes we all pay, are by far the largest source of available funds.

If the government spends more money than it brings it creates a federal deficit. The Treasury borrows money to cover the deficit by issuing interest-bearing securities called Treasury Certificates, Treasury Bills, or Treasury Notes. These securities are backed by the government and because they are “low risk”, private investors often invest in these.

In theory, this leads to a slowdown in the economy because the U.S. government is competing with private enterprise for the same dollars. The larger the federal deficit, the more the government competes with the private industry, leading to a negative effect on the economy. If the federal deficit is reduced, there is a greater supply of money for private industry investment.

**The Federal Reserve System**

In 1913 The Federal Reserve System was established as the nation's central banking system under the Federal Reserve Act. A seven member Board of Governors in Washington, D.C. are appointed by the President of the United States and approved by the Senate regulate the system.

The system has twelve Federal Reserve districts that regulate the flow of money and interest rates through more than 5,000 member banks by controlling their reserve requirements, discount rates and open market operations.
The “Fed”, as it is often referred to, also supervises Ginnie Mae, Freddie Mac, and Fannie Mae and enforces the Truth in Lending Act. The goal of the monetary policy is to stimulate a high employment and economic growth rate, and stabilize interest rates, prices, and foreign exchange markets.

**Discount Rate**

When member banks borrow money from the Federal Reserve Banks, the rate of interest charged for the loan is called the “discount rate”. If the Fed raises the discount rate, the banks pass this on to their customers by charging higher interest rates on their loans, including home loans. Of course, if the Fed lowers the discount rate, the banks lower the interest rates they charge as well. The “prime rate”, is the rate of interest charged by commercial banks to their largest and strongest customers, which will influence the “street rate” of interest available to the consumer.

**Reserve Requirements**

The FED determines the reserve requirements. Each member bank is required to keep a certain percentage of its assets on deposit at the Federal Reserve Bank as reserve funds that cannot be used for loans or other purposes. This requirement is intended to assure the depositors that their money is secure and available and to prevent any financial panics.

Reserve requirements also give the Fed some control over the growth of credit, by increasing or decreasing the reserve requirement. If the reserve requirement is raised, available loan funds decrease and interest rates would have to rise. If there is more demand than supply for money, the cost of borrowing money or “interest” will increase.

**“HUD” Department of Housing and Urban Development**

HUD is a federal cabinet level agency that has responsibilities in all areas of national housing policies. HUD provides grants and subsidy programs for various public housing urban renewal and rehabilitation projects, FHA insured loans and many, many other programs. It is also responsible for enforcement of the Federal Fair Housing Act.
“FHA” Farmer's Home Administration

The FHA should not be confused with the Federal Housing Administration. FHA is an agency of the U.S. Department of Agriculture, which was originally created to provide for farm financing. Today, FHA provides loans to borrowers in "qualified" rural communities. The FHA, The Farmer's Home Administration is a direct lender that originates and services loans for rural residents, ranchers and farmers.

In 1992, the government began a guarantee program that helped borrowers obtain loans through private lenders, rather than directly from FHA. These loans require no MIP, and can be for 100% of the purchase price or appraised value, whichever is less. The interest rate cannot be higher than VA or Fannie Mae rates. No discount points may be charged on FHA loans.

FHA loans can be used to buy, build, or rehabilitate farm homes and other farm buildings, or develop rural housing for the elderly in qualified communities. Qualified communities are rural towns with less than a 10,000 population, or cities lying outside of the standard metropolitan areas with populations between 10,000 and 20,000 that can show a lack of available home loan funding.

Federal Deposit Insurance Corporation (FDIC)

A federal agency created to insure savers' deposits held in those commercial banks that are members of the Federal Reserve System (FRS). In the event a member bank is liquidated, FDIC will pay off depositors up to the maximum amount of coverage, presently set at $100,000 per named individual.

Federal Home Loan Bank (FHLB)

A series of 12 regional Federal Home Loan banks providing a pool of reserve funds for loans to member savings and loan institutions.

Federal Housing and Federal Reserve System (FRS)

A federal agency created to assist in the management of the nation's economy. The "Fed" operates through 12 federal reserve district banks that provide a pool of reserve funds for loans to member commercial banks.

FIRREA

In 1986, Congress passed the Tax Reform Act, which eliminated the income tax shelters for investment real estate. Almost overnight, investment properties became devalued and the real estate market collapsed. When these borrowers defaulted, the properties were sold at foreclosure but the proceeds were far below the loan balance. The lenders suffered enormous losses and many became insolvent.

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act "FIRREA". The act created the "OTS", (Office of Thrift Supervision) and SAIF, (Savings Association Insurance Fund) to close the insolvent savings and loan associations and manage the remaining thrift industry, and the "RTC" Resolution Trust Corporation to dispose of insolvent savings and loan associations and the repossessed assets they held.

Today, saving and loan associations require much greater documentation before making a loan and they are required to maintain deposit insurance on their customer's savings. Deposit insurance can be provided by SAIF, the Savings Association Insurance Fund or by private insurance companies. SAIF is a government agency which insures savings deposits in savings and loans that are members of the FHLB. If the savings and loan association became insolvent, SAIF would pay the depositor up to the maximum amount of coverage, which is presently set at $100,000.
Since the enactment of FIRREA, the operations of savings and loan associations and banks have become quite similar. Because of the 1989 real estate collapse, there is far fewer saving and loan associations but commercial banks and mortgage bankers have significantly increased their market share.

The Primary Market

The primary market is actually various lending institutions where homebuyers go to borrow money to finance the purchase of a home. There are several major sources of loans in the primary market, but most home loans are made by one of these types of lenders:

- Savings and loans
- Commercial banks
- Savings banks
- Mortgage companies

Savings & Loan Associations

The savings of people and businesses in the community are the original source of funds in the primary market, and community savings and loan associations, also known as thrift institutions, are the most common lender in the primary market. These savings are used to make real estate loans to people in local areas.

The condition of the local economy will affect the amount of available funds the local lender has to loan. When local employment is high, there is usually more motivation to borrow money to buy homes, furniture, cars, vacations, or expand businesses. However, if lenders increase the number of loans to meet consumer demand, while fewer people tend to deposit savings, the decrease in money supply would deplete the available funds for loans.

Local lenders may decide to sell its mortgages on the secondary market to help meet the demand, or their funds would be depleted and the local economy would deeply suffer. This is a national market where real estate mortgages are bought and sold throughout the United States.

When savings are low, there is less money to lend and the lender's primary source of income is affected. It is also true that when savings are high and the lender is paying interest to its depositors, the savings must be quickly reinvested or the lender will lose money.

Saving and loan associations can usually provide a variety of both government-backed and conventional real estate. They are chartered by the federal government or state governments and are regulated as to maximum loan amounts, loan-to-value ratios, and ratio of home loans to other types of loans.

Commercial Banks

Since the savings and loan disaster in 1989, commercial banks became major competitors for home loans and refinancing. Prior to this, commercial banks were active in making loans for business ventures and short-term construction activities. Residential mortgages were not a large part of commercial banks' business.

The reason for this was that most commercial bank deposits were made to checking accounts, rather than savings. The government limited the amount of long-term investments the banks could make, and checking accounts are “demand deposits”, or “short term” funds. At the same time, federal regulations allowed commercial banks to offer a wide range of other types of loans, so the commercial banks had no reason to specialize in residential mortgages.

However, significant changes have been made since as far back as the 1970s. Commercial banks accepted an increasing amount of long term deposits, meaning that the short term “demand deposits” began to represent a much smaller percentage of the banks' total funds.
Even though they are still very active making commercial loans, commercial banks have substantially increased the number of personal loans and residential mortgages. Today, the commercial bank’s share of the residential mortgage market is as large as the savings and loan associations.

National Commercial Banks are chartered by the federal government, and the Federal Deposit Insurance Corporation (FDIC) must protect their deposits. State Commercial Banks are chartered by state government, but may still become members of FDIC to provide their depositors with federally insured deposits. They are the largest source of investment funds in the United States.

**Savings Banks**

Savings banks can offer the same basic services as commercial banks and savings and loan associations, such as checking, credit cards, commercial loans, as well as residential mortgages. However, in the past there was little difference between savings banks and the savings and loan. They focused on their local community, serving mainly individuals rather than businesses, and their deposits were mostly long-term savings deposits.

Savings and loan associations concentrated on home loans and although the savings banks did include home loans, they were also active in many other types of lending.

Most savings banks were established in 16 of the Northeast states and were originally chartered and regulated by the state, but not by the federal government. Until the 1950’s the savings banks held many more assets than savings and loans, but they did not expand as the savings and loans did after World War II.

In 1982, savings banks were given the option of a federal charter so that their depositors were protected with insurance against insolvency under the FDIC. Federal savings banks can be either mutual companies or stock organizations. State chartered savings banks can become members of the FDIC.

**Mortgage Companies**

What is the difference between mortgage bankers and mortgage brokers? There are two basic categories of mortgage companies. The first type is the mortgage broker; the second is the mortgage banker. The difference between the mortgage banker and the mortgage broker depends on the source funds to lend, and the servicing of the loans.

A mortgage broker simply acts as a broker. This means that he or she brings together a potential borrower and a lender and negotiates a loan. The mortgage broker receives a commission for this service, but does not loan his or her own funds, and does not service the loan. The mortgage broker's job is finished as soon as the two are brought together. The mortgage broker's income comes from the loan origination and loan discount fees.

Mortgage companies are sometimes referred to as mortgage bankers. Mortgage bankers sometimes use their own funds as a source to make loans, but more often they originate loans on behalf of their investors. The mortgage banker also services the loan and charges a fee. Mortgage companies can sometimes act as mortgage brokers, but mortgage companies are much more often mortgage bankers. Since bankers loan their own money, their income comes from not only loan origination and loan discount fees, but by packaging these loans and reselling them.

- Brokers bring parties together as the middleman.
- Bankers actually loan their own money, or they loan money on behalf of an investor.
- Banks have money and service.

Mortgage companies may also borrow money from banks to originate mortgages. These are packaged and immediately sold to investors or the on the secondary market. Many times mortgage companies make loans on behalf of large investors such as life insurance companies and pension funds.
Since these types of funds are not associated with sudden large withdrawals, they are excellent sources for long-term lending. National scale investors seldom handle day-to-day management of these loans. Instead, they usually use the specialization of mortgage bankers.

**REIT - Real Estate Investment Trusts**

A REIT is somewhat like a mutual fund. A mutual fund’s method of obtaining money to invest is accomplished by selling stock. A REIT obtains money by selling shares, or certificates of ownership, in the trust to give the individual investors the funds to purchase real estate investments.

A REIT must use at least 75% of its assets to invest in real estate to obtain certain federal income tax exemptions.

This current tax requirement results in a very large amount of investments being made. Because of this, Real Estate Investment Trusts often buy and sell through the secondary market rather than by direct loans.

**Life Insurance Companies**

Insurance companies are a huge source of funds for large projects. They not only invest the policyholders' insurance premium dollars, but they frequently participate in the investments with their own money and as part-owners.

These investments are typically in large commercial projects such as shopping centers, and multi-family complexes and office buildings, although they can also be involved in residential loans.

**Credit Unions**

Unlike a mortgage company, credit unions are depository institutions, more like savings and loan associations and banks. However, credit unions typically limit their lending services to their group members.

Credit unions were first established to make small, personal loans to members of a certain group, such as teachers, metal workers, government employees, etc.

Credit Unions have recently become involved in making residential home loans and loans on their borrower’s existing home equity.

**Private Lenders**

Although private lenders are apt to charge a higher rate of interest than the street rates, they are often easier to deal with than an institutional lender. These private lenders are investors, who make real estate loans secured with a note and deed of trust, which is a higher yield than investing the same money into a “certificate of deposit and certainly higher than putting the money into a savings account.

Private sources of money are always available and usually will negotiate face-to-face meetings with potential borrowers. Private investors could be anyone such as friends, relatives, or employers. They can also be referred by attorneys, financial advisors, accountants and other business contacts.

**The Secondary Market**

The secondary market is made up of private investors and government agencies that buy and sell real estate mortgage loans. Two thirds of all residential loans made in the United States are government-related loans that are sold to the secondary market. The three major government agencies are:

- FNMA or "Fannie Mae" - Federal National Mortgage Association
GNMA or "Ginnie Mae" - Government National Mortgage Association

FHLMC or "Freddie Mac" - Federal Home Loan Mortgage Corporation

Real estate loans made by primary lenders are "investments" that are expected to produce a return in the form of interest payments and other fees. Like other investments, real estate loans can be bought or sold. The value of the loan depends on the rate of return and the risk of default.

The conditions of the local economy affect the amount of available money the lenders have to lend. Sometimes they will have a shortage of money, or they may have an excess of money to lend.

The secondary market creates a balance in the market by moving available funds from areas with excess funds to areas with a shortage of funds. When a lender has a shortage of funds, selling some real estate loans on the secondary market can raise money.

However, unless the loans conform to the secondary market's underwriting standards, the secondary market will not purchase them.

Most lenders adhere to the uniform standards because of the stabilizing effect it has on the local mortgage market. These underwriting standards are a set of criteria that the loan applicant and the property must meet. The applicant must meet acceptable "debt-to-income" ratios and comply with a precise set of terms.

The borrower's "debt-to-income ratio", credit, "loan to value ratio" and other standard underwriting requirements are used to evaluate the strength of the loan applicant as well as the property being used as security to determine if the loan is a low or high risk.

Lenders are more willing to accept the risk of making long term real estate loans even when there is a shortage of funds, because they can raise more funds by selling their "uniform standards" loans on the secondary market.

Each year in January, Fannie Mae and Freddie Mac determine the maximum loan amount for conforming residential loans. "Conforming" loans are "regular" real estate loans for single family, and up to four unit multi-family home loans. A formula prepared by the Housing and Community Development Act of 1980, is used to set the limit, based on the national average price increase according to the Federal Housing Finance Board.

Federal National Mortgage Association

"Fannie Mae," originated in 1938 as a federal agency to provide a secondary market for FHA-insured and VA guaranteed loans. However, in 1968, FNMA became a private corporation, which offers common stock to the public, and also buys conventional loans. In the same year "Ginnie Mae" was created to take over Fannie Mae's governmental capacity.

Ginnie Mae - Government National Mortgage Association

Ginnie Mae is a federal agency that provides federally regulated secondary mortgage market for FHA, VA, Rural Housing Service, and the Office of Public and Indian Housing loans. The agency also purchases high-risk subsidized HUD guaranteed loans that provide "social benefits" such as urban renewal projects and housing for the elderly.

Freddie Mac - Federal Home Loan Mortgage Corporation

Freddie Mac is a federally chartered and regulated government agency that can buy FHA, VA, and conventional loans from any type of lender. The loans that are bought by Freddie Mac are packaged into mortgage based securities that are sold to investors all over the world. The Emergency Home Finance Act of 1970 created Freddie Mac to purchase conventional loans from savings and loan associations as a means to help them recover from the 1969 recession.

Uniform Residential Loan Application
In January of 1992, the Uniform Residential Loan Application form became mandatory for all loan applications to purchase residential single family and up to four unit multi-family housing.

The four-page form requires the applicant for any government-related loan, to undergo a thorough examination. The reason for this “tightening” was to prevent a repeat of the numerous foreclosures of the 1980’s and 90’s. These requirements may not be applicable if the loan is not government related and will not be sold to the federal secondary market. However, only a very small amount of loans fall into a non-government related category.

The Uniform Residential Loan Application form requires the applicant to provide all names used to obtain credit, such as a maiden name, married name, previous married name(s), aliases, information and addresses of all past and present residences during the past seven years, employment verifications, among many other requirements. The new form includes all of the home mortgage disclosure laws and a provision that the buyer is aware that if the loan is sold, the buyer can require the borrower to re-verify information.

The requirements for refinancing a home are usually the same as the application for a new home loan purchase. During the low interest rates of 1991 and 1992, borrowers flocked to lenders to refinance their home loans. While some were successful, many found that for a period of time since their purchase, real property had depreciated in value.

It is common for lenders to require a minimum of an 80% Loan to Value ratio in order to make a refinance loan. This means that in order to refinance a house, the loan amount can be no more than 80% of the home's value. In many other respects, a refinance loan is much like a new home loan. However, unlike new home loans, the points paid when refinancing a home are not tax deductible.

**The Truth in Lending Act**

The Truth in Lending Act, which is implemented by Regulation Z, was enacted in 1969 to protect consumers by requiring the lenders to disclose the complete cost of credit to their applicants and by regulating the advertisement of consumer loans.

Anyone who grants credit to customers in the ordinary course of their business must comply with the requirements of the Truth in Lending Act and Regulation Z, if the type of loans they made is consumer loans. If a lender makes a loan to a borrower for a personal, family, or household use, the loan is a consumer loan. The Truth in Lending Act covers all consumer loans if:

- They are to be paid back in four or more payments
- The borrower pays finance charges for the loan of up to $25,000
- The loan is any size and it is being secured by real property

This means that a mortgage loan to purchase a home or an equity loan for college tuition or remodeling the borrower’s home would be considered “consumer” loans. But if a corporation refinances real property for a business purpose, it is not a consumer loan and is not covered by the Truth in Lending Act.

Truth in Lending legislation requires all lenders of FHA, VA, or conventional loans, or any loans that will be sold on the secondary market, to provide the applicant with a Good Faith Estimate describing all costs of the loan.

This same law also requires that a seller, who is providing financing (as in a land contract), that contains a “balloon payment”, must advise the buyer of the total balloon payment amount, at the time of acceptance of the contract.

**Disclosure Requirements**
The purpose of disclosure is to inform the applicant of the total cost of the loan, so that there are no surprises at the closing table. Although there is no particular form, the disclosure statement must be clear and understandable and include all the disclosures required by Regulation Z.

The primary disclosures that the Truth in Lending Act requires a lender to make to the loan applicant are the:

1. **Total Finance Charge**

This includes the interest on the loan, origination fee, funding fee, discount points, document preparation fee, warehousing fee, escrow fee, title policy charges, etc. In real estate loan transactions, the appraisal fees, credit report charges, and points paid by the seller are not included in the total finance charge.

2. **APR - Annual Percentage Rate**

The annual percentage rate is the total of the finance charges in relationship to the amount of the loan, shown as an annual percentage (%). The lender must give an accurate computation of the APR within one eighth of one percent of the exact calculation.

In addition to the total finance charge and annual percentage rate, the form must disclose the following information:

- Total amount financed
- Payment schedule
- Total number of payments
- Total amount that will be paid
- Balloon payments, late fees, or prepayment charges
- And if the loan can be assumed without (or with) the lender’s approval

Lenders usually give the applicant a disclosure statement, or “Good Faith Estimate”, at the time of their application. The Truth in Lending Act requires the lender to provide this disclosure to the applicant within three days of receiving the written application. Estimated figures may change over the course of the transaction, and the lender must make these changes in new disclosures to the borrower prior to closing.

The Truth in Lending Act has special rules for the refinancing of homes. When the security property is the borrower’s existing principal residence, the act gives the borrower a right of rescission. The home equity borrower has a three-day “right of rescission”. This means that the borrower can back out of the refinance loan anytime during three days after:

1. Signing the agreement
2. Receiving the disclosure statement
3. Or receiving notice of the right of rescission

**WHICHEVER COMES LAST**

However, if the borrower is not given the statement or the notice, the right of rescission does not expire for three years. These rights apply only to home equity or refinance loans. There is no right of rescission for a borrower to purchase or build a home.

**Loans Exempt from TILA**

The Truth in Lending Act does not apply to loans made for business, commercial, or agricultural purposes, loans made to corporations, trusts or other “artificial” persons, or to loans in excess of $25,000, unless the loan is secured by real property. Almost all loans made by a seller, such as a land contract or installment contract, are exempt, unless the seller’s ordinary course of business is extending credit.
Advertising under TILA

The Truth in Lending Act applies to everyone who advertises consumer credit, so real estate brokers and agents must become completely familiar with Regulation Z’s limitations on the advertising of any finance terms.

If even one detail of financing information is mentioned in an advertisement, it may trigger “Reg” Z, making it necessary to give a full disclosure in order to comply with the law. If a real estate broker advertises “$1,000 down”, this would be a violation of the Truth in Lending Law unless the ad fully discloses the APR, the monthly and down payment, and complete terms and costs of repayment.

It is not a violation to state the price of a home, or to give a general statement such as "small down payment," "easy terms," or "low interest".

Regulation Z also applies to lenders that make loans for the purchase of personal property, such as cars, furniture, etc. The security agreement, also called a chattel mortgage or conditional sales contract, must include a full disclosure of all costs, and the annual percentage of the loan.

Equal Credit Opportunity Act

The Equal Credit Opportunity Act was enacted to ensure that anyone who is capable of repaying a loan must be considered for the loan. The Equal Credit Opportunity Act does not entitle any person to credit if the person does not have the ability to repay.

The Equal Credit Opportunity Act originally prohibited discrimination because of gender or marital status, but it now also includes the prohibition of discrimination because of race, color, religion, national origin, age, reliance on income from public assistance, or because of the exercise of rights under the consumer protection laws.

Applicants may be asked questions regarding credit, but only when asked for specific reasons to determine credit worthiness. They may also be asked their age to determine if the person is of legal age to enter into contract. The lender could ask about age to determine how many years the person might be employed or to determine a level of income, but the lender may not use the applicants age as a decision to refuse to lend to the applicant.

The creditor may ask to what degree the applicant's income is affected by alimony, child support or maintenance payments, whether paying them or receiving the payments. If the applicant is receiving any of these payments, the creditor must first inform the applicant that this information does not have to be revealed unless the payments will be used to repay the loan.

Creditors may not ask applicants about birth control choices, practices, intentions or pregnancy nor any discrimination based on a perception or assumption that a woman’s employment would in any way be affected or that the woman would stop working to have a child.

The creditor has a maximum of 30 days after the completion of the application to notify the applicant of approval. If approval is denied, the applicant has a right to request the reason for denial and the creditor must reveal the reason within 60 days of the request.

Creditors are defined as any person or any organization that regularly participates in credit decisions or whose regular business ordinarily allows customers the right to extend credit by deferring payment for goods or services purchased. Accepting credit cards issued by other companies, firms or banks does not make a merchant a creditor.

The Equal Credit Opportunity Act may be obtained from:

Department of Consumer Affairs
Federal Reserve Bank of Philadelphia
P.O. 66
Philadelphia, PA 19105
Review

When title is transferred without any right to possession, and only as collateral, it is called legal title, or naked title. The right of possession to the property is called the equitable right or title.

Financing real estate is known as “leverage”. Leverage is a benefit that comes from using as little cash of one’s own as possible, while using someone else’s cash. This frees up more of the purchaser’s cash to invest in more purchases to make more money.

Finance is the lending and borrowing of money and is considered to be the core of the real estate business.

Amortization is a method of repaying the principle and interest of a loan through periodic payments. An amortized loan makes it possible for the borrower to pay interest and principle in level payments. Each payment is the same amount each month, bi-weekly or annually, with the first part of the payment applied to the interest and the second part applied to the principle.

Negative amortization occurs in an amortized loan when the monthly (or periodic) loan payment amount is not large enough to pay the cost of accrued interest since the previous payment.

A straight loan is the payment of the interest only on a weekly, monthly or yearly basis. At the end of the term, the full principal amount of the loan becomes due and must be paid in full. The date of the end of the term is called the maturity date. Balloon loans of today originated from the term loan.

A construction loan is a short-term interim loan made to provide money to construct a house, building or other project.

An equity loan is a real estate loan based on the equity value of a property.

Loan-to-value ratio (LVR) is the amount of the loan in relationship to the property's appraised value or sale price, whichever amount is less.

The first to record has the highest priority. Because property can be used as security for more than one loan, from different lenders, the priority of the lien is established by the date of recording. There is an exception if a subordination agreement appears in the records.

Subordination clauses state that a certain lien will have lower priority than another lien that will be recorded in the future. This can be used to give a higher priority position or “first” mortgage position to a lien even though it will be a “junior lien”, recorded after the first lien.

The seller can provide the financing for a purchase using a security instrument called the land contract. This is also called an installment contract, real estate contract, contract for deed, or contract of sale.

The borrower is called the mortgagor and the lender is called the mortgagee. The lending institutions will explain these different loan services to the customer, but the agent must be able to advise the borrower of the choices that are most advantageous for their situation.

The United States Treasury and the Federal Reserve System have the authority to manage the national debt and the power to exercise influence and control real estate financing through the supply, demand and cost of money.

The factors that affect supply and demand are constantly changing and cycling. To keep the economy functioning, supply and demand need to remain in reasonable balance. The federal government’s role has been to regulate and limit adverse effects of the economy on real estate markets by shaping a national secondary market.

The primary market is actually various lending institutions where homebuyers go to borrow money to finance the purchase of a home. The secondary market is made up of private investors and government agencies that buy and sell real estate mortgage loans. Two thirds of all residential loans made in the United States are government-related loans that are sold to the secondary market.
PMI is private mortgage insurance that insures the lender in case of default of a non-FHA or any other governmental agency mortgage loan.

Points are the fees that most mortgage lender’s charge to increase the financial yield on a loan. Equity is the cash value difference between the property’s present market value minus all liens, mortgages and other encumbrances.

Lenders compute the interest rate on an adjustable rate loan based on an index. The prime rate is the rate of interest a lender charges its largest and strongest customers. Arbitrage results from the difference between two interest rates. For example, if a person borrows money at 8% and loans it to someone else at 12%, the income that results between the two interest rates is called arbitrage.

Caps are the maximum limits of increase or decrease in interest, payments, and time periods.

Junior liens are any liens in subordinate positions of priority to another lien on the same property.

The margin is an amount that is added to the current index value on the rate adjustment date to establish a new interest rate on an adjustable rate loan.

A Loan Origination Fee is the one-time charge made by the lender, to make and process a loan application.

An Impound Account is a trust account used by the lender to hold a portion of the borrower's payment to be used to pay insurance premiums, real estate taxes, etc. as protection for the lender.

The Equal Credit Opportunity Act was enacted to ensure that anyone who is capable of repaying a loan must be considered for the loan and does not entitle any person to credit if the person does not have the ability to repay. According to the Equal Credit Opportunity Act, a creditor is defined as a person (or organization) that regularly participates in credit decisions or whose regular business ordinarily allows customers the right to extend credit by deferring payment for goods or services purchased.

Chapter 9
FAQ’s and Myths

Introduction

Naturally, when it comes to most business entities, there are always numerous questions that need to be answered. On occasion, the agent is well-versed when it comes to being the “answer person” for the client. However, there are always those situations that arise wherein they are required to step aside --- e.g. accounting or legal issues. The content in this chapter relates to the more common FAQ’s and myths that exist within the subject matter.

The FAQ’s are broken down into the following four categories:

1. How appraisals and appraisers work
2. Appraisals and refinancing
3. Appraising the inside of the home
4. External factors and home improvements

In addition to this, the more common myths fall into these seven categories below:

1. Anyone can be an appraiser.
2. Appraisals are identical to home inspections.
3. Appraisers have no obligation to reveal home defects to buyers.
4. Appraisers use a specific formula (e.g., price per square foot) to figure out exactly how much each home is worth.
5. Good housekeeping can improve a home's valuation.
6. If the appraiser's opinion of value is lower than the purchase price, the buyer won't be able to purchase the home.
7. The primary purpose of an appraisal is to make sure the buyer doesn't pay too much for the house.

Hopefully, the content will provide some needed answers regarding future situations that may arise, and that even though some of the seven myths appear laughable, some truth will come out of that content, while that which is untrue will get dispelled in the process.

Four Frequently Asked Questions

How appraisals and appraisers work

Q: Why should an appraiser be hired?
A: First and foremost, the value of the house needs to be arrived at. But having a certified appraisal performed can affect certain financial aspects for the seller such as private mortgage insurance and tax liability. Analyzing the feasibility of proposed improvements, determining the best use for a property, estate planning, and insurance valuations are other areas that can be affected by the appraisal as well.

Q: How does the appraiser arrive at the value of the property?
A: The appraiser usually determines the value of the home by analyzing the following data:

- current offers
- market data (inclusive of current and historic comparable sales)
- pending sales
- proposed improvements

The property is then compared to the broader market. Depending on the reason for the appraisal, this process may vary somewhat. There may be a difference in the amount of weight carried by an insurance valuation versus the market valuation.

Q: Where does the appraiser find this information?
A: The following sources can provide the appraiser with the information he needs:

- the appraiser’s own personal knowledge
- county courthouse records
- interviews with owners
- the local MLS
- local real estate agents/licensed professionals
- private data vendors

The appraiser must weigh the quality and reliability of the information before making their final decision.

Q: Do appraisals have time limits?
A: Appraisals do not come with fixed expiration dates attached to them. However, most lenders will consider them invalid or outdated after a six month period has elapsed. This is due primarily to changes in the market that can affect the price positively or negatively.

Q: If a person spends the money to have their property appraised by five different appraisers, will each one come up with a different figure?
A: If a homeowner was approached by five prospective buyers, chances are, each one would offer them a different buying price. It stands to reason that the results would follow suit with the appraisal process. Granted, assuming that each appraisal was performed at the same time and under the same conditions, there shouldn't be that much of a variance in the arrived at values of the property.

But no two appraisers use identical techniques, so there is the possibility that there could be quite a difference in the results. Obviously, a drive-by appraisal will result with a different figure than a complete appraisal that involves an interior inspection. Drive-by appraisals cold not provide accurate information about such aspects as condition of the property, features of the property, or updates done to the property.

Q: If a person feels that the appraiser was errant in their measuring or other calculations, is there any recourse?
A: The best course of action would be for the person to contact the appraiser and the lender.

Q: Is the appraiser allowed to discuss an appraisal with people other than the homeowner that he did the appraisal for?
A: Absolutely not --- the relationship between appraiser and client is bound by confidentiality.

Q: Are there any professional appraisal organizations that an appraiser may belong to?
A: One of the best ways for an appraiser to demonstrate that they are committed to continuing their education, ethical standards, and professionalism is to join any of the numerous professional appraisal organizations that are available. In fact, there is evidence that some of these organization’s standards actually exceed those established by the state’s licensing board.

Q: If a person has a complaint about either the appraisal or the appraiser, is there an entity that they can lodge their complaint with?
A: Yes. Usually the licensing or regulatory board would be in charge of investigating any complaints regarding appraisals and appraisers.

Q: Can the appraisal be considered a home inspection as well?
A: Not usually. Aspects regarding the home’s condition and construction are often documented by an appraiser, but for the most part, an appraisal is not to be considered the same as a home inspection. Despite the fact that appraisers do not perform the same functions as a home inspector, they oftentimes offer a home inspection service or a referral to such a service.

**Appraisals and Refinancing**

Q: A person is refinancing their home using a local lender. If the appraisal results in a figure higher than the tax value, does that mean that the person will have a greater tax liability?
A: Due to client confidentiality, the lender should have no reason to discuss this with the IRS or the local tax authority. Technically, the person’s tax liability will not increase.

Q: When a person refinances their home, does this automatically entitle them to a copy of the appraisal?
A: Since the lender is the appraiser’s client, a lot depends on how the lender views this. The homeowner should contact their lender should they have any questions regarding this.

Q: A person refinanced their home a year ago, and in the process of the appraisal, the appraiser did an interior inspection. This year, when the same person applied for an Equity Loan, the appraiser never entered the home. How can the appraiser arrive at a value without entering the home?
A: Usually, an estimate can be arrived at by virtue of a drive-by appraisal. However, the appraiser must use outside sources for the information they need to complete the appraisal. They may consult the local MLS or even investigate court records to obtain information such as age and size as well as other features and characteristics of the property. These sources do provide information that will help them conduct the appraisal, but the records may not always be accurate.

**Appraising the Inside of the Home**

**Q:** What are some of the aspects appraiser looks for inside a person’s home?

**A:** The appraiser will normally document the following information:

- condition of the interior
- features
- improvements
- layout
- updates

This usually helps the appraiser in the comparison and valuation process.

**Q:** An appraiser spent only 10 minutes looking at the interior of a person’s home, and now that person has doubts as to whether or not the appraiser has arrived at an accurate estimate. Should the homeowner be concerned about the appraisal’s accuracy?

**A:** The overall appraisal process encompasses many functions, but the physical aspects of it are only a small part compared to other issues involved. The complexity and size of the person’s home usually determines the length of time that an appraisal will take. However, should the homeowner have questions regarding the thoroughness of the appraisal, they should definitely confront the appraiser and the lender.

**Q:** How does the appraiser actually arrive at a figure denoting the home’s “living area”?

**A:** The appraiser will usually measure the exterior dimensions of the home and then deduct the dimensions of the “non-living” areas (e.g. covered porches, garages, etc.).

**Q:** Are finished basements included in an appraisal?

**A:** Normally, a finished basement will be valuated separately from the above-ground living areas. Certain factors will help determine the “contributory value” of the basement. These are aspects such as:

- government regulations
- quality of the finish
- structural issues

**External Factors and Home Improvements**

**Q:** Do features such as an above-ground pool or a shed factor into the appraisal?

**A:** Since above-ground pools and sheds are not considered permanent structures, they normally don’t factor into the valuation of the property. However, there are instances, based on specific installation processes where these items may be considered part of the real estate and factor into the appraisal from that approach.

**Q:** What improvements will add the most value to a home or property?

**A:** Improvements to a home and property affect what the appraiser refers to as contributory value. What an improvement may be worth locally may not be the same in another area as the value is driven by the wants and needs of the individual neighborhood. The appraiser’s familiarity with the person’s neighborhood will usually help determine the value of the home improvements that have been done.
Q: If a person’s neighbors make improvements to their home, does this have any effect on that person’s home and property?
A: It’s possible that there may be an impact to the value, but things like this will vary considerably from market to market. In such instances, the homeowner should consult the appraiser should they have any questions.

Q: If a person who owns the largest home on their block has their house appraised, will the size of the adjacent homes decrease the appraised value of the larger home?
A: Since the appraiser takes into consideration all of the relevant real estate data in the area, the data would not normally be detrimental. However, when analyzing the various data from recent sales that may (or may not) affect the appraisal, they will generally look at homes that are comparable based on aspects such as:

- the appeal of the location, and
- similar physical characteristics

The appraiser will generally go outside the neighborhood to establish their criteria if the homes in that neighborhood do not provide them with the best comparison factors based on appeal and similar characteristics.

Seven Myths about Appraisals

Since every property is unique, the appraiser must rely on their expertise and knowledge in order to arrive at an opinion on value. Most consumers have some serious misconceptions regarding appraisers and the appraisal process. This is due mostly to the fact that they don’t experience appraisals that often. The following seven myths about appraisers and the appraisal process are the most common ones in the industry.

Myth #1: Anyone can be an appraiser.

Just because a person has a business card and owns a clipboard, it doesn’t mean that they are qualified to be an appraiser. Licensing practices and minimum standards are established in each state as a result of federal law requiring this. As an example, here are the main requirements for an appraiser trainee in California. The trainee must:

- complete 2,000 hours of supervised experience
- pass an examination
- take several courses

Myth #2: Appraisals are identical to home inspections.

An appraisal is not the same as a home inspection, nor should it be considered as a substitute for one. The two are distinguished as different entities based on the job responsibilities of the person performing the function. The appraiser formulates an opinion of the property’s value for the lender, while the inspector educates the buyer about the condition of the home and its major components.

Myth #3: Appraisers have no obligation to reveal home defects to buyers.

The appraiser is required by the FHA (pursuant to their new disclosure requirement) to disclose any and all potential problems with the home and property to the homeowner. This of course is pending a survey of the physical condition being performed by the appraiser. Non-FHA mortgages do not require this.

Myth #4: Appraisers use a specific formula (e.g., price per square foot) to figure out exactly how much each home is worth.
There are numerous factors that an appraiser takes into consideration when valuating a home and property. However, the following list contains the most significant ones:

- condition of the home
- location of the home
- proximity to desirable schools and other public facilities
- recent selling prices of other comparable properties
- size of the home
- size of the lot

**Myth #5: Good housekeeping can improve a home's valuation.**

Dirty dishes and dusty furniture does not influence an appraiser’s decision making. But the following are a few signs of neglect that will affect his judgment in evaluating:

- broken windows
- chipped or peeling paint
- cracked walls
- damaged floors
- non-operating appliances
- torn carpeting

**Myth #6: If the appraiser's opinion of value is lower than the purchase price, the buyer won't be able to purchase the home.**

It’s not uncommon for a transaction to survive a low appraisal however one or more of the following actions may need to transpire:

- the buyer makes a large downpayment
- the seller reduces the purchase price
- a separate escrow account is established for the purpose of funding repairs that will improve the home and property values

If there is new evidence to support a higher valuation, the appraiser may reconsider their opinion, however this rarely occurs.

**Myth #7: The primary purpose of an appraisal is to make sure the buyer doesn't pay too much for the house.**

Despite the fact that the buyer and seller gain valuable information from an appraisal, just remember that the appraiser’s primary mission is to always protect the lender. Owning an overpriced property is about as appealing to a lender as approving a loan to an irresponsible borrower. The lender will only grant final approval of the loan when the appraisal has taken place, never beforehand.

**Review**

There are numerous reasons to hire an appraiser besides determining the value of the home and property such as:

- analyzing the feasibility of proposed improvements
- determining the best use for a property
- estate planning
- insurance valuations
- tax liabilities
The appraiser usually determines the value of the home by analyzing the following data:

- current offers
- market data (inclusive of current and historic comparable sales)
- pending sales
- proposed improvements

The property is then compared to the broader market.

**A:** The following sources can provide the appraiser with the information he needs:

- the appraiser’s own personal knowledge
- county courthouse records
- interviews with owners
- the local MLS
- local real estate agents/licensed professionals
- private data vendors

Appraisals do not come with fixed expiration dates attached to them. However, most lenders will consider them invalid or outdated after a six month period has elapsed.

No two appraisers use identical techniques, so there is the possibility that there could be quite a difference in the results of the appraisal if there is more than one appraisal.

The homeowner should call the appraiser or lender if they feel that the appraisal was not accurate. Also, if the homeowner has complaints about the appraisal or the appraiser, they should contact the licensing or regulatory board about the matter.

Aspects regarding the home’s condition and construction are often documented by an appraiser, but for the most part, an appraisal is not to be considered the same as a home inspection.

Even though an appraisal results in a higher value than the tax value, the homeowner’s tax liability should not increase.

An estimate can be arrived at by virtue of a drive-by appraisal. However, the appraiser must use outside sources for the information they need to complete the appraisal. The local MLS office or even court records may provide the appraiser with information such as age and size as well as other features and characteristics of the property.

Appraisers will normally document the following information:

- condition of the interior
- features
- improvements
- layout
- updates

The overall appraisal process encompasses many functions, but the physical aspects of it are only a small part compared to other issues involved. The complexity and size of the person’s home usually determines the length of time that an appraisal will take.

The appraiser will usually measure the exterior dimensions of the home and then deduct the dimensions of the “non-living” areas. Normally, a finished basement will be valued separately from the above-ground living areas. Certain factors will help determine the “contributory value” of the basement. These are aspects such as:
• government regulations
• quality of the finish
• structural issues

If a person owns the largest home on the block, the smaller homes normally would not have a negative impact on the value of the larger home. The appraiser will usually take all of the relevant real estate data in the area into consideration. When analyzing the various data from recent sales that may (or may not) affect the appraisal, they will generally look at homes that are comparable. If there is not enough comparable data in the neighborhood, they will oftentimes go outside the area to find such data.

For purposes of the review, the seven myths are set up with either “True” or “False” as the answer. They will not appear on the chapter exam in this fashion.

Myth #1: Anyone can be an appraiser. **TRUE** provided they pass all necessary courses and licensing practices as well as meet all the minimum standards that the state requires in order to receive their certification. In some states, they may have to complete numerous hours of supervised experience, take several courses, and pass all applicable exams. **HOWEVER** --- the answer could also be **FALSE** based on a person’s mental capabilities to handle the courses and exams as well as the functions of the job.

Myth #2: Appraisals are identical to home inspections. **FALSE**. They can’t even be used as a substitute for a home inspection.

Myth #3: Appraisers have no obligation to reveal home defects to buyers. **FALSE**. The appraiser is required by the FHA (pursuant to their new disclosure requirement) to disclose any and all potential problems with the home and property to the homeowner.

Myth #4: Appraisers use a specific formula (e.g., price per square foot) to figure out exactly how much each home is worth. **TRUE** (for the most part). There are numerous factors that an appraiser takes into consideration when valuating a home and property.

Myth #5: Good housekeeping can improve a home’s valuation. **FALSE**. Dirty dishes and dusty furniture does not influence an appraiser’s decision making. Broken windows, chipped or peeling paint, cracked walls, damaged floors, non-operating appliances, and torn carpeting are several of the aspects that will influence the outcome of the appraisal.

Myth #6: If the appraiser’s opinion of value is lower than the purchase price, the buyer won’t be able to purchase the home. **FALSE**, although it can make things difficult for the buyer. In order to avoid that sort of outcome, the buyer could make a large downpayment, the seller could reduce the purchase price, and a separate escrow account could be established for the purpose of funding repairs that will improve the home and property values.

Myth #7: The primary purpose of an appraisal is to make sure the buyer doesn't pay too much for the house. **FALSE**. The appraiser’s main priority is to always protect the lender.

**Chapter 10**
**Appraisal and the Government**

**Introduction**

For all practical purposes, it's a foregone conclusion that the United States Government is the reigning authority over anything involving the Real Estate industry. So far the course has
covered 11 government agencies, four major congressional acts, and three subsequent agencies arising from one of the congressional acts. All of these directly or indirectly affect (or have affected) the real estate industry in some way. For the purposes at hand, here's a brief recap of those agencies and congressional acts.

The government agencies that are involved with the real estate industry are:

- Federal Deposit Insurance Corporation (FDIC)
- Farmer's Home Administration (FHA)
- Federal Housing Administration (also called FHA)
- Federal Home Loan Bank (FHLB)
- Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac")
- Federal National Mortgage Association (FNMA or "Fannie Mae")
- Federal Reserve System (FRS)
- Government National Mortgage Association (GNMA or "Ginnie Mae")
- (Department of) Housing and Urban Development (HUD)
- Internal Revenue Service (IRS)
- Office of Federal Housing Enterprise Oversight

The congressional acts that are involved with the real estate industry are:

- Equal Credit Opportunity Act (ECOA)
- Financial Institutions Recovery, Reform, and Enforcement Act (FIRREA)
- Tax Reform Act (TRA)
- Truth in Lending Act (TILA)

There were three other agencies created as a result of the FIRREA. These are:

- Office of Thrift Supervision (OTS)
- Resolution Trust Corporation (RTC)
- Savings Association Insurance Fund (SAIF)

Additionally, there is also the Office of Federal Housing Enterprise Oversight, which will be discussed deeper into the chapter regarding policy guidance on Fannie Mae and Freddie Mac mortgage fraud programs. It would seem like this is a lot to remember, however, as was mentioned above, they all have (or have had) a controlling interest or significant impact in the real estate industry.

**The Government Agencies**

**Federal Deposit Insurance Corporation** – created by the Glass-Steagall Act of 1933, the FDIC is a federal government corporation which guarantees deposits held by commercial banks. The Depositors Insurance Fund, originally created by the Commonwealth of Massachusetts in the earlier years of the Great Depression, was the forerunner to the FDIC. Deposit Insurance provided by the FDIC guarantees checking and savings deposits for up to $100,000 in its member banks.

Until 1989, there was another entity that guaranteed deposits in savings and loan institutions called the Federal Savings and Loan Insurance Corporation (FSLIC). Originally created in 1934 as part of the National Housing Act, the FSLIC was abolished in 1989 by the FIRREA due to insolvency that arose out of the savings and loan crisis of the 1980’s.

**Farmer's Home Administration** - the FHA should not be confused with the Federal Housing Administration. FHA is an agency of the U.S. Department of Agriculture, which was originally created to provide for farm financing. Today, FHA provides loans to borrowers in "qualified" rural communities. The FHA, The Farmer's Home Administration is a direct lender that originates and services loans for rural residents, ranchers, and farmers.
Federal Housing Administration – created as part of the National Housing Act of 1934, this FHA is a federal agency that focuses on three goals:

1. to improve housing standards and conditions
2. to provide an adequate home financing system through insurance of mortgage loans
3. to stabilize the mortgage market

Federal Home Loan Bank – the Federal Home Loan Bank Act, passed in 1932, created the FHLB system. In 1989, FIRREA abolished the FHLB Board and transferred responsibility of overseeing all federal home loan banks to the Federal Housing Finance Board (FHFB). It is interesting to note that the FHFB is an independent agency and not part of the United States government, hence no prior discussion of them prior in the course.

A series of 12 regional Federal Home Loan banks providing a pool of reserve funds, the FHLB provided low-cost, on-demand, stable funding for American financial institutions for agricultural, economic development, home mortgages, rural, and small business lending.

Federal Home Loan Mortgage Corporation – the FHLMC was created in 1970 by the Emergency Home Finance Act to purchase conventional loans from savings and loan associations as a means to help them recover from the 1969 recession. It was also to expand the secondary market where mortgages were concerned.

Oftentimes referred to as “Freddie Mac”, the FHLMC is a government-sponsored enterprise (GSE) and therefore a stockholder-owned corporation that is authorized to issue loans and loan guarantees. Freddie Mac can buy FHA, VA, and conventional loans from any type of lender. These loans are packaged into mortgage based securities that are sold to investors all over the world.

Federal National Mortgage Association – originally founded in 1938 as part of Roosevelt’s “New Deal”, the FNMA, or “Fannie Mae” Corporation provided liquidity to the mortgage market and literally held a monopoly on the US secondary mortgage market. It became a GSE in 1968 in order to balance the federal budget and is still a privately-owned corporation authorized to issue loans and loan guarantees. The FNMA offers common stock to the public, and also buys conventional loans.

Federal Reserve System – the Federal Reserve Act of 1913 created the Federal Reserve System in order to provide the United States with a centralized banking system. Under the Federal Reserve Act, a seven member Board of Governors in Washington, D.C. are appointed by the President of the United States and approved by the Senate in order to regulate the system.

The system has twelve Federal Reserve districts that regulate the flow of money and interest rates through more than 5,000 member banks by controlling their reserve requirements, discount rates and open market operations. The “Fed”, as it is often referred to, also supervises Ginnie Mae, Freddie Mac, and Fannie Mae and enforces the Truth in Lending Act.

Government National Mortgage Association – created in 1968 through a government partition of the Federal National Mortgage Association, the GNMA --- “Ginnie Mae” --- falls under the control of the Department of Housing and Urban Development (HUD) and is a government-owned corporation. Backed by federally insured or guaranteed loans, the GNMA provides guarantees on mortgage-backed securities (MBS).

The guaranteed loans are usually those from the FHA, VA, Rural Housing Service, and the Office of Public and Indian Housing loans. The agency also purchases high-risk subsidized HUD guaranteed loans that provide “social benefits” such as urban renewal projects and housing for the elderly.
**Department of Housing and Urban Development** – founded in 1965 as a Presidential Cabinet department, the Department of Housing and Urban Development (HUD) had its beginnings in the House and Home Financing Agency. Its purpose was to develop and execute policy on cities and housing. Focusing primarily on the housing market now, HUD has scaled back its urban development function.

HUD provides grants and subsidy programs for various public housing urban renewal and rehabilitation projects, FHA insured loans and many, many other programs. It is also responsible for enforcement of the Federal Fair Housing Act.

The Secretary of Housing and Urban Development administrates HUD, and in 1995 they took over the Chicago Housing Authority. Despite being administered by the individual states, HUD had been experimenting with granting economic incentives to financially starved urban sectors. These areas are referred to as Enterprise Zones.

**Internal Revenue Service** – the history of the IRS dates back to 1862 during the Civil War when President Abraham Lincoln created the office Commissioner of Internal Revenue for the purpose of creating income taxes for payment of war expenses. It was originally called the Bureau of Internal Revenue. Capital Gains and Losses as well as 1031 Exchanges are just a couple of aspects displaying the IRS’ involvement in the real estate industry.

**Office of Federal Housing Enterprise Oversight** – an agency within HUD, the Office of Federal Housing Enterprise Oversight (OFHEO) has the responsibility of ensuring capital adequacy as well as financial safety and soundness of Fannie Mae and Freddie Mac funds. To quote their website, their mission is “to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.”

The OFHEO actually conducts broad based examinations of the FNMA and the FHLMC wherein they use a “stress test” which simulates credit risk scenarios and a stressful interest rate. The goal is to create a risk-based capital standard therefore ensuring the capital adequacy, financial safety, and soundness of the two funds.

**Congressional Acts**

**Equal Credit Opportunity Act** - enacted to ensure that anyone who is capable of repaying a loan must be considered for the loan, the Equal Credit Opportunity Act (ECOA) does not entitle any person to credit if the person does not have the ability to repay. The Equal Credit Opportunity Act originally prohibited discrimination because of gender or marital status, but it now also includes the prohibition of discrimination because of race, color, religion, national origin, age, reliance on income from public assistance, or because of the exercise of rights under the consumer protection laws.

Creditors are defined as any person or any organization that regularly participates in credit decisions or whose regular business ordinarily allows customers the right to extend credit by deferring payment for goods or services purchased. Accepting credit cards issued by other companies, firms or banks does not make a merchant a creditor.

**Financial Institutions Recovery, Reform, and Enforcement Act** – enacted in the wake of the savings and loan crisis of the 1980’s, the Financial Institutions Recovery, Reform, and Enforcement Act (FIRREA) came into being in 1989. In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act “FIRREA”. The act created the Office of Thrift Supervision (OTS) and the Savings Association Insurance Fund (SAIF) to close the insolvent savings and loan associations and manage the remaining thrift industry, and the Resolution Trust Corporation (RTC) to dispose of insolvent savings and loan associations and the repossessed assets they held.
**Tax Reform Act** - In 1986, Congress passed the Tax Reform Act, which eliminated the income tax shelters for investment real estate. Almost overnight, investment properties became devalued and the real estate market collapsed.

When these borrowers defaulted, the properties were sold at foreclosure but the proceeds were far below the loan balance. The lenders suffered enormous losses and many became insolvent. (NOTE: see FIRREA above --- resulted from consequences of this act)

**Truth in Lending Act** - implemented by Regulation Z in 1969, the Truth in Lending Act (TILA) was created to protect consumers by requiring the lenders to disclose the complete cost of credit to their applicants and by regulating the advertisement of consumer loans.

Anyone who grants credit to customers in the ordinary course of their business must comply with the requirements of the Truth in Lending Act and Regulation Z, if the type of loans they made is consumer loans. If a lender makes a loan to a borrower for a personal, family, or household use, the loan is a consumer loan. TILA covers all consumer loans if:

- They are to be paid back in four or more payments
- The borrower pays finance charges for the loan of up to $25,000
- The loan is any size and it is being secured by real property

**HUD Appraisal and Property Requirements**

**Purpose and Scope**

The determination of acceptability of property and market value for FHA mortgage insurance purposes are the main reasons for performing an appraisal and assessing the condition of the subject property. The maximum FHA insurable mortgage loan is determined by using the market value as the basis. The appraisal is performed for both HUD's and the lender's use as well as for their benefit.

Visibly obvious and/or apparent deficiencies that could affect the livability of the property's occupants can be discovered when performing an appraisal. The appraisal is synonymous with an examination in that it looks for things that could affect the basic needs, health, and safety of the occupants.

Since HUD/FHA states that they will make “no warranties as to the value and/or condition of any FHA-appraised property”, the buyer/borrower needs to define what a “reasonable” price is for the property. They also need to determine if the condition of the property can be defined as “acceptable” as well. But of course, these definitions are those of the buyer/borrower.

**Expiration of Appraisals**

In chapter nine, there was a question regarding appraisals having an expiration date. Despite the fact that there is no hard and fast rule about appraisal expiration dates, it is pretty much a given that most lenders allow up to 6 months on existing properties and up to 12 months for proposed construction. HUD actually considers not only existing and proposed structures, but they also consider properties that can be classified as follows:

- those that are under construction
- those that are undergoing substantial rehabilitation

Appraisals on these classifications of property are good for 12 months. (EXCEPTION: if the appropriate HOC determines that soft market conditions exist in certain areas or markets, it may shorten the term of appraisals for proposed construction and substantial rehabilitation to a period of less than 12 months upon advance notice to lenders.) The appraiser always
dates the appraisal document the date that it is performed, and the term of the appraisal begins on that date.

Once the mortgage for which the appraisal was ordered has closed, it cannot be re-used. In other words, an appraisal that was used for the purchase of a property cannot be used for a subsequent refinancing of the property, even if the six month period has not expired.

**Appraising Refinances**

A complete appraisal is required for *standard refinances*, to include notations on all conditions and repairs. Streamlined finances do not always require appraisals and can be insured without one. The purpose of a streamlined refinance is to lower monthly principle and interest payments on a current FHA-insured mortgage. Except for minor adjustments at closing, if there is any cash due back to the borrower, it cannot exceed $500.

With the exception of lead-based paint repairs, FHA does not usually require repairs to be performed. However, this may not be the case where the lender is concerned as they may require the repairs to be completed as a condition of the appraisal. But a streamlined refinance is insurable with or without an appraisal.

If the lender is required to get an appraisal that is to be processed as if no appraisal was performed, the borrower can pay for the appraisal but only out-of-pocket. It cannot be financed. The lender could be required to get this appraisal for a number of reasons such as by the involved investors, banking regulations, or because it is required by state law.

**Appraisal Fees**

There are a few issues that need to be covered where this topic is concerned over and above the fact that HUD has not been responsible for establishing fee rates for over 10 years now. The price and due date is an issue that is negotiable between the appraiser and the lender inclusive of cancelled assignments, missed appointments, etc. The appraiser is solely responsible for the collection of unpaid fees. Once the appraisal is completed, HUD does expect the lender to compensate the appraiser in prompt fashion.

HUD policy and procedure do mandate that fees are paid for market value opinions. According to HUD, “Fees are never contingent upon the appraiser arriving at a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event such as loan approval."

The mortgagor can be charged for fees that result from services performed by the appraiser and/or their firm. It should be noted here that the total of these fees occasionally come with limitations pursuant to customary and reasonable fees for appraisals performed in the specific market area. RESPA expects the appraisal to comply with their guidelines and applicable rules.

HUD requires that even though the appraiser performing the FHA appraisal may be licensed, they must be on their approved roster. “Supervisory” appraisals are deemed unacceptable. The assigned appraiser is required to visit all comparable sales and the subject prior to completion of the appraisal analysis.

If part of the appraisal is performed by someone assisting the appraiser, then they must provide a summary of the assistance they received during the process. In addition, the name(s) of the persons providing the assistance are also required. It should be noted that an appraisal trainee is considered ineligible to perform an appraisal and may not sign an FHA appraisal report.

**Roster Eligibility, Selection Process, and License Renewals**
In order to be able to appraise properties that will be security for FHA insured mortgages, the appraiser must be eligible for selection by the lender. Eligibility for selection is determined by whether or not the appraiser is listed on HUD’s Approval Roster. For an appraiser to be included on the roster, they must meet two critical HUD requirements.

The first requirement is that they are certified and licensed by their state. The Appraiser Qualifications Board of the Appraiser Foundation requires that any certification and licensing meet their established criteria. The second requirement is that the appraiser cannot be listed on any of the following:

- **GSA’s Excluded Parties List** – contains information on parties that are excluded from receiving federal contracts, certain subcontracts, federal financial or non-financial assistance, and benefits
- **HUD’s Limited Denial of Participation (LDP List)** – this is a listing of companies and individuals that have been disqualified from HUD funding, received a limited denial of participation, or are voluntary abstentions
- **HUD’s Credit Alert Interactive Voice Response System (CAIVRS)** – “a Federal government database of delinquent Federal debtors that allows federal agencies to reduce the risk to federal loan and loan guarantee programs.”

Since an appraiser can be removed from HUD’s roster for disciplinary actions, the lender must be careful about this as they risk not being able to obtain a case number and/or the appropriate insurance if the appraiser is not on the approved list. This also applies to whether or not the appraiser can be re-approved or reinstated. The appraisal must include a case number and verification that the performing appraiser is on the HUD Approval Roster.

If an appraiser’s contact information and licensing status change, they are required to inform HUD immediately. They must provide a hard copy of applications, changes in certification levels, and licensing renewals to HUD.

**Appraisal Coercion**

The OFHEO announced in March of 2008 that an agreement had been reached between the New York Attorney General, the FHLMC, the FNMA, and themselves for the purposes of combating and (hopefully) eliminating fraudulent appraisals. Artificially inflated home prices are usually a result of appraisal fraud, and in some instances, this is also an indication of mortgage fraud. Fannie Mae, Freddie Mac, and the mortgage market in general rely on the accuracy of appraisals where safety and soundness are concerned.

According to James B. Lockhart, OFHEO Director, the agreement’s purpose is to restore confidence in the mortgage market by doing the following:

- creating more reliable home valuations
- enhancing underwriting practices
- reducing mortgage fraud

The agreement is also designed to strengthen the independence of the appraiser, enhance quality control within the appraisal process, and create a complaint hotline for consumers. The other key issues that the agreement is contingent upon include:

- the elimination of broker-ordered appraisals
- prohibiting appraiser coercion
- reducing the use of appraisals prepared in-house or through captive appraisal management companies in underwriting mortgages
As of January 1, 2009, a *Home Valuation Code of Conduct* will go into effect and will apply to lenders who sell mortgages to the FHLMC and the FNMA. Additionally, an Independent Valuation Protection Institute will be established for the following purposes:

- mediating appraisal disputes
- reporting mortgage fraud
- supplementing efforts to create an appraisal complaint process

During the Code's implementation process, the comments and concurrences from both the federal banking agencies and related market participants could be instrumental in amending the Code.

**The Federal Reserve and Appraisal Coercion**

The following is a quote from the Federal Reserve Board which will emphasize its stance on the growing problems related to appraisal coercion and mortgage fraud:

“Pressuring an appraiser to overstate, or understate, the value of a consumer's dwelling distorts the lending process and harms consumers. Inflated appraisals of homes concentrated in a neighborhood may affect other appraisals, since appraisers factor the value of comparable properties into their property valuation.

“For the same reason, understated appraisals may affect appraisals of neighboring properties. Thus, inflated or understated appraisals can harm consumers other than those who are party to the transaction with the inflated appraisal. Moreover, these consumers are not in a position to know of the practice or avoid it.”

**The Home Ownership and Equity Protection Act**

In 1994, the Federal Trade Commission (FTC) established the Home Ownership and Equity Protection Act to protect a homeowner's or borrower's rights where taking advantage of the equity in their property is concerned. The purpose was to ensure that the borrower would be afforded the fairest transaction possible by setting guidelines and standards for home loans.

In order for a loan to be protected by this law, it had to meet the following three criteria:

1. for a first-lien loan, that is, the original mortgage on the property, the annual percentage rate (APR) exceeds by more than eight percentage points the rates on Treasury securities of comparable maturity
2. for a second-lien loan, that is, a second mortgage, the APR exceeds by more than 10 percentage points the rates in Treasury securities of comparable maturity
3. the total fees and points payable by the consumer at or before closing exceed the larger of $510 or eight percent of the total loan amount. (The $510 figure is for 2005. This amount is adjusted annually by the Federal Reserve Board, based on changes in the Consumer Price Index.) Credit insurance premiums for insurance written in connection with the credit transaction are counted as fees

Refinancing loans were the primary targets of the act, but it also applied to home equity installment loans that were classified or defined as high-fee or high-rate loans. However, the rules of the act did not cover the following:

- home equity lines of credit (similar to revolving credit accounts)
- loans for building or buying a home with
- reverse mortgages

**The OFHEO, the FHLMC, and the FNMA**
As of July, 2005, both Fannie Mae and Freddie Mac are required to report mortgage fraud (or the possibility of) based on OFHEO policy guidelines and regulations. Additionally, it assured that there would be an effective system developed in order to detect and report any evidence of mortgage fraud or the suspicion thereof. This was accomplished by maintaining adequate internal controls, procedures, and training.

**Mortgage Fraud**

Mortgage fraud is defined by the OFHEO as “any material misstatement, misrepresentation or omission such as, but not limited to, false information contained in identification and employment documents, false mortgagee or mortgagor identity, fraudulent appraisals, theft of custodial funds, non-remitted payoff funds, misrepresentations of borrower funds, and property flipping where designed to falsely inflate property value.”

Basically, if it is proven that the borrower’s intentions were to materially misrepresent any required information on the mortgage loan application in order to be approved for the loan, these actions were deemed fraudulent. As a result, the borrower would be subject to high-dollar fines and further punishment that could include incarceration.

For the purposes of this course, mortgage fraud has been broken down into eight categories as follows:

1. Appraisal fraud
2. Cash-Back Schemes
3. Employment/income fraud
4. Failure to disclose liabilities
5. Identity Theft
6. Mortgage fraud ring
7. Occupancy fraud
8. Shotgunning

**Appraisal Fraud** – usually occurs when either a) the buyer tries to obtain a larger amount of money in the form of a cash-out or refinance or b) the seller attempts doing the same in a purchase transaction by having the value of the home deliberately overvalued. It should be noted that in many cases of mortgage fraud, that the appraisal is also involved.

**Cash-Back Schemes** – the lender is deceived by collusion between the buyer and the seller. Another example is when the lender lends too much to the buyer and is unaware that the seller has given the buyer a cash rebate, resulting in the buyer and/or the seller pocketing the excess. Usually, there is appraisal fraud involved in these schemes. (NOTE:

**Employment/Income Fraud** – an overstatement of income by the borrower in order to obtain a larger loan. This is a commonplace occurrence with so-called “stated-income” loans (oftentimes referred to as “liar loans”). Two other instances where this happens are the falsifying of W-2’s on full-documentation loans to overstate one’s income, and falsely claiming self-employment income when the business’ existence is unknown.

**Failure to Disclose Liabilities** – reducing (and therefore falsifying) the true amount of the borrower’s debt (e.g. mortgage loans on other properties or newly acquired credit card debt). This of course affects the borrower’s debt-to-income ratio.

**Identity Theft** – this often occurs within mortgage fraud rings (see below) and results when two persons assume the identity of a homeowner/seller and a borrower/buyer, and then take out a mortgage on the property. The two people use false identities, obtain the loan, split the ill-gotten gains between them, and disappear without ever making any payments on the mortgage.
**Mortgage Fraud Ring** - a scheme that involves multiple parties attempting to defraud a lender of large sums of money. One scheme includes a borrower whose credit report is used, an appraiser who intentionally and significantly overstates the value of the property, an attorney who prepares two sets of HUD closing documents, and a property owner. All of them are involved in this coordinated attempt of obtaining a large loan. As a result, the bank winds up lending hundreds of thousands of dollars against a property that is actually worth far less, while the parties involved share the ill-gotten gains and disappear without making payments on the mortgage.

**Occupancy Fraud** – a borrower falsely states on a loan that they will live on the property that they are trying to obtain the loan for. In reality they are actually trying to acquire it for the purposes of an investment. The benefit to the fraudulent borrower is that they receive a lower interest rate. As a result, the lender is over-exposed to losses compared to what was expected in the transaction due to an insufficient return on capital. Lenders typically charge a higher interest rate for non-owner-occupied properties, which historically have higher delinquency rates.

**Shotgunning** – this refers to a situation wherein a person takes out multiple loans on the same property simultaneously. In most cases, these types of people wind up leaving the country.

**Review**

The Federal Deposit Insurance Corporation was created by the Glass-Steagall Act of 1933, and is a federal government corporation which guarantees deposits held by commercial banks.

The Farmer's Home Administration should not be confused with the Federal Housing Administration. FHA is an agency of the U.S. Department of Agriculture, which was originally created to provide for farm financing.

The Federal Housing Administration was created as part of the National Housing Act of 1934 and is a federal agency that focuses on three goals:

1. to improve housing standards and conditions
2. to provide an adequate home financing system through insurance of mortgage loans
3. to stabilize the mortgage market

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