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Residential Highest and Best Use Analysis: More than Just a "Check Box" - Reviewers and state boards want to see more explanation

By Denis Desaix, SRA

Editor's comments: *I was trained at an assessor's office where the first question always was: "What is the highest and best use?" It is a critical first question when I do commercial or apartment appraisals, including 2-4 unit properties.*

But, when I started using forms for lender work, there was just a check box. Plus, if I ever checked that the current use was not the highest and best use, many lenders didn't like it.

Some lenders wanted me to continue with the appraisal at the highest and best use (such as an interim use for a house with many new apartments constructed nearby that had multi-family zoning or the H&BU was to subdivide the lot). However, these situations were relatively rare.

"Fannie Mae will only purchase or securitize a mortgage that represents the highest and best use of the site as improved." And, USPAP says: "An appraiser must analyze the relevant legal, physical and economic factors to the extent necessary to support the appraiser's highest and best use conclusion(s)".

Today, with increasing Scope Creep, residential appraisers are expected to include more explanation of H&BU. This article includes suggested "boilerplate".

To me, the primary issue is: "Why risk your license for doing a misleading appraisal when H&BU is not the current use?" You need to think about H&BU for all residential properties.

I was recently referred an assignment that involved three adjacent parcels needing valuations for estate purposes in a suburban neighborhood of $1,000,000+ homes.

One was a level flag lot with an old barn. The other two were hillside sites and had recorded easements for a shared driveway from the main street, but no driveway or usable dirt road yet existed. The two hillside lots were large enough where in theory they could be subdivided into two more lots (2 subdivided into 4).

To add to the situation, one of the hillside lots had a home with multiple additions done without permits, and the additions created an encroachment across the boundary line to the other hillside lot. The home had been abandoned for a number of years, was not habitable, and in very poor condition.

Per the planning authority, since these three lots had always transferred together under single ownership, the authority did not care about the encroachment. However, if the two hillside sites were sold separately, the encroachment needed to be demolished or remedied by a lot-line adjustment.

I was the 6th appraiser the attorney had contacted; she said the prior 5 were unsure of how to approach the situation. I told her the "how" to approach the problem was simple: I need to figure out:
(a) what are the likely uses for the parcels,

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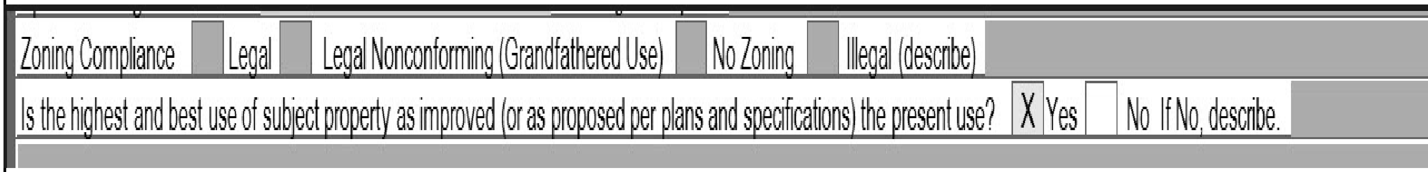
Zoning Compliance Legal Legal Nonconforming (Grandfathered Use) No Zoning Illegal (describe)

Is the highest and best use of subject property as improved (or as proposed per plans and specifications) the present use? X Yes No If No, describe.

(b) if there is more than one use, which use (or competing uses) will result in the highest value, and then (c) based on the use, who will be the likely buyer.

Knowing the answers to those questions would tell me what kind of sales (vacant sites, improved sites, sites that sold with the intent to subdivide, etc.) to use as comparables. She said that made sense to her.

In two minutes, the client understood why highest and best use analysis is critical to correctly solving the valuation problem.

The opening example may seem extreme, but it demonstrates why highest and best use analysis is a fundamental element of the appraisal process.

Commercial appraisers will spend a fair amount of time analyzing H&BU for their assignments as competing uses are more common within a commercial zone or general plan area that allows commercial use versus residentially zoned areas.

Residential lender appraisals and H&BU

For residential appraisers specializing in mortgage finance assignments, the question of H&BU is rarely challenging.

The Fannie Mae/Freddie Mac forms are limited to a check box regarding the "as improved" H&BU. Usually, (a) if the home exists, (b) the zoning allows for residential use, and (c) the improvement contributes value to the site, then (d) the highest and best use as-is is "as improved".

In such cases, an appraiser may be inclined to answer "yes" and move on. In fact, it is so common (as would be expected) that an existing residence's H&BU as improved is "as is" it is easy for us not to give the analysis any thought (or worse, not complete the analysis).

This article focuses on residential H&BU, regardless if the results are being conveyed in a narrative or form report.

Highest and best use analysis is a critical step in correctly identifying what kind of property the subject is, and what comparables to use when valuing the subject.

Highest and Best Use Analysis

H&BU analysis determines
(a) what should be done with the property if it were vacant, and if the property is improved,
(b) what should be done as-it-is.

Answering these questions helps the appraiser determine who the likely buyer will be and what is the best analysis and comparables to use for the assignment. H&BU analysis can also assist in identifying obsolescence (if something should be replaced because it is outdated, that likely translates into functional obsolescence).

The Four Factors

There are four criteria used to analyze H&BU:
(1) legally permissible,
(2) physically possible,
(3) financially feasible, and
(4) maximally productive.

Briefly, the process works as follows:
1. Legally Permissible. What uses are legally permitted at the site? What does the zoning or general plan regulation allow on the site? In many residential districts, zoning restricts the permissible use to residential only. Sometimes, the zoning will allow certain neighborhood support uses (such as houses of worship) in a residential zone.

Alternatively, one- or two-unit residential use may be permissible.

1. Legally permissible considers what restrictions exist now, but also must consider if any changes are likely in the near future.

2. Physically Possible. Size, shape, and topography are some of the elements analyzed in this category. Once the appraiser determines what uses are legal, the next step is to determine if the site can physically support the use. A site's shape or slope may eliminate it from reasonably being developed.

I emphasize the term "reasonably" because advances in construction technology make it possible to construct an improvement in almost every scenario, but the cost would be prohibitive with no expectation of recapturing it. This is different from the next step of "financial feasibility" which tests the cost of development, but does so in the context of "should the site be developed now or later?"

3. Financially Feasible. Once the uses are narrowed to what is legally permissible and physically possible, the next step is to determine if development (for vacant properties) or a change (for improved properties) is financially feasible.

In other words, if I improve this vacant site or make a change to the existing improvements, can I expect to earn more money than I spend? If the answer is "yes", then I should consider taking the action. If the answer is "no", then I should consider waiting.

It may not be financially feasible to

initiate a project now, but it might be in the future. If a property is improved and that improvement contributes value to the site, but it is likely the use will change in the near future, then the current use is "interim use".

4. Maximally Productive. When more than one use is financially feasible, then an evaluation of which one is maximally productive is necessary.

If the only use of a property is a one-unit residence and it is feasible to build one, then there is no alternative use to consider.

If, however, I can build a one- or two-unit improvement and both are financially feasible, then I have to consider which one creates the greatest return on my investment. The evaluation here is not which use has a higher sale price. I also have to consider my costs.

Example: Calculation of maximally productive use

Technically, maximally productive is the use that returns the highest value to the land. Using the one- vs. two-unit property scenario, the illustration is as follows:

Assume that I need a 20% return (my Entrepreneurial Incentive, or "EI") on my direct and indirect costs regardless if I build a one- or two-unit property. Assume that my costs for the one- and two-unit improvements are $150k and $250k respectively. Assume that the sale prices for the one and two-unit improvements are $500k and $600k respectively. What should I do?

Since I need to earn 20% return on my direct and indirect costs, I calculate the two options as follows:

(Sale Price) - (Cost + Entrepreneurial Incentive) = Land Value

One-Unit: ($500k) - ($150k + $30k) = $320k

Two-Unit: ($600k) - ($250k + $50k) = $300k

The one-unit option is the maximally productive choice. In theory, a potential buyer who intends to develop a two-unit improvement would not offer more than $300k for the specific site, but the one-unit developer will pay up to $320k.

As Vacant & As Improved

H&BU as vacant considers the subject's site as if it were vacant. If it were vacant, what (if anything) should be built and how soon should the construction start? It should be evident how the four steps of the H&BU analysis apply to vacant land. In the residential world, the answer is usually "build a house, and build it now." However, the answer could be "build a house, but not now… wait until it is financially feasible to do so."

It might not be as evident how the four steps of H&BU as improved are applied. The first two are quick and straightforward: If the current use conforms to the zoning, it is legally permissible, and since the improvement exist, it is obviously physically possible.

However, financially feasible and maximally productive are answered when evaluating the following possibilities. There are four things that I can do to an improved property:

A. Remodel (change the use)

B. Renovate (update/modernize; improve the existing use's functionality)

C. Demolish (tear it down; perhaps build a replacement, perhaps build an improvement with a different use, perhaps hold as-vacant for future development)

D. Leave as-is

Highest and Best Use & the USPAP

Standard Rule 1 contains the appraisal development standards. In the 2014-2015 USPAP, Standard Rule 1-3 states:

"When necessary for credible assignment results in developing a market value opinion, an appraiser must:

(b) develop an opinion of the highest and best use of the real estate."

"Comment: An appraiser must analyze the relevant legal, physical, and economic factors to the extent necessary to support the appraiser's highest and best use conclusion(s)."

Note that the requirement is for "market value" opinions. If an appraiser has an assignment for insurable value, highest and best use analysis may not be relevant. For market value appraisals where its consideration is necessary for credible results, it is required.

Market value appraisals used for residential lending require a H&BU analysis. Therefore, for the remainder of this article, the assumption is that in all cases where market value is being opined, an H&BU analysis must be complete.

Standard Rule 2 contains the appraisal-reporting standard.

- Standard Rule 2-2 (a) (x) states: "When an opinion of highest and best use was developed by the appraiser, summarize the support and rationale for that opinion;"

The above standard is for "appraisal report" formats and includes the Fannie/Freddie form reports. Since development of H&BU is required for opinions of market value, summarizing that analysis is a requirement.

Summarize vs. State? Appraisal Report vs. Restricted Appraisal Report

In the 2014 USPAP, one of the biggest changes is the creation of two reporting formats: the Appraisal Report and Restricted Appraisal Report. The significant difference between the two is how results are communicated to the client and intended users. In a restricted appraisal report, the requirement is to "state" certain things. In an appraisal report, the requirement is to "summarize" certain things.

Many appraisers confuse the type of report with the level of analysis necessary to conclude credible results. In theory, the level of analysis is the same regardless of the reporting option used.

Advisory Opinion 11 (AO-11) is updated to address the two new reporting formats and to provide some guidance on the difference between "summarizing" and "stating". One of the items noted in the AO requiring summarization is H&BU analysis.

Below is the section from the 1004 one-unit residential appraisal report that addresses H&BU:

INCLUDE IMAGE

It should be apparent after reading AO-11, a report that includes only a "yes" check box to this question is insufficient in terms of summarizing the analysis. Therefore, residential appraisers completing reports on the Fannie/Freddie report forms must supplement the check box section in order to ensure compliance with the USPAP.

H&BU and Fannie Mae

From Fannie Mae's current Selling Guide (April 2014):

"Highest and Best Use

"Fannie Mae will only purchase or securitize a mortgage that represents the highest and best use of the site as improved. If the current improvements clearly do not represent the highest and best use of the site as an improved site, it must be indicated on the appraisal report. The appraiser determines highest and best use of a site as the reasonable and probable use that supports the highest present value on the effective date of the appraisal. For improvements to represent the highest and best use of a site, they must be legally permitted, financially feasible, and physically possible, and must provide more profit than any other use of the site would generate. All of those criteria must be met if the improvements are to be considered as the highest and best use of a site."

"The appraiser's highest and best use analysis of the subject property should consider the property as it is improved. This treatment recognizes that the existing improvements should continue in use until it is financially feasible to remove the dwelling and build a new one, or to renovate the existing dwelling. If the use of comparable sales demonstrates that the improvements are reasonably typical and compatible with market demand for the neighborhood, and the present improvements contribute to the value of the subject property so that its value is greater than the estimated vacant site value, the appraiser should consider the existing use as reasonable and report it as the highest and best use."

Freddie Mac's requirements are similar. The above is consistent with the USPAP and accepted appraisal methodology.

H&BU analysis for improved properties: the four choices

To return to the H&BU analysis for improved properties, the four choices are:

A. Remodel (change the use)

B. Renovate (update/modernize; improve the existing use's functionality)

C. Demolish (tear it down; perhaps build a replacement, perhaps build an improvement with a different use, perhaps hold as-vacant for future development)

D. Leave as-is

If the choice is "A" or "C", the H&BU as improved is not as-is. The property's use must change (residential to commercial, or maybe one-unit to two-unit) or the improvement should be demolished. Choice "D" means as-is, nothing needs to be done (H&BU as improved is certainly as-is).

It is choice "B" that sometimes confuses appraisers. Again, as long as the existing improvements are a legal use and they continue to contribute value to the site, H&BU as improved is "as is".

Identifying if updates or renovation is likely to occur, and to what degree it will occur, is going to identify who competes to purchase the property (owner-user, investor, or both) and what the buyer will do (renovate now, renovate later, etc.).

This analysis helps ensure that the appraiser will select and analyze the most similar comparables.

Analyzing H&BU and Reporting the analysis for a mortgage appraisal assignment

If a house is in such bad condition that it no longer contributes value to the site the H&BU as improved is not "as is". It should be demolished or significantly renovated.

This situation is not that common and is the easiest to deal with. Keep in mind, however, that even a newly constructed home may not contribute value to the site. A new home built on a site where a multi-story office building should be might be fully depreciated when the final inspection is signed-off.

The examples I have selected are the more common scenarios: A recently renovated/updated home, a home with no updates ready for renovation, and a home that is in poor condition and requires repair and renovation. Each scenario has a unique market condition dynamic.

Example: Renovated home - market strong with nearby new construction

The subject is a 40-year old home in a neighborhood of similar age homes. The subject has been renovated (kitchen, baths, interior have all been renovated and updated, and exterior has been updated as well). The market is strong (demand exceeds current supply) and renovated homes sell quicker and at the upper-end of the value range.

A review of the sales for the last 12-18 months shows that most of the homes that have sold have some level of upgrades, and many are upgraded to a similar level as the subject. There are also newly constructed homes on sites where the older improvements were demolished. All the renovated and newly constructed homes are purchased by owner-users as a primary residence.

The H&BU analysis for this scenario may read like this:
The legal use of the site allows for one-unit residential and that is what the subject is. There is demand for such properties in this market; new home construction is occurring and older homes are being renovated. A residential improvement can be built on the site and it is financially feasible to do so. There is no other competing use for the site. HBU as vacant is to build a one-unit residential improvement.

Improved one-unit residential properties within this market are typically purchased for owner-occupancy (owner-user), although some homes are non-owner occupied/rentals. The typical buyer is purchasing for utility (residence). This is especially true of renovated homes or newly constructed homes. The improvements contribute value to the site: the property, as improved, is more valuable than if vacant, ready for development.

The HBU "as improved" is "as is". The improvement should be retained as is, with a regular maintenance schedule and routine replacement of short-lived items as needed.

The above summary communicates the following to the client/intended user:
1. The subject is a one-unit residence and that use is legally permissible. In fact, that is the only permissible use.
2. It is physically possible to build a residence on the site as evidenced by the existing improvement.
3. If the site were vacant and put up for sale, someone would buy it and build a house on it.
4. In general, one-unit homes in this market are purchased by owner-users. Therefore, my best comparables would be similar owner-user purchased properties.
5. Specifically, given the subject's renovations, the most likely buyer is an owner-user. Therefore, I am very much going to concentrate on finding owner-user purchases of renovated properties as comparables.
6. No one would tear down a recently renovated home in this neighborhood.
7. Since it is renovated, the best choice is to keep it as-is, and just make sure it has a regular maintenance and replacement schedule as needed.

Example: older home needing updates- stable market

The subject is a 55-year old home in a neighborhood of similar age homes. The subject, while adequately maintained, has no significant renovations or recent upgrades (the last upgrade was 30-years ago, and that was the kitchen and baths, which now appear dated to current tastes/expectations). The market is stable.

In this neighborhood, renovated homes sell quicker and at the upper-end of the value range, and homes with few or no renovations sell at the lower-to-middle price range.

A review of the sales for the last 12-18 months shows that there has been a mix of homes sold: some renovated (commanding a premium) and some without modernizations or renovations.

Calls to brokers reveal that homes without upgrades compete with owner-users and investors. Sometimes, the owner-user will purchase the home and update/renovated while occupying the residence and sometimes, the owner-user will purchase and renovate prior to move-in. Investors also compete for these homes, but prefer homes that need repairs as well as modernizations as they are priced lower.

There are newly constructed homes on sites where older improvements were demolished.

The H&BU analysis for this scenario may read like this:
"The legal use of the site allows for one-unit residential and that is what the subject is. There is demand for such properties in this market; new homes are being built and older homes are being renovated. A residential improvement can be built on the site and it is financially feasible to do so. There is no other competing use for the site. The HBU as vacant is to build a one-unit residential improvement.

Owner-users and investors purchase improved one-unit residential properties in this market, although investors prefer homes needing upgrades and repairs. The subject is an older home with no significant modernizations or recent upgrades: it would appeal to both an owner-user (who would purchase and occupy the home while updating) and an investor (who would purchase the home and either upgrade and sell, or upgrade and retain as a rental).

While the likely buyer of the subject will upgrade the property, the improvements in their as is condition contribute value to the site: the property, as improved, is more valuable than if vacant, ready for development. The HBU "as improved" is "as is", with a new owner likely to upgrade after purchase."

Again, a lot of information communicated in the above.
1. Like the first example, the as vacant H&BU is to construct a one-unit residential improvement; there are no other uses for this site.
2. In this case, there is competition

between owner-users and investors in the subject's segment of the market (homes not upgraded). Therefore, when I search for comparables, I am going to consider owner-user and investor purchases.
3. Whoever buys this home (owner-user or investor) is probably going to upgrade/renovate it to some degree after purchase.
4. Since the improvements contribute value to the site, the H&BU is "as improved" and I am going to value it as-is. My best comparables are those where the buyer's intent is to purchase and renovate/upgrade. For owner-users, the upgrade work might occur prior to occupancy or during occupancy. In this case, I can consider investor or owner-user purchases as long as the condition is similar to the subject.

Example: Fixer needing repair-market weak

The subject is a 40-year old home in a neighborhood of similar age homes. The owner has passed away and the estate is selling the property. It was a rental and the renter moved out 9-months ago. The property is not well maintained and has been vandalized since the renter moved out. It needs kitchen and bath repairs, window replacement, new flooring and paint.

This market has a number of foreclosures, and many were rental units abandoned during the default process with excessive deferred maintenance and needed repairs. There are more homes available for sale in this market than there are buyers willing to purchase. Owner-users are finding significant price discounting from 2-years ago, and even upgraded and renovated homes are selling at historically low prices.

There are also some vacant parcels in the neighborhood and a subdivision project started 2-years ago has stalled: the newly constructed homes in that project are listed at a $/sf below their replacement cost.

The H&BU analysis for this scenario may read like this:
"The legal use of the site allows for one-unit residential and that is what the subject is. There are no other competing uses for the site. At this time, there is an oversupply of available inventory and a weakness in demand. No new homes are being built in this market and vacant lots remain vacant. A residential improvement can be built on the site, but it is not financially feasible to do so. The HBU as vacant is to hold for future development. When market conditions change, this site will be developed as a one-unit residence.

While owner-users and investors purchase improved one-unit residential properties within this market, because of the subject's poor condition, the likely buyer is an investor. Investors typically purchase poor condition homes (many times all cash transactions), upgrade them, and sell (flip) or hold them as rentals. In this market, the competitive properties are homes in similar, distressed condition. This includes REO sales in similar condition. Although the subject is in need of significant work, the improvements in their as-is condition contribute value to the site. It is financially feasible to renovate the home and then sell it at a profit after cost or hold for rental income and then sell. The HBU "as improved" is "as is", with the buyer being an investor who will renovate and sell to an owner-user or retain as a rental."

Here are the significant points communicated in this summary:
1. The current use is legal and there are no other permitted uses. It is obviously physically possible to construct an improvement on the site. However, it is not financially feasible to do so at this time. No one would build a new home now, but probably will once the market conditions improve. The H&BU of this site as vacant is to hold for future development.
2. The market is weak and supply exceeds demand.
3. The subject is in poor condition, is a fixer, and may not qualify for conventional or regular FHA financing. Homes like the subject sell in an "all cash" transactions. The likely buyer is an investor who is going to renovate and sell or rent out.
4. Properties that are competitive to the subject are fixers; this includes REOs. Therefore, an REO (which some lenders and appraisers consider as being inappropriate comparables) in similar condition competing for the same type of buyer should be considered as a potential comparable (and may be the best comparable).
5. Even though the property is in poor condition, the improvement still contributes value to the site. It is not so bad that one should tear it down or that renovation is not financially feasible; therefore, the H&BU as improved is "as is". The value of this property, as is, is based on its investor pre-renovation value.

Summary

Highest and best use analysis is a fundamental component of the appraisal process for market value appraisal assignments.

The USPAP requires H&BU analysis for market value assignments (when necessary for credible results) and when communicated in an appraisal report format, requires the analysis be adequately summarized.

For residential mortgage assignments, the Fannie/Freddie report forms must meet the reporting requirements of SR2-2 (appraisal report). These forms provide a checkbox answer "yes" or "no" to one aspect of the H&BU analysis: "Is the highest and best use of the subject property as-improved (or as proposed per plans and specifications) the present use?" Simply checking the box does not meet the USPAP's summary requirements. The form must be supplemented with appropriate summary of the analysis.

Although the form asks for H&BU as improved, I recommend an appraiser also include the H&BU as vacant. In theory, one cannot complete the as improved analysis without completing the as vacant analysis. In practice, when completing the cost approach, one must always complete an H&BU analysis as vacant. Full compliance is always attained if the complete H&BU (as vacant & as improved) analysis is summarized in the report.

H&BU helps the appraiser determine

(a) what the best use of the site as vacant and as improved would be,
(b) who would buy the subject, and
(c) what types of sales are the best comparables.

What about original 3-parcel assignment?

Recall that there were 3-parcels: a flag lot with an old barn and two other lots that could be subdivided. Additionally, there was a significantly damaged house with illegal additions on one of the lots; additions encroached onto the other lot. What was the outcome of that assignment?

1. The flag lot's H&BU was to build a custom SFR. This was the easiest analysis. The likely buyer would be a developer, although there was a small section of the potential buyer pool that would be an owner-user who would develop the property for his/her own use. H&BU: tear down the barn and build a house.
2. The two other parcels could theoretically be subdivided (four parcels total). However, the shape of the area limited that feasibility to a realistic split of three parcels. Assemblage and then subdivision was a potential use.
3. Further analysis of the two parcels concluded that due to the topography, a 3-lot split would not be financially feasible; developing an additional easement/driveway to access all lots would require a new road to go up the steepest grade and terminate at the top of the hill (arguably the most valuable site for a house). Therefore, dividing the 2-lots was not an option.
4. One consideration was to apply for a lot-line adjustment to eliminate the encroachment and renovate the existing improvement. However, due to the location of the encroachment (at the top of the hill), adjusting the lot-line would significantly reduce the value of the non-improved parcel and reduce its building area to all hillside slope. The result would have been to eliminate the feasibility of developing it by itself. A lot line adjustment was not an option.
5. Another consideration was to merge the two lots; this would eliminate the encroachment and allow the existing improvement to be renovated. Unfortunately, due to the condition of the improvement, it was fully depreciated. It no longer contributed any value to the site, and it was not financially feasible to renovate. It should be demolished so that the site could be developed with a new improvement.
6. It was possible to merge the two lots and sell it as a single parcel for development. This would only be maximally productive if the value of the new, combined parcel exceeded the sum of the two individual parcels (after all costs). Based on the analysis, combining the two lots would have created a large lot with surplus land. Merging for a single lot sale was not maximally productive.
7. The H&BU of the improved lot was to demolish the existing structure and build a custom SFR. The H&BU of the second hillside lot was to sell as-is and build a custom SFR. Because of the topography (which still presented some development challenges), the likely buyer for these parcels would be a developer who had the wherewithal and competence to develop the sites.

About the Author

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The Cheese Has Moved

By Dustin Harris, The Appraiser Coach

Originally published March 23, 2013

Editor's comment: There have always been huge up and down cycles in residential lending. But, appraisal fees were stable whatever the demand. Starting in 2009, the declines in appraisal fees due to AMCs is the most significant change in the residential appraisal business that has ever occurred. Many appraisers have left the business, others have significantly reduced incomes and some are planning on not renewing their appraisal licenses or changing to another career. But, other appraisers who adapted are still in business and making money. Why? They changed their clients - work for AMCs who pay decent fees, have full fee direct lender clients, do non-lender work, or are willing to work long hours for low fees.

I don't know if we will ever return to the days of stable fees, whatever the demand. But, it won't be happening soon. Fees may go up when demand significantly increases with fewer appraisers available. My advice: Don't give up your appraisal license. In many states, you have to start all over as a trainee.

There are enough of our foes out there calling appraisers "rats" that I am not going to join the mantra. However, I do want to make an analogy as it relates to us and rodents. There is a great book out there by Spencer Johnson titled Who Moved My Cheese. It is worth picking up if you have not done so already. And, if you've read it before, read it again. Part of what makes it great is that it is short and to the point. The book makes a profound point and does so in an easy-to-understand way.

Basically, the message can be summed up like this. We are all like mice in a maze. Each of us have goals. Those goals are likened to the cheese, or prize, at the end of the maze. As creatures of habit, we tend to travel in the same paths and go to the same areas where we have found cheese in the past.

There is nothing wrong with this. If you want to eat, you go to the refrigerator. If you need gas, you drive to the local convenience store. Need money? Go to work. Wanna lose weight? Hit the treadmill. Habits are good things… if they lead us to our goals. The problem comes when we go to where the cheese has always been… and it is no longer there. This is when the book gets really fun.

How do mice react when the cheese has been moved? Simply put, some mice run around in circles and cry about why their cheese is gone, while others venture out and… wait for it… find more cheese! You can probably guess which mice are successful.

Throughout the past three or four decades, our "appraisal cheese" (if you will) has been nudged a bit here and shifted a little there. After the S&L Crises, we saw the move to USPAP and licensing. New technologies and software have come along, bumping our cheese a bit over the years. Fannie Mae and Freddy Mac have done their fair share of cheese pushing. Then along came HVCC, UAD, scope creep, customary and reasonable, and Dodd-Frank. Let's just say, our cheese has now officially been moved.

As these major changes have taken place over the past three to four years, I have watched with interest the reaction of different independent fee appraisers. Like in Dr. Johnson's book, there are a whole lot of ‘mice' running around in circles and whining about their lost cheese. I find them at appraisal conferences, on the web-boards, and frequently in my email inbox. They are easy to spot. Look for common rodent-language using words such as "can't," "used-to," "wish," and "give up." These words are often accompanied with gestures that look much like finger-pointing (but smaller as they are using paws instead of hands).

Of course, there are the other types of mice as well (though they are clearly in the minority). These mice are hard to spot because they do not hang around the other rodents. Rather, they have left to find the cheese somewhere else. Both types of mouse-appraisers have recognized that something is drastically different than it used to be. Both are not very happy about the changes. The main difference separating the two is that one group has decided to gripe, moan, and wish that things could just be the way they were in 2007, while others have made the decision to do something about it.

Many ask me why The Appraiser Coach is able to be so successful in such a difficult appraising atmosphere. The answer has many facets, but if I could boil it all down to one statement, it would be this: "I have been able to recognize the changes to our industry and have been able to adapt." In other words, the cheese has moved, and I left the pity-party to find its new resting place.

Now, I want to be fair. First of all, I have done my fair share of complaining as well. I cannot say I am happy with the majority of the changes that have been imposed upon us over the last little while. Indeed, appraisers got blamed for a lot more than they were responsible for in this so-called "housing crises." The politicians swooped in, and not knowing the first thing about appraisals, ‘fixed' the problem with legislation that frankly threw the baby out with the proverbial bath water. Secondly, I have in this article painted appraisers with a broad brush and unfairly placed them into two distinct camps. Obviously, that is an unfair characterization. Surely, most of us have both feet in each camp to some degree. However, I hope the overall lesson is not lost on the inconsistencies.

The facts are clear. Though there are things we should be doing to try to change the environment to a more free-market system, we will never see things return to the old norm. The cheese will never be rolled back into the same place. We are losing a lot of our rank-and-file to these changes. Rather than looking for more cheese, they are lifting up their tails and going home. What is even scarier is that very few new appraisers are entering the maze to take their place. And still, a large majority of us are apparently finding it more useful to run around in circles moaning about the lost cheese rather than picking up our paws and scampering off to find more.

Here's the good news, kids. There is still cheese to be found. It may not look or smell like the rich cheddar that we were used to in 2005-2008. The new cheese may be white and have a few holes in it, but it can be just as tasty. The lesson is simple; we must each first discover what kind of mouse we are. Are we going to whine about the way it used to be or get busy sniffing out the new cheese?

I for one am going to do what I can to change the system, sure, but I am also going to busy myself finding and conquering new mountains of cheese and prosperity wherever I can still find it.

Now, go create some value!

About the author

Dustin Harris is a multi-business owner and residential real estate appraiser. He has been appraising for nearly two decades. He is the owner and President of Appraisal Precision and Consulting Group, Inc. He owns and operates The Appraiser Coach where he personally advises and mentors other appraisers. He is also the Founder and President of Your Appraisal Office which implements some of the systems he has developed to help lower costs and free up time. His principles and methodologies are also taught in an online, Mastermind group. He and his wife reside in Idaho with their four children.

Changes by the AQB on January 1, 2015 Create New Challenges for both Trainees and Mentors- Part I

By Doug Smith, SRA

Editor's comment: Doug has been training two new appraisers for several years, recent college graduates, two in residential and one IS also doing commercial. .

The AQB (Appraisal Qualifications Board) set in place new criteria in the licensure process that affects both the trainee and the supervisory appraiser (formerly described as the "mentor." While these changes take effect on January 1, 2015, there are some changes that deserve immediate attention prior to January 1, 2015.

The following article is a description of some of these changes and a general review of the mentoring process. In a second part next month, I will address in more detail the training process.

Changes in terminology and qualifications

The first change deals with simple terminology. The AQB identifies the appraiser who oversees the training of candidates for licensure as a "supervisory appraiser," thus not adopting the commonly accepted term, "mentor."

The second change is to set out minimum qualification criteria for the supervisory appraiser.

Supervisory appraiser qualifications

State-certified Supervisory Appraiser shall be in good standing with the training and not subject to any disciplinary action within the last three (3)years that affects the Supervisory Appraiser's legal ability to engage in appraisal practice. Shall have been state certified for a minimum of three (3) years prior to being eligible to become a Supervisory Appraiser.

The supervisory appraiser may have experienced discipline in the last three years, but this does not affect eligibility for mentoring unless the supervisory appraiser's certification is somehow restricted in the scope of practice. An appraiser who has received a disciplinary notice, paid a fine and or fulfilled an educational requirement may continue or begin to supervise a trainee. If, in addition, to the required and completed discipline, the appraiser was suspended or restricted from doing specific types of appraisals, the appraiser would not be eligible to be a supervisory appraiser.

In every case, however, the AQB allows States to adopt more stringent requirements. An appraiser faced with disciplinary action in the past must check with their local Board.

States may adopt additional criteria for supervisory appraiser qualifications. The state of Montana, for instance, has consistently adopted a much greater level of basic requirements than are set out by the AQB as the minimum. Montana was one of the first states to require formal approval of supervisory appraisers and require the submission of examples of work product. The state reviews the work product and approval is based on acceptance of the supervisory appraiser by the vote of the full State Appraisal Board.

In some states, then, there may be a more formal procedure than is set out by the AQB to recognize the appraiser's status as a supervisory appraiser. These procedures may lengthen the process of getting started in the approval process.

In anticipation of the January 1, 2015 start date, it is best to review the procedure in the appraiser's home state.

Number of trainees

The second section of the Criteria governs the number of trainees. This is the wording of the criteria:

"A Supervisory Appraiser may not supervise more than three Trainee Appraisers at one time, unless a state program in the licensing jurisdiction provides to progress monitoring, supervising certified appraiser qualifications, and supervision oversight requirements for Supervisory Appraisers."

According to the AQB, the trainee status ends when the trainee receives his or her appraisal license or certified license. Therefore, the number of trainees only applies to those seeking licensure at the initial license level.

Once licensed, the supervisory appraiser may continue to train the candidate in the process of obtaining a certified residential license or certified general license, but the candidate is no longer counted as being a trainee for the purposes of the AQB three- trainee restriction.

Again, states my require a stricter interpretation of this rule.

Course requirements

Both the trainee and supervisory appraiser must take a training course beginning in January 1, 2015. This is the language of this criteria:

Both the Trainee Appraiser and Supervisory Appraiser shall be required to complete a course that, at a minimum, complies with the specifications for course content established by the AQB. The course will be oriented toward the requirements and responsibilities of Supervisory Appraisers and expectations for Trainee Appraisers. The course must be completed by the Trainee Appraiser prior to obtaining a Trainee Appraiser credential, and completed by the Supervisory Appraiser prior to supervising a Trainee Appraiser.

The AQB set out the following as to whether or not this criteria applied to existing credentialed trainees and supervisory appraisers.

AQB Q&As Supervisory Appraiser/trainee Appraiser Education

Question 1: I am currently a credentialed Trainee Appraiser. Am I required to take a Supervisory Appraiser and Trainee Appraiser course prior to January 1, 2015, in order to remain a Trainee Appraiser?

Response: While the AQB encourages existing Trainee Appraisers to take the course, the 2015 Real Property Appraiser Qualification Criteria do not require currently-credentialed Trainee Appraisers to do so (i.e., you are "grandfathered" from the AQB's perspective). However, check with your state appraiser regulatory agency, since it may adopt more stringent requirements.

Question 2: I am currently a Supervisory Appraiser of a Trainee Appraiser. Am I required to take a Supervisory Appraiser and Trainee Appraiser course prior to January 1, 2015, in order to continue to supervise Trainee Appraisers?

Response: While the AQB encourages existing Supervisory Appraisers to take the course, the 2015 Real Property Appraiser Qualification Criteria do not require current Supervisory Appraisers to do so (i.e., you are "grandfathered" from the AQB's perspective). However, check with your state appraiser regulatory agency, since it may adopt more stringent requirements.

Please note however, if you seek to serve as a Supervisory Appraiser of any additional Trainee Appraiser(s) after the implementation date (e.g., January 1, 2015) you must fulfill all of the 2015 Criteria requirements to become a Supervisory Appraiser at that time

Note from Doug: Check with the local appraisal Board for clarification of this requirement. In Montana, the State Appraisal Board acted to require only trainees and supervisory appraisers approved after January 1, 2015 take this course. Existing trainees and supervisory appraisers are exempted.

Should you take on a trainee in 2015?

Is now the time to start taking on trainees again? The short answer is course, no, if the potential trainee is planning to go into residential appraising and trainee/mentoring patterns remain unchanged.

Since 2007, the essential beginning of the residential downturn, not only is volume down, but since January 2011 when the Dodd-Frank kicked in, appraisal fees have remained unchanged or in some cases are less as more appraisers agree to accept lower fees offered by appraisal management companies.

Appraisers, in the struggle to maintain an acceptable level of income, are taking on a greater number of appraisals requiring more input at lower fees.

More appraisals at lower fees generally mean a greater number of work hours with the effort much as the Red Queen describes to Alice in Wonderland. In Lewis Carroll's classic Through the Looking Glass, ..." If you want to get somewhere else, you must run at least twice as fast as that!

Why then, even consider taking in a trainee during these uncertain times? There are two major reasons why this might very well be a propitious time to take on a trainee. The first is that the current market has proven that real estate is indeed cyclical in nature and most agree that the market is at the bottom and is likely to move up, albeit slowly. The second is that market conditions demand new thinking about how appraisers organize their business and how the new generation of appraisers will fit into this new business environment.

The business of appraising

Appraisers, particularly, residential appraisers, traditionally have been single person businesses and only took on trainees when times were busy. Trainees were taken on with the assumption they would go off on their own or, if retained, could be cut loose in hard times.

The bulk of independent appraisers, however, wanted little to do with taking on trainees, commenting that they had no desire to train the competition.

Long hours and the difficulty of taking any time off whether for illness or leisure is grim evidence that the one-person office is today an ineffective business model.

Appraisers maximize business results by adopting the concept of a "firm" whether they are the sole business entity or whether they employ other appraisers or assistants.

Thinking of the appraisal business side as the "firm" places a new emphasis on the professional aspects of the ongoing nature of business relationships. Thus, an appraiser must consider not only how they respond to customers, but how their business entity or "firm" responds to these customers whether they are clients or the client's agents.

The concept of the "firm" does not imply that a person must be an employee. An appraiser, for instance, may strike a strategic alliance with another appraiser where fees are kept separate, but costs are shared. There is also the possibility of taking on appraisers as independent contractors, a type of relationship that is not available for a trainee/mentor relationship due to IRS rules.

Overhead costs are increasing. One office may have several appraisers with one appraisal software master license with each computer licensed to an individual appraiser. Costs when shared are less. This applies to most overhead items.

The changing market

The subtle change brought about by Dodd-Frank and the growth of appraisal management companies has changed the client/appraiser relationship.

Appraisers must consider how their business entity responds to these customer needs. The market is settling into distinct tiers, the largest segment treating the residential appraisal as a commodity to be stamped out cheaply and quickly.

Appraisers meet client expectations by adopting the business strategy of being the low-cost provider. The consequence of this strategy is that it imposes the element of volume to maintain income. Appraiser have no time to develop clients who don't regard the appraisal as a commodity but think of it as necessary and important to achieving goals not the least of which is the maintenance of a fiduciary responsibility.

A famous bank robber was asked why he robbed banks. He answered, "Because that's where the money is." Such is the case with the residential market today.

The market, except for the appraisal management market, is thin, hard to find and difficult to maintain without a lot of continuous effort.

For the present, work derived from appraisal management companies is where the money is. Having more than one appraiser allows the "firm" to accept a wider range of work and allows time to develop more types of clients. Appraisers, however, must consider the obvious evolution of the appraisal business.

Will the AMC last?

There is ample evidence the present AMC model is not sustainable. State after state, including Montana, is putting into effect or already enacted AMC registration requirements that come with an AMC registration fee.

These fees provide money for enforcement and oversight. Each state is looking for new revenue sources and appraisal management companies appear to be easy pickings. Whether these fees can be passed on to the lenders or passed on to the appraisers in even lower fees is an open question.

Appraisal management companies took on clients initially with no increase in appraisal fees relying on appraisers to accept discounted fees.

Now, faced with increased overhead due to registration fees, appraisal management companies are caught in a squeeze. To continue, they must either raise fees or charge appraisers to offset their costs.

Furthermore, lenders are increasingly voicing their disappointment with appraisals produced by appraisal management companies.

The Dodd-Frank Bill, otherwise

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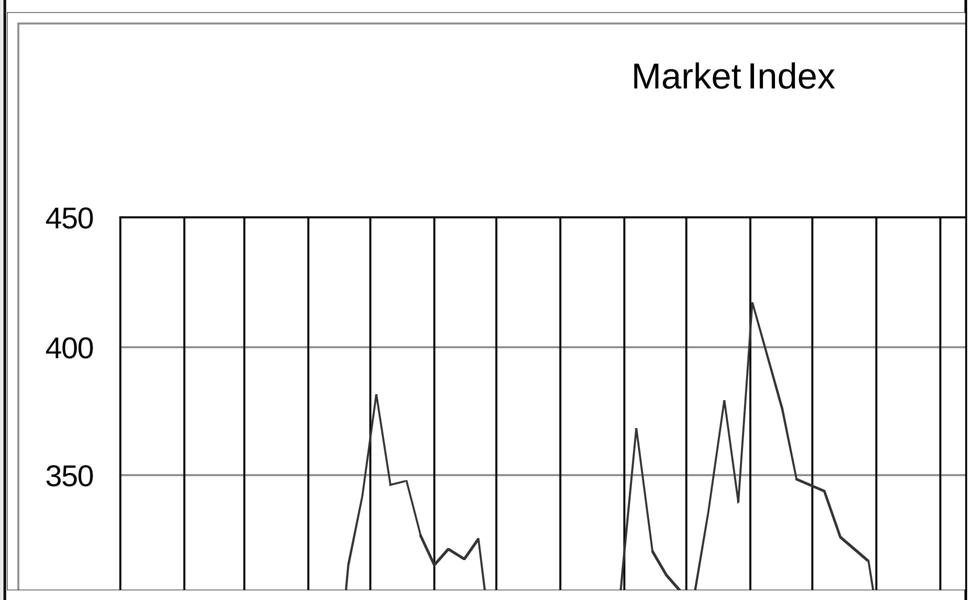
MBA Loan Volume Application Index – 1/13 to 6/14



known as Wall Street Reform and Consumer Protection Act, provides for mandatory reporting. States are bracing themselves for a rapid increase in complaints with some modifying their complaint procedures that formerly called for notarized complaint submissions. Disintermediary forces are unleashed and will play out in the near future.

Clients will eventually seek to eliminate the middleman (disintermediation) choosing instead to deal with alternative means to secure appraisals. A local bank system in Montana selects their own panel of appraisers and uses a portal to distribute and receive appraisals. This portal system satisfies the requirement to insulate the appraiser from influence.

Whether the AMC business model survives or other models appear to take their place, increased fees are not likely. As this is written, the whole issue of reasonable and customary fees has ended with no impact on current fees.

The great divide - old vs. new appraisers

The inclusion of a certified general appraiser within an appraisal firm is a logical step in meeting the breadth of client expectations. Again, if the primary emphasis of the organizing appraiser is residential work, the association of a certified general appraiser may simply be achieved by an alliance.

Due to changes in education requirements, the next generation of appraisers will be better educated and better prepared to take on more involved assignments. Therefore, the characteristics of the next generation of appraisers are changing significantly.

The successful appraiser of tomorrow does not have the same expectations of those entering the market just a few years ago. These new candidates will expect greater income and will have the intellectual resources to produce better work.

These new appraisers will be technologically savvy. Based on the current state of the market, they will recognize the importance of the need to plan for the future with a base source of income unaffected by real estate cycles.

Investing in income property will appeal to the new generation of appraisers.

The appraiser of tomorrow is likely to view residential appraising as a stepping stone to commercial appraising and a general certification.

Unfortunately, the educational system set in place on January 1, 2008 by the AQB works against this career path. Formerly, an appraiser took on one set of courses that applied to both residential appraising and certified general appraising.

Now, there are two sets of courses. For instance, there is a 15 hour residential income approach course and a 30 hour general income approach course. In Montana, a candidate may not include the 30 hour general income approach course for residential certification. Also, an appraiser who works towards general certification, who wants to hold residential certification in the interim, must take the residential required courses and later take the courses for the certified general level.

The same applies to the Appraisal Institute SRA program. The taking of the residential level courses are required and the longer courses required for general certification on the same subject matter are not accepted.

Thus, it is more difficult and costly to move from residential appraising to certified general appraising. In a recent disciplinary action in Montana, the issue hinged on the competency of a certified general appraiser to complete a residential form report.

As reporting issues for residential appraising such as the 1004MC and the UAD requirements increase, competency may very well become an issue requiring more of the certified general appraiser who has limited experience in using residential form reports.

In the next edition, Part II, I will cover the training process and the role of the supervisory appraiser.

About the author

Doug Smith has an appraisal practice in Missoula, Montana, and is a certified general appraiser doing both residential and commercial appraising with a specialty in hotel appraising and feasibility studies. He has an MBA from the University of Montana and the SRA designation from the Appraisal Institute. He can be contacted at hotelman@montana.com.

E&O Insurance Companies

Notice to subscribers - I ran out of room this month to include the 6-page full E&O article. *I have info on status of new claims. what to do if you are retiring or quitting appraising and other topics. If you want a draft version, send me an email at ann@appraisaltoday.com.* ***Note: the lowest price E&O companies do not offer full prior acts coverage, which increases your liability risk.***

Note on broker contacts: I have listed brokers who work with appraisers all over the country. Some insurance policies also are available through local agents. Be sure to check on which states are covered, as they change.

Brokers offer insurance from various companies. For appraiser E&O they typically use mostly the same insurance company. Some other companies are also available for states where their primary carrier does not offer appraiser E&O and other circumstances.

Most of the brokers below offer coverage for appraisers and other types of businesses and professions, such as real estate agents and accountants.

Alaska self-insures for appraisers.

For example, Lloyds of London is an insurance company. 5 Star Appraisers is an insurance broker.

5 Star Appraisers

All states through Lloyds of London. Only offers 1-4 unit residential coverage. No prior acts coverage. Thus, low E&O prices. Be sure to read the policy carefully. 5 Star Specialty Programs is a division of and operates under the licenses of CRC Insurance Services, Inc., a large, national insurance wholesaler.

Contact:
5 Star Appraisers
118 S. Clinton St., Suite 450
Chicago, IL 60661
800-497-4644
www.5starappraisers.com

Alia, a Division of Foundation of Real Estate Appraisers

E&O insurance was split off from FREA last year to provide only insurance.

Contact:
Foundation of Real Estate Appraisers
4907 Morena Blvd. #1415
San Diego, CA 92117
Phone: (800) 882-4410
Fax: (858) 273-8026
www.frea.com
www.aliains.com

CRES Insurance Services

Contact:
CRES Insurance Services

Insurance through QBE Insurance Co. **Prior acts coverage only back to 1/1/08.**

15010 Avenue of Science #100
San Diego, CA 92128
P: 858.618.1648
F: 858.618.1655
www.cresinsurance.com

Intercorp Insurance Program Managers

Coverage through Lexington.

Contact:
Intercorp Insurance Program Managers
1438-F West Main Street
Ephrata, PA 17522-1345
Phone: 800.640.7601
www.intercorpinc.net

Landy Insurance Agency

Coverage through Great American Insurance Company in all states except NY and LA.

Contact:
Herbert L. Landy Insurance Agency, Inc.
75 2nd Ave. Suite 410
Needham, MA 02494-2876
800-336-5422
www.landy.com

Liability Insurance Administrators

Coverage through Liberty Mutual Group of Companies.

Contact:
1600 Anacapa St.
Santa Barbara, CA 93102-1319
800-334-0652
www.liability.com

Mercer (formerly Marsh)Affinity Group Services

Coverage through Genstar.

Contact:
Mercer (formerly Marsh)Affinity Group Services
P.O. Box 8146
Des Moines, IA 50301-8146
Phone: 800-367-7950
Fax 515-365-3043
www.proliability.com

OREP (Organization of Real Estate Professionals)

Insurance though about 10 different companies.

Contact:
OREP (Organization of Real Estate Professionals)
6760 University Ave. #250
San Diego, CA 92115
Phone: 888-347-5273
www.orep.org

John Pearl & Associates

Coverage through Intercorp, Lexington and other insurers.

Contact:
John Pearl & Associates
1200 East Glen Ave., Peoria Heights, IL 61614
Phone: (309) 688-9000.
Fax: (309) 688-5444.
www.pearlins.com

Victor O. Schinnerer

Coverage through CNA (Continental Casualty Company) insurance company.
Prior acts coverage only back to 1/1/08.

Contact:
Victor O. Schinnerer
Two Wisconsin Circle
Chevy Chase, MD 20815
301-961-9800
www.schinnerer.com

Other sources of E&O

Special coverage is available in a few states through an appraiser association or a state agency. Check with other local appraisers.