Real Estate Economic News and Insight — May 30, 2008

# Economic Perspectives

## The useful life of an appraisal and other declining market appraisal issues

What happens at this point in a market cycle when there is a growing need for real estate appraisals yet there are limited meaningful data for an appraiser to work with? How long is an appraisal good for? How reliable is an appraisal in a declining market? What other challenges does an appraiser — and the bank — face? The answers can be difficult, sometimes non-specific and always judgment-laden but they are highly relevant in today's real estate environment. Read on.

There is a critical time shift between appraisal and lending which is often underestimated or overlooked entirely. The appraisal process, by its very nature, is historical and thereby a lagging indicator of both market conditions and real estate value. To estimate value, an appraiser will identify sales, leases and other relevant information about similar properties that have sold. They'll make certain adjustments and *time-shift* it forward to the date of appraisal in order to make inferences about the value of the property being appraised.

The data, however, are historical. The properties they represent were offered for sale in the past. The meeting of the minds between seller and buyer occurred under market conditions which existed historically - not conditions that exist today nor those that will exist in the future.

Loan repayment however, is undeniably a *future* event. In commercial real estate loans, such as those secured by shopping centers or office properties as well as those secured by *for sale* type properties such as subdivisions, condominium projects and others, repayment is critically linked to the property's ability to produce revenue sufficient to both operate the property and service the debt. To do so, it must compete successfully for tenants or buyers in some *future* marketplace.

If market conditions are stable, the effect of the appraisal-lending time shift may be insignificant — even irrelevant. Alternatively, if market conditions are *changing*, the time shift becomes highly relevant. Relying solely on history, when the bank's loan will be repaid in a potentially very different *future* marketplace is tantamount to appraising the wrong property.

**The future has arrived. We are in that very different marketplace**. Virtually all geographical markets and real estate product types are impaired — some more so than others. Values have declined. Borrower financial capacity has diminished and loan repayment has become increasingly collateral dependent. As a result, appraisal information has become more relevant, not less. Ironically though, in a slow down such as we are currently experiencing, there is an absence of data from which an appraiser can draw well supported conclusions. That results in a very difficult combination of circumstances where the appraisal takes on *more* relevance but at the same time is *less* reliable. That *"perfect storm"* puts the bank at greater risk and argues for greater diligence by the bank. That greater diligence may take the form of more frequent independent appraisals, greater internal scrutiny of those appraisals and extensive internal market and property research and analysis.

**How long is an appraisal useful** before the data and conclusions become irrelevant and a fresh appraisal is necessary? The answer is not linked to a specific time period but rather varies by geographic market and product type or both. If market conditions are stable, the useful life of an appraisal could easily be a year or more. In volatile market conditions such as those that exist today, an appraisal could realistically be deemed irrelevant and unreliable in a matter of a very short time — perhaps a few months or less.

In less than a year, we have witnessed vacant land lose 40% to 60% of the value it had as little as two years ago. We have watched residential properties in some local areas decline as much as 30%. Without a current appraisal, the bank would have little or no idea whether its loan was less than or more than the value of the underlying asset.

Seacoast National Bank bases its decision whether to obtain a fresh appraisal on three fundamental criteria. First, the extent to which the loan is collateral dependent. If borrower support has eroded to the point the bank is relying heavily on the collateral for repayment, we'll usually be quick to order a new appraisal and it will be scrutinized in depth. After all, the bank is making a variety of important decisions on the information in the appraisal. Second, the bank will consider the volatility of both the property type and the geographic market in which that property must compete for buyers or tenants. Third, the bank will carefully consider its financial exposure to the specific credit.

EQUAL HOUSING LENDER MEMBER FDIC
NASDAQ: SBCF

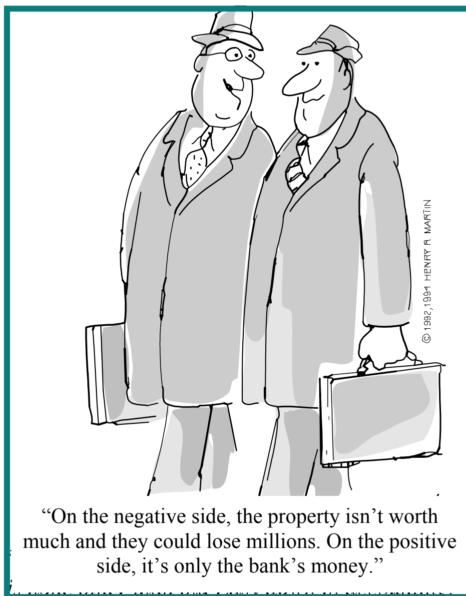
The regulatory view is similar. The useful life of an appraisal is deemed to be linked to market conditions and property type rather than an arbitrary time period. The bank (any regulated institution) can continue to rely on an older appraisal if it can clearly demonstrate that the appraisal remains valid. The reality is that an argument for a longer useful life is an impossible one today. Virtually all appraisals have a very short useful life today given rapidly changing market conditions.

**In the absence of current market data,** what are an appraiser's options? One option is to reach farther back in time to identify transactions that occurred in an active market and making an appropriate downward adjustment to account for today's impaired market conditions. If that adjustment is not accurate though, we risk valuing an asset at what may be an historic low point in time by using data from what may have been an historic high point.

The appraiser may also be forced to apply other creative solutions. For example, when appraising land or developed lots, the appraiser may start with the finished development and deduct all the hard and soft costs to get to a residual value — the land. While always a valid approach to test feasibility, it also requires sound judgment.

The appraiser may even draw comparables from geographically distant but economically and demographically similar areas where there are current sales and make an adjustment to the subject's location. They may also rely on interviews with market participants.

These, and other creative solutions are technically valid and useful but given the subjectivity and more *"moving parts"* together with the increased need for judgment, they may lead to decreased appraisal reliability and leave the bank vulnerable to increased risk. The bank can only mitigate that risk with increased internal market analysis and appraisal scrutiny.



"On the negative side, the property isn't worth much and they could lose millions. On the positive side, it's only the bank's money."

**Other impediments to appraisal reliability.** When the market grows as soft as it is today some participants in real estate transactions resort to creative and sometimes even illegal acts to advance an agenda. Occasionally these acts are intended solely to mislead either appraisers, financial institution decision-makers or both. Misleading activity includes kickbacks to transaction participants, undisclosed sales incentives, side agreements and *"flipping"* among related parties. The intent is to cast the appearance of higher property sale prices when such is not the case.

Misleading activity is usually subtle or sophisticated and is often difficult to identify. Nevertheless, knowing that these activities occur, it is incumbent upon the appraiser to get behind the numbers and clearly understand the reality of each transaction to the extent that is possible.

Oftentimes that understanding is the result of qualitative analysis of the transaction and simply understanding that the transaction does not make economic sense in the context of the bigger picture. Clues to misleading activity are often identified as a result of the appraiser's skill, overall experience and knowledge of the local market. These factors make a strong case for knowing your appraiser and understanding their background and experience.

**At its worst, misleading activity can turn criminal,** especially when done to influence a federally insured lending institution. The United States Code (Title 18, Part I, Chapter 47, Section 1014) is clear when it states: "*Whoever knowingly makes any false statement or report, or willfully overvalues any land, property or security for the purpose of influencing … any institution, the accounts of which are insured by the FDIC … shall be fined not more that $1,000,000 or imprisoned not more than 30 years, or both."*

**Absence of property information may soon impede real estate research**. Since 1986 the Florida Department of Revenue has required that a form listing the sales price of a property be submitted every time a deed is transferred. This information was processed by the state's county property appraisers at a cost to the state of about $11.5 million annually. In budget cutting action, the Governor signed into law a bill that would eliminate the form and therefore the reporting of property sale prices. This action will almost certainly make the jobs of county and independent property appraisers as well as those who perform Florida real estate research more difficult as they'll need to identify other sources for this much needed information. That change becomes effective on July 1st.

The material contained in this newsletter has been prepared by Seacoast National Bank. The content is provided for use by real estate, financial services and other professionals only and is not intended for consumer distribution. The material provided is for informational and educational purposes only and should not be construed as investment and/or mortgage advice. Although the material is deemed to be accurate and reliable, there is no guarantee it is not without errors.

***Economic Perspectives*** **is prepared by William L. Pittenger, Senior Vice President, Chief Real Estate Economist & Risk Advisor, Seacoast National Bank. E-Mail Mr. Pittenger at William.pittenger@seacoastnational.com**