

The Appraisal Industry, FIRREA and Professionalism

by Clyde B. Johnson

THE APPRAISAL INDUSTRY

Real estate appraising has undergone a tremendous change over the past 20 years. With the advent of the "computer age," we have witnessed a dramatic increase in new programs, techniques and applications that have stretched the original approaches to value to a new level of complexity. A cursory review of any modern appraisal text clearly supports this premise and generally prompts the beginning appraisal student to choose another profession. This surge of technology, information and data access has occurred in many professions, often with the same unsettling results.

As an outgrowth of the accounting profession, the appraisal business has for years struggled to reach "professional status." A recent article by Benedict J. Fredericks, Jr., MAI, provides an excellent analysis of this struggle and concludes that those in the appraisal industry must continue to push for professional recognition.¹

As a result of the Savings and Loan collapse and subsequent takeovers, federal agencies as well as state governments have been placed under a mandate to establish appraisal standards and create regulatory boards to provide for their enforcement. Several of the more prominent appraisal organizations formed the Appraisal Foundation (incorporated as an Illinois, non-profit corporation) that, by law, is to:

- establish and improve uniform appraisal standards by defining, issuing and promoting such standards
- establish appropriate criteria for defining, issuing and promoting qualified appraisers and disseminating such qualifications criteria to states, governmental entities and others, and

- develop or assist in the development of appropriate examinations for qualified appraisers

Law requires states to adhere to these standards. The indirect influence of some of the participating members of the Appraisal Foundation on the National Association of Realtors (NAR) created concern at the congressional level. The resulting breach between NAR and the American Institute of Real Estate Appraisers (AIREA) helped bring about the long discussed merger of the two largest national appraisal organizations. The AIREA and the Society of Real Estate Appraisers (SREA) recently voted to form a single organization, the Appraisal Institute. Almost simultaneously, the AIREA ended its long affiliation with NAR.

As a result of the Savings and Loan collapse and subsequent takeovers, federal agencies as well as state governments have been placed under a mandate to establish appraisal standards and create regulatory boards to provide for their enforcement.

The long disputed claim that the appraisal establishment seeks stronger standards as opposed to the real estate profession's desire for a less rigorous stance on regulations created a split within this union. The appraisal industry is now afforded a unique opportunity to advance the goal of professionalism by taking advantage of the current atmosphere that focuses on certification and licensing of real estate appraisers.

THE SAVINGS AND LOAN PUZZLE

A brief examination of the Savings and Loan industry's environmental climate in the early 1980s indicates that, in the second quarter of 1984 through the first quarter of 1985, approximately 34 associations failed (defined as "out of business" or "merged with regulatory assistance") with many more to follow. In their

article, "An Analysis of Post-Deregulation Savings and Loan Failures," Patricia M. Rudolph and Bassam Hamdan finds that the "economic environment is likely to determine, in part, the characteristics that are associated with failed associations."² This article seeks to analyze and explore the financial characteristics of failed Savings and Loan Associations in the deregulated environment. The article identifies only one variable that is significant in the studies included in the analysis, which is the capital adequacy measure: net worth to total assets. The study also concludes that financial characteristics associated with failure are not consistent over time. Others seeking to analyze the Savings and Loan industry in the deregulated environment found that

departures from traditional accounting principals and procedures were proposed or enacted within the industry, enabling individual thrift associations to perpetuate positive net worth.³

An analysis of major banking legislation and regulatory provisions since the Federal Reserve Act of 1913 reveals a remarkable scenario in that until deregulation in the 1980s, only four major Acts were established that affected the industry. Legislation enacted in the early 80s under "new federalism" later provided insight into subsequent problems. In 1980, the first of several acts that proceeded the Savings and Loan crisis became law. The Depository Institutions Deregulation and Monetary Control Act (1980) established uniform reserve requirements for all depository insti-

Continued on Page 18

The Appraisal Industry, FIRREA and Professionalism

Continued from Page 17

tutions, phased out deposit rate ceilings, allowed NOW accounts at all depository institutions and, for the first time, allowed thrifts to issue credit cards and make consumer loans. In 1982, the most important legislation that seemingly gave rise to the problems we face today was created. The Depository Institutions Act of 1982, or the Garn-St. Germain Act, provided for interstate and interinstitutional mergers and gave thrifts authority to make some commercial loans. Savings and Loans under deregulation received many new powers during the decade of the 1980s. This new power gave rise to potential conflicts of interest by simple manipulation of the appraisal process.

MANIPULATING THE APPRAISAL PROCESS

One document that sheds light on the problem faced by the real estate financial industry is the *Forty-Eight Report by the Committee on Government Operations*. This report concluded that federal regulatory agencies, lenders and appraisers share responsibility for the problems created by poor judgement. Appraisals utilized to document loans for values larger than market value was pervasive during this period. As Janet O'Toole, MAI, pointed out, "Between 1983 and 1985, more than 800 (25 percent) of the 3,200 federally insured Savings and Loans had real estate loan portfolios based on appraisals with significant deficiencies. These appraisals overvalued the property used to se-

cure loans by \$3 billion."⁴

The process of "flipping" properties and the problems generated by this activity created perhaps the greatest single stigma that haunts the appraisal industry today. An examination of some of the larger Savings and Loans that were industry leaders in the early 1980s indicate this activity was pervasive and generated enormous "paper assets" that were used to finance properties as well as associated fees. By flipping properties through resales at higher prices, an enormous amount of "paper profit" was created. We now know that some of these institutions used appraisers who had vested interest in selected projects and provided appraisals on properties up to four times their original worth.

Reaction to the Savings and Loan problem was initially slow. Empire Savings and Loan was taken over in 1984, yet little was done to stem the hemorrhage within the industry until 1989. The Silverado Savings and Loan has received much attention, and its failure and subsequent takeover in 1989 resulted in a projected \$1 billion bill for the taxpayers.

Finally with the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), changes were made in the structure of thrift institution regulations. Additional changes were made in the federal deposit insurance structure and financing requirements that centered on capital requirements and the qualified thrift lender test. Title XI - Real Estate Appraisal Reform Amendments specifically address the appraisal industry.

FIRREA — PUBLIC LAW 100-73

The mandate of the 1989 FIRREA law, which "rose like a phoenix" from the ashes of the Savings and Loan disaster and the failure of federally insured lending institutions, is to

**ALBERT
ALLEN
ASSOCIATES**

Right of Way Appraisers

- Expert witness testimony
- Right of way evaluation
- Gas and electric utility companies
- Communications and allied companies
- Federal, state and local governments
- Pipeline companies

Albert Allen Associates, Inc.
14925 Memorial Drive, Suite 200
Houston, Texas 77079
(713) 493-4444

put appraisal standards and regulations into effect in every state by July 1, 1991. Congress sought to reverse itself on its position that deregulation was necessary within the industry.

FIRREA is a complex Act that substantially changes the current operations of the thrift industry under deregulation. It introduces stricter rules concerning capital, and implemented a 70 percent qualified thrift lender test in an attempt to return the industry to solvency.

Title XI - Real Estate Appraisal Reform Amendments attached to FIRREA provides that federal financial and public policy interest in real estate related transactions will be protected by requiring that real estate appraisals use (in connection with uniform standards) "individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision." In hearings conducted in 1985, which promulgated this section of FIRREA, the House Banking Committee sought to examine the impact of faulty and fraudulent real estate appraisals on federally insured and regulated agencies. It was found that:

- many so called appraisers lacked adequate experience and education
- most were not members of professional organizations that required specific standards for an appraisal
- users of these services had little or no basis for evaluation of either the appraiser or the appraisal report (*Review Appraiser*), and
- the appraisal profession suffered from problems resulting within the thrift industry

Section 1116 of Title XI requires examinations and provides, through the Appraisal Foundation, for their development. To date, over 40 states have established laws regulating appraisers as required under FIRREA. Other states have similar legislation in various stages of

completion. As an example, the General Assembly of the State of Georgia passed legislation (effective July 1, 1990) that provides for state registration, certification or licensure, and regulation of real estate appraisers. At the same time, it created the Georgia Real Estate Appraisal Board, which will have authority to establish qualification for the appraiser, set standards for the actual real estate appraisals, and provide for disciplinary action against any violations. The Georgia law creates basically three types of appraisers: 1) registered, 2) licensed, and 3) certified. Each level requires different educational requirements, classroom hours and experience levels. Similar legislation has been enacted by most states effective June, 1991.

Under FIRREA, the Appraisal Subcommittee functions to:

- monitor State requirements for appraiser licensing and certification,
- monitor federal financial institutions (Appraisal Standards and Appraiser Qualifications),
- maintain the National Appraiser Registry,
- prepare the annual report for congress, and
- monitor the Appraisal Foundation activities.

It is empowered to:

- establish an advisory committee,
- hold hearings,
- take testimonies,
- receive evidence,
- provide information, and
- perform research.

The act also:

- permits establishment of a state certifying/licensing agency,
- provides for a waiver of certification,
- creates the Federal Financial Institution Examination Council,
- provides for an appeal process for

state agencies,

- defines federally related transactions, and
- specifies affected federal agencies.

FIRREA's role in addressing the appraisal/appraiser problem is the first step toward a national regulatory system for the appraisal industry. This, coupled with the requirement for state appraiser qualifications, holds promise in providing the vehicle for the final push into professionalism.

There are witnessed attempts to alter the appraisal exemption level, originally established at \$15,000, among certain federal agencies. One federal agency proposal to waive mandatory appraisals on transactions of \$100,000 or less created grave concerns within the industry. It now appears that a lower level will be designated, or at least a requirement for all appraisals, on transactions of \$50,000 or more.

WHAT IS THE PRIMARY GOAL OF FIRREA?

FIRREA on the surface appears to be attempting to protect federal financial and public policy interests in related real estate transactions by requiring each state to establish standards for appraisals and qualifications for appraisers. The effect on our goal of professionalism has yet to be addressed.

The cause and effect of the Savings and Loan collapse and resulting legislation remains a topic of heated discussion and much finger pointing. Current estimates set the cost of the bailout at \$500 billion or more. The analysis of the financial environment and accounting procedures within the Savings and Loan industry fail to present a definitive reason for the problems that arose after deregulation. Whether or not the reader accepts the premise that the attempt to regulate the industry arises from consumer protection, the final out-

Continued on Page 20

The Appraisal Industry, FIRREA and Professionalism

Continued from Page 19

come of FIRREA and the associated laws and regulations generated by this legislation may be viewed in a positive light.

The dramatic reaction, if not somewhat belated, to the Savings and Loan disaster created a sudden and dramatic rush toward appraisal certification and licensure. The present status of these efforts are somewhat confusing, especially if considered on a state-by-state basis. Attempts to ensure honest and realistic appraisals, must be tempered with reality.

WHAT IS A PROFESSIONAL?

Every profession attempts to define "professional" along lines that address their specific needs or goals. For our purposes, it may be defined as follows: "A profession is a calling requiring specialized knowledge and often long and intensive preparation, including instruction in skills and methods as well as in the scientific, historical or scholarly principals underlying such skills and methods, maintaining by force of organization or concerted opinion high standards of achievement and conduct and committing its members to continued study and to a kind of work which has for its prime purpose a rendering of a public service."⁵

The goal of the appraisal profession seems close at hand as a result of the requirements of FIRREA. For the first time in the history of the appraisal industry, appraisers will be regulated. The effects of FIRREA will enhance the credibility of the appraisal industry and, whether members of the industry become certified or licensed either voluntarily or mandated, it can only promote their cause. Requirements developed at the state level will strengthen national efforts and provide positive incentives for local organizations. The Real Estate Appraisal Reform Amendments of FIRREA, that resulted from Congressman Doug Barnards (D-GA) bill introduced into Congress in 1987 has provided impetus toward this goal.

A detailed study of professionalism within the appraisal industry was undertaken by John R. White, MAI, and presented in *The Appraisal Journal*, July 1987.⁶ This article correctly addresses the problems within the industry, affiliation with the National Board of Realtors, certification and uniform standards, and professional ethics and the enforcement of those ethics. The cost of professionalism will be both direct and indirect to the appraisal industry.⁷ Some of the most obvious will be:

- Certification/license fees
- Higher entry level cost for appraiser services
- Continuous education requirements and related cost
- Initial reduction in supply of licensed appraiser
- Higher product (appraisal) cost

The above cost will be passed along to the consumer. There is nothing new facing the appraisal industry as a result of FIRREA except some needed self-regulation, yet no other single legislative act has influenced the appraisal industry more since the inception of the Federal Highway Act of the early 50s and Public Law 91-646, the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970.

One interesting point that appears to be a key piece of the Savings and Loan puzzle is the lack of a separate review function to provide a second layer of responsibility for value estimates used within the industry. This review requirement has long been an integral and continuously emphasized part of the Federal Highway Administration's policy under the Uniform Act.

Are members of the appraisal industry professionals? In light of the Savings and Loan disaster and the stigma cast upon the appraisal industry, the final results are like a double-edged sword. What has been the cost to the industry? Ethics and standards

have long been stressed, yet many appraisers involved in questionable activities gave little credence to their existence. As a result of past actions within the appraisal industry, we must assume responsibility and the resulting additional cost generated by mandated regulation of our business. Professionalism will require self-discipline within the industry at a higher level than achieved to date in order to recapture public confidence.

Appraisal professionals must take advantage of the opportunity that now presents itself. Our goal appears close at hand and achievable if we react positively to the requirements of current legislation, and utilize it as the vehicle to reach "professionalism."



REFERENCES

1. Benedict J. Frederick, Jr., MAI, "Real Estate Appraising: At the Threshold of Professional Recognition?", *The Appraisal Journal*, (July 1990): 403-418.
2. Patricia M. Rudolph and Bassam Hamdan, "An Analysis of Post-Deregulation Savings and Loan Failures," *AREUEA Journal*, Vol. 16, No. 1, 1988, 17-20.
3. Julie A. Lockhart, Michael S. Long and Stephan E. Sefcik, "Regulatory Accounting Principles, Forbearance and the Perpetuation of the Savings and Loan Industry," *Housing and Finance Review*, Vol. 6, No. 1, Spring 1987: 79-91.
4. Janet O'Toole, MAI, "Appraisal Procedures and Real Estate Lending," *The Appraisal Journal*, (January 1989): 23-30.
5. U.S. Department of Transportation, Federal Highway Administration, Office of Right of Way, *Appraisal and Appraisal review for Federal-aid Highway Programs*, Chapter 3: 10-43.
6. John R. White, MAI, "The Real Estate Appraiser — The Elusive Goal of Professionalism," *The Appraisal Journal*, (July 1987): 325-377.
7. Linda L. Johnson and Christine Loucks, "The Effects of Certification and Licensure on Appraisers and Users of Appraisals," *The Appraisal Journal*, (October, 1988): 548-555.