After-Sale Evaluations: Appraisals or Justifications

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Abstract. This article argues that most residential evaluations done for lenders are not appraisals; instead, they are justifications for the amount of the loan applied for by the purchaser. The appraiser, by knowing the contract price, is under conscious or unconscious pressure to estimate value at or above the already agreed-to price. The research tests two hypotheses. First, appraisers are as likely to estimate value above contract price as below it. Second, staff appraisers are as likely to estimate value above contract price as are independent appraisers.

Introduction

Do appraisers really make independent value estimates unaffected by the sale prices already agreed to by purchasers? The purpose of this article is to develop and evaluate evidence about this question. The results may help appraisers recognize a bias that is commonly suspected but often unconfirmed—the tendency of residential properties to be appraised above the contract price.

The Clamor for Accuracy

The appraisal profession has had its share of recent criticism. Both professional and academic journals have discussed problems and suggested reforms. Mortgage bankers have wanted appraisers "to dig deeper for improved data and use more realistic evaluation methods." Many academicians, like Smith, called for reforms and made valuable recommendations. Leaders of professional societies have advocated the licensing of appraisers using national standards. Writers have illustrated methods for deflating values and accounting for creative financing and other special concessions by sellers. The thesis has been that market value estimates should be corrected for terms abnormal to the market. Other authors have argued that a lesser rate of inflation in real estate prices requires tighter appraisals.

Many of the suggestions and changes were prompted by the increased rate of delinquencies and foreclosures during 1982 and 1983. This trend is evident in Exhibits 1 and 2. When the Federal National Mortgage Association (FNMA) reported foreclosure losses in 1984 on properties with exaggerated appraised values, more critics joined in criticism of appraisal practices. In fact, FNMA issued guidelines holding appraisers to minimum standards when appraising income-producing property and requiring more detailed information on residential appraisals.

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In 1985 and 1986, the United States recorded a greater number of bank and savings and loan association failures than any other period since the Great Depression. With each failure, examiners reviewed mortgage loan packages for poor or fraudulent appraisals. The attendant publicity and media coverage played a role in the reaction of professional appraisal societies. In 1986, the Society of Real Estate Appraisers (SREA) recommended a stringent program of self-regulation for its 17,000 members. Eight societies offering appraiser designations agreed on eight common qualification standards for future designees. The societies' stated goal was to form a "national foundation that, in turn, would establish standards for a national designation, similar to a Certified Public Accountant."
At the same time, the Congress was holding committee hearings on appraisal practices. It appeared that legislation might be introduced that would call for national licensing of appraisers.

**Basis of the Problem**

A review of the criticisms, suggestions, reactions of the professional societies, and recommended legislation suggests one facet of the problem. Flawed appraisals may result
from lack of agreement between assignments and the definition of appraisal work. The assumption is that appraisers are to estimate market value under standardized conditions and assumptions. Academic and professional groups seem to agree on a definition of market value—_The most probable selling price under conditions and terms normal to the market_. There are also generally accepted assumptions about buyer and seller behavior. Moreover, the real estate market is usually considered localized.

However, are appraisers actually asked by a client to estimate market value? Or, are they asked to justify a sale price already negotiated between willing buyers and sellers?

**Exogenous Pressures**

When appraisers are aware of the sale price of a residential property, a change occurs in the evaluation process. Exogenous pressures arise for the appraiser “to come in” at or above the sale price. Never mind the fact that the builder or seller has bought down the interest rate for purchasers, is paying closing costs, or has done both.

Many lenders ignore the practice of sales people’s gathering “comparables” to influence the appraiser. Of course, these particular comparables also reflect builder or seller enticements that are recouped in the sale price. Because they are drawn from the same subdivision or planned development, sales people maintain that the enticements are normal to the market area. Once one builder or developer offers special terms, others tend to follow.

Appraisers with independent firms are more exposed to exogenous pressures than are institutional staff appraisers. Sales people and many loan originators (especially those seeking only to retain servicing rights) do not offer substantial business to independent appraisers having a reputation of “tight” evaluations. Only when loan officers are seeking reasons not to make loans are such appraisers in demand.

**Research Difficulty**

Is there evidence that the speculations advanced by this paper are valid? Are appraisals independent of contract price? Proving these contentions is difficult, because most statistical tests are based on random occurrences. The basic assumption of this research is that appraisers are as likely to estimate market value below the actual selling price as above it. Any significant deviation from this hypothesis is evidence of exogenous pressure or, at least, bias from some cause.

At a recent meeting of the American Real Estate Society, this assumption caused spirited discussion.¹⁰ Some participants agreed; others did not. One opinion was that appraisers lag behind market changes until the changes are overwhelmingly evident. Therefore, appraisers would generally tend to estimate values below actual sale prices.

A contrary view was that because brokers set asking prices using properties that usually sold months ago, the asking prices are probably too low for the market in most transactions. Without accounting for the lapse of time since the comparables sold, the agent is undervaluing the property. Appraisers are skilled in recognizing inflation and accounting for it. Their estimate would be higher than the sale price, especially since few buyers pay full asking price.

Both arguments have some merit. However, the contention of this paper is that if a hundred appraisers were asked to estimate the expected price of a property (unaware of any actual
sale prices), the expectation is that fifty estimates would fall below the actual sale price and fifty would fall above. Any significant deviation from these expected results cannot be attributed to chance or sampling error.

Methodology

The research employed two types of samples for inferences. First, two savings and loan associations and two savings banks in the Richmond, Virginia, area supplied information about appraisals made during April, May, and June of 1987. The result yielded a sample of 326 appraisals of existing and newly completed homes. No more than 20 estimates by any one appraiser were used; “extras” were discarded randomly. The thrift institutions were selected because they have numerous branches in the metropolitan area and do not concentrate their lending geographically. The appraisers were aware of the contract price in all the selected appraisals.

The second sample compared the estimates of staff appraisers with those completed by independents. The staff people had done 130 of the 326 appraisals.

Two hypotheses were tested:

1) Appraisers are as likely to appraise above contract price as below.

2) No significant difference exists in the proportion of above-contract appraisals made by staff and independent appraisers.

Inferences

To test the first hypothesis, the research used the Chi-square statistic \((x^2)\) to test for a significant difference between observed and expected results.

The \(x^2\) distribution from sampling is a close approximation of the continuous Chi-square distribution so long as all expected results from the sample are more than five.¹¹ In the particular sample under analysis, the expected number of appraisals above contract price is \(326 \times 0.5\) or 163 (the same number is expected “below”). Because the inference is from discrete data, rather than continuous data, the Yates correctional factor was employed.¹²

The \(x^2\) statistic is computed as follows:

\[
x^2 = \frac{[(O - E) - 0.5]^2}{E}
\]

where,

\[O\] = Observed number of appraisal results
\[E\] = Expected number of appraisal results
\[0.5\] = Yates correctional factor

The test was applied at the 0.5 level of significance.

<table>
<thead>
<tr>
<th>Number of Appraisals above contract price</th>
<th>(O)</th>
<th>(E)</th>
<th>-Yates F</th>
<th>(O-E)</th>
<th>((O-E)^2/E)</th>
</tr>
</thead>
<tbody>
<tr>
<td>241</td>
<td>163</td>
<td>0.5</td>
<td>77.5</td>
<td>6006/326</td>
<td>18.4</td>
</tr>
<tr>
<td>Number ... below</td>
<td>85</td>
<td>163</td>
<td>0.5</td>
<td>77.5</td>
<td>36.8</td>
</tr>
</tbody>
</table>

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There is a different $x^2$ distribution for each degree of freedom. Because there are but two possible outcomes (above or below), only one degree of freedom exists. The computed statistic is many times the value of 3.841, which is the figure that must be exceeded to reject the hypothesis. The conclusion is that the appraisals reflect some bias; the difference from the expected result is too large to attribute to sampling error. The bias that is readily apparent is for appraisers to estimate values above contract price.

The second inference uses the difference between sample proportions for an inference. Of 326 reports, 130 were performed by staff appraisers. About 63% or 82 of the staff appraisals were above contract price. In contrast, 81% (or 159) of the independent firms’ appraisals were above contract price. Are the percentages significantly different at the 5% level?

The test is as follows:

\[
p_{w} = \frac{159 + 82}{196 + 130} = \frac{241}{326} = .74
\]

\[
z = \frac{p_1 - p_2}{\sqrt{p_w (1-p_w) \left( \frac{1}{n_1} + \frac{1}{n_2} \right)}}
\]

where,

\[
p_1 = \text{larger proportion of two samples } \frac{159}{196}
\]

\[
p_2 = \text{smaller proportion } \frac{82}{130}
\]

\[
p_w = \text{combined proportion } \frac{241}{326}
\]

\[
n_1 = \text{sample number of larger sample } 196
\]

\[
n_2 = \text{sample number of smaller sample } 130
\]

\[
z = \frac{.81 - .63}{\sqrt{.74(.26) \left( \frac{1}{196} + \frac{1}{130} \right)}} = 0.18/0.05 = 3.63
\]

The “critical value” for $z$ at the 5% level of significance is 1.96. The 3.63 far exceeds the critical value; therefore, the second hypothesis is also rejected.

The results of both statistical tests support the contention that exogenous factors influence appraisers’ evaluations.

**Implications**

Statistical tests provide evidence for judgments. Although they are based on sampling and can never be 100% accurate, the two samples give a strong indication that appraisers do make estimates at or above contract price. Is this a negative finding? The answer is yes if
appraisers are supposed to make estimates of market value independent of contract price. However, in the samples, the appraisers were asked to justify the sale prices. The argument advanced in this paper is that this assignment differs from the definition of appraisal work. If lenders do not want appraisers influenced by builders, sales people, and already agreed-to prices, the lenders must help. First, they should not reveal the contract price. Second, they should never allow sales people to provide additional comparables for appraisers to consider. Third, they must welcome an appraisal significantly below contract price. After all, it saves them from making a poor loan.

For appraisers, the sample data have implications. Recognizing a bias is necessary before correcting it. Moreover, they should resolve never to accept comparables supplied by sales people without checking on the exact sales terms. Knowing the sales terms normal to their market is also essential.

One additional implication exists. If appraisals are performed under the general conditions of those in the sample, perhaps they should be called "justifications," not appraisals.

Notes

6See also Federal Home Loan Bank Board’s R Memorandum 41 b.
8Lazarus, p. 2, in interview with Klopfenstein, President of the Society of Real Estate Appraisers.
9See discussion of legislation in Barry A. Disken, Patrick Maroney and Frank A. Victory, "The Need for Regulation of Appraisers," The Real Estate Appraiser and Analyst (Summer 1986).
10Discussion following paper, "Exogenous Pressures and Appraisal Bias," at the meeting of the American Real Estate Society, April 1987, Orlando, Florida.

References