

# Appraising and Mortgage Lending

By Percy E. Wagner

*The author of this article has been engaged in the real estate, mortgage, and appraisal business for many years. His experience as both a mortgagor and officer of mortgage lending institutions has brought to him the strict demarkation which should exist between the appraiser and the mortgage officer as well as the importance of high ethical standards which both must possess. Mr. Wagner, 1960 President of the Institute, is First Vice President of the Oak Park Federal Savings & Loan Association.*

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THE IMPORTANCE of appraising in the business of mortgage lending is evidenced by the fact that over 56% of the homes in the United States are mortgaged. Under existing laws which govern home mortgage lending by government guarantee agencies, banks, insurance companies, savings and loan associations, and most private lenders, an appraisal of the real estate security must be made. This legal requirement has resulted in appraisals for the purpose of mortgage lending to be the largest single source of appraisal business. A discussion of the appraisal profession and mortgage lending policies is therefore of importance to appraisers and mortgage lenders. Professional appraisers and mortgage lending officers are morally and legally concerned with proper appraisal methods and the integrity of the appraisal profession. The appraiser is also concerned as to his obligation to and relationship with the mortgage lender—where they begin, where they end, and where they overlap. The mortgage lender, in turn, is concerned about the competency and integrity of the appraiser.

## **Mortgage Lender Limited Ownership Partner**

Appraisals are made for many purposes, and a single property may have a different value according to the purpose for which the appraisal is made. In the field of mortgage lending, the purpose of the appraisal is linked to the purpose of transfer of ownership and financing. In a mortgage transaction, the parties concerned are the owner of the property and the mortgage lender. The mortgage lender becomes a limited partner in the ownership of the property after a mortgage is recorded. As such, his lending activity is related to ownership as the security for his mortgage is in the possession of the holder of certain property rights. Certain rights are passed to the mortgagee and certain rights retained by the fee title owner in a mortgage transaction.

One of the rights retained by the owner is the important right of possession. Regardless of the extent of the property rights passed, the position of the mortgage lender is that of one having acquired certain spe-

cific rights, although limited rights, in the ownership of the real property. The physical security and property rights are therefore as important to the mortgage lender as to the property owner.

Of primary concern to mortgagor and mortgagee is the repayment of the money loaned. The repayment of a mortgage does not lie entirely in the real estate but derives from two sources. Thus the mortgage lending officer has two risk analyses to make.

### **Mortgage Comprises Two Elements**

To understand this better, it is necessary to understand that the legal instrument, the mortgage, comprises two distinct elements—the note and the security for the note. The word mortgage is of French derivation, meaning literally “dead pledge.” Practically, a debt is very much alive for mortgagor and mortgagee until paid and cancelled.

In order to create a mortgage debt, one must first create a personal debt. This debt is evidenced by a note. The note is secured by the pledge of real estate through an instrument known as a mortgage or trust deed. The note and mortgage bears the signature of a person, persons, or some legal entity which can legally create a debt. Proof that the real estate is additional security lies in the fact that default by the borrower occurs upon nonpayment of the mortgage note and not upon nonpayment by the property. A property per se does not create the default—the default is created by the mortgagor.

### **Sources of Repayment**

In practice a debt secured by real estate has four sources of repayment. First, the borrower usually exhausts his resources before default. After default, by use of the assignment of rents, the rent of the property is attached for the payment of the debt. Foreclosure procedure and sale becomes the third method of recapture. A fourth line of de-

fense may be the attachment of other assets of the mortgagor through deficiency judgment.

In mortgage analysis, the rating of the borrower's responsibility is the first consideration of risk. The borrower is the person or persons responsible on the note and is subject to investigation as to credit standing and ability to meet obligations. Until the ability to pay by the borrower is exhausted, the property is secondary in any consideration for repayment of the debt.

The necessity for an appraisal of the property is now apparent and the appraiser becomes concerned with the valuation of the physical security. The real estate which is offered for security is the usefulness of the physical commodity of land and buildings. Today, we have markets for every conceivable commodity. One of these markets is the market for shelter. Financing within this market is the financing of home purchases; and the risks found in the valuation of real estate by the market approach are among the risks analyzed in mortgage lending.

### **Security Must Have Future Value**

The money loaned today is paid back in the future; and one of the problems of the money lender and the real estate appraiser in the analysis of mortgage risk and property value is to consider the factors which affect future markets. Value has been defined as the future benefits arising from property ownership. An opinion of value is an estimate of value today based on consideration of the factors which may affect value in the future. Lending money today which is repaid in the future, requires real estate security which has future value.

If the real estate market is important in mortgage lending, the market approach becomes the predominant approach in the estimate of the value of real estate for home mortgage lending. A fundamental basis ex-

ists for this statement. First, a property is valuable as long as it is marketable. As related to a mortgage, the security is valuable as long as it is marketable; that is, as long as the property will return, either in rent or a sale, the amount of money loaned. The property must, during the life of a mortgage, be more valuable in money than the balance outstanding on the loan from time to time. Secondly, the loan must be repaid over a less number of years than the estimated economic life of the property.

The value of ownership and the physical value of the mortgage security are determined in the same market. Within this market are market value and market price. In appraisal practice, market value is not always market price. Value may be higher or lower than price. An economic definition of value is: The *relationship* between a thing desired and a potential purchaser. The measure of value is the amount (e.g., of money) which the potential purchaser probably will pay for possession of the thing desired."<sup>1</sup> The measure of value may be the price at a given time which a particular person may pay. Therefore the definition is subject to the limitation of the appraisal process and the purpose of the appraisal.

### Principle of Substitution

One of the principles which govern appraisers in reaching their final estimate of market value is the principle of substitution. The difference between market value and market price may be found within the scope of this principle. This principle states the premises on which informed and intelligent people make purchases when not subject to pressure and have time to become aware of market opportunities. These premises are:

1. Reproduction or replacement cost, less de-

preciation, sets one of the limits (usually the upper) of value.

2. The cost of acquiring a substitute property offering equal utility and functional advantages tends to set the price which a person will pay in the open market when the market is free and not under pressure of demand or oversupply.
3. Buyers and sellers will consider other investment opportunities or the cost of renting.

These rules delineate the difference between market price and market value. Market price may become market value when it is in balance with reproduction cost. During periods of activity and high prices, competition will tend to shear off excess profits and bring cost and value into balance.

Intelligent buyers are aware of the value of substitute properties and, unless under pressure or from caprice, will not pay a price more than the price at which an equally desirable substitute property can be acquired. Finally, a buyer weighs the value of real estate against other investment opportunities. His decision is made in his opinion of value and price. If to the buyer the price is too high, his attention will be drawn to another investment whose advantages of ownership are more attractive to him. If the cost of ownership is excessive and to him greater than the cost to rent, the advantages of renting may outweigh the advantages of owning.

Value to the informed or uninformed buyer or seller may be more or less than price. The whims, caprices, or circumstances of the buyer or seller will cause him to act. Such action may be personal and does not represent the thinking of the typical buyer and seller.

Value lies within the public's ability to pay. Properties may be desirable, worth their cost, and meet every test of the market except ability of the public purse to support the price asked. An article will have no value if the price is beyond the ability of a person to pay for it. By applying the above tests to

<sup>1</sup> American Institute of Real Estate Appraisers. *Appraisal Terminology and Handbook* (Chicago: Author, 1950), p. 115.

his data, the appraiser differentiates between value and price. In the market data approach, the tests of market value and market price are constantly applied by the appraiser.

As stated before, the first consideration of repayment is the borrower's ability to repay his loan at future stated intervals. While the property is in his possession payments are made from the resources of the borrower or rents from the property. This is the first line of defense and is not the concern of the appraiser but of the mortgagee. The appraiser is concerned with the ability of the property, by rental payments or sale, to repay the debt at some future date. The character and financial responsibility of the borrower or purchaser receives no consideration in his value of the real estate.

### **Appraiser Must Be Objective**

The appraiser may have knowledge of the purpose of the appraisal for mortgage lending but must be entirely objective in his approach. He should have no knowledge of the amount of loan requested or its terms. The mortgage negotiation should be of no concern to him.

His duty lies in estimating the value of the property as it is reflected in market transactions. He is aware that some unknown sum of money is to be borrowed, that said unknown sum must be returned in the future from the borrower's income, from rentals of the property, or from its future sale. To the appraiser the value of the property found lies in that broad market of present and future buyers and sellers.

Economic conditions at some period in the future may be different than those which existed at the time of appraisal and lending. The economic conditions which may obtain at the time of default will create the value of the property at that time. It is this value which will either pay or not pay the unpaid

balance on the mortgage. The amount loaned in the present will be based, in part, on the appraiser's estimate of value. Thus, the ability of the property to repay the loan in case of default depends on the soundness of the appraisal.

### **Factors in Analysis**

In the appraisal report, similar factors in the appraisal process and mortgage analysis are:

1. Land:
  - a. Location.
  - b. Utilities.
  - c. Facilities and their availability.
  - d. Topography.
  - e. Size.
  - f. Zoning, restrictions of use.
2. Improvements:
  - a. Architecture.
  - b. Condition.
  - c. Livability.
  - d. Quality.
  - e. Conformity.
  - f. Physical life.
3. Economic conditions of property unit:
  - a. Taxes.
  - b. Economic life.
  - c. Marketability.
  - d. Rental.
  - e. Highest and best use.

These physical, sociological, and economic influences on a property are related to human needs. The ability of the property to meet these needs is expressed in the price purchasers are willing and able to pay for benefits which arise in the future.

Estimates made in an appraisal which help the loan officer to make decisions are:

1. Estimate of value—setting the maximum legal ratio of loan to value.
2. Physical and economic life—set the term of the loan.
3. Rental value—set the repayment plan from the possible rental of the property.
4. Taxes and maintenance expenses—knowledge of prior obligations.

### Role of Loan Officer

The amount of loan, term, and repayment plan are decisions made by the loan officer. The credit of the borrower, his resources, future earning capacity, integrity, life expectancy, and the relation of the debt to his financial ability to pay are of no concern to the appraiser. To relate the property to the borrower in its ability to meet the needs of the borrower, to advise on the good or bad judgment of the borrower in purchasing or mortgaging the property, are mortgage lending functions. To request the appraiser to change his estimate of value in order to meet a requirement of more or less loan, shorter or longer life is improper. The loan officer

shirks his responsibility when such requests are made. If the lending officers do not have confidence in the judgment of the appraiser, the answer lies in the employment of a better appraiser or better lending officer. If the estimate of value is correct, the work of the appraiser should not be sabotaged nor made subservient to the wishes of the lender.

The mortgage lending officer and the appraiser have a relationship of integrity. A confidential relationship should exist between them. Their responsibility is a joint one, and their cooperation should spring from like experience and training. One must not dominate the other, but work in harmony for the common objective of better mortgage lending practice.

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