

## CRE'S VIEWPOINT

# Moses Where Are You?

by Bruce P. Hayden, CRE

Market value recently was redefined by federal law, and this redefinition makes it appear that we may be headed into an uncharted wilderness. This treatise will not attempt to provide any charts for the new territory, but it will identify some of the issues that need to be considered in preparing such material.

Evolutionary and revolutionary changes brought about by well-discussed problems in financial institutions, have resulted in the enactment by the U.S. Congress of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, commonly referred to as FIRREA. This act, in turn, has brought about a redefinition of "market value" as it has long been defined by the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers in *The Dictionary of Real Estate Appraisal* (1984 edition). The redefinition—which was made by the Federal Reserve Board and agreed to by the Federal Deposit Insurance Corporation (FDIC), Resolution Trust Corporation (RTC), Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS)—became mandatory for federally regulated lenders on September 19, 1990. Adopted almost verbatim was the definition recommended by The Appraisal Foundation in *Uniform Standards of Professional Appraisal Practice*, 1990 (USPAP), which will be quoted later in this discussion. This redefinition, as yet, has neither been thoroughly tested nor accepted by the appraisal industry for uses other than those for which it is mandated. It raises issues concerning:

- appraisal procedures, which may change in the light of USPAP and the use of new definitions mandated by the Federal Reserve Board for all federally regulated financial institutions;
- legality, which may be in question particularly with regard to the state and federal courts' willingness to accept the Federal Reserve Board's mandate and to apply these standards to non-regulated transactions;
- liability of appraisers, counselors, investment advisors—and their insurers—which may arise because of "competency provisions" in USPAP;
- licensing of appraisers, wherein each state will be required to set up new commissions that are totally divorced from existing banking and real estate commissions and on which anyone

connected with an affected industry will be ineligible to serve.

All of these will have to be addressed in the light of a national political and economic situation that—for the few real estate practitioners active today who experienced the Great Depression of 1929-1942—more and more appears to be "deja vu all over again," in Yogi Berra language. As to these major changes, a look back to 1930 may be useful.

### Remember When. . .

The Roaring Twenties were a period of great prosperity. People were rich who never expected to be, and the living was easy. Laws were treated with contempt; banks were flush with money; stocks were at all-time peaks; happenings in Wall Street were more significant and attention-getting than those in Washington, DC. "The sky was the limit."

Beginning with the stock market crash in late 1929, an erosion of public confidence turned into a tidal wave of economic collapse; most of the nation's commercial and savings banks and building and loan societies went under; major companies disappeared forever; millions of people became unemployed; bread lines proliferated. "Brother, Can You Spare A Dime" became the hit song of the early 1930s.

The Great Depression brought about a great political revolution. Hapless Herbert Hoover and the Republican House and Senate were replaced by Franklin Delano Roosevelt, the New Deal and the Democrats. Yet the more things changed, the more they stayed the same.

For real estate, the Thirties were a period of total disaster. The market for single family homes went sour: the \$5,000 "3 BR—1 B" home of 1929 went for \$1,500 fewer than ten years later... if one could find a buyer. Loans on apartment buildings were foreclosed by lenders, many of whom proved to be less able managers than the buildings' developer-owners. Store properties, whether on Main Street or in small neighborhoods, stood vacant. Like the new skyscrapers in New York and Chicago, the 12-story new buildings in Flint, Toledo and Omaha were closed.

Worldwide depression ruled. With it came political revolution in Germany; Labour governments in Britain and many other countries; Hitler and

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Mussolini; and the relegation to the political minor leagues of Winston Churchill. In the Far East, Japan prospered, overran Manchuria, parts of China and many of the Pacific Islands, and dreamed of world dominance. Although Europe, with the exception of Britain, had substantially recovered by the mid-1930s, things improved only slightly in America, despite Herculean efforts and revolutionary changes effected by FDR and the Depression-era Congress. It was the start of World War II in 1939 and America's resulting war preparedness drive that finally brought the Great Depression to its end.

### What Has Changed?

Are we faced with similar prospects for the 1990s? Although 1930 and 1990 do have many similarities, in many respects, the United States is less well off today than it was in the 1930s because of such problems as:

- drug addiction and a resulting increase in major crimes;
- tense interracial relationships despite much progress toward racial equality;
- badly eroded national educational standards and achievements;
- deeply troubled financial institutions;
- an astronomical national debt;
- increasing competition with Germany and Japan for industrial leadership.

What does all this have to do with us and our clients for real estate counseling, real estate appraising, registered investment advisory services, tax assessments—and how our state and federal courts will judge these problems? EVERYTHING.

Our current political, economic and other problems affect the major conditions that prevail in the real estate marketplace and the way in which real estate is assessed and financed.

It is widely recognized today that the appraisal process for determining market value is not working well because conditions in the U.S. economy and in the world of real estate have nullified a number of the major assumptions inherent in that process as established by the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers. USPAP standards help, but they do not solve the problems.

In fact, one of the East's leading appraisers, Edward F. Heberger, CRE, MAI, said recently:

The appraiser today is faced with the job of determining "market value"—when there is, in reality, no market value as we have known it. There are two values today: "Investment value" for the property that is of interest to the major pension and endowment funds, and other institutional investors. This type of property can still be appraised by the three-approach technique, but with much the heaviest weight assigned to the discounted cash flow or net present value approach. For the non-institutional type property, the only value is "market price"—which today equates to "liquidation value". This value can be only approached by analysis of recent sales, if any, of similar properties.

Furthermore, a recent communique released by a major New England bank about its commingled real estate fund, states:

It has been the fund's practice to appraise each property annually...by appraisers carefully selected by the bank who are qualified as members of the Appraisal Institute. Values submitted are then reviewed by a Valuation Committee composed of two outside consultants and a senior officer of the bank.

This process has been appropriate in the past; recently, however, falling rents, the unavailability of financing and the withdrawal of buyers have resulted in uncertainty in the appraisal process.

To pursue further the problems and difficulties in making the appraisal process work, let us review the Proposed Regulation on Uniform Appraisal Standards promulgated by the Federal Reserve Board and published in the *Federal Register* (Vol. 55, No. 36, February 22, 1990). These standards require that all appraisals be written and that they conform to the USPAP. The Federal Reserve Board regulation adopts the definition of market value as prescribed by USPAP:

Market value means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. Buyer and seller are typically motivated;
2. Both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest;
3. A reasonable time is allowed for exposure in the open market;
4. Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
5. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

As to each of the above, I believe questions can and should be asked, in the light of prevailing conditions:

1. Is it reasonable to assume that most buyers and sellers today are "typically motivated"? Is the financial institution, under great regulatory pressure to "clean up its non-performing loan portfolio," typically motivated? Is the "bottom fisher" purchaser or the owner-seller typically motivated who is unable to pay his debt service, but is still trying to salvage something?
2. The "best interest" for either buyer or seller may be survival.
3. For a high percentage of sales today, there is no such thing as an open market.
4. With either buyer or seller or both under extreme pressure, "financial arrangements" are all over the map, depending on who is being pressed the hardest.
5. In most markets today and for most properties, the term "normal consideration" simply does not apply. If a deal is to be made, it is most apt to be done with concessions or special or creative financing.

How then will the appraiser respond to his assignment as expressed in an engagement letter which necessarily and properly requires the appraiser to do his work by USPAP standards?

What of the legal issues involved? How will 50 state court systems and the federal courts rule in the future—particularly on appraisal, counseling or investment advisory cases that do not involve questions affecting the Federal Reserve Board, RTC, FDIC, OCC, OTS or other regulatory agencies?

Will all courts readily accept the Federal Reserve Board-USPAP definition of market value—whether or not conditions are such that market value, as defined, can be readily determined? Will the 1984 AIREA-SREA definition of market value be abandoned? If not, will opposing counsel select and argue for a definition of market value which best suits the case?

If, in fact, conditions are such that neither definition of market value will be applied consistently, how will a court proceed? How much leeway will opposing counsel have in arguing a case?

When the ill-defined term “investment value” is most appropriate to the circumstances, will any court accept it? Must each court make its own definition of this term and reach its own decision?

What added liability, if any, falls upon appraisers, investment advisors, real estate counselors? How is it measured? Can it be insured against? Will recommendations that are made in good faith in 1990 be judged with 20/20 hindsight in 1997, when achieved results may be far short of the results projected in the recommendations? In a recent case involving an action brought by a federal agency against a prominent appraiser, a federal court ruled that “clairvoyance is not one of an appraiser’s duties”; the regulatory agency involved appealed the decision.

What liability questions may be raised by the fact that USPAP, for the first time, formally raises the question of “appraiser competency”?

The competency procedure as specified in Chapter I of USPAP requires that, prior to acceptance of an assignment, the appraiser must identify the problem to be addressed and possess the knowledge and experience needed to perform the assignment competently. The comment section states that “the background and experience of appraisers varies widely, and a lack of knowledge or experience can lead to inaccurate or inappropriate appraisal practice.” In this connection, it is interesting to note that *The Appraisal of Real Estate* (8th edition, American Institute of Real Estate Appraisers) does not index the word “compe-

tency.” Perhaps the institute assumes that any MAI can appraise competently any type of real estate and any single one of the many rights in the “bundle of rights” which together constitute real property.

Whatever original assumptions were made concerning competency, the fact that it is being required for an appraiser, in effect, to certify his competence—and the fact that 28 lines of small type in the USPAP comment section discuss the competency provision—appear to open up a new area for legal challenge.

What *licensing* and certification problems may be inherent in the Federal Reserve Board’s regulations implementing the conditions of Title XI of FIRREA? According to Title XI, all states will be required to implement a licensing, certification and supervisory mechanism for avoiding even potential conflicts of interest. This mechanism must be established through appraisal regulatory functions that are independent of any other real estate regulatory function. Preferably, this totally independent agency will be answerable only to the state’s governor or a member of his cabinet, and it will promote the independence of the appraisal regulatory function, reduce conflicts of interest and address [read “prevent”] the grandfathering and dual licensing of appraisers...to provide maximum insulation for the agency from influences of any industry or organization whose members have a direct or indirect financial interest in the outcome of the agency’s decision (hereinafter “affected industry”).

It seems likely that anyone who is active in any phase of the real estate business, including counseling or financing, will be engaged in an “affected industry.” It should be interesting to see how these new licensing boards and commissions will be established and how they will work, if all who have knowledge and pertinent experience will be precluded from serving on them.

With major changes in appraisal definitions, regulations, legal processes, competency requirements, liability risks and certification and licensing procedures and with storm signals flying for the economy, we are finding ourselves on the edge of the wilderness; we are steadily moving more deeply into it; no one is able at the present time to chart the course through the wilderness.

Moses, where are you?