JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

I. MANUSCRIPTS

C. Published Journal Articles

20. "Hearings on the Real Estate Appraisal Reform Act of 1987, H.R. 3675", Committee on Government Operations, Feb/March, 1988

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February 25, 1988

TO: The Committee on Government Operations, 100th Congress
First Session

FROM: Professor James A. Graaskamp, Ph.D., SREA, CRE
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RE: IN SUPPORT OF H.R. 3675 TO ORGANIZE AND CONSOLIDATE FEDERAL MATTERS RELATING TO APPRAISALS IN LEGISLATION TO BE CITED AS REAL ESTATE APPRAISAL REFORM ACT OF 1987.

I. Credentials and Bias of the Commentator.

II. Statement in Support of Legislation as Drafted.

III. Response to Arguments in Opposition to Legislation as Drafted.

A. Fragmentation of Appraisal Profession undermines capacity to define standards, certify appraisers, to enforce sanctions, and to finance reform.

B. The historical weakness of appraisal organization has been and will be exploited by the powerful political organizations who represent primary customers for appraisal services and who have a vested interest in preserving a compliant appraisal trade with the trappings of independence.

C. There is a traditional, pervading anti-appraisal bias of mortgage loan officers who are represented by the powerful alliance of significant lobby groups including the ABA, USS&L, MBA, NAR, and NAHB at both Federal and State levels.

D. Real estate transactions and developments are driven by the commissions and fees of the deal makers rather than effective demand for space, which is the subject matter of appraisal. If accounting could trace the source and application of mortgage funds, it is probable that the losses of FDIC and FSLDIC represent the fees paid those who would oppose rigorous appraisal.

E. Citizens can sue doctors, lawyers, and accountants, who must finance malpractice claims with huge private insurance premiums and lose their licenses. However, the federal taxpayer will fund the deficits of FDIC and FSLDIC caused by negligent loan officers and compliant appraisers. Who will pay the employees of the defunct lender or the property owner whose net worth is crushed by an over supply of unneeded, newly built, competitive space?

F. The need for efficient allocation of capital, safety of the depositor and established real estate investor, as well as protection against insider profits in the banking industry, require congressional action on H.R. 3675 as drafted.

I. Credentials and Bias of the Commentator.

Our presentation to the committee is prompted by a career in developing appraisal theory, practice, and education, and not as a member of any professional group. We are here at our own expense other than travel monies provided by the University outside funds as the Dean of the University of Wisconsin Business School felt that educators have a significant vested interest in advancing contemporary methods and education for the appraisal process.

The resume in Appendix A will speak for itself, but it should be noted that we have received the highest awards for appraisal education and improvements to appraisal theory from the Society of Real Estate Appraisers, the American Institute of Real Estate Appraisers, and Lambda Alpha, the national honorary fraternity for urban land economics. Much of our consulting activity involves the use of appraisal in litigation, securities fraud, pension real estate, and bank lending on commercial investment properties. We have read hundreds of appraisals for investment properties by all the major appraisal firms on properties located from coast to coast. The general quality is from poor to average. Our conclusion has been that the majority of clients find appraisal mysterious, manipulative, and hopefully a tool for advocacy. The fees are too low for a professional piece of work because the clients seldom perceive the value added by careful research of the real estate market and the property. The lender will require at least one percent (1%) of loan proceeds for fire insurance in case the collateral should burn down but would never spend one percent (1%) of project cost to be reasonably certain the project would rent up. But the rental market is the true source of collateral value; many lenders today can only hope that their real estate interest burns down.

Our bias is that appraisal reform must be brought about by demand pull so that major clients for appraisal services, such as lenders, pension funds, and public agencies acquiring properties by eminent domain must be forced to recognize their own economic self-interest and to purchase responsible appraisal services at prices that justify responsible, professional appraisal work.

II. Statement of Support for H.R. 3675 of Real Estate Appraisal Reform Act of 1987.

Sound appraisal practices are critical to the security of our financial institutions and pension programs as well as the efficient allocation of capital in our economy. Sound appraisal practice is a fulcrum of social equity in matters of real estate taxation, eminent domain compensation, and allocation of costs and benefits of public infrastructure. Nevertheless, the appraisal process is controlled by 19th century economic theory, regulatory anarchy, and self-serving clients who desire advocacy rather than objectivity from presumably independent appraisers. To talk of appraisal reform is to expect massive business culture reform and social engineering of mind sets, economic interests, and juvenile concepts of enterprise that can only be accomplished by Federal intervention. With time, the Federal role of creating objective review of appraisal standards and certification requirements could be returned to the private sector once the real estate industry had learned it could survive with truly independent, professional appraisal services.

The creation of a Federal Interagency Appraisal Council is a timely and critical catalyst for much needed reform of the appraisal process, which has become parochial, paralyzed by internal, self-serving political struggles, and subverted by the investment industry to protect the fees of loan officers rather than the funds of savers. None of the Federal regulators as individual agencies have been able to withstand the internal political pressures created by the regulated in order to establish meaningful reforms of appraisal methods, the appraisal role in the lending process, and the independent role of the appraiser as a check on counterproductive incentives to make marginal loans. The diverse interests of the Council would prevent a travesty such as the recent repudiation of R-41C by the Federal Home Loan Bank Board. The arguments presented by Chairperson Dennis Wall were that appraisals performed to the standards required of R-41C were not cost effective in terms of competitive costs relative to the banking system, a statement which is no less astonishing when you consider that the lenders expect a Federal Agency and Congress to pay the $25-50 billion loss which can be attributed to the implicit conspiracy of loan officers/developers/ appraisers. These forces would have more difficulty subverting a Council of diverse interests and constituencies. In the future, the Council can be expanded to include the Internal Revenue Service, the Federal Highway Department, and other agencies involved in eminent domain acquisitions.

Of critical importance for implementation is the time pressure applied in the proposed legislation to provide appraisal standards and certification standards for review within twelve months of enactment and for installation within eighteen months. Any effort by the private industry will be deliberately stalled and extended for reasons to be discussed below. The enormous funding required for putting an adequate system in place is covered by a Federal loan for $19 million which could never be assembled by the private sector in a timely fashion. The historical <u>volunteer</u> efforts of the private professional appraisal groups have worked at a glacial pace and is a significant factor in the current vacuum of appraisal standards and enforcement. Where would the appraisal industry raise $19 million to fund a huge two-year effort? How soon could the private industry have an effective program without the money to employ full-time professionals to inaugurate the program? Only a Federal Council can enforce collections of fees and charges to support long-term funding of the program as contemplated by the legislation. The industry admits the cost to penalize abusers with existing designations has been a prime factor in the breakdown of private enforcement sanctions, so where would the money be found to install and to impose regulation if States fail to act as required by the industry proposal? It is important that a centralized Federal Council can operate to certify and to sanction those who abuse if the States fail to act since most States will fail to act for reasons discussed below. Nevertheless, States should be given the opportunity to be responsible legislators.

III. Response to Arguments in Opposition to Legislation as Drafted.

The appraisal profession is fragmented and lacks the institutional capacity to define standards, to certify appraisers, or to enforce sanctions on those who abuse designations. The current effort of eight appraisal organizations to create a foundation and model of self-discipline in the image of the certified public accountant is doomed to delay, dilution, and defeat for lack of funds to pay full-time staff, lack of consensus within a profession that has fought merger for years, and lack of legal clout to control its customers or designated members.

Appraisal reform is a Legislative issue that will generate significant resistance from a variety of trade organizations who have a vested interest in the status quo as stated above. None of these professional groups speak for the practicing appraisers in the field who have integrity and competence and who need and desire Federal Assistance to protect their independence and objectivity from mortgage lenders, real estate brokers, builders, and developers. Congress should recall that the Independent Society of Real Estate Appraisers has testified in favor of H.R. 3675 because these appraisers recognize that the professional organizations cannot impose sanctions without a power of subpoena, disclosure, and freedom from counter suits against those appraisers who pander to those parts of the industry that make their living from fees, commissions, and salaried bonuses based on volume. The position of the American Institute of Real Estate Appraisers (AIREA) is totally compromised because it is dominated by its parent organization, The National Association of Realtors, and because many designated members of AIREA are loan officers rather than independent appraisers.

We submit that the goals of most professional appraisal organizations to maintain their prestige, control of standards, and cash income from membership is in conflict with the goals of its competent individual members who are unable or unwilling to do appraisals for mortgage lenders at the cost of objectivity and independence. We have talked to dozens of designated members who believe that Federal involvement is the only hope for realistic reform and for public sanctions against tractable appraisers. Appraisers who think for themselves recognize the platitudes of the professional societies as the conditioned response of American business to any suggestion of government regulation.

There are natural institutional disincentives for thorough and objective appraisals which have been discussed in a symposium conducted by the Lincoln Institute in Cambridge, and a monograph on that subject, which we prepared for that symposium, is provided in Appendix B. There is a deep anti-appraisal bias among mortgage loan officers who state that appraisals are a necessary evil for regulatory purposes. The appraisal guidelines issued in January, 1988 by the FDIC, Federal Reserve and Controller of Currency reveal this bias blatantly in the statement

> "...undue reliance should not be placed upon the collateral value in lieu of an adequate assessment of the borrower's repayment ability..."

The lenders issue non-recourse loans on commercial properties and yet disregard the reliability of cash flow from the property as the source of repayment. Even the President of the American Institute, Terrell R. Oetzel, commented editorially in the December, 1987 issue of The Appraiser, as follows:

> On August 10, 1987, the Competitive Equality Banking Act of 1987 was signed into law. This act directed the Federal Home Loan Bank Board to implement appraisal standards consistent with the appraisal standards of the federal banking agencies. Quite frankly, the federal banking agencies do not have any appraisal standards. Therefore, the Federal Home Loan Bank had to withdraw their proposed rule (R41-C).

If the bankers and mortgage bankers sincerely wanted to improve mortgage loss ratios, they could have moved toward competitive equality by adopting the standards set by R41-C. Training of auditors to look for standardized appraisal methods that were the same for all members in all states would facilitate audit efficiency, appraiser understanding of his assignment, and consistent documentation for mortgage finance in the national capital markets. Instead bankers forced a rule that allows every institution to have their own definition of a prudent appraisal policy - the same rule that will cost the Federal Government $25-50 billion dollars to refinance FDIC and FSLDIC.

Defeat of rigorous appraisal standards is a major policy, albeit unwritten, of The American Bankers Association (ABA), U.S. Savings and Loan League (USSLL), The Mortgage Bankers Association of America (MBA), The National Association of Realtors (NAR), and the National Association of Home Builders (NAHB). We have taught hundreds of their members over the years and we are currently the Nominal Dean of Real Estate Finance courses for the ABA on the University of Wisconsin Campus each July. Few of these students are interested in learning how to critique an appraisal and they all know how to shop an appraisal for the right value commitment by the appraiser.

These same professional real estate associations control state legislative committees and generally have great influence in the Office of the Governor of each state, so that if they are unable to frustrate H.R. 3675 by crippling amendments or outright defeat, they will dilute and delay state legislation necessary to put permanent certification and enforcement into operation at the state level. We would suggest to you that if it were possible to retrace the source and application of all mortgage funds that have gone awry, that brokerage commissions, lender fees, developer profits and leasing commissions, and other profit centers would represent the $25-50 billion that will be funded eventually by the Federal Government Agency insuring the lending institution. No wonder so many sectors of the real estate industry fear rigorous appraisals and objective market studies as a test of any transaction.

The sanctimonious defenders of American tradition argue that lawyers, doctors, and accountants are not regulated by the Federal Government, but then those who are hurt by the negligence of lawyers, doctors, and accountants can sue for damages, sue to withdraw their licenses, and collect from insurance resources that do not include billions of federal dollars. Who does the depositor or the out-of-work employee of a bankrupt financial institution sue for damages done by an appraiser? How often does an appraisal organization successfully remove the designation of its own member? Who but the Federal Government provides significant insurance for the damages of malpractice by the loan officer and his implicit conspiracy with the borrower and the appraiser?

The conventional wisdom is that economic progress requires risk taking and the real estate industry lenders want Congress to take all the risks. At the moment the Federal Government lacks the laws and administrative powers to punish even the most fraudulent judgments by loan officers, appraisers, and borrowers. Another conventional wisdom of American business culture is that those who pay the piper get to call the tune and in real estate mortgage lending Congress and the tax payers are expected to pay the piper. Therefore, the taxpayer has every right to require real estate appraisal reform by H.R. 3675. The citizen has every right to impose banking rules which promote efficient allocation of scarce capital, which provide safety incentives for savers, and which prevent insider profits more blatant than those in the stock market.

JAMES A. GRAASKAMP

PROFESSIONAL DESIGNATIONS

SREA, Senior Real Estate Analyst, Society of Real Estate Appraisers

CRE, Counselor of Real Estate, American Society of Real Estate Counselors

CPCU, Certified Property Casualty Underwriter, College of Property Underwriters

EDUCATION

Ph.D., Urban Land Economics and Risk Management - University of Wisconsin

Master of Business Administration, Security Analysis - Marquette University

Bachelor of Arts - Rollins College

ACADEMIC AND PROFESSIONAL HONORS

Chairman, Department of Real Estate and Urban Land Economics,
School of Business, University of Wisconsin
Urban Land Institute Research Fellow
University of Wisconsin Fellow
Omicron Delta Kappa
Lambda Alpha - Ely Chapter
Beta Gamma Sigma
William Kiekhofer Teaching Award (1966)
Larson Teaching Award (1985)
Alfred E. Reinman, Jr. Award - Society of Real Estate Appraisers (1986)
Charles B. Shattuck Memorial Award, AIREA (1987)
Urban Land Institute Trustee
Research Committee - Pension Real Estate Association (PREA)
Richard T. Ely Real Estate Educator Award from Lambda Alpha
Homer Hoyt Foundation Fellow

PROFESSIONAL EXPERIENCE

Dr. Graaskamp is the President and founder of Landmark Research, Inc., which was established in 1968. He is also cofounder of a general contracting firm, a land development company, and a farm investment corporation. He is formerly a member of the Board of Directors and treasurer of the Wisconsin Housing Finance Agency. He is currently a member of the Board and Executive Committee of First Asset Realty Advisors, Inc., a subsidiary of First Bank Minneapolis. He is the designer and instructor of the Urban Land Institute (ULI) School of Real Estate Development and the American Bankers Association (ABA) National School of Real Estate Finance. His work includes substantial and varied consulting and valuation assignments such as investment counseling to insurance companies and banks, court testimony as an expert witness and the market/financial analysis of various projects, both nationally and locally, for private and corporate investors and municipalities. Currently is a member of Salomon Brothers Real Estate Advisory Board.