

Cost Approach Industry Survey

OVERVIEW:

The following is based on an industry wide survey conducted by the Real Estate and Lending Division of Strategic Development Worldwide, a San Diego based consulting firm, sponsored by the Bluebook International of Lake Forest, California.

The objective of the survey was to understand industry expectations of appraisers, and practices of lenders as a result of the changes in the URAR 1004 specific to the Cost Approach. Respondents included Chief Appraisers for prominent national lending institutions, nationally based appraisal management companies, and independent fee appraisers. The responses presented below have been aggregated and summarized.

QUESTION #1: *What are the issues you see with the Cost Approach, either continuing to use it or eliminating it from the appraisal process?*

General Consensus: *The Cost Approach should not be eliminated when it can be done accurately, and when its use is appropriate. Most appraisers do not perform it correctly and is not valid most of the time.*

Additional Comments: The majority of lender respondents held the opinion that the Cost Approach is typically not valid because it is not completed correctly. About half of the respondents stated it is appropriate to use and can be accurate for new construction because depreciation does not affect the calculations. Most feel that appraisers typically do not actually extract depreciation, making the Cost Approach on older homes much more likely to be inaccurate than with newer construction.

The general opinion is that the cost to replace new calculations in the Cost Approach do not reflect local building costs. Many also identified that there is a lack of actual land sales available for appraisers to determine the site value accurately.

Many appraisers share the opinion that they prefer to supply the Cost Approach only when they determine it to be applicable or credible, and determining its use should be at their discretion. However, they do have clients that require it be supplied whether applicable or not. A minority of appraisers indicated that they supply it because they always have. Most appraisers indicated that their clients did not appear to know if they needed it or not. This may be skewed based on the number of clients who i) are mortgage brokers and are either unaware of what their client needs, or ii) are not sure yet which lender they will be submitting the loan to.

Other comments of significance were (i) it is never relied upon in the final value estimate, (ii) it is useful for quality checks on the appraisers work, and (iii) eliminating the Cost Approach should not affect lenders getting the proper hazard insurance amount.

QUESTION #2: *Do you think that most appraisers "back into" the numbers? Why does this happen?*

General Consensus: *Yes, most appraisers "back into" or "wing" the numbers. The most frequent reason cited by the respondents was that appraisers (i) do not want to spend the time doing it right (faster to wing it), and (ii) they don't know how to do it properly.*

Additional Comments: responses as to why it is believed that appraisers "back into" or "wing" the numbers can be divided into three categories (i) appraiser issues, (ii) Cost Approach & market issues, and (iii) industry issues.

- o Appraiser Issues
 - Appraisers believe lenders won't tolerate large variances between market value and Cost Approach.

- Appraisers don't understand and/or are not willing to take the time to explain differences in values between market value results and Cost Approach results
 - Figuring depreciation is confusing and difficult
 - Most appraisers have not been trained properly how to do a Cost Approach
 - Appraisers don't understand how to use the cost services correctly
 - Some appraiser don't use the cost services although they list them as having been used
- Cost Approach / Market Issues
 - There is a lack of reliable land sales making the land value difficult to determine.
 - There is a general lack of accurate support for all the numbers in the Cost Approach
 - Industry Issues
 - The industry has not stressed the Cost Approach creating a climate where appraisers don't consider it to be an important part of the process in practice
 - No one checks the Cost Approach calculations
 - Up until recently the industry has not discussed the use of the Cost Approach for insurance purposes, and most appraisers were not aware of its use by lenders and insurance companies.
 - Traditional software used by appraisers makes it easy for the appraiser to back into the approach
 - Underwriters are not always willing to accept explanations as to why there is a substantial difference between the cost and market approaches so appraisers have adopted the attitude that it is just easier to back into the numbers and make the approaches match.

QUESTION #3: How do you prefer the appraisers handle the Cost Approach information and calculations?

General Consensus: *Appraisers should use cost manuals and on line services from reputable and nationally recognized cost sources and supplemented by local building information. Land values should be obtained from are market data and sources should be documented.*

Additional Comments: Some lenders also comment that replacement cost new would be adequate if no land sales were available, however this is not a comment received from all lenders who responded. Many require site value to be included.

Appraisers that responded indicated that they used cost manuals, free internet cost estimate sites and local contractors for their information. Most stated that they abstracted the land value.

QUESTION #4: What is your opinion about the Fannie statement referring to appraisers aiding lenders to determine the correct amount of hazard insurance (FAQ #12)?

General Consensus: *Most respondent lenders believe it is risky to rely on the Cost Approach for insurance purposes and it is not the responsibility of the appraiser to provide. A smaller group of lenders had no issue with the appraiser performing the Cost Approach for insurance purposes provided it was done correctly.*

1. Lenders that think it is risky also stated:

- (i) it is not reliable for insurance purposes because cost services don't reflect local building costs;
- (ii) consumers are not protected when the Cost Approach is weak;
- (iii) using the appraisal for something other than its intended use is dangerous to the appraiser, the lender and the consumer;
- (iv) the lender should take responsibility for the amount of insurance on a loan;
- (v) the appraiser has a right and USPAP obligation to know what the intended use of the appraisal is;
- (vi) appraisers are not insurance agents/adjusters insurance companies and should not be expected to supply for insuring the property;
- and (vii) figure used for hazard insurance purposes is only one piece of Cost Approach to value.

2. Lenders that don't have an issue with using the Cost Approach for insurance purposes also stated:

(i) Appraisers only need to supply the cost to replace new figure in the URAR 1004; (ii) If properly performed, is an added value the appraiser can provide the lender; and (iii) Appraisers should be able to accurately calculate figures.

Additionally, the secondary market respondents all felt that the lender opened themselves up to liability by relying on appraisers to supply the correct figures. Many of the large secondary market purchasers specifically state in their portfolio purchase requirements that the lender is expected to take the responsibility for the insurance amounts, because that is what the secondary market is assuming when they purchase a portfolio of loans. If there are problems, they expect the lender to be responsible for the insurance amounts, which is why they include it in their documentation requirements. The secondary market respondents did not believe appraisers should be held responsible for the insurance amounts derived from their Cost Approach calculations.

The appraisers who responded tended to disagree on whether or not they should supply a Cost Approach and whether or not they should be able to charge additional fees for it, but all agreed that there was a problem using it for insurance decisions.

QUESTION #5: *Is there an issue with intended users in relation to the Cost Approach and use of the calculations for insurance purposes?*

General Consensus: *Most lenders believe there is an issue, and a potential risk to all parties because of its assumed inaccuracy. Additionally, most lenders reported that in their opinion, the intended user is anyone ins the mortgage process other than the borrower. Appraisers no not consider that the portfolio purchasers are also an intended user.*

Additional Comments: Appraisers did not seem to be able to agree on the intended user issue. Some reported that there is no issue if the cost to replace new is done properly, while others reported that it is generally accepted practice for insurance companies and lenders to rely on the cost to replace new for insurance purposes. This may substantiate the lender claim that the appraisers don't necessarily understand the issues of how far down the chain the appraisal is used – intended users often times include portfolio purchasers. However, the majority of appraisers do not consider the insurance company to be included as an intended user which is most relevant for the purposes of this survey.

QUESTION #6: *What do you see is the effect (if any) of the appraiser putting in a disclaimer with regard to the Cost Approach being used for insurance purposes?*

General Consensus: *Most lenders reported that a disclaimer would not deter their use of the Cost Approach for insurance purposes.*

Additional Comments: lenders felt that it was not a problem that appraisers put disclaimers on the appraisal in regard to the Cost Approach and want the documentation/comments as to how it was calculated. Many lenders felt that the disclaimers were too broad and it was sufficient to state that more accurate estimates for insurance purposes could be obtained elsewhere.

E&O companies are recommending that appraisers include a Cost Approach disclaimer on their reports.

Appraisers are more typically putting disclaimer comments included with the Cost Approach. While the appraiser is unsure of how well it will protect them, they feel that by not including one, it leaves them open to significant liability.

A small minority of lenders reported that the use of the Cost Approach for insurance purposes puts the appraiser in a bad position and creates additional liability as a result of its "dual –use".

There have been some incidents reported, but not substantiated, that lawsuits have been avoided by appraisers who have included disclaimers with regard to use for insurance.

QUESTION #7: Does anyone in the operations group in your organization typically obtain the insurance policy to review for adequate coverage?

General Consensus: Some lenders do obtain the insurance policy for review and others don't. It is frequently done in underwriting rather than in the appraisal department.

QUESTION #8: Are there E&O insurance issues for the appraiser in the Cost Approach being used for insurance purposes?

General Consensus: The survey participants were split on this issue.

Lenders:

Lenders were not particularly concerned with this issue. Some felt that if the Cost Approach was done correctly there wouldn't be a liability problem if it were relied on for insurance purposes. Others (are who) understood the potential liability for the appraiser.

Appraisers:

Most appraisers felt that there were liability issues and were relying on the disclaimer to extricate them from any problems. It was expressed that additional guidance from E & O Companies on how appraisers could protect themselves and handle these situations would be helpful.

Secondary Market:

It is significant to note that secondary market participants reported that they would not hold the appraiser liable if there was a problem with the insurance amount, but would look to the lender to take responsibility.

QUESTION #9: Would you be interested in an accurate Cost Approach that is a stand alone product supplied by the appraiser that could be used in combination with a full appraisal or other types of valuation products?

General Consensus: Yes, however cost was a big factor.

Additional Comments: Most lenders expressed interest in a cost to replace new report separate from the appraisal that could be relied on as accurate for any purpose. Some were willing to pay for the report while others were not. Some were willing to pay the appraiser to supply it and others were interested in obtaining it directly from a cost-data supplier. They wanted to be sure that the report would be able to accurately supply local building costs.

The most frequent concern about a new product was implementation into their current systems and the training necessary. Cost was frequently brought up as a concern.

Several mentioned that a good product would be reproduction or replacement cost new in bulk for loan pools.

Generally, appraisers report that they find their clients are unwilling to pay extra for the Cost Approach or a related product. A separate Cost Approach product may be more likely to sell to the lender directly. Because mortgage brokers are in the middle of a transaction, they do not have an incentive to spend additional dollars.

Some appraisers indicated that they do not use the 1004 form for the cost calculations, but rather supply the information in a spreadsheet as an addendum to the report. This happens regardless of whether or not they intended to charge additionally for the work.