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CHAPTER 3

Appraisal Policies

APPRAISAL policies received little attention while the Home Owners' Loan Corporation legislation was under Congressional consideration. Yet the success of the HOLC in its over-all program and in its handling of individual cases hinged on its appraisal policies. The lower the valuation placed on properties, the less the HOLC's risk, but the fewer the home owners who could be benefited and the greater the sacrifice required of the former lenders. On the other hand, higher valuations exposed the HOLC to greater risks while extending more generous aid to home owners and to former lenders.

THE VALUATION STANDARD

There is no way of determining what Congress had in mind in empowering the HOLC to lend up to 80 percent of "value." As noted in Chapter 1, Mr. Russell, testifying for the Federal Home Loan Bank Board, argued that 80 percent of present value would be equivalent to roughly 50 percent of normal value and that, while a private lender might not give that high a loan, it was incumbent on the government to give this degree of help to the small home owner. The bill provided for no principle of valuation, but in early releases the Corporation stated that appraisals would be based on three factors, weighted equally: "(1) the market value at the time of appraisal; (2) the cost of a similar lot at the time of the appraisal, plus the reproduction cost of the building, less depreciation; and (3) the value of the premises as arrived at by capitalizing the monthly reasonable rental value of the premises over a period of the past ten years."[1] Probably without significant exception, the third value would be higher than the first; and, under the conditions prevailing in 1933, the second would not as a rule be lower than the first and would often be higher. The result, therefore, would be a valuation higher than

[1] *Loan Regulations,* Home Owners' Loan Corporation (Washington, 1933) p. 6. In capitalizing rentals no specific provision was made for discounting. See footnote 13 in this chapter.

the current market value. If not in principle, at least in application, the formula failed to take account of one important condition, namely, that, in those cases in which the HOLC would later acquire the property, the accumulations of interest, taxes, foreclosure costs, and deferred maintenance on the property plus the unpaid balance at foreclosure might exceed the reasonably probable sales price. If these matters had been as apparent to the HOLC in 1933 as they were to become a few years later, a less generous standard of valuation might have been adopted, even though there was general agreement that market prices would rise from the depression lows.[2] Other weaknesses, less of principle than of application, were to appear later—for instance, the failure to distinguish carefully between gross and net rents.[3]

Appraisal Organization

Speed was so important that the gradual development of an appraisal organization was out of the question. Although every community in the country had to be covered, in all but a relatively few there would not be over three or four dozen cases, distributed over several months or longer—not enough cases to require a full-time permanent appraiser. Centralization with full-time appraisers was undesirable, since familiarity with local conditions was essential. Yet both objectivity and impartiality were required. Persons with the greatest competence for each specific appraisal would tend to be those with local experience, probably in lending institutions or in real estate firms, but they would often be friends of the applicant, the lender, or both. Control was necessary, therefore, to prevent partiality or fraud and to enforce the new methods of appraising desired by the HOLC. The proposal to use a formula was, in fact, a rather novel procedure in appraising residences. The typical appraisal of a small- or medium-sized residence had apparently consisted of a more or less careful examination of the house and grounds and the setting of a valuation without detailed justification. In such cases, the appraiser's judgment and familiarity with local conditions had been considered

2 Even from the start, critical analysis would have shown that the HOLC needed a rising market to escape losses, although such a rise was to be expected. The risk assumed depended in part on the rate of amortization, but the shift from a fifteen-year to a twenty-five-year amortization period late in the thirties was less costly to the HOLC than expected due in part to the rise in property values that soon followed.

3 See Chapter 8, for a brief discussion of the later appraisal methods.

adequate, but the HOLC wanted information that would go beyond this.

To solve these problems, the HOLC decided upon a mixed system, using part-time fee appraisers except in large cities where full-time appraisers were employed, all to be under the direction of full-time appraisers. One or more part-time appraisers were selected for each county and paid a modest fee for each appraisal.[4] If the loan were granted, the fee was paid by the borrower; but if not, the Corporation paid it to avoid adding to the burden of a person already in distress and to give no inducement to appraisers to encourage the making of a loan merely to obtain the fee.[5] The appraisal report on each case was reviewed once or twice by a permanent, full-time HOLC appraiser, and some general field supervision of the local appraisers was exercised. For this plan to operate successfully, uniform procedures and standards had to be established and enforced.

The appointment of appraisers began in the late summer of 1933. Original selections seem to have been left to state managers, and no precise standards were enforced. Political pressure was at times effective in getting appointments for men with slight competence and insufficient objectivity. Many early loans were doubtless based on poor appraisals, but steps were soon taken to establish higher standards. In December 1933, the Corporation announced that, after consultation with the American Institute of Real Estate Appraisers, it had prepared regulations designed to get well-qualified local appraisers who had to meet one of the following qualifications: (1) at least five years full-time experience in real estate brokerage and appraisal; (2) at least five years experience as an appraiser of residential property for a banking or home-financing institution; (3) experience assessing residential property for the city, town, county, or state government; (4) qualification as an expert appraiser in court, membership in the American Institute of Real Estate Appraisers, or professional qualification as a builder or architect. Many months were needed, however, to rebuild the staff to meet these new qualifications.

Commenting later on this period, Mr. Fahey said, "A large proportion of the people in the organization came into this service without experience, and they had to be trained. . . . We found [that]

[4] During most of the original lending period, fees were about $5 per appraisal; later, the Corporation became convinced that a substantially higher sum was needed in most places, and the rate was raised to from $12 to $15.

[5] *First Annual Report,* Federal Home Loan Bank Board (December 31, 1933) p. 48.

a large proportion of those who were reputed to be qualified appraisers . . . had little experience and were quite unfitted to do this work, and we had to make changes. In order to carry on adequate training we had to more or less run schools in some sections of the country. . . ."[6] By June 1935, over 6,000 applicants for appraisal positions had been examined and rated, about 1,300 qualifying for salaried, and 2,700 for fee, positions.[7]

To help in training, as well as to maintain control, each appraisal was reviewed at a higher level at least once and ordinarily more than once, usually on the basis of data reported by the original appraiser rather than on a firsthand re-examination of the property. A review appraisal could raise a fee appraisal by not more than 10 percent, but there was no limit on reduction; field checks were also made by appraisers from main offices, sometimes without the knowledge of the local staff.[8]

The need for a large number of competent appraisers by no means disappeared when the last of the original loans was completed. Loans for reconditioning increased, and although the average loan in such cases was small relative to the original loan, the HOLC felt that the risks taken were large enough to require careful appraisals. Moreover, changes in property values, especially during the war years, questions of foreclosure raised by defaults, and problems of property management created by foreclosure required many reappraisals. The HOLC, therefore, needed and maintained a large though decreasing, staff of appraisers.[9] Extensive use of fee appraisers continued under the supervision of the permanent staff.

[6] U. S. Congress, House, Hearings before the Subcommittee of the Committee on Appropriations, *Independent Offices Appropriation Bill for 1938,* 75th Congress, 1st Session (1937) pp. 629-30. Mr. Philip Kniskern played a key role in developing the HOLC appraisal system.

[7] *Third Annual Report,* Federal Home Loan Bank Board (June 30, 1935) pp. 57-58.

[8] Published data on salaries of appraisers are incomplete, but it seems that to its full-time nonsupervisory appraisers HOLC paid, on the average in the early years, about $2,000 a year. State appraisers, whose responsibilities were heavier, received somewhat less than $3,600 a year. In 1937 the Chief of the Home Office Appraisal Section received $6,000 and regional appraisers about $5,000. There was some feeling at the time that these salaries would not attract and hold personnel of the high quality desired, especially as business improved.

[9] Its staff gradually acquired a reputation for competence and was called upon by other government agencies for reimbursable services. When the HOLC moved its headquarters from Washington during World War II, the War, Navy, Treasury, and Justice Departments asked that it set up a special staff in Washington to aid in appraisal problems. A staff was maintained for several years which appraised about half a billion dollars worth of property for other government agencies.

Appraisal Methods[10]

In developing its appraisal procedures, the HOLC attempted to devise and apply methods that would both guide individual appraisers and facilitate supervision and review. An informal appraisal—typically just a look at the property from the street—was the first step, to see if there was a reasonable prospect that the property would qualify for a loan. If the report was favorable, a detailed appraisal was ordered. For this purpose uniform appraisal regulations and a standard form and instructions had been developed by January 1934, early enough to cover about 95 percent of the cases on which the Corporation was to pass.

The form contained ninety-eight items (several with more than one query) to be filled in by the local appraiser, and eleven more items for reviewers. The requirement of specific answers, which was something of an innovation in appraising dwellings, compelled the appraiser to investigate certain factors which, presumably, affected his final valuation. Moreover, the forms standardized procedures and facilitated supervision.

The instructions to appraisers began with a warning against willful overvaluation, a paragraph emphasizing that the appraiser's first obligation was to protect the United States Government, to report fully and promptly on all matters bearing on the HOLC's interest, to keep full notes on each case and on real estate and building conditions generally, to make the appraisal independently of the amount of the loan requested, to be tactful and considerate, and to return the assignment if he had any interest in, or connection with, the applicant.

Each appraisal report was to contain a photograph of the building, a location map, and dimensions of the lot, such information about the neighborhood and property as would enable the "reviewing authority" very clearly to visualize the territory surrounding the subject property, and such facts bearing on the property's marketability as sidewalk and street surfacing, connected utilities, possible violations of building restrictions, the current bid prices for similar vacant land in the immediate vicinity, and the normal fair value of the land, as suggested by reasonable future use.[11]

10 The following summary is based on *Manual of Instructions for Appraisers*, Home Owners' Loan Corporation (Washington, 1934) *passim*.

11 The appraisal form provided for inclusion of the value of a detached garage. If there were other buildings of substantial value, a rider for each was to be attached to the form.

Instructions reminded the appraisers that, in general, cities had stopped growing, indicating the need for caution in estimating "higher potential use and value." Where this higher value was indicated, the appraiser was directed to take account of the time that would be required for this improvement to eventuate (allowing for carrying charges in that period) and to estimate the cost of removing existing buildings. The possibility of a downward trend of values was also to be reported on.

In valuing the buildings, the appraiser was directed to give the building code classification, if any, the material used (brick, frame, stucco, and the like), the quality of the structure (cheap, fair, good, or expensive), the number and kinds of rooms, repairs necessary to protect the structure as security for a long-term mortgage loan (with a rough estimate of cost), and an estimate of reproduction cost less depreciation.[12] As an alternative to reproduction cost less depreciation, and where it was lower, the appraiser might give an estimate of the economic value of the improvements, which was a normal rather than a current market value, taking into account, and explaining, all unfavorable factors, such as poor location, excess size and capacity, and special, related structures with poor marketability, such as swimming pools and greenhouses.

The final element in the appraisal formula—the capitalized value of rentals—called for the actual current rental value (unfurnished), the appraiser's estimate of a fair monthly rental, and the actual average monthly rental for the last ten years (the subject or a similar house in the neighborhood). A capital value was then computed on the basis of the ten-year average normal rental, the appraiser being told to use "the basis generally accepted or prevailing in the particular locality," an instruction which obviously left an important point to his judgment and that of his supervisors.[13]

12 To permit comparisons, the appraiser was required to make computations on the basis of square or cubic footage. Instructions provided general rules about what space was to be included, but the appraiser also had to report how the number of square or cubic foot units was determined. Reproduction cost was defined as the "present cost to produce the same building, computed on the probable contract price" under competitive conditions and assuming a reasonable amount of similar construction. Instructions indicated that "the percentage of depreciation [should be] based on the effective age of the building," regardless of date of construction.

13 Actual practice varied. In the early months, only one rental figure was, in fact, obtained—the normal or what the HOLC regarded as a fair figure for the last ten years. In some cases, the rental capitalized was the "reasonable" rental referred to in the

The HOLC formula appraisal—the arithmetic average of (1) the present market price obtainable (from a buyer with a substantial cash payment but not in a distress sale), (2) the reproduction cost minus depreciation, and (3) the capitalized rental value—was then computed. If the appraiser believed that the result did not give a fair value, he was to give his reasons.[14] He was also directed to state whether the improvements were adequate security for a long-term loan, to give his opinion as to the property's fair value as collateral for a first mortgage loan (keeping in mind the general principles of HOLC appraisals) and any additional relevant information on the property and the applicant.

The appraisal form also called for values assessed for tax purposes, taxes, unpaid assessments, and accrued interest charges.[15] The owner's appraisal, the preliminary appraisal, and the fee appraisal were noted together with the recommendations of the district appraiser and the chief state appraiser. The state manager indicated a final decision on the appraisal to be allowed and on the repairs to be made.

A credit report was obtained on each applicant from a commercial reporting agency giving information paralleling that provided by the applicant on the size of his family, his occupation and income, his age, color, and length of residence at the property. In addition, the credit report indicated the interest the applicant showed in the home, the experience of others in the community who had extended him credit, the applicant's standing as a moral risk, and his possible possession of other resources. Of the cases examined there were none where a bad moral risk was reported, suggesting that loans were

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original regulations, especially where the houses had not been rented. Actual rentals, where available, were used in other cases. Little, if any, weight was given to rentals at the time the loan was being made. The most common basis of capitalization seems to have been to multiply the figure chosen as the normal one month's rent by 100; sometimes 120 was used and in some cases a figure less than 100.

14 An examination of several hundred appraisals of properties on which loans were made revealed very few cases—probably less than 1 percent—in which the appraiser sought to modify the result reached with the formula.

15 Tax data were often not supplied even though called for. They could be obtained only by separate search of official tax records, and since the appraisal calculations did not require their use the omission is easily explained. In general, the appraisal forms seem to have been rather fully completed.

seldom if ever granted where the moral risk was considered poor.[16] Many loans, of course, were granted where the applicant's income was very low but where past experience indicated greater earning capacity and a determination to meet financial obligations.

[16] Mr. Horace Russell, HOLC General Counsel during the lending period, commented in correspondence on this policy. He expressed the belief that the character information obtained in credit reports was highly important because more than any other one thing the borrower's attitude determines the loan experience. The data in Chapter 6 lend considerable confirmation to this view.