James C. Walker

Accurate Appraisals in a Rural Market: Some Problems and Solutions

In a rural market, appraisals are often problematic—properties are extremely diverse and there are few sales. Because an appraiser is obligated to accurately reflect the market and to convey this understanding to the underwriter, specialized appraisal techniques are required to maintain accuracy in rural markets. Basing a rural appraisal on a format used for standard suburban markets can compromise accuracy.

The rural market is characterized by relatively few sales within large geographic areas, and complicated by the great diversity of properties within the same neighborhoods in terms of age, condition, quality, and size. Sales are often so scarce in some areas that recent (occurred during the past 12 months) or locationally appropriate (selected primarily for the similarity of their locations to the subject's) comparables cannot be found. As a result, it is sometimes too easy to use comparables that, while appearing to match, may in fact be locationally inappropriate, leading to inaccurate value conclusions.

STANDARDIZED APPROACHES

In most appraisal theory and literature, homogeneous suburban neighborhoods form the basis for examples and discussion. Unfortunately, the context of these examples is not typical for appraisals performed in the rural market. In addition, the secondary market has grown to expect that all appraisals will conform with the majority, which causes additional pressure on appraisers to provide appraisals that appear compliant. In light of these pressures, an appraiser often compromises the appraisal mission to replicate market behavior through study and analysis and instead attempts to generate an appraisal that conforms to the suburban standards presented in textbooks.

An appraiser would be equally remiss in ignoring needed adjustments in an effort to improve the presentation, or in minimizing adjustments to meet Federal National Mortgage Association (Fannie Mae) guidelines of 15% net adjustments or 25% gross adjustments.

James C. Walker is president of White Mountain Appraisals, Inc., in Franconia, New Hampshire, and is a Candidate Member of the Appraisal Institute. Generally certified to appraise in New Hampshire, he is also a registered professional engineer with an MS in architectural engineering and an MBA. Mr. Walker teaches appraisal courses at the University of New Hampshire's College for Lifelong Learning.

UNDERWRITERS' INFLUENCE

An appraiser may feel pressured in subtle ways to make a rural appraisal conform to a perceived standard. Underwriters exert this pressure by:

- Requesting new comparables rather than explanations of the comparables that were used in the appraisal
- Disregarding an appraisal and replacing it with a new appraisal from a more accommodating appraiser to "satisfy" the underwriter's needs
- Employing appraisers who are unfamiliar with a rural market
- Dropping appraisers from approved lists because of lack of "accommodation"

Underwriters are under pressure themselves from loan originators, whose income depends on the successful completion of loans, or from management production goals. All too often, a financial institution seeks vendors who provide appraisals that are easy to process over those appraisals that may better reflect the market but require additional thought and analysis.

UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE (USPAP) COMPLIANCE

Appraisals that compromise accuracy through inappropriate comparable selection or through ignoring adjustments that should be made could violate the provisions of Standards 1 and 2 of the *Uniform Standards of Professional Appraisal Practice* (USPAP) and the competency provision. Such practices may render the overall acceptability of the resulting appraisal questionable.

BASIS FOR SPECIALIZED TECHNIQUES

Appraisal theory

The Appraisal of Real Estate, ninth edition, defines an appraisal as "a supportable estimate of value" based on market data, logical analysis, and judgment.[1] "Supportable" implies that an appraiser has provided an appraisal with documentation that adequately justifies the appraisal analysis and conclusions. "Market data," the basis for an appraisal, must be sufficient in quantity to provide a basis for comparable selection and conclusions. "Logical analysis" requires an appraiser to study the market and determine the behavior of that market as a basis for market adjustments. "Judgment" is especially important in a rural market where great diversity and limited data often must be tempered.

Appraisal theory is sufficiently broad to provide the necessary foundation for accurate appraisal of a rural property. Specifically, two theories allow an appraiser to operate professionally in this environment. The theory of marginal productivity allows for the isolation and quantification of those elements that contribute to the value of the whole. The important point here is that these items vary from market to market. The theory of variable proportions allows for the fine tuning of these factors to the appraisal problem at hand. Again, these items are not standardized, but instead are determined from market analysis and applied to a specific appraisal problem.

Appraisal theory is rich with opportunities to develop and use the techniques and adjustments necessary to accurately estimate the value of a rural property.

Fannie Mae requirements

Fannie Mae's appraisal guidelines have become the industry standard for the production and review of residential appraisals. Fannie Mae holds a lender responsible for appraisal accuracy.[2] It should be remembered that these are guidelines—exceptions are allowed with explanations.

An underwriter's role is to analyze a property based on the appraisal and to judge the acceptability of the property as security for a loan. An underwriter can and should require additional information to make an informed decision. In ad-

1. American Inst. of Real Estate Appraisers, *The Appraisal of Real Estate*, 9th ed. (Chicago: American Inst. of Real Estate Appraisers, 1989), chap. 1.
2. Federal National Mortgage Association, *Selling: Underwriting Guidelines, Property and Appraisal Analysis* (Washington, D.C.: Fannie Mae, March 21, 1986), 29.

dition, an appraiser must remain free of outside influence, which includes, of course, underwriters and lenders. Traditionally, this influence is thought to consist of the production of an appraisal for a specified minimum value. Influence in the rural market, however, often takes the form of compromising accuracy to please underwriters and lenders.

According to Fannie Mae guidelines:

> We allow the appraiser discretion to properly develop the value estimate. The appraiser must, however, provide sound reasoning for working outside standards. Further, adjustments should reflect the market reaction to the difference in properties. The appraiser must satisfactorily justify the use of comparables that exceed 15% net adjustments, or 25% gross adjustments.[3]

Therefore, if the justification is adequate an appraiser can pursue a necessary analysis, even if it does not fully conform to the guidelines. This necessitates a cooperative working relationship between an appraiser and an underwriter. Fannie Mae guidelines are not overly restrictive and provide the necessary latitude to produce accurate appraisals in a rural market. Fannie Mae does not require an underwriter to request replacement comps that "may work better to satisfy investors." (Appraisers do not save their best comparables to be added after the appraisal is finished.) Further, Fannie Mae does not instruct financial institutions to obtain additional appraisals that may better satisfy an investor's requirements. It is important to note that the burden is placed on appraisers to provide the necessary documentation to support departure from accepted appraisal practices.

USPAP requirements

All appraisals must meet the requirements of USPAP Standards 1 and 2, which provide for a professional and competent appraisal. In addition, the adjustments to the comparable sales must reflect the market reaction to the difference between the subject property and the comparables. An appraiser must not fail to make adjustments when they are clearly indicated. Rule 1–1, in fact, requires that an appraiser "be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal."[4] The competency provision requires that an appraiser spend sufficient time to understand the market and the comparables. This familiarity is impossible to acquire in an afternoon's journey into an unfamiliar market.

SOME SOLUTIONS

The need for specialized appraisal techniques, their basis in theory, and regulations for their use have been discussed here. The techniques offered in the next section have been studied and tested in a rural New England market and have proven to ensure accuracy in such a setting.

Property rating

Underwriters must rely on an appraisal and the ratings. The characteristics that describe "average" in a rural market could describe something totally different in a more suburban market. An underwriter should rely on the "marketability" rating for the property, rather than draw conclusions about marketability from the information presented in the market grid.

Neighborhood

A neighborhood in a rural environment may not conform to the classic definition. A rural neighborhood often is defined not only by geographic boundaries, but also by general property characteristics. A rural neighborhood frequently is a submarket of properties of similar character associated with an economic center, generally a larger town in a rural area that provides surrounding small towns and villages with local shopping, services, entertainment, employment, and schools. Such an economic center in New England may serve five to ten smaller towns or villages and support 10,000 to 20,000 people.

Geographic boundaries present difficulties if defined in the usual neighborhood context because they are too small to be useful. If they encompass an entire

---

3. Ibid.
4. The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice* (Washington, D.C.: The Appraisal Foundation, 1990), II–1.

town, they may include too much diversity to be accurate. Neighborhoods are often better described in terms of similar characteristics of a rural submarket. These definitions are sometimes expressed as "better in-town properties" or "properties with large parcels greater than $100,000." Fannie Mae suggests that, at a minimum, neighborhoods belong to the same school district, which can encompass several towns and many square miles.

It is important that the economic centers be respected in a rural market. Comparables should always be selected from the same economic centers to maintain locational accuracy.

Comparable selection

Comparables should always be locationally appropriate and from the same economic center. Location, while the major component of value in real estate, is also one of the most difficult amenities to measure directly. As a result, locational adjustments should be minimized because they are generally subjective in nature and do not lend credibility to an appraisal. A locationally correct comparable that may not be the same size is preferable to a similarly sized comparable that is not locationally correct, because the size adjustment has more basis and credibility.

Maintaining locational appropriateness may also require the use of a comparable that is older than ideal. If time changes in value can be accurately estimated, then this adjustment is also more desirable than one for location. Style, although important to individual buyers, tends not to be a major factor in value differences or comparable selection.

Site value

The value differences among properties with respect to site cannot be handled accurately by a simple value-per-unit adjustment to site sizes. Site value varies considerably in a rural market and depends on location, view, amenities, and character of the site. As a result, an appraiser must estimate not only the value of a site for the subject (which is required in the cost approach), but also the individual site value of each comparable. Therefore, the site adjustments should represent the differences in site values between the subject and the comparables. An additional adjustment may be warranted when the market values of site improvements differ and may include the values of private water and septic systems, paved drives, and landscaping.

The site value of a subject should be determined by a separate market analysis with separate land comparables. In rural markets, value per acre is rarely constant and changes considerably with size. Instead of adjusting for size within the market grid, it is best to first adjust the comparables for such factors as time, financing, location, access, view, and slope, then determine the value per acre for each comparable. The adjusted value per acre should be plotted against size. The resulting graph usually indicates a clear relationship between value per acre and size, and can be used to estimate the value of any sized parcel with the subject's characteristics. This relationship may be a straight line (an opportunity for linear regression) or may be curved, depending on the range of parcel sizes used in the analysis. The relationship can be used directly to estimate the value of the subject. The graph should be entered with the parcel size and the value per acre should be read. The resulting value is then multiplied by the parcel size to estimate the total subject parcel value. This procedure is, of course, immensely simplified if done using a computer spreadsheet with graphing capability.

Comparables should always be selected from the same economic centers to maintain locational accuracy.

Ancillary structures

Barns, sheds, and oversized garages are often found on rural properties. Unfortunately, the market rarely pays near replacement cost or even depreciated replacement cost for these structures. A study of transactions that include these ancillary structures will indicate that the contribution to value is usually from 30% to 50% of depreciated cost. This of course varies with the type of structure, the neighborhood, and the condition of the ancillary improvement. Additional study will indicate a greater contribution to value as the total value of the subject increases. The only conclusions are that each situation requires independent study and that a contribution to value that exceeds 50% of depreciated replacement cost is rare.

Effective age

The diversity of properties in rural New England includes a wide range of structures, from newly built to over 200 years old. Unfortunately, most appraisers have spent insufficient time studying the effect of age on value. Consequently, too many appraisals fail to acknowledge any value differences among properties based on differences in age.

"Effective age" is the key to accurately adjusting for age. An appraiser must estimate the effective age for both the subject property and each comparable. The difference in effective age between the subject and each comparable is the basis for the age adjustment, and can be applied to the improvement value of the comparable through any means, including age-life or depreciation tables.

Effective age is estimated through observation and study of the structure, finish, materials, fenestration, and especially the kitchen and bathrooms, and how these items relate to a typically maintained home.

We have developed depreciation tables for residential properties in our rural market and have concluded that the majority of residential properties depreciate in a curvilinear fashion that is relatively straight in the early years, then increases as a property ages. For many properties, the initial straight-line portion appears to intercept the time axis near a 100-year life.

This leads to a convenient method to calculate the effective-age adjustment because the difference in years can be applied over the 100 years at the rate of 1% per year. For example, a subject with an estimated effective age of 20 years as compared with a comparable of 10 years would result in a −10% (20 years minus 10 years divided by 100) adjustment applied to the improvement value (market value minus site value) of the comparable (this adjustment also requires site values for each comparable).

To support this development of residential depreciation behavior, Figure 1 illustrates typical residential depreciation expressed as a percentage of initial value, using data from Marshall & Swift's residential depreciation table for a good quality property.[5]

Figure 1 presents the remaining value, which is 100%. To demonstrate the validity of using an approximate 100-year economic life for initial calculations, the initial straight-line portion of Figure 1 has been extended to show the intercept of the x-axis, which occurs at approximately the 100-year mark.

A GUIDE FOR REVIEW

Objective of the review

A review is conducted to ensure compliance with Fannie Mae guidelines and to "judge the property's acceptability as security."[6] An underwriter should understand the property as presented and seek additional information to clarify and document any unusual features or departures from standards.

USPAP and Fannie Mae compliance

All appraisals must meet USPAP under the new Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) guidelines and must also meet Fannie Mae guidelines to be satisfactory in the secondary market. As discussed previously, while both sets of guidelines require accuracy, they also allow appraisers the necessary latitude to provide this accuracy in a rural market with specialized procedures.

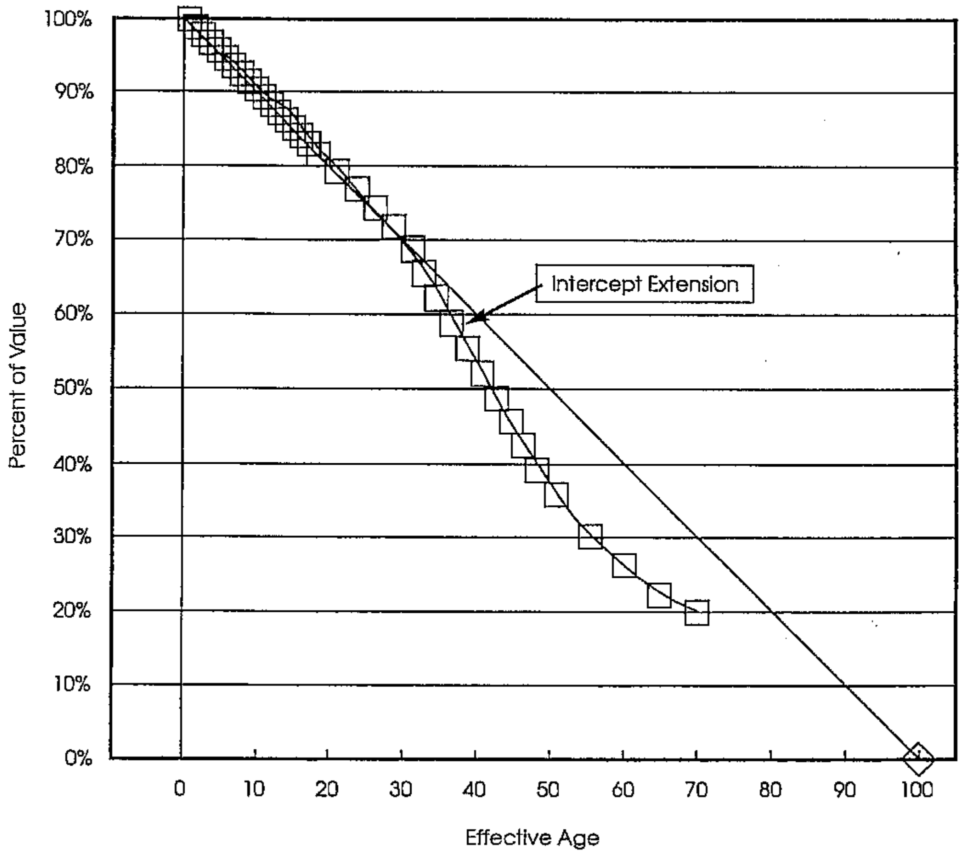
Red flags

Checklists can help screen for completeness and compliance. Accuracy should be assessed with a more thorough review after the entire appraisal and addendums are studied. Accuracy should be questioned and additional documentation requested if the following items are discovered during a review.

- Because the cost approach should be an accurate estimate, rounded costs per square foot or an unsupported site value may indicate that insufficient research has been done to establish the reproduction cost of a structure. Was the cost approach

5. Marshall & Swift, *Marshall Valuation Service* (Los Angeles, Calif.: Marshall & Swift, 1992), 97, 2–5.
6. *Selling: Underwriting Guidelines, Property and Appraisal Analysis*, 29.

FIGURE 1 Residential Depreciation



Note: Data taken from Marshall & Swift, *Marshall Valuation Service* (Los Angeles, California: Marshall & Swift, 1992), 97, 2–5.

"backed into" from the market approach?

- Comparables used should be locationally appropriate. Do all comparables come from the same economic center? Do all comparables represent the same neighborhood characteristics? Comparables of the same style or size are unlikely in a rural market, and their presence may indicate compliance that compromises accuracy.
- The market approach should have detailed adjustments for site value that reflect the actual difference in site values between the comparables and subject and not a uniform adjustment for size. The values should be tested for reasonableness. If the indicated land value of the subject in the cost approach is $16,000 and the adjustment to Comp 2 is $8,000, this implies that Comp 2 has a land value of $8,000. Is this reasonable?
- The age adjustment should always indicate a calculated difference between effective ages. If there is no age adjustment or if actual ages are represented in this category, an appraisal is incomplete.
- All comparables should converge on the same value if they are appropriate locationally and if proper adjustments reflecting the specific market are made. A significant divergence should be explained. Divergence, if any, from the cost approach should reflect current market conditions.
- An appraiser should regard rural appraisals that appear too good with caution. Are the adjustments for age, condition, and quality consistent with the pictures and descriptions? Have salient features been ignored to minimize adjustments?

CONCLUSION

Accuracy and rural appraisals are not mutually exclusive. Sufficient study and analysis will produce appraisals that are as accurate as appraisals prepared in a suburban environment. Both USPAP and Fannie Mae allow the necessary latitude to perform a competent appraisal in a rural environment.

The appraisal profession owes its clients accuracy in all appraisals, including rural assignments. An appraiser should not compromise accuracy to conform to urban standards. Underwriters need to understand the rural environment and should not expect suburban appraisals. Underwriters also should become knowledgeable about rural issues and adjustments to ensure that they do not discriminate against rural properties or rural appraisers.