

**SUNRISE ANALYSIS
OF PROPOSALS TO REGULATE
REAL ESTATE APPRAISERS AND
REAL PROPERTY APPRAISALS**

A Report to the Governor and the Legislature of the State of Hawaii

**Submitted by the
Legislative Auditor of the State of Hawaii
Honolulu, Hawaii**

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Introduction

In 1984, the Legislature amended the Hawaii Regulatory Act, known as the "Sunset Law," by incorporating a "sunrise" provision. That provision requires the Legislative Auditor to analyze proposed legislation seeking to impose licensing or other regulatory controls on unregulated occupations.

The Legislative Auditor is required to assess the probable effects of the proposed measure and to determine whether its enactment would be consistent with state regulatory policies in the Sunset Law. These policies establish criteria for regulation, such as the following:

- . Regulation is warranted only where reasonably necessary to protect the health, safety, and welfare of consumers.
- . Evidence of abuse shall be accorded great weight in determining whether regulation is desirable.
- . Regulation shall not be imposed except to protect relatively large numbers of consumers who may suffer a disadvantage in choosing the provider of the service.
- . Regulation should not unreasonably restrict entry into the occupation by qualified persons.
- . Regulation should protect the consumer and not the regulated profession.

The 1987 legislative session considered two related bills, one on real estate appraisers and the other on real property appraisals. Senate Bill No. 32 proposes to

regulate real estate appraisers through licensing and to establish standards for the preparation and communication of real estate appraisals. Senate Bill No. 89 focuses regulation on the appraisers' product, the appraisal itself, through a set of requirements for the preparation and reporting of a "certified" real estate appraisal.

In addition to these two bills, the Legislature also requested that we analyze the regulatory proposal endorsed and published by the American Institute of Real Estate Appraisers (AIREA) of the National Association of Realtors, entitled, *Conceptual Draft of Self-Regulatory Structure for the Real Estate Profession*. While not prohibiting appraisals by noncertified persons, it would set criteria for distinguishing those whose work should be certified.

This analysis contains background information on the appraisal profession, an examination of the need to regulate its practice, and an assessment of the proposed legislation.

Professional Characteristics and Background

The primary work of a real estate appraiser is to estimate accurately and impartially the value of particular pieces of property. The indicators of that value include, among other factors, present and allowable uses, condition and insurability, neighborhood uses and trends, liquidation considerations, taxes and easements, experience of comparable property, and market value as derived from such factors as income stream and sales potential. The Society of Real Estate Appraisers (SREA) described the practice in these terms:

"An appraisal is an impartial opinion of the value of real estate prepared by an expert who knows all the factors which make up the current behavior of the real estate market . . . an opinion of value based on experience and repeated analysis of these factors . . . which can be substantiated and justified."¹

The AIREA acknowledged that the accuracy of appraisal estimates rests largely on the competence and skill of the professional and on the pertinence of the data used.² Appraisers need a solid understanding of valuation theory, its principles and methodology, along with familiarity with economics, finance, and property.

Real estate appraisers serve a wide range of purposes and affect many kinds of people, from individual family home buyers/sellers to financial institutions, public agencies, and large-scale developers. Their services play important roles in property transactions and mortgages, in mergers and investment analyses, in earning forecasts and rental valuations, in urban redevelopment planning and taxation, and in insurance and arbitration. For some of these areas, an appraiser may serve as an expert witness in court.

Many appraisers specialize as to type of property appraised (e.g., commercial, residential, rural) or by purpose of appraising (e.g., for taxation, for public acquisition, for mortgages and sales or insurance). Specialization should not, however, affect the requirements for accuracy, impartiality, and proper methodology.

Although valuation theory and its application to real estate are not new, the emergence of a recognized profession of appraisers dates from the 1930s. During the Depression, the marked increase in foreclosures necessitated accurate appraisal work, and the federal government took an active role in trying both to stimulate the housing industry and to enhance the appraisal process by publishing educational materials in this field. At the same time, members of the real estate industry sought requirements to improve appraisals and set standards for valuation methodology.

During that same period, trade organizations for this profession made their initial appearance. First, in 1932, came the AIREA, a division of the National Association of Real Estate Boards. In 1935 the SREA was founded as an affiliate of the United States Savings and Loan League, followed by the American Society of Technical Appraisers in 1936 and the Technical Valuation Society in 1939. The last two merged as the American Society of Appraisers (ASA) in 1952. By 1986, some 30 appraiser organizations existed and represented in their membership one-third of the estimated 250,000 real estate appraisers nationwide.³

In Hawaii, the estimated 200 active real estate appraisers divide almost evenly between those in the private sector and those employed in government. Five national trade organizations in this field have chapters in Hawaii. They are: AIREA, ASA, the National Association of Independent Fee Appraisers (NAIFA), the National Association of Real Estate Appraisers (NAREA), and SREA. These have a combined membership of about 100. There is also in Hawaii a chapter of the International Right of Way Association.

Legislative Proposal for Regulation

Senate Bill No. 32. This bill proposes to regulate real estate appraisers through licensing. It would amend Chapter 467, Hawaii Revised Statutes, by expanding its regulation of real estate brokers and salesmen to encompass also real estate appraisers. That would commensurately expand the powers and responsibilities of the Real Estate Commission. The bill defines a real estate appraiser as "any person who for compensation or valuable consideration performs a real estate appraisal." However, the bill would exempt employees of federal, state, and county governments, court appointed appraisers, and trustees.

According to the bill, a real estate appraisal involves "a statement setting forth an estimate of value of an adequately described property as of a specified date and supported by the analysis and presentation of relevant factual basis." For licensing, an applicant would need to demonstrate required experience or education or a combination of both, the completion of a real estate appraisal course or its equivalent, a passing grade on a written examination, a good reputation, and attainment of the age of majority.

Senate Bill No. 32 also calls for standards covering: methodology; delineation and identification of the appraisal assignment, service, procedures, and data used; definition of type of value being considered; consideration of certain assumptions and factors; conformance to other guidances; and reporting (both oral and written) for understandability; as well as certification by the appraiser. Present coverage under the real estate education and real estate recovery funds would extend to real estate appraisers as well.

This bill provides for license suspension or revocation for: (1) failure to exercise reasonable diligence in developing an appraisal, preparing an appraisal report, or communicating an appraisal; (2) negligence or incompetence in performing an appraisal or its report; and (3) accepting an engagement for which the employment or fee is contingent on reporting a predetermined value or coming to pre-established findings. The commission would have the power to invoke disciplinary action. Other than automatic termination of a license upon the issuance of a court order authorizing payment from the real estate recovery fund to settle a claim, no specific penalties are provided.

Senate Bill No. 89. This bill proposes a new statutory chapter to be known as the Real Property Appraisal Act. Drawn from the Lancaster-Montoya Appraisal

Act of California, it would define a "certified appraisal" by law and provide certain requirements in the preparation and reporting of real estate appraisals.

Persons performing a "certified appraisal" would be required to: (1) utilize necessary and generally recognized methods and techniques; (2) exercise diligence to assure that all material data have been appropriately considered; (3) refuse to perform any part of the appraisal process for which one is not competent; (4) appraise proposed improvements only after examination of plans, specifications, evidence of probable completion date and development costs, and other documentation of proposed improvements; (5) base estimates of anticipated future income and expenses on reasonably clear and appropriate evidence and projections; and (6) follow other guidelines to identify properly the appraisal, assumptions, and other pertinent factors.

Senate Bill No. 89 would require that a "certified appraisal report" be presented in "clear and unequivocal terms" with sufficient information for comprehension. A written "certified appraisal report" would have to include all material facts, qualifications, limitations, or omissions; identify those who prepared it; disclose present or future interests in the subject property; certify correctness of the report and its conformity to law, or explain the absence of such a certification.

As in Senate Bill No. 32, Senate Bill No. 89 would prohibit a person from accepting a certified appraisal project for compensation that: required a predetermined value, analysis, opinion, or finding; or for which compensation is based on a percentage of monetary damages awarded in a legal action. However, there are no specific penalties cited for violations of these provisions.

AIREA proposal. Under this regulatory proposal (which includes a model state law), "certified" real estate appraisers must meet various certification requirements

of education, experience, testing, and the like, before they may perform "certified" work. That would not, however, prohibit appraisal work by non-certified appraisers.

This proposal would establish a national appraisal foundation which would elect an appraisal standards board. The appraisal standards board, assisted by an appraisal standards advisory council representing various interested parties, would set industrywide standards. The proposal would also establish a "certification trust" with a board of examiners to develop minimum requirements and a comprehensive examination.

In addition, this AIREA proposal suggests that federal and state agencies (especially those charged with regulating financial institutions) establish operational rules to prohibit their accepting appraisals unless performed by certified real estate appraisers. States would establish state boards of real estate appraisers with power to determine interim standards (until national standards gain acceptance) and to enforce them.

Analysis of Proposed Regulation

Summary of findings. Our analysis of Senate Bills Nos. 32 and 89 and of the AIREA is based on criteria in the Sunset Law. We find that regulation of real estate appraisers and appraisals is not warranted. In summary, our findings are:

1. Although a hypothetical potential for harm exists, available evidence does not indicate that the practice of real estate appraising at this time in Hawaii poses a threat of sufficient harm to warrant licensure and regulation.

2. A generally accepted set of standards has yet to emerge with which to impose a reasonably beneficial statutory basis for regulating real estate appraisals and licensing appraisers.

3. Senate Bill No. 89 would provide insufficient protection and assistance to consumers to warrant adoption.

4. Senate Bill No. 32 assigns regulatory responsibility to an inappropriate entity, the Real Estate Commission.

5. The regulatory proposal by the AIREA, in representing only one organization's perspective, lacks a generally accepted basis for implementation at this time.

Potential for harm. The Committee on Government Operations of the U.S. House of Representatives issued a report on September 25, 1986, entitled, *Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Money Market*. It found that problem appraisals had adversely affected savings and loan institutions, the Federal Savings and Loan Insurance Corporation, banks and credit unions, public (VA and FHA) and private mortgage insurers. "Their harmful effects are widespread, pervasive, and costly" contributing to insolvency of hundreds of the nation's financial institutions.

This congressional report pointed particularly at "client advocacy appraising," making an estimate of value to benefit a client's interests. However, it aimed its criticism at those financial institutions which treat appraisals as a necessary "rubberstamp" process; bank regulatory agencies were found to be generally lacking in policies and procedures for review of appraisals and correction of abuses.

Evidence nationwide apparently suggests that potential abuse does exist and has occurred, particularly in relation to large financial institutions which should have the expertise and resources to select qualified professional services. Whether the general public of individuals are poorly served is less certain. Available evidence in the form of complaints filed with public agencies and with professional

associations in the field of appraising, however, indicates that this potential for abuse and harm has barely surfaced in Hawaii to date.

We found little documentation of those problems cited by the congressional report to have affected financial institutions in Hawaii. Data on complaints from individual users of real estate appraisal services show little dissatisfaction in this field here. The Regulated Industries Complaints Office and the Office of Consumer Protection of the Department of Commerce and Consumer Affairs (DCCA) received no complaints. The State Office of the Ombudsman received no complaints during the 1980s, and only one complaint was filed with the Real Estate Commission.

It is possible that public agencies received no complaints because Hawaii lacked a regulatory law on real estate appraisers and appraisals. But even the major professional appraiser organizations received few if any complaints. ASA reported none in at least the last five years. AIREA has taken only one published disciplinary action in Hawaii since January 1984. Of the seven complaints to SREA, only two were upheld. As far as we could ascertain, there is no groundswell for regulation, neither from harmed clients nor from public agencies charged with the responsibility of protecting the public; not even from the profession itself. For lack of any statement of purpose within the legislative bills, what potential harm they would seek to remedy is not apparent.

Lack of generally accepted standards. The variables that play so central a part in determining real estate valuation are so extensive and often less than tangible (either due to inadequate data or conflicting data) that real estate appraising is highly subjective. It is easier to establish standards for methodology and reporting than for achieving uniformity of results. That appraisals might, in some cases, actually favor clients or only appear to do so is not then surprising.

Whether this inherent latitude encourages vastly different approaches and hence gives rise to a proliferation of professional organizations remains unclear. Nevertheless, that proliferation of organizations nationwide appears to have impeded the emergence of a set of generally accepted standards for methodology, reporting, and ethics in this field. In reaction to congressional findings that cited this weakness, an ad hoc committee representing nine appraisal trade organizations agreed in May 1986 for the first time to formulate such a uniform set of standards. In February 1987, they approved formation of a foundation to establish a national certification board and program. AIREA and SREA were also working to reconcile their diverse versions of a model state certification bill with the more broadly supported effort.⁴

While progress appears under way, proposals still differ on how to accomplish a unified approach to professional practice and to certification or licensing. The absence of standard requirements in this profession affects Senate Bill No. 32 and renders it deficient. Although it includes sections on licensing prerequisites, a written examination, and continuing education, these are vague and leave unclear what eligibility criteria the State should use in licensing real estate appraisers. That task it leaves to the real estate commission to work out later even though the commission's focus and member expertise lie in an occupational field other than appraising. The commission, for instance, need only "give favorable consideration" to educational courses and programs utilized by "professional appraisal organizations." But which organizations?

Senate Bill No. 89 would evade this confusion over qualifications for practitioners by focusing on their product and establishing criteria for acceptable ("certified") real estate appraisals. That strategy, however, has its own deficiency.

It means a client has no way of evaluating the likely quality of service until after it has been performed when it might be too late and too costly to have redone by some other appraiser.

Senate Bill No. 89 would hope to resolve this dilemma by specifying that an appraiser must "refuse to perform any part of the appraisal process which . . . the person does not have adequate knowledge and experience to perform." Left unanswered is the question of what standards an appraiser should use to judge whether in fact that person does or does not have adequate knowledge and experience to perform appropriately.

In allowing noncertified persons to conduct real estate appraisals, the AIREA proposal would bar neither entry into this profession nor inhibit alternative methods of performing appraisals. It would simply seek standards for designating a certain quality of professional expertise and service, then restricting the use of the term "certified" to those meeting that quality. However, thus far that approach and its standards represent the view of only one of many professional organizations in this field.

Insufficient protection. Senate Bill No. 89 provides a general statement on how a real estate appraisal should be done and what should go into its valuation and report. The bill does not, however, provide any process or designate any agency either to formulate and administer the requisite rules and standards or to investigate malpractice and take appropriate corrective action. In providing no way to prevent harm to clients, it simply provides a legal basis for a lawsuit after the damage has occurred. That approach would not appear to provide adequate protection to consumers if sufficient potential harm does exist to warrant regulatory legislation in this field. In short, it fails to protect the public.

Inappropriate assignment of responsibility. Senate Bill No. 32 places regulatory responsibility with a commission that is organized, focused, and assigned to an occupational field with quite different qualifications and orientation. The Real Estate Commission was established to regulate sales and salespersons in the field of real estate. Placing regulation of real estate appraisers under that commission assumes that the two occupational fields are closely similar or that one is a subcategory of the other. Neither assumption is valid.

Real estate brokers and salespersons concentrate on selling real estate. That is where their expertise and motivation lie. In contrast, an appraiser's work must be absolutely divorced from the rewards and pressures of selling so as to provide an impartial valuation. While both deal with real estate and need a working knowledge about each other's concerns, they differ in basic function, field of expertise, and objectives.

The previously mentioned congressional committee report took exception to the practice in 12 states of including appraisers within the regulatory system for real estate brokers and salespersons. Meeting requirements for real estate sales does not qualify someone for conducting appraisals.

Inadequate base. While the AIREA proposal does call for a distinct board to regulate real estate appraisers, it has yet to offer a generally accepted set of standards for procedures and professional qualifications. Lacking nationally accepted standards, this proposal (at least until national standards emerge) would leave to state boards the task of determining what would constitute "full-time experience in real property appraisal" and what type of examination, as well as what subject matter, would best indicate licensure qualifications.

Alternatives

If the Legislature deems that potential harm is sufficiently great to warrant some form of regulation over the real estate appraisal field, several alternatives either exist or have been suggested for consideration. The congressional report, for instance, pointed to the exercise of greater self-policing among financial institutions. Whatever amount that approach might contribute to a solution, it can at most only cover a portion of real estate appraisal work in Hawaii with a potential for harm.

As of May 1987, only 12 other states regulate real estate appraisers: Delaware, Florida, Indiana, Michigan, Mississippi, Nebraska, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, and Texas. In nine of these states the primary requirement for real estate appraiser is a real estate broker's or salesperson's license. A distinct appraiser's license was required in only two of those states: Nebraska and Oregon.

California took a different approach by adopting legislation to regulate appraisals. The Lancaster-Montoya Appraisal Act, passed in 1986 and effective January 1, 1988, established standards for a "certified appraisal" and a "certified appraisal report." It also imposed specific requirements upon those performing such appraisals, but did not prohibit other forms of appraisal not classified as certified. Senate Bill No. 89 employs this California approach.

National level. The 1986 congressional report recommended that:

"a joint public/private sector task force be constituted to establish a national, industry self-regulated appraiser certification and review system applicable to all real estate appraisers that would consist of uniform professional appraisal standards, appraiser qualification/certification requirements (including education, experience, and testing), stringent recertification procedures, appraiser performance and review criteria, and disciplinary principles with enforcement procedures."

Since federal legislation has been introduced, Hawaii could wait for this issue to be decided at a national level.

Distinct board. If regulation and licensure of real estate appraisers must come before national standards and/or national legislation gain acceptance, then state action should focus first on determining which type of agency could best handle the tasks of adopting appropriate rules, determining qualification, and administering both oversight and disciplinary action. We can find no justification for grafting real estate appraisers onto the real estate commission.

Either a new board (staffed by the DCCA) should be created specifically for real estate appraisers, or the entire responsibility should be assigned directly to DCCA to perform through its professional staff. Given the small number of practitioners in this field and the increasing professional capabilities within DCCA, we believe departmental staff can administer a regulatory program more expeditiously. Any advantage a board of appraisers might offer could be achieved equally well through the use of ad hoc advisory committees composed of professional practitioners.

Inclusion/exclusion. One other kind of alternative to the legislative proposals deserves consideration. It concerns who all should come under licensure regulation if the Legislature deems it appropriate to institute licensing in this field. Senate Bill No. 32 excludes almost half of all practicing real estate appraisers in Hawaii. While it is true that public employees are subject to public supervision, that does not provide a compelling reason for their exclusion. The same holds for court appointed or supervised personnel. If appraising is sufficiently complex and holds enough

potential for harm to warrant licensing at all, then that need and that potential for harm probably exist for all practitioners regardless of how they are compensated for their services.

Conclusion

Occupational licensing and regulation are efforts to ensure public protection and benefit by establishing minimal standards for practice. Unless there exists a preponderance of evidence showing consumers to be at a disadvantage or harmed by unregulated practice, licensure is not warranted.

We do not find sufficient evidence of consumer complaints and cases of damage by real estate appraisers in Hawaii to impose regulation. Moreover, no widely-accepted qualification standards for this profession have emerged upon which to base regulation. The proposed legislation would not significantly enhance public protection to warrant its costs, both public and private.

Recommendation

We recommend that neither Senate Bill No. 32, Senate Bill No. 89, nor the regulatory proposal of the American Institute of Real Estate Appraisers be enacted.

NOTES

1. Society of Real Estate Appraisers, *What is an Appraisal?*, Chicago, 1978, p. 4.
2. American Institute of Real Estate Appraisers, *What to Look for in an Appraisal*, Chicago, 1964, p. 2.
3. Phillip D. Hardwick, *Regulating the Real Estate Appraiser*, presented at the 1987 Annual Conference of the Real Estate Educators Association, May 20-22, 1987, p. 5.
4. Society of Real Estate Appraisers, *Model Certification Legislation*, proposed for approval by the Board of Governors, February 27-28, 1987, pp. D-26 to D-29.