REAL ESTATE APPRAISAL REFORM: WHAT IS IT WORTH?

By

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Real Estate Appraisal Reform:
What is it Worth?

An Examination of Title XI
of the Financial Institutions
Reform, Recovery and
Enforcement Act of 1989

by

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Introduction.

On August 9, 1989, President Bush signed the Financial Institutions Reform, Recovery and Enforcement Act of 1989¹ (FIRREA), often referred to as the savings & loan bailout bill. The act drastically changed the Savings & Loan industry forever². The bill makes sweeping, and expensive changes to the industry. It pumps billions of dollars into the industry and drastically alters the regulatory environment of thrifts and savings and loans. The bill will end up costing the federal government at least $166 billion³, and many experts believe that it will eventually cost much more⁴.

It is obvious that this is an expensive bill. It required $20 billion to be pumped into the savings and loan industry by September 30, 1989⁵. Ultimately, at least $50 billion will be infused into the industry and over $100 million will be paid by the government in interest⁶. In addition to pushing money into the industry, the bill also makes other significant reforms.

The bill abolishes the Federal Home Loan Bank Board and instead places thrifts and savings and loans under the regulatory control of the Treasury and Federal Deposit

¹Pub. L. 101-73
⁴Banking Week, August 14, 1989, p. 1.
⁶Id.
Insurance Corporation (FDIC), the agencies responsible for overseeing commercial banks'. The bill creates the Resolution Trust Corporation, an agency responsible for disposing of the real estate assets of failing thrifts and savings and loans. The bill also makes significant alterations in accounting and regulatory rules of the industry. Finally, the bill makes drastic changes in the way real estate appraisers are regulated. This final reform is the subject of this paper.

The purpose of this paper is to describe the real estate appraisal field, summarize the real estate appraisal reform, explain current occupational licensing and certification theory, analyze the appraisal reform in terms of this theory and provide comments and suggestions for improvement of the regulatory scheme. Most importantly, the purpose of this paper is to provide suggestions to state legislators on how to implement the appraisal reform.

The Real Estate Appraisal.

It should be helpful to first look at the real estate appraisal, define what an appraisal is and why the regulation of real estate appraisers would be included in a reform of the savings and loan and thrift industry.

Most generally, a real estate appraisal is "[a]n estimate of the value of property resulting from an analysis of facts
about the property." An appraiser is one qualified by education, training and experience who is hired to estimate the value of real and personal property based on experience, judgment, facts and the use of formal appraisal processes.

As a rule, the level of detail of an appraisal is determined by the purpose of the appraisal. Appraisals are often referred to as the "heart of all real estate activity." They are used in dissolutions of marriage, condemnation and probate proceedings, rent adjustments in rent control, property taxation and the preparation of financial statements. The primary purpose, however, and the purpose for which this paper is most concerned, is to determine the value of the collateral securing a mortgage-type loan.

Appraisals are used by savings institutions and commercial banks for loan underwriting and investment decisions. Appraisals provide important data to lenders which is needed to support decisions regarding risk exposure, loan to value ratios, and maximum loan amounts. Perhaps more importantly,

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"Id.

"Id.

"Id.

"Id.

"Id., p. I-3.
real estate appraisals are an important tool used by regulators to monitor the loan portfolio quality of financial institutions in terms of overall soundness and the risk exposure to federal insurance funds. 14 Thus, incorrect or fraudulent real estate appraisals can lead to undersecured loans and have been blamed for the troubles faced by the savings industry.15

It must be stressed that real estate appraisals are only subjective opinions of the value of the subject property. Since appraisals are opinions, their very nature leaves a margin for disagreement between individuals. Real estate appraising is something between an art and a science. Thus, the regulation of real estate appraisal is nearly impossible. The only alternative is regulate real estate appraisers.

Regulation of Real Estate Appraisers.

Despite the importance of the real estate appraisal in financial transactions, there has been little regulation of real estate appraisers at either the state or federal level. As of December, 1988, only 15 states required the licensing or certification of real estate appraisers. Five states required a real estate appraiser to have a real estate broker’s license. Four states permit appraisals by those holding either a broker’s or salesperson’s license. Only six states had laws

14"Id.
specifically certifying or licensing real estate appraisers.\textsuperscript{16} The remaining 35 states have no requirements whatsoever for real estate appraisers. There have been several attempts over the years to regulate real estate appraisers at the federal level. Most have either failed or been withdrawn.\textsuperscript{17}

The Professional Associations.

Although there is little government regulation of appraisers, many private trade groups have arisen with the stated purpose of self-regulation. There are at least 14 different trade groups in the appraisal industry. Each group offers a professional designation. Once an individual completes the required membership criteria, he or she may then place the association’s designation after his or her name. For example, one of the most widely known appraisal trade groups is the American Institute of Real Estate Appraisers (AIRESA). Once an individual meets AIRESA’s qualification requirements, the individual becomes an MAI (Member, Appraisal Institute) or an RM (Residential Member). The qualification standards of many of these organizations are not rigorous. Only 6 of the organizations require a four year bachelor’s degree or equivalent.\textsuperscript{18}

In October, 1987, eight of the professional organizations banded together and formed the Appraisal Foundation. The

\textsuperscript{16}Department of Real Estate, \textit{Appraisal Industry}, p. IV-1.

\textsuperscript{17}Id., p. I-17.

\textsuperscript{18}Id.
Foundation was organized as a response to the prospect of the enactment of federal legislation regulating the appraisal profession. The purpose of the Foundation is to establish appraisal guidelines or standards. The Foundation is also drafting a model bill for state certification. The Foundation plays an important role in the appraisal reform of FIRREA. The bill gives the Foundation the power, among other things, to set minimums for appraisal standards for the nation’s financial institutions.

The Impact of Faulty Appraisals on Savings Institutions.

Faulty and fraudulent real estate appraisals have contributed significantly to the poor health of many savings institutions. Hundreds of savings and loans "have been severely weakened or declared insolvent because faulty and fraudulent real estate appraisals provided documentation for loans larger than justified by the collateral's real value."¹⁹ The losses to financial institutions have been in the hundreds of millions of dollars.

Between January 1983 and mid-October 1985, the real estate loan portfolios of more than 800, or 25 percent, of the approximately 3,200 federally insured thrifts were found to have significant appraisal deficiencies. In more than 300 of these institutions, appraisal related problems contributed significantly to their being placed in problem status or declared insolvent. The problem appraisals found in these 800-plus associations overvalued the collateral securing real estate loans by an aggregate of $3 billion. In 70 percent of these associations' loans the reappraised value of the collateral property was significantly less than the market value

¹⁹The Bernard Report, p. 56.
in the original appraisal.\textsuperscript{20} Similar losses have plagued commercial banks, credit unions, mortgage insurers, and others.\textsuperscript{21}

The Background of Appraisal Reform.

The idea of federal appraisal reform is not new. As the result of an extensive study of the appraisal industry, an appraisal reform bill was introduced in the House of Representative in 1987 by Representative Douglas Bernard, the chairman of the Commerce, Consumer and Monetary Affairs Subcommittee. The bill, HR 3675, sought to establish a new regulatory agency to oversee the appraisal industry. Extensive hearings were conducted by the subcommittee. However, the bill was subsequently withdrawn due to concern over the creation of a new agency.\textsuperscript{22} The bill was then extensively redrafted to give the oversight power to an existing agency, however, the bill was apparently never reintroduced.

Title XI of FIRREA - A Summary.

The idea of federal appraisal regulation was reintroduced during the drafting of FIRREA. The bill was drafted to include appraisal reform. In essence, the law requires that any appraisal which is involved in a transaction with a federal financial institution be conducted by a state certified or

\textsuperscript{20}Id.

\textsuperscript{21}Id.

\textsuperscript{22}Department of Real Estate, \textit{Appraisal Industry}, p. I-6.
licenced appraiser. The purpose of the provisions is stated as follows:

The purpose of this title is to provide that Federal financial and public policy interests in real estate related transactions will be protected by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.

The sweep of this statement is quite broad. "Real estate related transactions" include "sale, lease, purchase, investment in or exchange of real property", the refinancing of real property, and the "use of real property...as security for a loan or investment."

The law sets up an appraisal subcommittee of the Federal Financial Institutions Examination Council. The subcommittee consists of the designees of the heads of the federal financial institution regulatory agencies. The subcommittee's duty is to monitor state licensing and certification standards, monitor appraisal standards, maintain a national registry of state certified and licenced appraisers and to monitor the Appraisal Foundation.

The law provides start-up financing for the subcommittee by drawing $5 million from the federal treasury. The continuing budget of the subcommittee is to come from fees

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12 U.S.C. 3331

assessed to appraisers for becoming licenced or certified. 26

Each state is to maintain a roster of all appraisers who are licensed or certified in their state. The roster must be transmitted to the appraisal subcommittee annually. 27

Each financial institution regulatory agency and the Resolution Trust Corporation is required to establish rules for real estate appraisals. The rules are, at a minimum, to conform to standards set by the Appraisal Foundation. Further, the statute requires that all real estate appraisals must be in written form. 28 These rules and standards must be proposed by March, 1990 and must be in place by August, 1990. 29

The statute distinguishes between a "state certified appraiser" and a "state licensed appraiser." A state certified appraiser is an individual who has satisfied state requirements for certification which meet the minimum standards for certification established by the Appraisal Foundation. 30 A certified appraiser must have passed an examination which meets the minimums established by the Appraisal Foundation. 31 A state licensed appraiser is an individual who has satisfied the

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requirements for state licensing in any state.  There are no minimum requirements set by the statute for licensed appraisers, thus, presumably the states are free to set whatever criteria they chose.

The bill only regulates appraisers who wish to engage in work which is a "federally related transaction." In deciding whether an appraisal in connection with a federally related transaction must be done by a certified appraiser, an agency must decide whether the transaction is of "sufficient financial or public policy importance to the United States" for the appraiser to be certified. However, if the transaction has a value of $1 million or more, the appraiser must be certified. If the appraisal is a 1-to-4 unit, single family residential appraisal, then the appraisal may be performed by a state licensed appraiser.

The law also contains various other provisions. It provides that violations of the statute may lead to civil fines. It also provides for temporary recognition by one state of another state's license or certification. The law further requires the appraisal subcommittee to conduct a study

3° U.S.C. 3345(d).
3° U.S.C. 3342 (1) and (2).
3° U.S.C. 3349(b).
3° U.S.C. 3351(a).
of the appraisal industry and report to Congress.\textsuperscript{37}

\textbf{Supply and Demand of Occupational Regulation.}

At the outset, it should be useful to examine why occupational regulation is likely to be passed by examining the supply and demand for such laws\textsuperscript{38}. Actors in the political process, as in other areas of life, seek to maximize their economic welfare.\textsuperscript{39} They will invest in political action either in support or opposition to a given piece of legislation only if they anticipate net gains from the investment.\textsuperscript{40} Investments in such actions include political contributions, lobbying, advertising, and, in the case of legislators, vote trading. The demand for occupational legislation is provided by members of the occupation to be regulated and, to a lesser extent, the general public, while the supply of legislation is provided by legislators.

The demand for any piece of legislation gives a good

\textsuperscript{37}12 U.S.C. 3351(e).

\textsuperscript{38}There are several models of political action which are still hotly debated. Some models include an economic approach and others do not. In traditional neoclassical economics, government is treated as a benevolent body which seeks to maximize social welfare. (William D. White, "Dynamic Elements of Regulation: The Case of Occupational Licensure," \textit{Research in Law and Economics}, Vol. 1, 1979, p. 16) Other economic models view government behavior as determined by legislators who are basically political animals who seek to maximize their chances of re-election. (\textit{Id.}) It is not the purpose of this paper to become entangled in this argument. This paper assumes the truth of the latter model.

\textsuperscript{39}White, p. 17.

\textsuperscript{40}\textit{Id.}
indication of those individual who believe they will experience a net economic gain from the law. In occupational regulation, the demand most often comes, not from the public as one might expect, but from the occupation itself. The same is true in the case of appraisal reform. During hearings conducted on HR 3675, representatives of most of the appraisal organizations testified in favor of the regulation. Members of the occupation will support regulation if they believe it will increase their net wages from the occupation. It is also possible that consumers may see a potential gain from licensure and also support such legislation. However, it is much more likely that the push for licensure will be led by members of the occupation.

There are two reasons why attempts to introduce licensure are likely to be led by the occupation rather than consumers. First, general action costs are likely to be much lower for occupation. The gains and losses from licensure are likely to be more concentrated for the occupation than for consumers. Since the legislation deals with the livelihood of members of the occupation, they will feel the impact much more strongly.


Id., p. 24.

Id.
than the general consumer. Further, members of the occupation are likely to have more information than consumers.\textsuperscript{4} For example, members of the occupation are likely to subscribe to newsletters or journals and thus will be more informed of events which will affect the profession. Second, the kinds of situations in which consumers are likely to gain from licensure are those situations where they are least likely to engage in supporting it. Consumers will benefit from licensure in situations where they purchase small quantities of complex services on an irregular basis.\textsuperscript{4} Appraisal services are an excellent example. The typical consumer will not use appraisal services on a regular basis. Under such conditions, the benefits from licensure will be highly diffused and action costs will be high. Thus, consumer political action is unlikely to occur.

The supply of occupational regulation obviously comes from legislators. Legislators have definable economic interests just like any other group of individuals. Legislators are re-election maximizers.\textsuperscript{4} Whether or not a given piece of legislation is introduced will depend upon the amount of political pressure that will be applied by various groups.\textsuperscript{4} In the case of appraisal regulation, there are many highly

\begin{itemize}
\item \textsuperscript{4}Id.
\item \textsuperscript{4}Id.
\item \textsuperscript{4}Id., p. 16.
\end{itemize}
organized trade groups who can push for regulation through lobbying and political contributions. Further, the establishment of the Appraisal Foundation by eight of the trade groups strengthened unification among the various groups. Despite the fact that legislators often respond to the interests of organized groups, legislation is invariably justified on the grounds of benefit to the public."

In the case of appraisal reform, legislators did not have to look far to find a public-serving rationale for reform. The public perception of appraisers, and the popular press reports of the poor state of the savings industry provided an easy excuse. A study by Congress itself, demonstrated that fraudulent and faulty appraisals contributed to the sickly financial condition of the savings industry.\textsuperscript{50} Thus, the conditions were appropriate for legislators to provide a supply of legislation.

**Occupational Licensing Theory.**

Up to this point, occupational licensing and certification have been discussed in general terms. However, it is important to distinguish between the terms "licensing" and "certification". Licensing is an arrangement whereby permission must be obtained from some recognized authority in


\textsuperscript{50}The Bernard Report, pp. 56-80.
order to engage in an occupation." A license requires some demonstration of competence or testing. Anyone who engages in the occupation without a license is subject to a fine or a jail sentence. Certification is less onerous. With certification a government agency may certify that an individual has certain skills, but does not prevent the practice of the occupation by individuals who are not certified. There is a third level of occupational regulation which is sometimes discussed. "Registration" is an arrangement under which individuals who engage in an occupation are required to list their names in some official register if they engage in an occupation.

Although Title XI of FIRREA does contain elements of registration, the economic effects of registration are not covered very thoroughly in the literature, thus, registration will not be dealt with in this paper.

Occupational licensing and certification theory is broken down into two schools of thought. The first school follows, to a greater or lesser extent, the views of Milton Friedman in his book Capitalism and Freedom. The Friedman school focuses on

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5Id.

5Id.

5Many authors who generally follow the theories of Friedman do not reach Friedman's conclusion that all occupational licensing should be abolished. Although the authors differ in details and conclusions, the school of thought will be referred to as the Friedman school for simplicity.
the economic detriments associated with occupational licensing and certification. The second school of thought is often referred to as the "public interest" school of thought. The public interest school focuses on the benefits to society of occupational licensing or certification.

Although there are two schools of thought, they are not necessarily incompatible. In a sense, they seem to argue past one another. Neither school seems to refute the claims of the other school, rather, they focus on different sides of the same issue. The schools of thought also provide support to the earlier discussion of the supply and demand for occupational regulation. The Friedman view explains why the self interest of members of the occupation would demand occupational regulation. The public interest view provides an explanation of why a legislator would be interested in supplying such regulation.

Since the operation of licensing and certification is different, they will be discussed separately. The theory behind licensing is more extensive, so it will be examined first.

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55 In this paper, the schools will be broken down into the benefits and detriments of occupational licensing and certification. In an article by Alan Wolfson and others, the authors list their views of the benefits and detriments of occupational licensing and certification. For the sake of organization, their views will be split between the two categories. Alan D. Wolfson, Michael J. Trebilcock, and Carolyn J. Tuchy, "Regulating the Professions: A Theoretical Framework," *Occupational Licensure and Regulation*, (Washington D.C., 1980), pp. 180-214.
The Detriments of Occupational Licensure.

The Friedman school of thought focuses on the detriments to society of occupational licensing. The net loss to society, however, is a net gain to the regulated occupation, thus, the Friedman view explains why there would be a demand for such legislation by the industry to be regulated.

The underlying premise of the Friedman view is that government intervention to protect consumers in markets is only necessary when the market fails to perform a function." A market solution is always preferable to government intervention unless intervention facilitates the transaction more efficiently." The question boils down to whether consumers of a particular service are able to make informed and intelligent decisions regarding the selection of service providers. If they are not able to do so, then there is a market failure. The problem is that their are many inefficiencies in occupational licensing.

The best known and most obvious effect of occupational licensing is the creation of barriers to entry into the occupation." Barriers are placed on the individual and can be controlled by educational institutions.

Barriers to entry of the individual may come from educational requirements, citizenship requirements, experience

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"Rose, p. 190.

"Id.

"Id., p. 193.
requirements and similar barriers. The requirements impose significant costs on an individual wishing to enter the occupation. There are the opportunity costs while an individual is being educated and while the individual is completing his or her apprenticeship. There may be entrance fees that are not recaptured after licensing. There is also the costs of tuition and books to meet the educational requirements. Some of these costs are justifiable, while others are of questionable validity.

It is not clear at this time exactly what kind of requirements will be set due to the appraisal reform. The details of licensing and certification are up to the individual states. The only requirement is that the criteria for certification meet the minimums set by the Appraisal Foundation. There are no maximum limits on certification and no requirements at all on state licensing. Thus, there will probably be many different requirements imposed by each state. Appraisers will therefore have a chance to lobby state legislatures to impose restrictive requirements in order to raise barriers to entry.

Past experience with other professions indicates that


60Id.

61Id.

62Id.
examinations and entry criteria are often more restrictive than is necessary.⁶¹ In Friedman's words,

any relationship between the requirements imposed and the qualities which the licensure is intended to assure is rather far-fetched. The extent to which such requirements go is sometimes little short of ludicrous.⁶²

He cites the licensing of barbers. In many states barbers must take more than one thousand hours of instruction in topics ranging from chemistry to diseases.⁶³ He concludes that such state intervention is "a serious infringement on the freedom of individuals to pursue activities of their own choice...."⁶⁴

Again, due to state control of licensing and certification, appraisers will have an opportunity to lobby state legislatures to pass restrictive licensing and certification schemes.

A related problem is the power given to educational institutions to restrict entry into the regulated profession. Once education requirements are mandated, specialized educational institutions naturally arise. Some writers feel that this is a cause for concern, since it is these institutions who will "ultimately control how many there will be" since attendance at these institutions is mandatory to

⁶¹Rose, p. 194.

⁶²Friedman, pp. 141-142.

⁶³Id.

⁶⁴Id.
entering the profession.⁶⁷

There is a concern that this gives the institutions too much power to restrict admission into the profession. Educational institutions can raise additional barriers to entry by including irrelevant criteria in order to be accepted into the school. Additionally, there is the concern about this being a tool of the "old-boy network," and thus allowing only a homogeneous group of persons into the profession. There are no provisions in the statute for the regulation of educational institutions. Therefore, Congress has again given significant control to the state legislatures.

Another disadvantage of occupational licensure is that it leads to monopolization.⁶⁸ This naturally arises from the fact that the requirements of licensing must be met before a person can offer certain services. The anticompetitive effects of the requirements are significant where the regulated activity is described with such breadth that it includes activities that could be offered competently by less trained individuals.⁶⁹ In some cases a consumer may want to make the choice between a generally more expensive licensed professional and a cheaper unlicensed individual. However, because the licensing system prohibits such an unlicensed individual, the consumer is not

⁶⁷Rose, p. 196.
⁶⁸Rose, p. 197.
⁶⁹"Id."
entitled to make the choice." For example, in the case of licensed real estate appraisers, the definition of those individuals required to be licensed might include any person who gives another person an opinion of value regarding a piece of real property. A consumer may then wish to list his or her home for sale with a real estate broker. The consumer, having no information regarding home sales in the area, does not know at what price to list the home. Under the definition above, the real estate broker would not be able to give an opinion of value unless he or she was also a licensed appraiser. The consumer is now forced to obtain the services of a real estate appraiser, in addition to the broker so an intelligent decision can be made regarding a listing price.

Occupational licensing may also result in barriers to movement to professionals." Once an individual is licensed in a given state, differing criteria for licensing in other states increases the cost of moving across state lines. An individual may be forced to retake classes or fulfill new criteria to become licensed in another state. Further, raising these barriers to mobility restricts the flow of supply of

7Id.

professional services to meet changing demand conditions in various states. The result is a misallocation of the supply of professional services. This problem is especially acute where there are restrictions placed on reciprocity.

It is interesting to note that FIRREA confronts the problem of reciprocity directly, however, provides for only temporary reciprocity between states. No provision is made for permanent reciprocity. Movement between states may therefore be impeded.

Professor Rose suggests another disadvantage of occupational licensure. He argues that anticompetitive market division often results in licensed occupations. In other words, many needless specialties are created. He cites the example of building contractors. There may be as many as one or two hundred types of specialty contracting licenses. Work in any one of these specialties requires a separate license, which means that the separate requirements of each license must be met. Thus, contractors in each of the specialty fields are assured that they do not have to compete with each other.

At this point, appraisal reform has not provided for multiple specialties. However, presumably the states are free

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Holen, p. 496.


Rose, p. 198.

Id.
to segment the profession as they see fit. The possibility, therefore, still exists that the profession could be broken down into various fields. This in itself is not a problem unless needless specialties are created which limit competition among the various groups.

Professor Rose suggests yet another problem with occupational licensing. He suggests licensing regulations normally include prohibitions of "unethical conduct." He argues that this has anticompetitive effects which stem from two causes. First, the prohibited categories of conduct are usually overbroad and include conduct which is desireable and beneficial to consumers. He cites examples of prohibitions on advertising and solicitation. Second, he suggests that anticompetitive effects result from the substitution of occupational licensing boards to monitor professional behavior rather than the process of judicial supervision by tort law. He argues that "[p]ermitting the practitioner group with its clear economic self interest to control these matters results in overzealous and overbroad prohibition of conduct...."

It is too early to tell whether prohibitions of unethical conduct will be enacted by the states and if so, what will be included in this category of conduct. The effects of the control by occupational licensing groups, however, are more clear. It is likely that the states will put control of the

"Id., p. 199.

"Id.
occupation into the hands of occupational licensing boards which may be captured by the profession. Indeed, on the federal level, regulation is already strongly controlled by the Appraisal Foundation.

A troubling aspect of occupational licensure is the possible disproportionate impact on racial and language minorities. One study has suggested that "the less educated, blacks, apprentices, and other specific groups are more likely than others to fail written licensing examinations, even though they do not appear to be less able than workers who are admitted." The better educated have an advantage on written examinations. Experience with testing improves the ability to cope with written examinations. This experience is especially important when examinations are of poor quality. Some have suggested that occupational licensing examinations are often of poor quality since they are often written by licensing officials who have no training in test writing procedures. Stuart Dorsey found that the attributes important in passing a written test were "essentially unrelated to a measure of productivity."

In this appraisal reform, state testing is mandated for certified appraisers. The statute provides that the

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"Id., p. 424, fn. 3.

"Id., p. 433.
examination must meet the minimums set by the Appraisal Foundation. States are presumably free to include additional questions as they see fit. These examinations have the potential to be racially discriminatory.

The research of Wolfson, Trebilcock and Tuohy has revealed many more disadvantages of occupational licensure. The first they discuss is the assumption of a high correlation between quality of output and licensure. Licensing systems assume that "simply by prescribing a set of educational and other inputs as a condition for...licensing, we can be assured of the provider's ability to furnish us with the desired quality of service forever."" They assert that "the more narrowly defined the prescribed inputs and the more widely differentiated the desired outputs, the weaker will be the correlation between them."" Some individuals who have fulfilled the requirements for licensing will simply not provide adequate quality services. Further, there is no assurance that an individual who meets the criteria at one point in time will continue to retain his or her level of skill. Licensed individuals may forget what they learned in preparing for the examinations or theories and practices may change over time. Without a program of continuing education, there is no way to determine whether a currently acceptable level of skill is maintained.

Wolfson also suggests that of all the regulatory schemes

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"Wolfson, p. 204.

"Id."
that were surveyed, "licensure introduces the greatest number of rigidities and elements of arbitrariness into a market."\textsuperscript{83} Licensing acts as though the market for a product is static. In a market where technology or theory changes, this may cause serious social costs by "creating impediments to innovation."\textsuperscript{84} While appraisal theory might not change as rapidly as theory in other occupations, changes in value theory do occur and to that extent licensure may stifle innovative thought.

Licensing also assumes that quality is a discontinuous attribute.\textsuperscript{85} Either a professional satisfies the licensing criteria and provides a corresponding quality of service or one does not meet the criteria and is not permitted to offer a lesser quality of service. Consumers who wish to purchase inferior quality goods are forced into a choice of purchasing the higher quality goods at a corresponding higher price, or do without the service. According to Wolfson and the others, this results in "an unclear but probably negative impact on [consumers'] general welfare."\textsuperscript{86} This could become a problem with appraisal reform, although it is not a pressing worry. The statute seems to leave open the possibility that non-licensed and non-certified appraisers could exist at the state level. The law does not require states to licensed everyone

\textsuperscript{83}Id., p. 207.
\textsuperscript{84}Id.
\textsuperscript{85}Id.
\textsuperscript{86}Id., p. 208.
who might give an opinion of value, merely those individuals who wish to deal in federally related transactions.

Licensing is only a crude quality signal. While some tasks in the licensed profession call for a modest degree of skill, others call for a high degree of skill. A one level licensing scheme sends fuzzy quality signals to consumers. If one tries to remedy this problem with multiple types of licensing, however, Wolfson asserts that this would result in "the problems of rigidity inherent in any licensing scheme [being] correspondingly increased." 87

Given that a single licensing standard for the entire profession is necessary and that there is a spectrum of quality for any given service, licensing presents a difficult policy decision of where on the spectrum to set the standard for licensing. 88 There is no way of avoiding a trade-off between access and quality. There is no available policy that will make all those affected better off.

Another difficulty when establishing a licensing regime is how to differentiate complex occupational functions from one another. 89 A professional's responsibilities are not easily categorized. For example, where does an appraisers duty stop and a broker's duty start?

Finally, Wolfson suggests that a licensing scheme, once in

87 Id., pp. 208-209.
88 Id.
89 Id.
place, is difficult to remove."90 Others have termed this problem the "ratchet effect."91 If entry constraints were to be removed, new workers could immediately enter the occupation. The result would be an immediate fall in wages, and everyone in the occupation would lose."92 Therefore, those in the occupation will strongly lobby against the removal of constraints. Additionally, licensure may reduce the costs of political action for the regulated professionals. Entry requirements tend to create a homogeneous group which is much easier to organize. Further, licensure makes it easier for professionals to identify one another. Government records provide the professionals with an inexpensive updated mailing list, whether or not they belong to other professional organizations.

These lower action costs may also lead to "escalator effects."93 Since after licensure it costs less to take action in support of licensure, the group may seek to increase entry constraints even more, thus increasing the associated problems. Further, licensure creates vested interest groups. Schools and government agencies will arise which depend on licensure for their livelihood. Thus, they will be willing to invest large amounts to maintain and expand regulation once it is introduced.

91 White, p. 25.
92 Id.
Most of the disadvantages discussed lower the supply of professionals. As the number of professionals decline, the cost of services will increase. Thus, consumers will be hurt unless there is a corresponding increase in the quality of appraisals or there are other benefits.

**The Benefits of Occupational Licensure.**

The public interest school of thought focuses on the benefits of occupational licensing to society. Thus, it is a good explanation of why a legislator would be willing to supply such regulation. Within the public interest school of thought there are two main sub-schools. The first is traditional theory, the second is based on "informational economics."

Traditional economic theory is based on the premise that protection from unlicensed competitors is justified by the upgrade of the quality of services offered for sale in the market. The assumption is that the imposition of higher educational and other standards increases quality.

The current "public interest" theory centers on informational economics. This school can be traced to Akerlof’s seminal article "The Market for 'Lemons': Quality

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Uncertainty and the Market Mechanism." Akerlof suggests that occupational licensing may improve efficiency in markets where buyers are unable to prejudge the quality of services. In certain markets, providers possess information about quality, but they may refuse to voluntarily disclose the information. According to Akerlof, if this information disparity between buyers and sellers is not corrected, a market failure termed "adverse selection" may result."

Akerlof demonstrates this market failure by examining the market for used cars. He argues that the used car market is one in which adverse selection occurs because potential buyers can not differential between bad cars, "lemons", and good cars, "nonlemons." In the used car market, sellers of lemons will not reveal the quality of their cars to the prospective purchaser. The lemon seller will therefore demand a price consistent with nonlemons. Since buyers are unable to distinguish between lemons and nonlemons, the market equilibrium price will be based on what the buyer perceives is the average quality of a used car, rather than the actual quality of the car in question." At this price, sellers of high quality cars will withhold their products from the market, since they are not rewarded for the superior quality of their merchandise, thus at the average quality price, only lemons

"Johnson, p. 479.
"Id.
will be offered for sale. According to Akerlof, this process will continue repeatedly, continually decreasing the quality of goods offered for sale.

The same sort of information asymmetry problem can also be present in the market for professional services. The quality of professional services varies significantly, however, differences in quality are not easily observable by potential buyers. This might be true in the appraisal market. If consumers of appraisals are unable to differentiate between good appraisers and bad appraisers, high quality appraisers may not be able to obtain an adequate price for their superior services and overall quality of the appraisal market may deteriorate as high quality appraisers are priced out of the market.

Two corollaries to Akerlof's theory have been offered in support of the view that the information asymmetries between buyers and sellers are often corrected by the market itself without any need for government intervention.

The first corollary was suggested by Spence. He maintains that in markets which have extreme information asymmetries, sellers of high quality services have an incentive to voluntarily inform or "signal" potential buyers of their superior qualifications. By signaling, high quality providers can differentiate themselves from low quality providers and

\[100\text{Id.}, \text{p. 480.}\]

\[101\text{Id.}\]
thus are able to obtain higher than average prices.\textsuperscript{102}
According to Spence, two conditions must be present in the
market before voluntary signaling can occur. First, there must
be a signaling mechanism available. There must be a credible
method to verify the asserted quality of the services.\textsuperscript{103}
Second, there must be an expectation by consumers of the
service that the benefits obtained by the signaling will exceed
the costs.\textsuperscript{104}

In the used car market, studied by Ackerlof, there are no
such mechanisms available, thus there will be no signaling by
the market. In the appraisal market, however, such mechanisms
do exist and there is signalling occurring. The professional
designations, at least to some degree, offer a mechanism to
signal the quality of appraisal providers. Further, consumers
seem to feel that the quality signal is worth its expense,
since designated appraisers are usually used.

The answer to the signalling problem is not necessarily
licensing. In his work, Moore\textsuperscript{105}, has suggested that
occupational certification offers the same advantages as
licensing, but without the potential anticompetitive side
effects. Certified professionals are voluntarily signalling to
consumers their superior qualifications.

\textsuperscript{102}Id.
\textsuperscript{103}Id.
\textsuperscript{104}Id.
\textsuperscript{105}Moore, p. 105.
A second corollary to Akerlof's theory is attributable to Stigler. Stigler suggests that in many markets, consumers have an incentive to voluntarily search out and acquire information which will allow them to make more informed purchases. Assuming that the information is not costly to obtain, many information asymmetries may thus be self correcting. According to Stigler, however, two conditions must be present for buyers to be able to correct the deficiency. First, there must be an intermediary channel. There must be a source through which consumers can acquire the information. Second, there must be an expectation by buyers that the benefits obtained by finding the information will exceed the costs of conducting the search. Stigler believes that there are many markets where both these conditions exist and thus the asymmetries will be automatically eliminated. He suggests that firms will appear that specialize in collecting and selling information.

In the appraisal profession, the professional associations seek to act as the information intermediaries. They attempt to provide information to consumers regarding the high quality of professional designations.

Schwartz and Wilde suggest that the imposition of occupational licensing may actually hamper the emergence or continued existence of intermediary channels.104

Wolfson and the others have suggested several benefits to occupational licensing as opposed to other forms of occupational regulation. First, "[l]icensure is anticipatory."\(^{107}\) It attempts to keep incompetent providers out of the market and thus keep the costs of incompetence from ever appearing. This contrasts with regulatory methods such as certification or civil liability were the costs of incompetence still occur.

Wolfson also maintains that licensure economizes on enforcement costs.\(^{108}\) Apparently, this is opposed to regulatory methods such as professional liability or setting standards for the service itself, rather than setting standards on the practitioners.

Licensure creates valuable property rights in a professional’s legal ability to practice. Wolfson argues that the possibility that these rights might be taken away should serve as a valuable incentive to practice competently.\(^{109}\)

A licensing system may substantially reduce information costs to consumers.\(^{110}\) Licensing statutes usually create a central regulatory agency, which has the benefit of economies of scale. This agency obtains information about the quality of services provided by a given professional. The consumer is

\(^{107}\)Wolfson, p. 206.

\(^{108}\)Id.

\(^{109}\)Id.

\(^{110}\)Id.
then able to request this information from the agency at a much lower cost than the consumer could obtain on their own.

Incompetent services often cause third-party costs. Individuals may be hurt who are not parties to the transaction. For example, in the appraisal industry, critics argue that incompetent appraisals have caused losses to taxpayers. Incompetent appraisals contributed to the large losses experienced by the savings and loan industry and taxpayers are being forced to make up the losses. A licensing system directly addresses the problem of third party costs by removing the consumers' choice to use lower quality services.\textsuperscript{111}

Wolfson also argues that a licensing system strengthens the position of small businesses.\textsuperscript{112} He asserts that a licensing system bolsters the public’s confidence in the licensed professional. Thus, the uncertainty of using a smaller firm is reduced.

One can see that there are many arguments in favor and against the use of occupational licensing. Further, there are separate schools of thought which have concentrated on one side or the other. However, neither school actually refutes the claims of the other.

\textsuperscript{111}Id., pp. 206-207.

\textsuperscript{112}Id., p. 207.
The Empirical Evidence.

As this paper demonstrates, there has been much theoretical examination of occupational licensure, however, there has not been much empirical work done relating occupational licensing to its effects on quality. Sidney Carroll and Robert Gaston, have, however, attempted to conduct studies which do measure the quality provided by licensed occupations.\textsuperscript{113}

The first conclusion reached by Carroll and Gaston is that restrictive licensing significantly lowers the stocks of individuals in a profession.\textsuperscript{114} This hardly seems surprising since the Friedman school argues that entry will be reduced because entry costs are increased. What is more interesting is that they found

consistently from occupation to occupation there existed a strong negative association between per capita numbers of an occupation and measures of per capita quality of service received. ... There is, then, evidence from several professions and trades that indicates that restrictive licensing may lower received service quality.\textsuperscript{115}

They reached a similar conclusion when studying the effects of


\textsuperscript{114}Carroll and Gaston, Southern Economic Journal, p. 973.

\textsuperscript{115}Id.
licensing on the real estate profession.\textsuperscript{116}

\textbf{Occupational Certification Theory.}

Up to this point, the discussion has centered on occupational licensing theory. Title XI, however, is not strictly an occupational licensing law. Title XI is something of a hybrid. It merely allows state licensing of real estate appraisers. On the other hand, certification is mandated. Interestingly, certification is deemed the more rigorous of the two.

Unfortunately, certification has not been as extensively studied as licensing. The most extensive analysis to date appears to be the article by Wolfson. Others have, however, mentioned certification in their writings.

In his book, \textit{Capitalism and Freedom}, Friedman discusses certification. He states,

\begin{quote}
[c]ertification is ... difficult to justify. The reason is that this is something the private market can do for itself. There are private certification agencies in many areas that certify the competence of a person or the quality of a particular product.\textsuperscript{117}
\end{quote}

He does believe, however, that certification is much better than licensure.

Certification is much less harmful [than licensure]. If the certified "abuse" their special certificates; if, in certifying newcomers, members of the trade impose unnecessarily stringent requirements and reduce the number of practitioners too much, the price differential between certified and non-

\textsuperscript{116}Carroll and Gaston, \textit{Research in Law and Economics}, p. 10.

\textsuperscript{117}Friedman, p. 146.
certified will become sufficiently large to induce the public to use non-certified practitioners. In technical terms, the elasticity of demand for the services of certified practitioners will be fairly large, and the limits within which they can exploit the rest of the public by taking advantage of their special position will be rather narrow.\textsuperscript{118}

Thus, even Friedman seems to tolerate the use of certified professionals. He argues that certification is a good "half-way house" that maintains protection against the possibilities of monopolization.\textsuperscript{119} He concludes "I personally find it difficult to see any case for which licensure rather than certification can be justified."\textsuperscript{120}

Similarly, Thomas Moore suggests that all the problems pointed out by the informational economics perspective are solved by the use of certification.\textsuperscript{121} Certification may prevent the quality deterioration of a market by providing consumers a means to differentiate a high quality product. Thus, high quality providers are able to charge more for their service and are not driven from the market.

The paper by Wolfson and the others suggest several benefits which are obtained by certification. First, they argue that certification responds directly to the problem faced by uninformed consumers trying to determine the competence of a given professional. It accomplishes this by "grading"

\textsuperscript{118}Id., p. 149.

\textsuperscript{119}Id.

\textsuperscript{120}Id.

\textsuperscript{121}Id.

\textsuperscript{122}Moore, p. 104.
professionals into at least two categories, certified and uncertified.\textsuperscript{122}

Certification is more flexible than licensure.\textsuperscript{123} While informing the public about degrees of competence, it also allows free entry into the market by uncertified individuals. This allows a market niche for uncertified, low cost appraisers for non-savings-institution work, such as determining a listing price for a parcel of real property.

Wolfson and the others do, however, point out several detriments associated with certification. First, like licensing, certification systems make large assumptions about quality correlations between certification or licensing requirements and the quality of services.\textsuperscript{124} If the findings of Carroll and Gaston are correct, these assumptions may not be true.

The public’s reliance on certification may become very strong, especially in markets with a high amount of uncertainty or high risks associated with poor quality.\textsuperscript{125} The public’s reliance may become so strong that certification may tend to operate like a licensing system, with all the associated disadvantages.

Like licensing, certification has the potential to

\textsuperscript{122}Wolfson, p. 203.

\textsuperscript{123}Id.

\textsuperscript{124}Id., p. 204.

\textsuperscript{125}Id., p. 205.
introduce misinformation if inappropriate criteria are chosen for differentiating between certified and non-certified professionals.\textsuperscript{126} All certification systems are, to a certain extent, misleading. They can never precisely inform a consumer of what a professional is certified to do or how well the service will be performed.

On the other hand, where the social cost of low quality service is high, certification may not be a sufficient guarantee of quality.\textsuperscript{127} Further, certification systems do not address the possible third party costs from faulty services.\textsuperscript{128}

Thus, although certification systems have less inherent problems than licensing systems, they still have significant deficiencies. Since certification of appraisers will soon be the law, it should be helpful to set forth some suggestions which might minimize the problems which may be created by Title XI of FIRREA.

\textbf{Suggestions for Improvement.}

Title XI vests a great deal of power in the states. The states are responsible for enacting legislation which specifies the day-to-day operation and implementation of appraisal reform. Since the states are given so much power, the bulk of the suggestions for improvement in the appraisal reform will consist of suggestions to state legislatures for the

\textsuperscript{126}Id.

\textsuperscript{127}Id.

\textsuperscript{128}Id.
implementation process.

Suggestions for State Implementation of Title XI.

The main consideration for state legislatures must be the purpose set forth in Title XI, the protection of public interests. As this paper demonstrates, occupational licensure can easily be used for the protection of the profession's interests. State legislators should be aware of this possibility and take this into consideration when enacting legislation.

It is the responsibility of state legislators in the regulation of occupations to correct inefficiencies in the market. The literature suggests that the detriments of occupational licensure outweigh the benefits and that occupational certification will correct most of the inefficiencies that licensure is intended to correct. This paper suggests that state certification can have benefits to the public if properly implemented. However, state legislation should be written with the detriments of occupational certification in mind.

First, the requirements for certification should be kept to a minimum. The requirements should be strictly tailored to occupationally required skills and knowledge. The goal of certification is to provide information to the public about the quality of a given appraiser prior to hiring. Thus, strictly tailoring certification requirements to needed skills and knowledge will reduce the amount of misinformation given to
consumers and increase information exchange. This allows a transaction to be accomplished with the highest possible efficiency. State legislators must therefore make a critical appraisal of certification requirements in order to determine that the requirements are relevant.

Second, state examinations which will be required of all state certified appraisers should also be job related. To a certain extent, this is beyond the control of state legislators. The law requires that the examination meet the minimums set forth by the Appraisal Foundation and oversight of the Appraisal Foundation is a federal function. However, states should refrain from adding additional questions to exams, unless the questions are specifically related to address appraisal problems unique to that state or region. As with other certification requirements, this will facilitate efficient information exchange between appraisers and consumers. In addition, there is the discrimination concern when writing exams. The exams must be carefully written by individuals who are trained in exam writing, not by practitioners. This will limit the disproportionate impact on racial and language minorities.

Third, although it might be beneficial to construct more than one level of certification, this specialization approach should be kept to a minimum. Although creating different specialty certifications has the benefit of giving consumers more detailed information about the skills of a particular
appraiser, excessive specialization will also lessen competition between appraisers and may unnecessarily raise the price of appraisals.

Fourth, some state regulation of private educational institutions which are devoted to appraisal training will be required, at least if graduation from such an institution is made a requirement of becoming state certified. If a state requires a prospective appraiser to graduate from an appraisal school, power is given to the school to control entry into the occupation. The institutions will be able to establish criteria for entry into the school. It is possible that these entry decision could be based on entirely subjective criteria. As a result, becoming certified could depend upon belonging to the "old-boy" network. This is simply an unfair restriction on the practice of an occupation. Further, it could result in a disproportionate impact on women or racial minorities. State legislators must therefore consider not only regulation of the appraisal profession, but also regulation of appraisal schools.

Finally, states must provide for some kind of continuing educational requirements for certification. It is clear that simply because an individual can pass certification requirements at one point in his or her career does not mean that individual will keep apprised of changes or advances in appraisal theory. Further, a continuing education requirement will assure the public that appraiser regulation is indeed meant to increase the quality of appraisals and not simply to
raise barriers to entry into the occupation. Thus, implementation legislation should include a provision for continuing education.

Suggestions for Federal Improvement in Title XI.

Although it seems as if the drafters of Title XI took into account many of the criticisms of licensure when drafting the legislation since they did not require licensing on the federal level, there is still some room for improvement in the law. The lack of permanent reciprocity among states will raise barriers to the interstate mobility of appraisers. It is unclear why Congress chose to provide only temporary reciprocity when it drafted the bill. The lack of permanent reciprocity will mean that appraisers may have to fulfill completely different educational requirements when moving from one state to another. This will raise the costs of movement and thus may restrict the movement of appraisers between states and restrict the market from correcting supply and demand variations in different regions. Certainly one might argue that knowledge of local real estate conditions is necessary for accurate real estate appraisals and thus there should be no reciprocity. However, if this argument is true, it argues against certification on a state-wide basis and for certification on a more local level. Such a system however would greatly restrict competition among appraisers and would probably result in an increase in prices. Thus, Congress should examine the possibility of making the reciprocity
provisions of Title XI permanent.

**Conclusion.**

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 makes great changes in the financial services industry. In addition to other sweeping reforms, the law provides for regulation of real estate appraisers. The regulation allows for both state licensing and certification of appraisers.

Licensing has been criticized by many scholars because of its detrimental economic effects, although some believe that licensing has many benefits. There has been little empirical research on the subject, however, the research that has been done tends to support the views of those who are critical of licensing.

Certification has not been studied as extensively as licensing and has meet with lukewarm support among the critics of licensure. Certification is considered by the critics to be the lesser of two evils.

The implementation of licensing and certification has been left to the state legislatures. Since there are major detriments to licensure which are not a concern with certification, legislatures should opt for certification of appraisers to comply with the new federal appraisal regulations. However, since certification also has its drawbacks, state legislation should be drafted with these concerns in mind.
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