

# Is That Property Even Legal?

Appraisals must address zoning and permit regulations to reduce risk

By Richard Garrie

**T**he topic of zoning often brings confusion to everyone involved in the origination process. Loan originators should be aware of potential problems. Questions often arise as to whether a property is legal if it does not have the proper permits, for example. The answer is yes and no.

Before you can answer the question and finish processing that loan, you must understand the difference between permits and zoning. Zoning is the legal authority that governs what can be built on a site and generally sets the rules that govern the potential improvements that can legally be built on the site.

Permits govern what has been built on the site and whether it was built in compliance with local zoning laws and/or in compliance with local, state and federal codes. These are specific to the improvements already built on the site.

It is important for mortgage originators to be aware of these concepts and how they should be handled in the appraisal process. Understanding the difference is the key to establishing whether a property is considered legal or not. This can affect whether a loan makes it through underwriting or not or if it can be sold on the secondary market.

## Collateral preservation

Can we rebuild it? This question is important to lenders who will be taking on the risk of a loan on a specific property. Most mortgages are made today with a 30-year term. The lenders an originator works with will want to make sure that the improvements they are taking as collateral will be there at the end of the mortgage term. If some disaster occurred and the

home was destroyed, can it be rebuilt to the same footprint that was previously constructed on the site, including all improvements?

This is where the difference between permits and zoning must be understood. If the improvements that were on the site did not meet the minimum zoning requirements, regardless of whether they had the adequate permits at the time, it is possible the borrower could be restricted from rebuilding to the same footprint of the improvements that were originally there, which can create risk for the lender that could have been avoided if the zoning had been reported in the appraisal.

Most often, if a property has the proper permits, rebuilding will be allowed if the structure is destroyed, but that is not always the case. There have been times when rebuilding was not allowed to the prior footprint because changes to the zoning regulations occurred over the years, or perhaps the permits were inadvertently issued. In those cases, any new improvements must adhere to the new zoning requirements.

What about improvements that were built without permits? Can they be legal? The answer is yes. Remember, legal refers to zoning and whether something meets the zoning requirements. If improvements are built on the site that do not have the proper permits, but are within the zoning requirements, there is nothing that can prevent the property from being rebuilt to the same footprint if destroyed. It will just require the proper permits to be pulled at that time.

## Why appraisals matter

Once you understand the differences between permits and zoning, how do you address potential issues? Check the appraisal.

Let's talk about zoning first. There are three different designations for zoning in an appraisal: legal, legal nonconforming and illegal. The first two — legal and legal nonconforming — are typical appraisals that don't require anything atypical and can be completed under standard appraisal practice.

When a property is illegal, however, the appraiser must take into consideration the highest and best use of the property. If the property is not legal, it can't be at its highest and best use, which means the appraiser cannot place a market value on the property.

Fannie Mae and the Federal Housing Administration (FHA) will not accept properties with illegal zoning. In that case, it is relatively simple how to proceed. The appraisal must be made invoking the hypothetical condition that the property conforms to zoning. This requires the appraisal to be made subject to whatever is necessary to bring the property back into compliance with zoning.

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Take a borrower who has built a deck off the side of the house, for example. If that deck was built beyond the setback requirements of zoning, the appraisal would need to be made subject to removal or alteration of the deck to meet zoning setback requirements.

### How permits fit in

When discussing permits, originators must first understand that Fannie Mae and FHA do not expect appraisers to be the permit police. Actually, they both say very little on the subject.

The Fannie Mae Selling Guide B4-1.3-05 states, "If the appraiser identifies an addition(s) that does not have the required permit, the appraiser must comment on the quality and appearance of the work and its impact, if any, on the market value of the subject property."

This is the entirety of Fannie's comments on the subject. FHA says even less and, in the new 4000.1 handbook, they do not even address permits on work already performed on a property. So, how do appraisers address something when they discover there are no permits?

Appraisers need to identify if the quality and appearance of an improvement is consistent with typical building standards. If you were a buyer walking into the home, would you be tipped off that it was different? Would you know that something wasn't right with a

deck off the back of the house or that there is an addition to the home?

Let's take, for example, two homes that have unpermitted additions. The first home has a bedroom addition to the second floor, adding 300 square feet of living area. You walk into the home and don't notice anything different. The room flows with the floorplan and, without additional research, you would never know it was an addition. In this case, the appraiser could easily state that the quality and appearance of the work is consistent with the rest of the home and there are no functional issues with the addition.

In the second scenario, you have a home with a 300-square-foot addition to the rear of the home where the roofline and siding don't match, and the interior finish and windows are all inferior. The addition is a large second living room.

Many of these factors might affect how a buyer perceives this area. The room does not have the same functionality as the previous example. The home already has a living room, so the addition of a second living room does not function the same as a similar-sized home with an additional bedroom. Then take into consideration the inferior quality and workmanship. This creates a problem. In this case, rather than including it in gross living area (GLA), the appraiser might make a line-item adjustment to address the functionality and inferior workmanship, and comment as such.

In both examples, the appraiser might say the addition has a positive impact on the value, but in the second that impact is limited and does not have the same contributory value as additional GLA because of inferior workmanship and limited functionality compared to other homes of similar size. This can affect the value of the home, which can impact the underwriting of the loan.

### Addressing safety

The last items that need to be addressed when determining the viability of improvements are health, safety and structural issues. Typically, appraisers would only address items that are readily observable, but when it comes to additions, they need to be a little more diligent.

If an addition to the home required major electrical or plumbing work, a lender may want this inspected because of the potential health and safety issues associated with electrical and plumbing. If a wall was removed for the addition, it may require an inspection to ensure that a weight-bearing wall wasn't removed.

In either case, it is prudent for both appraisers and originators to make sure they are addressing the proper terms. There are specific health and safety rules that apply to both zoning and permits, and knowing the difference is the key to producing a credible and reliable appraisal, and understanding the implications of that appraisal on loan risk. ■