

# Basics of Collateral Appraisal

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For Real Estate Properties and Vehicles

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# GLOSSARY

Accretion

An increase in dry land by gradual deposit of waterborne, solid material, and riparian land, i.e., accretion by alluvion. The owner of the riparian land becomes owner to the title to land formed by accretion. Ant: Erosion

Accrued Depreciation

The difference between the present worth of improvements and the reproduction or replacement cost new, both measured on appraisal date.

Adverse possession

Acquisition of title to real property owned by someone else, by open, notorious, and continuous possession for the statutory time.

Amenities

Tangible and intangible benefits generated and received through exercise of rights to real property, not necessarily in a form of money.

Angle

A measure of rotation about a point, generally used in surveys to show the relationship of one line to another. Usually measured in degrees, 360 to a full circle or one full rotation back to the point of the beginning.

Appraisal

A written estimate and opinion of value; conclusion resulting from analysis of facts.

Appraiser

One qualified by education, training, and experience who is hired to estimate the value of real and personal property, based upon experience, judgment, facts, and the use of the formal appraisal

	processes.
Appurtenance	Something annexed to another principal thing and which passes as incident to it, for example, right of way or barn passing with a principal property.
Azimuth	The angle between a reference line, usually North and South and a line to an object, measured clockwise from south corps of engineer surveying.
Baseline and meridian	Established lines used by surveyors to locate and describe land under the rectangular survey method of the property description used in most locations.
Bearing	The cardinal direction (North, South, East, West) of a line.
Cadastral	Public record of the extent, value, and ownership of land; land surveying and mapping.
Capitalization	In appraising, determining value of property by considering net income and percentage of reasonable return on the investment.
Capitalization rate	The percentage ratio between net income from investment and the value of the investment. Commonly expressed as "return on and return of" capital.
Certificate of Title	A document stating that the title to a particular property is clear. It is prepared by a lawyer or a qualified person who examined the abstract of the title. This is not to be confused with title insurance. It is only an opinion that the title is deemed good. The Certificate of Title is usually given to a

Chattel	homeowner with deed. Personal property that is tangible and movable.
Clear Title	A title free and clear of all encumbrances.
Collateral Appraisal	The process of developing an opinion of value of a certain property being offered as security for loans.
Collateral Security	A separate obligation attached to a contract to guarantee its performance.
Comparable Property	Properties listed in an appraisal report that are substantially equivalent to the subject property, and comparable in selling, rental, income, or similar measure.
Conveyance	The transfer of title to real property by means of a written instrument such as a deed.
Cost Approach	Also known as replacement or reproduction cost less depreciation.
Debt Service	Periodic payment on a debt, for interest on and retirement of the principal.
Deed	A legal instrument in writing, duly executed, sealed, and delivered, whereby the owner of real property (grantor) conveys to another (grantee) some right, title, and interest in real estate.
Deed of Restriction	A provision in a deed controlling or limiting the use of the land.
Depreciated Value	The value remaining after deducting depreciation from the acquisition cost.
Depreciation	A lowering of value. A reduction; lessening. The decline in value of property. Loss in market value.

Deterioration	Deterioration over a period of time. Impairment of condition. One of the causes of depreciation and reflecting the loss in value brought about by wear and tear, disintegration, use in service, and the action of the elements.
Discount	That which can be taken off the established amount.
Economic Life	The period over which a property will yield a return on the investment, over and above the economic or ground rent due to land.
Economic Life	It is the estimated period over which it is anticipated that a machinery may be profitably utilized.
Economic Obsolescence	Impairment of desirability or useful life arising from economic forces, such as changes in optimum land use, a legislative enactment that restrict or impair property right, and changes in supply and demand relationships.
Effective Age	Age in years, indicated by the condition and utility of a structure.
Elevation	The distance above and below datum.
Encroachment	To trespass. The building of a structure or any improvements partly or wholly that intrudes upon the property of another.
Encumbrance	Any claim, lien, charge, or liability attached to and binding upon real property that may lessen the value of the property but will necessarily prevent transfer of title. There are two classifications of title: 1) Those that affect the title (e.g., judgment,

	mortgages, mechanics lien, and other liens that are charges on [property used to secure a debt or obligation; 2) Those that affect the physical condition of the property (e.g., restrictions, encroachments and easements)
Estate	In real estate, it refers to the degree, quantity, nature, and extent of interest that a person has in real property, such as fee simple absolute estate, an estate for years.
Fair Market Value	Legal term for "market value."
Functional Obsolescence	A loss in value of an improvement due to functional inadequacies, often caused by age or poor design.
Gross Income	The projected annual income from operation of a business or from management of property.
Gross Rent Multiplier	Ratio of sales price to monthly rental income for single family residential properties.
Homestead	A home that is used as a personal residence.
Improvement	An addition to land that costs labor and capital (buildings, pavements etc.), more or less permanently attached. More than repair or replacement.
Income Approach	An appraisal technique used to estimate the market value of a property on the basis of the income it produces or is capable of producing.
Lien	A hold or claim that one person has upon the property of another, as a security for some debt or charge.
Lis Pendens	A public notice, filed against specific lands, that an action at law is



**Market Data Approach**

pending that may affect the title to the land.

Also known as “Sales Comparison Approach.” Traditionally, an appraisal procedure in which the market value estimate is predicated upon prices in actual market transactions and current listings.

**Market Value**

The price at which a willing seller would sell and willing buyer would buy, neither being under abnormal pressure.

**Metes and Bounds**

A common method of land description that identifies the property by specifying the shape and boundary dimensions of the parcel, using terminal points and angles.

**Monument**

A natural or artificially made fixed object used as a permanent reference point for surveying, or mark and ownership boundaries.

**Mortgage**

A legal instrument pledging a described property for repayment of loan under certain terms.

**Patent**

An instrument by which the government conveys public land to an individual.

**Personal Property**

All physical objects of a personal or movable nature, subject to ownership.

**Plat**

Map of town, section or subdivision, showing location and boundaries of individual properties.

**Plot**

A piece of land.

**Price**

The amount paid in legal tender, goods or services; the consideration; purchase price. The terms for which a thing is done.

Property	The rights or interests that a person has in the thing he or she owns; not in the technical sense, the thing itself.
Real Property	Land anything built on, growing on, or affixed to land
Replacement Cost	Cost of the building with equivalent utility but with modern materials and deficiencies of the building it replaces.
Reproduction Cost	Cost of the building; an exact duplicate of a structure, including deficiencies.
Restriction	A limitation upon the use or occupancy of real estate, placed by covenant in deeds or by public legislative action.
Right of Way	The right or privilege, acquired through accepted usage or by contract, to pass over a designated portion of the property of another.
Survey	The act by which the quantity and boundaries of a piece of land are ascertained; the paper containing a statement of the courses, distance, and quantity of land is also called a survey.
Tax Map	Is a graphic representation of a portion of the earth's surface drawn to scale on standard size drawing material, having property line and jurisdictional boundaries delineated showing all parcels of real property and identifying each separate real property ownership by a unique number.
Title	The right to or ownership of land. Also evidence of ownership.
Valuation	The act or process of estimating

Value

value; the amount of estimated value.

Zoning

Ability to command goods, including money, in exchange; the quantity of goods, including money, that should be commended or received in exchange for the thing valued.

The public regulation, through police power, of the character and extent of real estate use.

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## INTRODUCTION

In the course of providing consultancy services to cooperatives since 2011, the Consultancy Unit of the National Confederation of Cooperatives (NATCCO) has observed that one of the challenges faced by cooperatives is conducting appraisal of collaterals that are submitted by members to secure their loans. The said challenge is mostly attributable to incomplete components of the appraisal report (e.g., inadequate physical identification of the property, no plotting of bearings, no comparable properties) that, in the end, will make the valuation questionable, later leading to problems. As these problems occur, the loans that are secured by the submitted collaterals will be more vulnerable to credit risks.

The main purpose of this handbook “Basics of Collateral Appraisal: for Real Estate Properties and Vehicles” is to guide cooperatives in conducting collateral appraisal, without undermining the capacity of the loan applicants because, of course, the cooperatives must always factor into their decision-making the importance of granting credit vis-à-vis the loan applicants’ cash-flow. This handbook also aims at delivering some of the basics in collateral appraisal relative to credit granting.

Cooperatives accept various types of collateral, such as live cattle, jewelries, water pumps, real estate properties, and vehicles, among other properties that may be used as collaterals. This handbook will discuss only two types of collaterals, that is, real estate properties and vehicles because most of the cooperatives that were diagnosed by the NATCCO Consultancy Unit had been accepting already these collaterals. In line with this, it is viewed that cooperatives that will read this handbook until the very last part will be able to create more professional and acceptable collateral appraisal reports that are specific to real estate properties and vehicles collaterals.

## Users of the Handbook

This handbook is for employees of cooperatives and other individuals who conduct and prepare appraisal reports; and for managers and Board of Directors of cooperatives, to help all of them understand the risk entailed in each appraisal report, a document that will eventually guide them in credit decision-making.

This handbook is also for other individuals who are interested in learning the basics of collateral appraisal.

## **Importance of Collateral Appraisal in the Cooperative Environment**

As seen among a number of cooperatives, the conduct of collateral appraisal has been an issue in granting credit. As this issue magnifies, the granting of credit becomes riskier, especially for bigger loans. Thus it is important to consider and understand the value of collateral appraisal.

The appraisal report is created to identify if the collateral being offered as security by the member-borrower would be acceptable to the lender-cooperative. Additionally, the appraisal report would enable the lender-cooperative to identify the loan exposure over loan amount. Lastly, the appraisal report's desired outcome would enable the lender-cooperative to determine the demand for an identified property that would eventually help the cooperative assess its disposal. Cooperatives, therefore, must bear in mind that properties are accepted as collaterals to somehow secure a loan and not to make collaterals as an outright payment.

## **Appraisal Definition and Concepts**

For most lenders, doing collateral appraisal is necessary so as to determine the loan exposure over risk to a certain property. In order to mitigate the credit risks entailed in collateral loans (in layperson's terms), the cooperative must understand how valuation and evaluation are being conducted.

According to USPAP (Uniform Standards of Professional Appraisal Practice, 2009), "appraisal" is the process of developing an opinion of value. If we use the said definition of appraisal to the collateral being offered for loans, we may conclude that "collateral appraisal" is the process of developing an opinion of value of a certain property being offered as security for loans. Thus, with the said definition, the cooperative must be able to demonstrate the required

processes before making any opinion or making any credit decision, especially for loans bundled with collaterals as security.

Is appraisal an art or a science? Santos (Santos C.E., 2015) revealed in his book that if appraisal were a true science, various appraisers using the available data would come up with identical values of property. While theory and techniques used in appraisal have scientific basis, their application more closely resembles art. Why? Because an appraiser must use his or her professional judgment when considering factors that are subjective. And good judgment is developed through long years of experience in appraisal practice. The accuracy of an appraisal plus the appraiser's integrity or credibility are put on the line. Appraisal should be in accordance with the commonly used standards in appraisal practice and code of conduct. It is not surprising that two or more appraisers may give different values to a specific subject property. Thus appraisal maybe regarded as both an art and science that must be integrated together by the appraiser so as to develop a meaningful value of conclusion.

Is appraisal a valuation or an evaluation? Valuation is the process of estimating market value or other defined values of an identified interest in a specific parcel or parcels of real estate as of a given date. It can be performed by an unlicensed appraiser, for instance, a mechanical engineer who estimates machineries and equipment. The engineer who is not a licensed appraiser may give an estimate, but only an appraiser makes the written opinion. The engineer may appraise under the supervision of a licensed appraiser. Evaluation, on the other hand, is a study of nature, quality, or utility of a parcel of real estate or interests in a real estate property.

## Concepts of Value

Value is the present worth of future benefits. It is also defined as the amount of money deemed to be equivalent in worth of the property under appraisal. It is the power that commands other commodities in exchange. It is the relationship



between a thing desired and a potential purchaser. Thus value has four elements—utility, scarcity, demand, and transferability.

- **Utility**  
Refers to the usefulness or satisfaction one receives from goods or services. It also refers to the private or public service facilities, such as water supply, sewerage system, telephone lines, etc., as part of the development of the land.
- **Scarcity**  
An economic principle that can be used to explain real estate markets. It is also a state where there is no shortage of property, but there is an occasional shortage because of some economic activity.
- **Demand**  
The amount of goods people are willing and able to buy at a given price: often coupled with supply.
- **Transferability**  
Also known as effective purchasing power. It allows an individual who wants a commodity to participate in the market, that is, to acquire the item.

## Definition or Characteristics of Market Value

After understanding the concepts that affect the value of a property, the appraiser must understand the market value or appraiser's value that he or she usually comes up with. The market value or appraiser's value is the estimated price or probable amount with which a property would be exchanged in a typical market in terms of cash or its equivalent, transacted in an arms-length transaction (which means it is not an unrepresentative sale, e.g., fire sale, foreclosure sale, sale of parents to their children, sale of company to an

affiliated company). In addition, the buyer and the seller are both knowledgeable on the legal uses of the property and are not under duress or are not compelled to buy and sell the property. In other words, the market value of the appraiser must be the value in exchange or the objective value.\*

## Market Value, Price, and Cost

As the appraiser had understood the value that she or he was tasked to derive from the appraisal, she or he may likely encounter different kinds of values. For example, in the process of gathering market data, the appraiser must identify the figures if they are the market value, or just the price or cost.

- **Market Value**  
Most likely, the price by which a property would be sold in an open market. An objective value is commonly the target of an appraisal assignment.
- **Price**  
Actual selling price of the owner of a property, or the amount at which a property was actually sold.
- **Cost**  
Amount of money used to construct, for instance, a building plus the land value.

## Economic Principles of Value

Appraisal is based on economic principles of value. As the appraiser conducts her or his job, these principles must be kept in mind. These principles may be called "Appraisal Principles," "Principles of Value," "Economic Principles," or just "Principles." These principles may have many names, but the important thing is that they should be comprehended carefully so that the appraiser will be