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The Relationship Between Economic Circumstances and Appraised Values in the Hotel Appraisal Process, 1981-1998

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THE RELATIONSHIP BETWEEN ECONOMIC CIRCUMSTANCES AND APPRAISED VALUES IN THE HOTEL APPRAISAL PROCESS, 1981–1998

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ABSTRACT

The purpose of this paper is to examine the economic circumstances that motivated principals in the hotel appraisal process to influence appraised hotel values. The economic circumstances are the background in which appraisals are completed and may be germane to the issue of appraisal accuracy. This paper outlines the relationships in the process and examines the specific circumstances that may have motivated the parties to influence appraised values to be different than market values. Moreover, it provides a basis for further research and empirical tests of these relationships.

Introduction

The purpose of this paper is to examine the economic circumstances that impacted the motivations of principals in the hotel appraisal process. This paper will describe how differing economic circumstances may have changed the desires of the principals across periods of time, potentially changing appraised values relative to market values. This paper discusses how a strong economy and other circumstances influenced most principals to want appraised hotel values to be higher than market values. On the other hand, economic circumstances such as changes in tax laws or increased monitoring by federal regulators may have influenced principals to want appraised hotel values to be lower than market values.

The paper first describes the important relationships in the hotel appraisal process. A brief review of appraisal accuracy literature is provided, along with a discussion of the serious nature of the appraisal accuracy problem. The economic circumstances of three distinct periods are detailed next, including a discussion of the importance of lenders in the appraisal and their motivations. Some descriptive data are subsequently provided and followed by conclusions and recommendations for further research.

Important Relationships in the Process

The appraiser is the agent of various principals in the hotel appraisal process. The principals include the lender, buyer, seller, and appraisal monitoring authority. During the 1980s, the buyer typically commissioned an appraiser directly and would subsequently use the appraisal to "shop" for permanent financing. Although the other parties

were not explicit principals, they could provide selective or incomplete information to an appraiser in an effort to influence value. Additionally, there was no unified appraisal licensing authority that could regulate appraisers. Without an effective monitoring authority, appraisers were much more subject to the desires of the buyer, seller, and lender.

The relationships in the process changed in 1989 because of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). Buyers could no longer commission an appraisal directly if they were going to obtain financing from a federally insured lending institution. Instead, appraisals were to be commissioned by lenders, thereby making the lender the most influential party in the process. The decision to make the lender responsible for commissioning appraisals was to help solve appraisal problems. Additionally, appraisers were expected to be licensed and/or certified and to complete appraisals that met more stringent standards.

In the 1990s, however, some researchers (Rudolph, 1994; Petuck, 1996) are skeptical about whether or not federal and state regulations have effectively altered the motivations of the parties in the appraisal process regarding appraisal accuracy. Additionally, a recent survey of appraisers conducted by Smolen and Hambleton (1997) indicates that nearly 80% of appraisers reported that aggressive lenders are still asking them to change appraised values. Therefore, without the appropriate incentives to encourage accurate appraisals on a consistent basis, appraised values may be systematically higher or lower than market values based upon the needs of the influential parties in the process. The needs of the parties may vary from time to time, depending on the prevailing economic and regulatory environment.

Literature Review

A review of the literature reveals appraisal accuracy concerns during particular time periods (such as the 1980s) without establishing similarities to or differences from other periods. Additionally, there has been only a limited amount of research completed about the agency relationships in the appraisal process. Thus, an examination of exogenous factors affecting the motivations of the parties in the process may help explain changes in appraisal outcomes.

In a perfect steady state economy, appraised values should not differ significantly from sales prices in a systematic fashion. However, changes in economic circumstances or the regulatory environment may induce bias into this process. This is detailed by Webb (1994) who shows sign changes of differences between appraised values and sales prices of commercial properties during different time periods from 1978 through 1990. Similarly, we can examine why there are distinct time periods that involve changes in appraised values.

The 1980s period is considered distinct primarily because of the tremendous effect the 1981 Tax Reform Act had on commercial real estate markets (Federal Deposit Insurance Corporation (FDIC), 1997). This tax law change, combined with an improving economy of 1983–1984, produced an environment that encouraged real estate development.

Additionally, economic conditions were also generally favorable in the late 1980s. These circumstances provided an incentive for parties in the hotel appraisal process to want appraised values to be higher than market values.

Conversely, the Tax Reform Act of 1986 largely had a negative impact on real estate returns. A study by Follain, Hendershott, and Ling (1987) details the expected impact on real estate returns because of the decelerated depreciation schedules for commercial real estate. The Tax Reform Act of 1986 also restricted the deductibility of passive losses of real estate investments. This change in the tax law may have had an opposite effect from the 1981 tax law change. Principals in the process may have been looking to sell hotel properties rapidly, thereby influencing appraised hotel values to be lower than market values during the period immediately surrounding the enactment of Tax Reform Act of 1986.

Major regulatory changes affecting lenders—primarily savings and loan institutions—have been researched extensively by Kane (1989). The problems associated with commercial lending and appraisal practices were widely publicized by the U.S. House Committee on Government Operations (1986) in a startling report. A need for federal regulation of appraisers was not only recognized by legislators, but by appraisers themselves (Diskin, Maroney, & Vickory, 1988; Duvoisin, 1988). This led to the enactment of FIRREA in late 1989, opening a new chapter in terms of the hotel appraisal process.

FIRREA changed the appraisal landscape significantly by 1990. New appraisal standards and guidelines were to be implemented along with state licensing as described by Hicken (1991). The Resolution Trust Corporation (RTC) began cleanup operations of insolvent savings and loans by selling non-performing assets. Moreover, the Appraisal Institute was formed in 1991 to bolster confidence in the profession after much negative publicity in the late 1980s.

With all of the measures coming into effect, the appraisal environment of the early 1990s was very different from that of the 1980s. Hanford (1994) and Petuck (1996) describe the overzealous and critical nature of commercial appraisal reviews. Appraisers were generally of the opinion that the regulatory pendulum had swung too far. This environment, however, was not to last very long.

By 1993, appraiser certification licensing laws had been phased in. A variety of new banking laws that had been enacted in previous years began to improve the condition of the nation's banking system (FDIC, 1997). Moreover, the United States was at the beginning of an economic expansion that is still in effect today. These changes led to a more relaxed atmosphere for appraisers, with comparisons of the mid-1990s being made to the 1980s (Petuck, 1996). The survey by Smolen and Hambleton (1997) also reveals the generally pro-development attitude of lenders during this period.

With the establishment in the literature of three different historical periods over the past two decades, we can examine the specific circumstances within each period that may have influenced the parties in the appraisal process toward wanting higher or lower appraised hotel values.

Economic Circumstances

Economic Circumstances 1981–1989

Based upon an examination of economic indicators, the two recessions of the early 1980s were from January through July 1980 and July 1981 through November 1982 (Rogers, 1994). These recessions contributed to the enactment of the Tax Reform Act of 1981 in an effort to stimulate the economy. This act provided tremendous incentives for real estate development by increasing real estate depreciation tax shields.

The tax shield increase, combined with the availability of large foreign and domestic capital inflows, led to a dramatic increase in the supply of hotel rooms and other types of commercial real estate (Roulac, 1994). For example, new hotel room construction in the U.S. increased from approximately 80,000 rooms in 1980 to 140,000 in 1984, nearly 160,000 in 1985, and approximately 150,000 in 1986.[1]

Hotel supply generally lags behind an increase in demand by approximately 18 to 24 months because of the time needed to have a market study completed, negotiate a franchise, secure financing, and complete construction. Therefore, an improving economy in late 1982 or early 1983 could initiate the hotel development process and result in a newly completed hotel sometime in 1984.

Table 1 shows the U.S. average hotel occupancy and new hotel room construction activity between 1983 and 1989. Rooms demand and associated occupancies were strong in 1984, which led to new hotel room construction in 1985 and 1986. The new rooms decreased occupancy somewhat in those two years, but demand remained relatively strong throughout the rest of the decade. In fact, according to PKF Consulting data, occupancy levels increased steadily from 1986 through 1989 as shown in table 1.

Table 1
New hotel room construction and annual occupancy
rates in the United States, 1983–1989

Year	New Hotel Rooms	Average Annual Occupancy Rate
1983	120,000	64.4%
1984	140,000	67.8%
1985	160,000	66.9%
1986	150,000	65.6%
1987	120,000	65.8%
1988	110,000	66.3%
1989	110,000	67.2%

Note. The new hotel rooms column data are rounded.
The data in this table are adapted from Bill Saporito, "Boom at the Inn," *Time*, July 8, 1996, p. 43 and PKF Consulting, *Trends*, 1983–1989.

[1] Saporito, Bill, "Boom at the Inn," *Time*, 8 July 1996, p. 43.

The tax incentives of the 1981 Tax Reform act improved the return performance of commercial real estate by increasing the depreciation tax shield. In this environment, lenders such as commercial banks, thrifts, pension funds, and life insurance companies sought to increase real estate lending. This encouraged them to have appraisals completed that would justify a lending decision.

In the days before FIRREA, developers could commission an appraisal themselves and then subsequently "shop" the appraisal around in search of financing. Developers, who wanted to build hotel rooms, had a vested interest in obtaining an appraised value at or above construction cost. Commercial loan officers at commercial banks and thrifts were eager to earn loan origination fees and receive the developer's business. These parties could easily influence the appraiser, who was heavily dependent on them for business. Thus, the relationships motivated developers and lenders to increase appraised values.

The Role of Lenders during the 1980s

Commercial banks and thrifts played a large role in the increase in hotel room supply in the 1980s. Some of them, because of a large increase in interest rates in the early 1980s and the resulting disintermediation, were forced into "gambling" on real estate projects in order to earn higher returns. Commercial lenders, particularly commercial banks and thrifts, were seriously committed to increasing the amount of commercial real estate loans in their portfolios. As an example of that commitment, the increased involvement by banks in commercial real estate through the 1980s is shown in the table 2.

Table 2
Real estate and commercial real estate loans for domestic national banks in the United States, 1981–1989

Year	Total Loans (in millions)	Real estate loans (in millions)	As a percentage of total loans	Commercial real estate loans (in millions)	As a percentage of total loans
1981	$ 669	$168	25.1%	$ 36	5.4%
1982	728	180	24.7%	40	5.5%
1983	786	200	25.4%	46	5.9%
1984	924	232	25.1%	56	6.1%
1985	998	264	26.4%	67	6.7%
1986	1,073	308	28.7%	82	7.6%
1987	1,113	358	32.2%	100	8.9%
1988	1.185	408	34.4%	115	9.7%
1989	1,271	466	36.7%	132	10.4%

Note. The data regarding total loans, real estate loans, and commercial real estate loans are adapted from the Comptroller of the Currency, *Quarterly Journal 1981–1991,* 1992, p. 125.

Given the new tax incentives in place after the 1981 tax law changes, institutional investors such as pension funds became much more interested in commercial real estate investments. According to a 1984 survey, more funds were interested in owning real estate. Although a survey at the time dealt only with equity investment, this clearly is an indication of interest in commercial property, including hotels. The overall interest by funds in commercial real estate is shown in table 3.

Table 3
Number of funds owning real estate, 1981–1984

Year	Number of funds owning real estate	Percentage owning real estate
1981	90	44%
1982	120	47%
1983	123	50%
1984	132	47%

Note. The data in this table are adapted from "Real estate investing by pension funds—1984," *Pension World 20* (September 1984), p. 24.

Overall, the atmosphere of many lenders seeking higher returns via commercial real estate may have motivated lenders and others in the process to seek higher appraised values.

The Tax Reform Act of 1986 and Other Changes

By 1986, the circumstances affecting commercial real estate development began to change. The Tax Reform Act of 1981 was enacted in part to encourage economic growth. This act and a subsequent improvement in economic conditions encouraged extensive real estate development so much that by 1986 and 1987 oversupply resulted. For example, one study showed a 30-city average commercial office vacancy rate for 1980 to be only 4.2%, but by 1986, the vacancy rate increased to 17.2%.[2] Given the large increases in new hotel construction, investors began to worry about oversupply. This oversupply had a carryover effect into the late 1980s and early 1990s, exerting downward pressure on appraised values.

Another major effect was the Tax Reform Act of 1986. This legislation had a negative impact on the commercial real estate industry because of the treatment of passive losses and the lengthening of depreciation schedules. At the time, experts tried to predict what effects the 1986 Tax Reform Act would have on real estate returns. Brueggeman and Thibodeau (1987) hypothesized that in order to maintain investment returns for investors, rents would have to increase or else property values would have to decline.

Given that rents are relatively fixed in the short run, the latter appears to have occurred. Demand for real estate declined, causing a decline in property values. Brueggeman

[2]Wheaton, William C., "The Cyclic Behavior of the National Office Market," *American Real Estate and Urban Economics Association Journal,* Vol. 15 (1987), p. 281.

and Thibodeau estimated that commercial property values with an eight-year holding period would have to decline between approximately 17% and 25% to maintain the rates of return required by investors before the new tax law was enacted. This type of decline made some investors and lenders (particularly institutional lenders) reconsider financing hotel projects. Some principals who had only become involved in the hotel business for tax purposes wanted to sell properties fast or only lend on lower-priced "bargain" properties. Economic conditions not only lowered prices, but may also have encouraged lower appraised values in the period immediately before, during, and after the Tax Reform Act of 1986 (i.e., 1985–1987).

Economic circumstances had encouraged aggressive development in most hotel markets throughout most of the 1980s. This increase in supply was beginning to exert an adverse impact on hotel operating performance by the end of the decade. The average hotel in PKF Consulting's annual *Trends* survey had a taxable income of approximately 12% of total revenue in 1981. Despite some modest increases in occupancy during the decade, 1984's taxable income had declined to approximately 5% of total revenue. This figure subsequently fell to a low of negative 5% in 1987. The taxable income figure remained negative throughout the rest of the decade.[3]

Additionally, commercial banks were forced to handle more real estate problems. As the decade wore on and the oversupply of commercial real estate increased, banks were foreclosing on an increasing number of mortgages secured by commercial properties. The table below details the increase in REO (real estate owned property) of national banks during the 1980s.

Table 4
Real estate owned by domestic national banks, 1981–1989

Year	Total Assets (in millions)	Real estate owned* (in millions)	As a percentage of total assets
1981	$1,202	$1.5	.12%
1982	1,296	2.5	.19%
1983	1,392	2.9	.21%
1984	1,497	3.3	.22%
1985	1,630	3.9	.24%
1986	1,740	5.0	.29%
1987	1,770	6.2	.35%
1988	1,846	6.7	.36%
1989	1,976	9.2	.47%

Note. The data regarding real estate owned means other than bank premises. The data are adapted from the Comptroller of the Currency, *Quarterly Journal 1981–1991*, 1992, p. 116.

[3] Pannell Kerr Forster, *Trends in the Hotel Industry* (1991), p. 5.

While the real estate owned statistics include all types of real estate, they correlate strongly with the number of hotel failures during the 1990s. By the late 1980s, hotel failures had increased 40% over 1984 levels. Historical hotels and other lodging place failure statistics are shown in table 5.

Table 5
Hotel and other lodging place business failures in the United States, 1984–1997

Year	Number
1984	245
1985	303
1986	313
1987	336
1988	313
1989	260
1990	411
1991	510
1992	495
1993	424
1994	334
1995	322
1996	233
1997	261

Note. The data is this table are adapted from Dun and Bradstreet's *Record of Business Failures*, 1984–1997.

The aggressive position of lenders, brokers, and others in the development of new hotels and the sale of existing properties had helped force a temporary oversupply condition. The Tax Reform Act of 1986 may have changed the hotel investment environment during the time period immediately preceding and following the passage of the legislation. Nevertheless, after the initial impact of the Tax Reform Act of 1986 had "shaken out" the market, a relatively strong economy prevailed and continued to encourage hotel investment. On the other hand, the continuing problems with commercial lenders forced changes in lending and appraisal practices and resulted in FIRREA legislation in late 1989. This legislation altered the relationships between the parties in the process and got government authorities more involved in the monitoring of appraisal practices.

Economic Circumstances 1990–1992

For thrifts and commercial banks, early warnings of problems with the deposit insurance system began as early as 1985 with the bankruptcies of the Ohio and Maryland state savings and loan insurance funds. The Federal Savings and Loan Insurance Corporation

(FSLIC) became insolvent by 1986, and the FDIC experienced two consecutive years of losses in 1988 and 1989.[4] FSLIC was finally dissolved when FIRREA was enacted in August 1989.

FIRREA sent a signal to the nation's lending institutions that the government was going to pursue extensive monitoring practices in the heretofore largely unmonitored lending process. As previously stated, FIRREA intended to force appraisers to be more rigorous in their analysis of properties, and for banks to be much more familiar with the appraisal process. Moreover, the legislation would like appraisals to have greater consideration in the loan approval process.

In the meantime, while new appraisal standards were being phased in during this period, economic conditions had begun to decline. Another recession began in July 1990 and lasted through March 1991. In terms of hotel values, the Hotel Motel Brokers of America (HMBA) reported the peak selling price to be $23,630 per room in 1988. Three years later, the average sales price was $18,400 per room, a decline of approximately 22%. Thus, it appears that the Brueggeman and Thibodeau study, which predicted a decline in value of between 17% and 25%, was reasonably accurate. An oversupply of hotel rooms, declining economic conditions, and uncertainty in the lending community had had a negative impact on hotel sales prices.

An examination of the changes from late 1980s to the early 1990s in hotel occupancy, average room rate, and RevPAR describes national market conditions for the hotel industry. Historical hotel operating statistics are shown in table 6.

Table 6
Average annual occupancy, average room rate and
RevPAR in the United States, 1988–1996

Year	Occupancy %	ADR $	RevPAR
1988	66.3%	$72.67	$48.18
1989	67.2%	$73.24	$49.21
1990	66.2%	$78.76	$52.14
1991	65.2%	$75.14	$48.99
1992	66.0%	$77.05	$50.85
1993	67.5%	$77.47	$52.29
1994	70.4%	$79.56	$56.01
1995	71.5%	$84.46	$60.39
1996	71.1%	$91.60	$65.13

Note. The data in this table are adapted from PKF Consulting, *Trends*, 1988–1996.

[4] Dotsey, M. & Kuprianov, Anatoli, "Reforming Deposit Insurance: Lessons from the Savings and Loan Crisis," *Economic Review (Federal Reserve Bank of Richmond)* Vol. 76 (1990), pp. 3–28.

As shown in table 6, 1991 was the worst year for the hotel industry in many years. Both occupancy and average room rate declined, with occupancy lower than at any time in the 1980s. Additionally, hotels were forced to cut rates to even maintain a relatively low level of occupancy. These circumstances, combined with new regulations, were impacting the motivations of the lenders to the hotel industry.

Commercial Lenders 1990–1992

Commercial banks and thrifts were forced to handle an increasing amount of foreclosed real estate. The percentage of national bank assets that were REO had increased from .12 percent in 1984 to .73 percent in 1990 and .89 percent in 1991. Additionally, the number of hotel failures was rising dramatically. As shown in table 5, hotel failures averaged 472 per year during the 1990–1992 period.

By this time, the full effect of FIRREA had been felt. In August 1990, government regulations stipulated that for appraisal purposes, an outside appraiser was to be hired directly by the financial institution or its designated agent. The appraiser was expected to have no direct or indirect interest in the property being appraised. Additionally, banks were to begin using state certified or licensed appraisers no later than December 31, 1992 (Hicken, 1991).

Commercial bank officers were very much aware that they were being scrutinized carefully after FIRREA was enacted. There was pressure on banks that owned hotels to sell them to satisfy federal regulators and "get them off the books." A low appraisal could help sell the property more quickly and give the impression of bank management competency if the sales prices of assets were above appraised values.

In addition, banks that were providing financing for buyers were also cautious and wanted to decrease exposure by lowering loan amounts via lower appraisals and by requiring increased equity contributions from buyers. Commercial lenders have long been aware that increasing loan-to-value ratios exemplifies risky behavior (Von Furstenberg, 1970). Banks wanted to demonstrate to federal regulators a decrease in risky behavior because of the increased monitoring from federal regulators.

In an agency theory context, an agent may take actions in his best economic interest even if they are detrimental to the principal. By the early 1990s, the agents (the bank owner and managers) were well aware that principals (the depositors and the deposit insurance fund) were monitoring them to ensure outcomes in the agents' best interests. In this case, that meant taking actions to reduce loan losses and depletion of the deposit insurance fund.

Regulatory forbearance was a policy where federal regulators kept insolvent banks open in hopes of not disrupting the banking system and thinking that economic conditions would improve to rescue insolvent banks. The regulatory forbearance policy of the 1980s was also applied to savings and loans in the southwestern United States, particularly Texas (Cole, 1993). However, the FDIC, which closed relatively few banks in the

early and mid 1980s, began to close a large number of banks during the late 1980s and into the early 1990s. The number of closings is shown in table 7.

Table 7
FDIC closing and assistance transactions in the United States, 1980–1992

Year	Number
1980	10
1981	10
1982	42
1983	48
1984	79
1985	120
1986	138
1987	184
1988	200
1989	206
1990	168
1991	124
1992	120

Note. These data include national banks, state member banks, federal savings banks and state savings banks. Adapted from the *Federal Deposit Insurance Corporation Annual Report,* 1995, p. 107.

Additional evidence of monitoring the agents at banks is an examination of the number of Compliance Enforcement Actions initiated by the FDIC during the early 1990s. These actions include cease and desist orders, removal of bank officers, and termination of deposit insurance. The historical record of these actions is shown in table 8.

Table 8
Compliance enforcement actions initiated by the FDIC, 1989–1992

Year	Number
1989	228
1990	255
1991	356
1992	339

Note. These data are adapted from *Federal Deposit Insurance Corporation Annual Report,* 1995, p. 45.

The large increase of enforcement actions in the early 1990s was a warning to bank officers. Additionally, appraisers were also aware of the new scrutiny and were wary of

providing overly aggressive values above sales prices. Based on the increased monitoring by federal agencies and the new appraisal regulations, the preceding evidence may indicate that principals in the process were wary of hotel investment during the 1990–92 period, pushing appraised values below market values.

Institutional Lenders 1990–1992

Pension funds and life insurance companies were also becoming aware of market conditions for commercial real estate. The decreases in real estate returns due to the 1986 tax law were considered soon afterwards by Brueggeman and Thibodeau (1987) and have already been discussed. The performance of real estate assets is measured by the Russell-NCREIF index, which uses quarterly appraisals and sales data (when a property is sold) to measure performance. This can be used as a benchmark for the pension fund manager.

Unlike commercial banks, however, pension fund managers value the assets in their funds internally every quarter. Fund managers will commission an outside appraisal once per year, usually at year-end. Nevertheless, pension fund managers have a vested interest in the valuation of the assets in their fund. Given that most pension fund managers are compensated based on the value of the assets in their fund, they must seek high returns in order to attract more capital contributions to the fund, and thus, more assets (Guilkey, Miles, & Cole, 1989).

By 1987, however, institutional managers had become concerned about the oversupply of real estate and the overvaluation of assets. Salomon Brothers, for example, issued a report in 1986 that discussed the overvaluation of office buildings. The Russell/NCREIF index hit a peak in 1986, with the ratio of market value to replacement cost being nearly equal (i.e., "1"). Declines in the index began in 1987. One study estimated that office buildings were overvalued by approximately 30% during the 1986–1989 period (as compared to the Russell-NCREIF index), but the gap between the two values closed significantly by 1992 (Hendershott & Kane, 1995).

Fund managers had an incentive to maintain appraised values in declining markets and "smooth" real estate returns, which may have led to overappraising of assets. However, studies have been completed which compare the sales prices of properties from the Russell-NCREIF database to their appraised values. Although hotels were not included, a study showed that sales prices exceeded appraised values for all property types from 1986 through the third quarter of 1987. However, the opposite was true for properties from the fourth quarter of 1987 through 1990 (Webb, 1994).

The oversupply and overvaluation of real estate was a concern for institutional lenders. Pension fund equity investment in real estate, which slowly began to increase during the 1980s, peaked in 1990 and began to decline steadily afterwards. Table 9 details the decline in pension fund equity investment in real estate from 1987 through 1992.

Table 9
Pension fund equity real estate investments as a percentage of assets, 1987–1992

Year	Percentage of Assets
1987	3.28%
1988	3.34%
1989	3.50%
1990	3.74%
1991	3.58%
1992	3.23%

Note. These data are adapted from Edward J. Farragher and Robert Kleiman, "How pension funds make real estate investment decisions," *Real Estate Review* 25 (1996), p. 18.

Additionally, given the fear of "oversupply" of commercial real estate in many markets at the time, institutional investors were beginning to become wary of real estate investments. Furthermore, these lenders were able to effectively assess the likely decline in property values that was to last for an unknown period of time. As previously discussed, hotel sales values declined significantly by the early 1990s.

Given the likely decline in values and reduced returns, institutional lenders may have been seeking very low-priced investment opportunities in hotel properties and commercial real estate or perhaps rejecting them altogether by the late 1980s and early 1990s. Therefore, this would provide a motivation for a lower appraisal of a property being financed to provide maximum protection of principal or even rationale to reject the loan applicant. This may indicate that sales prices exceeded appraised values of hotels for institutional lenders during the 1990–1992 period.

Economic Circumstances 1993–1998

Economic circumstances had begun to improve by 1993. Construction of new rooms in the U.S. was down to approximately 35,000 while profits were positive for the first time since 1985. By 1994, sales prices had increased to $19,068 per room, the highest since 1990.[5]

In terms of occupancy, average daily rate, and RevPAR, the hotel industry overall made dramatic increases over the later 1980s and early 1990s. As shown in table 6, occupancies climbed above the 70% mark for the first time since the late 1970s.

Furthermore, as shown in table 5, hotel failures declined to 233 in 1996. Between 1993 and 1997, failures averaged 315 per year, which is close to the 1984–1989 average of 295 annual failures.

[5] Hotel Motel Brokers Association, *HMBA Hotel Real Estate Annual Report* (1995), p. 26.

The decline in hotel failures, combined with an increase in the operating performance of hotels and an economic expansion in the United States, encouraged lenders to think positively about hotel investments again.

Commercial Banks 1993–1998

Commercial banks were once again actively seeking hotel loans (although very few savings and loans were). Hotel occupancies and rates were increasing, and sales prices were improving. The overall economy was improving and the once-moribund hotel industry was making a comeback. Lenders who had not been interested in making hotel loans during the early 1990s were interested again. Interest rates had declined and hotel financing was available to purchasers and for new development. By 1995, construction of new hotel rooms climbed to over 80,000.

The monitoring of the banks also decreased substantially during this period. The closing and assistance transactions by the FDIC, which had been as high as 206 in 1989, were reduced to 41 in 1993, 13 in 1994 and 6 in 1995. FDIC compliance enforcement actions, which had been 356 in 1991, declined to 228 in 1993, 144 in 1994 and 126 in 1995. In fact, in 1995 the Board of Directors of the FDIC voted to decrease the deposit insurance premiums for even the weakest banks from $.31 per $100 of deposits to $.27. This assessment was the lowest in FDIC history and was enacted because of the high balance of the bank insurance fund and the strength of the banking industry.[6]

Given the much improved hotel performance and a revived economy, commercial lending was available for hotels again. This is also because of the relatively healthy condition of the nation's banking system and the solvency of the bank and savings association insurance funds. Additionally, the atmosphere of excessive monitoring had quietly gone away. Thus, commercial banks were motivated to influence appraised values to be greater than sales prices from 1993 to 1998.

Institutional Lenders 1993–1998

By 1993, pension funds had become wary of real estate investment. The oversupply of real estate, combined with bad publicity about commercial banks' and thrifts' involvement in real estate, justified pension fund managers' decisions of the early 1990s. Hoping not to be caught in the real estate cycle at the wrong time and face FIRREA-type scrutiny, they decided to continue their policy of keeping appraisals low so as to reduce exposure or deny loans altogether.

Although not necessarily a direct indication of lending interest, research shows that real estate equity investment by pension funds peaked in 1990 at 3.7% of assets. By 1994, this had declined to 2.8% of assets, an indication of the pension fund practice of

[6] *FDIC Annual Report* (1995), p. 39.

remaining wary of real estate investment. Therefore, this led them to keep appraised values lower than sales prices.

Overall, the positive economic circumstances and diminished monitoring may have led to lenders influencing appraisers for higher appraised values. On the other hand, institutional lenders who were "burned" by bad commercial real estate investments in the early 1990s have shied away from extensive hotel lending despite improving economic conditions. Thus, the motivations of the principals may indeed affect appraised values relative to market values.

Descriptive Data and Analysis

A descriptive data analysis was completed to provide a preliminary assessment of the economic circumstances and their potential effect on appraised hotel values. A total of 112 appraised hotel values were gathered in conjunction with their respective market values. Since appraised values are proprietary data and not contained within a central source, the data were difficult to obtain. Therefore, the sample sizes are relatively small during certain periods of interest and must be considered carefully when interpreting the results.

The data available ranged from 1985 through 1998. An observation is considered to be the difference between the appraised value and its market values measured by (appraised value—sale prices/sales price). The sales prices of the hotels were matched to the date of appraisal using a pricing index documented by deRoos and Corgel (1996). This method uses a hedonic price index and is considered by academics to be the most accurate way to measure changes in lodging values over time.

The observations were examined based upon the time periods of interest and the types of lenders involved in the purchase (commercial or institutional). The periods are 1985–1987 (to show the impact of the 1986 Tax Reform Act); 1988–1989; 1990–1992; and 1993–1998. Unfortunately, no data were available for 1985. The descriptive data are shown in the table below.

Table 10
Differences between appraised hotel values and market values, 1985–1998

Period	**Sample Size**	**Lender Type**	**Expected mean difference (+ or –)**	**Actual mean difference**
1985–1987	10	All	–	–8.30%
1988–1989	17	All	+	+14.19%
1990–1992	21	All	–	–1.50%
1993–1998	59	Commercial Banks	+	+6.99%
1993–1998	5	Institutional	–	+1.16%

Note. These data represent the mean percentage difference between appraised hotel values and their respective sales prices. Lender type is either commercial bank or institutional lender (insurance company, pension fund, etc.). A "+" indicates an appraised value to be higher than the sales price.

As shown in table 10, the signs of the actual mean percentage differences are largely as expected and lend support to the notion of economic circumstances motivating principals to affect appraised hotel values. The effects of the Tax Reform Act of 1986 can be clearly seen, with principals influencing appraised hotel values downward. The remaining period of the late 1980s mirrors the aggressive development stance of most of the decade, with appraised values exceeding sales prices by a wide margin.

On the other hand, the early 1990s reveals another sign change with lower appraised values. Finally, the 1993–1998 period indicates a positive percentage difference for both commercial banks and institutional lenders. However, the mean difference is much lower for institutional lenders. Once again, the small sample size for institutional lenders in this period must be considered and is shown here for descriptive purposes only.

Conclusions and Recommendations for Further Research

An examination of the hotel appraisal process should be completed within the context of the agency relationships therein. Appraised hotel values may be a reflection of the motivations of the parties involved. Moreover, changing regulatory and economic circumstances may have affected appraised hotel values relative to market values in recent years. This paper has detailed the circumstances that may have motivated parties in the process to seek higher or lower appraised values. The descriptive data provided herein has also provided some support to this idea.

This paper provides a foundation for further research. Specifically, appraised hotel values should be examined relative to market values in other periods of time, particularly in the period following the 1981 Tax Reform Act (i.e., 1981–1984). Furthermore, if appraised values are a function of a set of agency relationships, a change in the agency relationships should affect the appraised values. Therefore, differences in appraised values relative to market values could be tested under different circumstances, such as appraising for private industry lenders versus appraising for government regulators.

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