

Real Estate Fundamentals

Eleventh Edition

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REAL ESTATE FUNDAMENTALS, ELEVENTH EDITION

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The authors would like to express special appreciation to the consulting editor, Erica Ramus, for her invaluable assistance in revising and preparing this text's eleventh edition. Erica Ramus has been in the real estate business since the year 2000 and opened her own brokerage in 2007 in Pennsylvania. She holds a Bachelor's Degree from Kutztown University and earned her Master's Degree in Real Estate (MRE). She served as the Reading Berks Association of Realtors President and chaired the Pennsylvania Association of Realtors Professional Standards Committee. She served as National Association of Realtors Research Committee Vice-Chair. Other past committee appointments have been serving on Realtor University's Board of Regents, NAR's Housing Opportunity Council, NAR's Professional Standards Committee, PAR's Member Service Committee, and PAR's Finance Committee.

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INTRODUCTION

The real estate industry has experienced significant change since the first edition of this textbook was released in 1981. From the manner in which real estate professionals establish business relationships to the means through which real estate is advertised and purchased, aspects of the real estate transaction continue to grow and evolve.

Also changing is the role of the real estate professional. Now, more than ever, brokers and their affiliated licensees are responsible for grasping the broadest principles and specific practices of the real estate industry. This eleventh edition of *Real Estate Fundamentals* celebrates 42 years of excellence by giving students the foundation they need to prepare for their licensing exams and providing the fundamentals they need to know as they begin their careers as real estate professionals.

Real Estate Fundamentals begins with an introduction to the real estate business by studying different types of real estate, underlying economic principles, and the variety of professions that help drive the sale and purchase of real estate. From there, the text delves into real estate's essential components: land descriptions, rights and interests, agency and brokerage, finance, contracts, and closings.

What distinguishes *Real Estate Fundamentals* as a textbook is the clear and concise manner in which these essential components are described. Even real estate's most sophisticated concepts become easy to comprehend. All units begin with a list of learning objectives and key terms designed to help reinforce students' learning, while numerous charts, figures, and illustrations help visualize key concepts along the way. Each unit concludes with a Unit Review that allows students to gauge their understanding of the material.

Real Estate Fundamentals is also an excellent source for exam preparation. Unit 18, "Real Estate Mathematics" and the 100-question practice examination are designed to familiarize students with real estate's basic computations and the test-item style of today's license exams. Students will also find an answer key with rationales that explain why an answer is correct, along with a page reference to where that material can be found in the text.

A Final Note

Please take a few moments to let us know what you thought of this edition. Did it help you? Has your understanding of real estate increased? How did you do on your course or licensing exam? Please be sure to indicate that you used the eleventh edition of *Real Estate Fundamentals* and send your comments to contentinquiries@dearborn.com.

SAMPLE

UNIT

1

An Introduction to the Real Estate Business

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- ◀ Identify different careers that are real estate-related and the organizations that support them.
- ◀ List five types of real estate properties.
- ◀ Describe the economic principles that affect real estate markets.
- ◀ Differentiate between factors that affect supply and those that affect demand.

KEY TERMS

agricultural
appraisal
broker
brokerage
commercial
demographics
Federal Deposit Insurance
Corporation (FDIC)

financing
industrial
market
property manager
real estate counseling
REALTOR®
rental market
residential

sales market
salesperson
seller's market
special purpose

OVERVIEW

Real estate transactions take place all around you, all the time. When a commercial leasing company rents space in a mall or the owner of a building rents an apartment, it's a real estate transaction. If an appraiser gives an expert opinion on the value of a marina or the bank lends money to a business to expand its office and manufacturing facilities, it's a real estate transaction. Most common of all, when a family sells their home and buys a new one, it takes part in the real estate industry. Consumers of real estate services include buyers and sellers of homes, tenants, landlords, investors, and developers. Nearly everyone, at some time, is involved in a real estate transaction. All this adds up to big business, involving billions of dollars every year in the United States alone.

REAL ESTATE SPECIALTIES

Many real estate professionals are involved in the real estate business. Real estate brokerage, appraisal, property management, financing, subdivision and development, counseling, and education are all separate businesses within the real estate field. To succeed in this complex industry, real estate professionals should have a basic knowledge of the work carried out by other specialists within the industry. What follows is a brief description of these specialties; most of them are discussed in more detail in later units.

Brokerage

Brokerage is the business of bringing people together in a real estate transaction. A brokerage firm acts as a point of contact between two or more people negotiating the sale, purchase, or rental of property. State law dictates that persons conducting brokerage activities for others must be licensed. Although some states have implemented single licensing, most still have two license categories—**brokers** and **salespersons**—that require different experience, education, and testing requirements. Brokers can perform the same functions as an affiliate licensee or can be the firm's designated broker. A designated broker, typically in charge of the brokerage office, is the person who enters into contractual arrangements with buyers and sellers, and is ultimately responsible for licensees affiliated with the office. Affiliate licensees act on behalf of the firm and the firm's clients as either employees or independent contractors. Each state has specific rules and regulations with regard to the operation and activities of a brokerage firm (see Unit 7).

Appraisal

Appraisal is the process of estimating a property's value. An **appraisal** is an appraiser's opinion of value, based on established methods of valuation and the appraiser's professional judgment. Although training gives brokers some understanding of the valuation process, lenders generally require a professional appraisal conducted by a state-licensed or certified appraiser (see Unit 11).

Property Management

A **property manager** is a person hired to maintain and manage property on behalf of its owner. A manager's basic responsibility is to protect the owner's investment and maximize the owner's return. A manager is considered an agent of the property owner and, therefore, owes the owner either fiduciary duties of care, obedience, accounting, loyalty, and disclosure or statutory duties as established by law for that state.

The scope of the manager's work depends on the terms of the individual employment contract, called a *management agreement*. The management agreement defines the manager's authority and responsibilities and establishes the manager's rate of compensation. Many states require a property manager to hold a real estate or property manager's license (see Unit 9).

Financing

Financing is the business of providing funds for the purchase and development of real estate. Real estate financing differs from other forms of financing in that real property is pledged as collateral for the repayment of the loan through a mortgage or deed of trust. Different entities involved in the process of loaning money to real estate owners include commercial banks, savings associations, real estate investment trusts, mortgage banks, and mortgage brokerage companies (see Units 12 and 13).

Insurance

Property owners purchase insurance to minimize risks associated with ownership. Insurance brokerage requires a specific state insurance license. Buying insurance transfers the financial risks to the insurance company. However, hazard insurance was never meant to cover maintenance and replacement, only to cover the costs of a major catastrophe. Real estate licensees should encourage their buyers to start the insurance process early because the buyer's credit score may affect the availability and cost of insurance. Because the insurance industry has found that those with low credit scores are more likely to file frivolous or maintenance types of claims, some borrowers with lower scores may find it difficult to obtain insurance, and those who do will have to pay more.

All lenders require that the mortgaged property be insured, not only for fire and lightning, but also for flooding if located in a special flood hazard area (SFHA). Real estate licensees should avoid giving insurance advice. Instead, they should strongly encourage buyers and sellers to ask their insurance agents about any special real estate situations, such as vacant homes, rentals while the home is on the market, and dual-use dwellings (second homes sometimes rented out). Licensees should encourage their clients to be totally honest about the use of the property when talking with their insurance agents.

The following policies are available to owner-occupants:

- *HO-1 basic form homeowner policy.* This policy covers damage caused by fire, lightning, hail, and a number of other perils. It is the default when the property has been empty for a certain length of time, which varies from company to company.
- *HO-2 broad form homeowner policy.* This includes more comprehensive coverage than HO-1 and is often available for second homes (not to be confused with rental properties).
- *HO-3 special form homeowner policy.* The HO-3 traditionally offers the most coverage for the most reasonable price. Replacement costs vary and might include caps on the amount covered. Personal liability may be expanded. Sellers who move before the property is sold should consult with their own insurance agents to determine at what time the policy will convert to a basic HO-1 policy.
- *HO-6 condominium policy.* The HO-6 covers the portions of the property that the condo owner owns; many policies must be customized to comply with the association bylaws. Town homes may be covered by HO-6 or HO-3 policies, depending on what is owned by whom.

Rental properties present other issues. Owners can only insure that which they own. Thus, a landlord cannot insure the tenant's personal property and vice versa. Different policies are available for rental properties:

- *HO-4 renter's insurance.* This is very similar to the HO-3, but it does not cover the real property owned by someone else.
- *Rental home or landlord's policy.* The landlord's policy is the reverse of the HO-4 policy and covers very little personal property (only the real property).

Flood Insurance

Flooding can occur anywhere—inland and along coastal areas. Licensees should encourage buyers to obtain flood insurance even if not required by a lender because a homeowner's policy does not cover rising water (i.e., flooding that may be caused by a broken water main, inadequate or overloaded drainage areas, melting snow, rising river water, and dam bursts).

Flood insurance is always a separate policy. Before making a price quote, the insurance agent must receive an elevation certificate, prepared by a licensed surveyor. The cost of flood insurance can affect the buyer's financial ratios and thus affect the price that buyers can pay for the property.

In the past, the term "100-year flood" area was used; people mistakenly thought the term meant that a significant flood might happen once every 100 years. The Federal Emergency Management Agency (FEMA) now uses the terms *base flood* and *one percent annual chance flood* (i.e., major flooding may occur two times in the same year or two years in a row, or five times in 100 years).

Flood history and location determine the risk of flooding. Statistically, there is a 26% chance that such a flood will occur once during the life of a 30-year mortgage. In contrast, there is only a 1%–2% chance that the house will catch fire during the same 30-year mortgage. According to the FEMA website (<https://www.fema.gov/flood-insurance>): "Floods can happen anywhere—just one inch of floodwater can cause up to \$25,000 in damage."

Flood insurance covers damage caused by rising water. If the excess water comes down (rain), then the damage is not covered by flood insurance. Professionals should refer all questions about the insurance program and current FEMA guidelines to insurance agents who can write flood policies. To determine the level of risk, the Federal Emergency Management Agency (FEMA) has graded nearly every county in the United States into two types of zones: A (inland) and V (coastal). The most flood-prone areas are designated SFHAs. If a property is located in an SFHA, federal law requires flood insurance before closing any property purchased with federally related monies.

To enforce compliance, the **Federal Deposit Insurance Corporation (FDIC)** can fine and withdraw FDIC insurance from lenders who hold mortgages that do not carry required flood insurance. Flood insurance becomes effective 30 days after purchase, unless the lender requires flood insurance, in which case, it is immediately effective.

Subdivision and Development

Subdivision is the process of splitting a single property into smaller parcels. *Development* involves the construction of improvements on the land. These processes, which are normally related but can occur separately, are integral to the growth of geographic areas and expansion of real estate uses (see Unit 14).

Real Estate Counseling

Real estate counseling involves providing clients with competent independent real estate advice based on sound professional judgment and expertise. A real estate counselor helps clients make informed decisions when purchasing, using, or investing in real property, without actually representing them as an agent.

Education

Real estate education is available to both real estate professionals and consumers. Colleges, universities, private schools, and trade organizations all conduct real estate courses and seminars on subjects ranging from prelicensing principles to the technical aspects of tax law. State licensing laws establish the minimum educational requirements for both obtaining and maintaining a real estate license. Continuing education helps ensure that real estate professionals keep their skills and knowledge current.

Other Areas

Many other real estate career options are available. Specialists are needed in a variety of areas, including law, tax, corporate real estate, and land use.

PROFESSIONAL ORGANIZATIONS

Many real estate professions have associated trade industries that serve that specialty. The largest brokerage trade organization is the National Association of REALTORS® (NAR). NAR is composed of state, regional, and local associations. NAR members subscribe to a code of ethics and are called **REALTORS®** or REALTOR-ASSOCIATES®. Note the difference between a *REALTOR®*, a person holding membership in NAR, and a *licensee*, a person holding either a state broker or salesperson license. All REALTORS® are licensees, but some licensees are not REALTORS®.

A sampling of other professional organizations includes the National Association of Real Estate Brokers (NAREB), whose members are called Realtists; the Appraisal Institute; the Real Estate Educators Association (REEA); the Real Estate Buyers' Agent Council (REBAC); the Building Owners and Managers Association International (BOMA); the Institute of Real Estate Management (IREM); and CCIM Institute—Certified Commercial Industrial Member. Each organization has a website that provides additional information about that association.

TYPES OF REAL ESTATE

Just as there are different real estate industry specializations, there are different types of property. Real estate can be classified as follows:

- **Residential**—all property used for single-family or multifamily housing, whether in urban, suburban, or rural areas
- **Commercial**—business property, including office space, shopping centers, stores, theaters, hotels, and parking facilities
- **Industrial**—warehouses, factories, industrial districts, and power plants
- **Agricultural**—farms, timberland, ranches, and orchards
- **Special purpose**—churches, schools, cemeteries, and government-held lands

REAL ESTATE MARKETS

A **market** is a place where goods can be bought and sold and a price established. The real estate market is not a set location, but rather the setting in which supply and demand establish market value for real estate interests. The real estate market is really a group of *submarkets*, which can be defined in a number of ways.

A submarket may be defined by property type, such as whether the real estate is residential, commercial, industrial, agricultural, or special purpose. A submarket can also be defined by geographic level, such as whether properties at a specific national, regional, community, or neighborhood level are being analyzed. Also, the market can be divided into the **sales market**, which involves the transfer of title and ownership rights, and the **rental market**, which involves the temporary leasing of space.

ABOUT DEARBORN REAL ESTATE EDUCATION

For over 60 years, Dearborn has set the standard for real estate education. As a full-service educational publisher, Dearborn offers the best content and support services in the industry. With unsurpassed experience and understanding of the real estate training industry, you can ensure your success with Dearborn.

The strength of our experience lies in our dedication and ability to continually produce the highest quality, up-to-date real estate educational and training content. Our seasoned authors have years of real-world experience and our content spans every stage of a real estate professional's career from prelicensing, exam prep, and continuing education to broker, appraisal, home inspection, and professional development.

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