Reengineering the Appraisal Process Redux

September 11, 2011

By Joan N. Trice

CRN
Collateral Risk Network, Inc.

Executive Summary

The appraisal problem remains a fundamental impediment to a housing recovery.

The "elephant in the room" is declining home values. Instability, lack of confidence, and fear of the unknown are keeping potential homebuyers on the sidelines. Buyers won't buy when they are uncertain where the bottom is. Lenders aren't motivated to lend in an environment of over regulation and fear of repurchase by the Government Sponsored Enterprises based upon unpublished guidelines. The secondary market won't thrive operating in a realm of uncertain markets. Portfolios can't be valued if the underlying house value is unknown and unstable.

25% of our economic engine is fueled by the housing sector

Until we can shore up the unstable housing market we will not create stimulus for homebuilders to build which begets bricklaying, carpet laying, roofing, interior design, furniture purchasing, appliance sales and so on. Lenders won't lend. Appraisers don't appraise. We have a very large interconnected ecosystem built upon the housing economy. Most are small businesses who are not counted in the current unemployment rolls. The economy is in far worse shape than reported due to the depression in the housing sector. It was the collapse of the housing market that led us in and it will be the housing sector that leads us out of this economic morass.

Lack of transparency

From the appraiser in the field, to the lender, through the securitization process collateral valuation remains an entirely opaque process. Fannie Mae and Freddie Mac have literally been "flying blind". The GSEs do not receive a copy of the appraisal and will not until December 2011 with the implementation of UCDP. And even then there is no mechanism for rating agencies, mortgage insurance companies, and other secondary market participants to have a transparent view into the data repository.

Lenders fear that UCDP is a one way mirror intended to create an entrapment scenario. The result is that lenders have expanded the scope of work for the field appraiser to the extent it has seized up the market. There just isn't enough that the appraiser can do to satisfy the lender.

Ironically consumers are now entitled to a copy of their appraisal 3 days prior to closing. With new data standards recently imposed by the GSEs appraisals are virtually unreadable to the average consumer.

Process is broken

Not since the Great Depression has the appraisal process been examined. We have analog processes in a digital world. It is time to merge technology with appraisal theory. A survey of every major participant in the mortgage sector will point to comparable sales selection as the fundamental flaw in the appraisal process. Manually typing "3 comps on a grid" is not only outmoded and inefficient the lack of transparency has allowed gross incompetence and fraud to thrive. We have a trillion dollars in bad loans, in part, based on faulty appraisals.

We rely on one approach to value: the Sales Comparison Approach. Both the Cost Approach and Income Approach have been virtually ignored or worse when developed not done so independently. Proper development of and reconciliation of all three approaches to value could have prevented the current crisis.

Greater reliance on a re-engineered collateral valuation process developed by competent, ethical appraisers is critical to the health of mortgage lending.

We must have a strategy

To state the obvious, we don't have a plan.

We've had short term unsustainable attempts at stimulus, irregular immature unenforced regulations with grand unintended consequences. We need a well crafted, coordinated, synchronized, holistic road map. And that is our proposal. Create a task force that engages all stakeholders. Write the plan and create a single authority to execute that plan.

Introduction

The original "Reengineering the Appraisal Process" white paper was published in April 2009 after a group of 135 members of the Collateral Risk Network met in Washington, DC a few months earlier. The purpose of revisiting the topic is to assess where we are, determine if any of the issues have evolved, and to evaluate if we've made any progress.

From a macro view the housing market continues to get worse. Much of the concern is that we may have achieved a "new normal". A housing market recovery is not likely in the foreseeable future. One of the biggest concerns in the valuation space is that we don't wish to squander a good crisis. Most of us deeply entrenched in the appraisal profession are aware of the problems, have good insight as to how to solve them, yet we have serious impediments to stifle that innovation.

And it is indeed innovation that will lead us out—new methods, thoughtful regulation, sound technology, and bright ideas.

As we discussed in our original white paper the approach must be holistic and transparent. Solutions that involve just one or a few stakeholders would not be meaningful. Stakeholders to a Reengineering project would include appraisers, lenders, mortgage brokers, appraisal management companies, ratings agencies, real estate agents, homebuilders, and regulators, Wall Street, the GSEs, FHA, VA, and mortgage insurers.

Structural Defects

What role did appraisers play in the housing crisis? Appraisers didn't directly cause values to decline. They weren't the catalyst for homeowners to stop paying their mortgage. But they did help create fictitious equity and were complicit in facilitating trillions of dollars of loans that never should have been made. There are varying degrees of valuation inflation performed by appraisers. On the lighter side, there was just that gray area where appraisers hit the highest possible value as opposed to the most probable value. On the dark side, there was blatant fraud. And then, somewhere in the mix, was the failure for appraisers to recognize an overheated market and report trends and risk to their clients.

Structurally we have flaws in the process that continue to exacerbate problems. The entire residential appraisal space is wholly dependent on Fannie Mae and Freddie Mac. The GSEs author the forms and control the practice and procedures by which homes that are financed by a federally regulated institution are appraised. The FHA and VA authorize the use of Fannie Mae/Freddie Mac forms. Appraisers are entirely form dependent upon the 1004 form(Uniform Residential Appraisal Report) which was last revised in 2005.

Both agencies failed, in part, due to their lack of understanding of fundamental appraisal issues or failure to recognize the importance of collateral valuation in their overall risk analyses. The Home Valuation Code of Conduct was imposed by agreement with the New York Attorney General's office, Fannie Mae and Freddie Mac and their regulator, OFHEO, now FHFA in 2008. Appraisal independence, or the lack thereof, played a pivotal role in the collapse of the housing market. Subsequently the GSEs have developed several appraisal initiatives to attempt to repair some of the deficiencies in the appraisal process.

The 1004 MC (Market Conditions) report was required as of April 2009. Although flawed, the intent was for appraisers to examine dynamics in the marketplace to identify and measure changes in property values. The GSEs zeroed in on the problem. Unfortunately the reporting is misleading primarily due to the uneven comparison of quarters to 6 month periods. GSE guidelines confine appraisers to select recent comparable sales. Yet the Market Conditions report requires appraisers to examine transactions from a historical perspective sufficient to establish trend lines. These two expectations are in conflict.

UAD (Uniform Appraisal Data) recently launched September 1, 2011 in an effort to standardize data. Lenders have expressed concern that this initiative will increase time and costs but will not create a more credible appraisal report. Appraisers are under pressure to expand their scope of work while fees continue to decline. Many stakeholders are concerned that the resulting appraisal report will not be readable by consumers who, post Dodd Frank, now receive a copy of the report 3 days prior to closing.

Across most stakeholders the charge has been that UAD is neither holistic or transparent and potentially benefits only the GSEs. With broad industry support, a strategic plan should be developed and executed that would return integrity to the appraisal process.

Ultimately it is the consumer who is harmed. At a micro level, individual homeowners have suffered the loss in equity. On a global plane, Residential Mortgage Backed Securities, our largest export, have brought down the house. Underlying collateral on these instruments has, to a large degree, vanished. In some, but not all cases, the values were never there. In others, property values declined and continue to spiral downward due to an overhang of supply with many being short sales or REO (Real Estate Owned).

Risk

The science of collateral risk has only been peripherally studied. With the mega financial catastrophes over the past few years our ability to predict or mitigate risks has seemingly not improved. We have a byzantine regulatory schema. Complex and highly integrated technology platforms are intertwined. Complex organizations interconnect in ways that by definition are complicated. Managing the outliers is now a task unto itself. The problem with complexity is that unintended consequences can have dramatic negative effects.

There are several articles suggesting that behavioral sciences should be considered. "Valuations don't have a role in defaults" was a notion long held. Borrowers historically defaulted on their loans due to catastrophic personal events: loss of a job, divorce, death of a spouse. We now have a term for borrowers who can afford to make their mortgage payments but choose to walk away - strategic default.

What risk factors are present in the appraisal process?

1) Data and Statistical Analysis - What we don't know can hurt us. We need to examine the data that is collected at the time of the property inspection by the appraiser. What external market data might impact property values? We can't predict that which we can't measure. Analyze more "what if" scenarios. Where were the stress tests? It is indeed the outlier that can bring down a market. We've just experienced the "big quake" and yet the possibility of systemic failure wasn't in anyone's model.

There are many who would argue over whether the housing market collapse was a Black Swan event. It would be a worthy academic exercise to pursue.

2) Outdated Policies and Procedures - Keeping policies and procedures in place that no longer drive integrity to the process is harmful. It may seem counterintuitive to relax GSE Guidelines but expanded scope of work may very well be creating a decline in credible valuations. USPAP may be far too complex.

3) Legacy systems - reliance upon outmoded technology is fraught with danger. What happens when "too big to fail" financial enterprises falter creating a rippling effect throughout the supply chain?

4) Infrastructure - not much need to worry here. We don't really have a real property infrastructure. There are 3,141 counties in the US each with their own standards for recording real property characteristics and transfers. If the current administration desires a shovel ready project, this is a big one. US real estate is the largest asset class in the world but not only is it not well documented, transactions are not available in real time, contrasted to the stock market where the market expands and contracts before our eyes.

As we have learned the difficult lessons that past behavior is not a predictor of future events how do we create a roadmap with yield signs and stops signs along the way?

Casualty Insurance companies have done a much better job of reserving for risk. Acts of nature are statistically measurable in both frequency and severity. Insurance enterprises have also done a much better job of managing the people part of their business. Customer behavior, relationships to other parties, and patterns of behavior are tracked for risk avoidance. Lenders are spending millions to repurchase loans after the loan has been made. By avoiding bad actors many of these losses could be avoided. Lenders are also spending enumerable resources on reviewing appraisals after the fact.

Collateral Risk

Specifically there is no body of knowledge on Collateral Risk. Ratings agencies apparently did no due diligence on the underlying collateral for a number of reasons but the best excuse was that appraisal files were not available to them. The GSEs until September 1 of this year have not received appraisal files. Although UCDP (Uniform Collateral Data Portal) is a first step, the early proposals to FHFA to create an appraisal repository to benefit all stakeholders seems not in the planning. Until a central repository of all valuation reports is created, both holistic and transparent, the secondary market cannot thrive. Participants must have confidence in underlying house values in order create a sound secondary market. Risk analysts must have access to data in order to be able to measure collateral risk.

There are very few studies available on the subject of collateral risk. Given the benefit of hindsight we know that we have an imperfect appraisal process. The appraisal process is disconnected from risk analysis. Each of these risk components need to be integrated into the appraisal process:

1) Property Risk - physical characteristics , depreciation, conformity, marketability, design, energy efficiency

2) Market Risk - Inventory, interest rates, taxes, subsidies, unemployment, crime, transaction fraud

3) Environmental and Disasters - proximity to brownfields, earthquakes, hurricanes, health hazards such as Chinese Drywall

Three Approaches to Value

Like a three-legged stool, appraisal theory dictates the development of the cost, income and sales comparison approaches to value. The appraiser then reconciles the approaches placing the most weight upon the approach that is the most applicable to the assignment.

There have been recent lawsuits brought by FHFA, Fannie Mae and Freddie Mac with accusations that lenders made loans on residential properties that were investment properties, not owner occupied dwellings. In these cases, an income approach should have been developed. Although we recommend the development of all three approaches to value we propose that the income approach principles be re-examined. One consideration is to rename it the investment approach to value and make it an independently developed analysis not reliant upon a gross rent multiple. By devising the GRM the income approach is improperly dependent upon the sale comparison approach.

An investment approach would allow for a break-even analysis for ownership. If the principal and interest, taxes, insurance and reserves for replacement are not covered by potential rent receipts then the value is not sustainable. And this is precisely one of the reasons for strategic defaults. When it becomes cheaper to rent than to own, the risks associated with homeownership create an imbalance. There are of course weaknesses to this approach. Market rent information is seldom available for higher end properties.

The cost approach was no longer required by the GSEs when new forms were introduced in 2005. The recognition that it was often not developed properly was ironically one of the leading factors for the abandonment of the approach. Studies around the cost approach suggest that the absence of the development of the cost approach allowed the bubble to inflate. The sole reliance upon frothy sales led to more inflated sales until it popped. There are several cost estimators available that would make the development of these approaches accurate and efficient.

Three Comps on a Grid

The process of three comparable sales on a grid is entirely outmoded. Given the availability of data in an electronic format we have few excuses.

The presumed practice of "matched pairs" is just silly when attempted to be completed as a manual exercise. The use of databases, technology, statistics and local knowledge must take a larger role in the interpretation of market reaction to differing property characteristics. Our practice needs to include Interactive Valuation Models (IVMs) for the appraiser to define the appropriate market, be able to review large datasets, remove the outliers, and run statistical models. This process, in a transparent manner, as opposed to a faceless Automated Valuation Model (AVM) black box, would demonstrate to the lender all data examined as well as those sales not considered. An examination of historical sales going back to at least 24 months would allow for trending and a more thorough reporting of market conditions. The weaknesses in this process would be lack of available data in some markets to obtain a credible result. But that holds true today with our highly manual processes. The clear advantages are that lenders would not need to order multiple products in an effort to collect data. By including the entire data set within the appraisal file this transparency allows the lender to truly review not only the final report but the logic behind the exclusion of some data.

There was discussion of separating the inspection from the valuation process. There are two different skill sets necessary to observe the "bricks and mortar" of a house as opposed to the analysis of market data. The valuation portion of any report should be performed by a licensed or certified appraiser. The inspection could be performed by a home inspector (using a standardized form), a trainee, or the appraiser. This would also allow the market to adjust fees commensurate with appropriate skills and training.

Most appraisers use the argument that a personal inspection by the appraiser of the property being appraised is always necessary to provide a credible report. In today's environment of electronic data, many aspects of property can be discerned through pictures and records readily available online, similar to what is used in analyzing the comparable sales used by the appraiser. It is unlikely that the appraiser has inspected the interior of comparable sales. New systems should be developed that allow for appraisal reports to be created, in modules, to allow the addition or deletion of sections within a report by flowing data streams of information that is important to that particular assignment, for that particular client for that particular risk decision. The forms should fit with the "Scope of Work". One-size-fits-all has helped to set the stage to allow competing products from unlicensed individuals to enter the market.

Market Value

There has been an argument made that the definition of market value needs to be examined.

"Market value means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;

2. parties are well informed or well advised and acting in what they consider their own best interests;

3. a reasonable time is allowed for exposure in the open market;

4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and

5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."

***** This example definition is from regulations published by federal regulatory agencies pursuant to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 between July 5, 1990, and August 24, 1990, by the Federal Reserve System (FRS), National Credit Union Administration (NCUA), Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Office of Comptroller of the Currency (OCC). This definition is also referenced in regulations jointly published by the OCC, OTS, FRS, and FDIC on June 7, 1994 and in Interagency Appraisal and Evaluation Guidelines, most recently updated December 10, 2010.

The flaws in the definition went mostly unnoticed during stable economic environments but became glaring defects when examined in the context of our current market. European markets recognize the concept of stabilized value (also referred to as "Mortgage Lending Value".) This approach requires the use of all three approaches and places limits on how large the disparity can be between the approaches.

Our markets have not recognized, until now, that residential appraisers are not just house appraisers. One by one, mortgages are collectively added to a pool. It was assumed that the risk of a single loan would not infect a pool of loans. It is much worse. The systemic disease of valuation inflation has infected the entire housing market and beyond.

The European Union Legislation Definition of Mortgage Lending Value:

The value of the property as determined by a prudent assessment of the future marketability of the property taking into account long term sustainable aspects of the property, the normal and local market conditions, and the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the mortgage lending value. The mortgage lending value shall be documented in a clear and transparent manner. (Pursuant to the Basle II Accord, a European Union Capital Requirements Directive [EU CAD] is currently being drafted. The above definition is cited in the Council of the European Union, Proposal for Directives of the European Parliament and of the Council, 12890/05 Add. 4, Annex VIII, Section 1.5, paragraph 65. This definition has been agreed by 25 governments with the European Parliament. (The definition has not yet been formally adopted, but adoption is anticipated imminently.)

Paraphrasing from the *European Mortgage Federation paper on Mortgage Lending Value:*

(1) Mortgage Lending Value may be used by the financial services industry in the activity of lending secured by real estate. The Mortgage Lending Value provides a long-term sustainable value limit, which guides internal banking decisions in the credit decision process (e.g. loan-to-value, amortization structure, loan duration) or in risk management. Mortgage Lending Value facilitates the assessment of whether a mortgaged property provides sufficient collateral to secure a loan over a long period. Given that Mortgage Lending Value is intended to estimate property value for a long period of time, it cannot be grouped together with other valuation approaches used to estimate market value on a fixed date.

(2) Mortgage Lending Value shall mean the value of the property as estimated by an appraiser making a prudent assessment of the future marketability of the property by taking into account the long term sustainable aspects of the property, the normal and local market conditions, as well as the current use and alternative possible uses of the property. Speculative elements should not be taken into account in the assessment of Mortgage Lending Value. Mortgage Lending Value should be documented in a clear and transparent way. All valuation methods (cost, sales and income) also apply to the Mortgage Lending Value.

(3) Regarding the technical transposition of the definition, the long term validity of Mortgage Lending Value requires compliance with a certain number of steps aimed at eliminating short term market volatility or temporary market trends. The appraiser must address the following key issues when determining the Mortgage Lending Value of a property:

- The future marketability and salability of the property has to be assessed carefully and prudently. The underlying time perspective goes beyond the short term market and covers a long term period.

- As a principle, the long term sustainable aspects of the property such as the quality of the location, construction and allocation of areas must be taken into account.

- As far as the sustainable yield to be applied is concerned, the rental income must be calculated based on past and current long term market trends. Any uncertain elements of possible future yield increases should not be taken into account.

- If the mortgage lending value is derived using comparison values or depreciated replacement costs, the sustainability of the comparative values needs to be taken into account through the application of appropriate discounts where necessary.

- The mortgage lending value is generally based on the current use of the property. The Mortgage Lending Value shall only be calculated on the basis of a better alternative use, under certain circumstances i.e. if there is a proven intention to renovate or change the use of the property.

(4) There are a number of clear differences between Market Value and Mortgage Lending Value; Market Value is internationally recognized for the assessment of the value of a property at a given moment in time. It estimates the price that could be obtained for a property at the date of valuation, despite that this value could change dramatically and quickly be outdated.. In contrast, the purpose of Mortgage Lending Value is to provide a long term sustainable value, which evaluates the suitability of a property as a security for a mortgage loan independently from future market fluctuations and on a more stable basis. It provides a figure, usually below Market Value and therefore able to absorb short term market fluctuations whilst at the same time accurately reflecting the underlying long term trend in the market.

The group believed that the concept of a stabilized value, i.e. value that had a longer-term perspective was viable and elevated the appraiser to not simply be a reporter of market activity but a trusted advisor.

Having a three-year window into the future provides the lender with a greater understanding of how value changes. The short and long-term can be reconciled. Similar systems in Germany, specifically known as "Pfandbriefs" provide lenders with an alternative to traditional market value definitions. In addition, this type of perspective also considers and adjusts for the impact of volatility in the housing market. In this scenario, any value that is above the stabilized three years value is considered unsecured. This would also lead to a different set of underwriting criteria that lenders could use to properly partition risk.

We need to carefully examine the need for various types of reporting of value and risk. It has been frequently noted by lenders that appraisers are not well trained in how to complete appraisals for properties in default. Enter BPOs (Broker Price Opinions). Appraisers have been trained to look in a rear view mirror. REO appraisals require one to look at current market conditions, inventory, and in most cases the value needed isn't market value but a quick sale value.Valuation products and scope of work need to match risk.

While the definition of "market value" has served the lending community adequately until the recent past, what is apparent is that new value definitions must be provided in order to effectively meet the challenges of an uncertain and volatile marketplace. To that end, it is likely a good goal to have appraisers provide multiple value opinions to clients. That may include, stabilized value, REO value, disposition value, quick sale value, etc. Any of these values can be presented to a client, based on their needs and their desire for greater understanding of market risk. Appraisers are the experts in market analysis, and they can bring this strength to their clients by understanding and presenting the nuanced indications that typifies the marketplace.

Price vs. Value

When a sale occurs appraisers are expected to get a copy of the contract and analyze it. There has been so much effort in some markets to hide the true terms of the contract that it is impossible for the appraiser to know the legitimacy of what they have been provided. The liability to the appraiser is tremendous. The appraiser should not be expected to be the fraud investigator. It should, however, be incumbent upon the appraiser to determine what effect sales concessions had on comparable sales. The appraiser's role is to estimate market value. It is the lender's role to determine risk associated with the collateral.

The appraiser should not be expected to confirm a contract price with their appraisal. The act of giving the appraiser the answer to the value question in advance of their analysis acts as an anchor. Even honest people are influenced by anchors. They should be free from pressure to overlook repairs and deficiencies. The appraiser should analyze trends and report market conditions as they interpret them. Independence and lack of advocacy for any value conclusion should be strengthened by creating sound policies and enforcement. If true independence is the goal let the appraiser indicate a range of value.

Reporting a range of value as opposed to a single value would shift the risk responsibility to the lender. The appraiser could report the most probable price with a confidence score, within a range. The practice of hitting the highest price would become a moot point. The lender would have that number and if they want to make a 125% LTV that would be their call. This would help set the appraiser apart from the valuation inflation practices.

Single Point of Value vs. a Range of Value

A consideration of ranges of value is a concept whose time has come. Just as the earlier section discussed new types of value definitions, so too must appraisers be allowed to provide ranges of values to clients. The point values that are presently pushed to clients are too restrictive, and ultimately unrealistic from the standpoint of the true nature of the marketplace. At present appraisers are hindered by client requirements that push point value requirements. Lenders would prefer a range of values but are presently precluded from requesting such because of the requirements of the GSE's-Freddie Mac and Fannie Mae. "Systems" don't allow for a range. The lender will need to make a risk decision. In the current economic environment, a single point of value is extremely difficult to estimate even by the most experienced appraiser. Value ranges ultimately make more sense and are more in keeping with the realities of the market. Our recommendation is that the GSE's should consider changing the system to allow value ranges.

Policy

Appraisers do not have a clear road map to complete an appraisal for a mortgage transaction. There are Fannie Mae Guidelines, Freddie Mac Guidelines, Interagency Guidelines, FHA rules, VA rules. On top of these, there are individual lender guidelines. There are State requirements. There is USPAP (Uniform Standards of Professional Appraisal Practice). There are numerous education providers, each of whom has a slightly different approach to application of theory. The communication and interpretation of policy, procedures and practice can be highly variable. There should be one unifying set of policies and procedures. And this one set of rules needs to be part of the educational offerings. The suggestion is not that there should be singular minimum property standards, loan product types and so on. Lenders may have a different set of qualifications required of their vendors. The proposal is not to homogenize all things appraisal but to communicate a concise set of procedures.

Appraisal reports have become convoluted with required meaningless information, self protection statements and boiler-plate comments in lieu of meaningful analysis. As a result, they have become difficult to read, understand and many times, difficult to use to make reliable risk-based decisions.

A set of analysis and reporting procedures for different collateral risk-based decisions should be modular and expansive and run the gamut of scope, yet there should be a single rule set from a single source.

Practice

With better data, appraisers would be in an enhanced position to utilize and perform predictive forecasting, which could then lead to the ability to provide stabilized values as detailed previously.

One of the key problems historically with tools that have been developed is that they are external to the appraisal process. AVMs and other tools lack the touch that an appraiser brings to the process, yet they offer sophisticated analytics. Appraisers, on the other hand, provide the ability to understand nuances that an automated appraisal model cannot. What makes sense in overcoming this "disconnect" is that appraisers should be utilized to do what a model cannot. In melding appraisers more intently into the analytics of property valuation, ultimately the best of both worlds can be achieved.

There is no real change to the approaches to value under any of these scenarios. In actuality, what is required is an evolution of the traditional approaches to value. To accommodate the plethora of data and analytics that are possible today, appraisers must re-invent what is probable and what is required from the marketplace. The approaches remain relevant. What is critical is that they adequately reflect the totality of data and analysis that is possible and important to clients.

As part of this process, it is critical to note that what appraisers need is more turn-key software that can assist them in the valuation process. Appraisers can be empowered if they have the software that can consume large amounts of data, and in so doing, can provide the analytics that the market demands. It is unlikely that appraisers will develop appropriate software on their own. What is necessary is for lenders to demand and compensate appraisers to report in-depth information, which will drive software providers to develop and push such products to market. In this manner, appraisers can more fully utilize all of their skill sets that both empower appraisers and ultimately serve clients best. A solution of this type is more likely to occur from the top-down approach being implemented from lenders or appraisal management companies (AMCs). A ground-up approach is not impossible but improbable.

From this perspective, tools can help with analysis; the appraiser remains the "boots on the ground" local market expert and the client is provided with a better understanding of risk and volatility.

Historically, the GSEs have sponsored residential appraisal forms for mortgage lending that have become the de facto standard. The current financial crisis has exposed many areas of vulnerability within the multi-faceted process of residential mortgage lending. As the industry identifies weaknesses in the appraisal process, we must ensure the appraisal form guides the appraiser properly and "ask the right questions".

The appraisal process has been defined by Fannie/Freddie forms that walk appraisers through a series of procedures to arrive at an opinion of value. New forms should be considered that remove the time consuming processes of data collection that have no bearing on the value conclusion. Appraisers are wasting valuable time focusing on many of the wrong elements.

GSE underwriting standards were developed to assist lenders in identifying high-risk properties. In some cases, properties are non-conforming in design, appeal, condition, and/or marketability. Yet, appraisers are forced - by underwriters - to attempt to make the property fit to inflexible standards. Expect not all properties to conform and not all appraisals will conform. Appraisers should be encouraged, not discouraged, from reporting the unbiased truth.

Technology

There is actually some positive activity with innovation in appraisal space. There have been numerous entries into the IVM (Interactive Valuation Model) space and more nearing a launch. Most of these products are chasing the default business as the Fannie/Freddie 1004 forms have stifled innovation. Some are reported to be pushing data backwards into the form and then creating a whole new output to satisfy current requirements.

The data standards around MLS data remain a significant challenge to producing reliable valuation tools nationwide. Although RETS (Real Estate Transaction Standards) standards exist there are still deficiencies with respect to applications in appraisal space. MLS data used to be considered the "Holy Grail". That would no longer hold true. Integrity of the data is suspect in many markets as agents attempt to manipulate sales and listing information. And in some markets basic information such as square footage is entirely missing.

Data import tools are essential for any productivity gains for the appraiser. Manually typing comparable sales has not been solved with the GSEs data initiatives. The UAD standard of converting generally accepted standards of bathroom count is inexplicable. Any standard that will require manual conversion is inefficient.

MISMO and RETS need to talk. Keep in mind there are no appraisal data standards. There are mortgage data standards and real estate standards, but appraisal standards do not exist.

That irony shouldn't be lost on many. In an era of instant access to information, as a profession, we have advanced very slowly. Real estate is the largest asset class in the world. Certainly the collateral valuation world has remained more art than science. While highly complex instruments involving mortgage backed securities have evolved the real estate practitioner is manually analyzing three comparable sales on a grid.

From a broad perspective, the real estate markets need to aggregate data into a national property database. From a local government perspective each county and local jurisdiction needs to maintain real property databases for the purposes of levying taxes. There is no single standard from county to county, let alone state to state. The quality of the data contained within these public records databases varies greatly.

Generally speaking real estate appraisers do not use public records as their data source. Multiple Listing Services (MLS) are more current and supply competing listings as well as sales. Public records are often used only to verify the MLS transactions. The multiple sources of data including economic data need to be merged under a single integrated data standard to give the appraisal community better access to facilitate the analysis of micro market trends. This will take the cooperation of the National Association of Realtors.

From a lending perspective, Google and other public facing websites are better sources of information in our current environment. Lenders should be able to access a national property database to discern even the most minimal needs such as property type. At present, that is not uniformly possible. The Obama administration should consider this project an "infrastructure" initiative. The benefits would be enjoyed by government, consumers, as well as financiers of housing. It became quite apparent after Hurricane Katrina that all levels of government need a geocoded national real property database. An inventory of all land and improvements thereon tied to the mortgage instrument would allow a measure of "all things real estate" in real time. The real estate market has not kept pace with the stock or commodity markets. Real estate is the largest asset class in the world yet we can't effectively measure it, study it, or analyze it.

It would also be advisable to move data standards as well as forms under the auspices of a single appraisal authority. Given the tenuous nature of the GSEs, forms should not be under their control.

Because there has been no data standard, it has been rare for the underwriting of appraisals to be automated. The GSEs up until September 1, 2011 did not receive a copy of the appraisal until and unless the loan was in default. The lack of technology within the appraisal profession has facilitated the lack of transparency within the transfer of the appraisal files from appraiser through the chain of intended users. A repository, or clearinghouse, would ensure the safety and soundness of appraisal transactions. A ping on an appraiser registry would confirm the identity of the appraiser and a secure platform would ensure a tamper proof file.

The UAD data initiative did not mandate acceptance of a single standard. MISMO 2.6 was adopted, an already outmoded standard. Other proprietary standards remain acceptable. As long as we continue to allow and support inconsistent standards and proprietary standards we will fail to thrive.

Regulatory and Legislative Issues

Dodd Frank has added the consumer as an intended user of appraisal reports. Historically, appraisal reports were never intended to be consumed by borrowers. And in their current form, they are generally indecipherable by industry experts as well as neophytes. This has added a whole new layer of complexity to the problem. UAD has rendered an appraisal report almost entirely unreadable.

The Customary and Reasonable Fees provisions within Dodd Frank need to be clarified. The statute was fairly clear on the issue, however Interim Final Rules contradicted the law most notably Presumption 1. HVCC was, for the most part, a huge leap forward in removing bias from appraisals. The strongest component of the code was the removal of mortgage brokers from the ordering process. But the shift toward AMCs becoming the predominant conduit for appraisal ordering, also meant that appraiser's net fees were reduced.

What should be the focus of all appraisal regulation is an environment whereby appraisers can produce credible reports free from bias. The current scenario is not sustainable. Taken to its logical conclusion the appraisal profession will cease to be. We urge that the Consumer Finance Protection Bureau issue Final Rules as soon as possible.

At present we have a structure that excludes many of the most competent appraisers. We also have a system that will discourage young professionals from pursuing the profession. Appraisers are exiting for financial reasons, we have an aging population, and we aren't attracting new talent.

To summarize, we strongly believe that the spirit of Dodd Frank is positive and will strengthen appraisal independence if first made clear and then strictly enforced. We do not believe that status quo was the intention of the law and we urge clarification and strong enforcement.

Interagency Guidelines effective December 2010 were a vast improvement over guidance issued in 2004. They have a stated goal of being in harmony with other appraisal regulations. The groundwork has been laid. Lack of enforcement was one of the factors allowing for unfettered appraisal inflation. Major areas identified as requiring policy include:

- Review
- Automated Valuation Models (AVM) testing and validation
- Broker Price Opinions(BPO)
- Engagement
- Fee panel management
- Reconsideration of value
- Mandatory complaints
- Appraisal Independence
- Portability
- Loan Modification

Broker Price Opinions(BPOs) were specifically addressed in Interagency Guidance. Although not condoned for originations they are the most common form of valuation product for defaults and also home equity loans. BPOs performed by real estate agents, not licensed or certified appraisers, clearly circumvent the intent of FIRREA of regulating the providers of collateral valuation services. BPOs directly conflict with independence and conflict of interest principles. The procurers of BPOs are aware that they are not at risk for ordering the product, only the agents are liable(in certain states) for violating state laws. They order them because they can- no enforcement, oversight or standards and they satisfy the cheap and quick needs of the client. Many industries face pressure to elevate "fast and cheap" over quality and integrity. The whole intent of regulation is to protect industries and the public from these gravitational pulls.

The Mortgage Fraud Task Force reports that the bulk of mortgage fraud is produced in the BPO, not the appraisal space. Low appraisals is one of the leading headlines currently. Low sales created by advocated agents involved in the short sale transaction are often the culprit. Even before a short sale occurs, agents will list a property at artificially low prices with the knowledge or approval of the lender to stimulate buyer interest. That practice vividly demonstrates the difference between Price and Value...a distinction often lost on agents not schooled in valuation education or practice.

Real estate appraisers do not list and sell real estate. They are not licensed or trained to do so. Yet real estate agents are performing the bulk of valuations. They are not licensed or trained in valuation. They are not subject to USPAP(Uniform Standards of Professional Appraisal Practice). Real estate agents benefit by a strong lobby. Allowing agents to produce valuation products without license or regulation would be no different than allowing appraisers to list and sell real estate without appropriate licensing.

Overall, any attempt to fix or improve the appraisal industry will be undermined by continuing to ignore the obvious contradiction of allowing BPO practices to continue.

Appraisers are the most fractured group under the mortgage umbrella. More appraisers belong to no organization than to all of the founding sponsors of the Appraisal Foundation combined. As a result there is no consistent, single, unifying voice. There is no cohesive, coordinated leadership despite efforts of the professional organizations.

Appraisers are unrepresented or worse misrepresented. One of the solutions proposed by the Collateral Risk Network is the formation of an SRO (Self Regulating Organization). That would take an act of Congress. All parties that touch collateral valuation should be regulated under that one umbrella. Within that structure would be educational support, training and mentorship. The SRO would be responsible for process, practices and procedures. The appraisal profession needs leadership and unifying voice.

Mentoring and Training

While the focus is on the current crisis of declining home values, no one is paying attention to the impending crisis of the graying of the appraisal profession. We are dying off, becoming technically obsolete and we aren't preparing the next generation. Of course that is impossible to do when we haven't laid out a roadmap on what the next generation should be trained to do. And we are woefully underpaying appraisers. Not only will there be natural attrition in our current ranks - we won't attract young talent.

The concern by many in the appraisal profession is that once we finally set aside appraisal bias, with the advent of HVCC, the lack of competence will become more apparent. It has been estimated that the average age of an appraiser is approximately 54 years old. There are business reasons as well as regulatory requirements that would discourage the training and mentoring of the next generation of appraisers. And then there is the assertion that perhaps we aren't even training the right things. There is virtually no practical training in place except the generational transference between family members of the trade. The business of appraising seems all but dead.

Needless to say the number of transactions in the housing sector has declined and shows no evidence of returning any time soon. We have a current oversupply of appraisers. The decline in the fee structure, increased educational requirements, over supply, and favor of service over quality has created unhealthy conditions.

In the short term, there is no guarantee that increasing fees will produce more credible appraisals. There is a foregone conclusion however that without fee increases we will indeed lose the talent pool within our ranks. It is impossible to estimate the damage done of rewarding the poorly trained and ethically challenged within the appraisal community over the past several years. The repression of fees has been maintained under the guise of consumer sensitivity to origination costs. In the end it is the consumer who pays for the tremendous losses in this housing market depression. We have tripped over trillions to save a few hundred dollars.

Lenders and AMCs need to do a much better job of vendor management. Less emphasis on service and greater focus on competence are essential. Licensing and certification are minimum standards. There is support for the engagement of the "best" appraiser, not the fastest and cheapest within Interagency Guidelines.

We have a number of barriers for new appraisers entering the market. A plan sponsored by lending institutions to promote proper training and education of appraisers would be critical to a sustainable appraisal profession.

Summary

A strategic plan to reengineer would need to be both dynamic and durable. The time is now for a broad industry collateral valuation initiative. The Collateral Risk Network proposes the creation of a task force to collaborate with industry representatives for discussions on reengineering the appraisal process.

These discussions would include but not be limited to:

- Appraisal repository inclusive of an appraiser credentials database
- Evaluation of the process for value estimation (market definition, data gathering, market analysis, inspection, and reporting)
- Creation of appropriate reporting formats
- Examination of market value definition vs. price
- Collateral risk measurement
- Approaches to value, range of value vs. a single point of value
- Interactive Valuation Models
- Data standards
- Risk Modeling
- Regulatory framework

The opportunity for real change is upon us. By working together, we have a unique opportunity to effect change in a more efficient and profound way. We are prepared to do the honest, hard work of building a roadmap for the future. The latter would require broad industry support and very likely Congressional intervention.

About the Author

JOAN N. TRICE

Joan N. Trice is the editor and publisher of Appraisal Buzz, an email publication circulated to 45,000 opt-in subscribers. In addition to the Buzz, Joan hosts the annual Valuation Expo, the largest conference for the valuation community that attracts the thought leaders as keynotes and speakers. Joan also hosts the Collateral Risk Network. Membership currently stands at over 300 members comprised of Lenders, Government Agencies, Wall Street, Vendor Management Companies and Appraisers.

Joan was an early adopter of Internet business strategies and sold a web based valuation business she developed to LandAmerica in 2000. Trice Appraisal, Inc., a company she founded in 1986 and owned with her brother was the largest appraisal firm in the Mid Atlantic region.

p: (513) 659-1656
e: jtrice@allterragroup.com

THANKS TO MANY MEMBERS OF THE COLLATERAL RISK NETWORK for their contributions to the development of this paper especially Alan Hummel, Mark Linné and Edward Pinto. Please note that the opinions contained herein do not necessary represent the opinions of each individual. There was extensive dialogue with all stakeholders to the appraisal process.