

Not an

Either / Or

BY NIMA NATTAGH

Accurate property valuations are critical to the well-being of the housing market. The key to better valuations is blending the best from traditional and non-traditional appraisal approaches.

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Now more than ever, utilizing multiple property valuation techniques—both traditional and non-traditional—is essential for sound collateral assessment. Especially in light of the recent crash in the housing market and unprecedented mortgage delinquency rates, the industry has become acutely aware of the importance of accurate property valuations to mitigate potential future mortgage delinquencies and portfolio losses. ■ Over the course of the last decade, the mortgage industry has seen tremendous growth in the availability of non-traditional—or alternative—property appraisal products. This growth was primarily driven by the tremendous increase in origination volumes that occurred earlier this decade. ■ But these alternative products—and the innovations that came with them—have not been effectively harnessed to consistently produce the higher-quality valuations that are possible. In fact, the mortgage market meltdown has demonstrated that a systematic process of checks and balances is sorely needed to ensure the integrity of the property valuation process.

Valuations through the mortgage life cycle

During the life cycle of a typical home loan, the value of the real property that backs the mortgage is evaluated at least four times. At each stage of the mortgage life cycle, a range of property valuation techniques is available, and the selection of the “best” technique usually hinges on two factors: cost and accuracy.

Automated valuation models (AVMs), broker price opinions (BPOs), desktop appraisals, drive-by appraisals, property inspections and full interior appraisals all have a role in a mature collateral-assessment program. The challenge that the mortgage industry faces is to balance cost on the one hand with the underwriting requirement on the other.

This article will review the market trends responsible for the growing popularity of alternative property valuation products. Two distinct pieces of research are included to encourage further debate on one of the greatest challenges to the property appraisal industry. That challenge is the need for a more effective integration of statistical models with the non-traditional and traditional field appraisals,

including BPOs.

It is important to note this is not an article about the respective merits of AVMs versus appraisals. To some extent, past commentaries shaped in that context have done a disservice to the industry.

A more appropriate discussion is the recognition that property valuation is—first and foremost—about the concept of a continuum. Single-point value conclusions, as opposed to a range of values—as well as single methodology valuations—are increasingly becoming irrelevant and antiquated.

The right valuation for the right product

Matching a property valuation product to the specific underwriting requirements of a mortgage has long been an arbitrary and inefficient process. During the high-volume years of the early and mid-2000s, the industry was more focused on loan-closing turn time. Accordingly, valuation products that catered to that need grew in favor.

Now, in the aftermath of the housing market meltdown,

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institutions have implemented more stringent underwriting requirements, but they still struggle with how best to reconcile a range of property valuation products to meet their underwriting needs.

The return to a more disciplined underwriting environment, in which property valuation is a key component, requires that we understand and appreciate the full range of valuation tools available and their respective strengths. After the collapse of the housing market, all appraisal and property valuation approaches certainly got some share of the blame for the housing bubble. Many observers focused on the fact that mortgage brokers and others had the ability to influence the outcome of the appraisal process. Others thought alternative appraisal products played a role as well.

But in reality, disciplined underwriting is not just about favoring one property valuation product over another. It is about process re-engineering that involves a more systematic analysis of how various property valuation products perform relative to each other and, where appropriate, deploying multiple valuation methodologies to boost confidence in the underwriting process.

Ultimately, the answer may not be either/or.

The process of valuing real estate is rather subjective. The appraisal process results in an “opinion of the worth of the property at a given time in accordance with a specific definition of value.”

Value must always be qualified and the intended use must be clearly identified. The process itself is supposed to render the most probable sale price under “normal” market conditions. Of course, today’s normal is much different than it was at the peak of the market.

Property valuation is primarily about the concept of a continuum. Couple this subjective process with a rapidly changing market environment and the result is a great deal of uncertainty about what is the “right value.” This topic will be returned to later in the article, when examining the impact of real estate-owned (REO) sales on the overall market. However, suffice it to say that prudence dictates whenever there is uncertainty in the valuation process, traditional and alternative property valuation products should be combined to produce a more complete and reliable collateral value.

The growth of alternative property valuation models

Since the late 1980s, five key trends have facilitated expansion of alternative property valuation products:

- The evolution of the mortgage secondary market, primarily in the United States, but also to some extent the international capital markets.
- The increasing influence of the government-sponsored enterprises (GSEs).
- The increasing share of third-party loan originations.
- A more varied mortgage product offering (second and

equity home mortgages, in particular).

■ Developments in information technology (IT), especially lower-cost and more effective computing power and the ability to compile large databases and electronically disseminate real estate information.

Sometimes these individual trends interacted to produce innovative, alternative property valuation techniques. For example, the growth of property valuation models is due in large extent to the appetite by the secondary market for such models, coupled with the GSEs’ desire to streamline the mortgage origination and underwriting process and the tremendous growth in electronic real estate databases in the 1990s.

The secondary market, by nature, is much more amenable to models and techniques that facilitate quick business decisions, and it tends to view risk in the broader statistical context. Of course, the growth of the secondary market has been crucial in the U.S. housing market’s transition from local and regional financing, servicing and investment to a national market. However, a Wall Street trader, issuer, investor or rating agency will not necessarily have the insight to understand—or the time to learn about—a particular regional housing market in the way that a local underwriter does. As a result, the secondary market has in many ways been a driver of the development and adoption of alternative valuation products.

The role of GSEs in the evolution of alternative property appraisal products should not be underestimated, however, and has also been a strong force behind their growth.

Moving beyond the appraisal product debate

At least among a segment of the professional appraisal community in the United States, some believe the GSEs have been influential in lowering the property valuation process to the lowest common denominator, and reducing residential appraisers to simply filling out forms. These appraisers feel that the traditionally more time-intensive process that requires them to implement the cost, income and the sales comparison approaches has been abandoned in favor of a simplified technique requiring three comparable sales and perhaps a property inspection to produce an appraisal report.

Others in the industry believe there is too much subjectivity in the traditional appraisal process and worry that the professional opinions of appraisers (who have a wide range of backgrounds and experience levels) are not as sound as the results from fact-based statistical modeling.

However, these discussions miss the essential point. The industry must move beyond “my approach is better than your approach” debates and set its sights on combining the latest best practices for accurate, reliable collateral valuations.

The balance of this article examines two case studies to advance two themes—both of which are concerned with

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enhancing the property appraisal process. In the first case study, the relative performance of field appraisals is compared with an AVM. Demonstrated in the second case study is the wisdom of integrating statistical models with other forms of property appraisals for more objective reporting.

Case study No. 1

A sample of mortgage loans that were originated between 2003 and 2007 was divided into three status categories as of December 2007:

- Current mortgages;
- Mortgages that were between 150 and 179 days delinquent; and
- Mortgages that were more than 180 days delinquent.

The submitted appraised values were then compared to the results of an AVM using data from the same time period. When we compare the relative difference between AVM results and the appraisal results provided at origination for the three buckets of loans, we find that—especially for the mortgages in the delinquent categories—AVMs produced lower valuations than the appraisals (see Figure 1):

- In 70 percent of cases where the mortgage was current, the AVM value was lower than the appraisal value at origination.
- In 90 percent of cases where the mortgage was 150 to 179 days delinquent, the AVM value was lower than the appraisal value at origination.
- In 80 percent of cases where the mortgage was more than 180 days delinquent, the AVM value was lower than the appraisal value at origination.

A collateral assessment program that routinely incorporates an AVM as part of the underwriting process would

clearly be beneficial as a component of a broader risk-mitigation practice.

The point that is being made is not so much the accuracy of AVMs versus appraisals. Rather, the point is that the relative cost of an AVM pales in comparison with the potential upside from reducing portfolio losses that result from overvaluation.

Case study No. 2

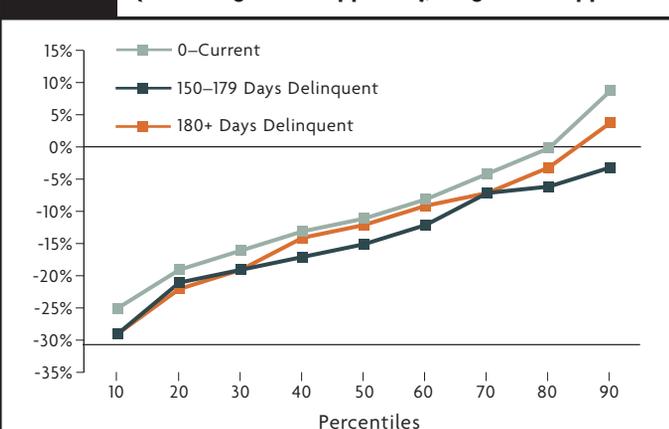
The unprecedented volume of foreclosures and REO sales over the last three years has rejuvenated another contentious debate in the appraisal industry: Should REO sales be included in the appraisal process? It is not uncommon to hear practicing appraisers refer to REO sales as “non-arm’s-length” and “not normal” market sales.

This is an example of the subjectivity that comes into play in the traditional valuation process referred to earlier. While the Uniform Standards for Professional Appraisal Practice (USPAP) guidelines should be sufficient to guide appraisers in this area, in practice there is a great deal of ambiguity.

Still, when we look at market trends, there remains little doubt that in certain markets, REO sales represent at least half of the market activity and are part of the “new normal” for those markets. While some industry participants advocate against REO sales being included in the comparables for traditional appraisals, clearly they represent an important aspect of the current market correction and should not be ignored.

This is an area where the property valuation industry as a whole would benefit from a more systematic integration of the statistical models with appraisal products. Models built on a broader set of observations than is available to the appraiser tend to infuse into the process more objectivity

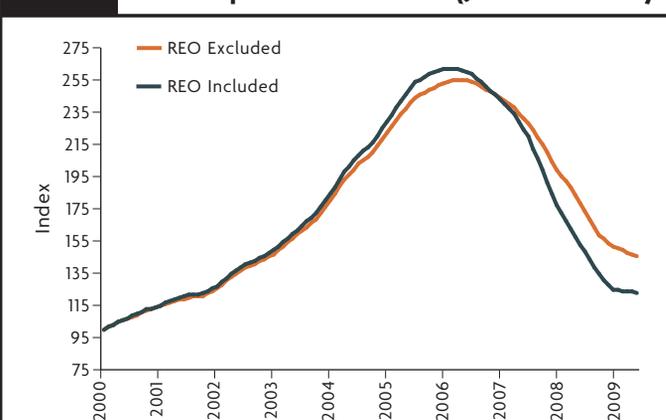
Figure 1 Relative Difference Between AVM and Origination Appraisal*
(AVM-Origination Appraisal)/Origination Appraisal



* Status of loans originated between 2003–2007, as of December 2007

SOURCE: LPS APPLIED ANALYTICS

Figure 2 California: Change in Home Values Based on a Repeat Sales Model (Jan 2000 = 100)



SOURCE: LPS APPLIED ANALYTICS

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around current market conditions.

The share of REO sales in various states since 2000 has grown tremendously. For example, in California and Arizona, REO sales represent well over half of market activity. That share is lower in Florida at 35 percent, and lower still in Massachusetts at 14 percent.

Clearly, it would be inappropriate to exclude REO comparables as non-normal-market sales in certain markets, because to do so would render an inaccurate picture of the market.

The relationship between REO sales activity and the extent to which such sales impact individual neighborhoods and the broader market is also fairly well-established. The latest data show that in Arizona, one of the worst-hit areas of the country in terms of home foreclo-

tures, REO sales are discounted by more than 20 percent compared with non-REO sales, followed by California at 18 percent and Florida at 13 percent (see Figures 2–4). At the other end of the spectrum, Massachusetts has seen relatively little impact by REO sales (see Figure 5).

Bottom line

This article attempts to advance the notion that in times of market turbulence a prudent risk-management practice calls for a closer integration of statistical models, traditional and alternative appraisal products. Property appraisals always include a subjective element. Thus models, when combined with human-produced reports, can reduce some of that subjectivity.

The property appraisal industry itself has moved away from being a monolithic practice over the last decade or so. It is becoming increasingly clear that best-practice property valuations will often encompass the full range of traditional, alternative and modeling techniques.

The challenge the industry faces is how best to match a combination of available valuation techniques to the risk profile of a mortgage applicant and the property that serves as the collateral. When the pace of originations picks back up, the challenge will be further compounded by the need to balance cost and business process efficiency.

Ultimately, reliable and consistent property valuation is a fundamental building block for recovery in the mortgage industry. As with so many other aspects of the financial sector, we must make the changes that are needed to strengthen our processes and improve their accuracy, for the benefit of consumers and financial institutions alike. **MB**

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Figure 3 Arizona: Change in Home Values Based on a Repeat Sales Model (Jan 2000 = 100)

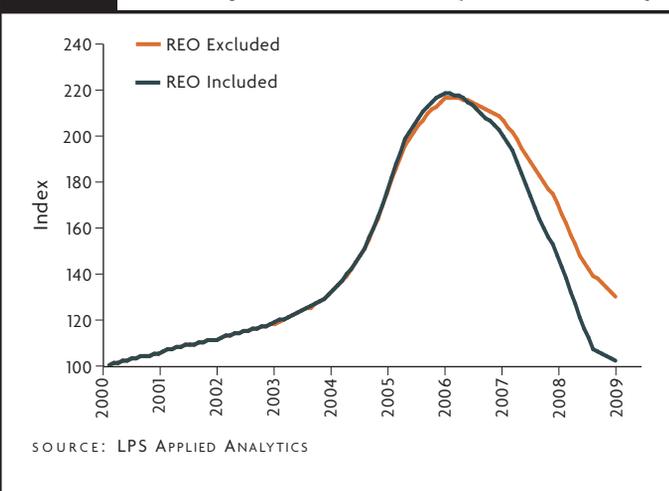


Figure 4 Florida: Change in Home Values Based on a Repeat Sales Model (Jan 2000 = 100)

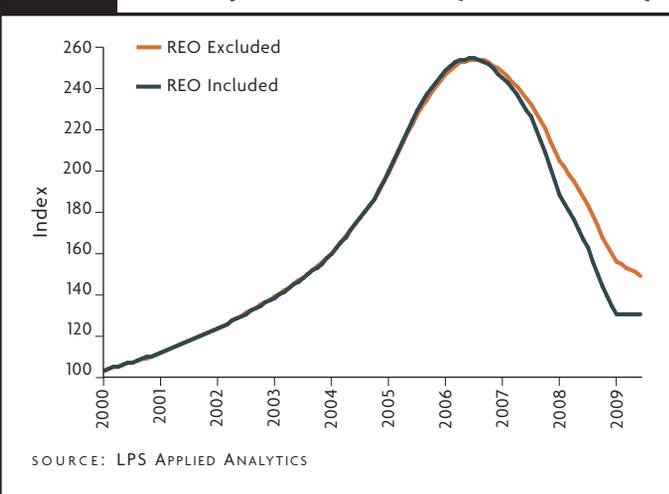


Figure 5 Massachusetts: Change in Home Values Based on a Repeat Sales Model (Jan 2000 = 100)

