The Appraisal Management Company Full-Fee Hypothesis

Benefits AMCs can realize from an industry-wide implementation of a full-fee model for acquiring mortgage appraisals.

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ABSTRACT

This paper examines the self-serving benefits to appraisal management companies (AMCs) resulting from a shift in how residential real estate appraisers are compensated by this sector of the residential mortgage services industry. The current fee-payment system enables AMCs to leverage their market share, nationwide coverage, information technology, specialized management services and relationships with national lender-clients to demand deep fee concessions from real estate appraisers. We offer twenty (20) such benefits here, although we admit the possibility that there may be more. And we have little doubt that a roughly equal number of competitive, statutory, and structural barriers stand in the way of implementing our full-fee, or retail fee, model; we address some of these barriers in the paper. We anticipate some readers will incorporate our arguments into their own firm's deliberations of the implications of the fee issue on the industry. Others may scoff at what they take as a misguided attempt to describe a world that can never be. Regardless of the faction, only time will tell if or to what extent the full-fee model for acquiring appraisals comes to pass.

Below are the 20 distinct benefits:

Paying appraisers their full (or retail) fees…

1. Removes the single-largest barrier to acceptance of AMC as legitimate business partners.
2. Increases the supply of appraisers willing to work with AMCs.
3. Encourages new appraisers to enter the appraisal profession.
4. Leads to better control of appraisal quality.
5. Lowers costs for recruiting, quality control, and rework.
6. Enables AMCs to gain market share.
7. Provides AMCs rationale to charge lenders for the actual value the AMC brings to the transaction.
8. Enables AMCs to provide clients quantifiable means with which to compare AMC alternatives.
9. Reduces third-party risks described in numerous FFIEC Financial Institution Letters and agency guidelines.
10. Promotes less contentious treatment of AMCs.
11. Takes the subjective "customary and reasonable" fee requirement in the Dodd-Frank bill off the table.

12. Paves the way for nationalizing AMC regulation.
13. Provides clients better overall service quality.
14. Preempts external efforts of factions to force AMCs to pay up.
15. Is the most ethical thing to do in a fair and equitable society.
16. Allows for significantly improved vendor relations between the AMC and the appraiser.
17. Reduces the risk that disgruntled appraisers will draw the attention of federal regulators.
18. Provides joint marketing opportunities because appraisers will see the AMC as worth promoting.
19. Opens the door to a better borrower experience because the appraiser doesn't enter the home angry.
20. Opens the door for joint publicity efforts because appraisers will feel like partners.

There are two methods of curing the mischiefs of faction: remove its causes or control its effects.

~ James Madison
Federalist Papers, No. 10 (3)

1. Introduction

When Madison penned these words more than two centuries ago, he had in mind the havoc that groups of people—factions as he termed them—aligned to one or another side of contentious issues could inflict on a large republic. Factions, he observed, were united and motivated to action by a common passion or interest adverse to the rights of others or the aggregate interests of the community [9]. This seems as good a way as any to describe the factious relationship, or contentious symbiosis, between real estate appraisers and the appraisal management industry.

A brief scan of the print, real estate trade, or social media leads informed readers to the same conclusion: appraisal management companies (AMCs) are not held in high esteem by many suppliers of the appraisal services they need to survive. Many appraisers believe AMCs either don't realize or don't care that the now over 30-year-old AMC industry is threatening the appraisal industry. Or at least that it is blamed for many of the appraisal industry's woes. A more likely explanation is that they not only realize it but care deeply about it. Yet like municipal governments insisting that federal highway funds must be used or surrendered to regions competing for the same influx of commerce, AMCs hold on to virtually every fee panel management tenet the industry's founders adopted so many years ago.

Two of these tenets, which are intimately related, stand out. One generally-held belief is that if the AMC doesn't provide mortgage lenders cheap appraisals delivered fast, the other guy will. The other is that they must demand discounted appraisal fees to keep client fees low. Otherwise, clients won't see the value added by the AMC industry.[1] It is the latter of these two beliefs that is the primary focus of this paper. Arguments relating to the former are sprinkled throughout this paper, and may be found elsewhere.[2]

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1 The authors believe in and have written extensively on their position on AMCs: that AMCs are inevitable in this age of advanced transaction management technology coupled with the nationalization and centralization of mortgage lending. Today, the top five mortgage lenders control over seventy percent (70%) of the market share. They do not want to be in the business of acquiring appraisals, and therefore have made the strategic decision to outsource these functions to AMCs. AMCs, we believe, could charge substantially more and still be a bargain for centralized lenders.

Conventional wisdom in the AMC industry, from the early days to the present, has been that if a lender could acquire an appraisal on its own in a given market for X amount of dollars, an AMC can charge the client approximately an additional $50 ($X + $50), but not much more. Should the AMC demand more, the client would simply "do it themselves," or self-manage their valuation fee panel. To accommodate the client, AMCs have relied on appraisers to participate in the inevitable fee haircut.

Equally vexing is a tendency of AMC clients to play one management company against another in contract negotiations. Typically, a lender sends out requests for proposals (RFPs) to a short list of potential AMC partners. AMCs interested in bidding for the work submit responses detailing their unique value proposition, experience, internal controls, and how they'll handle the client's stated needs. In theory, the AMC or AMCs judged to have the best overall value package win the contract. But that isn't what happens in a lot of cases.

Somewhere in the conversation, usually during the fee discussion, AMC candidates are told that if they meet a competitor's price they'll get a portion of the work. But wait! What about the client's non-fee-related interests? Those that one or another AMC excels in? Those that an AMC has spent tens of thousands of dollars to automate? The features the client insisted upon in the RFP? Does it all boil down to matching the lowest fee? "Is this the ultimate measure of our worth?" an AMC sales representative might ask. Often it is. For as much leverage an AMC might use to squeeze fee concessions from appraisers, the same leverage is being applied to them by potential clients.

The AMC is left with a choice: take it or leave it. Mostly they take it and then force appraisers on their fee panels to participate through lower appraisal fees. Appraisers don't like this arrangement. Increasingly they're pushing back. But not in the way one would normally expect—by refusing to accept the assignment. They know if they pass on the arrangement some other appraiser will accept it. Therefore, they agree to work with AMCs and harbor resentment of the terms of the deal. They voice this resentment in media interviews, congressional testimony, appraiser forums, and appraisal trade publications. Thus, fees paid to appraisers arguably are the single largest public relations challenge to the AMC industry.

We believe the factions—AMCs and appraisers—largely address these competing pressures by attempting to control the effects of low appraisal fees rather than removing the underlying cause(s). In this paper, we make the case that AMCs can remove or at least mitigate some of the causes of the friction—beginning with the biggest one: appraisal fees. Doing so will result in a more collaborative relationship between supplier and AMC client. But it will also assure the future of the AMC industry by insuring the sustainability of the appraisal industry.

2. A Brief History Lesson

Outsourcing management of appraiser fee-panels is not new. In fact, the seeds of what would become appraisal management companies (AMCs) were sewn some fifty years ago in the records room of the Cuyahoga County (OH) courthouse. There, Bruce Felder, a student at nearby John Carroll University and part-time clerk, recognized a need by attorneys for current owner property searches. Up until then, title agents were the go-to resource for property information. However, many limited these services to full 60-year title searches, delivered in two weeks or more; large loans got priority.[3] Those seeking current owner searches were shown the door.

The only threat to the industry's inevitability is if 1) mortgage lending returns to its locally-based roots, or 2) enough appraisers leave the profession to render it unsustainable.

2 Here are just two such sources: www.tavma.org, and www.mortgagethirdpartyriskblog.com. There are others.

3 Title agents earned far more on a $50,000 loan for an S&L than a $5,000 secondary mortgage loan (the maximum allowable second mortgage in many states back then).

This reluctance to serve the lower end of the title insurance spectrum became even more significant throughout the 1970s as states began to pass secondary mortgage acts. Consumer finance companies (a.k.a. consumer discount companies), the subprime lenders of the day, just a step above loan sharks in the eyes of many title agents[4], had to find an alternative source for current owner searches. Mr. Felder found an opportunity. Riding a wave of secondary mortgage acts sweeping the nation, Felder founded Legal Messenger Service in 1959, a one-county property search operation that, nine years later, morphed into national vendor management giant Record Data, Inc.[5]

RDI's success was based on more than good fortune in timing the secondary mortgage wave. It succeeded by meeting five additional customer needs: 1) a single simple-to-read-and-understand report format in all 3,400 or so U.S. counties; 2) ordering done by a third-party management company rather than branch managers wielding white-out and a tendency to under report, or fail to report at all, blemishes in title, tax obligations, and other credit worthiness determinants; 3) backing by classroom instruction for branch managers on RDI products and services; 4) fast delivery; and 5) competitive pricing. By 1970, customer demand prompted RDI to add real estate appraisals to its menu of offerings.[6]

Lender's Service, Inc., founded as Pennsylvania Property Reports in 1967, a current owner property reporting company in Western Pennsylvania, followed a similar path but with more emphasis on appraisal management. Initially, LSI established brick-and-mortar operations in regions where their main clients (The Associates, Signal Finance, and others) had a large presence. This strategy gave way beginning in 1984, when LSI leveraged its vendor management capabilities to establish the first centralized National Service Center. And for good reason. Back then the fax machine was emerging as a technology for transmitting appraisal and title reports. Workers needed little more than a desk, telephone, map books (3-inch-thick, 3-ring letter-size binders containing area maps of states with appraisers' contact information nearby), and a legal-size 3-ring binder in which to record and track order statuses. So the need for local operations diminished into irrelevance. The nationalization of appraisal management had begun, and the appraisal management industry—indeed the centralization of mortgage back office services—never looked back.[7]

The effects of these developments were felt in every segment and by every worker in the real estate mortgage finance sector. From that point on independent appraisers have been unable to make a compelling case as to how in-house vendor management and direct placement of appraisal orders offered centralized mortgage lenders a superior value proposition to outsourcing the function to AMCs.

2.1 The AMCs' Challenge

For their part, AMCs have done little over the years to overcome often scathingly negative portrayals of the industry and those who work with AMCs, by appraisers and others who object, even vehemently, to not only their business practices and ethics, but their very existence. Perhaps they can't mount such a public relations outreach.

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4 According to Bruce Felder in an interview with Schurman in 2004. This observation was confirmed by Joe Casa, publisher of *The Title Report*, *Valuation Review*, and other publications in a subsequent interview.

5 RDI was incorporated in 1968; Legal Messenger Service International, Inc., changed its name to Record Data International, Inc., in 1971.

6 Felder wasn't a big fan of offering appraisals but felt RDI had to in order to compete with upstart LSI.

7 Additional information on the genesis of the VMC industry can be found in the report, "The Three Day Turnaround Time in the Real Estate Settlement Services Industry," by Jeffrey M. Schurman (2010), and at the Mortgage Third-Party Risk Blog, at www.mortgagethirdpartyriskblog.com.

After all, the industry has long held an unwritten "publish and perish" mindset. It started with the industry's pioneers who believed that flying under the radar was the best way to avoid scrutiny. But the same advancement in information technology that fueled the growth of AMCs also led to social media, blogs, forums, and other channels now being used to scrutinize the AMC model.

This scrutiny of the AMC model centers on a trio of nagging fee-related questions:

- Why do AMCs underpay appraisers?
- Is it true that only bad appraisers work with AMCs?
- Do they really send appraisers 100 miles to unfamiliar areas to do appraisals?

Not the kind of publicity that moves an industry to greatness!

2.2 AMCs and Appraiser Relations

A recent survey of designated appraisers is illustrative of the oft-cited complaints against AMCs. The industry thus far has not adequately responded. In the survey, nearly 50% of the respondents who've accepted AMC assignments rated their relationships with AMCs as *unsatisfactory*. Here's why:

- AMCs manage the ordering and placement of the appraisal services;
- AMCs often do not provide the appraiser sufficient information;
- AMCs are unresponsive to the appraiser's questions;
- AMCs dictate the appraisal fees;
- Some AMCs require appraisal results to be modified to their liking before the appraiser is paid.

All of these complaints, with the exception of the last one, relate to business practices. Therefore, the AMC industry conceivably can change most of these perceptions by making changes to the appraisal fee model. We propose that AMCs can benefit most by changing the appraisal fee structure. Not only would it cause many or most other friction points to disappear, but it will insure a sustainable and cooperative future for appraisers and AMCs.

Other Appraiser Dislikes Toward AMCs

The AMC business model is unsustainable. AMCs, say appraisers, assume an endless supply of desperate appraisers willing to do their work. AMCs want certified appraisers to work cheap and provide next day service. Also, the average appraiser is over 50 years old. There's no incentive for young people to enter the business.

AMCs are parasites that don't earn their fees. Appraisers resent that AMCs provide little assistance in developing and reporting appraisals. They do a fraction of the work and take upwards of $200 of the appraisal fee. And appraisers reject that AMCs perform marketing and other services otherwise done by appraisers.

AMCs have commoditized the appraisal industry. A commodity is something for which there is demand yet is supplied without qualitative market differentiation. AMCs treat the industry like commodities rather than unique products provided by qualified professionals.

To AMCs, Faster + Cheaper = Better.
A common criticism of AMCs is that quality seems the least important characteristic of an appraisal. AMCs focus on fees and turnaround times, not appraisal quality.

AMCs barrage appraisers with repeated status requests, appointment verifications, and addendums. Appraisers cringe at the stream of uninformed and sometimes irrelevant questions by "reviewers" based on checklist prompts, and aren't paid for the additional work.

Appraisers are outraged when AMCs require them to sign indemnification agreements. (Some states are enacting restrictions prohibiting AMCs from this practice, and some legal experts dispute the enforceability of indemnification clauses.)

Appraisers hold AMCs partially responsible, some say complicit, in formulating toothless AMC regulations. Conspiracy theories aside, many feel there are too many statutes with little or no return on compliance investments.

3. The Benefits of the full-fee model.

In this section, we propose that there are at least 20 self-serving benefits to the AMC industry by paying appraisers their full-retail fees. We rely extensively on research we and others have conducted, our extensive combined interactions with appraisers and AMC industry leaders, and basic economic principles, chief among them supply and demand. Most of our observations are grounded in free market behaviors among buyers and sellers of settlement services. Significantly, much of the rationale is grounded in the discipline generally known as *systems thinking*.

3.1 Systems Thinking: A brief tutorial.

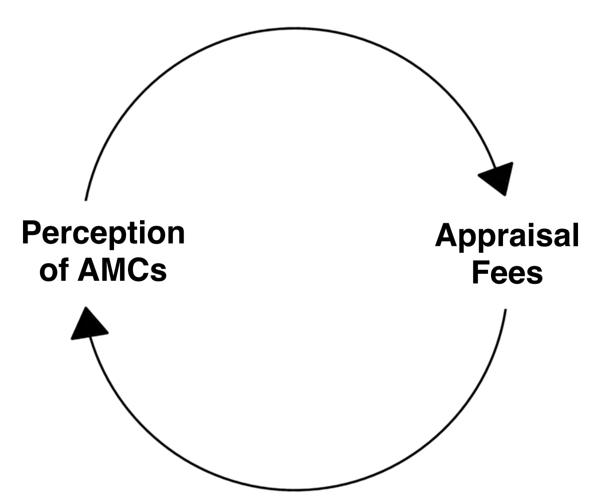
Management consultant Peter Senge is a thought leader in the discipline of systems thinking. He became renowned by business executives for his seminal work, *The Fifth Discipline*, the authoritative text on systems thinking (or *system* thinking as it is elsewhere referred). We build our case in this section around Senge's core argument: *Events that are distant in time and space are all connected within the same pattern, or system, with each event influencing the rest* [6].

The illustrations used in the paper depict these systematic circles of influence. Working through the illustrations and nearby text, starting with the right-most text box (the eastern-most side of the circles), and moving clockwise to the left, readers will see how each event influences the next event along the circular path.

For example, our first claim is that paying full fees removes the single-largest barrier to acceptance of AMCs as legitimate business partners. Thinking linearly, we'd be tempted to consider the claim by looking at the next step along a straight-line path. Yet the claim takes on additional, hopefully clearer meaning when thought of as a system of events.

As the illustration below suggests, paying appraisers more—or less, for that matter—influences how appraisers perceive AMCs as business partners. In other words, if the AMC industry is perceived as paying appraisers retail fees, the popular perception of AMCs should be seen more favorably than today. By this logic, paying retail fees and tossing in, say, a $100 bonus should cause many in the appraisal industry to view them very favorably. Conversely, lowering fees from where they are today should have the exact opposite reaction among appraisers. The graphic helps to make this visual connection between these two interrelated events.

AMC Fee/Appraiser Perceptions Reinforcing Loop



It should be noted that an increase in one event doesn't by necessity lead to an increase in the immediately-following event. For example, if the starting-point event depicts, say, improved productivity due to automation of a process, the next event would not necessarily reflect an increase as well. In fact, it would likely be the opposite: increased productivity would lead to lower overall cost (a reduction rather than an increase due to an increase in the preceding event).

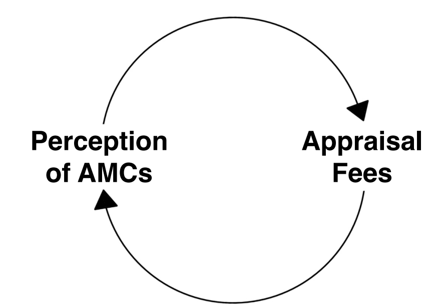
Hopefully this too-brief overview of systems thinking will be helpful as we move to our thesis, which is that paying full-fees for appraisals benefits the AMC industry.

3.2 The Benefits of the full-fee model.

1. Paying full fees removes the single-largest barrier to acceptance of AMCs as legitimate business partners. At an April 2009 meeting with representatives of TAVMA (Title Appraisal Vendor Management Association), a former Appraisal Institute president observed that paying appraisers their full fees would remove 95% of the appraisal industry's problem with AMCs. To the extent this is true, the AMC industry would benefit by paying appraisers their full fees.

In a 2010 poll of designated appraisers, nearly 50% rated their relationships with AMCs as unsatisfactory due in large part to the fees, along with the demands AMCs put on appraisers [3]. AMC fees—low fees specifically—are at the top of appraisers' list of grievances against AMCs. The cumulative effect of such negative perceptions is to harm the AMC brand and limit the industry's growth.

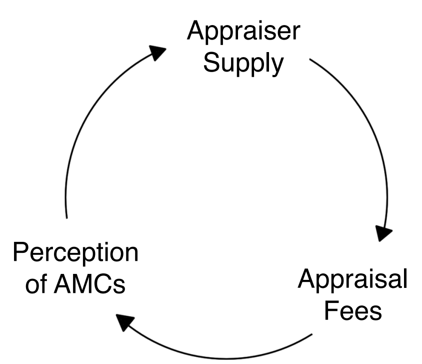
AMC Fee/Appraiser Perceptions Reinforcing Loop



To the right is a graphic depiction of the reinforcing loop pertaining to the relationship between appraisal fees and the perception of AMCs among appraisers (and others). From right to left: 1) As appraisal fees rise (or fall), 2) so too will the perceptions of AMCs among appraisers.

This single change would go a long way in resolving a public relationship dilemma that has dogged the AMC industry for, in some cases, almost a half-century. AMCs can start by standing up to clients pushing for ever-lower service fees. They need to explain that although AMC transaction management fees are negotiable, appraisal fees are not. Then hold the line.

AMC Fee/Appraiser Supply Reinforcing Loop



2. Paying full fees increases the supply of appraisers willing to work with AMCs. A 2007 survey found that 60% of appraisers indicated that AMCs must "pay reasonable fees" in order to recruit them to join their fee panel [4]. This is significant. The illustration to the left suggests that 1) as appraisal fees rise (or fall), 2) the perception of AMCs will likewise rise (or fall), and 3) so too will the supply of appraisers willing to work with AMCs.

When the fees paid by AMCs approach or reach parity with the fees paid by other retail clients, AMCs should be flush with motivated, high quality appraisers on their fee panels.[8]

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[8] At least three obvious counterarguments for stacking the fee panel are evident. First, federal AMC fees ($25-$80 proposed) for each appraiser on their fee panels will encourage AMCs not to hire any more appraisers than they require, even if a prospective fee panel appraiser's fees are competitive. Second, AMC regulation is crafted such that it is difficult to remove an appraiser from an approved list. Thus, AMCs risk being sued by suppliers who haven't received work claiming they've been unfairly blacklisted. Third, the competitive nature of the appraisal industry suggests that suppliers will discount fees in return for additional order volume, thereby reducing the benefits of the full-fee model.

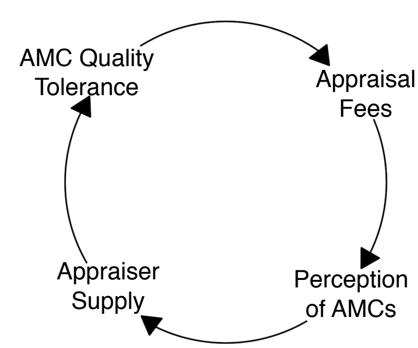
3. Paying full fees encourages new appraisers to enter the appraisal profession. Removing the fee issue not only increases the supply of appraisers (see #2, above), but also protects the vitality of the settlement services ecosystem. Appraisers in particular are sounding alarm bells about the aging of the appraiser population and lack of new entrants to repopulate the gene pool. Why, they ask, would a young person come into the industry to make what many say amounts to minimum wage? Why, indeed. The average appraiser is now 50 years old. Driving down appraisal fees is an unsustainable strategy in such an environment. At some point there won't be enough appraisers.

Certainly, lenders and a handful of AMCs with automated valuation tools may step in to fill the void. However, like the vendor management and mortgage lending industries in the past decade or so, we can expect many of these AVM providers to be bought up by mortgage lenders and/or title companies.

Paying full fees may not stave off the proliferation of AVM technologies. However, it is a far more sustainable long-term strategy for both AMCs and the appraisal industry than the current fee structure.

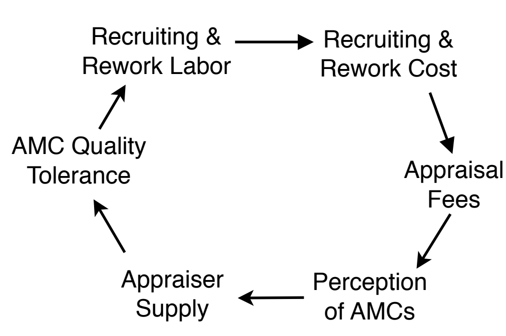
4. Paying full fees leads to better control of appraisal quality. Appraiser surveys suggest that upwards of 60-70% of residential appraisers say they work with AMCs. Many of these appraisers are overtly or covertly hostile to the AMC business model. Either way, it is not a productive work environment. Paying full fees will incentivize current AMC appraisers, both monetarily and competitively. Appraisers won't want to lose work due to substandard performance and the implicit requirements of better service quality that come with paying retail fees.

AMC Fee/Appraiser Quality Reinforcing Loop



The anticipated increase in the appraiser supply enables AMCs to dole out work based on the best combination of service quality, timeliness, and cost (assuming they have fair and transparent tracking, measurement, and reporting capabilities). This should lead to reductions in AMC appraisers' pipelines, resulting in less rework, errors, and costly mistakes.

AMC Fee/Appraiser Recruiting/Rework Reinforcing Loop



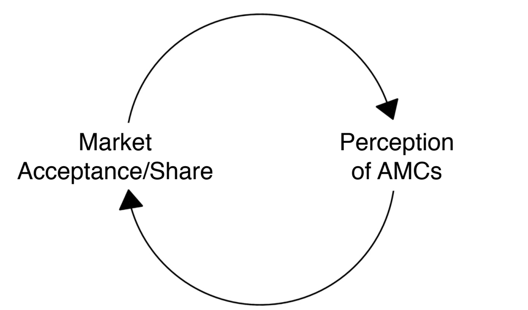
5. Paying full fees lowers costs for recruiting, quality control, and rework. Many industry observers argue that the resources invested in pre-delivery quality reviews, rework, addendums, re-orders, etc., can be reassigned to more productive profit center work, while putting the onus of appraisal quality squarely on the shoulders of the appraiser. Indeed the very concept of Total Quality Management is grounded in the notion that quality is managed throughout each step of a value chain. It is not, TQM asserts, something done mostly at the back end of the transaction. By then it is too late.

The same can be said for appraisal management. The full-fee model enables the AMC to demand quality all along the value chain. AMCs would argue, rightly, that they do this already. They do have internal controls around recruiting, order placement, tracking, and delivery. They have pre-delivery reviews, either automated rules-based or human-checklist, before the appraisal goes out to the client. Yet they do not control, nor could they, the work effort of the appraiser in developing and/or reporting the appraisal. Appraiser shirking is a risk in every outsourcing relationship.

An alternative to hiring cheap and monitoring the supplier's quality post-delivery, according to our model, is to hire appraisers at retail fees and then demand—with little tolerance for error and a meaningful way to track and assess quality over time—appraisals that are consistently high-quality works of the art and science that is appraisal.

6. Paying full fees enables AMCs to gain market share. That's because as the industry's reputation rises, the negative connotations about AMCs will at some point fade away. This will reassure lenders who today may be leery of switching to the AMC model on account of concerns about fees, quality, appraiser selection, etc., that handing over supplier management to a third-party provider is not a career-ending decision. As a result, market share should increase with the positive publicity.

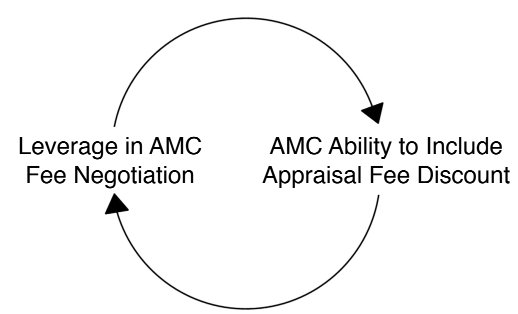
Client Perception of AMCs/Market Share Reinforcing Loop



As we argue elsewhere, the appraisal management industry is an inevitable result of the nationalization of mortgage lending, increased understanding and acceptance of outsourcing as a viable alternative to the vertically integrated banking organization model, and vast advancement in information technology for managing large volumes of transactions associated with production, underwriting, closing, funding and recording mortgages. Even today, when AMCs are subject to more scrutiny than ever, they maintain a significant market share. Acceptance of AMCs as valuable partners can only help AMCs to capture additional market share.

7. Paying full fees provides AMCs rationale to charge lenders for the actual value the AMC brings to the transaction. In appraisal management's early days, AMCs generally maintained a 60/40 fee split on full URAR appraisals: the appraiser got 60% of the fee charged to the client, and the AMC took 40%, its gross margin for the transaction. From this 40%, the AMC paid expenses such as salaries, overhead, taxes, utilities, profit, etc.

Fee Negotiation Absent Appraisal Discount Reinforcing Loop



The downside is that someone on the supply-side has to take a haircut on the fee. A fee model that removes the dual points of negotiation (AMC fee + appraisal fee = client fee) reduces or eliminates the possibility of artificially under-pricing the actual value of the combined service. For example, say that the appraiser's normal fee is $X, and it cannot be touched in client fee negotiations. This incentivizes the AMC to properly price its own administrative service fees. If the lender demands a discount, the AMC can provide one out of its fee for managing the transaction.[9]

Splitting the fees is a necessary and transparent win-win-win solution for all three parties−the lender, appraiser and AMC. It should reflect the actual level of work invested by the appraiser and AMC.

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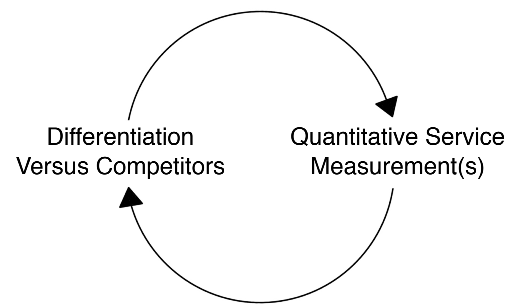
[9] There are, for example, AMCs that charge lenders the appraiser's fee plus a $50 transaction fee. However, much or all of the fee goes to providing only a technology gateway, perhaps a do-it-yourself pick list of available appraisers, and the infrastructure and human resources required to perform these services. A full-service AMC, on the other hand, provides many additional services in addition to these basic services, and charges accordingly.

8. Paying full fees enables AMCs to provide clients quantifiable means with which to compare AMC alternatives. As we alluded to in the section above, a blended appraisal-plus-AMC fee doesn't give the lender a concrete means to assess the implications of fee differentials from one AMC to the next. In other words, if one AMC quotes the lender a $400 fee, and another AMC quotes a $450 fee, no one, especially the lender, knows what added value they'll get by engaging the $450 AMC. Paying suppliers what local clients pay them provides mortgage lenders an infinitely more transparent way to compare and contrast prospective AMCs.

Removing the appraiser's fee from the price negotiation offers the lender a clearer understanding of what various AMCs are charging for their transaction management services. This benefits the lender by helping it to assess the level of strategic, operational, reputational, and reporting and compliance risk associated with each VMC alternative. It also helps the lender to match their board of directors' stated appetite for risk to the most appropriate supplier.

For the AMC, removing the supplier fee from the price negotiation presents yet another benefit relating to competitive differentiation. With the appraisal fee off the table, the AMC can legitimately differentiate itself from other AMCs. They could compete as the...

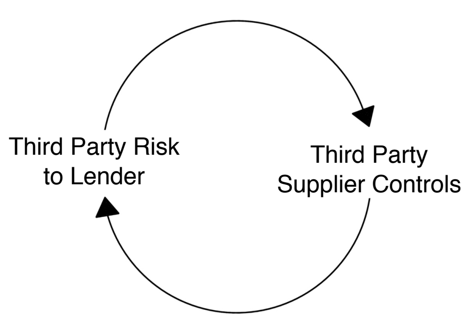
Quantitative Service Level Measurements Reinforcing Loop



- Low-cost leader: Hiring from a deep pool of suppliers (in each of these options paying higher fees attracts more suppliers) and charging the client a small transaction fee for limited administrative, IT, and support services; cost is the differentiator.
- Service quality leader: Hiring from a deep pool of suppliers and charging the client a premium transaction fee for carte blanche administrative, IT, and support services; the over-the-top quality of the buying experience is the differentiator.
- Specialty service leader: Hiring from a deep pool of suppliers and charging the client a mid-range transaction fee for a limited menu of administrative, IT, and support services; the balance of quality, service, and price is the differentiator. Or, offer premium pricing for premium provider network (SRAs only, etc.).

The point is that the lender can tell by the price—and verify in on-site audits—that the AMC is providing services commensurate with the fee it's charging. And it offers the client something quantitative (rather than a generic "we have the best people/customer service/technology" qualitative claim). It even offers the client a way to quantify the timeliness of delivery in a way that's more meaningful than the current 3-day turn-time as a quality measurement.

Third Party Risk Reinforcing Loop



9. Paying full fees reduces third-party risks described in numerous FFIEC Financial Institution Letters and agency guidelines. For instance, in the Financial Institution Letter FIL-44-2008, entitled "Guidance for Managing Third-Party Risk," the FDIC cites examples of risks associated with outsourcing bank services to third-party providers. The agency warns that outsourcing does not relieve the banking institution of responsibility for the outsourcing partner's activities. Therefore, as the agent of these regulated institutions, reputation risks (among others) associated with AMCs can adversely affect their client's reputation as well. Paying full fees goes a long way in reducing these risks.

These risks make clear the need for lenders to go into outsourcing relationships with more than a vague notion or supplier's assurance that it will pay off in the end.

10. Paying full fees promotes less contentious treatment of AMCs by the appraisal trades in congressional testimony. Better perception of AMCs smooths the path to more favorable governmental opinions of the industry, which can lead to fairer treatment of the industry in statutes and regulations.

11. Paying full fees takes the subjective "customary and reasonable" fee requirement in the Dodd-Frank bill off the table. Not literally, but functionally. The Appraiser Independence section of the Dodd-Frank bill requires AMCs (among others) to pay appraisers a so-called "customary and reasonable" fee. Fair enough. But the lack of a clear definition of what exactly constitutes such a fee both enables AMCs to argue that they are paying appropriate fees and puts them at risk of violating this subjective standard. By paying full fees, AMCs would mitigate risks the clause entails and take yet another issue off the anti-AMC talking points list. This also has potential game-breaking implications for the next benefit: Nationalization of AMC regulatory oversight.

12. Paying full fees provides clients better overall service quality. All the benefits AMCs realize by paying appraisers their full fees are bestowed upon the clients and future clients of AMC industry. Even paying full retail appraisal plus the actual value of AMC fees for the levels of services rendered is almost certainly less than the client would pay in building its own AMC arm. Moreover, customers of the mortgage lender can also share in these benefits through lower origination fees (due to increased productivity and reduced overall operating costs in managing fee panels, risk, etc.), lower

Third-Party Risks [1] and [2]

Strategic risk Risk arising from deliberate activities by vendors aimed at taking advantage of clients. A vendor's appraisals or service quality don't match the client's strategic goals; fail to provide benefits or to avoid the very risks a customer expects in utilizing an appraisal.

Shirking, or the Principal-Agent Problem A form of strategic risk caused by a supplier's deliberate under-performance while claiming full payment for agreed-to services. Occurs when the agent perceives an under-incentive to complete the job as agreed, and the client has insufficient information to monitor agent's performance.

Poaching Misuse of information provided to the supplier for legitimate contractual purposes. Poaching entails deliberate attempts to create unauthorized revenue streams at the client's expense.

Opportunistic renegotiation Unilateral change to terms of a contract after its inception when the client discovers that it has no alternative supply source(s) beyond those controlled by the vendor.

Operational risk (1) Risk of unintentional breakdowns in the supplier's operations due to inadequate internal controls, production backlogs, under staffing, improper training, insufficient scaling up of operations during peak periods, etc.

Reputation risk Risk of negative public opinion. Third-party actions resulting in dissatisfied customers; actions inconsistent with institution policies; inappropriate recommendations; security breaches resulting in the disclosure of customer information; violations of law and regulation that could harm the reputation and standing of the client organization in the community it serves.

Transaction risk Risk arising from problems with service or product delivery. This includes a third party's failure to perform as expected, lack of an effective business resumption plan and appropriate contingency plans, weak control over technology used in the third-party arrangement, and/or unauthorized transactions or the inability to transact business as expected.

Credit risk Risks that third party, or any other creditor in the third-party relationship is unable to meet the terms of the contractual arrangements with the financial institution or to otherwise financially perform as agreed.

Compliance risk Risk arising from violations of laws, rules, or regulations, noncompliance with internal policies or procedures, or with the institution's business standards.

Other risks The types of risk introduced by a mortgage lender's decision to outsource settlement services to a third party provider. And there are many.

appraisal transaction fees, and other efficiencies.

13. Paying full fees now preempts external efforts of factions to force AMCs to pay up. There is a widely supported initiative underway to force AMCs to separately report the appraisal fee and AMC fee on the HUD-1. It is likely to become the law of the land, if not right away, certainly some day soon. And for good reason. It also is a matter of time before outrage among appraisers, actions by the Consumer Financial Protection Bureau (CFPB), court action against AMCs alleging violation of customary and reasonable fee requirements, and state legislation mandating payment in accordance to the Veterans Administration Fee Schedule (among others) will overcome whatever resistance the AMC industry can muster. Already some AMCs report paying appraisers full fees—and tout this fact in marketing efforts as points of differentiation from "those other guys." AMCs can fight these trends or preempt them by breaking reliance on the discounted fee model. The resulting hodge-podge of regulatory regimes bearing different requirements, reporting procedures, and penalties for bad acting will continue to delay the inevitable. And it is inevitable: the full-fee model for appraisals will be the industry norm.

14. Paying full fees paves the way for nationalizing AMC regulation. Today, AMCs are regulated on a state-by-state basis. Although there are similarities among the states in their laws and guidelines, staying on top of these regulations, let alone complying with them, is a mammoth undertaking. A single federal oversight agency (preferably within one of the FFIEC regulatory agencies) sets the stage to enact a single comprehensive set of regulations for the AMC industry. National AMC registration will dramatically improve the quality of AMC oversight and promote meaningful regulation that will benefit AMCs, lenders, and appraisers.

15. Paying full fees is the most ethically appropriate thing to do in a fair and equitable society. The modern ethics literature cites three prescriptive approaches to ethical decision-making that can be applied to the full fee hypothesis. According to Trevino and Nelson (1999/11) [8], ethical decisions focus on consequences (consequentialist theories); duties, obligations, and principles (deontological theories); or integrity (virtue theories). Consequentialist theories, as the name suggests, argue that an ethical decision should maximize benefits and minimize harms to society. What matters is the net balance of good consequences over bad ones for society in whole. In other words, "the greatest good for the greatest number, or the least harm to the smallest number." This greatest good/least harm idea is characteristic of the most common form of consequentialist theories, utilitarianism.

Deontological theories base the rightness of actions on one's ethical duty. For instance, faced with an ethical question between doing right versus doing wrong, even if the wrong action is more pleasant,

10 Characteristics of Meaningful Regulation [5]

Meaningful regulation:
(1). Compels the regulator to create a single uniform set of standards and guidelines for the industry;
(2). Compels the industry to improve quality and/or risk management as may be needed to meet the agency's rules and regulations and existing FFIEC guidance on third-party risk management;
(3). Flags educational and compliance gaps in the industry's systems that they can duly address;
(4). Encourages the industry to invest in IT to meet reporting and compliance rules (compliance, record-retention, performance report generation, etc.);
(5). Provides compliant industry competitors with a competitive advantage over those that lag in the compliance area;
(6). Puts the industry – which at the core perform functions that the lender would otherwise do (and be responsible for even if they engage service providers from the industry) – under the regulatory auspices of the same entity tasked with overseeing, auditing, and supervising the mortgage lending industry;
(7). Ensures compliance of the industry's product development efforts to consistent and reasoned standards and guidelines; regulatory clarity encourages innovation;
(8). Provides mortgage lenders meaningful standards and guidelines upon which to assess current and potential industry partners;
(9). Levels the competitive field in the industry while weeding out bad actors; and
(10). Eliminates the oft-cited objection that the industry is either unregulated or under-regulated.

profitable, or self-satisfying, the deontological theorist would base their decision on the actor's duty with regards to broad, abstract, universal ethical principals or values such as honesty, fairness, loyalty, justice, rights, respect for other humans, etc. We recognize it as, "What is the right thing to do under these circumstances?"

Virtue theories focus more on the virtue of the moral actor than on the act itself. The goal, Trevino and Nelson assert, is "to be a good person because that is the type of person you wish to be."

Among the challenges in applying ethical standards to free market business practices is that the sheer complexity of commercial transactions and contract law create numerous gray areas. For instance, how is the gray area reconciled in a business transaction in which AMCs and appraisers enter the fee negotiation of their own free will? Appraisers would argue that they're over a barrel due to the AMCs' take-it-or-leave-it approach to negotiating. But can this be true if either party is free to walk away from the table?

An AMC's offer to pay an appraiser $X is either accepted, counter-offered, or rejected by the appraiser. There is no proverbial gun to his head. The appraiser may be unhappy with the fee, the gall of the client to extend such an offer, and/or any other part of the arrangement. The appraiser may freely walk away from the negotiation. Or not walk away. The standards of a legally binding contract—offer, acceptance, and consideration—having been met, the parties enter into a legally binding contract. At least that is what the AMC would contend—that the amount of the appraisal fee does not determine the ethics of a freely-entered negotiation. And in a sense they would be correct.

Yet there is something unsettling about this determination. As ethicists Shaw and Barry (2007) argue, from the moral point of view, prices, like wages, should be just or fair [7]. Although they do not distinguish between prices paid by consumers versus prices paid to suppliers, it seems not to matter: "Pricing," whether on the buyer- or seller-side of the table, should be just or fair for *all* parties to the transaction. Therefore, to argue that a fee is fair because the other side accepted it doesn't sit well in a civil society. It is analogous to arguing that usury (lending money at an excessive interest rate) is fair because the customer accepted it. It just doesn't sit well.

A virtue ethics theorist would agree. So too, we suspect, would AMC owner/operators themselves. Although the very characterization of heartlessness personified, if the media and blogosphere are to be believed, we believe AMCs would readily state that they'd like to pay appraisers more.[10] In fact, few of us would judge ourselves virtuous to underpay suppliers, the very third-parties we depend on to service our customers. To wake up every morning asking, "How can I screw these drudges today?" seems strangely at odds with the biblical admonition to find satisfaction (or be happy) in our work.[11] Few suppliers, for their part, would feel virtuous about shirking (i.e. deliberately underperforming) to take advantage of clients.

Consequentialist and deontologist theorists would run up against more than a few gray areas. That's because the universe of viewpoints about the ethics of an action is sufficiently large enough to make any determination suspect. For instance, in weighing the "greatest good for the greatest number" the consequentialist considers not only the appraiser and AMC, but also the lender (which seems more and more to seek out ever-lower fees for settlement services). So too would they consider the government and consumer advocates, both of which have pounded the drum for lower fees to consumers for years. And secondary market investors—they too want lower fees. And what about consumers? Conversely, the "greatest good" to these groups may be to pay more for appraisals in order to assure a sustainable future for the appraisal profession and thus the users of appraisal services. The consequentialist may conclude that mortgage lenders are better off paying more in order to protect their portfolios, their market share, profitability, and risk tolerances. The same conclusion may be reached for the other groups as well.

For the deontological theorist, who judges an act right or wrong based on the duty of the actor, fewer gray areas exist than for the consequentialist. Yet gray areas remain, mostly as they relate to the contractual agreement between the parties. The AMC owner/operator's main duty is to shareholders in their organization. So too is the appraiser's to his or her lender/client and their shareholders and customers. Certainly if the appraiser and AMC's top officer were to talk privately, they would likely agree that fair compensation is the duty of every enterprise.[12] Yet the number and variety of stakeholders makes the issue, and the conversation, take on a "grayer" tone.

How then to reconcile the ethics of the Great AMC Fee Debate?

There are several ethics tests that can help resolve this debate, as well other ethical questions in business and life: The first two are the tests of reversibility and universality. Reversibility asks the actors to discern the answer to the question, "Would I wish for this standard to be applied to me, or to my organization, the way I wish it to apply to my counterpart in this debate?" If the answer is no, there is probably a better ethical solution to be had.

The second test, universality, asks a similar but farther-reaching, universal question: "Would I want this standard to become the universal law of the land? The new way things are done in this world?" If not, it is probably time to rethink the ethics of the situation.

And for good measure, if these tests—reversibility and universality—aren't sufficiently clear, or fail to act as arbiters of right and wrong, there is always the Golden Rule to fall back on. The Golden Rule, of course, admonishes us all to do unto others as we'd have them do unto us.

To be fair, more than a few AMC business owner/operators will argue that for as much as AMCs push appraisers for ever-lower fees, lenders apply the same screws to appraisal management companies. This is true. But does it necessarily mean then that it is either ethical or even sustainable? It seems more appropriately a call to the mortgage lending industry—and consumer advocates in media and government—to rethink the downside impacts of ever-lower settlement service fees.

16. Paying full fees allows for significantly improved vendor relations between the AMC and the appraiser. As has already been pointed out, the relationship between the AMC and the independent fee appraiser is already strained. This is disadvantageous to the AMC for a number of reasons, many of which have led to the problems already examined within this paper. Faced with the reality they are today, it's easy to see why many executives within the AMC haven't fully considered the advantages that come with a stronger relationship with appraisers.

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[10] The authors both have spent significant time working with and for the AMC industry, and have enjoyed close professional relationships with many industry leaders through our work with TAVMA, the settlement services industry trade association. Our experience has been, and we expect will continue to be, that there is not a heartless AMC owner/operator in the business. Though vilified by many, they are as a group pretty much the same as the rest of us: thinking, feeling, compassionate human beings.

[11] Ecclesiastes 2:24 and 5:19.

[12] Although as we point out elsewhere, they may strongly disagree on what constitutes fair compensation in a transaction in which both parties absorb some or all of the transaction costs; the appraiser absorbs the production costs to develop and report the appraisal.

The risk of quality issues with the appraisal report is reduced when the appraiser is happy with the relationship he enjoys with his employer. This is not meant to suggest that professional appraisers would purposely do a poor job on a report, but the subconscious desire to please a valued source of business will naturally result in a better, more thorough job. Beyond that, taking work for less than full fee requires the appraisers to work more quickly in order to earn the same amount of money, and speed breeds error. AMCs respond that they do in fact offer appraiser-facing benefits like marketing, customer service and dispute resolution, scheduling, accounting/collections, quality control, etc. Yet many appraisers dispute such contentions, arguing they have to perform most or all of these functions regardless of the AMC's involvement. [13]

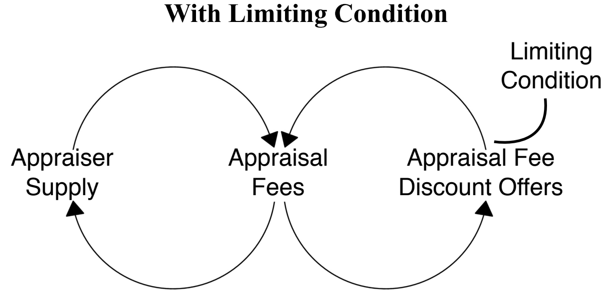
A secondary but equally important benefit is that lenders will rest easier in the knowledge that the appraisers hired by their AMC are working hard on their reports instead of spending time on the Internet in flame wars with other industry participants. Lenders are accountable for the compliance of any third-party supplier or service provider they hire. It will be far easier for a lender to feel secure about a relationship with an AMC (and to recommend switching to an AMC to the lender's risk management committee) when it is clear that this trusted third party is also on good terms with the professionals completing the work.

17. Paying full fees reduces the risk that disgruntled appraisers will draw the attention of federal regulators. Lenders are not the only parties monitoring the Internet for signs of friction. The federal government, primarily through the new Consumer Financial Protection Bureau, is also attuned to these industry interactions.

Federal bureaucrats are under constant pressure to spend their budgets in pursuit of their strategic objectives. Unfortunately, most agencies, including the CFPB, do not yet have clear strategic objectives, other than to identify problems in the industry and solve them in a manner compliant with Dodd-Frank and other federal laws. This means that they will seek out industry problems to "solve" with new rules and then visit those rules upon the industry. The specter of unintended consequences aside, this often has the effect of complicating a process that could have been solved by the industry in a far simpler manner.

Human nature seems to dictate that when one party to a transaction finds himself committed to a job that will not ultimately be profitable, that party becomes ambivalent to the additional costs visited upon the other party to the transaction. We're already seeing signs that disgruntled appraisers will cooperate with federal and state regulators to make the environment more difficult for AMCs to negotiate. Appraisers paid a full fee are less likely to be complicit in this manner.

AMC Fee Negotiation Reinforcing Loop With Limiting Condition



18. Paying full fees provides joint marketing opportunities because appraisers will see the AMC as worth promoting. There are significant opportunities for joint promotion of an AMC and a real estate appraisal company if the two parties are willing to participate at a high level. This requires the parties to feel and act like partners, allowing them to effectively sell each other to the lender client.

[13] The authors are unaware of any studies having been done in the recent or distant past to confirm or refute either side's argument.

Many AMCs already use this type of marketing, but usually without the benefit of a real appraiser. They speak to the size of their fee panels, the many years of experience of their appraisers and the professional nature of their services. This marketing tends to be generally ineffective but sufficient to bring the AMC to the lender's attention, who then negotiates with them purely on price or turn times.

By showcasing some of the talent in the AMC's fee panel, lenders will have another reason to send business to that AMC and the appraisers it represents.

19. Paying full fees opens the door to a better borrower experience because the appraiser doesn't enter the home angry. One of the first steps the CFPB took upon its inception was to build web-based functionality to allow it to interface easily with the hundreds of millions of American consumers who may be in the market for a mortgage loan at some point in the future. The agency has made it very easy for borrowers to send feedback and seems only interested in feedback that is negative. Consequently, lenders have become very concerned about the overall experience the borrower enjoys during the loan origination process.

Sharing detailed financial history with a lender can be uncomfortable for the borrower, but nothing is more invasive than when the appraiser must enter their home and tell them how much it is worth—or in so many cases today, how little the home is worth. This experience is completely outside of the borrower's control, but the AMC can have an influence here. Unfortunately, it tends to be negative.

By paying less than full fee, the appraiser must conduct the physical inspection more quickly, which can make him or her seem rude to the homeowner. When a value is returned that is lower than anticipated, a fast-moving appraiser often leaves homeowners with the feeling that corners were cut, important details that might have increased the value of the home left out. Angry appraisers exacerbate these problems.

In contrast, a well-paid appraiser can take more time with the homeowner, answering questions when necessary, to establish an impression on the homeowner of a competent professional who is serving both the lender and the borrower, even if that is not technically the case. The result is a better experience and less risk of negative feedback reaching a federal regulator.

20. Paying full fees opens the door for joint publicity efforts because appraisers will feel like partners. Public relations is often forgotten in the pursuit of business success when it should be one more tool companies use to advance their cause, solidify their brands in the minds of their target audience, and share their successes with current and future clients.

Joint press releases, white papers, and press interviews are great ways to bring attention to a strong AMC/appraiser team. These opportunities are not available to AMCs that have contentious relationships with their appraisers. They are, however, simple ways to gain more business for those firms that truly partner with the professionals on their fee panels.

4. Why the Full Fee Model is a Difficult Sell

In the previous section we laid out what we believe are the benefits to the AMC industry of adopting an industry-wide standard for paying appraisers their full retail fees. Yet even as we write the previous line, it is hard to overlook such a recommendation as being viewed as broaching, or at least approaching, the antitrust realm occupied by the class-action lawyer trade. If the very suggestion for such a "standard"—or worse, price fixing—can be conceived as an antitrust issue, even if it results in a benefit to those who supply such services, all the good points of the full fee model are rendered moot. As maybe it ought to be. Antitrust violations can be costly.

Another hurdle is that many AMCs are unwilling to risk losing clients to competitors who would gain a competitive price advantage by sticking with the current fee structure. They have a point. Unless the mortgage lending industry voices a mandate—on their own ethical and risk-based grounds—many in the appraisal management space may opt to remain attached to the fee schedule the industry has used for the past 30 years.

A third hurdle relates to the very nature of the free market competitive system that our country enjoys: the freedom of buyers and sellers to negotiate fees. What this means is that even if the AMC industry migrates to the full-fee model, there is little to stop individual appraisers and appraisal firms from negotiating a better deal.

As we suggested earlier, as the fees AMCs pay to appraisers increases, they should see a corresponding increase in the supply of appraisers ready, willing, and able to work with them. It won't be too long before one or more of these enterprising appraisers calls the AMC with an offer to reduce his or her fees in hope of additional order volume. Then what? Does the AMC agree to these discounted fee offers? As soon as other local AMC appraisers see volume drop off they too may be willing to offer even deeper concessions. Then the reinforcing loop we presented earlier slows and may even reverse.

Another hurdle that could be minimized if the government changes its plan to charge AMCs for each appraiser on their fee panel is that AMCs are unlikely to want every available appraiser on their panel for cost reasons. In addition to the proposed per-appraiser fee, there are several additional costs the AMC would have to absorb (or pass on) for qualifying and recruiting new appraisers. Someone at the AMC must respond to appraiser inquiries about joining the panel. They must process applications, check references and work samples, and verify state licensure and/or certification and errors and omissions coverage, among other tasks. This can be a costly effort. As such, it is a disincentive for bringing on new appraisers to a retail-fee paying environment.

The last hurdle we'll mention in this discussion deals with the competitive advantage appraisal firms will enjoy over sole proprietor appraisers in an AMC industry-wide retail-fee environment. The reason for this is that AMCs simply do not wish to work with all 60,000 residential appraisers in the United States. AMCs (or any buyers of goods and services on a large scale basis) would much rather deal with a small optimal number of suppliers rather than an unwieldy slew of independent providers. Dealing with small numbers is more productive, less costly, and far less difficult to monitor at both the transactional and business levels than large numbers. It is simpler to track, monitor, and counsel small numbers regarding performance issues. Therefore, even if they pay full fees, AMCs won't race out to stock their fee panels to the rafters.

How does this benefit appraisal companies? By hiring a single large company to cover a geographic area rather than hiring every individual appraiser who works there, AMCs can offload responsibility for service quality to the appraisal firm; with individual appraisers this is a function borne by the AMC. Thus if given a choice between using a single appraisal firm with several appraisers versus managing numerous individual appraiser relationships, many AMCs will opt for the former at the expense of the latter.

There are other hurdles, some more significant than others. The point is that AMCs will need to move carefully and make thoughtful decisions if they decide to migrate to a full-fee appraisal model.

5. Conclusion

Reflecting on the history of the appraisal management industry, it is apparent that not much has changed about the business model in the past 30 years. Every natural and manmade system follows the same general transition of birth, growth, peak, renewal, and regeneration. Businesses and industries throughout the ages are susceptible to these same cycles by updating and revising their business models. That is essentially what we are proposing to the appraisal management industry.

AMC lifers may object, saying, with a point, that AMCs have led the change in how lenders acquire appraisals. This is true, but the underlying way they acquire appraisals—the process—remains the same as it did in the early days. Although advances in information technology and certain management practices in the industry have been innovated and automated, the buy-low/sell-high approach to transaction-related costs remains the same. But there are signs that the model is about to change, whether the change is by choice within the AMC industry, or from outside the industry through a hodgepodge of legislative and judicial means.

It is increasingly apparent that the AMC industry growth (due in large part to the effects of the HVCC and seemingly simultaneous shedding of production jobs by mortgage lenders dealing with the housing bust that began in 2008) has now peaked. There are now two factions—those convinced that AMCs benefit the mortgage lending ecosystem, and those convinced that AMCs are a cancer that need to be eliminated in order to save the industry. But there is a middle ground, which honors both factions. It is the renewal of the AMC business model to serve not only the self-serving needs of the AMC industry and the clients the industry serves, but also the providers of the very services AMCs rely on for sustenance: appraisers.

The starting point for renewal, in our view, is to pay appraisers their full-retail fees. Each of the other dozen or so categories of criticism of the AMC model will seem more tolerable and perhaps even acceptable absent the fee issue. Others will fade away or go away as AMCs leverage their retail fee model to place more of the quality control and customer service burden where it belongs—on appraisers.

We envision a future in which the former factions come together to educate another industry undergoing a renewal period of its own—the mortgage lending industry—as to why appraisers in partnership with appraisal management companies ought to be valued advisors rather than necessary inconveniences, and as to why they're a superior solution than AVMs and other low-end evaluation tools. And why not? AMCs, as inevitable as they are to the mortgage lending ecosystem, will be of no value to anyone if the appraisals they supply to lenders become passé.

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