By Robert Murphy

How to End Appraisal Pressure Once and for All

As long as commissioned loan officers or mortgage brokers pick and talk to appraisers, there will be appraiser pressure, inflated values and mortgage meltdowns like the one we have just experienced. That, in essence, is what I told a U.S. congressional committee—20 years ago.

At the time, I was explaining one of the root causes of the savings-and-loan (S&L) crisis: directed appraisals. But I could just as easily have been talking about how the appraisal industry operated during 2005, 2006 and 2007—the run-up to the subprime crisis. That's because directed appraisals have continued to be the industry's Achilles' heel for the past two decades, despite federal guidelines that prohibit them and despite the growth of appraisal-management companies that were supposed to serve as a firewall between appraisers and lenders.

Of course, no one condones or acknowledges these practices. But until very recently, they happened all too often at lenders large and small. As the founder of two vendor-management companies (Lender's Service Inc. and ValuAmerica), I have discussed this issue regularly with clients over three decades, and no one ever disagreed—at least in theory. But when the push back came—and it always did—it would come from the same place: retail lending. Loan officers would complain about new appraisal ordering procedures, and their managers would acquiesce rather than risk losing their star performers.

And then we'd start to hear the age-old code words: "Has to travel too far . . . comps aren't accurate . . . charges too much." Translated, these seemingly innocuous statements meant: This appraiser isn't hitting the numbers we need to do these deals; use our favorite appraiser instead, because he or she will.

Recently, the New York attorney general sued one appraisal-management firm, publicly criticized the appraisal practices at a major national lender, and questioned Fannie Mae and Freddie Mac oversight on this issue. Out of this controversy came a new agreement in February among the New York attorney general; the government-sponsored enterprises (GSEs); and the GSEs' regulator, the Office of Federal Housing Enterprise Oversight (OFHEO).

Part of that agreement is a Home Valuation Code of Conduct. Lenders that don't follow the procedures and practices set forth in this code won't be able to sell loans to Fannie Mae and Freddie Mac after January 2009.

The new code

The new code of conduct, like the interagency guidelines before it, prohibits commissioned loan officers from selecting appraisers or influencing their reports.

But the code goes further, saying the GSEs won't buy mortgages from wholesalers if they let their mortgage brokers order appraisals. It also cuts off lenders that use staff appraisers or order appraisals from captive vendor-management companies or appraisal-management companies that employ staff appraisers.

Clearly, these are all steps in the right direction. Particularly important is closing the enormous loophole that had let mortgage brokers use their favorite appraisers to make their deals work. Interestingly, there is at least one business practice that the code missed and the Uniform Standards of Professional Appraisal Practices (USPAP) requires: providing appraisers with sales contracts for first mortgages. If we really want appraisers to arrive at a true value without any prompting, why give them the precise number we're trying to hit?

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Whether these rules stick this time around will depend upon whether the GSEs and the federal agencies are serious about enforcement, and what will be required to demonstrate compliance.

New policies alone won't do it. Just hiring appraisal-management companies, apparently, doesn't insulate appraisers from pressure. So how do we as an industry finally put an end to a problem that we first acknowledged and outlawed 20 years ago?

How to end appraisal pressure for real

Making adherence to the code a condition of selling to the GSEs certainly means it will get the industry's full attention. In this

market, conforming is the only game in town.

But a number of other forces are aligning this time around. I suspect that the New York attorney general's suit will prompt appraisal-management companies to take a tougher stance with clients, and remember the main reason they're in business is to prevent inflated appraisals.

The alleged behavior, recounted in the New York attorney general's suit, is simply a snapshot, taken out of context, of what happens all too often in appraisal-management company engagements. A lender's senior management sees the advantages and decrees that the company will use an appraisal-management company; channel management agrees, then goes right ahead and undermines the process. As with the accounting firms after Enron and the telecom failures, my guess is that appraisal-management companies have now seen the light and realize that while making their clients happy is good, staying in business is better.

Also, mortgage lenders have just relearned a very painful lesson: Collateral is a critical part of the underwriting equation. Ignore it at your peril. And for years, that's pretty much what happened. As an industry, we told ourselves the only number we needed to look at in a mortgage transaction was a three-digit number followed by FICO®. After all, property values only go one way, right?

This kind of thinking was responsible for many of our biggest mistakes: 100 percent loan-to-value (LTV) ratios, negative-amortization products, on-the-spot home-equity line of credit (HELOC) deals, and so on.

Today, our industry's obsession with speed (and cost) has been replaced by caution. Suddenly vendors are not hearing that much about automated valuation model (AVM) cascades. On the origination side of the business, no one is talking about AVMs or desktop appraisals. Full appraisals are making a comeback, even in refis and in home equity.

Banks and surviving mortgage companies are also taking a hard look at those with whom they are doing business. Hardly a day goes by without some large lender announcing it's closing a wholesale or correspondent channel and focusing on retail, where there is greater control. Ironically, when it comes to demanding exemptions from appraisal policies, I have found retail channels are usually first in line.

For the moment, those loan officers who still have jobs seem to be playing by the rules and keeping a low profile. Over the past few months, for example, our company has heard virtually no complaints about appraisal values.

Technology is the key

Technology is one of the big differences between the early 1990s, when the first rules on directed appraisals were announced, and this time around. Lenders of all sizes can easily and relatively inexpensively use technology to enforce and document compliance with their appraisal policies. Think of it as parental controls for loan officers.

My company, for example, has a software platform, known as ValuNet xsp. It uses an algorithm to select appraisers. Unless the controls are overridden, a loan officer can't see who gets an appraisal order. The selection is made based on the appraiser's credentials and licensing, location, workload, past performance and USPAP rating.

In addition to preventing loan officer interference, the beauty of the technology is that it automatically documents compliance. The system tracks every step in the order, payment and communications process. And most appraisal-management companies and vendor-management companies probably have similar systems that could, with some re-engineering, help lenders comply with the new GSE requirements and demonstrate compliance.

If the GSEs are serious about their code, they'll demand that lenders use technology to prove they are complying. A 19th-century mathematician summed it up best: "To measure is to know."

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