

SDW Best Practices Discussion Paper

Home Value Protection Program Unforeseen Consequences and Advantages

There has been much discussion in the industry over the past few weeks concerning the Home Value Protection Program and Code of Conduct. Most of it has centered on the need to return comment by the deadline with a flurry of activity to get input and documentation submitted. Conference calls and meetings both internal and industry wide have been held for this purpose.

Word on the street from those who are close to the politics (of course, no one knows what the actual outcome will be) is that the legislation will pass pretty much the way it has been written, perhaps with additional clarification, but not much change in intent or operational target.

So if we are to assume that this is the case, and that the industry will be dealing with a new set of rules for the bulk of their lending activity concerning collateral valuation, we might look past the immediate concerns of submitting comments, and move on to what and how things may be affected farther down the road.

The Independent Valuation Protection Institute

The "Cooperation Agreement" establishes an Independent Valuation Protection Institute that will oversee process changes at least in their initial stages and perform further study as things move forward. It would appear, through reading the document and discussions with some of the Washington groups, that despite the jockeying around of several established or newly formed entities, the intent is for this controlling board to be appointed politics-style most likely from players in or close to the Beltway.

One might ask themselves who those players are. Of course this is all speculation at this point. Depending on the people chosen to be on the IVPI Board and the background and experience of the Board Chairman, how the Institute handles itself, the decisions it makes, and the assumed power it wields in the industry could fall within a wide range.

An industry savvy nonpolitical group could do much to further the direction that Chief Appraisers have felt would be beneficial. It could provide more strength to the position inside the lending institution and place Chief Appraisers truly in the position of identifying collateral risk and protecting the safety and soundness of the institution as regulators have always expected. However, a Board of Directors that is weighted down with political agendas may serve little or no purpose but to create more infighting and confusion.

With the money involved to fund the IVPI, it would seem that there is a potential for member placement based on back room politics that may only on the surface be an industry favorable choice. As the Cooperation Agreement currently stands, the decision to place the Board is controlled in a political environment with no input even from Fannie and Freddie who are the funding entities.

Since there are extensive reporting requirements for lending institutions to provide information on their valuation processes as well as the reporting of any complaints from appraisers or consumers, it is important that this group not become a bureaucratic bottleneck to the system. Hopefully, those that appoint and design the IVPI will understand the enormity of the undertaking as currently proposed and be able to provide a workable operation in the short order that has been specified in the agreement.

The implications of implementing an inefficient system from the onset can be substantial. As will be discussed further in this document, the Code of Conduct rules will, at least initially, create a large flow of issues coming through as the lender and appraisal community sort out the new workflow and requirements. The release of appraiser pressure, lender testing, and appraiser tracking will enable many appraisers to do their job properly. However, it will also unleash the appraisal quality issues that have been prevalent in the industry and chalked up to pressure rather than more correctly assigned to lack of training or purposeful poor quality appraisals.

Home Valuation Code of Conduct

Appraiser Coercion vs. Quality

Any experienced appraiser looking at the list of coercion activities in this Code will not see anything surprising. However, just the process of listing the undesirable activities does provide the specificity needed with this issue. There are those who are new to the industry, both on the origination and appraisal vendor side, who have seen these types of activity throughout their career and consider it typical behavior. Specifically stating that these are not acceptable practices serves to draw the line in the sand purposefully.

Many Chief Appraisers at lending institutions have been saying over the past few years that they have seen a substantial drop in quality of appraisals that come in to their institutions as part of a loan

package. While they attribute some of this low quality to appraiser pressure, they have felt that much of it is due to lack of quality appraiser training – Appraisers either unknowingly make errors in facts or judgment throughout the appraisal, or purposefully omit or embellish information to make the job easier and increase their ability to produce reports timely or in volume. Many appraisers have come to rely on the estimates of value provided by the lender or broker and are unable to independently identify the range of value that should be assigned to the property. Many appraisers choose to cut corners, manufacture or adjust subject, neighborhood or comparable information.

The Code of Conduct requires that appraisers be notified when they are removed from an approved list with written evidence of the illegal conduct, substandard performance (not actually defined) or USPAP violation. While many lenders already have a process to do this along with steps for the appraiser to respond to the removal, there is now added the requirements to report this conduct to the IVPI as well as to the state agency where the property and appraiser reside. This adds not only an additional reporting step, but also the potential for difficulties inherent with including more people in the process.

Without the mask of appraiser pressure, the lack of quality work in the appraisal industry will be uncovered. The additional Code requirements for testing of all valuation processes would bring this to light even more so than the quality control standards that lenders have had in place. One of the unintended consequences of this action (not to imply that this is a negative consequence) may easily be the greatly increased number of appraisers who are taken to task for their inability or unwillingness to do the work necessary to provide a quality appraisal report.

The state agencies are already overburdened with the task of keeping up with complaints. Often so much so that lenders and other report users have stopped submitting complaints as they see no results for their efforts. With the IVPI involved in the middle of the process, it must be clearly defined as to how they will be able to improve an already overburdened system with the creation of multiples of additional complaints. This may serve to force the following solutions:

- Increase in funding for state agencies to handle the workload
- Agency processes that actually address the appraisal complaint in an adequate fashion
- Increase in *effective* training programs that actually provide appraisers with the education they need as opposed to the training mills that provide easy access to continuing education credits
- Decrease in the number of appraisers in the market as those who are unable or unwilling to provide the quality necessary move on to other professions
- Increase in the pool of quality appraisers who are willing and able to do the work necessary and are able to obtain fees that are reflective of that quality due to fewer incompetent appraisers competing for the work

Valuation Testing and its Implications

Discreetly buried on the last page is a single item that requires lenders to quality test 10 percent of the appraisal reports or other valuation types being used such as AVMs, BPOs or desktop evaluations. These test results are to be reported to the IVPI as well as to other "relevant regulatory bodies". This could appear to almost be a non-event, as most lenders have always had a quality review process. However, there are hidden implications that could potentially provide for major changes in the way things have been done.

Due to the reporting requirements, lenders will now have to do a better, more organized job of testing and tracking, presumably being able to sort the results by appraiser and other factors. Since all methods of valuation within the institution will now be tested, there will be a newly leveled playing field from which to work.

It is only natural, that with report requirements being met, the institutions will use that information internally to be able to determine which valuation methods actually provide the most accurate, timely, and yet cost effective reports. With portfolios suffering from pushed appraisal disease, many are left to wonder how different the risk would have been if automated valuations had been used instead of appraisers who were forced or willing to turn in biased valuations. The fear that AVMs were not able to recognize turns in the market may have been valid, but no one discussed the fact that appraisers were not only ignoring the market downturns, but also not even willing to check the box to indicate that the market was declining. With the implementation of the Code of Conduct, testing and reporting of all valuation methods will provide an easy comparison of accuracy and customer service factors.

As a result, it may be that lenders find that the additional risk of using the non-traditional products is minimal, compared to the risk they have taken on with the full appraisal that had been assumed to be the gold standard in determining valuation. The GSE's have already softened their approach with regard to accepting automated products or products that combine automated values and appraiser expertise. Comparison of testing results for the different products may help to move that trend forward, rather than support the assumption that the appraisal provides the lowest risk option.

Keep in mind that the final paragraph in the Code of Conduct specifically states that it should not be construed to "establish new requirements or obligations that (1) require a lender to obtain a property valuation, or to use any particular method for property valuation...in connection with any mortgage loan or mortgage financing transaction...". This leaves the door open for the lender to be able to use any valuation product they choose, as backed by the accuracy testing reports. The Cooperation Agreement signed with the GSEs does not require them to accept any particular type of valuation method. It only requires them to accept loans from lenders who abide by the Code of Conduct.

Particularly with the rulings regarding no longer receiving broker ordered appraisals, the wholesale lending environment would suffer a process slowdown based on the Code of Conduct rules. If the quality testing report comparisons indicate that there is little to no additional risk by using AVM or hybrid products, that becomes an easy fix to the looming issues around turn times in the wholesale environment.

Quality reporting will also provide an opportunity to compare and track appraiser performance along with documentation of any related issues. Current market conditions, direct ordering, and readily available tracking statistics will uncover a multitude of appraiser quality issues that should force an industry culling of inept appraisers. Perhaps the result will be a smaller professional body of quality appraisers and result in the clearing out of the appraisal industry that most have been aware is greatly needed. Once the focus is off the appraiser pressure and the mortgage broker influence, it can only be assumed that inaccurate appraisals are the result of problem appraisers.

Operations and Workflow

Most of the changes required focus in one way or another around transparency of the methods of valuation that the lender chooses to use. Ease of disclosure to the Valuation Institute and regulators is a must to be able to operate efficiently without having reporting and quality assurance become an impediment. Systems for reporting quality testing information, appraisal issues, and best practices into the IVPI will need to be set up in a way that falls into the general workflow without disruption.

Communication, always an important factor, is now essential as the valuation process becomes less visible to the broker and the borrower. Documentation of the communication between the lender and the appraiser or mortgage broker should be easily accessible to provide proof of the independence wall put up for the appraisal.

Testing processes must be designed and implemented seamlessly so that workflow at both the front and back end of the process will not be disrupted. Quality scoring and tracking for appraisers and other valuation products need to be readily accessible both for the scoring process and the ability to reference the information in the database. Testing processes require upfront determinations as to acceptable ranges of value for each product and what will need to be done if the product does not perform within that accuracy tolerance range. The testing process itself is a large project that, once designed and implemented correctly, will provide useful information. However getting to the implementation stage is not an easy task and requires detailed designing.

Appraiser panel management will be required whether the lender is managing his own appraisal panel or working with an AMC. Approved or disapproved lists will need to be maintained with substantial documentation that shows communication to the appraiser of the issues. Documentation of unacceptable or substandard performance and other issues should be provided to the appraisers so

that the specific lender guidelines can be met without question in order to avoid negative interaction with the Independent Valuation Protection Institute.

Conclusions

While it is yet to be determined if the proposed legislation will pass and in what form, it is likely that it will address the important issues that it is currently concerned with. The issues that drove the legislation, regardless of the political motivation, are valid and will need to be addressed in some ways similar to those that have been laid out in the Cooperation Agreement and Code of Conduct. Adjustments may be made based on the comments sent in by concerned parties. However, the reality that we are not going back to the old ways of mortgage lending is evident and, in fact, beneficial to all in the long run.

There have been no surprises here for the Chief Appraisers of the existing or defunct lending institutions. They knew the problems, reported the facts, and warned whoever would listen that there was an inevitable correction in the making. Perhaps one of the positive outgrowths will be that the position of Chief Appraiser will take on a new level of responsibility. The position title should change to encompass the aspects of all collateral valuation methods as well as general collateral risk. Rather than operating in a vendor/client relationship with the sales organization the collateral risk group should be seen as the gatekeeper for the organization to provide the protection for safety and soundness of the institution.

It is inevitable that there will be much more detailed reporting and risk measurement coming out of the collateral risk groups within mortgage lending. The measurement tools are available currently and vendor partners are willing and able to build new and better tools with internal data that will come available as a result of the testing requirements. More information will be available to make better risk and pricing decisions for the organization that will ultimately result in better lending products for the consumer.

However, the road to that result will be somewhat painful as old methods and attitudes are discarded and new are adopted. It is now up to the valuation industry to step up to the plate and take advantage of the opportunities being presented as there can be much to gain.